2020

Pillar 3 Report

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Guðmundur Kristinn Birgisson

CRO Review 2020

Íslandsbanki's capital position remained strong throughout 2020 and the Bank's liquidity position is well above regulatory limits. The Bank is therefore well prepared for continued economic uncertainty resulting from the spread of the coronavirus and is able to provide supportive services to its customers in order to minimise the permanent impact of the pandemic on households and businesses.

The COVID-19 pandemic has had a substantial impact on the economy and financial institutions worldwide. At Íslandsbanki, most headquarters' employees worked from home for a large part of the year, and as a precaution, customer access to the Bank's branches was limited significantly. Because of the Bank's investment in digital customer solutions in the past few years, no serious disruption in customer service has been caused by these arrangements.

Guðmundur Kristinn Birgisson was appointed Chief Risk Officer at Íslandsbanki in 2018. Guðmundur joined the Bank in 2011 and was Executive Director of Lending in the Bank's Personal Banking Division before being appointed CRO. Guðmundur holds a Ph.D. in Mathematics Education from Indiana University and has a wide range of professional experience.

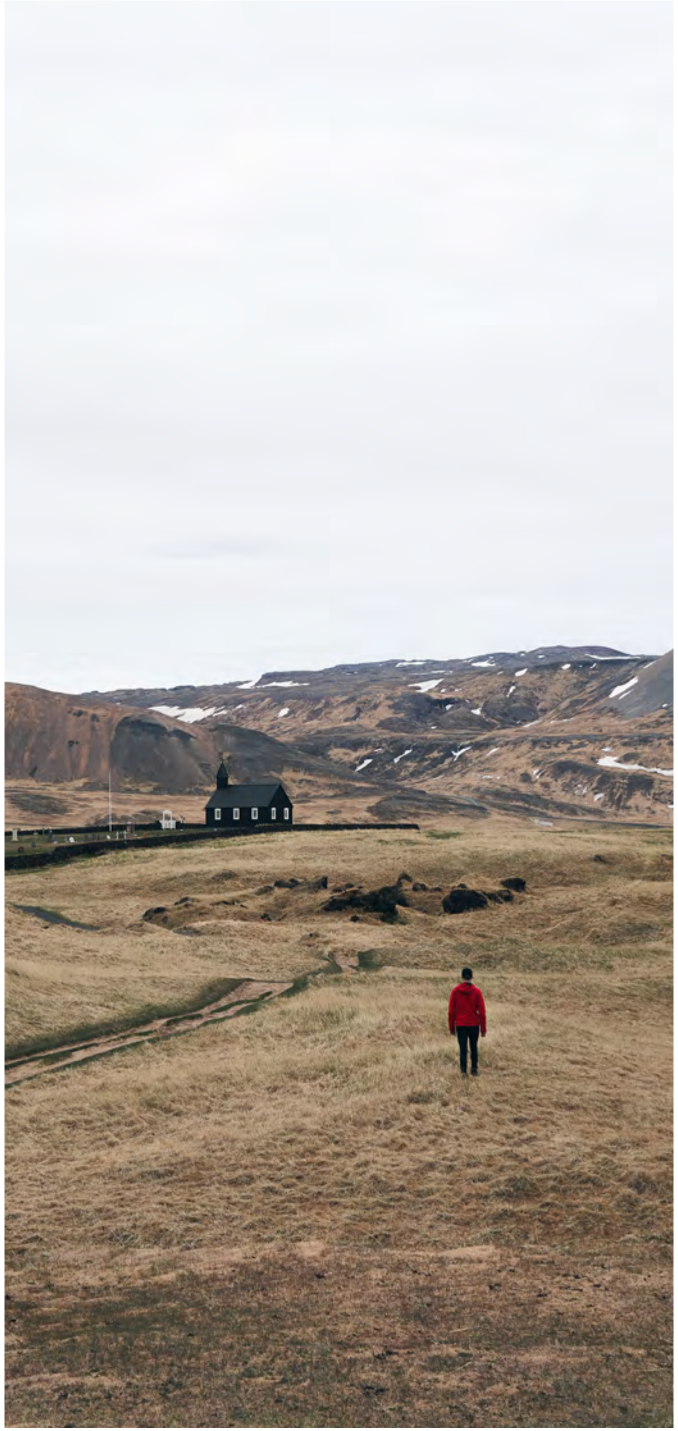
The Bank has taken full part in coordinated efforts in Iceland to support customers that have been impacted the most by the pandemic. The Bank channeled support to corporate customers by extending credit, guaranteed by the government to a various degree. The Bank also entered into an agreement with other financial institutions and lenders in Iceland to provide a uniformly executed moratorium for both corporate customers and households that expected a temporary reduction in income due to the pandemic. All moratoria granted under the agreement expired before year-end 2020, and any further payment holidays are classified as forbearance. Forbearance measures have been applied to 11.1% of performing loans.

