Arion banki

Pillar 3 Risk Disclosures

Arion Bank 2020

Disclaimer

The information in these Pillar 3 Risk Disclosures is obtained from different sources, not all of which are controlled by Arion Bank, but which Arion Bank deems to be reliable. All views expressed herein are those of the Bank at the time of writing and may be subject to change without notice. Whilst reasonable care has been taken to ensure that the contents of this publication are not untrue or misleading, no representation is made as to its accuracy or completeness. These disclosures are informative in nature and shall under no circumstances be used or considered as investment advice or investment research, or an offer to sell, or a solicitation of any offer to buy any securities. It does not refer to the specific investment objectives, financial situation or the particular needs of any person who may receive the report. Arion Bank accepts no liability whatsoever for any direct or consequential loss arising from the use of this publication or its contents.

Declaration

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

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

Risk Statement

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

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

Credit risk is one of the Bank's primary risk factors. The Bank's credit policy forms the basis for its credit strategy as integrated in the business plan. Credit risk is managed in line with credit risk appetite metrics, which includes single-name and sectoral concentration and credit quality measurements. At the end of 2020, the Bank's largest exposure was 10.3% of eligible capital and expected credit loss rate was 47 bps.

The Bank invests its own capital on a limited and carefully selected basis in transactions, underwriting and other activities that involve market risk. Market risk is managed in accordance with the risk appetite, by maximum equity position and losses, and the risk limit framework. At the end of 2020, total net equity position in the trading book and total equity position in the banking book was 2.4% and 8.6%, respectively, of normalized own funds.

Liquidity risk is a key risk factor. The Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirement. The Bank's funding profile supports its liquidity profile. Liquidity positions are managed on a day-to-day basis by internal limits and targets in line with the risk appetite and regulatory standards. The Bank's liquidity coverage ratio was 188% at the end of 2020, while the regulatory requirement was 100%.

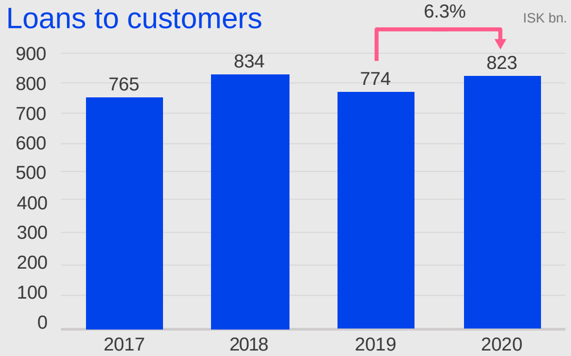
The Bank's business units are primarily responsible for managing their own operational risks, including reputational risk, with support from control functions. The Bank's operational risk framework integrates risk management practices into processes, systems and culture. The risk appetite contains a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

The Bank is well capitalized with capital adequacy ratio of 27.0%, and CET1 ratio of 22.3% at the end of 2020 exceeding both the regulatory requirements and the risk appetite.

The Board of Directors of Arion Bank

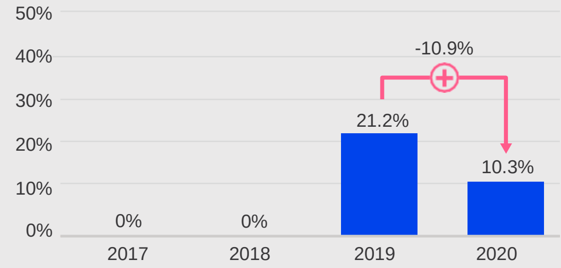
Risk Metrics Overview

Loans to customers



See section 4.4

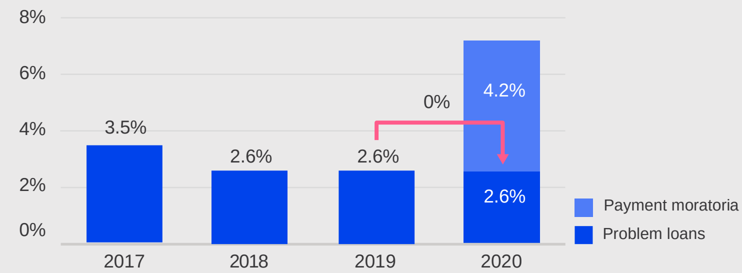
Sum of large exposures*



*net of eligible collateral

See section 4.4.3

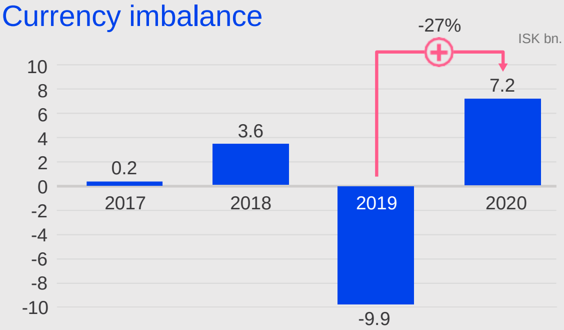
Problem loans and payment moratoria



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

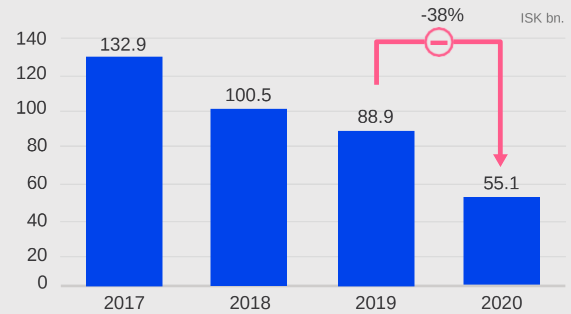
See section 4.8.6

Currency imbalance



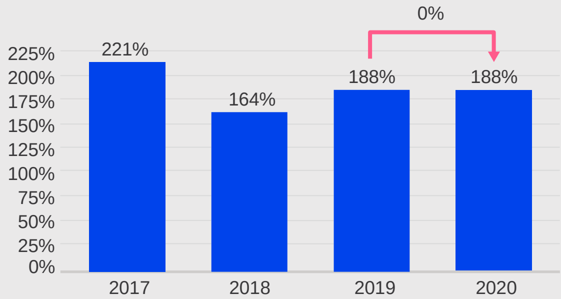
See section 5.5

Indexation imbalance



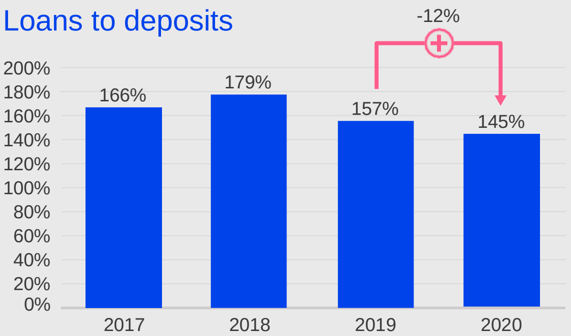
See section 5.6

Liquidity Coverage Ratio



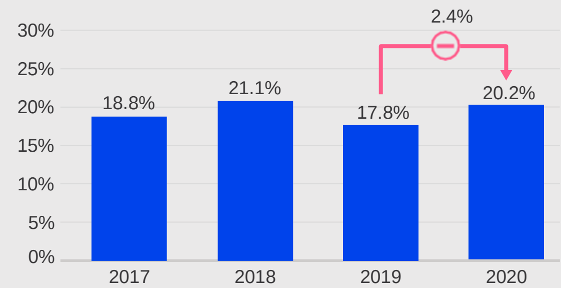
See section 6.4

Loans to deposits



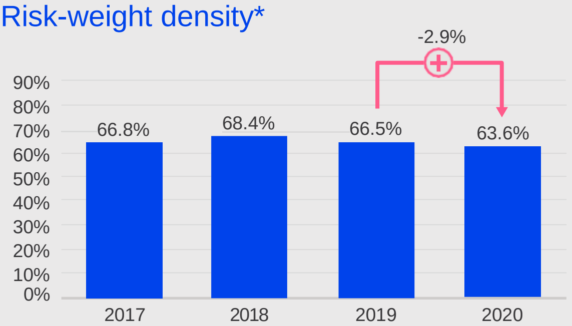
See section 6.5

Asset encumbrance ratio



See section 6.5

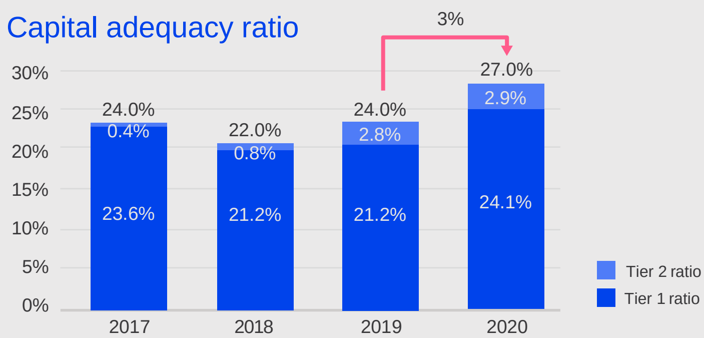
Risk-weight density*



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

1.1 Arion Bank at a Glance

Arion Bank ('the Bank') is a well-balanced and diversified universal relationship bank operating in the Icelandic financial market. The Bank is listed on the Nasdaq Iceland and Nasdaq Stockholm regulated markets. The Bank is classified as a domestic systematically important 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 strong heritage and infrastructure. Arion Bank is a strongly capitalized bank which provides broad banking services to corporations and individuals. The Bank aims to excel by offering smart and reliable solutions which create future value for customers, shareholders and society as a whole. The Bank operates a number of branches across Iceland but has been optimizing its branch network in recent years by streamlining branch premises and introducing digital branches. Numerous new digital solutions have been launched in the past few years, which increase customer convenience and operational efficiency.

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 one of 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 relative to the Icelandic economy.

At year end 2020 the number of full-time equivalent (FTEs) positions at Arion Bank was 648 with an additional 128 FTEs in subsidiaries.

The Bank's Annual and Sustainability Report 2020 provides further information about the Bank, such as strategy and vision, sustainability policy and corporate governance.

Figure 1.1 Arion Bank's branch network

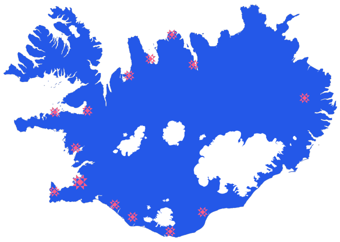


Figure 1.2 Arion Bank's primary strategic subsidiaries

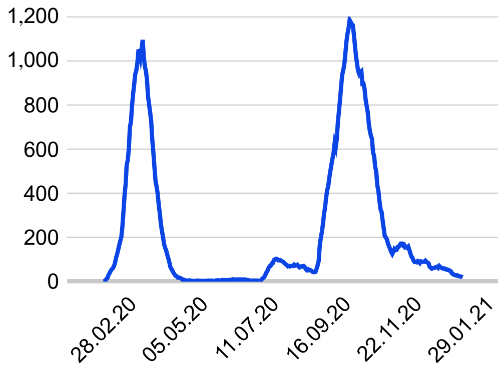
1.2 Major Changes in 2020

Several developments influenced Arion Bank's risk profile in 2020. Highlights include:

The COVID-19 pandemic

The global economic shock caused by the COVID-19 pandemic is far-reaching. Social distancing measures have disrupted supply chains, altered consumer behavior and resulted in a collapse in tourism activities, which represents Iceland's largest export industry. The first wave of infections in Iceland started in March 2020, and the curve was successfully flattened in the beginning of June following a period of strict social distancing, ban on large gatherings and comprehensive testing and tracing. Restrictions, including inbound travel restrictions, were lifted on June 15, resulting in activities over the high-summer that exceeded bleak forecasts. A second wave started at the end of July and quaranties were imposed on inbound travelers on August 19, which coincided with the start of the third wave. The vaccination program started on December 29 2020, at which time the third wave had been mostly controlled.

Figure 1.3 Active COVID cases in Iceland from 28.02.2020. Source: www.covid.is



To mitigate the economic effects of the outbreak and associated health measures, the government has introduced various measures. These include part-time unemployment benefits, government guaranteed support loans and resilience subsidies for businesses with significant revenue losses, and various support schemes for individuals. Furthermore, the flag carrier Icelandair went through a successful public share offering with support from the Icelandic government.

Figure 1.4 Tourists arriving in Iceland [in millions]. Source: Icelandic Tourist Board.

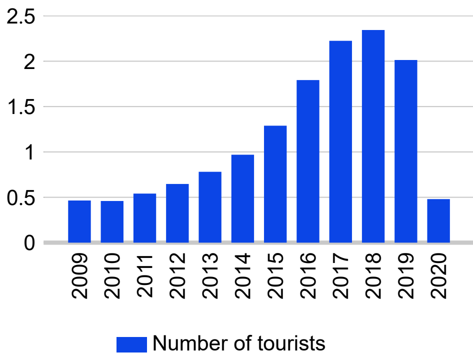
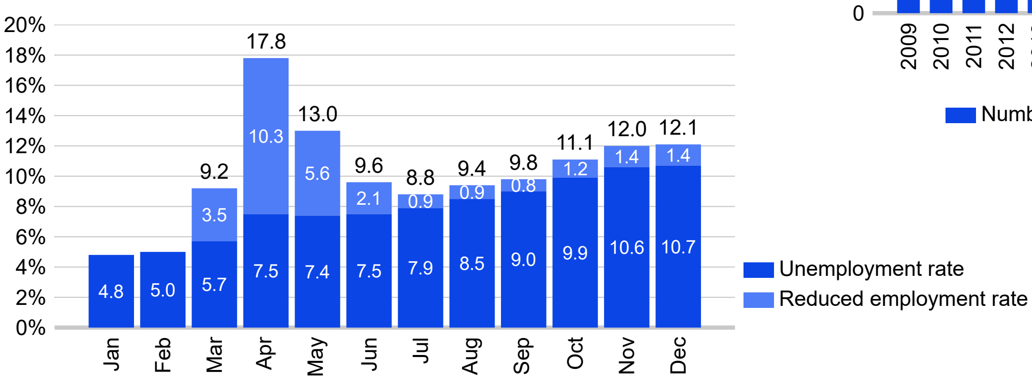


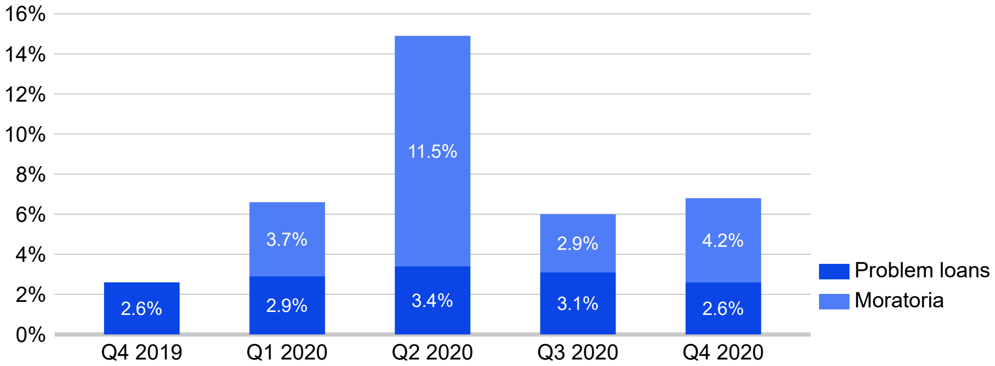
Figure 1.5 Unemployment rate [%] in Iceland for 2020, as measured by the Directorate of Labour



Through the Icelandic Banking Association, the Bank participated in a general payment moratoria scheme in accordance with EBA guidelines, and has supported its trusted clients, both corporates and individuals. As a result of these measures, defaults and problem loans have not increased as otherwise would have been expected. Payment moratoria have decreased from the outset as extensions of moratoria in Q4 2020 were based on a more selective criteria.

Exposures that are classified as being dependent on tourism activities are 8.8% of loans to customers. For a discussion on the Bank's sector concentration, see section 4.4.1. For a discussion and analysis of credit exposures that are assessed as being distinctly affected by the pandemic, see section 4.8.1 and Note 42 in the Bank's Consolidated Financial Statement for 2020. In contrast, for a large segment of the economy the economic fallout is limited and borrowers are experiencing an increase to savings and improved purchasing power. For this segment, the Bank's short-term credit risk indicators are improving.

Figure 1.6 Problem loans and COVID-19 related payment moratoria, as % of loans to customers at gross carrying value



With the advent of vaccines, a recovery is on the horizon. The speed of the recovery and viability of many businesses is however largely dependent on the tourism high-season of 2021. The long-term economic effects should also be considered, e.g. social implications due to increased unemployment, increased sovereign debt which might lead to fiscal tightenings, and permanent changes to industry and consumer behavior.

The Bank's operations have been significantly affected but without major consequences. The Bank's Business Continuity Plan was activated and the Bank's Security Committee held frequent meetings as the Bank adjusted its operations to frequently changing social restrictions. The transition to work-from-home mode was mostly seamless, with laptops and other equipment dispatched to employees and video conferencing established.

Residential mortgages and deposits

As a result of the pandemic, the Central Bank of Iceland has lowered its benchmark interest rates to unprecedented levels. Furthermore, the countercyclical capital buffer was vacated and the bank levy was lowered.

With this change to the competitive environment, coupled with the domestic pension funds' limited appetite for low short-term interest rates, the dynamics of the mortgage market changed significantly in 2020. The general trend is described in consumers refinancing their residential mortages to floating non-indexed interest rates and the banking sector gaining market share from the pension funds. In 2020, the Bank's residential mortgage portfolio increased by ISK 68 billion or 22%.

Despite the recession, the mortgage market was active in 2020 and real estate prices in the capital area increased by 7.7%, which gives rise to the risk of inflation of real estate prices and risk of increased default rates if and when monetary measures are reversed, resulting in increase to borrowers' monthly payments.

Figure 1.7 The Central Bank's key interest rate (policy rate)

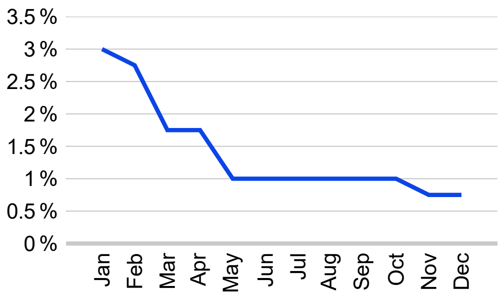


Figure 1.8 12-month change in the residential property price index for the capital area. Source: Registers Iceland.

