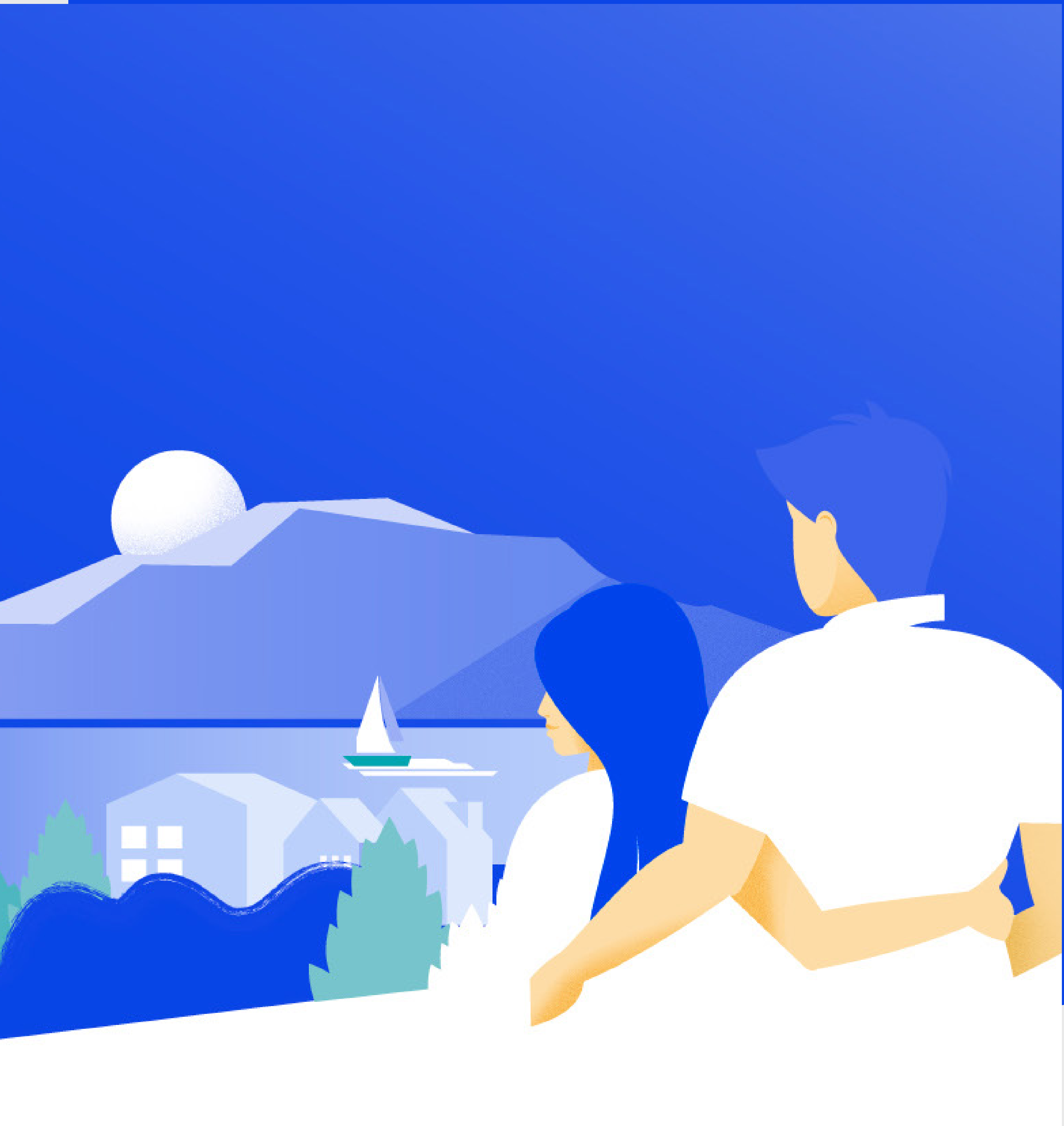


Pillar 3 Risk Disclosures

Arion Bank 2019

Disclaimer

Declaration

The Board of Directors is responsible for the Bank's risk management framework and 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 which provides universal banking services to corporations and individuals with the aim of creating future value for customers, shareholders, partners and society as a whole. The Bank places focus on customers who require diverse financial services, positive customer experience and long-term customer relationships.

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.

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 the credit risk appetite metrics, which includes credit concentration and credit quality measurements. At the end of 2019, the Bank's largest exposure was 10.9% of eligible capital and 12 month expected credit loss rate was 19bps.

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, by maximum equity position and losses, and the risk limit framework. Total equity exposure was 11.6% of total own funds at the end of 2019, thereof 6.1% was due to unlisted equity.

Liquidity risk is a key risk factor to the Bank. 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 188% at the end of 2019, while the regulatory requirement was 100%.

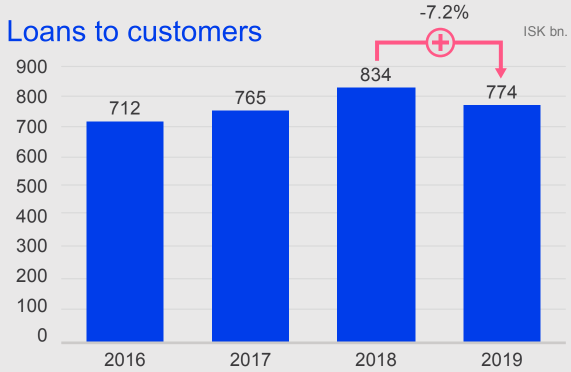
The Bank's business units are primarily responsible for managing their own operational risk, including reputation risk, with support from control functions. The Bank's operational risk framework integrates risk management practices into processes, systems and culture. The risk appetite contains a statement of non-tolerance policy for internal fraud and elimination of incidents and mistakes.

The Bank is well capitalized with capital adequacy ratio of 24.0%, and CET1 ratio of 21.2% at the end of 2019 exceeding both the regulatory requirements and risk appetite.

The Board of Directors of Arion Bank

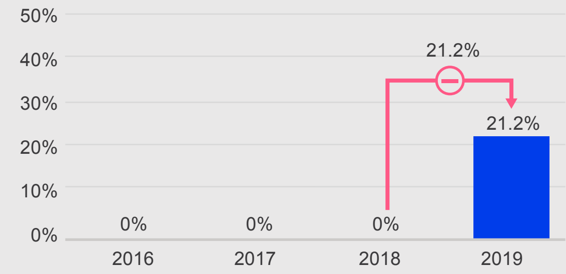
Risk Metrics Overview

Loans to customers



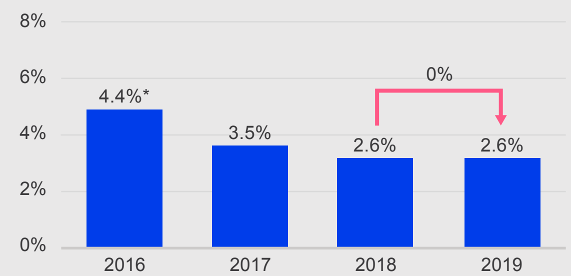
See section 4.4

Sum of large exposures net of eligible collateral



See section 4.4.3

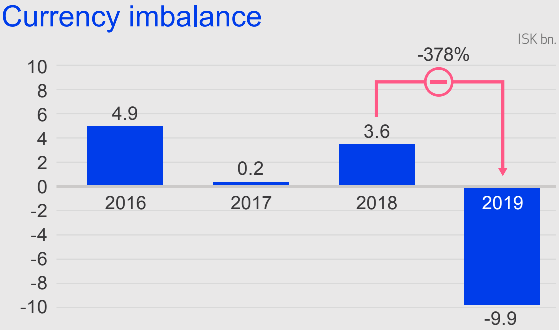
Problem loans (stage 3 gross)



*Approximation according to new definition

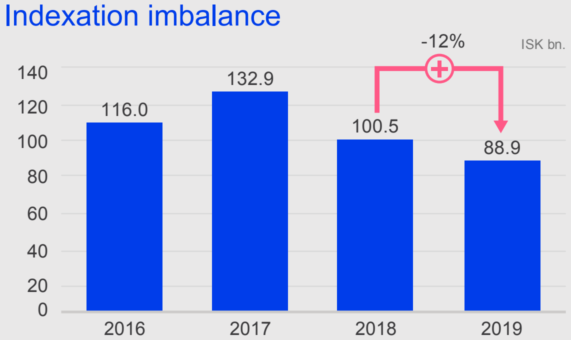
See section 4.8.5

Currency imbalance



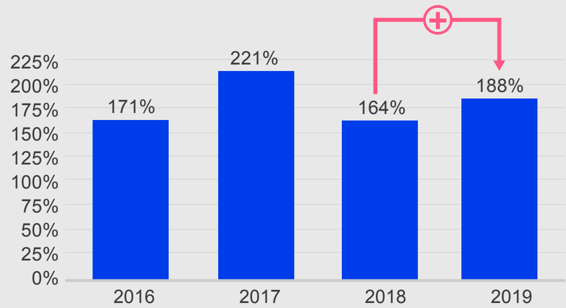
See section 5.5

Indexation imbalance



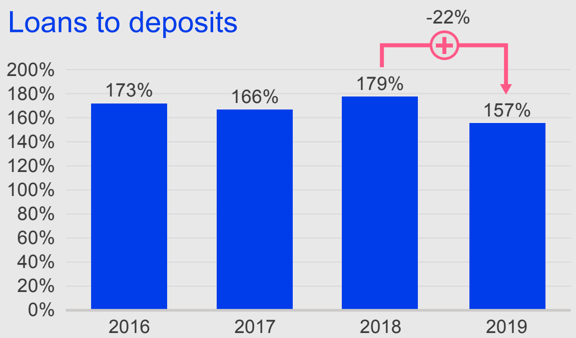
See section 5.6

Liquidity Coverage Ratio



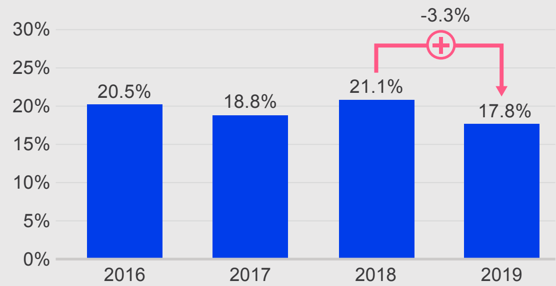
See section 6.4

Loans to deposits



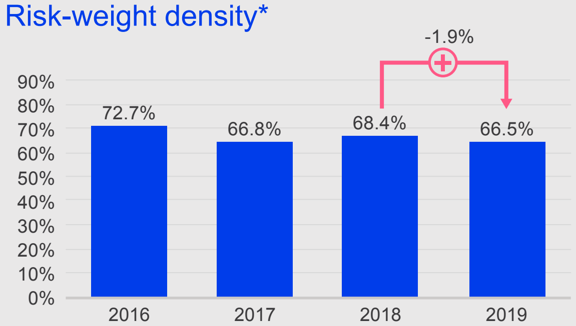
See section 6.5

Asset encumbrance ratio



See section 6.5

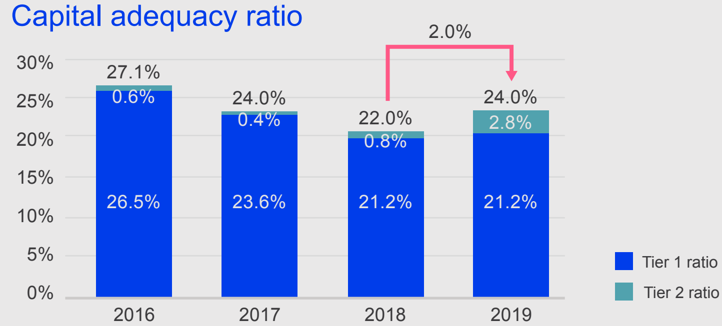
Risk-weight density*



See section 3.3

*Risk-weighted exposure amount divided by total assets

Capital adequacy ratio



See section 3.3

Regarded as a positive development   Regarded as a negative development

Table of Contents

1 Introduction

1 Introduction

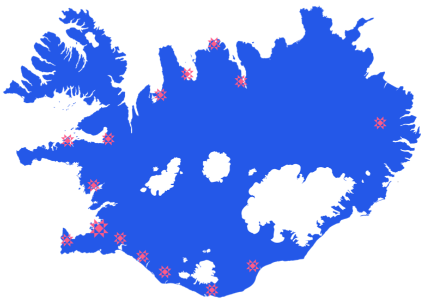
The Pillar 3 Risk Disclosures comprise information on capital and risk management at Arion Bank. The purpose of the disclosures is to meet regulatory requirements and to inform readers about Arion Bank's risk profile and risk management. The disclosures contain information on the governance of risk, capital structure and capital adequacy, and risk management with respect to each type of material risk. Information on new and forthcoming legislation as well as information on remuneration policy is included in the disclosures.

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 main lists of Nasdaq Iceland and Nasdaq Stockholm. The Bank is classified as a domestic systematically important bank (D-SIB) by the Financial Supervisory Authority of the Central Bank of Iceland (FSA).

The Bank, whose roots date back to 1930, is built on a strong heritage and infrastructure. Arion Bank is a strongly capitalized bank which provides universal banking services to corporations and individuals with the aim of creating future value for customers, shareholders, partners and society as a whole. The Bank operates a number of branches across Iceland but has been optimising its branch network in recent years by streamlining branch premises and introducing digital branches.

Figure 1.1 Arion Bank's branch network



Arion Bank's focus is on customers who require diverse financial services, positive customer experience and long-term relationships by providing outstanding service through diverse channels. The Bank aims to have a leading position in terms of innovation, efficiency and security in financial services. The Bank has set itself the goal of being a leader in digital solutions and innovation, and numerous new digital solutions have been launched in the past few years. Digital solutions make the business more efficient and in the long term this results in lower operating expenses across the Bank.

Arion Bank has taken important funding and market initiatives in recent years, see section 6.5.

The Bank consists of three business segments: Retail Banking, Corporate & Investment Banking, and Markets, and three support units: Finance, Information Technology and Risk Management. Furthermore, the Bank owns strategic subsidiaries which are important for its service offerings. Stefnir is the largest fund management company in Iceland, and Vörður is the fourth largest insurance company in Iceland, 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.

At year end 2019 the number of full-time equivalent (FTEs) positions at Arion Bank was 687 with an additional 114 FTEs in the subsidiaries.

The Bank's Annual Report 2019 provides further information about the Bank, such as strategy and vision, and corporate governance.

1.2 Major Changes in 2019

Several developments influenced Arion Bank's risk profile in 2019. Highlights include:

Changes in Ownership

On 15 June 2018, trading of Arion Bank shares commenced in the stock exchanges of Nasdaq Iceland and Nasdaq Stockholm, following a successful initial public offering to international and domestic investors.

On 9 July 2019 Kaupthing ehf. announced that Kaupskil ehf. had completed the sale of its remaining stake in Arion Bank hf. to a group of international and domestic investors. The transaction represented the conclusion of nearly ten years' ownership of Arion Bank following the restructuring of Kaupthing Bank and was an important step in the ownership normalization.

Table 1.1 shows the shareholders of Arion Bank at end 2019.

The sale of Kaupskil's remaining stake in Arion Bank was the conclusion of nearly ten years' ownership of Arion Bank following the restructuring of Kaupthing Bank

Table 1.1 Shareholders of Arion Bank on 31 December 2019

Shareholders of Arion Bank	31 December 2019
Taconic Capital	23.53%
Sculptor Capital Management	9.53%
Gildi Pension Fund	8.79%
Lansdowne partners	5.02%
Stodir hf.	4.96%
Goldman Sachs International	3.72%
The Pension Fund of Commerce	3.67%
The Pension Fund for State Employees	3.47%
Eaton Vance funds	3.23%
Stefnir hf.	2.46%
Arion Bank hf.	**2.27%**
Frjalsi Pension Fund	2.18%
Stapi Pension Fund	1.89%
Hvalur hf.	1.45%
Birta Pension Fund	1.32%
Jupiter Capital Management hf.	1.10%
MainFirst Bank AG	1.09%
Islandsbanki hf.	1.00%
Other shareholders with less than 1% shareholding	19.32%
Issued share capital	**100.00%**

Introduction

Organizational Changes

One of Arion Bank's main objectives in 2019 was to build stronger foundations for the future and better enable the Bank to support its customers and earn dividends for shareholders. To achieve those objectives, Arion Bank took proactive steps in response to the situation on the Icelandic financial market and the operating environment created by the authorities, see section 8.2.

In mid-2019 the Board of Directors appointed a new CEO, Benedikt Gíslason. In the autumn the Board of Directors approved organizational changes which resulted in a 12% reduction in the number of employees and the Bank's divisions were reduced from eight to six.

These organizational changes did not represent a fundamental shift in strategy and the Bank's strategy of offering its customers universal banking services remains unchanged. However, there has been a change in emphasis, particularly as far as loans to large companies are concerned.

As a consequence of high capital requirements and taxes the Bank faces challenges competing in the market if loans are to yield satisfactory returns. Arion Bank's focus will be on providing larger companies with expert advice and helping them secure the most effective financing at any given time. A key focus going forward will be developing partnerships with lenders in Iceland and abroad.

Arion Bank's focus will be on providing larger companies with expert advice and helping them secure the most effective financing at any given time

An added benefit to this strategy will be a more effective risk distribution in the Bank's loan portfolio, as in the future Arion Bank will seek to have fewer large exposures in its accounts.

The Bank's policy on lending to individuals and SMEs has not changed.

Capital and Dividends

The Bank's capital ratio at 31 December 2019 was 24.0%, which exceeds the total regulatory requirement of 20.3% (inclusive of the February 2020 combined capital buffer requirements). Taking into account the Bank's internal management buffer, currently 100-200bps, the Bank's benchmark capital ratio is 21.3% to 22.3%.

The Bank's Common Equity Tier 1 ratio (CET1) at 31 December 2019 was 21.2% compared to a 15.4% regulatory requirement and the Bank's benchmark of 16.4% to 17.4%.

After the 1 January 2020 introduction of the SME supporting factor the capital ratio increases to 24.4% and the CET1 ratio to 21.6%

On 1 January 2020, the SME supporting factor according to articles 500 and 501 of the Capital Requirements Regulation No. 575/2013 (CRR) took effect in Iceland. The SME supporting factor offers capital requirements relief for certain credit exposures of small and medium-sized enterprises. The articles in question had been excluded when CRR was ratified in Iceland as Regulation No. 233/2017, pending the adoption of CRR into the EEA Agreement. The adoption comes into effect on 1 January 2020 with the effect that the Bank's capital ratio rises to 24.4% and the CET1 ratio to 21.6%. For additional information about the SME supporting factor refer to section 3.6.1.

The Bank has recently taken active steps to normalize the Bank's capital structure as part of the efforts to improve return on equity. In 2019, the Group's Tier 2 capital increased by ISK 13.5 billion through new issuance of subordinated bonds.

Introduction

In March the Annual General Meeting approved a dividend payment of ISK 10 billion, or ISK 5 per share. In September 2019 the FSA approved the Bank's share buy-back program for up to 3.25% of issued shares or a maximum of 59 million shares, for up to ISK 4.5 billion market value. By year-end the Bank had bought 41 million own shares and Swedish Depository Receipts (SDRs), approximately 2.27% of issued shares, for ISK 3.3 billion. The dividend and share buy-back in 2019 therefore totalled ISK 12.4 billion, after adjusting for the Bank's own share holdings. These have been important steps in reducing the Bank's surplus capital.

An optimal capital structure will include Additional Tier 1 (AT1) capital instruments, but the timing of the issuance of AT1 will depend on, among other things, market conditions and pricing of such instruments. With the Bank now operating on a capital level close to the requirements, the Bank will increase its focus on the management of Risk-weighted Exposure Amount (REA) and capital management with the aim to improve profitability.

The 24.0% capital ratio at 31 December 2019 accounts for a foreseeable equity reduction of ISK 14.2 billion due to dividend distribution and own shares buy-back

On 24 January 2020 the Bank announced an increase in the amount of shares that the Bank is permitted to buy back by 41 million shares/SDRs following approval from FSA. Additionally, the Board of Directors proposes that the Bank pay dividends of ISK 10.0 billion. The capital ratios at 31 December 2019 account for a foreseeable equity reduction of ISK 14.2 billion due to dividend distribution and own shares buy-back, after adjusting for the Bank's own share holdings.

Valitor Sales Process

On 15 November 2018 Arion Bank announced that it had engaged Citigroup Global Markets Limited (Citi) to advise on a potential change of ownership in Arion Bank's subsidiary Valitor Holding hf. (Valitor), which could include the divestment of all the shares or the majority of the shares in Valitor.

Valitor has invested heavily in growing its international business in recent years. In addition to its Icelandic business, Valitor operates in Denmark and the United Kingdom and provides services to companies across Europe. Although it has performed well in many areas and developed cutting edge payments solutions, revenue from its international operations have fallen short of expectations. At the end of 2019 the board of directors of Valitor decided to scale back investments in the company's international business and to strengthen core operations. Approximately 20% of employees were made redundant at Valitor in the year. These changes are expected to help the company generate positive EBITDA in 2020.

The sale process has taken longer than planned and will continue in 2020. One of the objectives of the changes made by Valitor was to facilitate the sale of the company.

At year-end 2019, the Bank classified Valitor as *disposal group held for sale* in accordance with IFRS 5.

United Silicon Bankruptcy

On 22 January 2018 United Silicon, a silicon metal factory under development in Helguvík, Iceland, was declared bankrupt following serious operational problems which resulted in its operating license being temporarily suspended, following a failed attempt at reaching a composition arrangement with its creditors. In February 2018 an agreement was reached between the administrator of the bankrupt estate of United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets.

The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through the subsidiary Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, with measures including the securing of all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. Stakksberg ehf. is currently engaged in the final stages of concluding a new environmental impact assessment for the plant. The proposed remedial actions fully fit within the scope of the current local plan for Stakksberg's plot in Helguvík. Nevertheless Reykjanesbær will be required to amend the current local plan to reflect building licenses which have already been issued by Reykjanesbær.

The Bank's objective is to divest Stakksberg ehf. on the basis of this preparatory work. Consequently Stakksberg ehf. is classified as *disposal group held for sale* in accordance with IFRS 5.

Implementing new data systems

The Bank has adopted a suite of risk data aggregation and regulatory reporting systems from Moody's Analytics. With the implementation of these systems the Bank has taken important steps toward satisfying the 14 principles for effective risk data aggregation and risk reporting described in the Basel Committee on Banking Supervision's standard number 239 (BCBS 239).

The implementation of a new core banking system from Sopra with solutions from Reiknistofa bankanna hf. (RB) has been underway during the year. The purpose is to bring added efficiency to the business and to reduce the costs of running the Bank's IT system and facilitate further product development. The new system will make it easier for the Bank to develop its services and to launch new digital solutions aimed at simplifying banking for customers. The implementation of the new system is an extensive undertaking and involves more than 100 employees of Arion Bank, RB and Sopra. The new system is expected to launch before end 2020.

Tourism

Over the past decade, tourism has grown to become Iceland's largest export industry and has been the key to Iceland's recovery from the economic crisis of 2008. During the period, the number of tourists visiting Iceland annually grew from less than half a million to nearly 2.5 million in 2018, see Figure 1.2. In the three years prior, approximately one quarter of commercial investment had been attributed to tourism related activities. Prior to 2019 there were signs that the annual growth in the number of tourists was slowing giving rise to concerns that overinvestments had been made in the industry. In 2019 the number of tourists declined for the first time since 2008, by 15% compared to 2018.

The primary explanation for the decline can be attributed to the operational difficulties of the two major Icelandic carriers, Icelandair and WOW Air. WOW Air ultimately ceased operations on 28 March 2019. Icelandair was poised to acquire WOW Air's market share but experienced capacity problems due to the grounding of the Boeing 737 Max. Consequently, the number of domestic carrier passengers, which had grown annually by approximately 24% during 2012-2018, fell by 37% in 2019, see Figure 1.3.

Analysis indicates that the economic impact of the decline in the number of tourists has been mitigated by the added focus on stopover passengers, extended duration of stay and disproportionately greater spending of each tourist. The prospects for Icelandic tourism in 2020 are dependent on two factors – the development of the Boeing 737 Max and the global development of the COVID-19 coronavirus influenza.

For a discussion about the Bank's exposure to Tourism, see section 4.4.1.