In Iceland, tourism has been the sector hardest hit by the COVID-19 pandemic. While the Bank expects the downturn to be temporary and that the tourism industry will recover promptly as the pandemic subsides, the portfolio of loans to companies in this sector was moved to stage 2 under IFRS 9. This led to a substantial change in proportion of loans with significant increase in credit risk, currently at 15.6% up from 2.6% the year before. The worsening economic outlook also impacted loan impairments, as the forward-looking impairment method under IFRS 9 ensures that reserves are put aside for expected losses although actual losses have not been incurred. Defaults have not yet followed and in fact the NPL ratio decreased slightly between years and is now 2.9%.

The bank-specific regulatory capital requirement was unchanged between years while the countercyclical capital buffer was lowered from 2% to 0%. The current capital ratio of 23.0% is therefore well above the overall capital requirement of 17.0%. As requested by the Central Bank of all Icelandic banks, no dividend was paid out in 2020 due to increased uncertainty, but dividend payments are expected to commence in 2021.

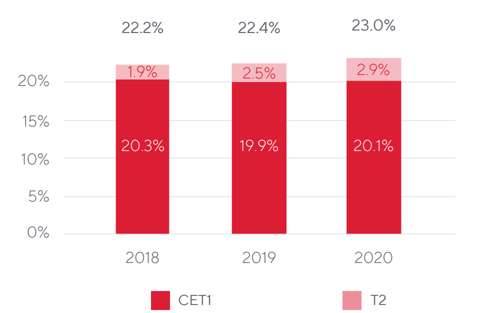
Despite the downturn in the economy, loans to customers increased by 11.9% in 2020. This was almost exclusively due to growth in the mortgage portfolio. Following a reduction in the Central Bank's key interest rates from 3.0% to 0.75%, households have been migrating from CPI-linked to non-indexed mortgages and refinancing mortgages from pension funds. As a result, loans to individuals increased by 25%, which had a positive effect on the average risk weight, with the risk exposure amount over total assets decreasing from 74% to 69% in 2020.

Although the immediate challenges posed by the pandemic are very much in the spotlight, the Bank has kept up its important work on sustainability. Íslandsbanki's *Sustainability policy* aims at making the Bank a model of exemplary operations in the Icelandic business community and a catalyst for positive social action. Sustainability risk has received increased attention in 2020, in particular climate risk, as can be seen in a new section in this report that follows recommendations from from Task Force on Climate-Related Financial Dislosure (TCFD).

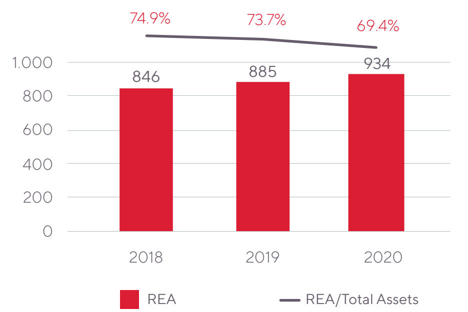


Key Metrics

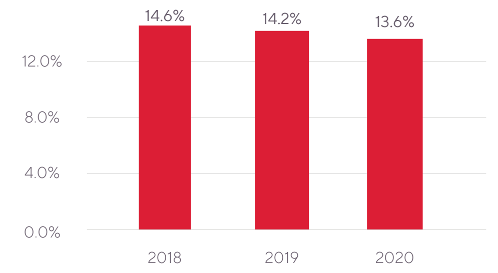
Capital ratio



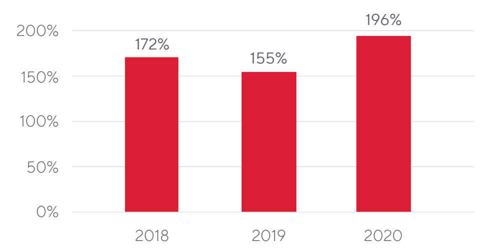
Risk Exposure Amount (ISK bn)