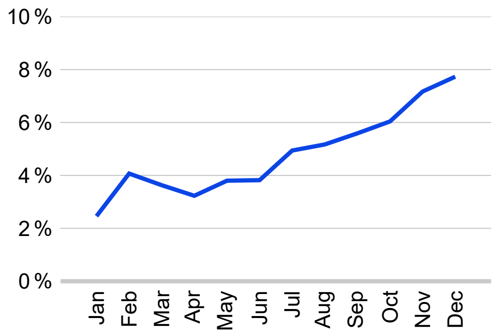
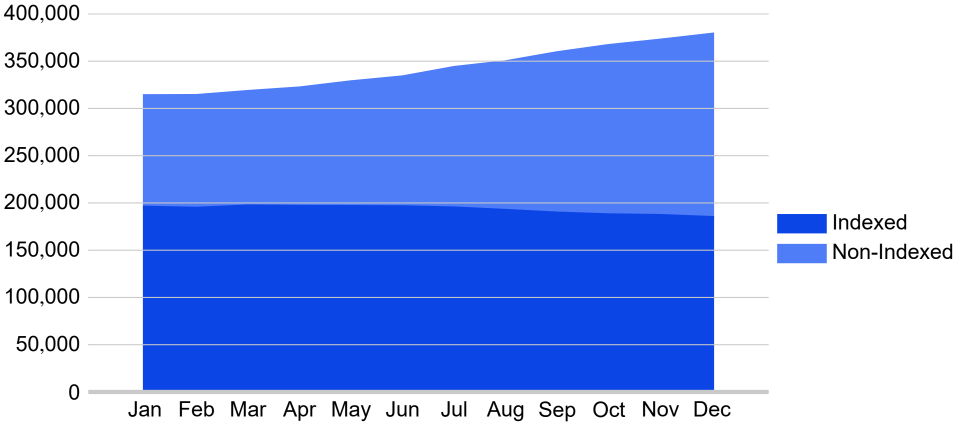
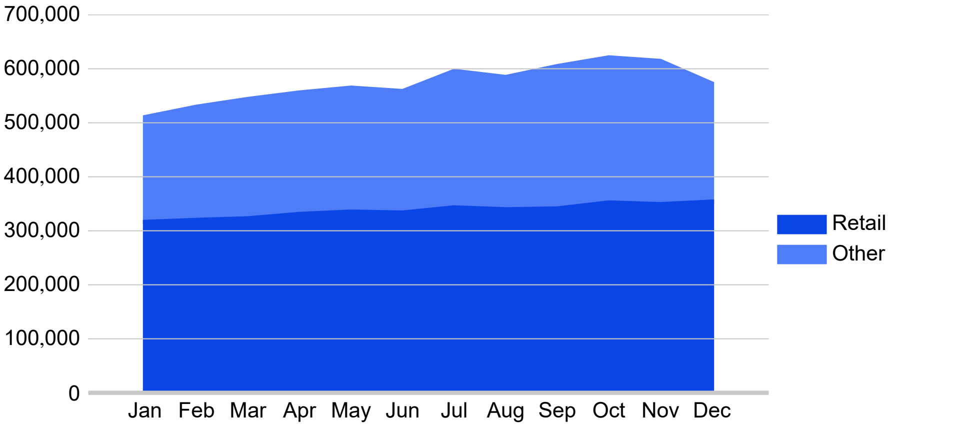


Figure 1.9 Development of the Bank's residential mortgage portfolio in 2020 [million ISK]



The growth in mortgage lending was supported by significant increase in deposits, which is primarily due to reduced consumer spending and businesses securing liquidity in uncertain times as a result of the pandemic. There is risk of an outflow of deposits in the advent of a strong recovery.

Figure 1.10 Development of the Bank's deposit base in 2020 [million ISK]



International Credit Rating – Investment Grade

In April 2020 Standard & Poor's downgraded Arion Bank's long-term credit rating from BBB+ to BBB with stable outlook. The Bank's short-term credit rating remains A-2.

Standard & Poor's expressed the view that the global recession due to COVID-19 would affect the open and concentrated Icelandic economy and its banks, despite a substantial government package to counteract the effects and exacerbate some of the Icelandic banking industry's weaknesses.

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

The rating and outlook factored in the Bank's solid market position in Iceland. In S&P's view, the Bank is well ahead of many other European banks in its preparation for technological disruption. S&P expects the Bank to withstand the consequences of the looming economic recession by maintaining solid capital position and comfortable funding and liquidity profiles.

Capital adequacy

The Bank's capital ratio at 31 December 2020 was 27.0%, which exceeds the total regulatory requirement of 18.4%. The Bank's

Introduction

Common Equity Tier 1 ratio (CET1) at 31 December 2020 was 22.3% compared to a 13.5% regulatory requirement. Both ratios account for a foreseeable equity reduction of ISK 18 billion in the form of a ISK 3 billion dividend distribution and ISK 15 billion buyback of own shares. In addition to the foreseeable equity reduction, the Bank has ISK 40 billion of excess capital relative to its target CET1 capital ratio of 17%.

Arion Bank is one of the best capitalized banks in Europe and encounters the recession with extraordinary financial strength

The Bank has recently taken active steps to normalize the Bank's capital structure as part of the effort to improve return on equity. In 2019, the Group completed its Tier 2 capital issuance and in February 2020, the Bank issued Additional Tier 1 bonds for a total of USD 100 million. In response to the COVID-19 pandemic and its economic consequences, on 12 March 2020 EBA urged banks to halt dividend distributions and the Icelandic FSA followed suit. As a result, the Bank was not able to complete the normalization of own funds through an equity reduction that corresponds to the AT1 issuance. Consequently, Arion Bank is currently one of the best capitalized banks in Europe and encounters the recession with extraordinary financial strength.

On 1 January 2020, the SME supporting factor according to articles 500 and 501 of the CRR took effect in Iceland as the CRR was adopted into the EEA agreement. The articles in question had been excluded when CRR was ratified in Iceland through Regulation No. 233/2017. The SME supporting factor offers capital requirements relief for certain credit exposures of small and medium-sized enterprises. Changes to the supporting factor, which entail further capital relief, are expected when CRR2 is adopted in Iceland.

Valitor Sales Process

In November 2018, Arion Bank announced that it had engaged advisors on a potential change of ownership in Arion Bank's subsidiary Valitor hf., which could entail the divestment of all the shares or the majority of the shares in Valitor. The sale process has taken longer than planned and will continue in 2021. At year-end 2020, the Bank classified Valitor as *disposal group held for sale* in accordance with IFRS 5.

At the end of 2019, the Board of Directors of Valitor decided to scale back investments in the company's international business, execute structural changes and strengthen core operations. Herdís Fjeldsted, the chairmain of the Board, took over as CEO of the company in March 2020. In May 2020 Valitor Group sold the operations of Valitor in Denmark, Valitor A/S, and some of its UK operations.

Implementation of a new core banking system

The implementation of a new core banking system from Sopra Banking Software has been underway since 2019, in collaboration with Reiknistofa bankanna hf., the established IT service centre for the Icelandic financial market. The system replaces the Bank's solutions for deposits and payments. The purpose is to upgrade technology, 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 scheduled to be rolled out in the second quarter of 2021.

1.3 Regulatory Framework

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

The Basel framework encompasses three complementary pillars:

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

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

The CRD IV / CRR II package is expected to be implemented in Iceland in 2021

In 2013, the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive (CRD IV: Directive No. 36/2013) and the Capital Requirements Regulation (CRR: Regulation No. 575/2013). This regulatory framework represented the EU's first major step in implementing the Basel III reforms. 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.

Iceland adopts this EU regulatory framework through its membership of the EEA Agreement. Since 2016, numerous legislative acts have been passed by Parliament to implement the CRD IV / CRR framework. These acts have mostly brought amendments to the Financial Undertaking Act No. 161/2002 and in 2017 CRR was adopted through a secondary legislation (Regulation No. 233/2017) by the Minister of Finance and Economic Affairs. The CRR was incorporated into the EEA Agreement in late 2019 so the last remaining provisions of CRR entered into force 1 January 2020. In 2019, the EU passed the CRD V / CRR II package, which amends CRD IV/CRR to finalize the Basel III implementation and sets the stage for what is widely refered to as Basel IV. The CRD IV / CRR II package is expected to be implemented in Iceland in 2021.

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.

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

1.4 Communication Policy

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

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

1.5 Pillar 3 Risk Disclosures

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfill the aforementioned legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures are prepared in accordance with legislative requirements regarding public disclosure, including 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 information on regulatory capital and leverage ratio are provided quarterly in the Bank's interim financial reports.

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

These Pillar 3 Risk Disclosures are in accordance with CRD IV / CRR requirements, 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

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

All financial figures, calculations and information in the disclosures are based on 31 December 2020 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 liquidity risk, interest rate risk, compliance risk, cyber risk and business risks that are inherent in the Bank's strategy, product range and operating environment.

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

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

2.1 Internal Controls and Lines of Reporting

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

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

The CEO, on 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 and capital adequacy. The BRIC reviews the Bank's risk appetite at least semi-annually, see section 2.7, and makes recommendations thereon to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls, 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 material risks and in so doing enhancing the risk culture within the Bank. The Board Audit Committee (BAC) reviews and approves Internal Audit's plans and resources, and evaluates the effectiveness of Internal Audit. The Chief Internal Auditor is appointed by the Board and accordingly has an independent position in the Bank's organizational chart.

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

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

For further information on the Bank's governance arrangements please refer to the Corporate Governance Statement for the year 2020, 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 2020.

2.2 Three Lines of Defense

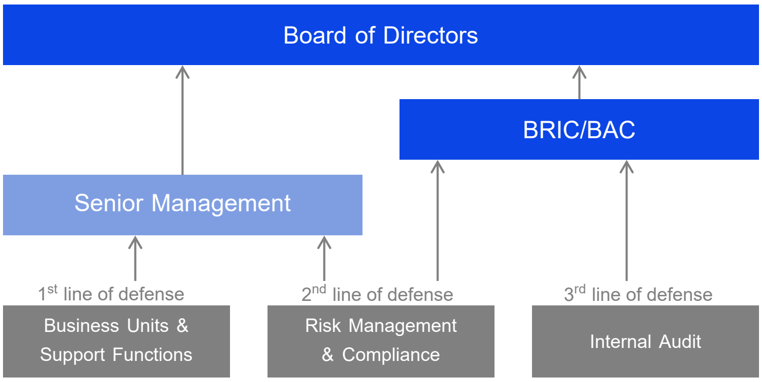
In order to ensure the effectiveness of the Bank's internal controls, to clarify responsibilities and coordinate essential risk management, and to foster the culture wherein risk is every employee's business, the Bank has adopted the three lines of defense model.

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

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

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

Figure 2.2 Three lines of defense



First Line of Defense: Business Units & Support Functions

Business units and support functions, i.e. those in charge of running day-to-day business operations, naturally serve as the first line of defense. They implement controls and processes designed to identify, manage and mitigate risk to which the business is exposed thus ensuring ownership.

Second Line of Defense: Risk Management & Compliance

The second line of defense is established to monitor and facilitate the effective risk management of the first line of defense. The second line assists the first line by maintaining the risk management framework, tools and methodologies, and oversees and challenges the adequacy and effectiveness of risk controls employed. The Bank's Risk Management and Compliance divisions are the primary second line of defense.

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

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

Figure 2.3 Risk committee structure

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

Table 2.1 Board level committees

Committee	Responsibilities
Board Audit Committee (BAC)	The Board Audit Committee assists the Board in meeting its responsibilities in monitoring the effectiveness of the Bank's internal governance and controls and for meeting its external financial reporting obligations under applicable laws and regulations. The BAC supervises accounting procedures, the organization and function of the Bank's internal audit, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The Board Risk Committee advises and supports the Board on the alignment of the Bank's risk policy, high-level strategy and risk appetite, and risk management structure. The BRIC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BRIC assesses whether incentives which may be contained in the Bank's remuneration system, including variable remuneration, are consistent with the Bank's risk policy.
Board Credit Committee (BCC)	The 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. The committee periodically reviews reports on various aspects of the credit portfolio. The BCC defines credit rules for ACC.

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

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

Table 2.2 Executive level risk committees

Committee	Responsibilities
Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases within limits set by the BCC. The committee delegates limited authority and sets forth credit rules to lower credit granting bodies. ACC reviews reports concerning the credit portfolio. Risk Management and the Chief Credit Officer are authorized to veto all decisions or escalate to the BCC for final approval.
Asset and Liability Committee (ALCO)	The Asset and Liability Committee is responsible for strategic planning relating to the developments of the Bank's balance sheet as well as the planning of liquidity and funding, capital activities, and decides on underwriting and investment exposures within limits set by the BCC. The CRO or their deputy is a non-voting observer in committee meetings.
Operational Risk Committee (ORCO)	The Operational Risk Committee is responsible for managing operational risk and compliance, which includes information security, financial crimes, regulatory compliance and data managment. The CRO, the Compliance Officer and the Risk Officer for Security and Data are non-voting observers in committee meetings.
Arion Composition and Debt Cancellation Committee (ADC)	The Arion Composition and Debt Cancellation Committee deals with applications to reach composition with debtors, within limits set by the BCC.

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

2.4 The Risk Management Division

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

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

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

Figure 2.4 Structure of Risk Management division

Risk Analysis

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

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

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

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

Risk Monitoring and Framework

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

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

The Bank's Risk Officer for Security and Data belongs to Risk Monitoring and Framework and supervises security issues and data management in the Bank's second line of defence.

Credit Analysis

Credit Analysis ensures Risk Management's envolvment in credit transactions and analyzes and monitors loan cases submitted to the Bank's credit committees. Credit Analysis represents Risk Management at ACC meetings and participates in credit decisions and has the power to veto ACC's credit decisions and escalate to the BCC for final approval. The department also administers and organizes credit committee meetings, advises on changes to the credit rules and reports to the BCC deviations from credit rules and overview of new lending.

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

Risk Officer for Pension Funds

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

2.5 The Compliance Function

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

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

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

2.6 Risk Policies

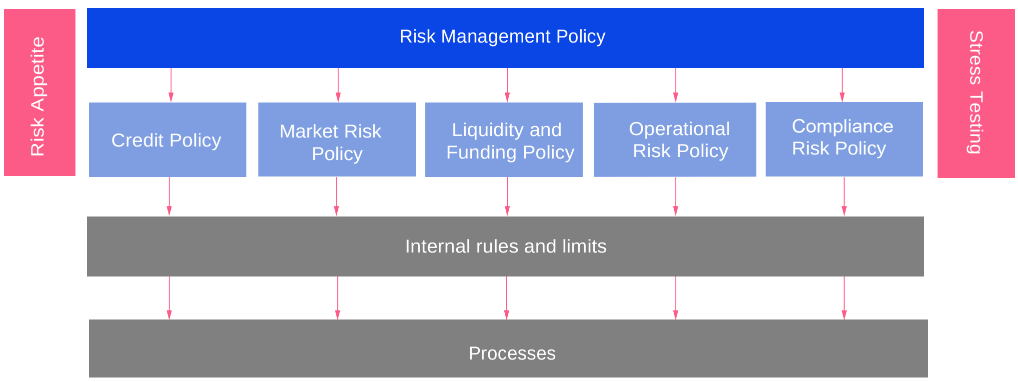
In pursuance of ensuring that existing and potential material risks are identified, managed and monitored, the Bank has an enterprise risk management policy in place. The policy is reviewed and approved by the Board of Directors annually. The policy outlines, at high level, the key aspects of the Bank's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

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

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

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

Figure 2.5 Risk policies implementation



2.7 Risk Appetite

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

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

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

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

Table 2.3 Risk appetite metrics

Category	Risk metric
Capital adequacy	Capital adequacy ratio Leverage ratio
Liquidity and funding risk	Liquidity coverage ratio Net stable funding ratio Loans to deposits ratio Asset encumbrance ratio
Market risk	Foreign exchange rate risk Interest rate risk and indexation risk Equity risk in the trading book Equity risk in the banking book
Securities financing and counterparty credit risk	Uncollateralized exposure as per stress test
Credit risk	Diversification and sector concentrations Single-name concentration Expected credit loss Loan to value of residential mortgage portfolio
Operational risk	Operational losses

2.8 Reporting

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

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

Table 2.4 Primary reporting within the Bank

Primary reporting	Contents	Frequency	Recipient
Credit risk portfolio report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the credit quality of the loan portfolio.	Monthly	ACC
Liquidity and market risk report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit developments, secured liquidity, funding measures, currency and indexation imbalances, margin trading activities, and other relevant liquidity and market risk information.	Monthly	ALCO
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 ALCO
Internal bank-wide stress testing	Evaluation of the impacts on the Bank's earnings and own funds, the Bank's capital and liquidity ratios and other risk appetite metrics under various stress scenarios. The report is submitted for review and/or approval.	Annually	Board BRIC Exec. Com.
Compliance updates	An aggregate report covering key events regarding both compliance risk and financial crime risk	Quarterly	BRIC
Compliance report	An annual report summarizing previous year with regards to both compliance risk and financial crime risk	Annually	Board BRIC

3 **Capital** Management

3 Capital
Management

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

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

3.1 Governance

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

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

At year-end 2020 the Bank's CET1 ratio was 22.3% and total capital ratio 27.0%. The ratios account for a foreseeable equity reduction of ISK 18 billion through buyback of own shares and dividend distribution

3.2 Capital Strategy

The Bank's target for Common Equity Tier 1 (CET1) ratio is 17% and maximum utilization of Additional Tier 1 (AT1) and Tier 2 (T2) capital to meet Pillar 1 and Pillar 2 capital requirements, see section 3.3. Relative to the total CET1 regulatory requirement of 13.5%, this implies a management buffer of 3.5%. The target is 1.0% above the total regulatory capital requirement assuming the highest possible value for the countercyclical capital buffer. The Bank's management buffer accounts for volatilities in the risk-weighted exposure amount (REA) and own funds and facilitates further flexibility in the management of capital.

The Bank's capital position is in excess of its capital targets. According to the Bank's capital plan, surplus capital is to be distributed to shareholders. In the period from Q4 2018 to Q4 2019 the Bank 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. In Q1 2020 a further step in the normalization of own funds was taken through USD 100m issuance of an AT1 eligible hybrid bond. Following that step it was intended to reduce CET1 capital through dividend distribution and buyback of own shares.

Due to the COVID-19 crisis, that plan was halted. In 2020 the Bank thus paid no dividends. The Central Bank of Iceland has in February 2021 approved the Bank's plan of a buyback of ISK 15 billion of own shares. Furthermore, the Bank indends to pay ISK 3 billion in dividends which is well within the Bank's dividend policy of paying out 50% of net earnings attributable to shareholders as dividend but the amount is limited by the Central Bank guidance that dividend payments should not reduce the CET1 ratio by more than 0.4 percentage points.

The Bank's REA increased by ISK 26 billion in 2020. The increase is mainly due to the change in the treatment of the Bank's shareholding in Vörður tryggingar hf. The insurance company is not part of the Group's regulatory consolidation in respect of Capital Requirements Regulation (CRR). Previously, the Bank's holding of Vörður's equity was deducted from the Group's own funds but now it contributes instead towards risk-weighted exposure amount with a risk weight of 250%. In other respects, the net change in REA is minimal despite the fact that the loan book grew by ISK 49 billion. There are two main reasons for this. At the beginning of 2020, the implementation of the CRR in Iceland was completed which reduced capital requirements for SMEs and this reduced REA at the Bank by ISK 13 billion. Another key factor is the fact that the Bank's mortgage portfolio has grown by ISK 68 billion while assets which tie up more capital, e.g. corporate loans and financial assets in the investment book, have decreased.

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 earnings attributable to shareholders.

Figure 3.1 Development of own funds [ISK m]

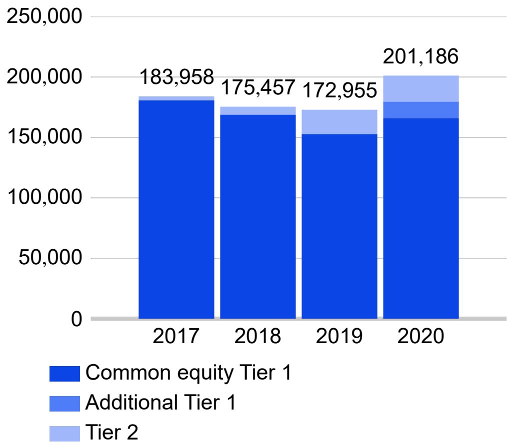
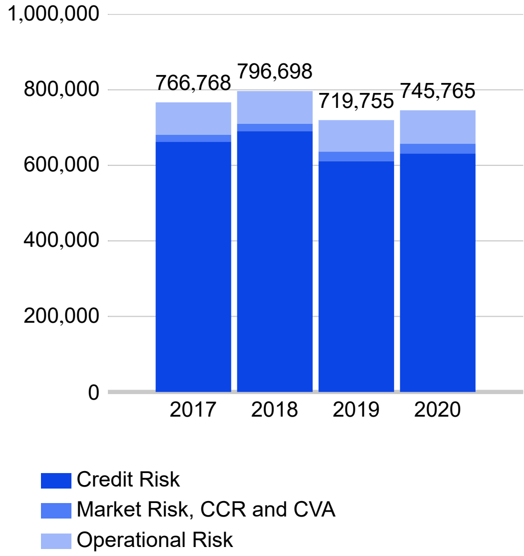


Figure 3.2 Development of REA [ISK m]



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 3.6.2.