Figure 1.2 Tourists arriving in Iceland [in millions]

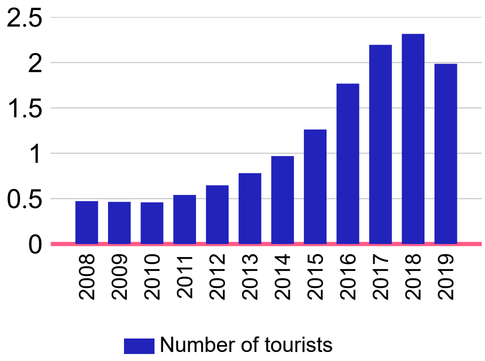
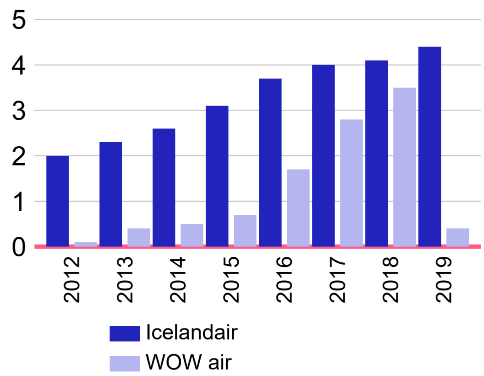


Figure 1.3 Number of passengers from Icelandair and WOW air [in millions]



International Credit Rating – Investment Grade

In July 2019 Standard & Poor's affirmed Arion Bank's long-term credit rating BBB+ but revised the outlook from stable to negative. The Bank's short-term credit rating remains A-2.

Standard & Poor's expressed the view that in a fiercely competitive environment, no longer supported by a strong economy, Icelandic banks' business prospects and earnings have become weaker. The role of pension funds in lending distorts Icelandic banks' competitive environment in terms of business generation and margins. The economy was expected to contract in 2019 but rebound in 2020. The negative outlook was said to be reflective of the likelihood of downgrades if current conditions persist, to the further detriment of earnings.

S&P confirmed its long-term rating of Arion Bank of BBB+ with a negative outlook

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.

Introduction

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 2013/36/EU) and the Capital Requirements Regulation (CRR: Regulation No. 575/2013), and represents the EU's implementation of the Basel III reforms. Basel III aims 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.

Recent years have seen numerous legislative acts passed by Parliament to implement the CRD IV/CRR framework. These acts have mostly brought amendments to the Financial Undertaking Act No. 161/2002.

The Minister of Finance and Economic Affairs adopted the CRR as secondary legislation (Regulation No. 233/2017) in 2017. The CRR was incorporated into the EEA Agreement late 2019, and enters into force 1 January 2020.

In December 2016 the European Banking Authority (EBA) published a final report on guidelines on disclosure requirements under Part Eight of the CRR. The objective of the guidelines is to provide standardization of disclosures for financial institutions. The guidelines apply from 31 December 2017.

Few remaining issues are yet to be implemented of the CRD IV framework. They concern e.g. activities of branches of financial undertakings and other financial services operating within the EEA and some issues regarding supervision on consolidated bases, see further in Chapter 10.

Arion Bank follows the legislative requirements regarding public disclosure of information concerning capital adequacy and risk management.

The CRR was incorporated in the EEA Agreement late 2019, and enters into force 1 January 2020

1.4 Disclosure Policy

The Bank has in place a formal disclosure and transparency 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 EBA guidelines on disclosure requirements under Part Eight of the CRR and guidelines on disclosure of non-performing and forborne exposures. EBA standardized disclosure templates can be found in the Additional Pillar 3 Risk Disclosures document on the Bank's website.

The disclosures are reviewed for accuracy and appropriateness, and verified and approved internally, in line with the Bank's disclosure policy.

Summarized information on risk management and capital adequacy is presented in the Bank's Annual Report and regulatory capital information and leverage ratio are provided quarterly in the Bank's interim financial reports.

The Pillar 3 Risk Disclosures 2019 have been prepared in accordance with regulatory capital adequacy rules and differ from similar information in the Bank's Consolidated Financial Statements for 2019, which are prepared in accordance with International Financial Reporting Standards (IFRS). Therefore information in these disclosures may not be directly comparable with the information in the Financial Statements.

These Pillar 3 Risk Disclosures are in accordance with CRD IV / CRR, unlike the Bank's Financial Statements, which conform to IFRS. Therefore Pillar 3 information may not be directly comparable with that of the Financial Statements

Information in the disclosures refers to the Arion Bank Group, which consists of the parent entity, Arion Bank, and its 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 differ from regulatory capital reporting purposes. The differences in the scopes of consolidation are set out in the EBA standardized disclosure template EU LI3 in the Additional Pillar 3 Risk Disclosures, which are available on the Bank's website.

Where necessary, a distinction is made in the report between the group and parent entity.

All financial figures, calculations and information in the disclosures are based on 31 December 2019 and presented in ISK millions, 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 and semi-annually. Information in the disclosures are not subject to external audit.

2 **Risk** Management

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 market, liquidity, operational, cyber, business and other 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 risk culture in which risk is everyone's business.

The Bank's strategy is to have effective risk control which includes the identification of significant risks, the quantification of the risk exposure, actions to limit risk and monitoring risk. The Executive Management Committee devotes a significant portion of its time to the management of the Bank's risk. The Bank's risk is categorized in four types; credit, market, liquidity and operational 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 delegates risk management to the Chief Risk Officer (CRO) and regulatory compliance to the Compliance Officer.

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

The CEO, on the 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 managers and consolidates the assessment of capital requirements for the Bank.

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 including, but not limited to, credit, market, liquidity, operational and reputational risk, and capital adequacy. The BRIC reviews the Bank's risk appetite at least semi-annually, see section 2.6, 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, and 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 high risks and in so doing enhancing the controls 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 BAC and annually to and the Board of Directors.

The role of Compliance is to apply effective precautionary measures to ensure that Arion Bank complies at all times with the law, regulations and good business practices, and to foster an affirmative corporate culture in this respect.

The Compliance Officer is the Bank's Money Laundering Reporting Officer (MLRO), and is responsible for supervising the Bank's measures against money laundering and terrorist financing.

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. Reporting to the CRO, and working in the Risk Management division, are department heads responsible for the management of retail and corporate credit risk, market risk, liquidity risk and operational risk. Along with their teams, the department heads are responsible for overseeing and monitoring the risks and controls of their risk type. The departments interact with each business unit as part of the monitoring and management processes, see section 2.4.

For further information on the Bank's governance arrangements please refer to the Corporate Governance Statement for the year 2019, 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 2019.

2.2 Three Lines of Defense

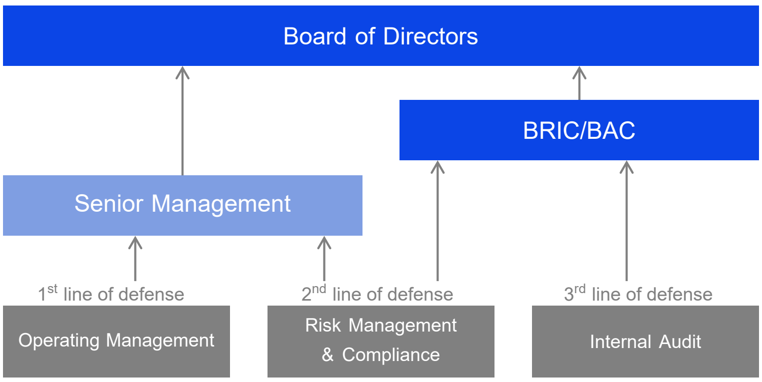
In order to ensure the effectiveness of the Bank's internal controls, to clarify responsibilities and coordinate essential risk management, and to foster the culture wherein risk is every employee's business, the Bank has adopted the three lines of defense model.

The Bank has adopted the three lines of defense model in order to ensure the effectiveness of internal controls

The model distinguishes between three lines involved in effective risk management:

1. Functions that own and manage risks
2. Functions that oversee risk management
3. Functions that provide independent assurance of effectiveness

Figure 2.2 Three lines of defense



First Line of Defense: Operating Management

Operational management, i.e. those in charge of overseeing and designing business operations, naturally serves as the first line of defense, which owns and manages risks, as controls are designed to fit into systems and processes under their guidance.

Second Line of Defense: Risk Management & Compliance

The second line of defense is established to ensure that the first line of defense is properly designed, in place, and operating as intended. The Bank's Risk Management and Compliance divisions are the primary second line of defense, but other divisions may also have limited second line of defense duties.

Third Line of Defense: Internal Audit

Internal Audit provides the Board of Directors and the senior management with comprehensive assurance based on the highest level of independence and objectivity within the Bank.

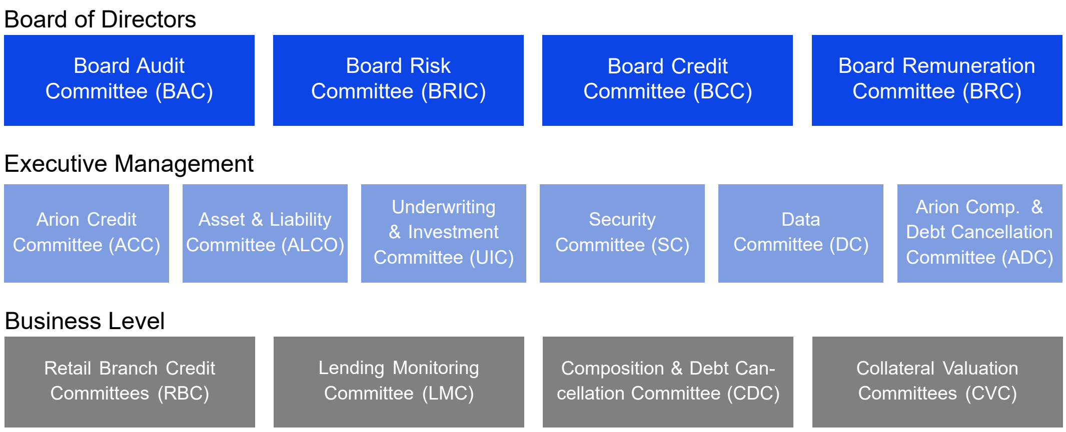
Internal Audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives.

2.3 Risk Committees

The structure of risk committees within the Bank can be split into three levels. 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 committees are established by the Board and composed of members of the Board or external representatives nominated by the Board. An overview of the 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 ensuring an effective system of internal controls and compliance 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 controls, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The Board Risk Committee provides guidance to 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 Board Credit Committee is the Bank's supreme authority in granting of credit and makes decisions on credit, debt cancellations, investments and underwriting in accordance with its authority framework, as decided by the Board. The BCC can delegate specific authority to the CEO to be used in extraordinary circumstances. The committee periodically reviews reports on various aspects of the credit portfolio. The BCC defines credit rules for ACC.
Board Remuneration Committee (BRC)	The Board Remuneration Committee prepares a remuneration policy for the Bank that shall be reviewed by the Board at least annually and submitted to the AGM for approval. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor and on the Bank's incentive scheme and other work-related payments. The CEO proposes a salary framework for Managing Directors, the Compliance Officer and Chief Internal Auditor in consultation with the BRC.

Executive-level 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 committees

Committee	Responsibilities
Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases below BCC's credit granting limits. The committee delegates limited authority and sets forth credit rules to lower credit granting bodies. ACC reviews reports concerning the credit portfolio. The CRO or his alternate has the right to be present at ACC meetings but does not participate in credit decisions. Risk management and the Chief Credit Officer are authorized to escalate all decisions of the ACC 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, and capital activities. The CRO or his deputy is a non-voting observer in committee meetings.
Underwriting and Investment Committee (UIC)	The Underwriting and Investment Committee decides on underwriting and principal investments. The CRO or his deputy is a non-voting observer in committee meetings.
Security Committee (SC)	The Security Committee is a consultation forum on security matters. The committee formulates, reviews and approves security goals and policies, monitors compliance with security policies and implements information security rules. The committee is chaired by the CRO.
Data Committee (DC)	The Data Committee serves as a central governing body for all matters relating to data quality and data management. The Data Officer works on behalf of the Data Committee to advance the level of data quality within the Bank in line with the principles for effective risk data aggregation and risk reporting set forth in BCBS 239. The committee is chaired by the CRO.
Arion Composition and Debt Cancellation Committee (ADC)	The Arion Composition and Debt Cancellation Committee deals with applications to reach composition with debtors.

The third and lowest level comprises committees on business level with delegated authority from the executive level committees, see Table 2.3.

Table 2.3 Business level committees

Committee	Responsibilities
Retail Branch Credit Committees (RBC)	Four Retail Branch Credit committees make decisions on credit cases within authorized limits and according to credit rules.
Lending Monitoring Committee (LMC)	The Lending Monitoring Committee reviews compliances with credit rules and credit committees' decisions in relation to disbursements.
Composition and Debt Cancellation Committee (CDC)	The Composition and Debt Cancellation Committee deals with applications to reach composition with debtors within authorized limits.
Collateral Valuation Committees (CVC)	Five Collateral Valuation Committees set guidelines on collateral assessment and valuation.

2.4 The Risk Management Division

The Risk Management division focuses on the identification, monitoring and control of risk. 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.

Risk Management's approach is based on understanding the Bank's operational exposures and how unexpected events may affect them, coupled with sound judgment from risk takers. Good judgment and common sense is often the best risk management tool.

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

The Risk Management division is divided into three departments; Credit Control, Balance Sheet Risk, and Operational Risk. The Bank's Security Officer and Data Officer report to the CRO.

Figure 2.4 Structure of Risk Management division

Credit Control

The Credit Control department monitors weak and impaired credit exposures on a customer by customer basis. The department analyzes credit exposures according to various credit quality factors, see section 4.8. Credit Control oversees the provisioning process and reports impairments and write-offs to the ACC. Credit Control also monitors the portfolio credit risk, such as single name and industry-sector concentrations, as well as monitoring financial relationships of obligors and the large exposures to financially related obligors.

Credit Control ensures that the book value of distressed loans accurately reflects the expected recovery value of loans and is responsible for collateral supervision and reporting.

Credit Control department attends all ACC meetings with a monitoring and advisory role.

Balance Sheet Risk

The Balance Sheet Risk department is responsible for analyzing, monitoring and reporting on market risk, liquidity risk and capital requirements. The department is also responsible for quantitative functions, including 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, the calculation of the regulatory capital requirements and managing the Bank's economic capital models, allocated capital model and stress tests. Balance Sheet Risk is responsible for the design, implementation and management of the Bank's ICAAP and ILAAP, and interfacing with the FSA in the Supervisory Review and Evaluation Process (SREP).

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.

Operational Risk

The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk at Arion Bank. Operational Risk is also responsible for providing leadership and support to every business unit regarding the implementation of operational risk tools, processes, and ongoing improvements of the control environment. The department serves as the ICFR coordinator in the Bank's ICFR process, see section 7.6.

Operational Risk has the objective to minimize the impact of losses suffered in the normal course of business (expected losses) and to avoid or reduce the likelihood of suffering extreme tail events (unexpected losses) resulting in large losses.

The Bank's operational risk framework comprises a number of elements which allows the Bank to manage and measure its operational risk profile. These are for example Risk and Control Self-Assessment (RCSA) and loss data collection. The bank uses the standardised approach to evaluate the minimum amount of operational risk capital it needs to hold to absorb potential losses. However, these elements can also be used to determine if the bank needs to hold additional capital, beyond what the standardised approach dictates.

Security Officer

The Bank's Security Officer is a part of the Risk Management division and reports directly to the CRO. The Security Officer's main task is to devise a strategy on security issues, supervise security issues and report to the Security Committee and the Executive Management. The Security Officer is also responsible for the Bank's contingency plans.

Data Officer

The Data Officer reports to the CRO. He leads data governance on behalf of the Bank's Data Committee. The Data Committee is the authority on data and data management in the Bank. The Data Officer's tasks include formulating policy on data management issues, devising strategy for data management improvements, and monitoring of data management related risk and compliance exposures.

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. By positioning the Risk Officer in the Bank's Risk Management division the Bank aims to secure independence from the business units managing the pension funds.

2.5 Risk Policies

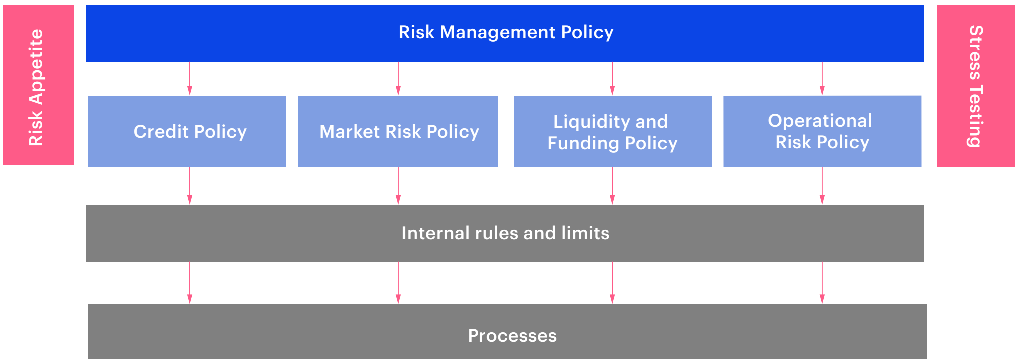
In pursuance of ensuring that existing and potential material risks are identified, managed and monitored the Bank has an enterprise risk management policy in place. The policy is reviewed and approved by the Board of Directors annually. The policy outlines, at high level, the key aspects of the Bank's 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 2.6.

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. Four risk types have been defined as significant; credit, market, liquidity and operational 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



2.6 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.

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

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 approved by the CEO or relevant executive level committee. The Bank's 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, and remuneration.

The Bank's quantitative risk appetite metrics are shown in Table 2.4. Additionally, the risk appetite statement includes qualitative criteria such as tolerance statements for various operational risk and regulatory compliance breaches.

Table 2.4 Risk appetite metrics

31 December 2019	Value	Legal Limit	Within Risk Appetite	Definition
Credit Risk				
Largest exposure	10.9%	25.0%	✓	Net exposure to a single customer or group of connected customers as a percentage of eligible capital.
Sum of large exposure	21.2%	-	✓	Sum of all large exposures on a net basis as a percentage of eligible capital.
Sum of 3 largest sectors*	66.1%	-	✓	Book value of loans to the three largest industry sectors as a percentage of the corporate loan portfolio.
Largest sector*	32.8%	-	✓	Book value of loans to the largest industry sector as a percentage of the corporate loan portfolio.
Expected credit loss*	0.19%	-	✓	12 month expected loss for the customer loan portfolio as a percentage of the total customer loan portfolio.
Market Risk				
Total equity exposure*	11.6%	-	✓	Total equity position, excluding investments in core assets, as a percentage of total own funds.
Unlisted equity exposure*	6.1%	-	✓	Unlisted equity position, excluding investments in core assets, as a percentage of total own funds.
Indirect equity exposure*	0.86%	-	✓	Maximum capital loss due to derivatives and margin lending in the event of an equity market stress event, based on assumptions which the Bank has adopted for such purposes.
Funding and Liquidity Risk				
Liquidity coverage ratio*	168%	100.0%	✓	Definition and calculation in accordance with the CRD IV framework.
Net stable funding ratio in foreign currency	126%	100.0%	✓	Definition and calculation in accordance with the CRD IV framework.
Loans-to-deposit ratio	157%	-	✓	Ratio of total loans to customers to total customer deposits.
Asset encumbrance ratio	17.8%	-	✓	Assets pledged as security for borrowings as a percentage of total assets.
Capital Management				
Capital adequacy ratio	24.0%	20.3%	✓	Total own funds as a percentage of total risk-weighted assets.
Leverage ratio	14.1%	3.0%	✓	Definition and calculation in accordance with the CRD IV framework.
Assets and Liability Management				
Currency imbalance	5.7%	10.0%	✓	Net position by which foreign currency assets exceed foreign currency liabilities as a percentage of total own funds.
Interest rate risk*	2.5%	-	✓	The amount at risk, which is calculated as a change in fair value due to yield curve movements that corresponds to the 99th percentile of the loss distribution.

* Parent level metric

2.7 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 2.5.

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 an annual reports on the Bank's Recovery Plan, ICAAP, ILAAP and stress testing.

Table 2.5 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 loan's portfolio quality.	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
Risk report	An aggregate report containing the credit risk portfolio report and the liquidity and market risk report, as well as information on the Bank's risk appetite, recovery indicators and ICAAP status, operational risk 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.	Annually	Board BRIC Exec. Com.
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.

3 **Capital** Management

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 future development.

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 to regulatory requirements and supervises the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and allocation of capital. Stress testing, supervised by the Executive Management Committee and 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 2019 the Bank's CET1 ratio was 21.2% and total capital ratio 24.0%. The ratios account for a foreseeable equity reduction of ISK 14.2 billion through buy-back of own shares and dividend distribution

3.2 Capital Strategy

The Bank's objective is to maintain a capital adequacy ratio that is 1-2% above the total regulatory capital requirement, which includes the Pillar 1, Pillar 2 and the combined capital buffer requirement. The Bank has previously communicated a management buffer of 150bps but now employs a 100-200bps range to account for volatilities in the risk-weighted exposure amount (REA) and own funds and facilitate further flexibility in the management of capital. The Bank's target for CET1 ratio is 17%.

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 and the Bank's own funds are to be restructured through issuance of Additional Tier 1 (AT1) and Tier 2 capital instruments. In the period from Q4 2018 to Q4 2019 the Bank has issued ISK 20 billion of subordinated liabilities, which achieves the normalized use of Tier 2 capital, which is 2.8% of the Bank's REA. The final step in the normalization of own funds requires the issuance of ISK 15 billion of AT1 eligible hybrid instruments, assuming unchanged REA. This step depends on a number of factors, including pricing, tax legislation, regulatory consent and foreign currency balance restrictions.

The increase in Tier 2 capital, coupled with reduced REA, results in surplus CET1 capital that can be distributed to shareholders. Accordingly, the Bank's capital ratios as at 31 December 2019 account for a foreseeable equity reduction of ISK 14.2 billion, which is the aggregation of an ISK 10.0 billion dividend distribution and full utilization of the Bank's share buy-back program, approved by the Board of Directors and FSA in November 2019. The figure is adjusted to account for the Bank's shares in its possession. In 2019 the Bank paid ISK 10 billion in dividend and purchased own shares in the amount ISK 3.3 billion.

The Bank's REA decreased by 10% in 2019. This is primarily attributed to the sale of the Arion Bank Mortgages Institutional Investor Fund (ABMIIF) mortgage portfolio, contraction of corporate loans and commitments, reduction of liquid assets as a result of buy-back of borrowings and own shares, and impairments of assets held for sale.

As the Bank is now operating on capital levels that are close to but comfortably above regulatory requirements, the Bank puts great emphasis on managing the allocation of capital to its business units, with the aim of maximizing profitability.

As stipulated in the Bank's dividend policy, based on the Bank's expected financial performance over the medium term, the Bank aims to pay an annual dividend before special distributions, in line with a pay-out ratio around 50% of net income attributable to shareholders.

3.3 Capital Requirements

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 (CRD IV / CRR), excluding Article 501 on capital requirements relief for small and medium-sized enterprises. On 1 January 2020, the CRR was however incorporated into the EEA Agreement, effectively introducing the SME supporting factor into the capital adequacy framework in Iceland. See further discussion in Section 3.6.1.

The Bank's consolidated situation as stipulated in CRR is Arion Bank's accounting consolidation without insurance subsidiaries. The capital position and solvency requirements of Vörður tryggingar hf. should therefore be viewed independently from capital adequacy for the Group's consolidated situation.