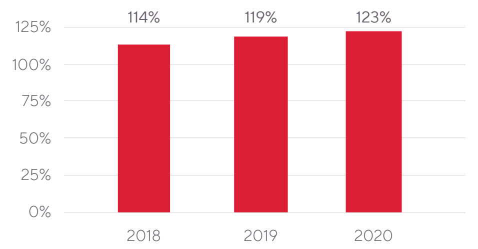
Leverage Ratio



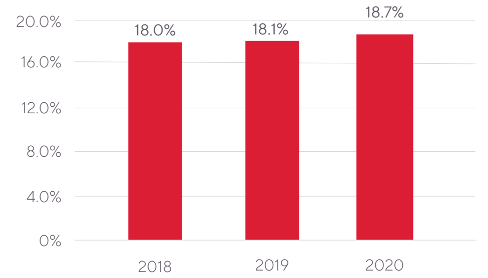
Liquidity Coverage Ratio (LCR)



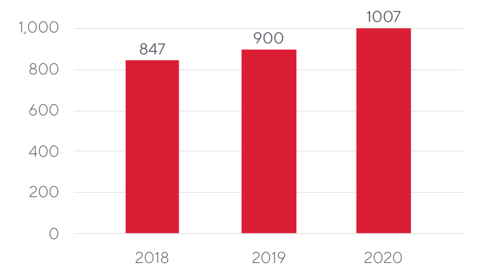
Net Stable Funding Ratio (NFSR)



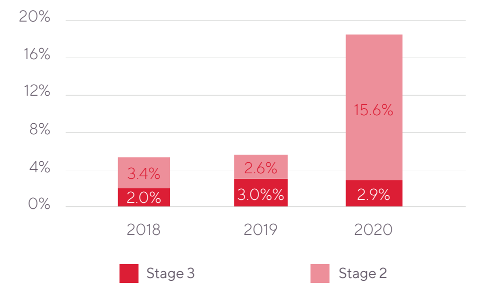
Encumbrance Ratio



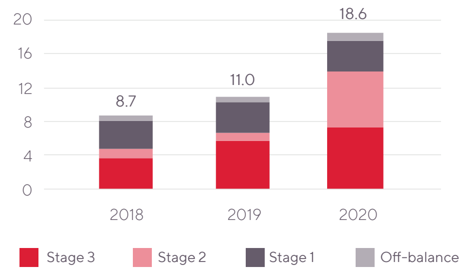
Loans to customers (ISK bn)



Loans to customers: Share in stage 2 and 3



Loans to customers: Impairment allowance account (ISK bn)



1 Introduction

Íslandsbanki's Pillar 3 Report contains information on risk management, risk measurement, material risk exposures, capital adequacy and liquidity adequacy, in accordance with Icelandic law and European Regulation. The report should provide market participants and other stakeholders with information that facilitates a better understanding of the Bank's risk profile and capital adequacy.

1.1 Regulatory Background

The EU Capital Requirements Directive IV[1] and the EU Regulation on Prudential Requirements for Credit Institutions and Investment Firms[2] (CRR), hereafter referred to together as CRD IV, have for the most part been transposed into Icelandic law by amendments made to the Act on Financial Undertakings[3] and with the Regulation on the Prudential Requirements for Financial Undertakings.[4] These amendments incorporate, among other things, the CRD IV capital buffer requirements, disclosure requirements, minimum leverage ratio, supervisory review and evaluation process and capital definitions.

The scope of the CRD IV is broken into the following components:

Pillar 1 – Rules for risk coverage, calculation of the capital requirements, quality of capital and minimum leverage ratio. Pillar 1 sets the minimum capital requirement for credit, market and operational risk.

Pillar 2 – Supervisory Review and Evaluation Process (SREP) and framework for banks' Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP).

Global liquidity standard and supervision monitoring – Rules on minimum liquidity (LCR) and stable funding (NSFR) requirements.

Pillar 3 – Market discipline through disclosure requirements.

For each of the Pillar 1 risk factors, the CRD IV allows for different methods to be used for calculating the minimum capital requirements and thereby risk exposure amount (REA). For credit risk and market risk, the Bank uses the standardised approach to calculate the capital requirements and for operational risk the Basic Indicator Approach. The minimum capital requirements under Pillar 1 are 8% of REA.