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

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

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 composed of 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

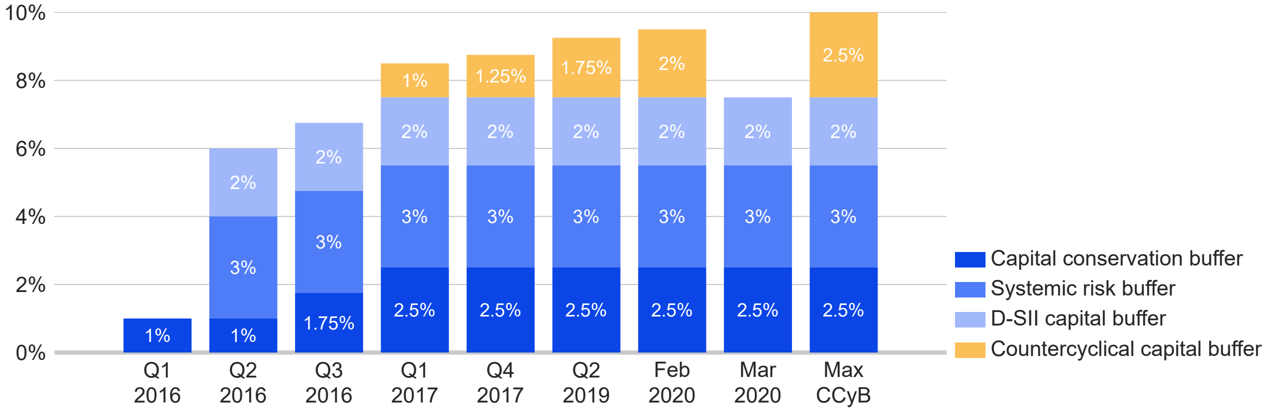
The SREP review of the Bank's ICAAP, which concluded in September of 2019 and was based on financial figures on 31 December 2018 for the Group's prudential consolidation, resulted in a Pillar 2 requirement that corresponds to 3.1% of REA. See further discussion in section 3.4.1.

Due to the uncertainty related to COVID-19, the FSA decided that the SREP review of the Bank's ICAAP based on financial figures on 31 December 2019 would not result in an updated Pillar 2 requirement and instead the requirement was left unchanged from the previous year.

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 from 1.75% to 2.00% in February 2020 but was then set to 0% in March 2020 as a response to the COVID-19 crisis. The development of the capital buffers is 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 7.3% at year-end 2020

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 where the buffer only applies to domestic exposures. Given the Bank's geographic credit risk profile at year-end 2020, the effective combined capital buffer requirement for the Bank is 7.3%.

Table 3.2 Arion Bank's capital buffer requirements as of March 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%	0.0%	2.8%
Countercyclical capital buffer	0.0%	CCyB of country	0.0%
Total	**7.5%**	**4.5%+CCyB**	**7.3%**
REA credit risk weight	94.5%	5.5%	

To summarize, the Bank's total regulatory requirement is 18.4%. Management's policy is to maintain a CET1 ratio of 17% and utilize AT1 and T2 to the maximum extent to meet the Pillar 1 and Pillar 2 capital requirement. This implies that the target capital adequacy ratio is 21.9%. The 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 18.4% at 31 December 2020. The Bank's capital ratio benchmark is 21.9%

The Bank's own funds at 31 December 2020 take into account a foreseeable equity reduction of ISK 18 billion. Therefore, a corresponding distribution will not affect the Bank's capital adequacy ratios.

Capital Management

Figure 3.4 Arion Bank's own funds regulatory requirements with combined capital buffer requirements at 31 December 2020

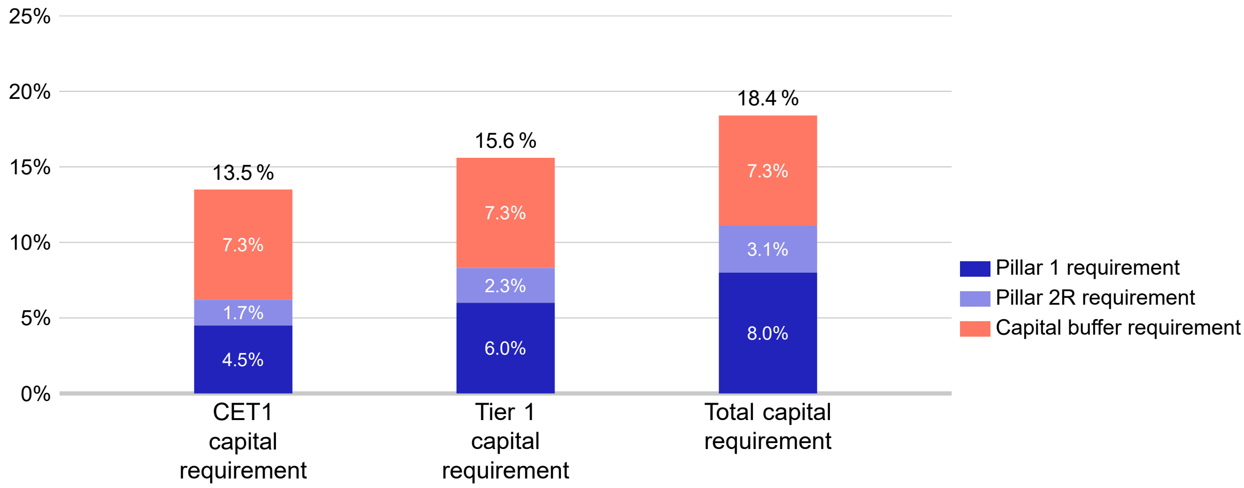
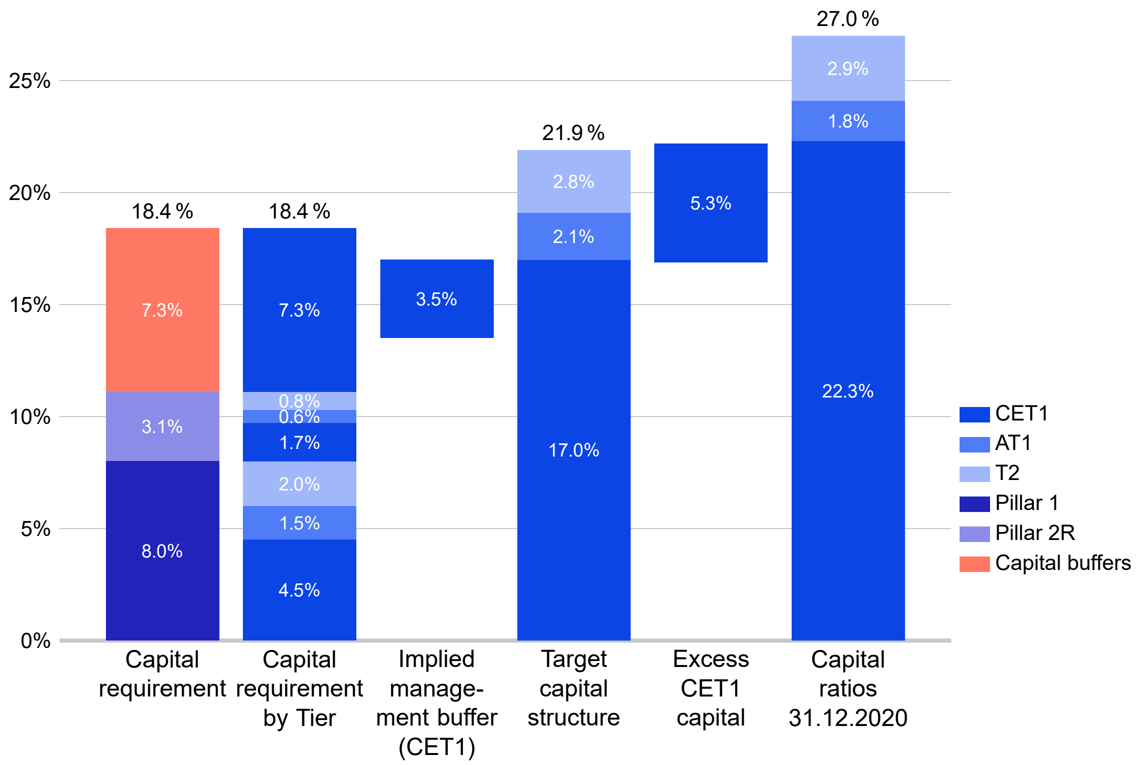


Figure 3.5 Arion Bank's capital requirement, target capital structure and capital ratios

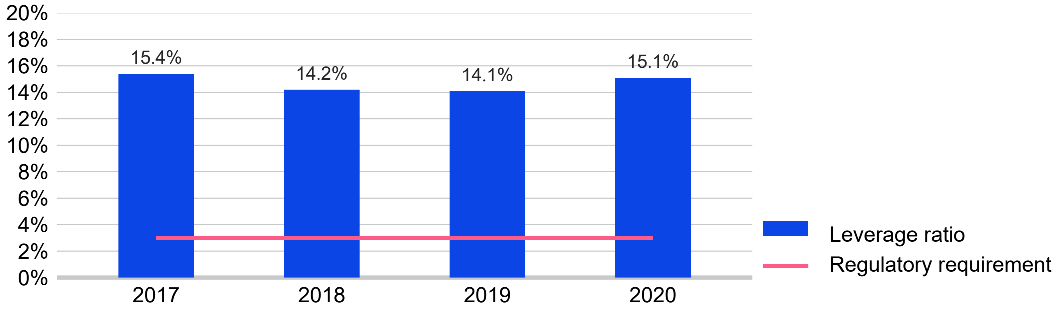


The leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting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

Arion Bank is a rare 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

At year-end 2020, the Bank had a strong leverage ratio of 15.1%, 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 7.3%, which is applied to a standardized REA. The Bank's average risk-weight is 64% for the consolidated situation.

Figure 3.6 Development of the Bank's leverage ratio



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

For further details on the Bank's leverage ratio, please refer to 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 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.

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

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	Compliance risk	Business risk	Political risk
Retail Banking	✓			✓	✓	✓	✓
Corporate and Investment Banking	✓			✓	✓	✓	✓
Markets	✓	✓		✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓		✓
Other divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓

The Bank's ICAAP methodology involves assessing key risks that are not believed to be adequately addressed under Pillar 1. For each risk factor, a capital add-on is applied on top of the minimum 8% regulatory capital requirements. 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 to justify the level of the buffer. The Bank does therefore not include these risk factors in its Pillar 2 capital assessment. Among those is the lack of diversification of the Icelandic economy, which is reflected in sector concentration in the Bank's loan portfolio.

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

The SREP of 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. Due to the uncertainty related to COVID-19, this was not updated in the 2020 SREP process.

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. Due to the uncertainty related to COVID-19, this was not updated in the 2020 SREP process.

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.

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

Figure 3.7 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

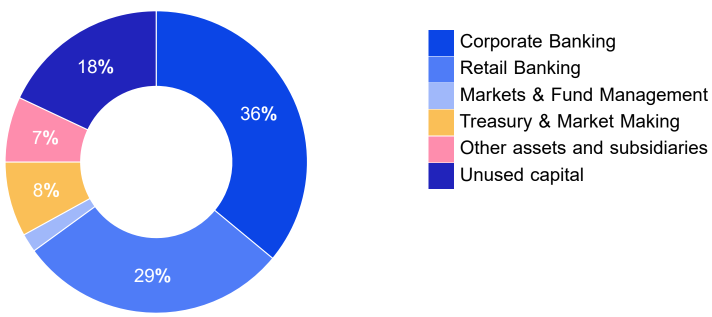
Scenario analyses are carried out on the Bank's business plan. The Bank's Chief Economist contributes an economic base case projection as well as stressed projections that are used in the Bank's capital planning and in preparation of the Bank's five year business plan. The design of the bank-wide internal 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

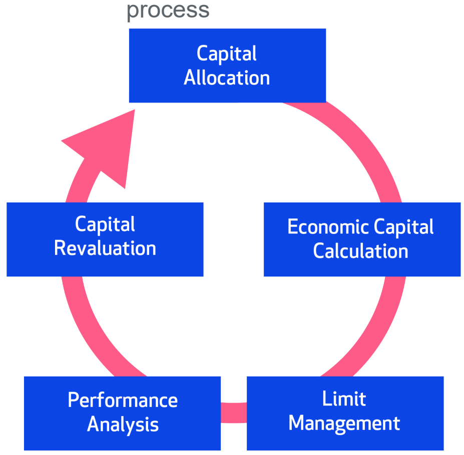
The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP and SREP. The risk-adjusted performance of the business units is based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning on a quarterly basis, based on the Bank's rolling business plan for each business unit. 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 2020, current need and 12 month horizon



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.

Figure 3.8 Capital planning and monitoring process



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 32 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's Additional Tier 1 capital consists of a USD subordinated liability issued in Q1 2020.

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]	2020	2019
Total equity	**197,845**	**189,825**
Deductions related to the consolidated situation	0	-10,159
Non-controlling interest not eligible for inclusion in CET1 capital	-173	-181
Common Equity Tier 1 capital before regulatory adjustments	**197,672**	**179,485**
Intangible assets	-13,092	-10,604
Tax assets	0	-296
Cash flow hedges	-2,282	-1,616
Additional value adjustments	-238	-125
Foreseeable dividend and buyback	-17,990	-14,153
Adjustment under IFRS 9 transitional arrangements	1,890	0
Common equity Tier 1 capital	**165,960**	**152,691**
Non-controlling interest not eligible for inclusion in CET1 capital	173	181
Additional Tier 1 capital	13,498	0
Tier 1 capital	**179,631**	**152,872**
Tier 2 instruments	22,562	20,083
Tier 2 instruments of financial sector entities (signif. invest.)	-1,007	0
Tier 2 capital	**21,555**	**20,083**
Total own funds	**201,186**	**172,955**

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

31 December [ISK m]	REAs		Minimum own funds requirements
	2020	2019	2020
Credit risk (excluding CCR)	**608,697**	**610,765**	**48,696**
of which the standardized approach	608,697	610,765	48,696
CCR	**4,304**	**4,824**	**344**
of which mark to market	3,462	3,347	277
of which CVA	842	1,477	67
Settlement risk			
Securitisation exposures in the banking book (after the cap)			
Market risk	**21,632**	**20,679**	**1,731**
of which the standardized approach	21,632	20,679	1,731
Large exposures			
Operational risk	**88,462**	**83,487**	**7,077**
of which standardized approach	88,462	83,487	7,077
Amounts below the thresholds for deduction (subject to 250% risk weight)	22,670		1,814
Total	**745,765**	**719,755**	**59,661**

Table 3.6 Overview of own funds and capital adequacy

31 December [ISK m]	2020	2019
Own funds		
Common Equity Tier 1 (CET1) capital	165,960	152,691
Tier 1 capital	179,631	152,872
Total own funds	201,186	172,955
Risk-weighted exposure amount	745,765	719,755
CET1 capital ratio	22.3%	21.2%
Tier 1 capital ratio	24.1%	21.2%
Total capital ratio	27.0%	24.0%
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%	3.1%
of which CET1 requirement	*1.7%*	*1.7%*
of which Tier 1 requirement	*2.3%*	*2.3%*
Combined capital buffer requirement	7.3%	9.0%
of which capital conservation buffer requirement	*2.5%*	*2.5%*
of which systemically important institution buffer requirement	*2.0%*	*2.0%*
of which systemic risk buffer requirement	*2.8%*	*2.8%*
of which countercyclical capital buffer requirement	*0.0%*	*1.7%*
Total CET1 capital requirement	13.5%	15.2%
Total Tier 1 capital requirement	15.6%	17.3%
Total capital requirement	18.4%	20.1%
Own funds in relation to minimum capital requirement	3.38x	3.00x
Leverage ratio		
Exposure measure for leverage ratio calculation	1,189,511	1,085,614
Leverage ratio	15.1%	14.1%

3.6 Regulatory Changes

3.6.1 IFRS 9 Transitional Arrangements

The IFRS 9 standard for impairment calculations took effect on 1 January 2018. In anticipation of higher and more volatile levels of impairment, Regulation (EU) 2017/2395 introduced transitional arrangements which allowed the effect of the change in impairment on banks' captial ratios to be phased in over time. This Regulation was not introduced into Icelandic law until 4 May 2020. Institutions that elect to make use of these transitional arrangements can in 2020 add back CET1 equivalent to up to 70% of provisions incurred from the application of IFRS9 and up to 50% in 2021. At the reporting date, these transitional arrangements increase the capital adequacy ratio of the Bank by 0.2 percentage points.

3.6.2 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.

In CRR II, the scope of the SME supporting factor is expanded. There is no longer a limit on the group exposure of the SME. However, the size of the multiplication factor depends on the size of the group exposure, the first EUR 2.5 million group exposure is multiplied by the factor 0.7619 whereas any exposure above that limit is multiplied by the factor 0.85. This change is expected to increase the Bank's capital adequacy ratios by around 0.6% after CRR II will be incorporated into Icelandic law.

3.6.3 CRR II

On 7 December 2017, the Basel Committee on Banking Supervision published an updated Basel III standard which finalizes the Basel III post-crisis reforms. In the EU, these updates are implemented through CRD V and CRR II. The initial batch of changes comes into effect on 30 June 2021 but other changes are due in 2023 and beyond. The Icelandic government has announced plans to incorporate CRD V and CRR II into Icelandic law and that process may be completed within 2021.

The changes to the SME supporting factor are discussed above in section 3.6.2. Other changes which take effect from 30 June

2021 or as soon as the Icelandic legislation process has been completed include:

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

From 2023, the framework for counterparty credit risk will be overhauled and at the same time changes will be introduced to the standardized and IRB framework for credit risk to level the playing field between these two approaches.

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 for short term trading purposes and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 4.5.

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.

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 witin limits set by the BCC, 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, Head of Credit Analysis and CCO attend the BCC's meetings as advisors.

Risk Management attends all ACC meetings. Risk Management and the Chief Credit Officer have the power to veto or escalate controversial credit committee decisions to a higher authority as well as put any credit case on the agenda on an ACC meeting for discussion and decision if applicable. Credit proposals outside of the authority of the ACC 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.

Assessment of a credit case is based on the customer's ability to service the debt and/or the quality of the collateral. However, if collateral is liquid, less emphasis is placed on assessing solvency of the customer.

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 analyzed 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. Risk framework and monitoring department aggregates the portfolio monthly, based on consistent criteria, to analyze the outstanding risk, the collateral level, as well as the portfolio quality. Risk framework and monitoring analyzes loans that have been classified at risk and maintains an independent and centralized overview of distressed credits. Risk framework and monitoring, based on its analysis, manages 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 the rules on capital requirements are derived from original exposure (gross carrying value including off-balance sheet amounts), net exposure after applying specific credit risk adjustments to the original exposure, adjusted exposure value (net exposure after applying credit risk mitigation (CRM), i.e. exposure net of collateral) and exposure at default (EAD) which is the adjusted exposure value after applying credit conversion factors (CCF) to off-balance sheet items. Also shown are risk-weighted exposure amounts (REA), which is EAD multiplied with the relevant risk-weight.