The Bank's calculation of REA is based on standardized approaches for the assessment of credit risk, market risk, credit value adjustments, 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:

Figure 3.1 Development of own funds [ISK m]

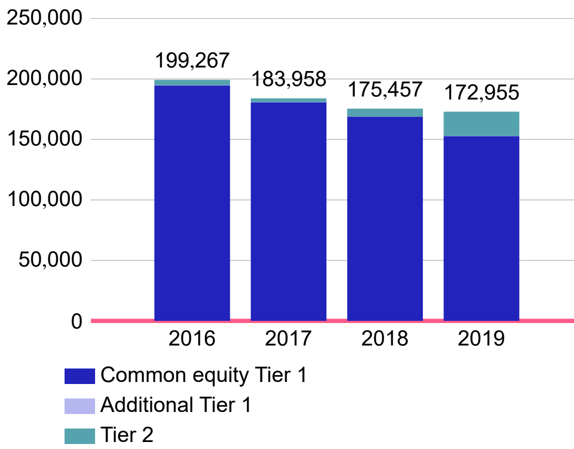
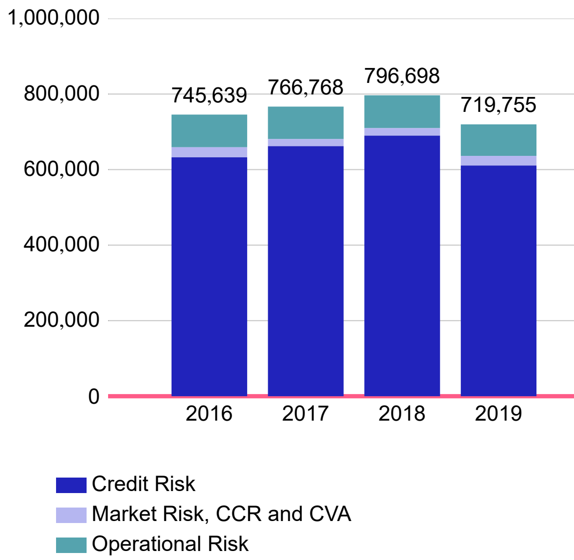


Figure 3.2 Development of REA [ISK m]



Capital Management

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 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%

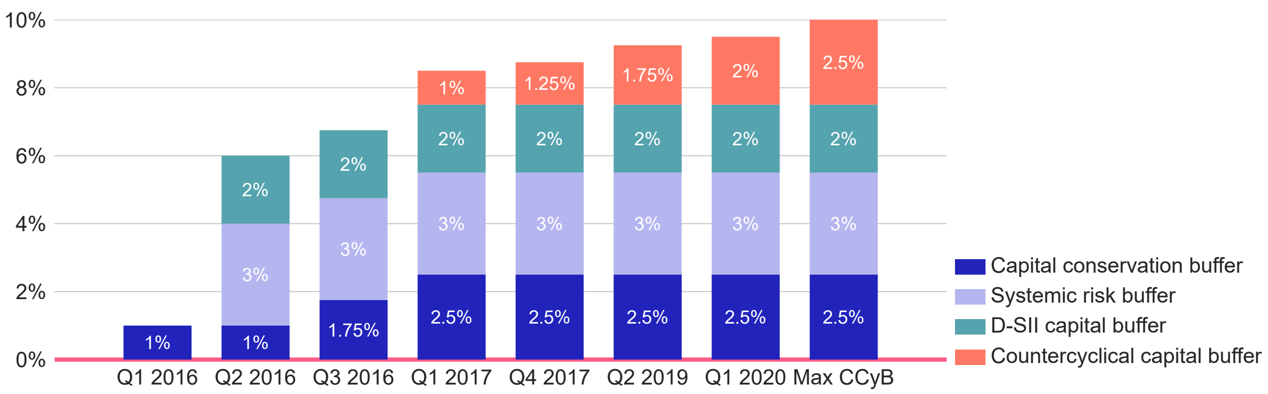
The same proportion applies to the Pillar 2 capital add-on, i.e. it can be comprised of 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

The SREP review of the Bank's ICAAP, which concluded in September of 2019 and was based on financial figures on 31 December 2018 for the Group's prudential consolidation, resulted in a Pillar 2 requirement that corresponds to 3.1% of REA. See further discussion in section 3.4.1.

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 paragraph 5 of CRD IV. The countercyclical buffer increased by 0.5% in May 2019 and by 0.25% in February 2020. The implementation of the capital buffers are shown in the chart below. The requirements are presented as percentage of REA.

For the Bank's consolidated situation, the Pillar 2 capital requirement is 3.1% of REA and the institution-specific combined capital buffer requirement is 9.0% at year-end 2019

Figure 3.3 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 while weighting only applies to domestic exposures. Given the Bank's geographic credit risk profile at year-end 2019, the effective combined capital buffer requirement for the Bank is 9.0%. Taking into account the capital buffer increase as of February 2020, the Bank-specific combined buffer requirement increases to 9.2%.

Table 3.2 Arion Bank's capital buffer requirements as of February 2020

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%		2.8%
Countercyclical capital buffer	2.0%	CCyB of country	1.9%
Total	**9.5%**	**4.5%+CCyB**	**9.2%**
REA credit risk weight	94.3%	5.7%	

To summarize, the Bank's total regulatory requirement is 20.3%. Management's policy is to voluntarily hold an additional management buffer of 1-2%, which brings the total capital benchmark level to 21.3% to 22.3%. The following figure shows the Bank's capital position and the capital requirement, along with an normalised capital structure under CRR.

The Bank's total regulatory requirement is 20.3% as of February 2020. The Bank's capital ratio benchmark is 21.3% to 22.3%

The Bank's own funds at 31 December 2019 take into account a foreseeable equity reduction of ISK 14.2 billion. Therefore, a corresponding distribution will not affect the Bank's capital adequacy ratios.

Figure 3.4 Arion Bank's own funds regulatory requirements with combined capital buffer requirements as of February 2020

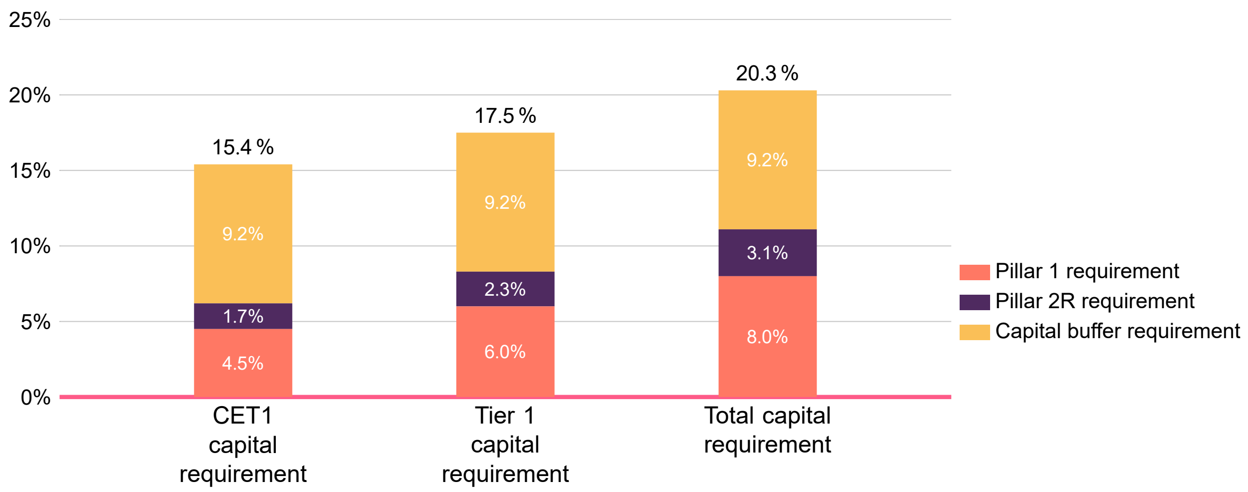
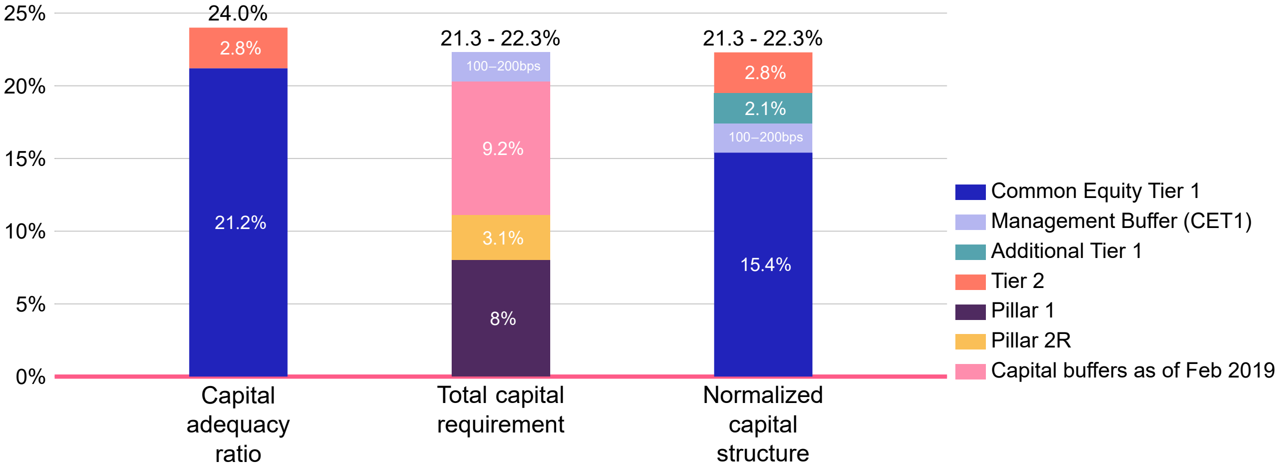


Figure 3.5 Arion Bank's own funds and own funds requirement with combined buffer requirements as of February 2020 and internal management buffer

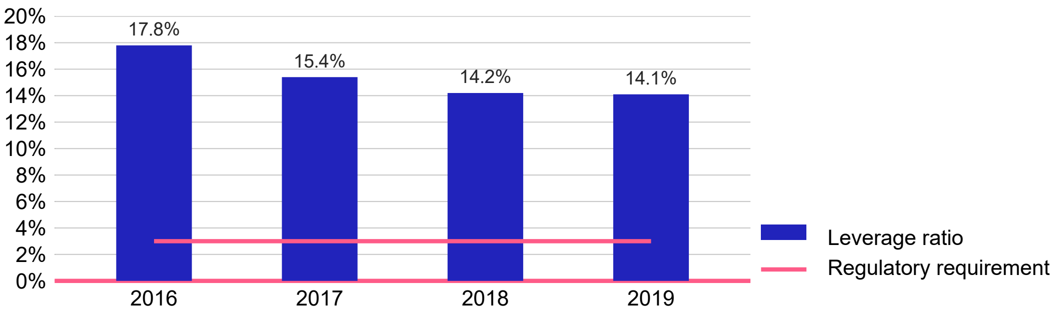


The leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting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

At year-end 2019, the Bank had a strong leverage ratio of 14.1%, significantly higher than the 3% minimum prescribed by the Act on Financial Undertakings. 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 standardised approach for capital adequacy. As such, Arion Bank has a relatively high combined capital buffer requirement of 9.2%, which is applied to a standardized REA. The Bank's average risk-weight is 68% for the consolidated situation.

Arion Bank is the example of a systemically important institution that applies the standardised 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



Although Tier 1 capital decreased by ISK 16 billion in 2019, the Bank's leverage ratio remains stable. The decrease in capital is offset by decreased leverage as a result of contraction of the balance sheet and off balance sheet items. 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 the standardized leverage ratio disclosure according to Regulation EU 2016/200 in the Bank's Additional Pillar 3 Risk Disclosures.

3.4 Capital Management

The Bank employs various techniques in its assessment of capital need. The Bank's 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 to the Bank's operations and business planning. The Bank's capital is allocated to different business units on a quarterly basis on the basis of the rolling business plan. The allocation decision is supported by an analysis of risk adjusted performance of allocated capital.

3.4.1 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 is the Bank's consolidated situation, which 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. The FSA reviews the Bank's ICAAP report and sets capital requirements following its supervisory and review process (SREP). Arion Bank's own funds exceed both the internal assessment of capital requirements and the FSA's SREP requirements.

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

- Raise risk-awareness to all the Bank's activities and to ensure that the Board of Directors and the Executive Management Committee understand the Bank's risk profile.
- 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 3.3.

Table 3.3 Risk identification down to operating segment

Business Units	Credit risk	Market risk	Liquidity risk	Operational risk	Legal risk	Reputational 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. This additional capital requirement is referred to as the Pillar 2R requirement. 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 which the Bank therefore does not include in its Pillar 2 capital assessment. Among those is the lack of diversification of the Icelandic economic, 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. The Bank's assessment is that the capital requirements specified by the standardized approach are adequate for residential mortgages, car loans, loans to retail SMEs and non-specialized loans to customers within mature sectors.

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 result also includes a special add-on for distressed assets.

The SREP of 2019, which was based on financial figures from 31 December 2018 for the Bank's consolidated situation, resulted in a Pillar 2R capital requirement of 3.1% of REA.

The SREP of 2019, which was based on financial figures from 31 December 2018 for the Bank's consolidated situation, resulted in a Pillar 2R capital requirement of 3.1% of REA

3.4.2 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.

The impact of stress testing is estimated on the Bank's earnings and capital adequacy as well as 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 3.7 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, Planning & Analysis	Risk Management	Planning & Analysis, Chief Economist, Risk Management	Planning & Analysis, Risk Management	Planning & Analysis, 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.

3.4.3 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 units. Capital is allocated both based on current need and on the basis of a 12 month forward horizon.

Figure 3.9 Allocated capital for Q4 2019

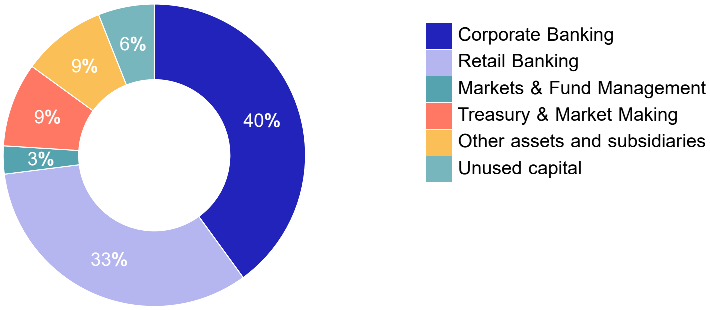
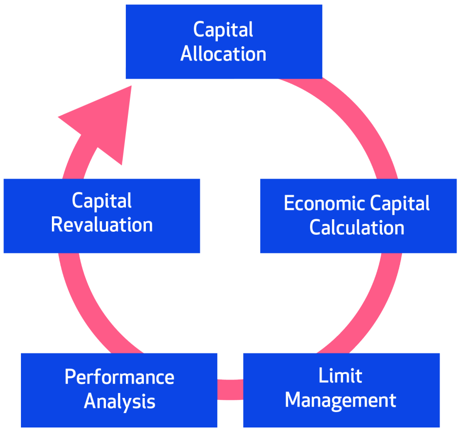


Figure 3.8 Capital planning and monitoring process



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.

3.5 Capital Position

The Bank's accounting consolidation is different than that of its prudential consolidation for capital adequacy as insurance subsidiaries are excluded from the Group's consolidated situation as stipulated by CRR. The solvency requirements and capital position of insurance subsidiaries should be viewed separately from the consolidated situation.

For further details on the Bank's regulatory consolidation, own funds and regulatory adjustments, please refer to the EBA standardized templates EU-LI1, EU-LI2, EU-LI3 and OFD in the Group's Additional Pillar 3 Risk Disclosures.

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 2019. The contractual maturities range from 2028 to 2031, and the first call option becomes active as of November of 2023.

The Bank had no outstanding Additional Tier 1 instruments at reporting date.

Apart from the Bank's insurance subsidiaries, which are excluded in prudential consolidation, the Bank had no significant investments in insurance undertakings.

Table 3.4 Reconciliation of own funds

Own funds [ISK m]	2019	2018
Total equity of Bank's accounting consolidation	**189,825**	**200,859**
Deductions related to the consolidated situation	-10,159	-8,986
Non-controlling interest not eligible for inclusion in CET1 capital	-181	-130
Common Equity Tier 1 capital before regulatory adjustments	**179,485**	**191,743**
Intangible assets	-10,604	-12,152
Tax assets	-296	-191
Indirect holdings of own CET1 instruments	0	-190
Cash flow hedges	-1,616	-1,221
Additional value adjustments	-125	-126
Foreseeable dividend	-14,153	-9,069
Common Equity Tier 1 capital	**152,691**	**168,794**
Non-controlling interest not eligible for inclusion in CET1 capital *	181	130
Tier 1 capital	**152,872**	**168,924**
Subordinated liabilities	20,083	6,532
Tier 2 capital	**20,083**	**6,532**
Total own funds	**172,955**	**175,456**

Table 3.5 Overview of risk-weighted exposure amount (EU OV1)

31 December [ISK m]	REAs		Minimum own funds requirements
	2019	2018	2019
Credit risk (excluding CCR)	**610,765**	**689,900**	**48,861**
of which the standardized approach	610,765	689,900	48,861
CCR	**4,824**	**6,633**	**385.92**
of which mark to market	3,347	4,405	267.76
of which CVA	1,477	2,228	118.16
Settlement risk			0
Securitisation exposures in the banking book (after the cap)			0
Market risk	**20,679**	**13,208**	**1,654**
of which the standardized approach	20,679	13,208	1,654
Large exposures			0
Operational risk	**83,487**	**86,957**	**6,679**
of which standardized approach	83,487	86,957	6,679
Amounts below the thresholds for deduction (subject to 250%risk weight)			
Total	**719,755**	**796,698**	**57,580**

Table 3.6 Overview of own funds and capital adequacy

31 December [ISK m]	2019	2018
Own funds		
Common Equity Tier 1 (CET1) capital	152,691	168,794
Tier 1 capital	152,872	168,924
Total own funds	172,955	175,456
Risk-weighted exposure amount	719,755	796,599
CET1 capital ratio	21.2%	21.2%
Tier 1 capital ratio	21.2%	21.2%
Total capital ratio	24.0%	22.0%
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)	3.1%	2.9%
of which CET1 requirement	*1.7%*	*1.6%*
of which Tier 1 requirement	*2.3%*	*2.2%*
Combined capital buffer requirement	9.0%	8.5%
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	*2.83%*	*2.8%*
of which countercyclical capital buffer requirement	*1.66%*	*1.2%*
Total CET1 capital requirement	15.2%	14.6%
Total Tier 1 capital requirement	17.3%	16.6%
Total capital requirement	20.1%	19.4%
Own funds in relation to minimum capital requirement	3.00x	2.75x
Leverage ratio		
Exposure measure for leverage ratio calculation	1,085,614	1,191,117
Leverage ratio	14.1%	14.2%

3.6 Regulatory Changes

3.6.1 SME supporting factor

Article 501 of the EU Capital Requirements Regulation (CRR) stipulates a capital requirements deduction 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 is applicable to SMEs (using only the turnover threshold) with group exposure below EUR 1.5 million, excluding exposures secured on residential property collateral.

The rationale 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.”*

This article was omitted in the adoption of CRR into Icelandic law. As of 1 January 2020, CRR was however incorporated into the EEA Agreement, which effectively introduces this provision into prudential requirements in Iceland. As of 2020, the Bank's REA decrease by approximately ISK 12 billion, increasing the Bank's capital adequacy ratios by 0.4%.

3.6.2 Basel III Revision

On 7 December 2017 the Basel Committee on Banking Supervision published an updated Basel III standard which finalizes the Basel III post-crisis reforms. The updated standard will be effective from 1 January 2022 for banks using the standardized approach (SA) and implemented in steps from 1 January 2022 to 1 January 2027 for banks using the IRB method. The initial phase of the Basel III reforms (2010) focused on strengthening global capital and liquidity rules with the goal of promoting a more resilient banking sector.

The Basel III reforms include improvements on the standardized and IRB approaches. The goal is to restore credibility in the calculation of REAs, reduce their excessive variability, improve the comparability of banks' capital ratios and restore a level playing field between standardized and IRB banks.

According to the Bank's assessment, with other things equal, the changes to prudential requirements will likely result in decreased capital requirements for the Bank. The more risk-sensitive standardized approach will result in lower average risk-weights for loan secured by residential and commercial real estate, as well as loans to retail and corporate SMEs. This reduction will however be partly offset by higher risk-weights for specialized lending, development and construction projects, and equity positions.

4 **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, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance.

Loans to customers and credit institutions are the largest source of credit risk but credit risk is also inherent in other types of assets, such as bonds, short-term debt securities, derivatives, and in commitments such as guarantees and 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. To maintain and improve the quality of the loan portfolio it is imperative to constantly monitor the performance of loans, counterparties, and collateral, both individually and at the portfolio level.
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.
Bonds and debt instruments	The Bank trades and invests in bonds and debt instruments. Bonds and debt instruments are important to the Bank's liquidity management.
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. These assets form a key part of the Bank's liquidity buffer.
Counterparty credit risk	The Bank offers financial derivative instruments to professional investors, e.g. FX, interest, and securities derivatives. The Bank also uses hedging derivatives and engages in securities lending. For further information on counterparty credit risk, see section 4.9.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made in short term trading purpose 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 4.5.

4.1 Credit Policy

The Bank's credit policy contains high-level criteria for credit granting, as well as outlining the roles and responsibilities for further implementation and compliance. The Bank's credit policy is the base for the Bank's credit strategy as integrated in the business plan, the Bank's risk appetite towards credit exposure, the Bank's credit rules, and the Bank's credit procedures and controls.

Arion Bank is a universal bank offering companies and individuals tailored banking solutions. Credit is granted by a hierarchy of credit committees with different credit granting limits, or by employees with restricted credit granting limits. The emphasis is on maintaining a high quality credit portfolio by adhering to a strict credit process, and seeking business with financially strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in its pricing.

Credit granting, where the underlying collateral is securities issued by Arion Bank, is prohibited.

4.2 Credit Granting

The Board Credit Committee (BCC) is the supreme authority in granting credit. The Arion Credit Committee (ACC), which acts below BCC's granting limits, in cooperation with the CEO, delegates authority within its own credit limits and sets credit granting rules and guidelines for the business units. The Bank's Chief Credit Officer (CCO) manages and advises on the Bank's credit rules and policies. The CRO and CCO attend the BCC's meetings as advisors.

Risk Management attends all ACC meetings and is authorized to attend any sub-credit committee meeting. Risk Management and the Chief Credit Officer have the power to escalate controversial credit committee decisions to a higher authority as well as put any credit case on the agenda on a ACC meeting for discussion and decision if applicable. Extraordinary credit proposals are referred to the BCC for approval, e.g. new loans exceeding 5% of eligible capital and credits to groups of connected parties exceeding 10% of eligible capital.

The Bank gathers information for each credit application and evaluates certain elements that serve as a basis for a decision, e.g. the company profile, the financial analysis of the company, the proposed collateral, the company's credit rating, and related parties and their total exposure.

The Bank generally requires collateral but a central element in assessing creditworthiness is the customer's ability to service the debt.

4.3 Credit Risk Management

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

To ensure well informed lending decisions, borrowers' key risk and performance indicators are analysed and available for the credit committee. Risk Management participates in all ACC meetings as an advisor as well as a monitoring unit. 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 IT systems.

During the repayment phase, Risk Management monitors the credit portfolio. The Credit Control department aggregates the portfolio monthly, based on consistent criteria, to analyze the outstanding risk, the collateral level, as well as the portfolio quality. Credit Control analyzes loans that have been classified at risk and maintains an independent and centralized overview of distressed credits. Credit Control, based on its analysis, manage provisions and reviews write-offs. Monthly credit risk reports are sent to the ACC, the BRIC and the Board of Directors.

4.4 Credit Risk Exposure

The Bank is exposed to credit risk from both on-balance sheet exposures and off-balance sheet exposures, the latter of which represents credit commitments to customers in the form of undrawn credit limits, unused overdrafts, guarantees, and letters of credit. 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 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.

The Bank's credit exposure decreased in 2019, primarily as a result of the sale of the Arion Bank Mortgages Institutional Investor Fund (ABMIIF) mortgage portfolio, contraction of corporate loans and commitments, reduction of liquid assets with foreign institutions as a result of buy-back of borrowings, and impairments of assets held for sale.