Pillar 2 sets out total regulatory requirements for the Bank, in view of its risk profile, by means of additional capital requirements for risk factors not addressed or not adequately covered under Pillar 1. The Bank's internal capital adequacy assessment is then reviewed by the Central Bank (CB) through the supervisory review and evaluation process. The SREP also includes a review of the Bank's liquidity adequacy assessment and if the Bank adequately identifies and measures its liquidity risk, holds adequate liquidity in relation to its risk profile and if it uses sound risk management systems and processes to support it.

The European Banking Authority (EBA) issued Pillar 3 Guidelines[5] on disclosure requirements under Part Eight of CRR. The guidelines include specific guidance and prescribed

[1] Directive 2013/36/EU
[2] Regulation 575/2013/EU
[3] Act no. 161/2002 on Financial Undertakings
[4] Regulation no. 233/2017 on the Prudential Requirements for Financial Undertakings
[5] EBA Guidelines on disclosure requirements under Part Eight of Regulation (EU) no 575/2013

tables and templates, which are regarded as a significant step towards enhancing consistency and comparability between banks through their regulatory disclosures. This Pillar 3 Report contains information in accordance with the disclosure requirements in the form of standardised EBA tables. The tables are included in an Excel sheet on the Bank's website and will hereafter be referred to as Additional Pillar 3 Disclosure.

Additional Pillar 3 Disclosure

The Pillar 3 Report is intended to allow market participants to assess key information on capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

Legal and regulatory changes, relevant to the Group's operations that came into effect within the year, have been incorporated into relevant risk chapters in the Pillar 3 report instead of having a separate chapter for legal and regulatory changes like previous reports.

1.2 Consolidation

The Pillar 3 Report includes figures for the consolidated group, hereafter referred to as Íslandsbanki or the Group. When figures are shown for the parent company, it is specifically noted by referring to the parent. Names and primary businesses of major subsidiaries at year-end 2020 are listed in Exhibit 1.1. Further details on the Bank's subsidiaries can be seen in LI3 in the Additional Pillar 3 Disclosure. In July 2020, the Bank concluded a sale of the subsidiary Borgun hf. which is therefore no longer a part of the consolidated Group at year-end 2020.

1.3 Disclosure and Communication Policy

Íslandsbanki has in place a formal *Disclosure and Communication Policy* approved by the Board of Directors. The policy outlines the governing principles and framework for external disclosure and communication.

Risk and capital management disclosure aims at giving a true and fair view of the Bank's capital structure and adequacy, material risk exposures and risk assessment processes and governance. Íslandsbanki may decide not to disclose information that is considered immaterial. In addition, the Bank will not disclose information that is deemed to be proprietary or confidential. The classification of proprietary and confidential information is based on the relevant Icelandic laws and regulations as well as the Bank's own assessment.

The main channel for Íslandsbanki's risk and capital management disclosure is through the Pillar 3 Report, the Annual Report, Consolidated Financial Statements and investor presentations. All these documents are available on the Bank's website. The Pillar 3 Report is published annually in conjunction with the Annual Report and the Consolidated Financial Statements. The Additional Pillar 3 Disclosure that is published in an Excel sheet on the Bank's website is partially updated quarterly and semi-annually. If material risk exposures change significantly between reporting periods, Íslandsbanki can choose to disclose information thereon more frequently.

Reports 2020

1.4 Verification

The Pillar 3 Report has not been audited by external auditors and does not form a part of Íslandsbanki's audited financial statements. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2020.

Exhibit 1.1. Íslandsbanki's major subsidiaries at year-end 2020.

Name	Main Business	Ownership	Country
Íslandssjóðir hf.	Investment fund management company	100%	Iceland
Allianz Ísland hf.	Insurance agent	100%	Iceland

The Pillar 3 Report has been prepared in accordance with the CRD IV, not in accordance with International Financial Reporting Standards (IFRS). This can cause some discrepancy between financial information in the Consolidated Financial Statements and information in the Pillar 3 Report, see LI2 in the Additional Pillar 3 Disclosure. For some parts, figures are only available, or relevant, on parent level and are clearly marked as such.

1.5 Disclaimer

The Pillar 3 Report is informative in nature and shall under no circumstances be interpreted as a recommendation to take, or not to take, any particular investment action. Íslandsbanki holds no obligation to update, modify or amend this report in the event that any matter contained herein changes or subsequently becomes inaccurate. Nothing in this report shall be interpreted as an offer to customers nor is it intended to constitute a basis for entitlement of customers. Íslandsbanki accepts no liability whatsoever for any direct or consequential loss arising from the use of this publication or its contents.