Credit Risk

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

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

Table 4.2 Continued

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	0.0%
Institutions	30,010	3,468	30,010	1,215	6,934	22.2%
Corporates	312,039	59,738	303,594	20,508	324,103	100.0%
Retail	109,492	42,683	109,034	5,354	85,791	75.0%
Secured by mortgages on immovable property	343,158	3,874	342,83	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	150.0%
Covered bonds	417		417		83	20.0%
Collective investments undertakings	4,907		4,907		4,140	84.4%
Equity	4,325		4,325		4,325	100.0%
Other items	30,763		30,763		30,763	100.0%
Total	**1,002,225**	**113,684**	**994,347**	**29,545**	**610,782**	**59.7%**

The Bank's credit risk-weight density, or REA density, measured as REA relative to EAD, decreased from 59.7% to 56.5% in 2020. There are two main reasons for this decrease. At the beginning of the year, the SME supporting factor took effect in Iceland and this resulted in reduced capital requirements for SMEs. The other key factor is the fact that the Bank's mortgage portfolio grew by ISK 68 billion while assets which tie up more capital, e.g. corporate loans and financial assets in the investment book, have decreased.

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

Table 4.3 Continued

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**

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, 53% are loans to individuals, of which 87% are mortgage loans. Credit exposure to individuals represents 39% 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 33% of loans to corporate entities or 16% 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

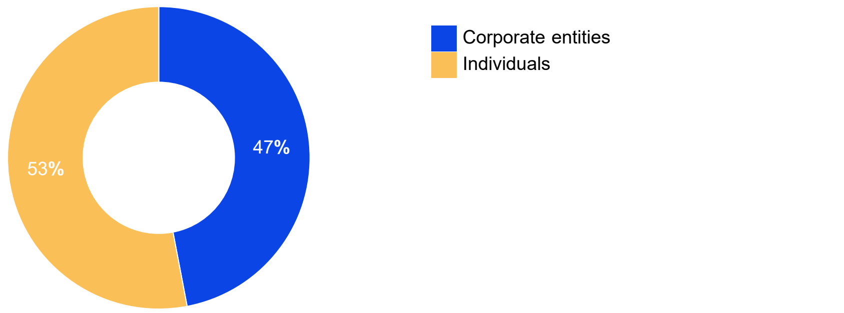
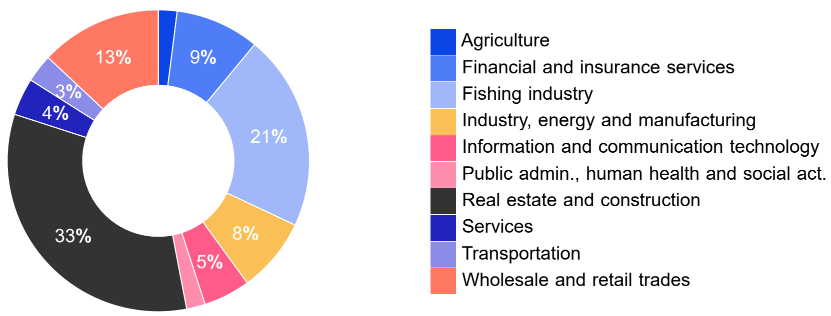


Figure 4.2 Sector distribution of loans to corporate entities



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 9% of loans to customers at the end of 2020, compared to 8% in 2019. The tourism exposure draws mainly from three standard industry sectors: Wholesale and retail trades (42%), Real estate and construction (35%) and Transportation (11%).

9% 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 90% towards counterparties domiciled in Iceland.

The majority of the 10% foreign credit exposures is due to liquid assets in foreign currencies, which includes short term deposits and money market loans at credit institutions, and sovereign bonds, the counterparties of which have high grade or upper medium grade credit ratings from certified external credit agencies (ECAI).

Figure 4.3 Geographic distribution of total net exposure

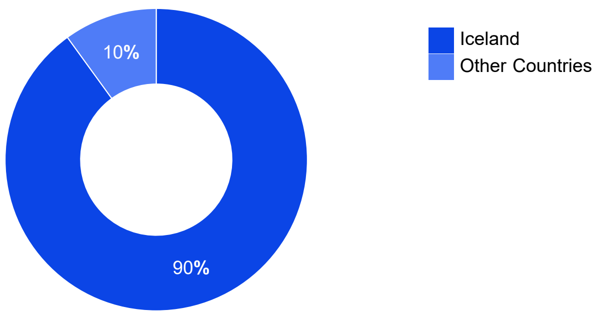
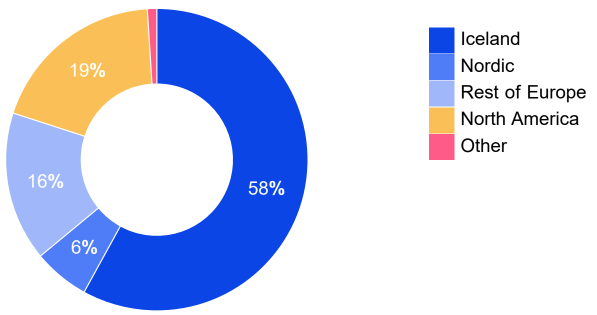


Figure 4.4 Geographic distribution of total net exposure to institutions, central governments and central banks



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

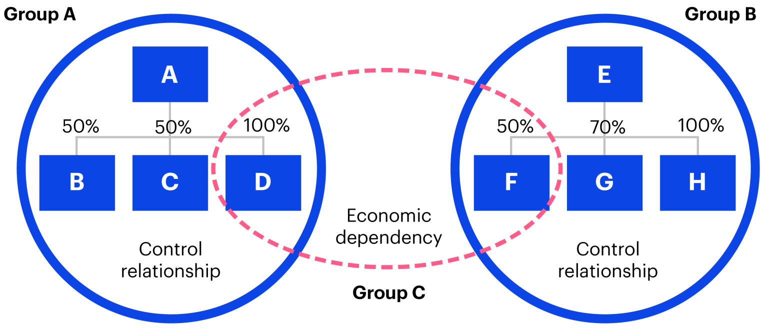
A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's eligible capital according to Act on Financial Undertaking No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures, net of eligible collateral,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

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

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 the relevant conditions 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

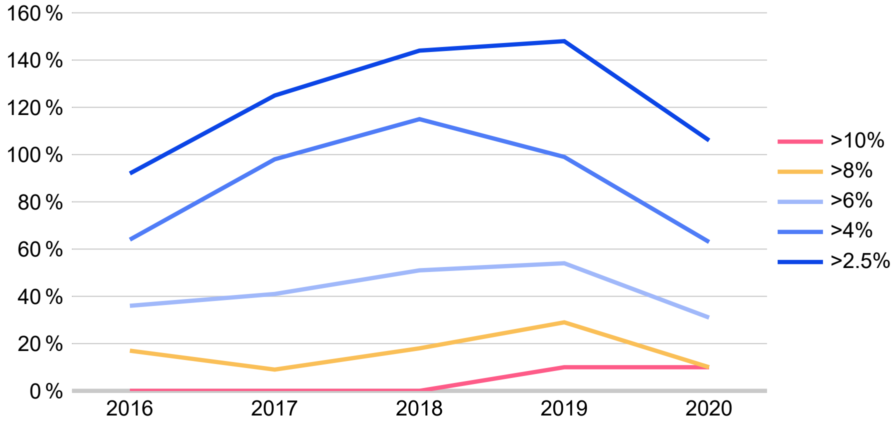
Customers' exposures are updated daily and are available at any time through the Bank's CRM system. In addition, an exposure report for a group of connected clients is updated weekly and is accessible at any time to Risk Management, Corporate and Investment Banking and Retail Banking. The report shows 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 2020, the Bank had one large exposure within loans to customers, totaling ISK 20.9 billion before accounting for eligible collateral. 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.

One exposure to a group of related parties within Loans to Customers was classified as a *large exposure* at year end 2020

The sum of exposure exceeding 2.5%, net of eligible collateral, decreased from 148% to 106% year-on-year, see Figure 4.6. This is largely a result of the Bank's increased capital base.

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



4.5 Equity Risk in the Banking Book

Exposure limits for equity positions 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 listed equities was reduced in 2020, mainly as a result of the sale of shares in Visa Inc.

Table 4.4 Equity exposure in the banking book

31 December 2020 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		290	290
Equity instruments with variable income	2,668	2,385	5,053
Fund shares - Bonds		811	811
Fund shares - Other	52	2,114	2,165
Total equity exposure in the banking book	**2,720**	**5,600**	**8,320**
Unrealized gain/loss at year-end 2020			1,612
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

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.

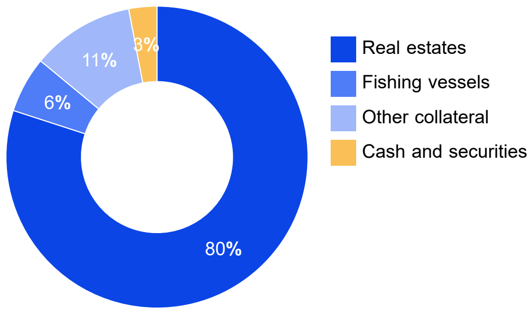
To ensure coordinated collateral value assessment, the Bank operates five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The five committees' areas of expertise are:

- 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 80% of the total collateral. At the end of 2020, loans to customers were secured by collateral conservatively valued at ISK 745,390 million, which results in a collateral coverage ratio of 91% compared to 90% at the end of 2019.

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 2020 was 91% compared to 90% at the end of 2019

Table 4.5 Collateral for loans to customers

31 December 2020 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2020	Unsecured ratio % 2019
Individuals	52	393,680	8	12,335	406,075	6.3%	7.9%
Real estate activities and construction	273	110,453	65	2,912	113,703	11.1%	4.9%
Fishing industry	244	13,655	41,206	25,665	80,770	1.0%	7.8%
Information and communication technology	44	5,184	0	4,693	9,921	52.3%	57.0%
Wholesale and retail trade	274	38,600	25	10220	49,119	4.8%	11.1%
Financial and insurance services	18,295	3,267	0	9,606	31,168	12.8%	3.2%
Industry, energy and manufacturing	14	16,214	0	12,520	28,748	7.8%	12.4%
Transportation	1	744	1875	2,340	4,960	61.1%	58.0%
Services	33	8,615	152	1,998	10,798	18.0%	14.9%
Public sector	3	2,103	7	228	2,341	65.5%	71.1%
Agriculture and forestry	0	7,423	0	364	7,787	3.7%	7.7%
Total	**19,233**	**599,938**	**43,338**	**82,881**	**745,390**	**9.4%**	**10.2%**

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

Figure 4.9 shows the mortgage portfolio broken down by LTV bands based on the face value of the mortgages. At the end of 2020, 87% of the mortgages, by value, had loan-to-value below 80%, the same as for the end of 2019. 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]

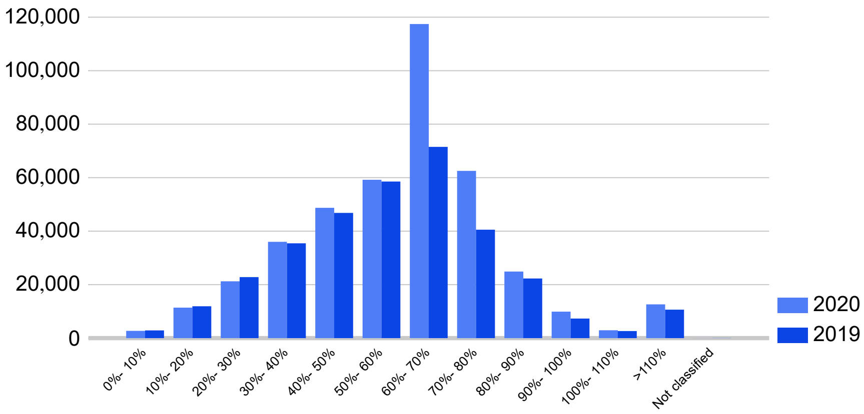
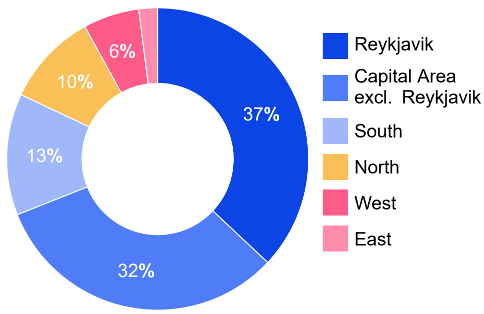


Figure 4.8 Mortgage portfolio by location



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, calculation of loss allowance 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 for corporates was changed in 2020 where the exposure limit for large corporate was raised and the model for retail corporates was updated. In all tables and figures in this chapter large corporates are reported for both 2019 and 2020 with this new exposure limit.

Table 4.6 Probability of Default models

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

The Bank's PD models are developed within Risk Analysis, while the validation of the models is performed independently by Risk Monitoring and Framework.

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. At the end of 2020, only 0.4% 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, see chapter 4.8. Around 1.8% of the portfolio, by exposure, was assigned a default rating at the end of 2020, which is 0.1 percentage points higher than at the end of 2019. Active PD values are translated into an internal rating scale of letters from CCC- to AAA. The scale is shown in Table 4.8. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

Table 4.7 Breakdown of rating status by exposure

Rating Model	2020			2019		
	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	97.0%	2.5%	0.6%	98.2%	1.7%	0.1%
Retail corporates	95.5%	4.5%	0.0%	95.4%	4.0%	0.6%
Other entities	94.6%	1.1%	4.2%	98.7%	1.1%	0.2%
Individuals, mortgages	99.1%	0.9%	0.0%	98.7%	1.3%	0.0%
Individuals, consumer loans	99.2%	0.8%	0.0%	98.8%	1.2%	0.0%
Individuals, other exposures	97.8%	2.2%	0.0%	97.5%	2.3%	0.2%
Total	**97.8%**	**1.8%**	**0.4%**	**98.1%**	**1.7%**	**0.1%**

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 comparison uses the new division between retail and large corporates for both 2019 and 2020.

The exposure-weighted average PD for the large corporate portfolio was 5.8% at year-end 2020, compared to 2.5% at year-end 2019. In terms of exposure, approximately 14% have been upgraded towards a better risk class, in contrast to 27% that have been downgraded. The reason for this rise in the average PD is due to the COVID-19 specific shift, see chapter 4.8.1. 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 2019 and 2020 – Large Corporates

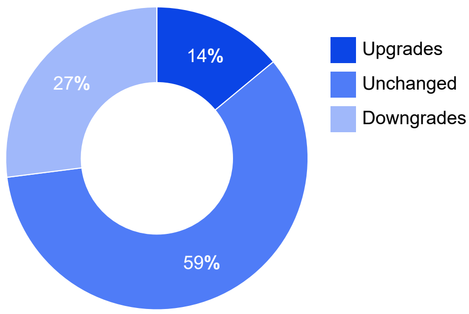
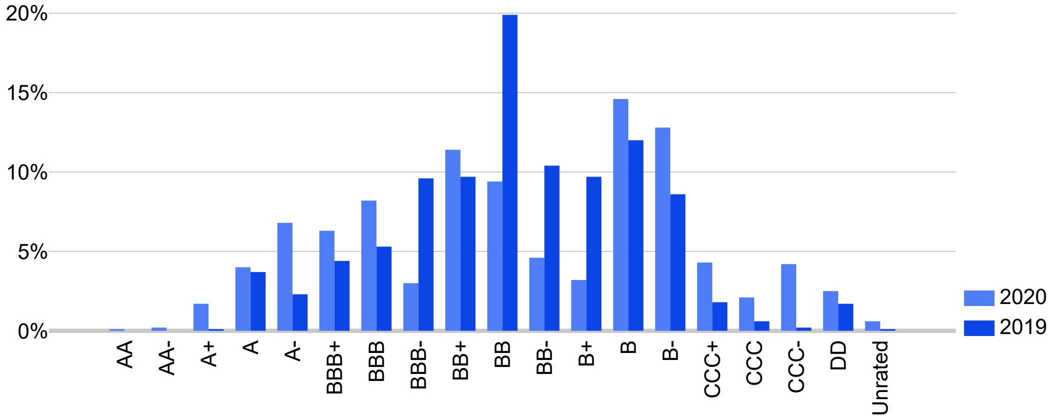


Figure 4.11 Distribution of exposure by rating for large corporates



Retail Corporates

Figure 4.13 shows the retail corporate portfolio broken down by ratings. The distribution of PD values has shifted towards worse values from 2019 to 2020. The change can partly be attributed to pure migration but is mostly due to COVID-19 shift, see chapter 4.8.1.

The exposure-weighted average PD was 7.8% at the end of 2020, compared to 5.1% at year-end 2019. In terms of exposure, 19% have been upgraded towards a better risk class whereas 27% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.12 Risk class rating migration by exposure between 2019 and 2020 – Retail Corporates

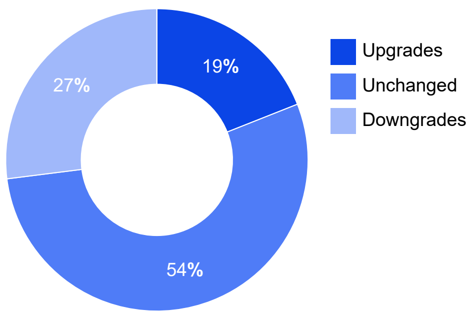
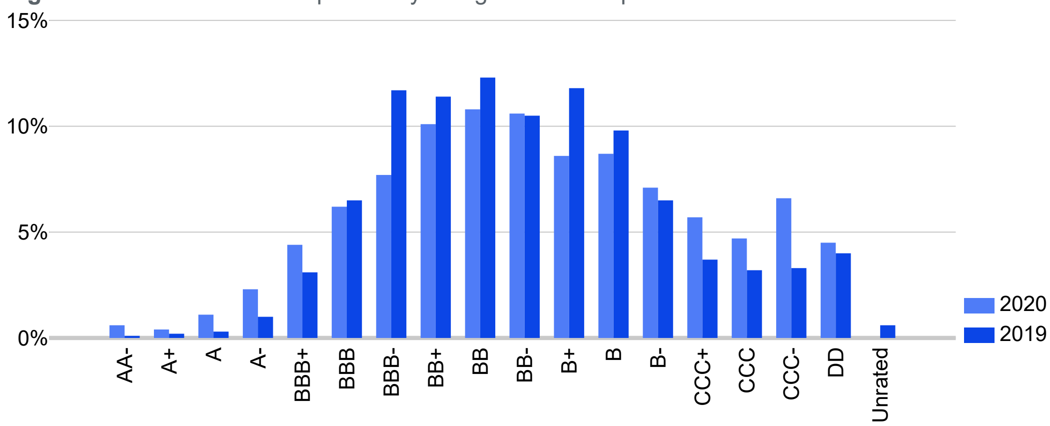


Figure 4.13 Distribution of exposure by rating for retail corporates



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, significant number of new mortgages and moratoria granted in 2020 due to COVID-19.