Credit Risk

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

31 December 2019 [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	146,942	138	147,227	2	496	0.3%
Regional governments or local authorities	3,972	2,049	4,342	400	948	20.0%
Public sector entities	900	10	619	1	310	50.0%
Multilateral development banks	0	0	1,033	16	0	0%
Institutions	30,010	3,468	30,010	1,215	6,934	22.2%
Corporates	312,039	59,738	303,594	20,508	324,103	100%
Retail	109,492	42,683	109,034	5,354	85,791	75%
Secured by mortgages on immovable property	343,158	3,874	342,830	1,253	131,559	38.2%
Exposures in default	13,406	1,724	13,352	794	18,490	130.7%
Exposures associated with particularly high risk	1,893		1,893		2,839	150%
Covered bonds	417		417		83	20%
Collective investments undertakings	4,907		4,907		4,140	84.4%
Equity	4,325		4,325		4,325	100%
Other items	30,763		30,763		30,763	100%
Total	**1,002,225**	**113,684**	**994,347**	**29,545**	**610,782**	**59.7%**

Table 4.2 Continued

31 December 2018 [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	134,470	171	134,470	86	0	0%
Regional governments or local authorities	4,971	3,647	4,968	1,518	1,336	20.6%
Public sector entities	314	32	314	14	213	65.1%
Multilateral development banks	0	0	799	0	0	0%
Institutions	78,425	704	78,127	352	17,857	22.8%
Corporates	362,438	88,827	355,890	33,880	389,771	100%
Retail	113,229	41,715	112,782	15,551	96,250	75%
Secured by mortgages on immovable property	348,556	5,398	348,365	1,477	125,106	35.8%
Exposures in default	13,826	1,408	13,802	695	17,659	121.8%
Exposures associated with particularly high risk	3,118		3,118		4,677	150%
Collective investments undertakings	3,780		3,780		2,747	72.7%
Equity	6,337		6,337		6,337	100%
Other items	27,945		27,945		27,945	100%
Total	**1,097,409**	**141,902**	**1,090,697**	**53,573**	**689,898**	**60.3%**

The Bank's credit risk-weight density, or REA density, measured as REA relative to EAD, decreases slightly from 60.3% to 59.7% in 2019. The contraction of the Bank's corporate loan book and commitments, increased tax value of real estate and sale of equity positions contribute to lower density, while the sale of the ABMIIF mortgage portfolio and reduced liquid assets increase the density.

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 2019 [ISK m]	Risk weights								Total	Of which unrated
Exposure classes	0%	20%	35%	50%	75%	100%	150%	Other		
Central gov. or central banks	143,773	1,502						1,955	147,229	0
Regional governments		4,742							4,742	4,742
Public sector entities				620					620	620
Multilateral dev. banks	1,049								1,049	1,049
Institutions		28,931		2,292		2			31,225	5
Corporates						324,103			324,103	323,796
Retail					114,388	0			114,388	114,972
Secured by mortgages on immovable property			315,737	14,590		13,757			344,083	344,412
Exposures in default						5,459	8,687		14,146	14,176
High risk exposures							1,893		1,893	1,893
Covered bonds		417						1,174	1,591	0
CIU						3,645	88		3,734	4,907
Equity						4,325			4,325	4,325
Other items						30,763			30,763	30,763
Total	**144,822**	**35,592**	**315,737**	**17,502**	**114,388**	**382,054**	**10,668**	**3,129**	**1,023,892**	**845,660**

Table 4.3 Continued

31 December 2018 [ISK m]	Risk weights							Total	Of which unrated
Exposure classes	0%	20%	35%	50%	75%	100%	150%		
Central gov. or central banks	134,556							134,556	
Regional governments		6,437				48		6,485	6,485
Public sector entities	6			217		105		328	328
Multilateral dev. banks	799							799	799
Institutions		71,276		7,203				78,479	10,508
Corporates						389,771		389,771	383,413
Retail					128,333			128,333	128,333
Secured by mortgages on immovable property			332,099	17,743				349,842	349,842
Exposures in default						8,174	6,323	14,498	14,498
High risk exposures							3,118	3,118	3,118
CIU	107	961		314		2,398		3,780	3,780
Equity						6,337		6,337	6,337
Other items						27,945		27,945	27,945
Total	**135,468**	**78,674**	**332,099**	**25,477**	**128,333**	**434,778**	**9,441**	**1,144,271**	**935,386**

4.4.1 Credit Risk Exposure by Sector

The Bank's loan book is diversified with regard to individuals and industry sectors. Of loans to customers, 48% are loans to individuals, of which 84% are mortgage loans. Credit exposure to individuals represents 36% of the total net credit risk exposure, see template EU CRB-D in the Bank's Additional Pillar 3 Disclosures.

Real estate activities and construction is the largest industry sector comprising 32% of loans to corporate entities or 14% 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 4.1 Loans to customers, by counterparty type

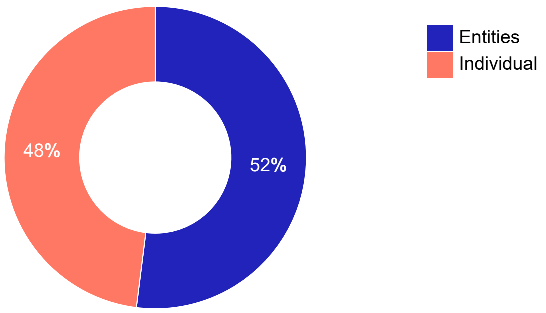
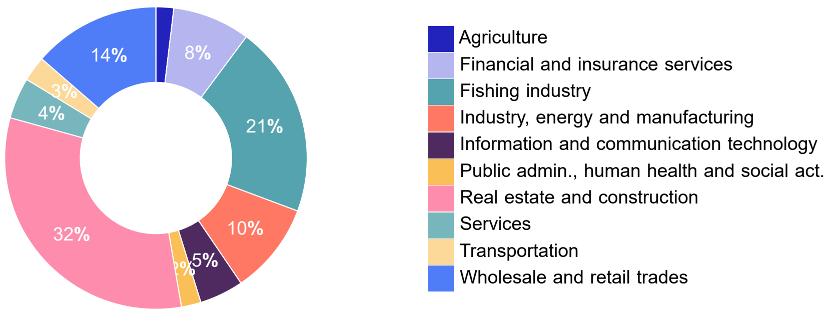


Figure 4.2 Sector distribution of loans to corporate entities



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 2019, compared to 6% in 2018. The tourism exposure draws mainly from three standard industry sectors: Wholesale and retail trades (40%), Real estate and construction (33%) and Transportation (13%).

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

For EBA standardized disclosures of credit risk exposure by sectors please refer to templates EU CRB-D and EU CQ-6 in the Additional Pillar 3 Risk Disclosures.

4.4.2 Credit Risk Exposure by Geographic Area

The Bank is not significantly exposed to credit in other countries than Iceland. The total net exposure is 92.5% towards counterparties domiciled in Iceland.

The majority of the 7.5% 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).

Loans to customers outside Iceland amounted to ISK 28,104 million at the end of 2019 or 2.5% of total net exposure.

Figure 4.3 Geographic distribution of total net exposure

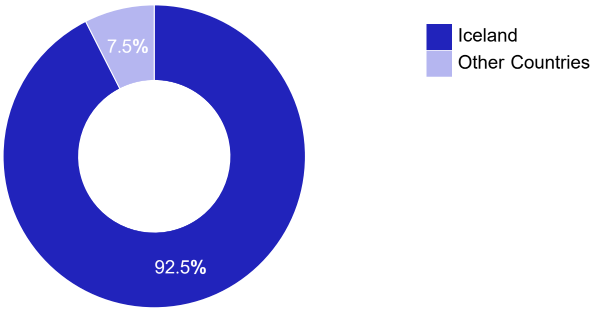
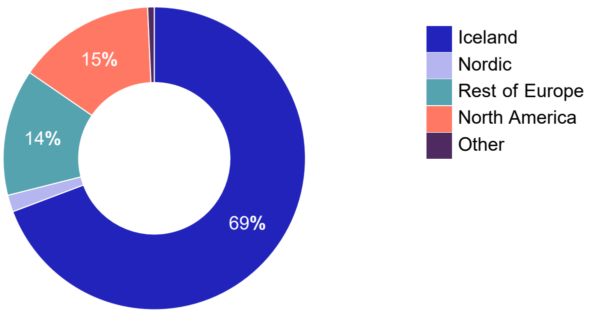


Figure 4.4 Geographic distribution of total net exposure to institutions, central governments and central banks



For EBA standardized disclosures of credit risk exposure by geographic area please refer to templates EU CRB-C and EU CQ-5 in the Additional Pillar 3 Risk Disclosures.

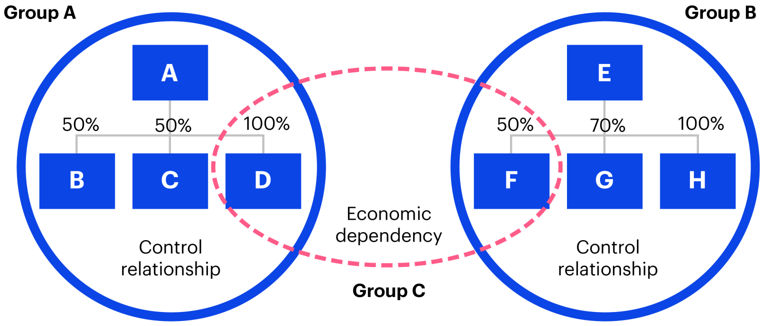
4.4.3 Related Parties and Large Exposures

A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's eligible capital according to Act on Financial Undertaking No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures, net of eligible collateral, is 25% of the eligible 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 or sum of large exposures shall exceed limits expressed in the Bank's risk appetite.

The Bank connects related parties according to internal rules that conform to Act on Financial Undertakings No. 161/2002 and relevant EBA guidelines, which define the groups of related parties. The internal rules define the Bank's interpretation of conditions a. and b. in the FSA rules, 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. This relationship is illustrated in Figure 4.5.

Figure 4.5 Related parties



Risk Management monitors party relations both prior to the granting of a loan and during the lifetime of the loan. Connections are stored in the Bank's customer relationship management (CRM) system and the Bank's relationship database.

Risk Management monitors party relations both prior to granting a loan and during the lifetime of the loan

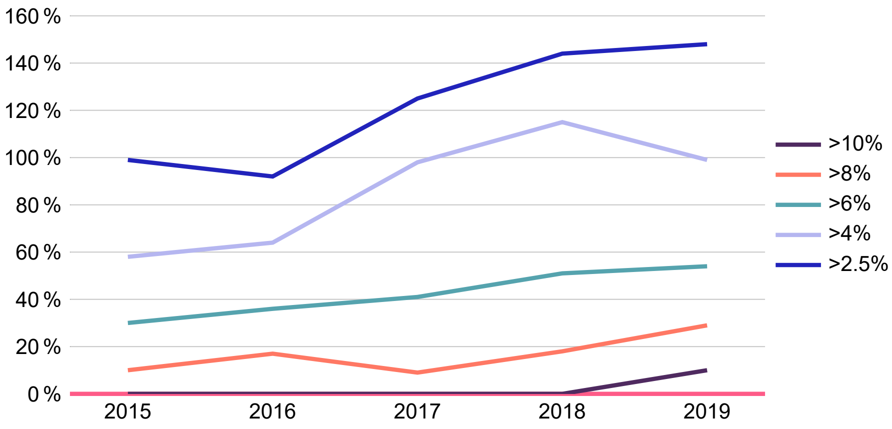
Customers' exposures are updated daily and are available at any time through the Bank's CRM system. In addition, an exposure report for a group of connected clients is updated weekly and is accessible at any time to Risk Management, Corporate and Investment Banking and Retail Banking. The report shows a breakdown of lending to each group. Exposures that exceed 2.5% of the eligible capital are reported monthly to the ACC and to the BRIC.

At year end 2019 the Bank had one large exposure within loans to customers and one to a foreign bank with better credit rating than the Icelandic Government, totaling ISK 36.8 billion before accounting for eligible collateral. At year end 2018 the bank had no large exposures.

One exposure to a group of related parties within Loans to Customers was classified as a *large exposure* at year end 2019

The sum of exposure exceeding 2.5%, net of eligible collateral, increased from 144% to 148% year-on-year, see Figure 4.6. This is largely a result of the Bank's optimization of the capital base.

Figure 4.6 Total of net exposures to a group of related parties (excluding loans to financial institutions)



4.5 Equity Risk in the Banking Book

Exposure limits for the banking book are set in the Bank's risk appetite statement. The Bank has had a disposal schedule for non-core assets which it acquired during the process of restructuring companies following the financial crisis in 2008. The Bank has successfully carried out this plan, resulting in a significant reduction in equity exposures over the past years. The position in unlisted equities was reduced in 2019, mainly as a result of the sale of shares in Stoðir.

Table 4.4 Equity exposure in the banking book

31 December 2019 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		298	298
Equity instruments with variable income	4,634	2,590	7,224
Fund shares - Bonds		1,180	1,180
Fund shares - Other	44	3,468	3,512
Total equity exposure in the banking book	**4,678**	**7,535**	**12,213**
Unrealized gain/loss at year-end 2019			3,395
31 December 2018 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		382	382
Equity instruments with variable income	3,193	5,949	9,142
Fund shares - Bonds		1,582	1,582
Fund shares - Other	95	2,605	2,701
Total equity exposure in the banking book	**3,288**	**10,519**	**13,807**
Unrealized gain/loss at year-end 2018			3,503

4.6 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:

- Retail loans to individuals: Mortgages in residential properties.
- Corporate loans: Real estate properties, fishing vessels and other fixed and current assets including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity, and funds that consist of eligible securities.

Other instruments used to mitigate credit risk include pledges, guarantees and master netting agreements.

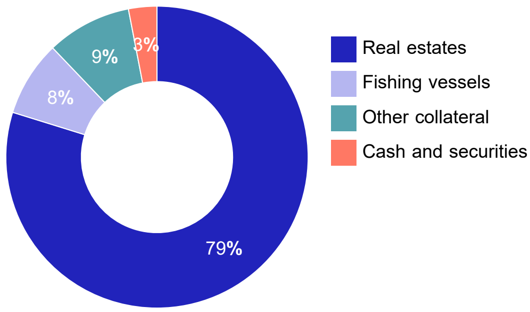
To ensure coordinated collateral value assessment, the Bank operates five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The five committees' areas of expertise are:

- Agriculture
- Fishing vessels and fishing quota
- Real estate
- Securities
- Inventory and trade receivables

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 79% of the total collateral. At the end of 2019, loans to customers were secured by collateral conservatively valued at ISK 693,207 million, which results in a collateral coverage ratio of 90% compared to 91% at the end of 2018.

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 4.7 Collateral by type



The collateral coverage ratio of loans to customers at the end of 2019 was 90% compared to 91% at the end of 2018

Table 4.5 Collateral for loans to customers

31 December 2019 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2019	Unsecured ratio % 2018
Individuals	198	328,243	13	10,996	339,450	7.9%	6.2%
Real estate activities and construction	1,972	113,465	55	8,022	123,514	4.9%	4.3%
Fishing industry	17	12,365	54,121	9,946	76,449	7.8%	7.0%
Information and communication technology	375	3,529	-	4,308	8,212	57.0%	48.0%
Wholesale and retail trade	375	32,508	7	15,98	48,870	11.1%	10.6%
Financial and insurance services	17,726	7,254	-	7,622	32,602	3.2%	4.3%
Industry, energy and manufacturing	60	28,183	0	6,711	34,954	12.4%	11.4%
Transportation	0	1,048	313	3,285	4,646	58.0%	74.5%
Services	61	9,137	92	5,669	14,959	14.9%	26.7%
Public sector	4	2,194	-	289	2,487	71.1%	65.6%
Agriculture and forestry	4	6,797	-	263	7,064	7.7%	2.7%
Total	**20,792**	**544,723**	**54,601**	**73,091**	**693,207**	**10.2%**	**9.4%**

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

Figure 4.9 shows the mortgage portfolio broken down to LTV bands based on the face value of the mortgages. At the end of 2019, 87% of the mortgages, by value, had loan-to-value below 80%, the same as for the end of 2018. As shown in figure 4.8 the mortgage properties are primarily located in the Greater Reykjavik area or 69% of the portfolio, by value.

Figure 4.9 Loan to value of mortgage loans [ISK m]

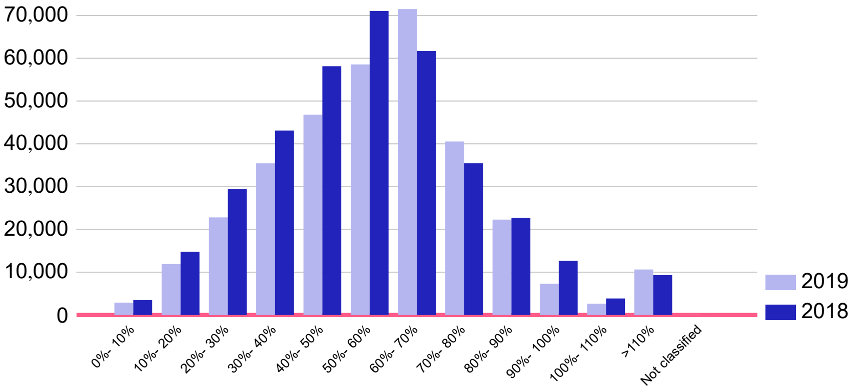
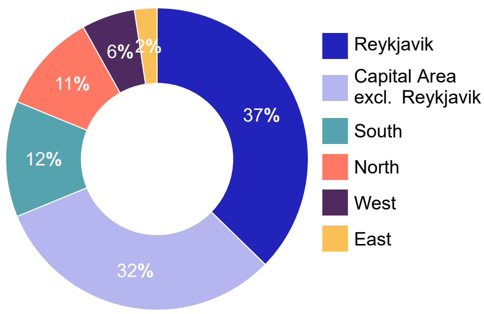


Figure 4.8 Mortgage portfolio by location



4.7 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, collective provisioning and internal economic capital calculations.

The Bank uses different credit rating models that apply 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 was updated in 2019, new models created and current models updated.

Table 4.6 Probability of Default models

Model	Description
Large corporates	Defined as corporate clients with a) individual exposure over ISK 160 million (approx. EUR 1.2 million) or b) individual exposure over ISK 65 million and related exposure over ISK 160 million. The model is statistical, run manually, 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 65 million or b) individual exposure between ISK 65 million and ISK 160 million and related exposure below ISK 160 million. The model is statistical, run 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, run automatically, and based on historical behavior of customers and characteristics of the customer and the exposure.
Individuals, consumer loans	Applied to all consumer loans - credit cards, overdrafts, etc. The model is statistical, run 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 PD models are developed within the Balance Sheet Risk department, while the validation of the models is performed independently by the Risk Management's Credit Control unit.

4.7.1 Credit Exposure by Rating

Table 4.7 shows the portfolio's rating status, by exposure. In some cases, companies are temporarily unrated. This primarily applies to newly formed entities where no financial or historical information is available, and entities for which the Bank's main rating models are deemed unreliable. During the process of carrying out compliance with IFRS 9, emphasis was placed on rating every customer. Newly formed entities and corporates without financial statements were rated using application models and special rating models were created for holding companies and public sector entities based on expert judgment, supported by analysis of historical data. At the end of 2019 only 0.1% of the parent company's loan portfolio was unrated.

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, which, among other things, can be a result of provisioning against the customer's exposure. Around 1.7% of the portfolio, by exposure, was assigned a default rating at the end of 2019, which is the same percentage as at the end of 2018. Active PD values are translated into an internal rating scale of letters from CCC- to AAA. The scale, which was updated in 2019, is shown in Table 4.8. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

Table 4.7 Breakdown of rating status by exposure

	2019			2018		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	98.0%	1.8%	0.2%	97.8%	1.4%	0.7%
Retail corporates	95.8%	4.2%	0.0%	95.2%	4.6%	0.2%
Other entities	98.2%	1.1%	0.7%	98.3%	0.8%	0.9%
Individuals, mortgages	98.7%	1.3%	0.0%	98.5%	1.5%	0.0%
Individuals, consumer loans	98.8%	1.2%	0.0%	98.3%	1.7%	0.0%
Individuals, other exposures	97.5%	2.3%	0.2%	96.6%	3.4%	0.0%
Total	**98.1%**	**1.7%**	**0.1%**	**97.9%**	**1.7%**	**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%
1	A+	0.045%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
	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

Figure 4.11 shows the large corporates portfolio broken down by ratings. The change in the rating distribution is mainly due to pure migration i.e. a shift in the rating of existing customers. The migration is furthermore affected by a model update for large corporates in 2019. Separate models have been created for other counterparty types, such as holding companies, to improve the differentiation of risk.

The exposure-weighted average PD for the large corporate portfolio was 2.5% at year-end 2019, compared to 1.8% at year-end 2018. In terms of exposure approximately 6% have been upgraded towards a better risk class, in contrast to 25% that have been downgraded. 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 4.10 Risk class rating migration by exposure between 2018 and 2019 – Large Corporates

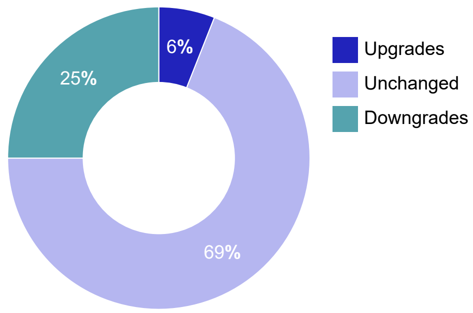
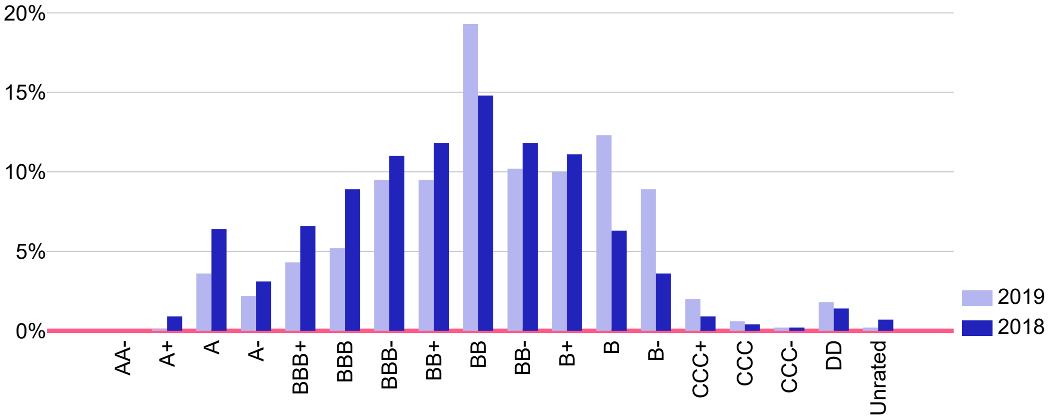


Figure 4.11 Distribution of exposure by rating for large corporates



Retail Corporates

Figure 4.13 shows the retail corporate portfolio broken down by ratings. The distribution of PD values has shifted towards improved values between 2018 and 2019. The change can partly be attributed to pure migration, but is also affected by a model update in which the calibration is based on the most recent data.

The exposure-weighted average PD was 5.5% at the end of 2019 and was the same at the end of 2018. In terms of exposure 45% have been upgraded towards a better risk class whereas 12% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated or rated by the model for large corporates.

Figure 4.12 Risk class rating migration by exposure between 2018 and 2019 – Retail Corporates

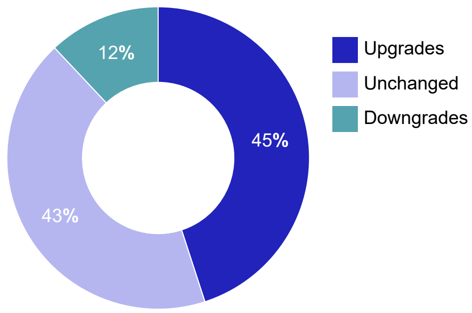
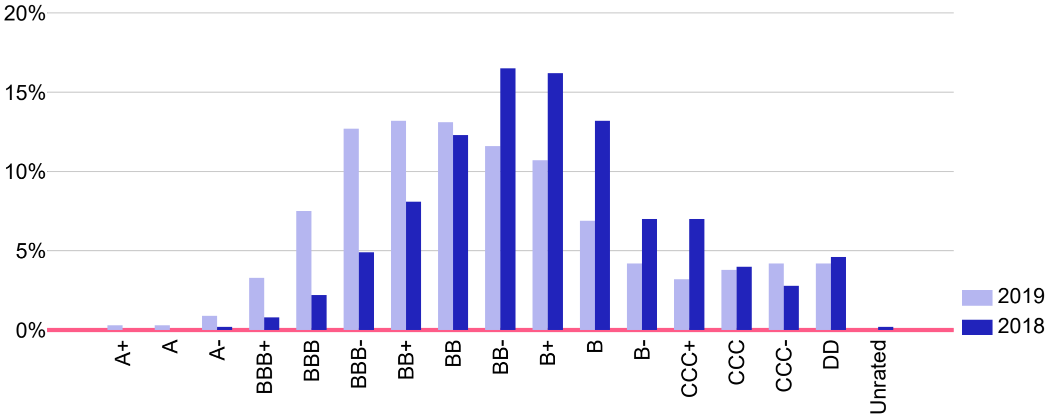


Figure 4.13 Distribution of exposure by rating for retail corporates



Mortgages to Individuals

Figure 4.15 shows the mortgage portfolio broken down by ratings. A migration towards an improved credit profile is observed between years. The change can partly be attributed to pure migration, but is also affected by a model update in which the calibration is based on the most recent data.