Exhibit 1.2. List of disclosures in the Additional Pillar 3 Disclosures.

Table	Additional Pillar 3 Disclosure	Frequency of Disclosure	Reference in Pillar 3 Report
EU OVA: Institution risk management approach	OVA	Annual	Chapter 2
EU CRA: General qualitative information about credit risk	CRA	Annual	Chapter 4
EU CCRA: Qualitative disclosure requirements related to counterparty credit risk	CCRA	Annual	Chapter 4
EU MRA: Qualitative disclosure requirements related to market risk	MRA	Annual	Chapter 5
EU LIA: Explanations of differences between accounting and regulatory exposure amounts	LIA	Annual	Chapter 3
EU CRB-A: Additional disclosure related to the credit quality of assets	CRB-A	Annual	Chapter 4
EU CRC: Qualitative disclosure requirements related to credit risk mitigation techniques	CRC	Annual	Chapter 4
EU CRD: Qualitative disclosure requirements on institutions' use of external credit ratings under the Standardised Approach for credit risk	CRD	Annual	Chapter 4
Template			
EU LI1: Diff between accounting and regulatory scopes of consolidation and mapping of financial statement categories with regulatory risk categories	LI1	Annual	Chapter 3
EU LI2: Main sources of differences between regulatory exposure amounts and carrying values in financial statements	LI2	Annual	Chapter 3
EU LI3: Outline of the differences in the scopes of consolidation	LI3	Annual	Chapter 1
EU OV1: Overview of RWA	OV1	Quarterly	Chapter 3
EU KM1: Key metrics template	KM1	Quarterly	Chapter 1
EU CCyB1: Geographical distribution of credit exposures relevant to the calculation of the countercyclical buffer	CCyB1	Semi-annual	Chapter 3
EU CCyB2: Amount of institution-specific countercyclical capital buffer	CCyB2	Semi-annual	Chapter 3
EU CRB-B: Total and average net amount of exposures	CRB-B	Annual	Chapter 3
EU CRB-C: Geographical breakdown of exposures	CRB-C	Annual	Chapter 4
EU CRB-D: Concentration of exposures by industry or counterparty types	CRB-D	Annual	Chapter 4
EU CRB-E: Maturity of exposures	CRB-E	Annual	Chapter 4
EU CR1-A: Credit quality of exposures by exposure classes and instruments	CR1-A	Semi-annual	Chapter 4
EU CR1-B: Credit quality of exposures by industry or counterparty types	CR1-B	Semi-annual	Chapter 4
EU CR1-C: Credit quality of exposures by geography	CR1-C	Semi-annual	Chapter 4
EU CQ1: Credit quality of forborne exposures	CQ1	Semi-annual	Chapter 4
EU CQ3: Credit quality of performing and non-performing exposures by past due days	CQ3	Semi-annual	Chapter 4
EU CQ4: Performing and non-performing exposures and related provisions	CQ4	Semi-annual	Chapter 4

Exhibit 1.3. List of disclosures in the Additional Pillar 3 Disclosures (continued).