The exposure-weighted average PD for the mortgage portfolio was 1.0% in year-end 2020 compared to 1.3% in year-end 2019. In terms of exposure, approximately 8% of mortgages have migrated towards an improved credit grade and 8% 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 2019 and 2020 - mortgages to Individuals

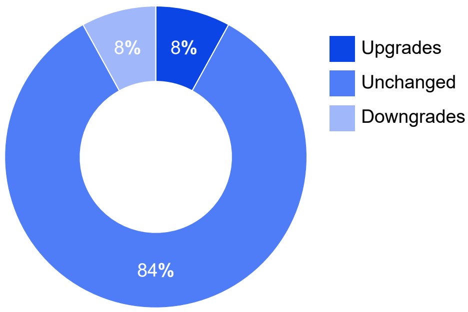
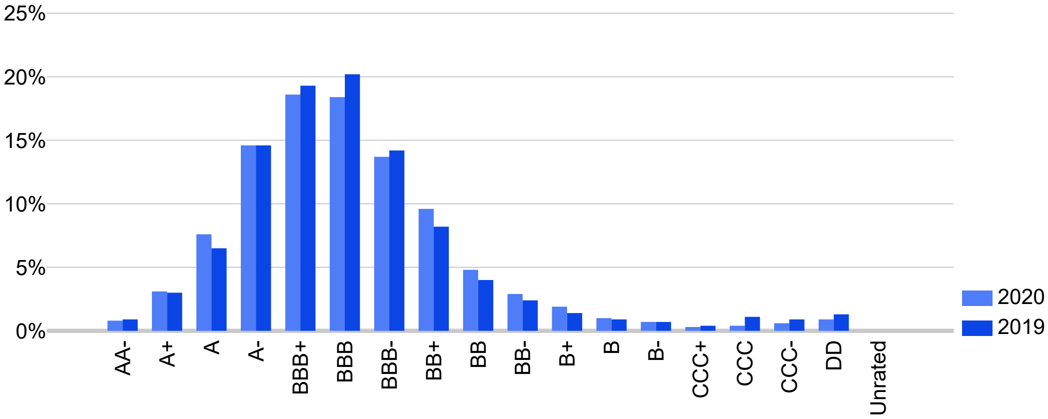


Figure 4.15 Distribution of exposure by rating for mortgages to individuals



Consumer loans

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. The change can partly be attributed to pure migration and COVID-19 related moratoria for mortgages.

The exposure weighted average PD for the portfolio was 2.2% at year-end 2020 compared to 2.7% at year-end 2019. In terms of exposure, about 14% have been upgraded towards a better risk class whereas 16% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.16 Risk class rating migration by exposure between 2019 and 2020 - Consumer loans

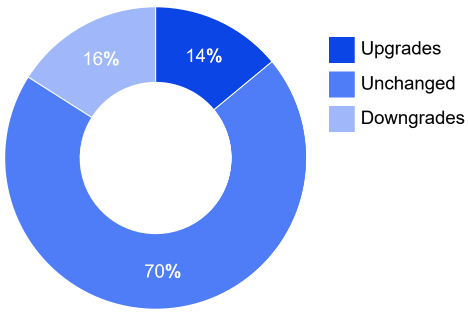
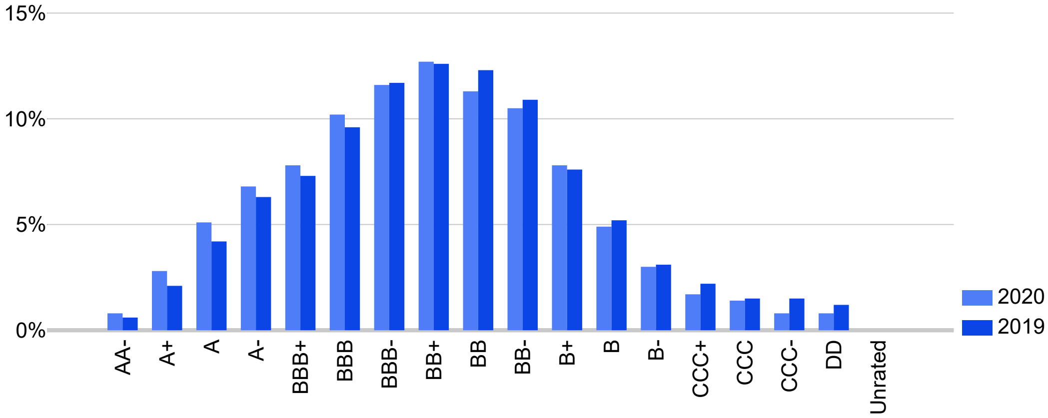


Figure 4.17 Distribution of exposure by rating for consumer loans



Model performance

At the end of 2020, the discriminatory power of the four rating models with the largest exposure is in line with or exceeds the Bank's internal requirements and the prediction accuracy is satisfactory. The comparison values for the exposure weighted average PD estimates at the end of 2019 and exposure weighted observed default rates in 2020 are shown in the following table.

Table 4.9 Model performance. Observed default rates in 2020 compared to probability of default predicted at year-end 2019

Model portfolio	Average PD	Observed avg default rate
Large corporates	2.5%	3.4%
Retail corporates	5.0%	6.1%
Individuals, mortgages	1.2%	1.4%
Individuals, consumer loans	1.9%	1.7%

In figures 4.18 and 4.19, the actual default rate for each rating level in 2020 is compared to the predicted default probability at the end of 2019 for individuals (Mortgages and Consumer loans) and corporates (Large and Retail corporates), respectively.

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

Figure 4.18 Comparison of actual default rate in 2020 and predicted default probability - Individuals

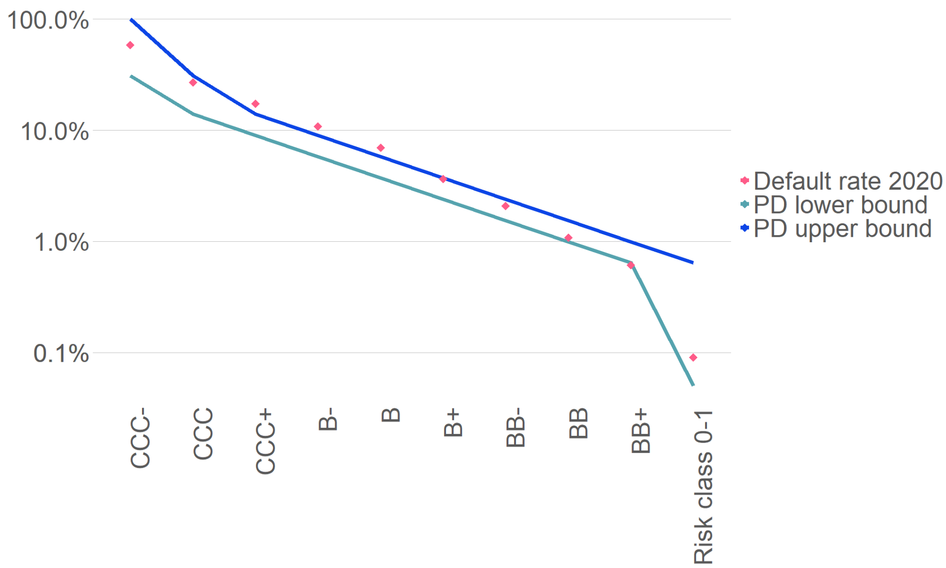
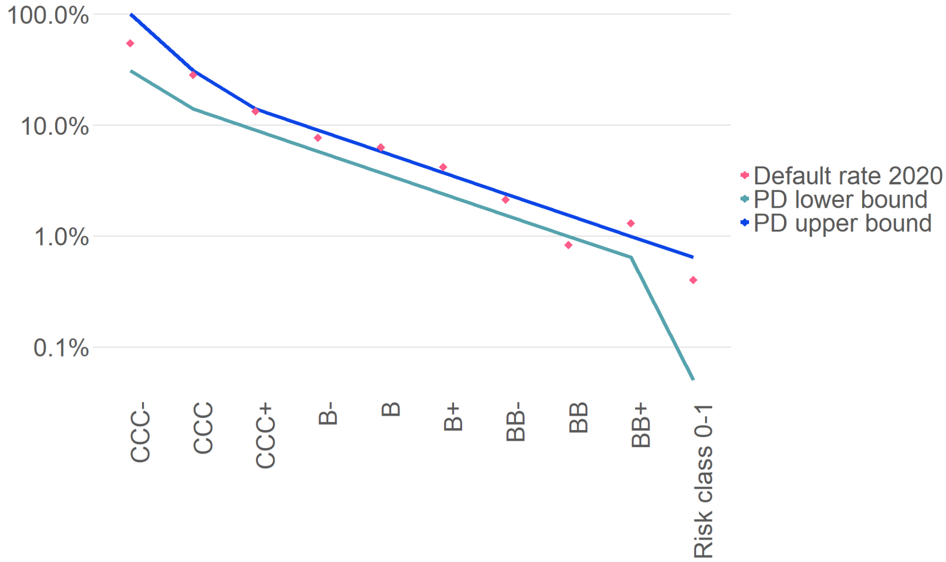


Figure 4.19 Comparison of actual default rate in 2020 and predicted default probability - Corporates



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 Effects of the COVID-19 pandemic

Chapter 1.2 describes how the global COVID-19 pandemic has affected the economy and states the various mitigating measures that the government of Iceland has introduced. The measures that the Bank has participated in are e.g. general payment moratoria and loans through government sponsored loan schemes, initiated as a result of the crisis. The government sponsored loans were directed towards corporates, but payment moratoria were granted to both individuals and corporates.

Figure 4.20 COVID-19 related payment moratoria for individuals [ISK m]

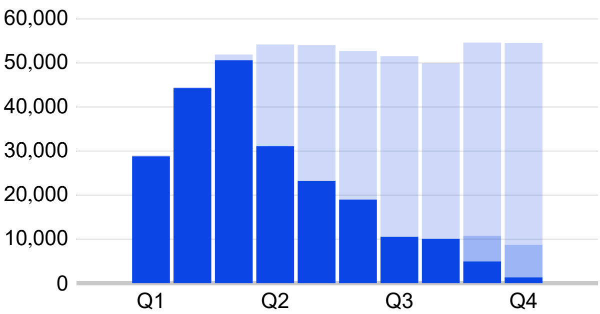
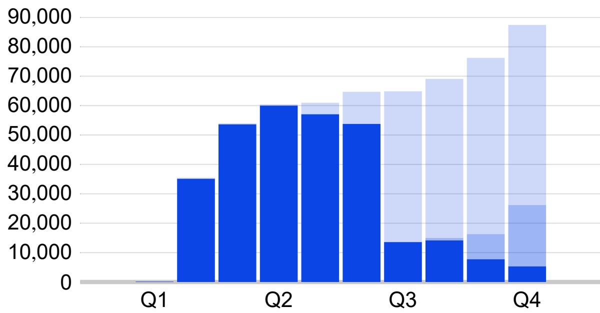


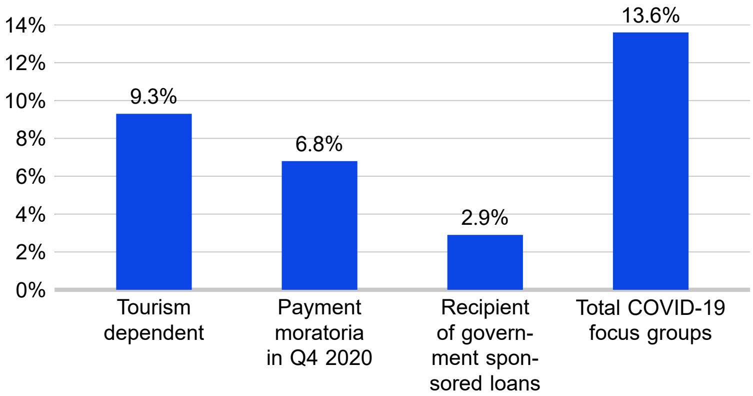
Figure 4.21 COVID-19 related payment moratoria for corporates [ISK m]



For further information, see Note 42 on Payment moratoria and groups with special focus due to the COVID-19 pandemic in the Bank's Consolidated Financial Statements for 2020.

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

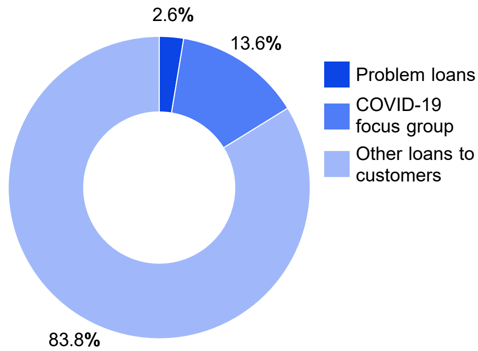
Figure 4.23 Segments of loans to customers considered as COVID-19 focus group. Shown as percentage of gross carrying amount.



As a response to the crisis, the exposure to the focus group described above was divided into four impact groups according to impact assessment. The customers that were considered having minimal impact were placed in impact group 1. In groups 2, 3 and 4 the impact was assessed to correspond to credit rating downgrades by 1, 2 and 3 grades, respectively. The largest exposures in tourism were assessed separately into the four groups and the average assessed impact was group 3, with a downgrade of 2 rating grades, and other customers in the focus group were therefore given that assessment. The exposure in each impact group is broken down by industry sector and displayed in Note 42.

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

Figure 4.22 Breakdown of loans to customers at year-end 2020



4.8.2 Impairment and Provisions

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 exposures, a cross-default approach is applied i.e. if a corporate borrower has one impaired credit then all exposures to this borrower are moved to Stage 3 and classified as risk class 5 (a DD rating). For individuals, the same applies within each credit model and a default in one portfolio can result in a default on other portfolio if the defaulting exposure is significant.

For further information, see Note 42 on Credit Risk Rating in the Bank's Consolidated Financial Statements for 2020.

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 42 on Expected credit losses in the Bank's Consolidated Financial Statements for 2020.

4.8.3 Past Due Exposures

Figures 4.24 and 4.25 show the development of serious defaults from the end of 2015 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. In the past years defaults on loans to individuals has been decreasing, while default rates on loans to companies has increased in part due to large default events.

Customer loans that are more than 90 days past due represent 1.2% of the total loan book at year-end 2020 if measured at facility level

Figure 4.24 Development of past due exposures to individuals, parent company

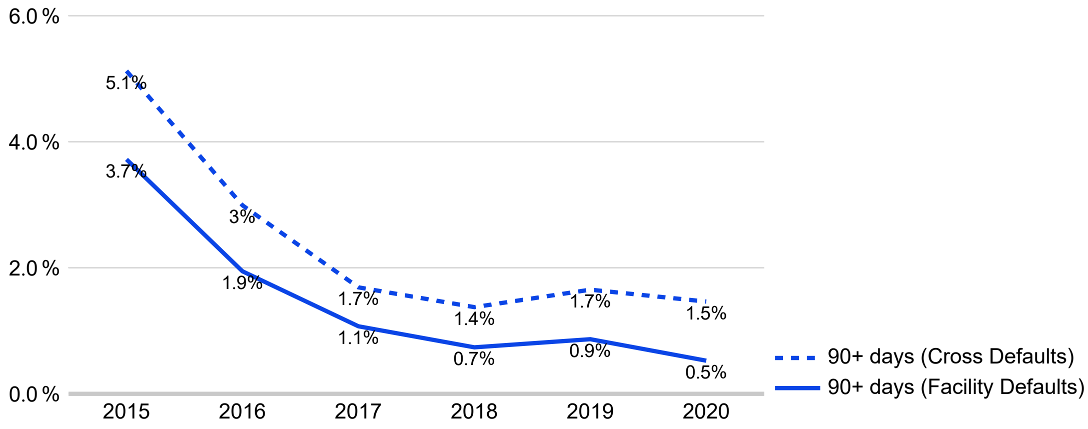
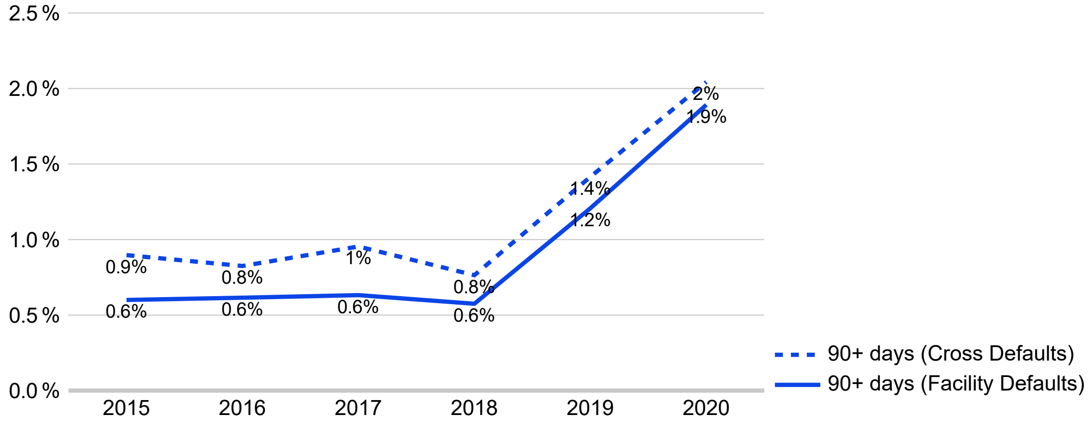


Figure 4.25 Development of past due exposures to companies, parent company



Customer loans that are more than 90 days past due were 1.2% of the total loan book at year-end 2020 if measured at facility level. The cross default ratio more than 90 days past due was 1.7%; 1.5% for individuals and 2.0% 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.

4.8.4 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 quality of forborne exposures please refer to templates EU CQ-1 in the Additional Pillar 3 Risk Disclosures.

4.8.5 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 following the financial crisis. 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), loss given default (LGD) and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see sections 4.7 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 and any loss occurring for the bank within 18 months from the default event
- the *collateral gap* of the defaulted exposure, with haircuts based on historical evidence and expert judgment
- assessment of recoveries of defaulted non-collateralized 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. The PD and LGD values are weighted by the corresponding gross carrying value, taking off-balance sheet items also into account. The ECL values shown are impacted by the IFRS9 macro economic forecasts. The reason for the rise in the 12 month expected credit loss between years is primarily due to a worsening economic outlook as a result of the COVID-19 pandemic.

Table 4.10 Expected credit loss by exposure type

31 December 2020	PD	LGD	EL
Large Corporates	5.3%	11.2%	0.71%
Retail Corporates	7.5%	7.7%	0.89%
Individuals, Prime Mortgages	1.0%	1.4%	0.12%
Individuals, Other	2.3%	31.0%	0.99%
Weighted average	**3.3%**	**7.9%**	**0.50%**

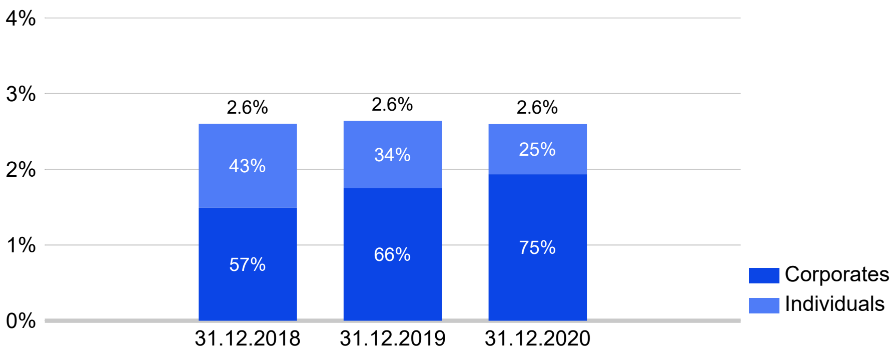
31 December 2019	PD	LGD	EL
Large Corporates	2.6%	8.3%	0.18%
Retail Corporates	5.2%	7.9%	0.43%
Individuals, Prime Mortgages	1.3%	0.7%	0.02%
Individuals, Other	2.4%	27.5%	0.92%
Weighted average	**2.2%**	**6.9%**	**0.19%**

4.8.6 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* is calculated based on the gross carrying value of loans. At the end of 2020, the Problem loan ratio is 2.6% of the loan portfolio, the same as for the end of 2019. 75% of problem loans, by value, at year-end 2020 are loans to corporates and 25% to individuals.