The exposure-weighted average PD for the mortgage portfolio was 1.3% in year-end 2019 compared to 1.7% in year-end 2018. In terms of exposure, approximately 33% of mortgages have migrated towards an improved credit grade whereas only 4% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.14 Risk class rating migration by exposure between 2018 and 2019 - mortgages to Individuals

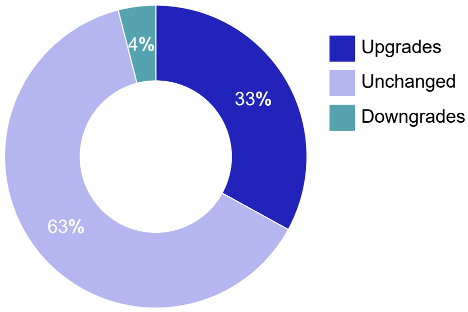
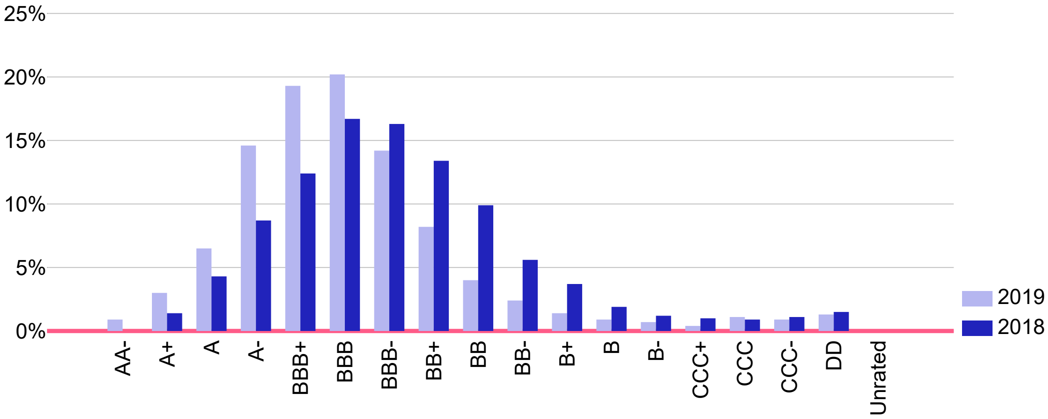


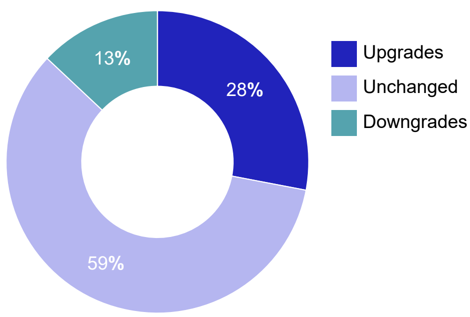
Figure 4.15 Distribution of exposure by rating for mortgages to individuals



Consumer loans to Individuals

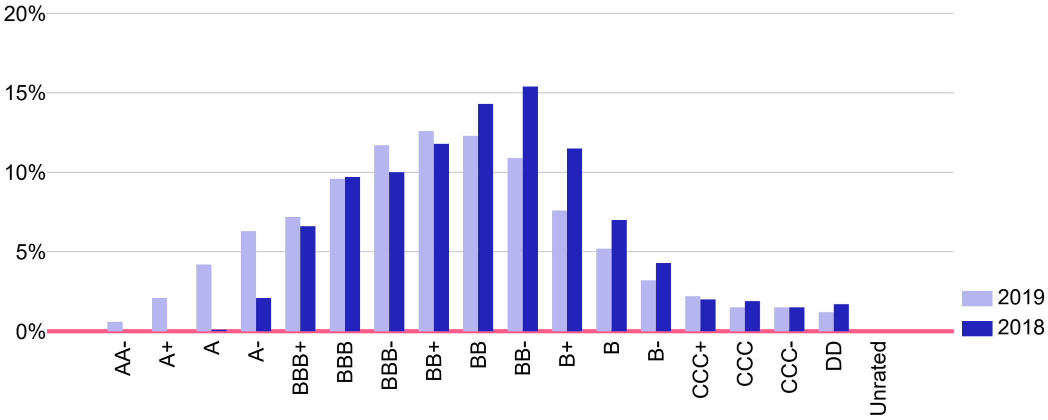
Figure 4.17 shows the consumer loans (overdrafts, credit cards and unsecured short-term loans) portfolio to individuals broken down by ratings. A migration towards an improved credit profile is observed between years and the portion of exposures in default has decreased. The change can partly be attributed to pure migration, but is also affected by the aforementioned change in model structure and calibration based on most recent data. In 2018 consumer loans were rated by a model that included all customers exposures other than prime mortgages (cross-default), while the new model is based on consumer loans only and therefore more effectively captures the specific risk characteristics of this exposure class. This results in improved model discriminatory power.

Figure 4.16 Risk class rating migration by exposure between 2018 and 2019 - Consumer loans to Individuals



The exposure weighted average PD for the portfolio was 2.8% at year-end 2019 compared to 3.0% at year-end 2018. In terms of exposure about 28% have been upgraded towards a better risk class whereas 13% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.17 Distribution of exposure by rating for consumer loans to individuals



Model performance

At the end of 2019, the discriminatory power of the four, new 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 2018 and exposure weighted observed default rates in 2019 are shown in the following table.

Table 4.9 Model performance. Observed default rates in 2019 compared to probability of default predicted at year-end 2018

Model portfolio	Average PD	Observed avg default rate
Large corporates	1.9%	1.7%
Retail corporates	4.3%	5.2%
Individuals, mortgages	1.0%	1.3%
Individuals, consumer loans	1.8%	2.2%

In figures 4.18 and 4.19, the actual default rate for each rating level in 2019 is compared to the predicted default probability at the end of 2018 for individuals and corporates, respectively.

For individuals, one default event was observed for ratings -A, A and A+ each and none for AA-. For corporates, no defaults were observed for corporate customers with rating BBB+ or better.

Figure 4.18 Comparison of actual default rate in 2018 and predicted default probability - Individuals

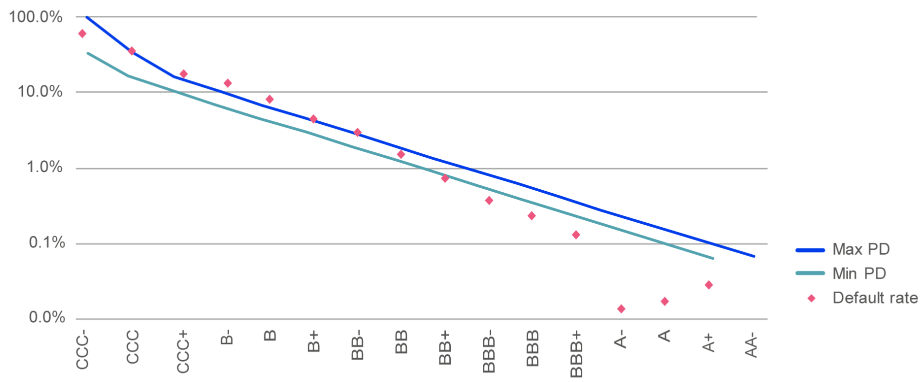
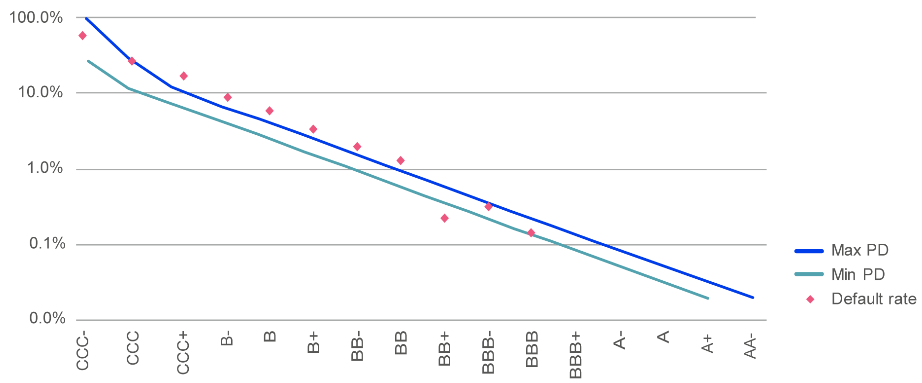


Figure 4.19 Comparison of actual default rate in 2018 and predicted default probability - Corporates



4.8 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

4.8.1 Impairment and Provisions

The Credit Control department is in charge of the Bank's provisioning process. Provisions for credit loss are made according to the IFRS 9 three-stage expected credit loss model. For impaired loans, Stage 3 provisions are made based either on a portfolio level assessment or by individual assessment of credits. 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 exposres 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 (a DD rating). For individuals the same applies within each credit model e.g. prime mortgages to individuals do not automatically trigger a movement to Stage 3 and risk class 5 for other exposures to the borrower, and vice versa. A default event for one type of exposure can however be an indicator on the likelihood of default for the borrower's other types of exposures, and vice versa.

For further information, see Note 56 on Credit Risk Rating in the Bank's Consolidated Financial Statements for 2019.

Individual assessment

Financial assets are impaired when the borrower is more than 90 days past due or considered to be unlikely to pay. 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 chapter 4.7) are considered. For larger borrowers, interviews with account managers are also conducted.

Portfolio assessment

The provisions for impairment for prime mortgages and other exposures to individuals, where the amount of the exposure is within a predetermined, and acceptable range, is made on a portfolio basis. The impairment is based on a 90 days delinquency status and a collateral allocation method where the collateral is usually the tax value of the pledged real estate property.

For further information on measurement of impairment, see Note 56 on Expected credit losses in the Bank's Consolidated Financial Statements for 2019.

4.8.2 Past Due Exposures

Figures 4.20 and 4.21 show the development of serious defaults from the end of 2014 for individuals and corporates, using the facility default and the cross default methods. In the latter method, all exposure to the customer is considered in default if one facility is in default. Defaults have steadily decreased during the period, mainly due to the progress made in restructuring problem loans, the resolution of the legal uncertainty surrounding the FX loans, progress in legal collection, as well as a better economic environment.

Figure 4.20 Development of past due exposures to individuals, parent company

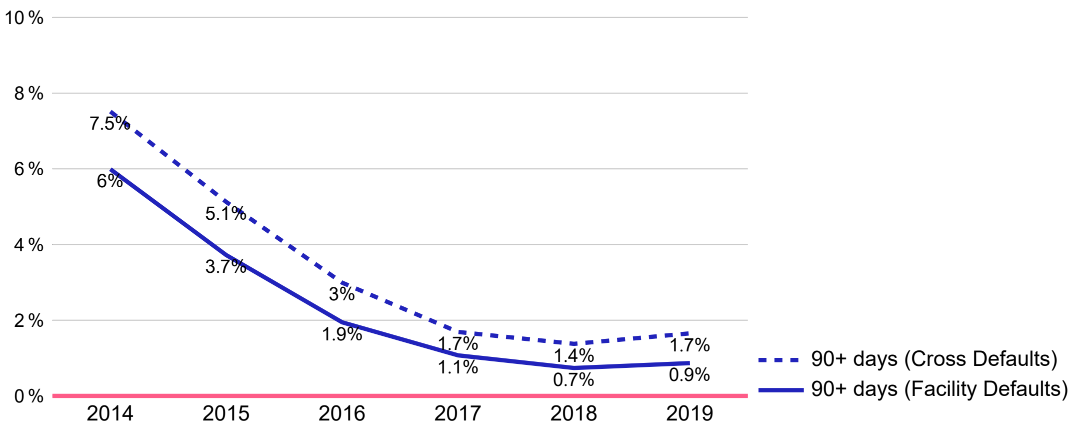
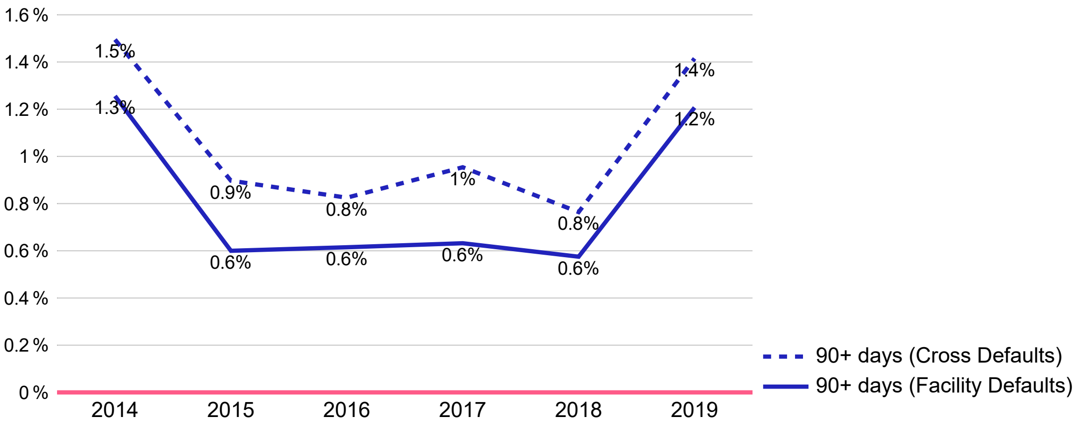


Figure 4.21 Development of past due exposures to companies, parent company



Customer loans that are more than 90 days past due were 1.0% of the total loan book at year-end 2019 if measured at facility level. The cross default ratio more than 90 days past due was 1.5%; 1.7% for individuals and 1.4% for corporates.

For EBA standardized disclosures of credit quality by past due days please refer to templates EU CQ-3 in the Additional Pillar 3 Risk Disclosures.

Customer loans that are more than 90 days past due represent 1.0% of the total loan book at year-end 2019 if measured at facility level

4.8.3 Forbearance

The Bank has adopted the European Banking Authority's (EBA) definition of forbearance. 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 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 4.2 and for potential forbearance cases there is, as a part of the relevant credit committee's decision, a determination of whether the concession constitutes forbearance.

For EBA standardized disclosures of credit risk exposure by sectors please refer to templates EU CQ-1 in the Additional Pillar 3 Risk Disclosures.

4.8.4 Expected Credit Loss

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 in order to be able to meet unexpected loss (see chapter 3.3).

During the IFRS 9 implementation the Bank has further refined its ECL model taking advantage of enhanced collateral management within the Bank and the experience gained from the economic difficulties in the past few years. Apart from the IFRS 9 implementation other areas have benefitted from these refined ECL calculation such as, 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) as per the Basel III definition, loss given default (LGD) for the credit type, and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see sections 4.7 and 4.7.1.

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, within one year 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 exposures, conditional on non-cure

Table 4.10 shows the 12 month Expected Loss rate for different customer and exposure classes for exposures in Stage 1 and Stage 2. PD and LGD values are weighted by the corresponding Gross Carrying Value taking Off-Balance Sheet items also into account.

Table 4.10 Expected credit loss by exposure type

31 December 2019	PD	LGD	EL
Large Corporates	2.6%	8.3%	0.18%
Retail Corporates	5.2%	7.9%	0.43%
Individuals, Prime Mortgages	1.3%	0.7%	0.02%
Individuals, Other	2.4%	27.5%	0.92%
Weighted average	**2.2%**	**6.9%**	**0.19%**

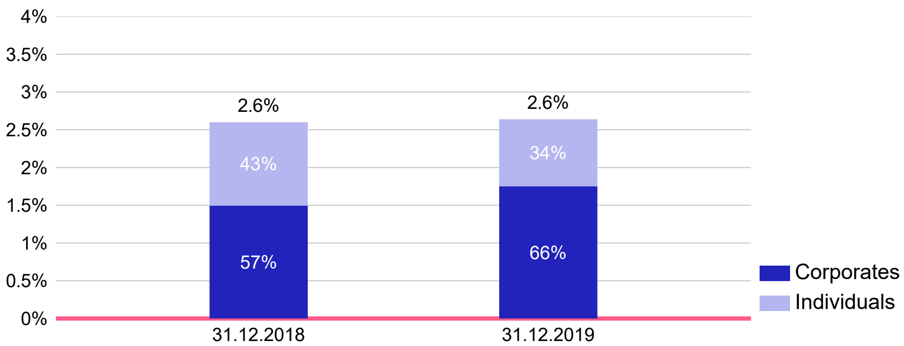
31 December 2018	PD	LGD	EL
Large Corporates	2.0%	11.5%	0.17%
Retail Corporates	4.7%	13.1%	0.88%
Individuals, Prime Mortgages	1.5%	0.6%	0.03%
Individuals, Other	2.7%	32.3%	0.79%
Weighted average	**2.1%**	**10.5%**	**0.25%**

4.8.5 Problem loans

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* takes is calculated base on the gross carrying value of loans. At the end of 2019 the Problem loan ratio is 2.6% of the loan portfolio, the same as for the end of 2018. 66% of Problem loans, by value, at year-end 2019 are loans to corporates and 34% to individuals.

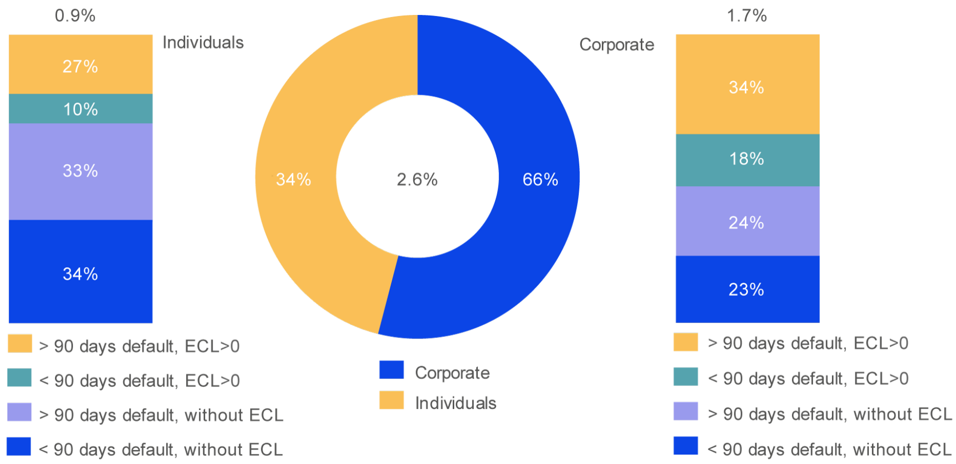
Problem loans ratio is 2.6%, at gross carrying value.

Figure 4.22 Development of Problem loans



The breakdown of Problem loans by status is shown in Figure 4.23. 54% of the Problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

Figure 4.23 Breakdown of Problem loans by status



4.9 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. Replacement risk and future risk are used to calculate the capital requirement for counterparty credit risk in combination with the counterparty's risk weights, taking into account collateral posted (credit risk mitigation, CRM).

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

31 December 2019 [ISK m]	Risk weights						
Exposure classes	0%	20%	50%	75%	100%	Total	Of which unrated
Central governments and central banks	5	0	0	0	0	5	0
Regional governments or local authorities	0	191	0	0	0	191	0
Institutions	0	1,432	4,050	0	0	5,481	34
Corporates	0	0	269	0	849	1,117	0
Retail	0	0	0	15	0	15	0
Total	**5**	**1,623**	**4,318**	**15**	**849**	**6,809**	**34**

Table 4.13 Impact of netting and collateral held on exposure values (EU CCR5A)

31 December 2019 [ISK m]	Gross positive fair value or net carrying amount	Netting benefits	Netted current credit exposure	Collateral held	Net credit exposure
Derivatives	6,719		6,719	4,814	1,905
SFTs	234		234	45	189
Cross-product netting					
Total	**6,954**		**6,954**	**4,860**	**2,094**

Table 4.14 Composition of collateral for exposures to CCR (EU CCR5B)

	Collateral used in derivative transactions				Collateral used in SFTs	
	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		1,401				516
Cash - other currency		2,666		772		
Domestic sovereign debt		327			310	
Other sovereign debt						
Institutions		40			190	
Corporate		1,069			65	44
Equity securities		5,291				
Other collateral		438				
Total		**11,232**		**772**	**565**	**560**

4.10 Informative: CPI-linked Loans Explained

Loans indexed to the official consumer price index (CPI) have been a common credit product in Iceland since 1979. An Icelandic government agency, Statistics Iceland, maintains the CPI by measuring changes in the prices paid by consumers for a reference-basket of goods and services, the composition of which is based on an expenditure survey conducted regularly. The expenditure survey has been carried out continuously since 2000, and the results are used in the annual revision of the CPI base. The CPI is published monthly.

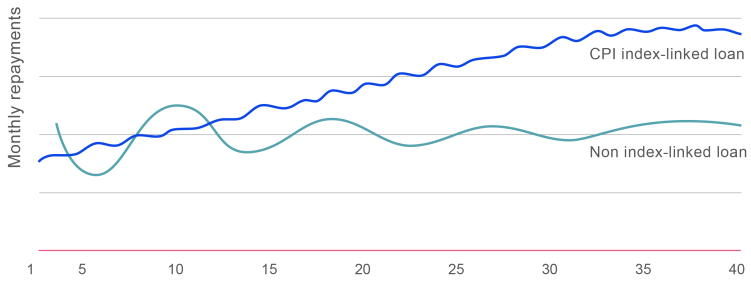
CPI-linked mortgages are a common form of mortgage lending in Iceland. They are typically annuities, where the monthly payment and the remaining principal are linked to the CPI. As the real interest rates on the loans are generally lower than nominal rates, the initial payments for CPI-linked loans are lower than those for corresponding non-CPI-linked loans. This increases the borrower's purchasing power, which contributes to the popularity of the product.

CPI-linked mortgages are typically annuities, where the monthly payment and the remaining principal are linked to the CPI

In an inflation environment there will be a gradual increase in the monthly payment. To understand the risk trade-off for the borrower it is interesting to contrast a CPI-linked mortgage and a non-CPI-linked mortgage with a variable interest rate. In a high inflation environment, with e.g. 20% annual inflation, a monthly payment of 100 would rise to 120 year-on-year. In this environment, a non-CPI borrower might see a doubling of his interest rate which could lead, approximately, to a doubling of the monthly payment. The greater risk of default for the non-CPI loan is evident in this scenario. For CPI-linked loans, the inflation effect accumulates on top of the principal, effectively being borrowed throughout the lifetime of the exposure.

For CPI-linked loans, the inflation effect accumulates on top of the principal, effectively being borrowed throughout the lifetime of the exposure

Figure 4.24 Monthly payments of a 40 year CPI-linked annuity, for illustrative purposes

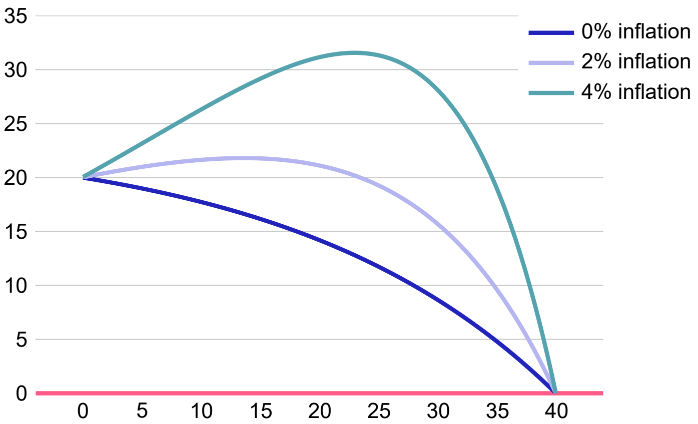


Default-risk in CPI-linked loans is further mitigated by a legislated mechanism called *payment adjustment* (IS: greiðslujöfnun). The purpose of this mechanism is to reduce the risk of borrower distress in periods when inflation outpaces increases in wages. The mechanism is triggered when the CPI exceeds the official wage index and has the effect that the monthly payment is temporarily indexed to the wage index instead of the CPI and a portion of the monthly payment is deferred. The deferred portion is drawn down once the wage index has surpassed the CPI or by extending the term of the loan.

The downside for CPI-linked loans is the borrower's equity position. Because the remaining principal is CPI-linked, in an inflation environment a negative amortization may occur, particularly during the first part of the term, see Figure 4.25. During the period of 20% inflation in the aforementioned scenario, the remaining principal would increase by approximately 20%, which could deplete the borrower's equity (LTV could increase from 80% to 100%).