Template	Additional Pillar 3 Disclosure	Frequency of Disclosure	Reference in Pillar 3 Report
EU CQ7: Collateral obtained by taking possession and execution processes	CQ7	Semi-annual	Chapter 4
EU CR2-A: Changes in stock of general and specific credit risk adjustments	CR2-A	Semi-annual	Chapter 4
EU CR2-B: Changes in stock of defaulted and impaired loans and debt securities	CR2-B	Semi-annual	Chapter 4
EU CR3: Credit risk mitigation techniques – overview	CR3	Semi-annual	Chapter 4
EU CR4: Standardised approach – credit risk exposure and Credit Risk Mitigation (CRM) effects	CR4	Semi-annual	Chapter 4
EU CR5: Standardised approach	CR5	Semi-annual	Chapter 4
EU CCR1: Analysis of the counterparty credit risk (CCR) exposure by approach	CCR1	Semi-annual	Chapter 4
EU CCR2: Credit valuation adjustment (CVA) capital charge	CCR2	Semi-annual	Chapter 4
EU CCR8: Exposures to central counterparties	CCR8	Semi-annual	Chapter 4
EU CCR3: Standardised approach – CCR exposures by regulatory portfolio and risk.	CCR3	Semi-annual	Chapter 4
EU CCR5-A: Impact of netting and collateral held on exposure values	CCR5-A	Semi-annual	Chapter 4
EU CCR5-B: Composition of collateral for exposures to counterparty credit risk	CCR5-B	Semi-annual	Chapter 4
EU CCR6: Credit derivatives exposures	CCR6	Semi-annual	Chapter 4
EU MR1: Market risk under standardised approach	MR1	Semi-annual	Chapter 5
EU LR1 - LRSum: Summary reconciliation of accounting assets and leverage ratio exposures	LR1	Quarterly	Chapter 3
EU LR2 - LRCom: Leverage ratio common disclosure	LR2	Quarterly	Chapter 3
EU LIQ1: LCR disclosure template, on quantitative information of LCR which complements Article 435(1)(f) of Regulation (EU) No 575/2013	LIQ1	Annual	Chapter 6
EU LIQA-1: Table on qualitative/quantitative information of liquidity risk in accordance with Article 435(1) of Regulation (EU) No 575/2013	LIQA-1	Annual	Chapter 6
EU LIQA-2: Template on qualitative information on LCR, which complements the LCR disclosure template	LIQA-2	Annual	Chapter 6
EU LIQ2: Net staple funding ratio (NSFR)	LIQ2	Semi-annual	Chapter 6
EU AE1: Encumbered and unencumbered assets	AE1	Semi-annual	Chapter 6
EU AE2: Collateral received and own debt securities issued	AE2	Semi-annual	Chapter 6
EU AE3: Sources of encumbrance	AE3	Semi-annual	Chapter 6
COVID-19 1 - Information on loans and advances subject to legislative and non-legislative moratoria	COVID-19 1	Quarterly	Chapter 4
COVID-19 2 - Breakdown of loans and advances subject to legislative and non-legislative moratoria by residual maturity of moratoria	COVID-19 2	Quarterly	Chapter 4
COVID-19 3 - Information on newly originated loans provided under newly applicable public guarantee schemes introduced in response to COVID-19	COVID-19 3	Quarterly	Chapter 4

2 Risk Management and Internal Control

Risk assessment and the prudent evaluation and pricing of risk are key elements in Íslandsbanki's operations. In turn, an efficient risk assessment framework forms the foundation of the Bank's risk and capital management strategy. Íslandsbanki's risk governance is based on a three lines of defence framework and aims for informed decision-making and strong risk awareness throughout the Bank.

2.1 Risk Governance and Organisation

Íslandsbanki is exposed to various risk factors and managing these risks is an integral part of the Bank's operations. Íslandsbanki emphasises sound governance principles. The risk management and internal control framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with the relevant laws, regulations, supervisory requirements and the Bank's internal rules and decisions.

2.1.1 Three Lines of Defence Model

The first line of defence consists of the Bank's business and support units. The business units take on risk through the extension of credit, through proprietary trading, and by providing other services to the Bank's customers. The primary responsibility for managing these risks lies with the business units. Each business unit shall have in place effective processes to identify, measure or assess, monitor, mitigate and report on the risks taken on by the unit. Support units, whose decisions have an impact on the Bank's operational risk and sustainability risk, are subject to the same requirements for risk identification and management as the Bank's business units.