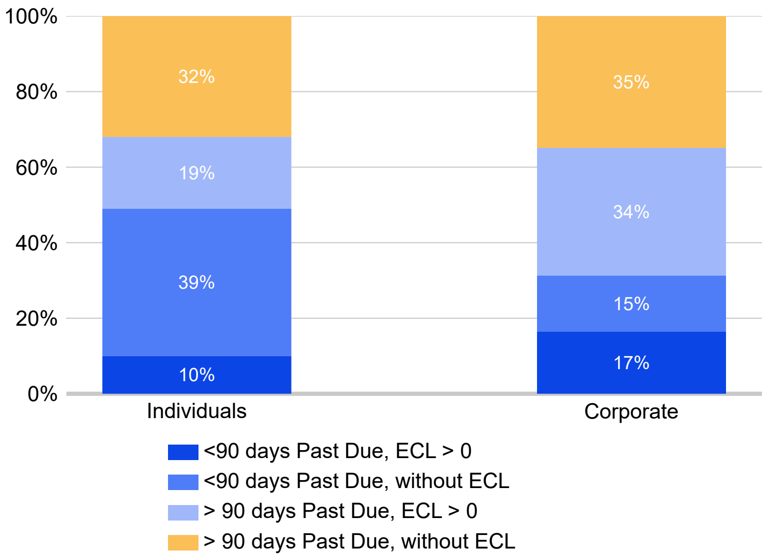
Problem loans ratio is 2.6%, at gross carrying value.

Figure 4.26 Development of problem loans



The breakdown of problem loans by status is shown in Figure 4.27. Around 55% of the problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

Figure 4.27 Breakdown of problem loans by status



4.8.7 New definition of default

EBA has issued a guideline, EBA/GL/2016/07, regarding the definition of default. The guideline provides a further explanation and details of the definition of default as presented in article 178 in CRR. The Bank has interpreted this into its own definition of default with technical details, which complies with the guidelines and is suited for the Bank's size and procedures. The guideline includes a requirement to consider the co-debtor group for a facility and a cross-default requirement if the obligor is in default on a large obligation.

The new definition can be divided into three types of default; unlikely to pay, 90 days past due and cross-default, and probation with or without forbearance. The definition for an obligor to be considered as unlikely to pay remains similar but the conditions that must be satisfied for an obligor to exit this state have been clarified. The main difference to the definition of 90 days past due is that instead of always considering the oldest unpaid due date, the count depends on continuous past due days. Another change to the 90 days past due definition is the relative threshold, which means that a debtor is not considered in default for a specific portfolio unless the ratio of exposure in default and the total exposure is over 1%.

A probation period is a new type of default. When a debtor has been marked in default as a result of 90 days past due, they will have to wait for a probation period of at least three months to end their in-default state. If an obligor becomes past due while on probation, the counter starts again for three months after they have paid off outstanding arrears. Furthermore, if a forbearance measure is granted after an obligor goes into default, the probation period will be one year counting from when the forbearance measure was taken. The effect of the new definition appears gradually as the probation periods start to apply. Thus, it will be seen in the Pillar 3 report for next year.

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 2020 [ISK m]	Risk weights						
Exposure classes	0%	20%	50%	75%	100%	Total	Of which unrated
Central governments and central banks		1,550				1,550	
Regional governments or local authorities		79				79	
Institutions	3,790	1,729	2,043			7,562	25
Corporates	3,414		55		1,715	5,184	
Retail	357			202		588	
Total	**7,560**	**3,358**	**2,097**	**202**	**1,715**	**14,933**	**25**

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

31 December 2020 [ISK m]	Gross positive fair value or net carrying amount	Netting benefits	Netted current credit exposure	Collateral held	Net credit exposure
Derivatives	10,054		10,054	8,176	1,877
SFTs					
Cross-product netting					
Total	**10,054**		**10,054**	**8,176**	**1,877**

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

31 December 2020	Collateral used in derivative transactions				Collateral used in SFTs	
[ISK m]	Fair Value of Collateral received		Fair Value of Collateral posted		Fair Value of Collateral received	Fair Value of Collateral posted
Item	Segregated	Unsegregated	Segregated	Unsegregated		
Cash - domestic currency		2,031			6,950	79
Cash - other currency		4,411		702		
Domestic sovereign debt		841			478	2,801
Other sovereign debt						
Local government debt		59			79	
Institutions		2,452				5,350
Corporate		1,069			65	44
Equity securities		5,291				
Other collateral		697				
Total		**15,831**		**702**	**7,507**	**8,229**

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.

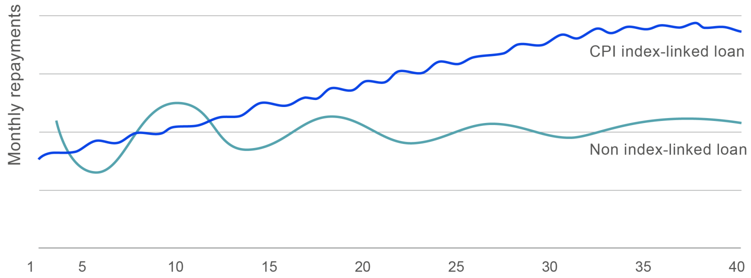
CPI-linked mortgages are typically annuities, where the monthly payment and the remaining principal are linked to the CPI

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.

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 their 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 4.28 Monthly payments of a 40 year CPI-linked annuity, for illustrative purposes

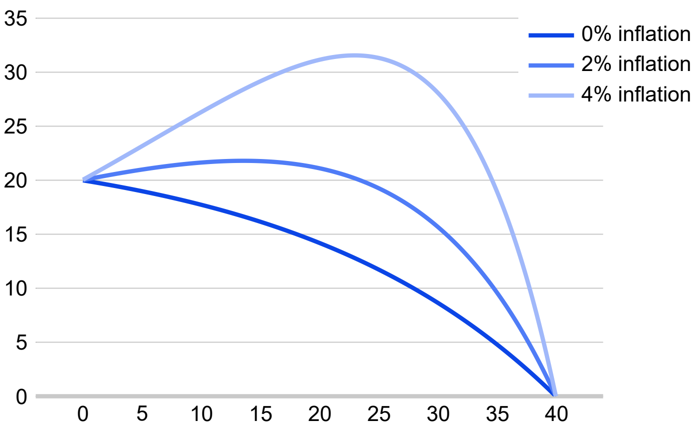


Default-risk in CPI-linked loans is further mitigated by a legislated mechanism called *payment adjustment* (IS: greiðslujöfnun). The purpose of this mechanism is to reduce the risk of borrower distress in periods when inflation outpaces increases in wages. The mechanism is triggered when the CPI exceeds 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 4.29. 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 4.29 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 4.30

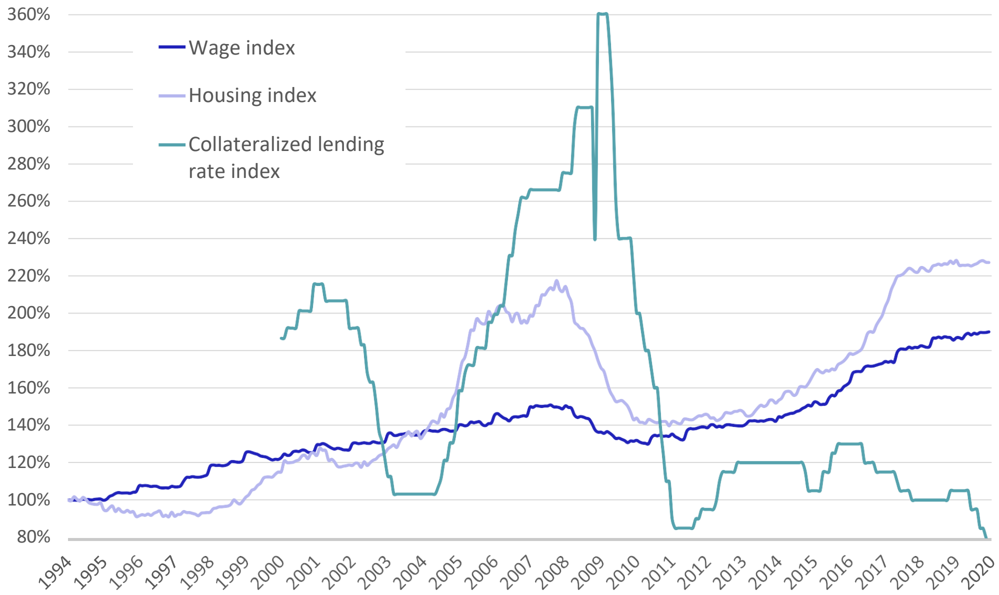
shows the development of the official wage and housing indices, in real terms. The figure demonstrates the approx.35% average drop in housing prices and approx. 15% average drop in salaries – in real terms – during the recession of 2009-2010.

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

Figure 4.30 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.

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

Figure 4.30 Development of wages, housing prices and interest rates



5 **Market** Risk

5 Market Risk

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

5.1 Governance and Policy

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

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

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

5.2 Market Risk Management

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

Table 5.1 Sources of market risk

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

Risk Management is responsible for measuring and monitoring market risk exposure and compliance with the limit framework.

The performance, exposure and relevant risk measures for the trading book are summarized and reported to the relevant employees and managing directors on a daily basis. Exposures and relevant risk measures are reported on a regular basis to ALCO, BRIC and the Board of Directors.

5.3 Market Risk Measurement

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

Table 5.2 Market risk measurement methods

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

5.4 Minimum Capital Requirements

The Bank's capital requirements for market risk under Pillar 1 are calculated using the standardized method as stipulated in CRR.

Table 5.3 Market risk minimum capital requirements (EU MR1)

31 December 2020 [ISK m]	REAs	Capital requirements
Outright products		
Interest rate risk (general and specific)	5,052	404
Equity risk (general and specific)	8,012	641
Foreign exchange risk	8,569	685
Commodity risk		
Options (non-delta)		
Securitisation (specific risk)		
Total	**21,632**	**1,731**

5.5 Foreign Exchange Risk

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

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

Foreign currency [ISK m]	Net Exposure	10 day 99%VaR
EUR	5,043	179
USD	733	109
GBP	2,391	38
DKK	-898	32
Other	-98	41
Diversification	-	-139
Total	**7,171**	**261**

At year-end 2020, 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 2020, the total amount of CPI-linked assets amounted to ISK 272.2 billion and the total amount of CPI-linked liabilities was ISK 217.1 billion. Therefore, the net CPI-linked imbalance was ISK 55.1 billion, which means that deflation would result in a loss for the Bank. The indexation imbalance decreased by ISK 34 billion in 2020, primarily due to contraction of indexed loans in excess of that of indexed liabilities. As interest rates have been lowered significantly in 2020 in response to the economic recession, refinancing of indexed loans to non-indexed loans has been the general market trend.

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 47.6 billion at year-end 2020. Indexed loans to customers decreased from ISK 283.9 billion in 2019 to ISK 257.8 billion at-year-end 2020, primarily due to customers seeking refinancing in non-indexed loans as nominal rates in Iceland are historically low.

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 2020 inflation was measured at 3.6%. 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]

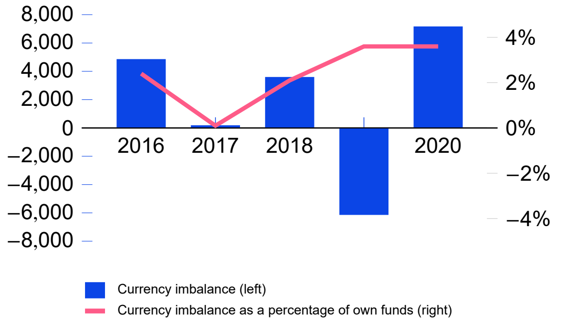


Figure 5.2 Development of the Bank's Indexation imbalance [ISK m]

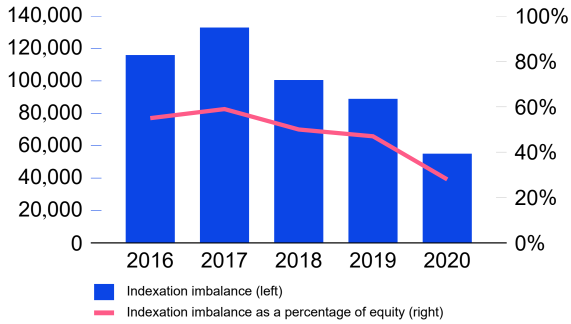
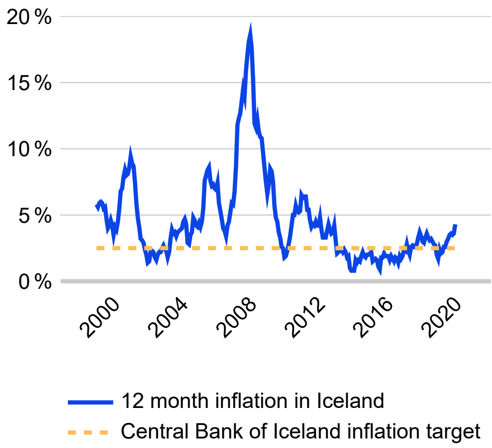


Figure 5.3 12 month inflation in Iceland



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

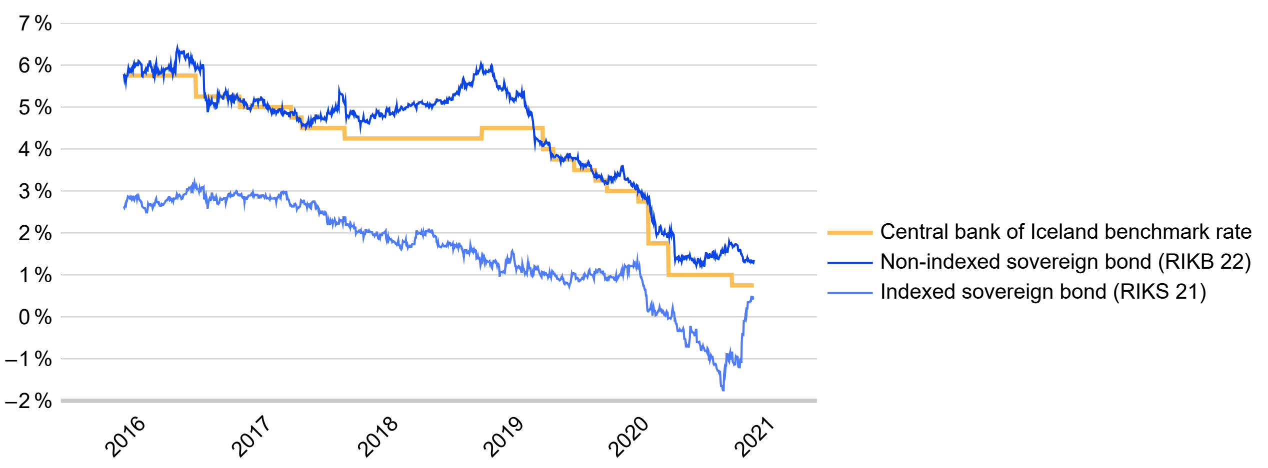
The Bank's strategy for managing interest rate risk is to strive for a balance in the interest fixing profile between assets and liabilities.

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

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

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years, resulting in reduced average duration of fixed rates for the Bank's assets. Prepayment risk is mitigated by prepayment fees and the Bank's own prepayment options. The Bank's prepayment of structured covered bonds in the past years is a reaction to mortgage prepayments and mortgage refinancing. Decreasing domestic interest rates 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]

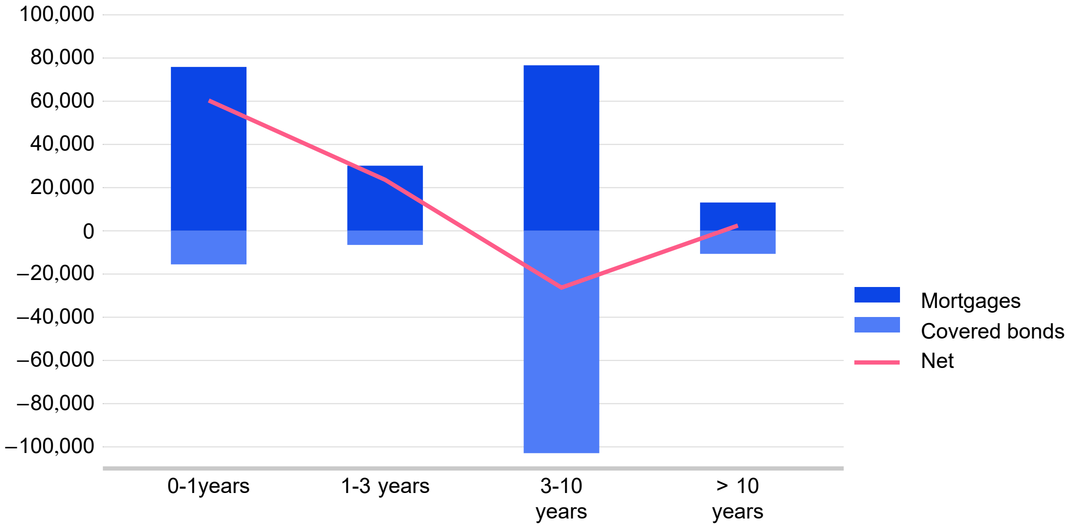


Figure 5.6 Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]

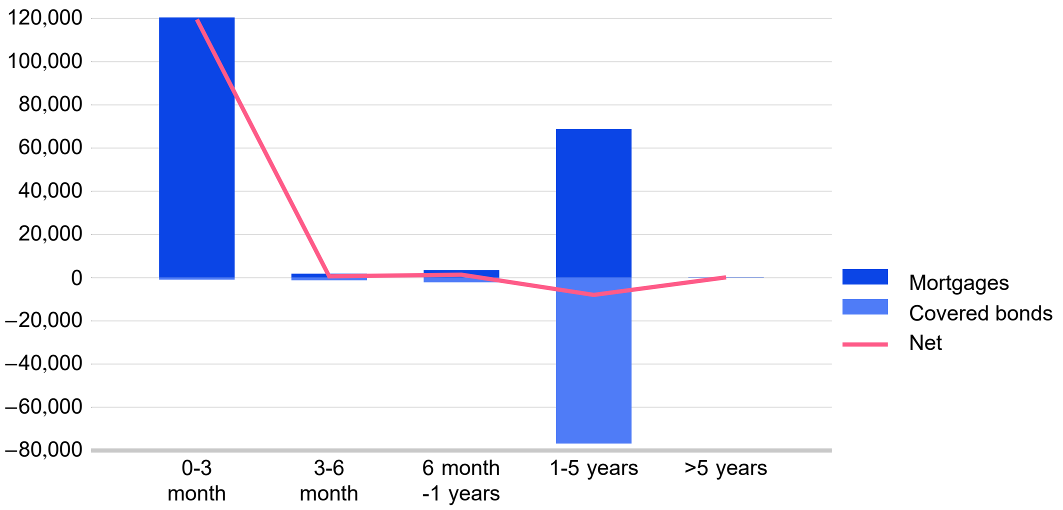


Table 5.5 shows the fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched 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. Due to a sharp reduction in interest rate in 2020 the Bank has used its large liquidity reserves at the Central Bank to buy government bonds and covered bonds due to their higher yields. This causes the Bank to now be fair value sensitive to increased rates in non-indexed ISK.