In an inflation environment a negative amortization of a CPI-linked loan may occur, particularly during the first part of the term

Figure 4.25 The effect of inflation (x-asis) on the development of the remaining principal of a 40 year CPI-linked annuity [ISK m] (y-axis)



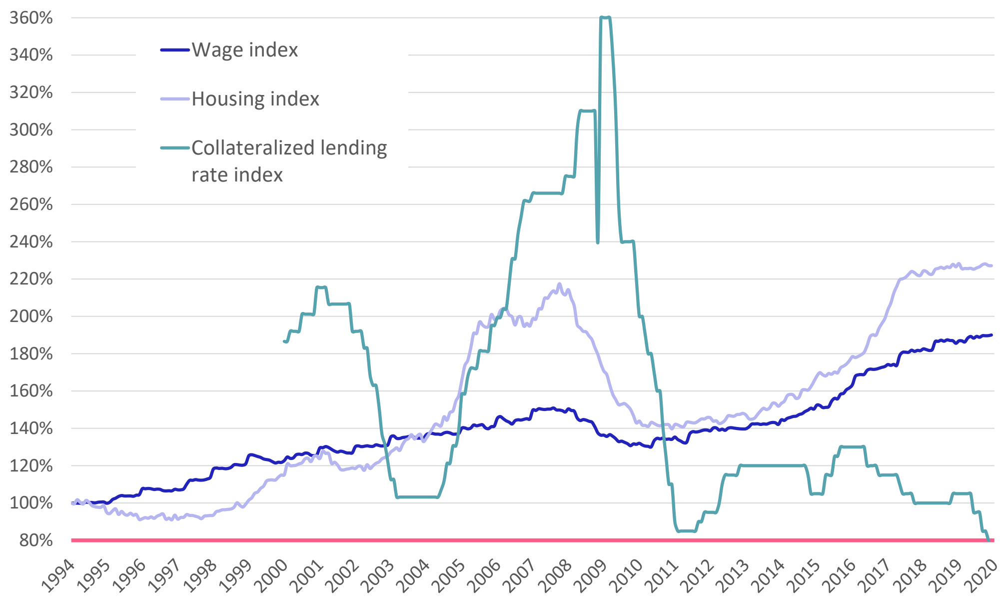
Typically wages and housing prices are correlated to the CPI in the medium and long term. Therefore, payment difficulties and LTV-deficiencies for a CPI-linked mortgage are often demonstrated to be temporary. This relationship was stressed following the financial crisis which began in October 2008. Figure 4.26 shows the development of the official wage and housing indices, in real terms. The figure demonstrates the approx.35% average drop in housing prices and approx. 15% average drop in salaries – in real terms – during the recession of 2009-2010.

The loss of home equity and purchasing power during the recession of 2009-2010 explains the loss in mortgage portfolio quality during the period

The loss of home equity and purchasing power explains the loss in mortgage portfolio quality during the period.

Figure 4.26 also shows the development of the Central Bank's key interest rate (not CPI-linked) for collateralized lending (indexed to the 5% believed to be prevailing in 1994). Periods with sharp increases in the key rate are evident.

Figure 4.26 Development of wages, housing prices and interest rates



5 **Market** Risk

5 Market Risk

Market risk is 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 Directive, 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 currencies, 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's Balance Sheet Risk department 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 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 unexpected loss to earnings due to indexation, the CPI is simulated in conjunction with interest rate movements.

5.4 Minimum Capital Requirements

The Bank's capital requirements for market risk under Pillar 1 are calculated using the standardized method as stipulated in the EU Capital Requirements Regulation (CRR) No. 575/2013.

Table 5.3 Market risk minimum capital requirements (EU MR1)

31 December 2019 [ISK m]	REAs	Capital requirements
Outright products		
Interest rate risk (general and specific)	3,854	308
Equity risk (general and specific)	6,755	540
Foreign exchange risk	10,070	806
Commodity risk		
Options (non-delta)		
Securitisation (specific risk)		
Total	**20,679**	**1,654**

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.

For management of currency risk and prudential requirement purposes, the Bank excludes goodwill positions of the subsidiary Valitor, which is classified as held for sale. The Group's accounting currency imbalance at 31 December 2019 was affected by impairments of assets denominated in foreign currencies and does not represent management's view of the imbalance at reporting date. The Value-at-Risk calculations are based on the currency imbalance as viewed by management.

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

Foreign currency [ISK m]	Net Accounting Exposure	Net Management Exposure	10 day 99%VaR
EUR	-1,278	1,620	52
USD	-2,519	-2,519	114
GBP	-219	-208	10
DKK	-3,748	-2,918	94
Other	-2,137	-2,118	110
Diversification	-	-	-168
Total	**-9,901**	**-6,144**	**213**

At year-end 2019 the Group's currency imbalance was 3.6% 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.

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 2019, the total amount of CPI-linked assets amounted to ISK 297.5 billion and the total amount of CPI-linked liabilities was ISK 208.6 billion. Therefore, the net CPI-linked imbalance was ISK 88.9 billion, which means that deflation would result in a loss for the Bank. The indexation imbalance decreased by ISK 12 billion in 2019, primarily due to contraction of indexed loans in excess of that of indexed liabilities. Furthermore, the Bank has entered into strategic derivatives positions in order to manage the imbalance.

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 82.7 billion at year-end 2019.

The Bank strives to keep its indexation imbalance stable. The Bank views the imbalance as an important hedge against loss to equity in real value terms and as a hedge against increased leverage. The price of the hedge is reflected in higher volatility of earnings in nominal terms.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. The period from 2014 to date is largely unprecedented as inflation has been around or below the Central Bank of Iceland target inflation of 2.5%. In 2019 inflation was measured at 2.0%. 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 5.1 Development of the Bank's Currency imbalance [ISK m]

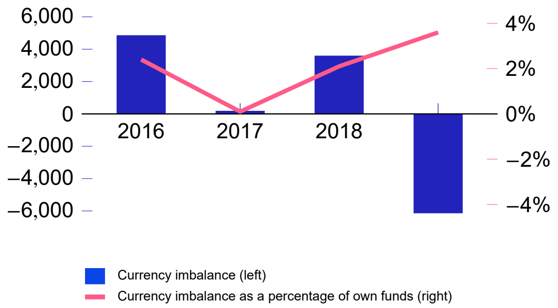


Figure 5.2 Development of the Bank's Indexation imbalance [ISK m]

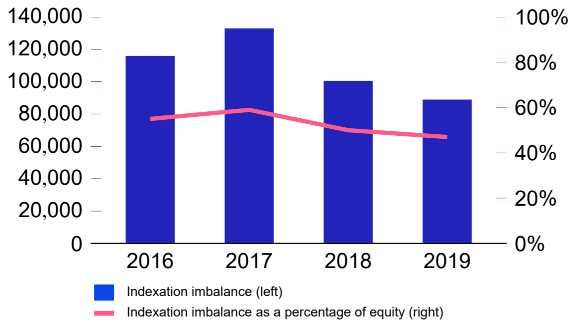


Figure 5.3 12 month inflation in Iceland

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

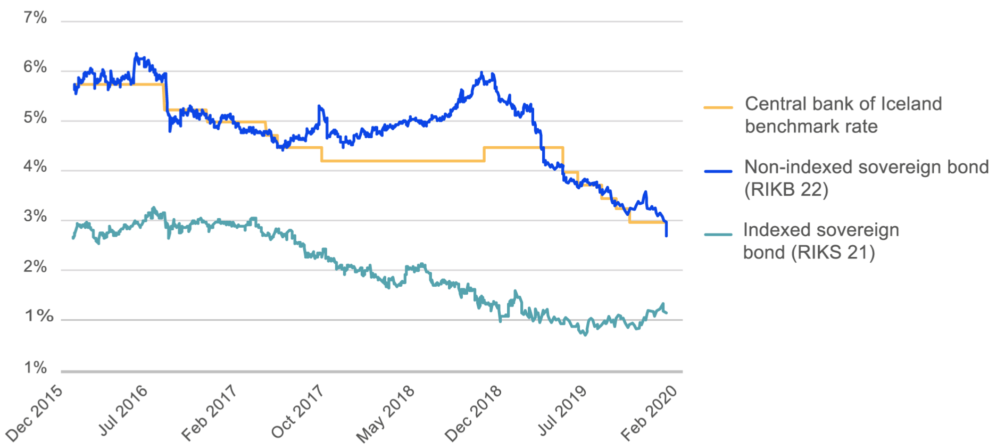
The Bank's strategy for managing interest rate risk is to strive for an interest rate balance between assets and liabilities.

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. The sale of the Arion Bank Mortgages Institutional Investor Fund (ABMIIF) mortgage portfolio, executed in October 2019, with resulting full prepayment of the remaining matched structural covered bonds issuance, significantly shortens the interest fixing profile of the Bank for indexed rates.

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 and the Bank's own prepayment options. The Bank's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing. Decreasing domestic interest rates furthermore put pressure on the Bank's net interest income as a result of tighter margins for deposit funding.

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]

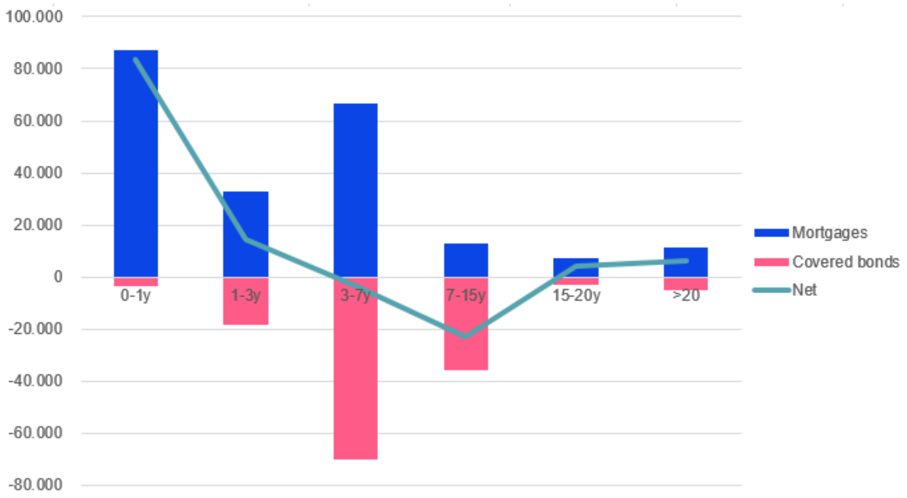


Figure 5.6 Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]

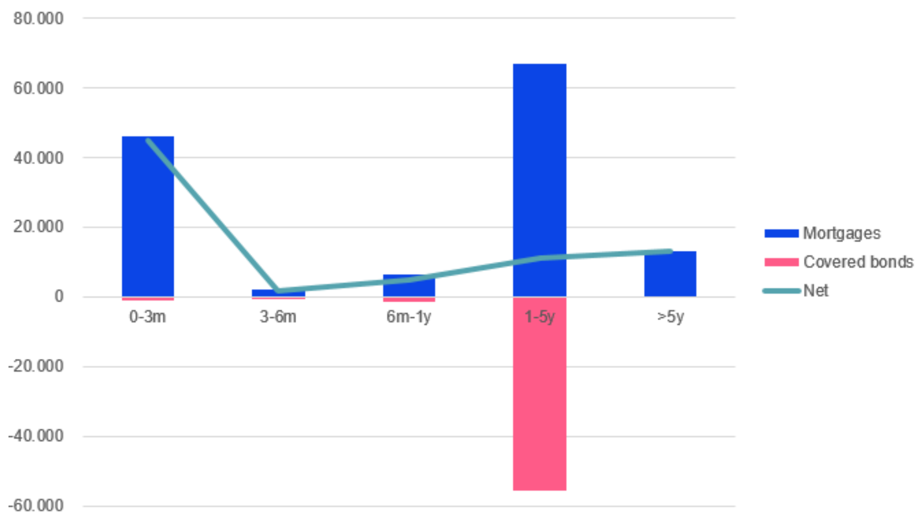


Table 5.5 shows the fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched 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. The Bank's issuance of non-prepayable non-indexed covered bonds in 2019 has resulted in the Bank's fair value sensitivity for non-indexed ISK instruments now being sensitive to lower interest rates.The decrease in fair value sensitivity for indexed rates is mainly due to the liquidation of ABMIIF. For FX instruments, the Bank is however sensitive to higher rates. This risk was reduced in November 2019 as the Bank sold FX denominated bonds from its liquidity buffer to prepay EUR EMTN issue maturing in 2020.

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

	2019		2018	
31 December [ISK m]	-100bps	+100bps	-100bps	+100bps
ISK, CPI index-linked	-3,198	2,650	-4,544	4,872
ISK, Non Index-linked	-134	209	624	-139
Foreign currencies	365	-392	700	-708
Total	**-2,967**	**2,467**	**-3,220**	**4,024**

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 on 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]	2019	2018
Bonds	5,042	6,536
Equity	2,991	2,307
Total	**8,032**	**8,843**

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 2019 average and maximum exposure in both equity and bonds.

Table 5.7 The Bank's proprietary trading exposure

31 December 2019 [ISK m]	Bonds		
	Long	Short	Net
Year-end	5,426	-384	5,042
Average	7,002	-215	6,787
Maximum	9,740	-1,062	9,740

31 December 2019 [ISK m]	Equity		
	Long	Short	Net
Year-end	3,015	-24	2,991
Average	3,127	-17	3,110
Maximum	4,425	-222	4,425

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 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 2019 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	101	177	265	-88	19,462	Market risk
Interest rate and exchange rate agreements	26	237	256	-19	18,193	Market risk
Bond swap agreements	58	46	48	-2	9,914	Credit risk
Share swap agreements	163	1,447	431	1,016	14,270	Credit risk
Options	0	0	0	0	0	Market risk
Total	**348**	**1,907**	**1,000**	**907**		

31 December 2018 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	133	747	388	359	33,721	Market risk
Interest rate and exchange rate agreements	34	162	371	-209	22,769	Market risk
Bond swap agreements	40	18	45	-27	7,538	Credit risk
Share swap agreements	144	1,341	84	1,256	8,138	Credit risk
Options	6	8	8	0	1,149	Market risk
Total	**357**	**2,275**	**896**	**1,379**		

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 4.9.

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 2019, 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.

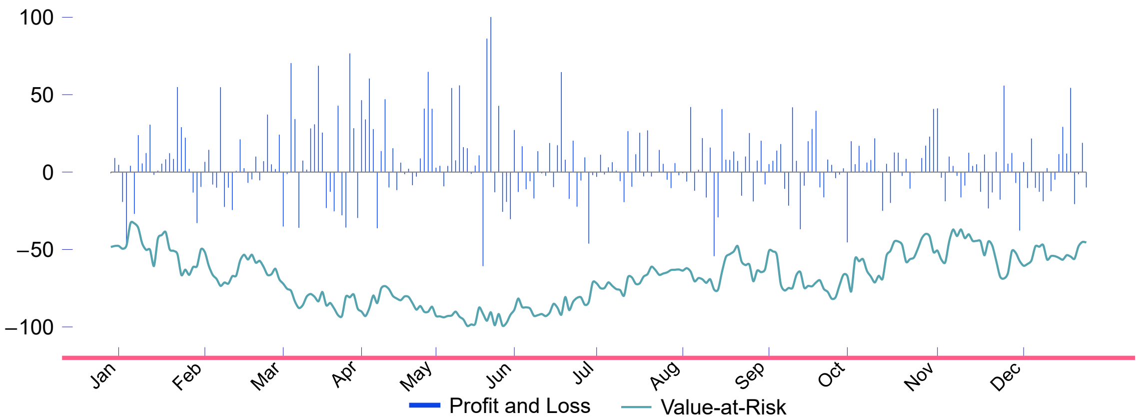
Table 5.9 Value-at-Risk for the trading book with a 99 percent confidence level over a 10 day horizon

31 December 2019 [ISK m]	10 day 99%VaR
Equities	171
Equity options	0
Bonds	53
Interest rate swaps	45
Diversification effects	-125
Trading book Total	**144**

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 144 million over a 10 day period.

Figure 5.7 further shows the daily profit and loss of the Bank's trading book for 2019 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss never exceeded the VaR 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 2019 [ISK m]



6 **Liquidity** Risk

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.

At year end 2019, Arion Bank's strong liquidity position was reflected in high LCR values, namely 188%, 334% and 158% for total, foreign currency balances and ISK respectively

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 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.

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 the Balance Sheet Risk department. Treasury provides all divisions with funds for their activities against 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 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 3.4.1, 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 following its 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. Although it is unlikely that a funding crisis of any significant degree could materialize, 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 each of the monthly ALCO meetings, based on various analysis 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.

In addition to applying the prescribed 100% minimum for LCR, the Central Bank of Iceland has implemented additional requirements for LCR in ISK, LCR in foreign currencies as well as NSFR in foreign currencies. The minimum requirement for LCR-Total, LCR-FX and NSFR-FX 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 will increase by 10 percentage points between years until reaching 50% in 2022.

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.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions in 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 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. Subject to 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 its 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 using LCR and NSFR for liquidity and funding measurement, the Bank performs various analysis, including liquidity survival horizons and stress tests in relation to the concentration of deposits.

6.4 Liquidity Position

At year end 2019, the Bank's liquidity buffer amounted to ISK 162,680 million, or 15% of total assets and 33% 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 188%, 334% and 158% for total, foreign currency balances and ISK respectively.

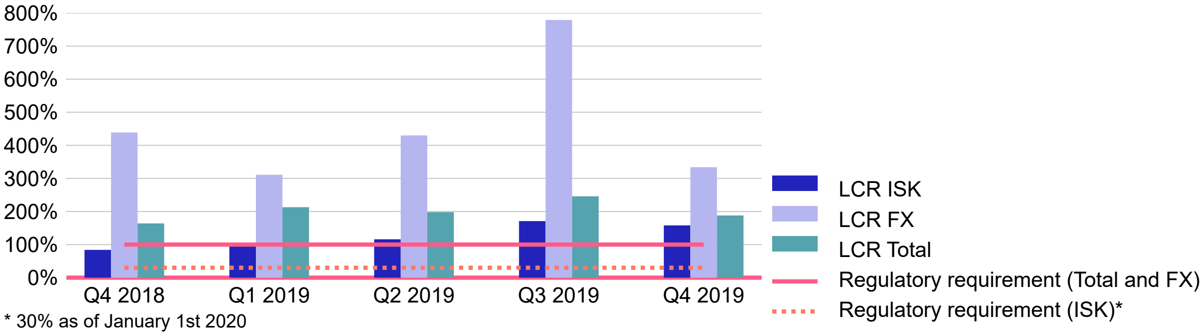
Table 6.1 Liquidity Coverage Ratio

31 December 2019	ISK	FX	Total
Liquidity Coverage Ratio	158%	334%	188%
LCR Central Bank requirements	N/A*	100%	100%

* 30% as of January 1st 2020

The Bank has held a strong liquidity position throughout 2019, 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. For EBA standardized disclosures of LCR please refer to template EU LIQ1 in the Additional Pillar 3 Risk Disclosures.

Figure 6.1 Development of the Bank's LCR



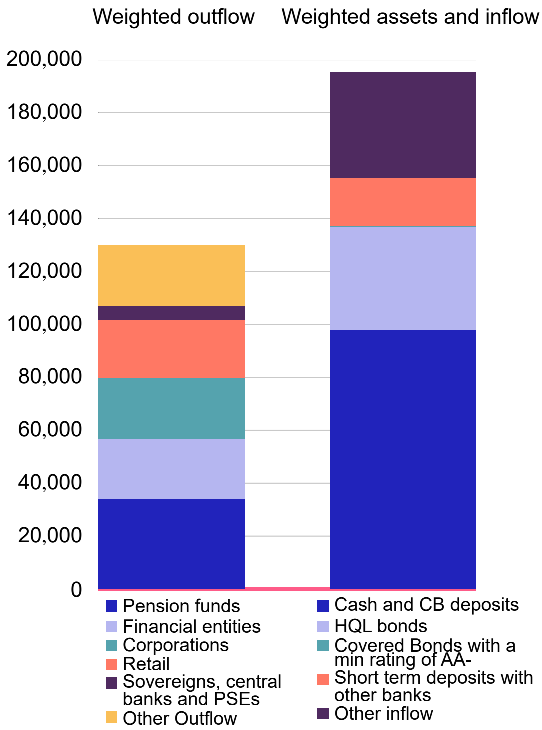
* 30% as of January 1st 2020

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 2019, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 195,311 million, substantially exceeding the weighted outflow of ISK 130,965 million. Of the total stressed outflow, ISK 113,264 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 2019 [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 6.4 shows the contribution of each category, in order of magnitude, to the stressed outflow under LCR, whereas Figure 6.3 shows the distribution of the Bank's deposit base.

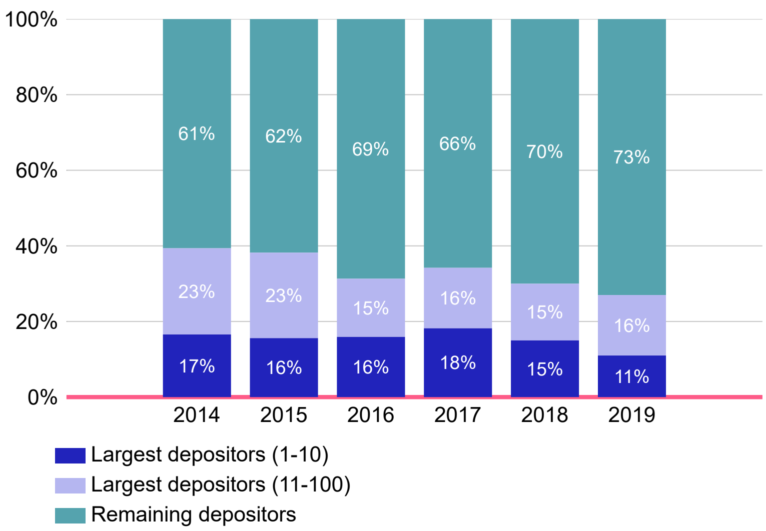
At year end 2019, 64% of the Bank's deposit base are due to retail clients, same as at year end 2018. The Bank has placed emphasis on increasing its retail deposit base.

Liquidity Risk

6.4.3 Concentration of Deposits

As seen in Figure 6.5, 74% of the Bank's deposits mature within 30 days, down from 77% at year end 2018. At the end of 2019, 11% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors, down from 15% at year end 2018 as seen in Figure 6.6.

Figure 6.6 Concentration of deposits on demand within 30 days



6.5 Funding

Over the past few years Arion Bank has taken significant steps to diversify its funding issuing senior unsecured bonds in euros and other currencies. In 2019 the Bank continued to work on diversifying its funding, such as by issuing subordinated bonds and bonds in euros and other currencies. Domestically the Bank issued covered bonds, subordinated bonds and commercial paper.

In 2019 the Bank issued ISK 14 billion under its EMTN program while in November 2019 repurchasing €258 million of a €300 million issue maturing in June 2020.

In 2019 the Bank concluded three subordinated issues in foreign currencies, EUR 5 million in March, NOK 300 million in July and SEK 225 million in December. The Bank also issued two new subordinated bonds series in Icelandic krona, totalling ISK 5.7 billion. The total issuance of Tier 2 capital was ISK 13.6 billion in 2019.

The Bank continued to issue covered bonds which are secured under the Covered Bond Act No. 11/2008. In 2019 the Bank issued covered bonds amounting to ISK 32.2 billion and fully prepaid the last remaining structured covered bond series Arion CB 2, a total of ISK 81 billion.

In recent years Arion Bank has issued commercial paper on the domestic market. In the autumn the Bank decided to stop issuing commercial paper and no further issues are planned for the time being. Commercial paper amounting to ISK 14.5 billion was issued in 2019. Outstanding commercial paper at the end of 2019 amounted to ISK 1,680 million.