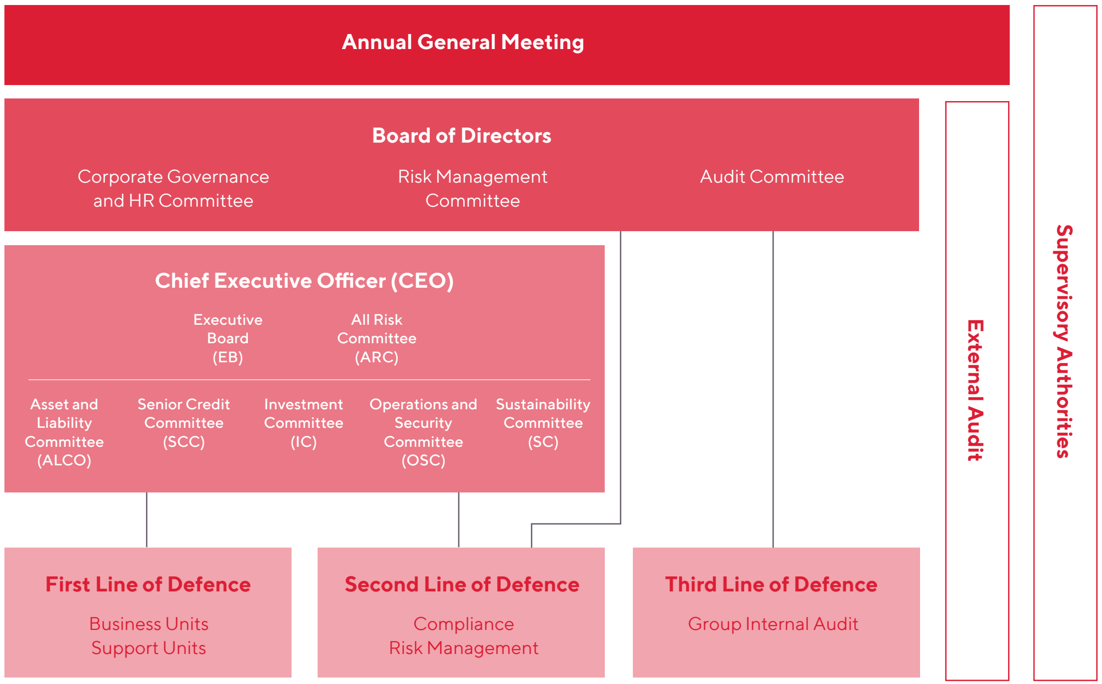
The second line of defence comprises the Bank's internal control units. The internal control units are responsible for developing and maintaining an efficient internal framework to facilitate adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported or disclosed, and compliance with the relevant laws, regulations, supervisory requirements and the Bank's internal policies and procedures. The Bank's internal control units are Risk Management and Compliance.

The third line of defence provides independent assurance to management and the Board of Directors of the effectiveness and completeness of the internal control framework, including both the first and the second line of defence. The third line of defence duties are performed by Group Internal Audit.

2.1.2 Organisational Hierarchy

The Bank's management body has a dual structure. The Board of Directors has a supervising role in setting and monitoring the execution of policies, the sound control of accounting and financial management and ensuring that group internal audit, compliance and risk management are effective. The Chief Executive Officer (CEO), the Chief Risk Officer (CRO) and other members of the senior management committees are responsible for implementing risk management practises and internal control in accordance with Board authorisation. Exhibit 2.1 provides an overview of the Group's risk management and internal control governance.

Exhibit 2.1. Íslandsbanki's risk management and internal control governance.



2.2 Roles and Responsibilities

2.2.1 Board of Directors

The ultimate responsibility for ensuring an adequate risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through risk management policies and the *Risk Appetite Statement*.

2.2.2 Board Committees

To assist the Board in fulfilling its oversight responsibilities, the Board has appointed three board subcommittees, the Risk Management Committee, the Audit Committee and the Corporate Governance and Human Resource Committee. Further information on the Board subcommittees' role, composition and frequency of meetings can be found in the Bank's corporate governance statement in an unaudited appendix to the Consolidated Financial Statements.

2.2.3 Chief Executive Officer

The CEO is responsible for the day-to-day operations of the Bank and that the Bank's business is managed in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO appoints members of the Executive Board and other Senior Management Committees.

2.2.4 Chief Risk Officer

The CRO heads Risk Management and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at Íslandsbanki and verifying that the Bank has the appropriate resources and organisation to manage its risks efficiently.

The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the Group and cannot be removed without the Board's prior approval. The removal or appointment of the CRO shall be publicly disclosed and the Central Bank informed about the reasons.

The CRO is independent from the business units. The CRO chairs the All Risk Committee (ARC), is a member of the Executive Board and reports directly to the CEO. The CRO provides an independent view on the Group's exposure to risk. The CRO has the right but not the responsibility to escalate certain risk-taking decisions of the Bank's business committees if an internal control unit considers the proposed risk inconsistent with the Bank's risk appetite, policies or procedures.

2.2.5 Compliance Officer

The Compliance Officer heads the Compliance unit and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. The Compliance Officer is responsible for monitoring the compliance risk management regarding anti-money laundering laws and regulations and to monitor that the Bank is always in compliance with its obligations as provided for in the Act on Securities Transactions.

The Bank's Compliance Officer is selected and appointed by the CEO, subject to Board confirmation, and reports directly to the CEO. The Compliance Officer cannot be removed without the Board's prior approval. The Central Bank and Chief Audit Executive (CAE) shall be notified of the dismissal or departure of the Compliance Officer. The Compliance Officer is a member of the ARC.