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

	2020		2019	
31 December [ISK m]	-100bps	+100bps	-100bps	+100bps
ISK, CPI index-linked	-3,849	3,511	-3,198	2,650
ISK, Non Index-linked	933	-1,002	-134	209
Foreign currencies	301	-327	365	-392

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]	2020	2019
Bonds	5,346	5,426
Equity	3,909	3,015
Total	**9,255**	**8,441**

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

Table 5.7 The Bank's proprietary trading exposure

31 December 2020 [ISK m]	Bonds		
	Long	Short	Net
Year-end	5,346	-40	5,306
Average	6,526	-321	6,205
Maximum	10,520	-1,475	10,520

31 December 2020 [ISK m]	Equity		
	Long	Short	Net
Year-end	3,909	-63	3,846
Average	3,603	-18	3,585
Maximum	5,885	-182	5,885

5.8.2 Trading Derivatives

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

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

Table 5.8 Derivatives on the trading book

31 December 2020 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	151	803	406	397	36,201	Market risk
Interest rate and exchange rate agreements	31	193	66	127	24,061	Market risk
Bond swap agreements	63	101	41	60	11,138	Credit risk
Share swap agreements	171	1,511	501	1,010	11,031	Credit risk
Options	0	0	0	0	0	Market risk
Total	**416**	**2,608**	**1,014**	**1,594**		

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**		

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 2020, 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.

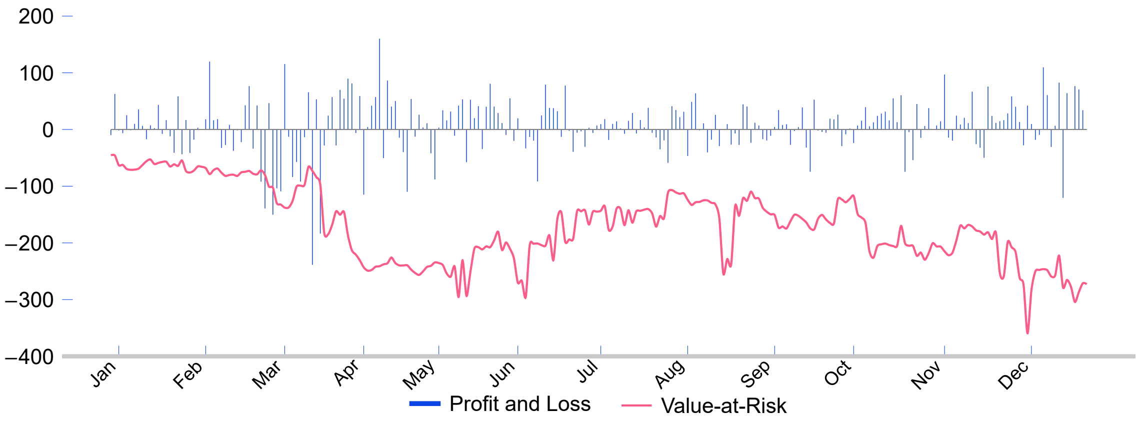
Table 5.9 Value-at-Risk for the trading book with a 99 percent confidence level over a 10 day horizon

31 December 2020 [ISK m]	10 day 99%VaR
Equities	527
Equity options	40
Bonds	166
Bond options	29
Interest rate swaps	55
Diversification effects	**45**
Trading book Total	862

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 862 million over a 10 day period.

Figure 5.7 further shows the daily profit and loss of the Bank's trading book for 2020 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss exceeded the VaR 6 times 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 2020 [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.

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

At year end 2020, Arion Bank's strong liquidity position was reflected in high LCR values, namely 188%, 449% and 144% for total, foreign currency balances and ISK respectively

6.2 Liquidity Risk Management

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

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

Liquidity Risk

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

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

6.2.1 Internal Liquidity Adequacy Assessment Process

In conjunction with the ICAAP, see Section 3.4.1, 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 in accordance 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 analyses and stress tests. ALCO reviews a report on liquidity risk from Risk Management and receives projections on sources of funding and the use of funds from Treasury.

6.3 Liquidity and Funding Risk Measurement

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

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 was scheduled to increase by 10 percentage points in between years until reaching 50% in 2022. The Central Bank has now decided to extend the adaptation period by one year; i.e., the minimum liquidity ratio in ISK will remain 30% through the end of 2021. It will then rise to 40% on 1 January 2022 and 50% on 1 January 2023.

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

The new NSFR rules are based on the same foundation as the current domestic rules and the impact on calculated NSFR is minor.

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

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

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

6.4 Liquidity Position

At year end 2020, the Bank's liquidity buffer amounted to ISK 211,960 million, or 18% of total assets and 37% of total deposits. Composition of the Bank's liquidity buffer is shown in Note 44 of the Bank's Consolidated Financial Statements.

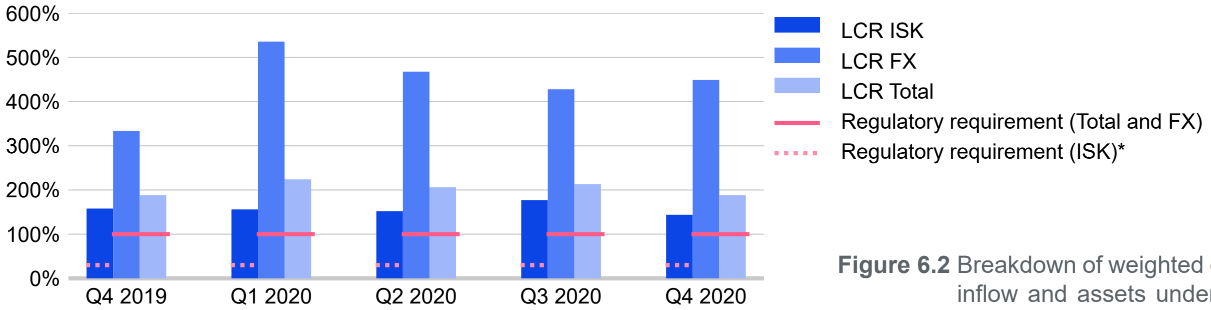
The Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 188%, 449% and 144% for total, foreign currency balances and ISK respectively.

Table 6.1 Liquidity Coverage Ratio

31 December 2020	ISK	FX	Total
Liquidity Coverage Ratio	144%	449%	188%
LCR Central Bank requirements	30%	100%	100%

The Bank has held a strong liquidity position throughout 2020, 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

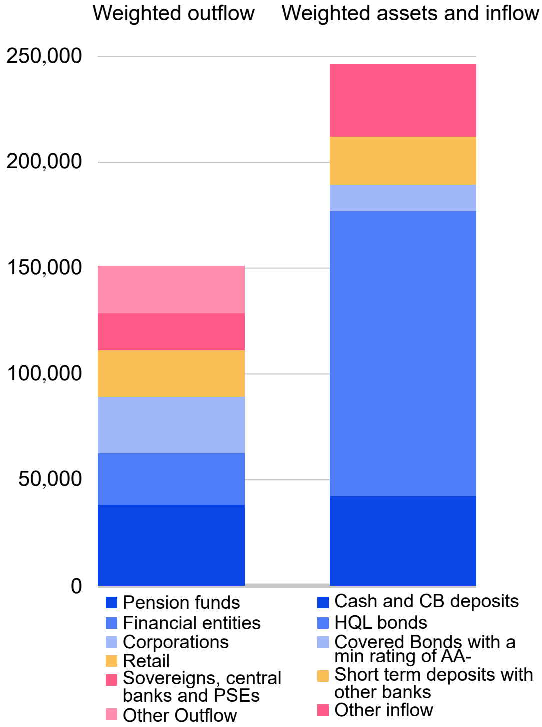


6.4.1 Breakdown of LCR

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 2020, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 232,059 million, substantially exceeding the weighted outflow of ISK 149,933 million. Of the total stressed outflow, ISK 127,477 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 2020 [ISK m]



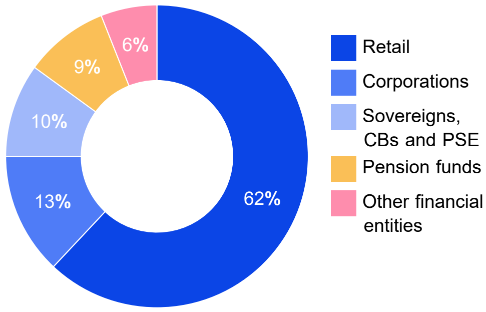
6.4.2 Deposit Categories

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

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

At year end 2020, 62% of the Bank's deposit base are due to retail clients. The Bank has placed emphasis on increasing its retail deposit base.

Figure 6.3 Distribution of deposits by LCR categories at year-end 2020



6.4.3 Concentration of Deposits

As seen in Figure 6.4, 79% of the Bank's deposits mature within 30 days. At the end of 2020, 13% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors as seen in Figure 6.5.

Figure 6.5 Concentration of deposits on demand within 30 days

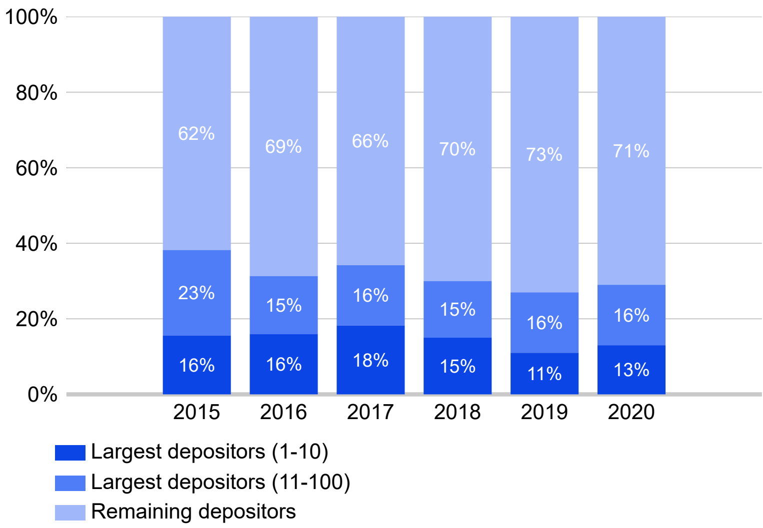
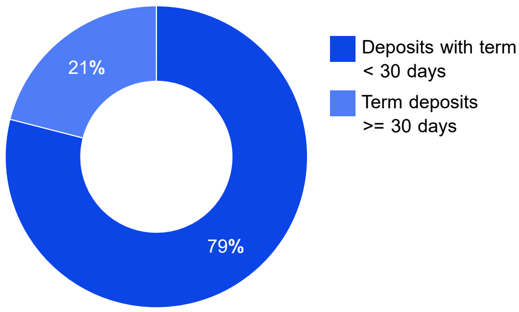


Figure 6.4 Deposit term distribution



6.5 Funding

Over the past few years, Arion Bank has taken significant steps to diversify its funding, issuing senior unsecured bonds in euros and other currencies. The Bank is a regular issuer of Covered Bonds in the domestic market. The Bank did its inaugural Additional Tier 1 (AT1) note issue in February 2020, when it issued USD 100 million perpetual note callable after 5.5 years. The AT1 note issue was an important milestone for the Bank as it has demonstrated access to the capital markets across the capital structure of the Bank.

In November, Arion Bank issued 3.5-year bonds in the amount of €300 million. The issue was oversubscribed, attracting offers for over €500 million from more than 50 investors. The instruments bear a fixed 0.625% coupon and were sold at terms equivalent to 1.15% margin over interbank rates. The new issue was announced in conjunction with a capped tender offer targeting Arion Bank's outstanding EUR 500m senior unsecured bonds due on December 2021.

Standard & Poor's (S&P) downgraded Arion Bank's and its Icelandic peers' credit rating to BBB with a stable outlook in April 2020. The short-term rating is A-2. S&P's reasoning for downgrading the banks is the sharp reduction in economic activity S&P

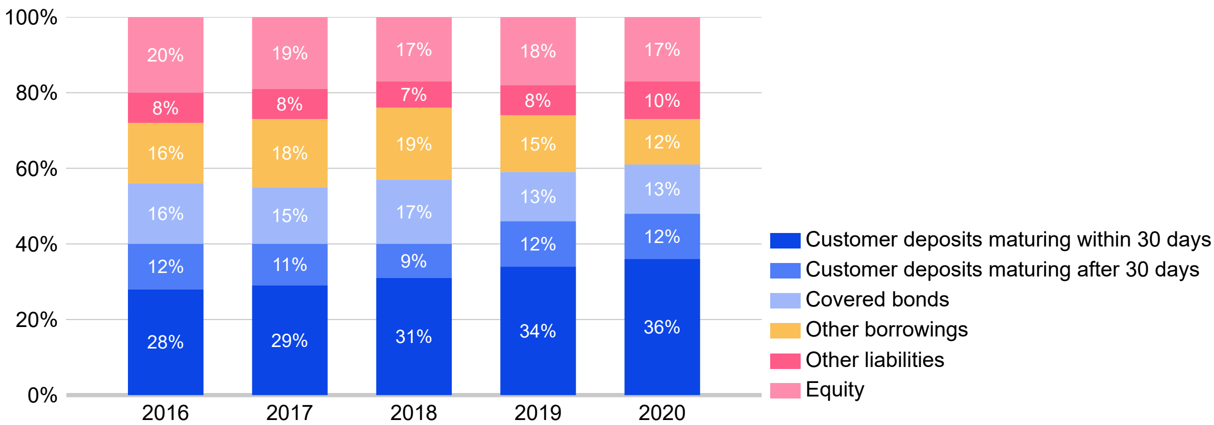
anticipated for Iceland and Europe in 2020. In the agency's view, this will exacerbate the structural weaknesses of the domestic banking industry. Meanwhile, economic risks are building up on the back of the COVID-19 pandemic.

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

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 145% as at 31 December 2020.

Figure 6.6 shows the development of the Bank's funding profile.

Figure 6.6 Development of funding by type



The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, increased from 17% to 20% in the year 2020. This is primarily due to the Bank's increase in the Bank's covered bonds issuances, athough a part of the new issuance is owned by the Bank. 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	2020	2019	2018	2017	2016	2015
Loans to deposits ratio	145%	157%	179%	166%	173%	145%
Asset encumbrance ratio	20%	17%	21%	19%	21%	23%

At year-end 2020, the Bank had an outstanding amount of covered bonds totalling ISK 154 billion. Figure 6.7 show the contractual payment profile of the Bank's covered bonds and corresponding pledged mortgages. Note that the behavioral maturity of mortgages is generally much shorter than the contractual maturity.

Other liabilities are mostly foreign currency denominated. Following the Bank's repurchase of the greater part of its EUR EMTN issue maturing in December 2021, the Bank's refinancing risk has been significantly reduced. Figure 6.8 shows the Bank's maturity profile of borrowings other than covered bonds. The maturity date for Tier 2 capital instruments are shown at the earliest callable date.

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

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

Figure 6.7 Contractual cashflow profile of covered bonds and corresponding pledged mortgages [ISK m]

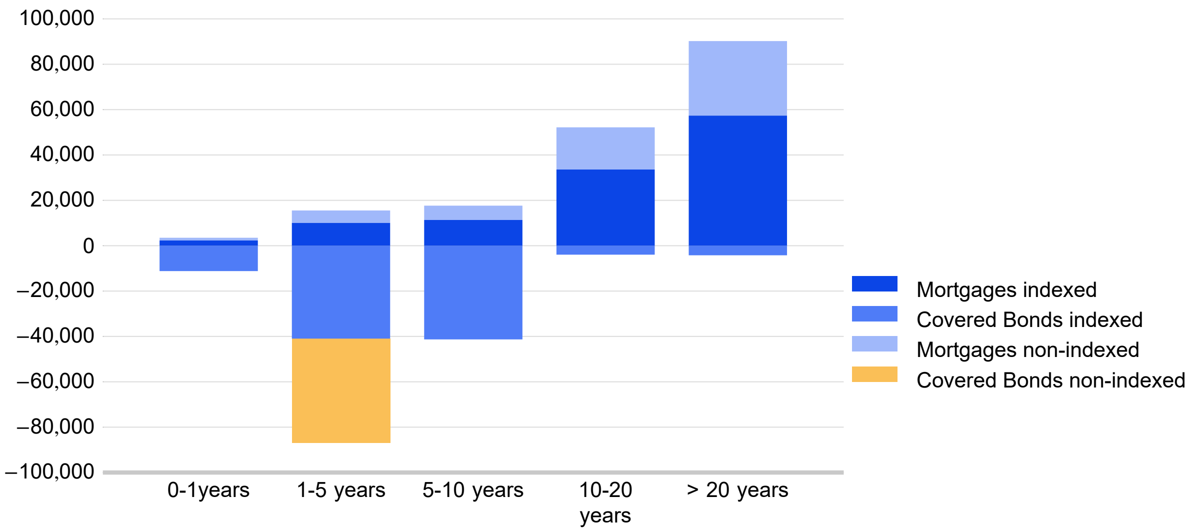
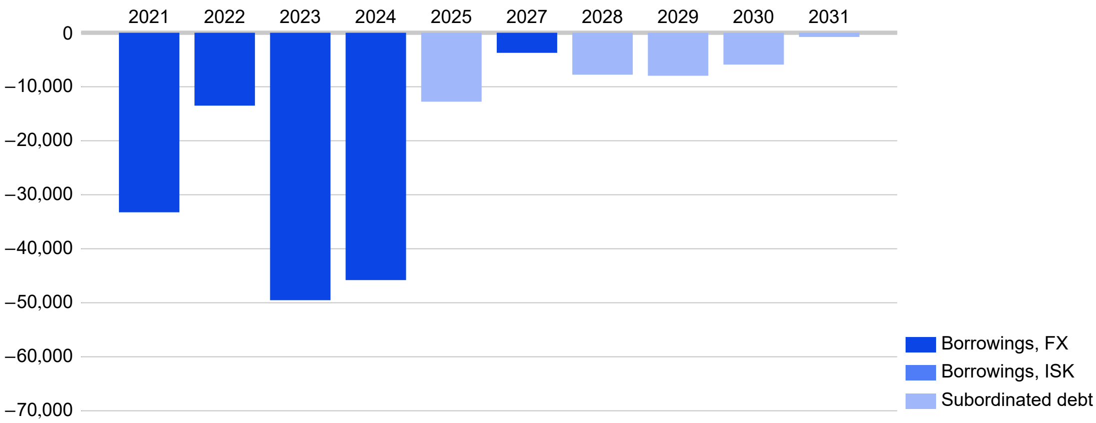


Figure 6.8 Maturity profile of borrowings, other than covered bonds [ISK m]



The NSFR for financial institutions' foreign currency positions shall be greater than 100%. The Bank's NSFR in foreign currencies is at 134% at year-end 2020 while the total NSFR is 117%. The Bank has held the NSFR-FX level well above the minimum regulatory requirement during 2020, as well as a strong NSFR-total as seen in Figure 6.9.

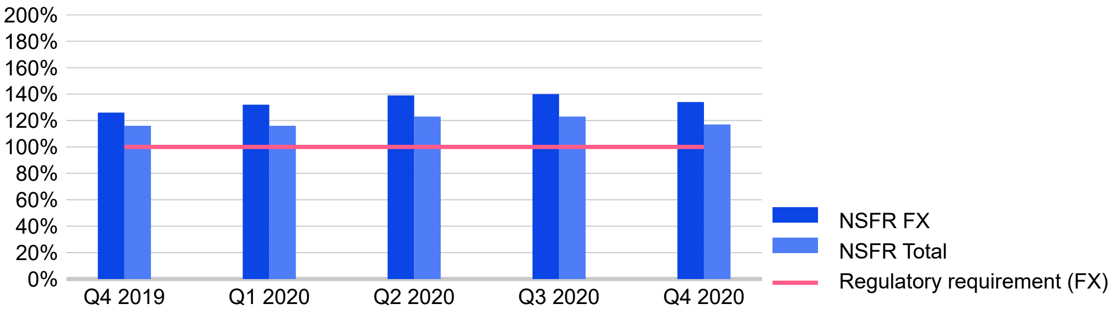
The Bank's NSFR in foreign currencies is at 134% at year-end 2019 while the total NSFR is 117%

Liquidity Risk

Table 6.3 Net Stable Funding Ratio

31 December 2020	FX	Total
Net Stable Funding Ratio	134%	117%
NSFR Central Bank requirements	100%	N/A

Figure 6.9 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.