Figure 6.3 Distribution of deposits by LCR categories at year-end 2019

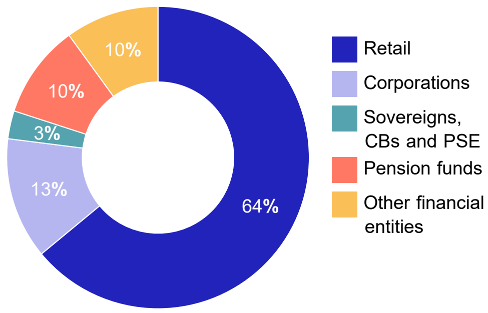


Figure 6.4 Source of impact on LCR outflow from deposits categories

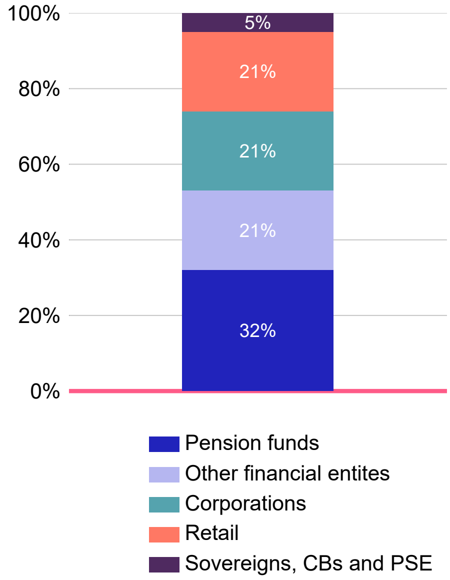
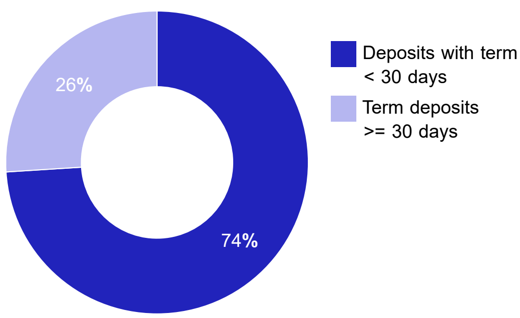


Figure 6.5 Deposit term distribution



Liquidity Risk

Standard & Poor's (S&P) affirmed Arion Bank's credit rating at BBB+ but revised the outlook from stable to negative. The short-term rating is A-2.

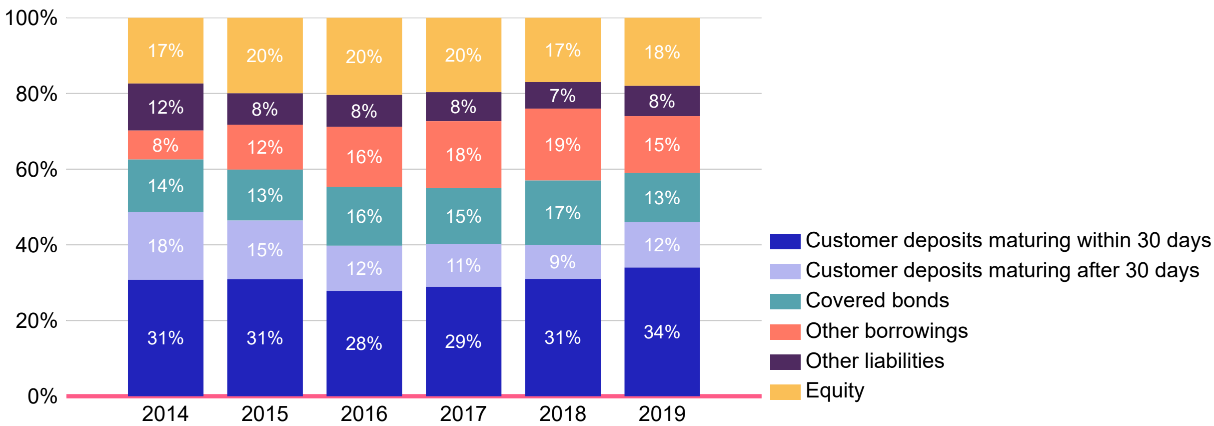
S&P noted that the revised outlook takes into account the challenges in the Icelandic banking environment and points out that an economic downturn was expected in 2019, along with falling interest rates, continued high tax rates and fierce competition from the pension funds. S&P believes that these factors will negatively affect the Bank's profitability. S&P also notes that the economy is expected to rebound in 2020.

Standard & Poor's (S&P) affirmed Arion Bank's credit rating at BBB+ but revised the outlook from stable to negative. The short-term rating is A-2

Figure 6.7 Development of the market spread for EUR bond issues of the three systematically important banks in Iceland [basis points]

Figure 6.8 shows the development of the Bank's funding profile.

Figure 6.8 Development of funding by type



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 157% as at 31 December 2019 and decreased in 2019 due to contraction of loans to customers.

The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, has decreased from 21% to 17% in the year 2019. This is primarily due to the Bank's prepayment of its last structured covered bond CB 2. The development of the loans to deposits ratio and asset encumbrance ratio are shown in Table 6.2.

Table 6.2 Development of the Bank's loans to deposits ratio and asset encumbrance ratio

31 December	2019	2018	2017	2016	2015
Loans to deposits ratio	157%	179%	166%	173%	145%
Asset encumbrance ratio	17%	21%	19%	21%	23%

At year end 2019 the Bank had an outstanding amount of covered bonds totalling ISK 145 billion. Figure 6.9 show the contractual payment profile of the Bank's covered bonds and corresponding pledged mortgages.

Other liabilities are mostly foreign currency denominated. Following the Bank's repurchase of the greater part of its EUR EMTN issue maturing in June 2020, the Bank's refinancing risk has been reduced and no significant redemptions are due in 2020. Figure 6.10 shows the Banks' maturity profile of borrowings other than covered bonds. The maturity date for Tier 2 capital instruments are shown at the earliest callable date.

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

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.

Figure 6.9 Contractual cashflow profile of covered bonds and corresponding pledged mortgages [ISK m]

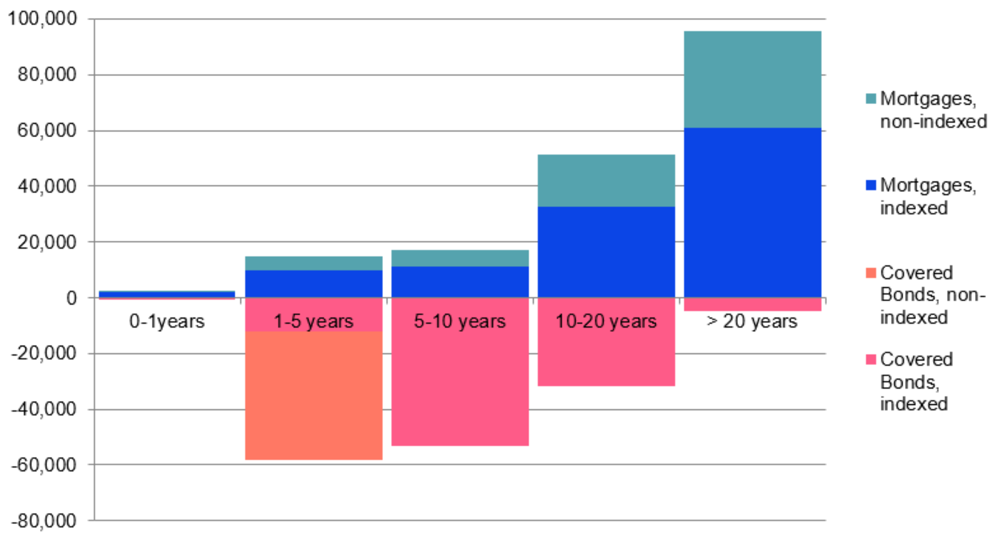
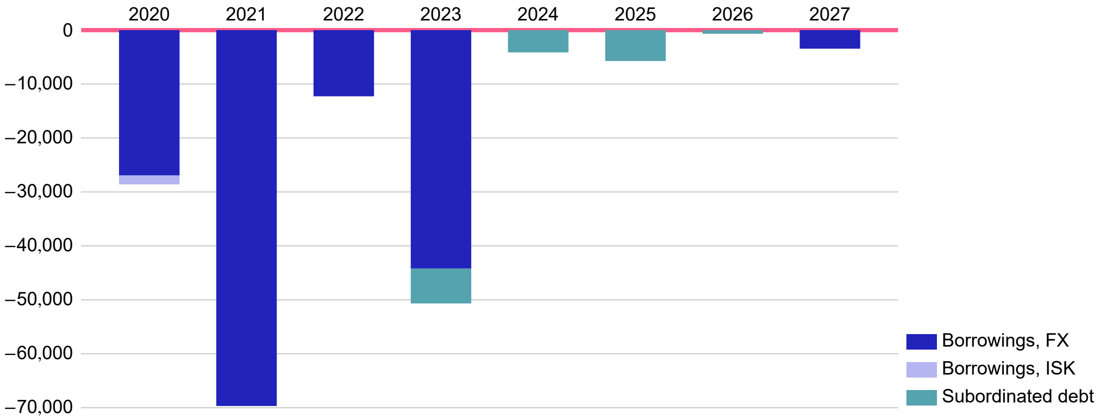


Figure 6.10 Maturity profile of borrowings, other than covered bonds [ISK m]



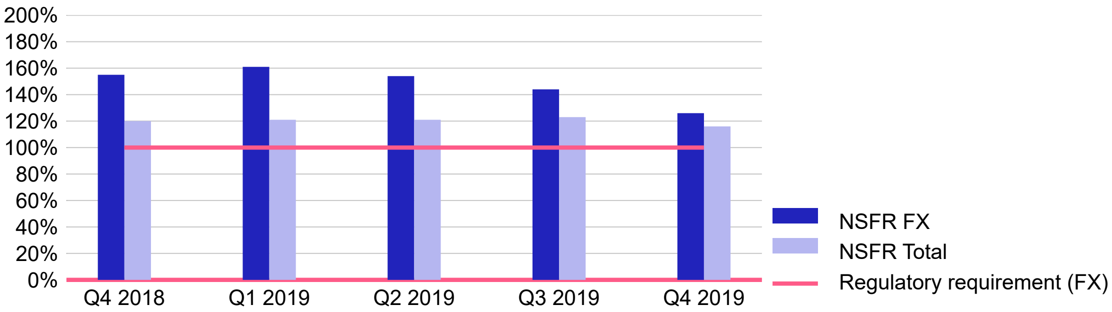
The NSFR for financial institutions' foreign currency positions shall be greater than 100%. The Bank's NSFR in foreign currencies is at 126% at year-end 2019 while the total NSFR is 116%. The Bank has held the NSFR-FX level well above the minimum regulatory requirement during 2019, as well as a strong NSFR-total as seen in Figure 6.11.

The Bank's NSFR in foreign currencies is at 126% at year-end 2019 while the total NSFR is 116%

Table 6.3 Net Stable Funding Ratio

31 December 2019	FX	Total
Net Stable Funding Ratio	126%	116%
NSFR Central Bank requirements	100%	N/A

Figure 6.11 Development of the Bank's NSFR



7 **Operational** Risk

7 Operational Risk

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

Legal risk, conduct risk, model risk and IT risk are among others subcategories of operational risk. See section 8.1 for further information on legal risk).

Each business unit within the Bank is primarily responsible for managing their own operational risk. The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk.

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

7.1 Operational Risk Policy

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank reduces its exposure to operational risk with a selection of internal controls and quality management, educated and qualified staff, and awareness of operational risk. The Bank follows the Basel principles of sound management of operational risk. This policy defines operational risk at a high-level and delegates responsibility for further implementation and compliance within the Bank.

The Bank reduces its exposure to operational risk with a selection of internal controls, quality management and well-trained and qualified staff

7.2 Operational Risk Management Framework

The operational risk management framework at the Bank aims at integrating risk management practices into processes, systems and culture. The Operational Risk department serves as a partner to senior management, supporting and challenging them to align the business control environment with the Bank's strategy by measuring and mitigating risk exposure, contributing to optimal return for the stakeholders.

The ideology behind the framework is based on the effectiveness of managing processes, their risks and controls, analyzing deviations from best practices and continuously improving the operation.

Figure 7.1 Operational risk management framework

Process Management

The most important business processes are documented, where primary activities, risks and respective controls are identified, along with employee roles and responsibilities. A uniform methodology is used to improve efficiency and increase standardization within the operation. Process mapping is not only an effective method to streamline the operation but necessary to determine the risks within the processes and relevant control activities.

Risk Assessment

The Bank regularly performs a formal Risk and Control Self-Assessment (RCSA) on the main processes underlying the operation, detecting and evaluating risks within the processes, and the effectiveness of the respective controls. The risks are assessed based on severity and likelihood of an event occurring as well as the effectiveness of the internal control environment. The assessment of the severity of an event includes both financial losses and reputational damage. Actions are planned for risks with extreme, high or moderate impact due to insufficient controls. The goal is to bring relevant risks to acceptable levels by enhancing the control environment.

The goal of the operational risk management is to bring relevant risks to acceptable levels by enhancing the control environment. The Operational Risk department follows up on the planned actions with the units

Control Management

Internal controls minimize losses from operational risk events and ensure that the Bank's operation is efficient, compliant and that information is reliable, timely and complete. The Bank's internal controls involve management control as well as confirmation and testing of controls. Key ICFR controls are tested periodically based on design, implementation and performance.

Deviation Analysis

The Bank captures information on deviations from the Bank's standard operations, resulting in financial loss (loss data) or near miss. This provides meaningful information on operational risks and the effectiveness of internal controls. The analysis involves the impact of deviations on financial losses, damage to the Bank's reputation and the Bank's capital requirements. The information is utilized to understand the root cause of the event to be able to mitigate the risk and improve internal controls.

In order to quantify the operational risk the Bank faces, it uses the categorisation from Basel. This allows it to quickly draw out a statistical summary that shows to which category most of the events belong and where the most significant losses occur.

Corrective Actions

Any issues arising from the RCSA, deviation analysis or control testing, findings resulting from internal or external audits, or regulator demands are used to enhance the internal control environment of the Bank and can result in remediation on processes or internal controls. Once the issues are identified, analyzed and assessed, the responsible unit is in charge of improvements, but the Operational Risk department will support and follow up on planned actions.

7.3 Change Management Process

The Bank has an approval process for all critical changes within the operation. This includes new or changed products, activities, processes and systems. The process assesses the possible impact on the Bank's processes, risks, controls and systems. The process is used for new products, services or systems that are currently not offered to clients or a significant change to an existing product, service or systems. The process ensures an appropriate level of cross communication with all stakeholders and an adequate preliminary assessment prior to implementation.

With the rapid changes in product offerings and product distribution channels the change management process has become even more important to support successful changes and safe implementation. Special focus is on securing the interest of the consumers, both regarding the product characteristics and the way they are offered.

7.4 IT Risk and Cyber Security

Information security means that information is protected against a variety of threats (including threats from cyberspace), to ensure business continuity, to minimize damage and to maximize performance. Information- and cyber security practices at the Bank have a foundation in globally recognized and proven security standards and frameworks, strong partnership with trusted partners and vendors in information security and continued strengthening of security awareness amongst employees.

The Bank follows a risk-based approach to information security in order to ensure business continuity by guarding the confidentiality, integrity and availability of its data, systems and services and to remain compliant at all times with current laws and regulations. A reliable, efficient three lines of defense is in place to secure the quality and effectiveness of the Bank´s Information Security Program.

The Bank's Security Officer (SO) is responsible for the day-to-day supervision of issues relating to the Bank's IT and Information security, and is under the authority of the Security Committee. The Security Committee is responsible for the implementation and enforcement of the Bank's security policy.

Risk related to information security is managed according to the Bank's Information Security Management Manual and is based on best practices according to ISO/IEC27001:2013 Information technology - Security techniques - Information security management system - Requirement and the Information Technology Infrastructure Library (ITIL). The Bank has in place a business continuity management (BCM) approach with the aim to ensure that specific operations can be maintained or recovered in a timely fashion in the event of a major operational disruption.

The Bank has in place a business continuity management (BCM) approach with the aim to ensure that specific operations can be maintained or recovered in a timely fashion in the event of a major operational disruption

To understand security risks better, the Bank conducts a special Information Security Risk Assessment on the Bank's most important assets, according to Guidelines No. 1/2019 on the Information Systems of Regulated Parties published by the FSA.

7.5 Operational Risk Measurement

The Bank uses Key Risk Indicators (KRIs) to provide an early warning that may be indicative of increased risk and/or ensure that risks remain within established tolerance levels.

Major Incident (MI) is an event causing interruption in IT or a failure in a system classified as important. As these events can affect the service level provided to the Bank's customers and can, if serious enough, harm the operation, they are managed through a robust MI process. The purpose of the process is to ensure firm, coordinated and controlled action in the occurrence of MI, in order to restore service as soon as possible with minimum interruptions and damage to the business.

All Major incidents are classified into one of the three categories, Minor, Partial or Extensive. Minor are incidents that have little impact but need quick reactions, Partial are incidents that have a moderate and delimited effect on the business, and Extensive are incidents that have a significant impact on the Bank and are reported to the FSA by the Security Officer.

In the beginning of 2019 the 12 and 3 month averages in the number of MIs continued to increase from 2018. As can be seen in figure 7.2 the number of MIs dropped drastically as of June 2019. This is primarily linked to the fact that in May the IT Release Process was reinforced. This reinforcement is believed to have decreased the number of Partial MIs, which translates to the drop in the averages.

The Bank utilizes deviation data to quantify the operational risk the Bank faces in its current affairs. The MIs are naturally a part of the Bank's deviation events but are handled separately in order to ensure firm, coordinated and controlled action like mentioned earlier.

Figure 7.2 Development of Major Incidents in IT

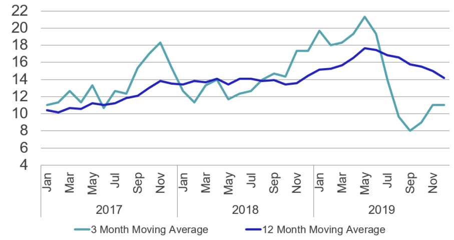


Figure 7.3 Distribution of loss events by number, parent company

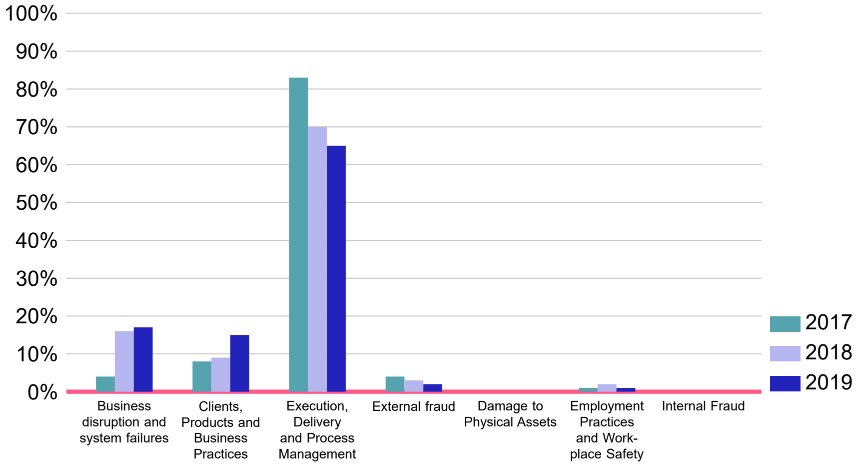
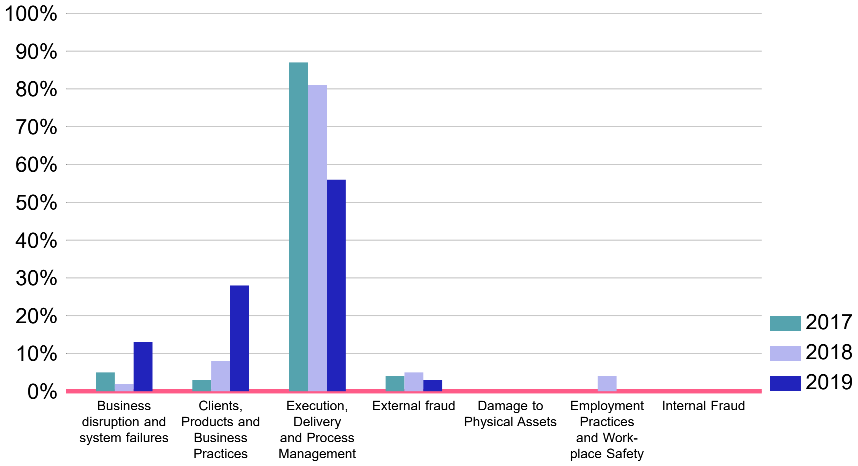


Figure 7.4 Distribution of loss events by amount, parent company



7.6 Internal Control Over Financial Reporting

Internal Control over Financial Reporting (ICFR) is a process designed to provide reasonable assurance regarding the reliability of financial reporting and reduce the risk of misstatement. The Bank's ICFR is based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Operational Risk unit has taken on the role of ICFR coordinator.

The ICFR framework is built upon five internal components: Control Environment, Risk Assessment, Control Activities, Information & Communication and Monitoring. The text below describes how the ICFR work is organized within the Bank with regards to these five components to ensure structured monitoring of key controls.

Process Risk Assessment and ICFR Catalogue

In order to identify and understand the risks in the financial reporting, the Bank has identified the key processes affecting the financial statements. The processes were risk assessed and key controls, that mitigate the assessed risk, were identified. The Bank will continuously monitor that the most significant risks are identified and that the controls in place will appropriately mitigate the risks.

The identified risks and key controls that affect the financial reporting are listed in the ICFR catalogue with a detailed description. The ICFR coordinator and Group Accounting continuously communicate with involved parties within the Bank that are responsible for controls, to set expectations and clarify responsibilities. The framework consists of group-wide controls as well as IT and process controls, for example, validation of the valuation of financial instruments.

Control Monitoring and Testing

The controls are monitored and evaluated on a continuous basis by control owners through self-assessments. Control owners shall confirm the implementation and effectiveness of controls which they are responsible for.

The ICFR coordinator performs a formal testing of all of the key controls that have been assessed as significant in mitigating risks regarding the financial closing of the Bank. The tests are performed in accordance with an annual testing plan that is based on the frequency and risk of failure in the performance of each control. The testing focuses on the design and implementation of each control and whether the control was performed. The results from the evaluations of the controls are analysed to assess the risk of misstatements in the financial reporting.

The Bank has issued procedures on the management and testing of controls within the Bank, linking the responsibility of controls to the overall internal control framework of the Bank.

Reporting

Annually the ICFR coordinator reports to the BAC the outcome of the self-assessment and testing. Group Accounting is responsible for updating the Bank's financial handbook and other accounting instructions and making them available to the reporting units.

8 **Other Material** Risk

9 **Remuneration**

10 **Forthcoming and New** Legislation

11 **Abbreviations**

8 Other Material Risk

In addition to the previously mentioned risk categories, the Bank faces other types of risks. Of these risk types, the Bank has identified legal and compliance risk, business risk and political risk as material risk. Other risk categories are not considered material, and will not be discussed further.

8.1 Legal and Compliance Risk

Legal risk is defined as the risk to the Bank's interests resulting from instability in the legal and regulatory environment, as well as risk arising from ambiguous contracts, laws or regulations. The Bank assesses capital need for legal risk as part of ICAAP and holds additional capital for exceptional cases.

The Bank assesses capital need for legal risk as part of ICAAP and holds additional capital for exceptional cases

Compliance risk is defined as the risk of not complying with rules and guidelines applicable to the firm as a licensed bank regarding rules and guidelines targeting the financial sector, as a listed company, and as a company with large scale processing of personal data. Compliance risk can lead to fines, damages and/or the voiding of contracts and can diminish the Bank's reputation.

In November 2019 the Bank and the FSA agreed to reach a settlement on the violation of Article 8 (2) of the Securities Transactions Act No. 108/2007. The Bank agreed to pay a fine of ISK 21 million and acknowledged that it had failed to keep a formal and systematic record of its analysis of conflicts of interest concerning the financing of the United Silicon plant at Helguvík.

Frequent changes to applicable requirements, and any ambiguous requirements, increase compliance risk. The Bank monitors upcoming changes, and has in place procedures for regulatory change management. Foreseeable changes in legislation that might affect the Bank are discussed in Chapter 10. These risk factors are considered in the Bank's ICAAP.

Legal Claims

Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. 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 makes adjustments to account for any adverse effects which the claims may have on its financial standing. The largest cases concerning the Bank and possible impact on the Bank's financial position, can be put into a two categories: a) court cases and b) cases before supervisory authorities. In 2019 there were several legal matters or unresolved legal claims that were considered contingent liabilities, such as legal proceedings regarding damages. The Bank is a party to a few significant cases that fall into category a). Description of these cases can be found in Note 37 in the Consolidated Financial Statements for 2019.

Competition

Competition is one of the factors that the Bank is constantly monitoring. To safeguard its own competitive practices, the Bank has set a competition compliance policy. According to the compliance policy, the Bank endeavors to protect and encourage active competition for the good of the consumer, the business sector and society at large. It is furthermore the Bank's policy to practice effective and powerful competition on all the markets on which it operates. An integral component of the Bank's competition policy is to ensure that the Bank complies with competition law at all times.

An integral component of the Bank's competition policy is to ensure that the Bank complies with competition law at all times

8.2 Business Risk

Business risk is defined as risk associated with uncertainty in profits due to changes in the Bank's operations and competitive and economic environment. Business risk is present in most areas of the Bank. Business risk is considered in the Bank's ICAAP.

The Bank faces competition in the marketplace. Competition from less regulated financial institutions has been increasing in recent years, for example the use of specialized credit funds that are able to offer better terms for quality loans. The pension funds' expanded participation in the mortgages market for individuals is further affecting the Bank. The Bank responds by offering more versatile and tailored services, and competes on price where possible. Another threat is competition from foreign banks that mainly target strong Icelandic companies with revenues in foreign currency.

Another competitive factor facing the Bank is the large footprint of the Icelandic State in financial services through its ownership in Landsbankinn hf., Íslandsbanki hf., The Icelandic Housing Financing Fund and the Icelandic Student Loan Fund, who together are representing the largest pool of all loans to individuals. In recent statements, Iceland's Minister of Finance and the Chairman of the Icelandic State Financial Investments (ISFI) have indicated that the government could soon begin the process of releasing the state's ownership of Islandsbanki. The privatisation of a significant share of Icelandsbanki could impact Arion Bank's competitive environment.

Arion Bank faces a business risk in the form of specific Icelandic taxes which increase the operating costs of Icelandic banks and undermine their competitiveness compared with other lenders in Iceland and abroad. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion. The bank levy will be decreased in four even steps in the next four years, from 2020 to 2024. In the year 2020 the bank levy will be 0.318%, ending with a 0.145% tax rate effective from 2024. See section 10.1 for further information.

Special taxes on Icelandic banks include the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion

8.3 Political Risk

Political risk is defined as risk to the Bank's interests resulting from political uncertainty, e.g. from political decision making or destabilizing political events, which therefore lead to instability in the legal and regulatory environment. In the present political and economic environment in Iceland, the Bank faces some political risk.

Government measures during the last decade, many of which represented a logical response to circumstances at that time, restrict the ability of Icelandic banks to lend money and reduce their capacity to support value creation and economic growth. Now that economic growth has slowed down, it is more important than ever for financial institutions to be able to perform their roles as financial intermediaries effectively.

Iceland is part of the EEA Agreement and applies therefore most of the European Union legislation in the financial services sector. The Single Rulebook of the European Union aims to provide a single set of harmonized prudential rules which institutions throughout the EU must respect. Nevertheless, a number of special Icelandic rules in the field of financial services are still to be found.

Given discussions in the Icelandic Parliament there is a certain possibility that the government will resort to regulatory restrictions that are different and more stringent than reforms being discussed in the rest of Europe. As the Icelandic Sate is now the majority owner of the Bank's principal domestic competitors, Landsbankinn hf. and Íslandsbanki hf., the likelihood of this event may have increased.

In October 2019, the Financial Action Task Force (FATF) decided to place Iceland on its list of jurisdictions with strategic AML/CFT deficiencies. Icelandic authorities consider this decision to be unwarranted and disproportionate, and expect Iceland to be removed from the list at the next possible opportunity. Moreover, authorities have noted that none of remaining issues directly concern Icelandic financial companies. Although the decision has not yet had any material impact on the Bank, it increases the Bank's political risk and risks damaging international relations.

Foreseeable changes in legislation that might affect the Bank are discussed in Chapter 10. These risk factors are considered in the Bank's ICAAP.

8.4 Environmental, Social and Governance Risk

Arion Bank is increasingly conscious of risks arising from Environmental, Social and Governance factors and is exploring methods to manage its exposure to these risk factors.

During 2019 the Bank became a signatory to UN PRB, Principles for Responsible Banking, along with 130 banks from various countries. The principles are created by United Nations Environment Programme – Finance Initiative (UNEP FI), which is a partnership between United Nations Environment and more than 250 financial institutions across the world working to understand today's environmental, social and governance challenges. The principles place a strong emphasis on environmental issues and they are designed to align banking with international goals and commitments such as the UN Sustainable Development Goals and the Paris Climate Agreement.

In 2019 the Board of Directors adopted an ambitious environmental and climate policy with targets for the next few years. Under the policy Arion Bank is committed to contributing to efforts to ensure that Iceland can meet its obligations under the Paris Climate Agreement and other local and international environmental and climate agreements. Targets for the next few years were also adopted and in 2020 Arion Bank will evaluate its loan portfolio according to green criteria and establish targets in this respect. These targets entail that the Bank will increasingly turn its focus on to financing projects which relate to sustainable development and green infrastructure. When evaluating suppliers the Bank will require them to take into account the environmental and climate impact of their activities.

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 the FSA's Rules No. 388/2016, on Bonus Schemes under the Act on Financial Undertakings. The policy is an integral part of Arion 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.

The Design of the Remuneration System

Arion Banks remuneration policy is framed in accordance with regulatory requirements, such as those established in the FSA Rules No. 388/2016 on Bonus Schemes under the Act on Financial Undertakings. Arion 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 2019, 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 with regard to employee remuneration is to offer competitive salaries in order to be able to attract and retain outstanding and qualified employees. 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 its healthy 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 previously cited FSA's rules on Bonus Schemes under the Act on Financial Undertakings, 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

Lastly, in accordance with the Rules, Risk Management, Compliance and Internal Audit review and analyze whether the variable remuneration scheme complies with the aforementioned rules and the Bank’s remuneration policy. The objective of the scheme is to incentivize employees to help the Bank achieve its objectives. Well defined measures concerning risk and compliance are an integral part of the scheme. Parameters deciding the amount of the payments are on four levels:

- The performance of the Bank as a whole (these include return on equity, return on risk-weighted assets and costs-to-net income)
- Performance of individual divisions
- Performance of individuals
- Compliance with internal and external rules

In 2019 the Board approved, after considering the current standing of the bonus scheme, that the scheme will be temporarily suspended and other options are being considered.

In 2019 the Board approved that the scheme will be temporarily suspended

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 5 times in the year 2019. 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.

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 CEO decides on a salary framework for Managing Directors and the Compliance Officer in consultation with the Head of Human Resources taking into consideration the size of the relevant division and level of responsibility.

A performance based compensation system has been in place since 2013 where both BRC and BRIC have a role as regards its design. 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. About 85 employees take part in the scheme. They include the CEO, Managing Directors, many heads of divisions as well as several other employees. Excluded are the CRO, the Internal Auditor, the Compliance Officer, the Head of Research[1] and all the employees they manage.

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

[1] During organizational change in September 2019 the Research department was eliminated and the new role of Chief Economist was introduced.

Remuneration

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 remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution. Table 9.1 discloses information on remuneration for all employees not excluded from variable remuneration.

Table 9.1 Remuneration broken down by business areas

[ISK m]	Markets	Corporate and Investment banking	Retail banking	Other functions
Total remuneration in the year 2019	593	706	2,228	2,727
of which variable remuneration	0	0	0	0

Table 9.2 Remuneration broken down by fixed and variable remuneration

[ISK m]	Executive management committee	Other beneficiaries
Number of beneficiaries	7	78
Total remuneration in the year 2019	260	1,485
Fixed remuneration	260	1,485
Variable remuneration	0	0
of which cash	0	0
of which to be paid out	0	0
Ratio of variable remuneration to fixed	0.0%	0.0%
Outstanding deferred remuneration		
Outstanding deferred remuneration from previous years	24	139
Deferred remuneration awarded during 2018	0	0
Reduced through performance adjustments	0	0
Vested in 2019 and paid out	-12	-67
New sign-on and severance payments made during 2019	7	-
Number of beneficiaries	1	-
Severance payments awarded during 2019	-	-
Number of beneficiaries	-	-
Highest severance payment	-	-

Table 9.2 shows total remuneration earned in the financial year 2019 by the members of the Executive Management Committee of Arion Bank, as well as other beneficiaries, separated into fixed remuneration—including pension contributions and other salary related benefits—and variable, performance based remuneration. Regular remuneration payments related to the duration of a notice period are not considered as severance payments.

Boards of directors of individual subsidiaries decide on an incentive scheme for the subsidiaries. The Asset Management Company Stefnir has an incentive scheme in place while the card and payment solution company Valitor does not. For information on a consolidated basis, see Note 12 in the Consolidated Financial Statements for 2019.

10 Forthcoming and New Legislation

As a financial undertaking Arion Bank and many of its subsidiaries must comply with various laws and regulations. The legal environment is dynamic and the Bank must therefore constantly monitor forthcoming changes to legislation in order to meet legal requirements at any given time. The following section covers recent legislative activities by Parliament, Althingi, as well as some of the forthcoming legislation announced by the Icelandic authorities.

10.1 New Legislation

Act No. 131/2019 amending the Act on Special Tax on Financial Undertakings, No. 155/2010

This Act, was revisited and amended by Parliament in 2019. The previous tax rate on "bank levy" was 0.376% but this amending Act legalizes an even four step decrease in the tax rate from 2020-2024, ending with a 0.145% tax rate effective from 2024. Namely, the Act prescribes that:

- Taxation in 2021 for the 2020 tax year will be 0.318%
- Taxation in 2022 for the 2021 tax year will be 0.261%
- Taxation in 2023 for the 2022 tax year will be 0.203%
- Taxation in 2024 for the 2023 tax year will be 0.145%

Arion Bank urged members of parliament to go even further in a draft bill comment without avail.

The Act entered into force 1 January 2020.

Acts No. 91/2019 and 92/2019 on the merging of the Financial Supervisory Authority and Central Bank of Iceland

The Financial Supervisory Authority and the Central Bank of Iceland merged under the name Central Bank of Iceland at the turn of the year. The prelude to the merger stems from the October 2018 decision by the Ministerial Committee on Economic Affairs and Financial System Restructuring to begin reviewing the statutory framework for monetary policy, macro prudential policy, and financial supervision following wide-ranging examination and preparation. The institution operates pursuant to the Act on the Central Bank of Iceland, No. 92/2019.

The Governor of the Central Bank directs and is responsible for the Bank's operations and is authorized to take decisions on all matters not entrusted to others by law. Decisions on the application of the Bank's monetary policy instruments are taken by the Monetary Policy Committee, decisions on the application of financial stability policy instruments are taken by the Financial Stability Committee, and decisions falling under the auspices of the Financial Supervisory Authority are now entrusted to the Financial Supervision Committee.

The Acts entered into force 1 January 2020.

Forthcoming and New Legislation

Act No. 82/2019 on the Registration of Beneficial Ownership

A new Act which transposes Articles 30 and 31 of Directive 2015/849/EU (AML4), with amendments. It entails an obligation to identify all beneficial owners in the business registry and grants competent authorities access to information on beneficial ownership. With an amendment act later in 2019 the deadline for registration was shortened. Legal entities registered before 30 August 2019 must now inform the business registry of its beneficial owners no later than 1 March 2020 instead of the previous 1 June 2020 deadline. The shortening of the deadline is linked with the Parliament's reactions to the Financial Action Task Force's Grey Listing of Iceland.

The Act entered into force 6 July 2019.

Act No. 59/2019 amending Act on Deposit Guarantees and Investor- Compensation Scheme No. 98/1999

The amending Act decreases contributions from commercial- and savings banks to the Depositors' and Investors' Guarantee Fund. After the decrease the contribution amounts to 0.02% of all deposits up to ISK 10 billion and 0.16% of all deposits in excess of ISK 10 billion annually or 0.005% of deposits up to ISK 10 billion and 0.04% in excess of ISK 10 billion on quarterly due dates.

The Act came into force 1 July 2019.

Act No. 31/2019 Act on Interchange Fees for Card-based Payment Transactions

The Act is an adoption of Regulation 2015/751/EU on interchange fees for card-based payment transactions. The regulation was adopted with the particular aim of addressing the problem of widely varying collectively-agreed inter-bank fees regarding card and card based transactions. It introduces EU wide ceilings for such interchange fees. It also addresses rules limiting retailers' possibilities to steer consumers to using cards with lower fees.

The Act entered into force 1 September 2019.

Act No. 14/2019 amending the Foreign Exchange Act, No. 87/1992, and the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, No. 37/2016

The Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, No. 37/2016, entered into force on 22 May 2016. The Act was an important element in the authorities' capital account liberalization strategy. The restrictions were expected to be temporary and in 2019 it was deemed that resident entities' asset portfolios had been better rebalanced and conditions allowed for liberalization without excessive risk to economic and financial stability.

The amendments entail permission for owners of offshore króna either to close out their offshore króna positions in full by exchanging them for foreign currency in the onshore market or to hold them as unrestricted onshore króna assets in cases involving continuous ownership from the time before the capital controls were imposed. If the bill is passed into law, this will provide expanded authorizations for withdrawals from accounts subject to special restrictions. These expanded authorizations are of three types.

First is a general authorization for all holders of offshore króna to release their offshore króna assets in order to purchase foreign currency and export it to an account abroad. Second is an authorization for offshore króna holders that have owned offshore króna assets continuously since 28 November 2008 to release those offshore fkr assets from the legal restrictions. Third is an authorization for individuals to withdraw up to ISK 100 million from accounts subject to special restrictions. Offshore króna holders that have not owned their assets continuously since before the capital controls were furthermore subject to other conditions to ensure the equal treatment of foreign investors.

The Act entered into force 5 March 2019.

Act No. 8/2019 amending the Financial Undertaking Act No. 161/2002, concerning the Board of Directors, CEO and audit

The Act amends the Act on Financial Undertakings, concerning the Board of Directors, CEOs, auditors and audit firms. The amendments are based on Directive 2013/36/EU (CRD IV). First off it is stipulated that board members and CEOs should allocate sufficient time towards their position in a financial undertaking. The amendments also establish a limit to the number and nature of directorships for members of the management bodies of a systematically important financial undertakings.

The Act entered into force 22 February 2019.

Act No. 78/2019 on Security of Network- and Information Systems of Important Infrastructures

This new Act transposes the substantive provisions of Directive 2016/1148/EU on Cybersecurity of network and information systems (NIS Directive).

The objective is to harmonize minimum requirements regarding risk management and capabilities of major infrastructures as well as legalizing notification requirements in cases of serious incidents, regarding network and information systems.

Additionally it is worth noting that the bill imposes strict standards on operators, including the Bank, regarding specific organization of their network and information security as well as the overall framework of risk management and capabilities. Failure to meet the imposed standards can lead to sanctions. On the other hand the operators gain valuable access to the post and telecom administration, safety and response team.

The Act will enter into force 1 September 2020.

Act No. 138/2019 amending the Act on Investment by Non-residents in Business Enterprises No. 34/1991 concerning the abolition of living conditions

The Act is a legislative response to a comment from the EFTA Surveillance Authority (ESA) concerning the then conditions on residency and domicile of board members and CEOs in Icelandic business enterprises. ESA considered the conditions to be in disagreement with the Agreement on the European Economic Area. This Act amends the conditions to conform to the Agreement by removing the domicile requirements within EU/EEA/Faroe Islands and rather focusing on citizenship.

The Act entered into force 24 December 2019.

Act No. 64/2019 on the Freezing of Funds and Designation of Entities on a Sanctions List in relation to Terrorism Financing and the Proliferation of Weapons of Mass Destruction

This Act is one of the legislative responses to the Financial Action Task Force (FATF) comments on Iceland's defences against money laundering and terrorist financing. The purpose is to set out procedural rules on the freezing of assets in connection with certain sanctions decided by the UN Security Council cf. Article 41 of the UN Charter.

The Act entered into force 3 July 2019.

Act No. 56/2019 amending the General Penal Code, Act respecting Public Limited Companies, Act respecting Private Limited Companies, Act respecting Foundations Engaging in Business Operations concerning the misuse of company forms and on conditions of qualification

A new paragraph was added to the General Penal Code stating that any person found guilty of violating Art. 262 on tax evasion can furthermore be prohibited from establishing, being a board member, assume the role of CEO, control a majority voting share or in another way participate in the management of a company with limited liability for up to three years.

The Act entered into force 28 June 2019.

10.2 Forthcoming Legislation

10.2.1 Bills to be submitted or due to be submitted to Parliament

Bill on MiFID II/MiFIR

The MiFID II Directive 2014/65/EU and the accompanying MiFIR Regulation 600/2014 represent a review and update to the Markets in Financial Instruments Directive 2004/39/EC (MiFID), passed into law in Iceland in 2007.

The review seeks to increase market stability and confidence and bolster consumer protections. The MiFID II Directive applies to all financial entities providing investment services, amongst others introducing a new trading venue for bonds, structured finance products, emissions allowances and derivatives. These organized trading facilities (OTF) aim to increase transparency and efficiency of the financial market. Financial undertakings licensed to engage in securities trading will be made to fulfil more extensive organizational and trade transparency requirements.

A bill is due to be submitted early spring 2020.

Bill concerning managers of alternative investment funds (AIFMD)

The bill transposes Directive 2011/61/EU on Alternative Investment Fund Managers. The Directive introduces a legal framework for the authorization, supervision and overview of managers of a range of alternative investment funds (AIFM), including hedge funds and private equity funds located and/or operated in EU countries requiring fund managers to obtain authorization from the competent authority as well as making them subject to supervision. Furthermore, the bill will repeal provisions of the Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and institutional investor funds regarding investment funds (No. 128/2011).

The bill is currently under review in Parliament's Economic Affairs and Trade Committee.

Bill on Bank Recovery and Resolution (BRRD)

A bill proposing a new entire Act on Bank Recovery and Resolution has been submitted to Parliament. It is intended to adopt the second and main part of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD). BRRD provides authorities with comprehensive and effective arrangements to deal with failing banks at national level. It grants national authorities powers to ensure an orderly resolution of failing banks with minimal costs to taxpayers. It includes rules to set up a national resolution fund which all financial institutions have to contribute to, based on their respective size and risk profile.

The bill is currently under review in Parliament's Economic Affairs and Trade Committee.

Bill on the Prospectus Regulation

A bill adopting Regulation 2017/1129/EU on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (Prospectus Regulation) has been submitted to Parliament. The bill entails amendments to Act No. 108/2007 on Securities Transactions that currently hold the provisions relating to prospectuses in Icelandic legislation.

The bill is currently pending a second debate in Parliament.

Bill amending the Financial Undertakings Act No. 161/2002 concerning a line of defence on the ratio of investment banking

The planned amendments limit direct and indirect positions of systematically important commercial banks so that capital adequacy resulting from said positions cannot exceed 15% of their capital base. These amendments were suggested in The White Paper on a Future Vision for the Financial System. The amendments' aim is to limit the risk of depositors and the Treasury from investment banking but still allowing commercial banks the necessary breathing room to function.

The bill is due to be submitted early 2020

Bill further amending the Financial Undertakings Act No. 161/2002 resulting from CRD IV CRR and amendments

Further amendments resulting from CRD IV and CRR transposition are expected in 2020. A draft bill has yet to be published for public consultation. The envisioned amendments incorporate amendments to CRR with Regulations 2016/1014/EU and Regulation 2017/2395/EU.

A bill is due to be submitted early spring 2020.

Forthcoming and New Legislation

Bill transposing Directive 2013/50/EU, amending the Transparency Directive

A new Act is proposed on transparency in connection with security issuers' obligation to inform in a regulated market. The bill simultaneously proposes the deletion of corresponding articles in the Securities Transaction Act No. 108/2007.

The bill is due to be submitted early spring 2020.

Bill on the limitation of indexing loan agreements to consumers

A collective wage agreement was signed 3 April 2019. A part of this agreement is the involvement of the government through legislation. The proposed bill, which is subject to be submitted early 2020 is one element of the government's involvement.

The bill's aim is to take the first steps towards the abolition of loan indexing in Iceland.

The bill is due to be submitted early 2020.

Bill on payment services (PSD2)

Directive 2015/2366/EU, (PSD2) which the bill seeks to transpose into Icelandic law, broadened the scope of the Directive on Payment Services 2007/64/EC considerably, which previously only applied to intra-EEA payments. The legal framework introduced by the Directive further strengthens intra-EEA cross-border payment activities, including payments to and from third countries where one of the payment service providers is located in the European Economic Area, and enhances consumer protection. The Directive sets out strict security requirements for electronic payments and the protection of consumers' financial data; increases the transparency of conditions and information requirements for payment services; and sets out rules concerning the rights and obligations of users and providers of payment services.

The Directive, furthermore, seeks to open up payment markets to new entrants, which is expected to lead to increased competition. It is specifically aimed at emerging and innovative payment services, such as internet and mobile solutions. As regards the Bank specifically, once implemented, the Bank's customers, consumers and businesses alike, will be able to use third-party providers to manage their finances. Banks will be obligated to provide access to customers' accounts to these third-party providers, through open APIs (application program interface), enabling third-parties to build financial services on top of the banks' data and infrastructure. The Directive is complemented by Regulation (EU) 2015/751, which puts caps on interchange fees charged between banks for card-based transactions. This is expected to drive down the costs for merchants in accepting consumer payment cards.

PSD2 is thus foreseen to fundamentally change the payments value chain, impacting the profitability of more traditional business models in banking.

A bill may be submitted to Parliament in 2020.

Forthcoming and New Legislation

Undertakings for the collective investment in transferable securities bill (UCITS V)

Directive 2014/91/EU (UCITS V) brings amendments to the regulatory framework outlined by Directive 2009/65/EB Undertakings for collective investment in transferable securities, in conjunction with higher standards vis-à-vis alternative investment funds which the implementation of the AIFM Directive will introduce. The amendments focus on further clarifying the UCITS depositary's functions and improvements to provisions governing their liability, should assets be lost in custody; the introduction of rules on remuneration policies; and harmonization of the minimum administrative sanctions that are to be available to supervisors.

A bill may be submitted to Parliament in 2020.

Bill on market abuse (MAR)

A draft bill is expected concerning the implementation of Regulation No. 596/2014 on market abuse (MAR). The regulation entails new provisions on insiders, lists of insiders, handling of insider information, duties of notification, market abuse, etc. The MAR regulation contains more extensive provisions than the present legal framework, a broader scope and includes more financial instruments than previously.

A bill may be submitted to Parliament in 2020.

Bill on key information documents for packaged retail and insurance-based investment products

Packaged retail investment and insurance products (PRIIPs) are at the core of the retail investment market. Despite their potential benefits for retail investors, PRIIPs are often complicated and lacking in transparency. The information which institutions make available to investors when selling these products can be overly complex. They often contain too much jargon and can be difficult to use for comparisons between different investment products. Since institutions selling these products often also play a role in advising investors, conflicts of interest may arise producing advice which may not be in the investor's best interests.

Regulation 1286/2014/EU on key information documents for PRIIPs obliges those who produce or sell investment products to provide retail investors with 'key information documents' (KIDs) about the products. These documents should be simple, no more than three (3) pages and provide clear information on a product allowing the investor to take an informed investment decision.

A bill is expected to be submitted to Parliament late 2020.

11 Abbreviations

ABMIIF	Arion Bank Mortgages Institutional Investor Fund
ACC	Arion Credit Committee
AIFM	Alternative Investment Fund Managers
ALCO	Asset and Liability Committee
BAC	Board Audit Committee
BCC	Board Credit Committee
BRC	Board Remuneration Committee
BRIC	Board Risk Committee
BRRD	Bank Recovery and Resolution Directive
CBI	Central Bank of Iceland
CCF	Credit Conversion Factor
CCO	Chief Credit Officer
CCR	Counterparty Credit Risk
CEO	Chief Executive Officer
COREP	Common Reporting
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Credit Risk Mitigation
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CVA	Credit Value Adjustment
D-SIB	Domestic Systemically Important Bank
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
ECL	Expected Credit Loss
EFTA	European Free Trade Association
EMIR	European Market Infrastructure Regulation
EMTN	Euro Medium Term Note
ESA	EFTA Surveillance Authority
ESAs	European Supervisory Authorities
EU	European Union
FATF	Financial Action Task Force
FSA	Financial Supervisory Authority of the Central Bank of Iceland
FTE	Full-time equivalent
ICAAP	Internal Capital Adequacy Assessment Process
ICFR	Internal Controls over Financial Reporting
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
MD	Managing Director
MI	Major Incident
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
NSFR	Net Stable Funding Ratio
PD	Probability of Default
PSD	Payment Services Directive
PSE	Public Sector Entities
RB	Reiknistofa bankanna hf.
RCSA	Risk Control Self-Assessment
REA	Risk-weighted Exposure Amount, previously referred to as Risk-Weighted Asset (RWA)
SDRs	Swedish Depository Receipts
SME	Small and Medium Enterprises
SREP	Supervisory Review and Evaluation Process
SFTs	Securities Financing Transactions
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value at Risk

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