Each business unit within the Bank is responsible for managing operational risk that is inherent in its operation. Risk Management is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk.

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

7.1 Governance and Policy

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

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

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.

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

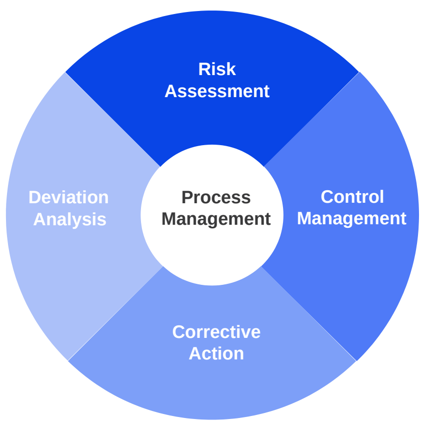
7.2 Operational Risk Management

The Bank's operational risk management framework aims at integrating risk management practices into processes, systems and culture. Risk Management 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.

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.

Figure 7.1 Operational risk management framework



Operational Risk

Risk Assessment

The Bank regularly performs a formal Risk and Control Self-Assessment (RCSA) on the Bank's operations, detecting and evaluating risks, 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 may be based on financial losses, customer impact, reputational damage and compliance failure. Actions are planned for risks with extreme or high 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 risk awareness and mitigation. Risk Management follows up on the planned actions with the responsible units

Control Management

Internal controls are designed to minimize losses from operational risk events to an acceptable level with the goal of optimizing operating efficiency. Controls are furthermore designed to ensure compliance to laws and regulations and to deliver and gather reliable information on a timely basis. The Bank's controls are tested and monitored based on their significance. Key emphasis has been put on ICFR controls, see section 7.7.

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 includes the impact of deviations on financial losses, damage to the Bank's reputation and the Bank's capital need. The information is utilized to understand the root cause of the events to be able to mitigate the risk and improve internal controls.

In order to quantify the operational risk the Bank faces, it uses both the Basel and ORX (*Operational Riskdata eXchange Association*) taxonomy. The Basel taxonomy has only 6 categories and it has been the leading taxonomy though the years when it comes to classifying operational risks. The banking system has gone through significant changes in the last years, e.g. increased digital touch with the customer, more outsourcing and increased data complexity. This in turn calls for a more detailed taxonomy for possible operational risk event. This is where ORX comes to play.

As of January 2020, all deviation events have been classified both in terms of Basel and ORX. The main reason the Bank implemented the ORX taxonomy when it comes to deviation events is to try to understand better where the main operational risks lie. This is crucial in order to strengthen the Bank's response and awareness for operational risk.

Corrective Actions

Any issues arising from the RCSA, deviation analysis, control testing, findings resulting from internal or external audits, or regulator demands are used to enhance the internal controls of the Bank. Once the issues are identified, analyzed and assessed, the responsible unit is in charge of improvements, but the Risk Management division supports and follows 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, 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 within the Bank have a foundation in globally recognized and proven security standards and frameworks, collaboration with trusted partners and vendors in information security and security awareness amongst employees.

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

The Bank's Chief Information Security Officer (CISO) in IT is responsible for the day-to-day operation of Bank's Information security. The Risk Officer for Security and Data in Risk Management oversees IT and security risk. ORCO 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 System (ISMS) and is based on best practices and standards. The Bank has in place a business continuity management system (BCMS) to ensure that critical operations can be maintained and 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 assess security risks, the Bank conducts an information security risk assessment on the Bank's most important information assets, according to Guidelines No. 1/2019 on the Information Systems of Regulated Parties published by the FSA.

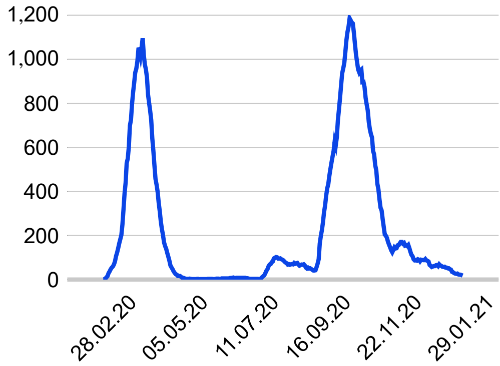
7.5 Operational Risk in times of COVID-19

The Bank has been affected by COVID-19 in the same way as most organizations. The Bank monitored closely the progress of the pandemic abroad and was ready to react when the pandemic hit Iceland. The first wave gathered momentum in February and peaked in early March but was swiftly brought under control. A second wave started in the autumn, see figure 7.2. The Bank‘s Security Committee activated the Bank‘s business continuity plan and had frequent meetings to adjust the Bank‘s response to the pandemic.

The Bank made arrangements in line with the Directorate of Health regulations on social restrictions. During times of strict measures, the Bank closed branch offices to walk-in customer visits but customers could make appointments for important business that required a visit to a branch. Staff worked from home whenever possible. The Bank was not disproportionately affected by COVID-19 infections among staff. Customers have increasingly turned to online and app solutions.

The Bank‘s transition to a mobile workforce with laptops was accelerated in the initial stages of the pandemic. Using VPN connections on their computers the staff could continue working from home without any significant disruption. The Bank switched its video conferencing technology to Microsoft Teams to good effect. Security of computers for remote working was ensured through exclusive use of Bank issued computers, under strict security controls and using VPN connections. The security of the computers was ensured using advanced end-point protection and anti-malware solutions, data loss protection and application security control software. The Bank has not registered a marked increase in employee errors in transaction processing, fraud or critical IT operational incidents during the pandemic. The number of cyber events directed against the Bank has not notably increased due to COVID-19.

Figure 7.2 Active COVID cases in Iceland from 28.02.2020. Source: www.covid.is



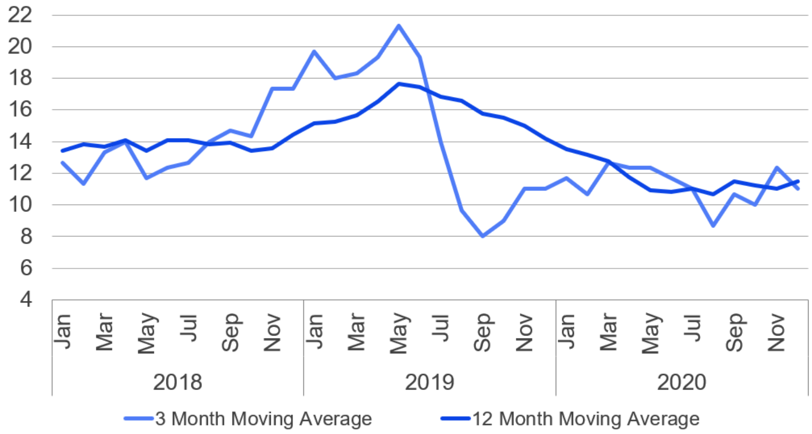
7.6 Operational Risk Measurement

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 MIs 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 Risk Officer for Security and Data.

Operational Risk

Figure 7.3 Development of Major Incidents in IT



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 7.3 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 impact from this change is still visible thoughout 2020 where the 3 and 12 month averages have been relatively stable.

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

Figure 7.4 Distribution of loss events by number, parent company

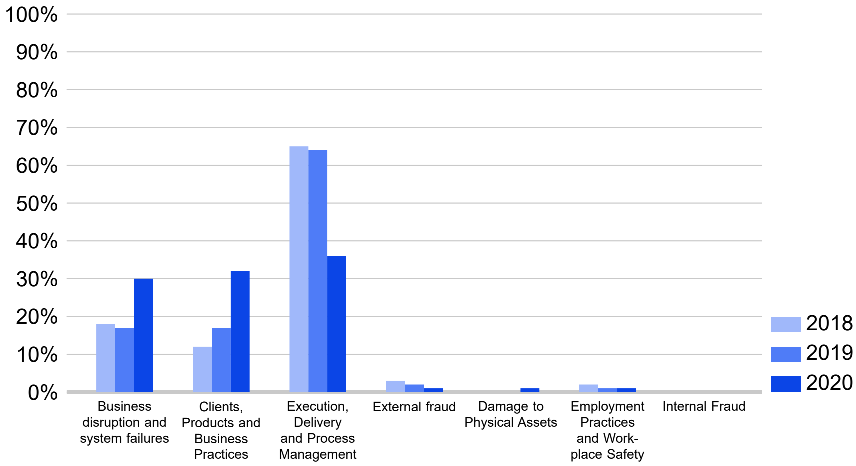
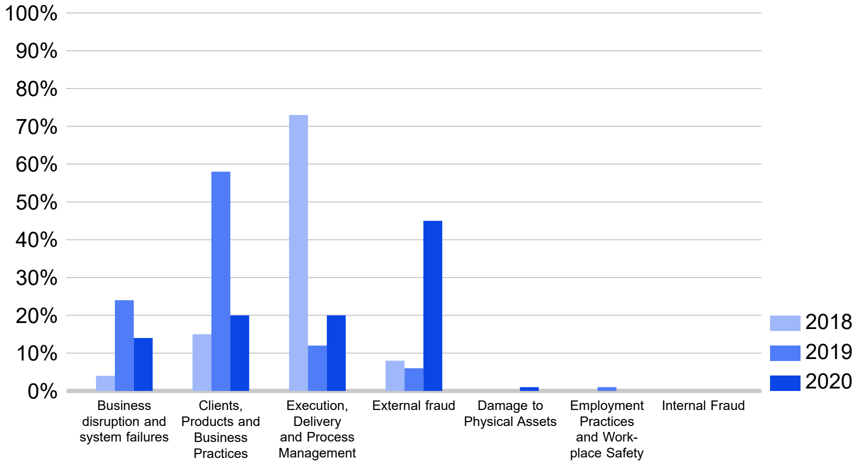


Figure 7.5 Distribution of loss events by amount, parent company



7.7 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). Risk Framework and Monitoring unit has taken on the role of ICFR coordinator.

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 risks, 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.

7.8 Compliance Risk

Compliance risk is the risk of not complying with rules and guidelines applicable to the firm as a licensed financial sector entity, as a listed company, and as a company with large scale processing of personal data.

Compliance risk is managed in accordance with the Bank's compliance policy, established by the Board of Directors and reviewed on an annual basis. The objective of the policy is to reduce compliance risk, using a selection of proactive and cost-effective measures, such as:

- Compliance risk assessment process
- Suitable procedures and processes
- Compliance training and awareness program, and ready access to advice and support
- Compliance monitoring and testing
- Change management process for monitoring and implementing regulatory changes
- Internal alert process

Each business unit within the Bank is primarily responsible for managing the compliance risk inherent in its operation. The Compliance function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting compliance risk.

7.9 Financial Crime Risk

It is the Bank's policy to combat financial crime and to prevent the misuse of the Bank's services and operations for such purposes. The Bank implements and upholds both domestic and internationally recognized standards in this regard, including those relating to international sanctions.

Financial crime risk is managed in accordance with the Bank's policy on combating financial crime, established by the Board of Directors and reviewed on an annual basis. The Bank uses a selection of measures to combat financial crimes, such as:

- Financial crime risk assessment process
- Suitable procedures and processes, including a detailed process for customer due diligence
- Training and awareness program, and ready access to advice and support
- Monitoring and testing, including sophisticated automated monitoring
- A process for reporting suspicious transactions and activities

Each business unit within the Bank is primarily responsible for managing the financial crime risk inherent in its operation. The Compliance function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting financial crime risk, and for investigating and reporting suspicious activities.

In October 2020, Iceland was removed from the Financial Action Task Force's (FATF) list of cooperative jurisdictions with strategic deficiencies, following actions taken by Icelandic authorities to successfully address deficiencies previously identified by the FATF.

7.10 Legal Risk

Legal risk is the risk to the Bank's interests 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.

In July 2020, the FSA decided to levy an administrative fine on the Bank in the amount of ISK 87,7 million, allegedly for failing to disclose inside information immediately after news on planned organizational changes was published by an online media on 22 September 2019. The FME found that the Bank had failed to ensure confidentiality, and therefore no longer satisfied the applicable criteria for further delaying publication of the information. The Bank has challenged the decision, with proceedings pending before the district court of Reykjavík.

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 two categories: a) court cases and b) cases before supervisory authorities. In 2020 there were some legal matters or unresolved legal claims that were considered contingent liabilities, such as legal proceedings regarding damages, as well as a claim by the Bank for annulment of a decision by the FSA. The Description of these cases can be found in Note 37 in the Consolidated Financial Statements for 2020.

8 **Other Material** Risk
9 **Remuneration**
10 **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 business risk, political risk, and climate risk as material risk. Other risk categories are not considered material, and will not be discussed further.

8.1 Business Risk

Business risk is defined as risk associated with uncertainty in earnings 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 business planning process and 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. In 2016-2019, market share by pension funds in the consumer mortgage space' expanded significantly. This trend reversed in 2020, coinciding with historically low policy rates by the CBI and individuals refinancing in bank issued non-CPI linked mortgages. However, participation in the mortgages market for individuals by pension funds will continue to affecting the Bank. Additionally, there are signs that some funds have begun loosening conditions to attract more market share. 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 represent 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 Íslandsbanki. The privatization of a significant share of Íslandsbanki 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 0.145% on liabilities exceeding ISK 50 billion.

Special taxes on Icelandic banks include the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.145% on liabilities exceeding ISK 50 billion

8.2 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. With the advent of the COVID-19 pandemic and its economic consequences, 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.

There have been cases when Icelandic Authorities have deviated from the European regime, and implemented more stringent regulatory restrictions or avoided implementation of regulatory reliefs. This remains a source of political risk. The aforementioned partial privatization of Íslandsbanki may reduce this risk.

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

8.3 Environmental, Social and Governance Risk

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

Arion Bank has adopted an ambitious environmental and climate policy with targets for the next few years. Under the policy, the 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.

In 2020, Arion Bank evaluated its loan portfolio according to green criteria. The Bank applied the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) on its loanbook and has disclosed its findings in the Bank's Annual and Sustainability Report 2020. The climate-related risk is divided into physical risk and transitional risk. Climate-related risk is also discussed in the ICAAP report for the year 2020. Enhanced focus on climate-related risk factors entails that the Bank will increasingly turn its attention to financing projects which relate to sustainable development and green infrastructure. The next step will then be to develop pricing strategy for climate-related loans.

When evaluating suppliers, the Bank will continue to 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 FSA's Rules No. 388/2016 on Variable Remuneration. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

The Design of the Remuneration System

Arion Bank's remuneration policy is framed in accordance with regulatory requirements, such as those established in FSA's Rules No. 388/2016 on Variable Remuneration under the Act on Financial Undertakings. The Bank's remuneration policy is reviewed annually by the Board and submitted and approved at the Bank's annual general meeting. Arion Bank's remuneration policy is, furthermore, published on the Bank's website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2020, see Note 12.

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

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

Remuneration Components and Parameters

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

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

In accordance with the rules, Risk Management, Compliance and Internal Audit review and analyze whether the variable remuneration scheme complies with the FSA's rules and the Bank's remuneration policy, which is approved annually by the Bank's AGM.

A restated performance-based system was approved in December 2020 and will apply in 2022 based on 2021 performance. The

Board of Directors had previously agreed that no bonus payments would be made in 2020. Under the new scheme all employees of the Bank, excluding internal controls units, are included and can receive up to 10% of their fixed annual salary for 2021 in the form of a bonus once the annual financial statement for 2021 has been published, on condition that the targets set out in the scheme have been reached. The managers and employees who have the greatest influence on the Bank's revenues and costs will on the other hand be eligible to receive a bonus of up to 25% of their fixed annual salary, in which case it will be in the form of shares in the Bank which may not be sold for a period of three years.

A restated performance-based remuneration system was approved in December 2020 and will apply in 2022 based on performance in 2021. The Board of Directors had previously agreed that no bonus payments would be made in respect of 2020

The Bank's CRO, Compliance Officer and Internal Auditor are excluded, as well as all employees they manage.

The criterion used to determine whether a bonus will be paid in 2022, in part or in full, is whether the Bank's return on equity (ROE) in 2021 is higher than the weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn and Kvika. Failure to reach this target means that no bonus will be paid. The total amount paid out in bonuses will, however, never be higher than the amount by which the Bank's ROE exceeds the weighted ROE of competitors.

When estimating the bonus amount to be paid in respect of 2021 performance, a range of factors will be taken into consideration, such as ROE of the Bank and individual divisions, the cost-to-income ratio, employee NPS, compliance with law and internal rules, knowledge of the customer (KYC/AML) and the number of different services used by the customers.

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

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

Corporate Governance Arrangements

The Board Remuneration Committee (BRC) and the Board Risk Committee (BRIC), which are established by the Board of Directors of Arion Bank, provide guidance to the Board on the Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor, as well as the Bank's remuneration scheme and other work-related payments. The BRC convened 5 times in the year 2020, thereof once at joint session with the Bank's BRIC. The committee consists of at least three members, the majority of whom must be independent of the Bank and the Bank's day-to-day management. The CEO, Managing Directors, or other employees of the Bank cannot be members of the Committee.

Remuneration

The main responsibilities of the BRC are to review and propose changes to the Board on the Bank's remuneration policy, which proposes the changes to a shareholders' meeting. In addition, the BRC is tasked with ensuring that wages and other employment terms are in accordance with laws, regulations and best practices as current from time to time.

The 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 and both BRC and BRIC have a role as regards its design and annual review. BRC reviews and monitors the scheme, before submitting it to the Board, and BRIC's role is to assess annually whether incentives which may be contained in the Bank's system are consistent with the Bank's risk policy.

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

Quantitative Information on Remuneration

According to disclosure requirements set out in Art. 450 of the Capital Requirements Regulation (EU) No. 575/2013, financial undertakings are required to provide aggregate quantitative information on total remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution. Table 9.1 discloses information on total remuneration for all employees in the parent entity, who are 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 2020	658	919	2,544	3,398
of which variable remuneration	0	0	0	0

Remuneration

Table 9.2 Remuneration broken down by fixed and variable remuneration

[ISK m]	Executive management committee	Other beneficiaries
Number of beneficiaries	5	72
Total remuneration in the year 2020	207	1,247
Fixed remuneration	207	1,247
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	13	73
Deferred remuneration awarded during 2020	0	0
Reduced through performance adjustments	0	0
Vested in 2020 and paid out	-13	-73
New sign-on and severance payments made during 2020	-	-
Number of beneficiaries	-	-
Severance payments awarded during 2020	-	-
Number of beneficiaries	-	-
Highest severance payment	-	-

Table 9.2 shows total remuneration earned in the financial year 2020 by the members of the Executive Management Committee and other beneficiaries of the Bank's preceding performance-based system. Included in the figures for the Executive Management Committee are two former members who have left the Bank. Total remuneration is separated into fixed remuneration and variable, performance based remuneration.

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. For information on a consolidated basis, see Note 12 in the Consolidated Financial Statements for 2020.

10 Abbreviations

ACC	Arion Credit Committee
AGM	Annual General Meeting
AIFM	Alternative Investment Fund Managers
ALCO	Asset and Liability Committee
AT1	Additional Tier 1
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
CET1	Common Equity Tier 1
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
ORCO	Operational Risk Committee
ORX	Operational Riskdata eXchange Association
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 Enterprise
SREP	Supervisory Review and Evaluation Process
SFT	Securities Financing Transaction
T2	Tier 2
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value at Risk

List of tables

List of figures

List of figures

Table of contents

Table of contents

Arion Bank
Borgartún 19 105 Reykjavík Iceland

+354 444 7000
arionbanki.is