2.2.6 Chief Audit Executive

The CAE is appointed by the Board, reports directly to the Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Group.

2.2.7 Managing Directors in Business Units

The managing directors for individual business units are responsible for the risks taken on by their units and for earning an acceptable level of return on these risks. This entails the responsibility for ensuring the necessary resources and training of employees for understanding, identifying, measuring or assessing, continuously monitoring and reporting on these risks.

Managing directors for individual business units can be assigned authorisations for assuming risk on the Bank's behalf. For business decisions exceeding the authorisations of managers at individual business units, further authorisation must be requested from the relevant senior management committee.

2.2.8 Managing Directors in Support Units

The managing directors of individual support units are responsible for the implementation of the technical and operational infrastructure necessary to fulfil internal and external requirements for the identification, continuous monitoring and reporting on the risks assumed by the business units.

The responsibility for managing individual risk factors that are owned by a business unit can only be transferred to a support unit through clear documentation, mandate letters, product descriptions, service level agreements or some other formal manner.

2.2.9 General Counsel

The General Counsel heads the legal department and reports directly to the CEO. The General Counsel provides legal advice to senior management, including the Board of Directors, and manages the Bank's legal department that provides comprehensive legal advice to the Bank's business and support units.

2.2.10 All Employees

Each employee is responsible for understanding the risk related to their day-to-day work, for knowing and understanding the respective internal and external rules and procedures, for using the alert procedures in the event of possible fraudulent activities and for conducting business in accordance with the Bank's code of conduct.

2.2.11 Internal Control Functions

The Bank's internal control functions are responsible for developing and maintaining an efficient internal control framework to facilitate adequate risk management, prudent conduct of business, reliability of financial and non-financial information reported or disclosed, and compliance with the relevant laws, regulations, supervisory requirements and the Bank's internal policies and procedures.

Risk Management

The Bank has an independent risk management function, Risk Management, headed by the CRO.

Risk Management is responsible for ensuring efficient implementation of the Bank's risk strategy and policies, for verifying that the Bank has in place efficient risk management processes and that each key risk that the Bank faces is identified and properly managed by the relevant function.

Risk Management is mandated to identify, understand, measure and monitor the risks that the Group is exposed to. It provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by senior management and business or support units as to whether they are consistent with the risk appetite and risk policies set by the Board. Emphasis is made on actively involving Risk Management at an early stage in elaborating the Bank's risk strategy and in all material risk management decisions, especially when offering new products, taking on new business or making other material changes to the Bank's operations.

Where necessary, Risk Management makes recommendations to senior management and the Board for improvements to the risk appetite, the risk strategy and the risk management framework to further clarify risk policies, procedures and limits.

Risk Management provides senior management and the Board with all relevant risk-related information to enable them to define the Bank's risk appetite and maintain oversight over the Bank's overall risk profile. Risk Management takes an active part in developing the Bank's business strategy by ensuring that risks are appropriately and timely considered and that targets, which include credit ratings and rates of return on equity, are plausible and consistent. However, accountability for the business and pricing decisions taken remains with the business and support units and ultimately the senior management and the Board.

Compliance

The Bank has an independent compliance function, Compliance, headed by the Compliance Officer. Compliance is an independent control function and is a part of the second line of defence.

Compliance is specifically responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures concerning securities transactions and anti-money laundering (AML) in accordance with the applicable law. Other compliance risk control processes and monitoring are managed and performed within Risk Management as part of the operational risk management framework.

Compliance verifies, in close cooperation with Risk Management, that the process for new products and new procedures complies with the current legal framework regarding anti money laundering laws and the Act on Securities Transactions.

2.2.12 Group Internal Audit

Group Internal Audit is an independent function headed by the CAE and is responsible for assessing whether the Group's risk management, internal control framework and governance processes are effective and efficient.

Group Internal Audit is not responsible for internal control or its implementation, but provides the Group with independent, objective assurance and consulting services designed to add value and improve the Group's operations. It helps the Board and senior management to evaluate and improve the effectiveness of the risk management, controls, and governance processes.

Group Internal Audit evaluates the compliance of the Bank's operations to internal policies and procedures. Group Internal Audit also assesses whether existing policies and procedures remain adequate and whether they comply with the relevant legal and regulatory requirements.

Group Internal Audit verifies the integrity of the processes ensuring the reliability of the Bank's methods and techniques, assumptions and sources of information used in risk models and accounting measurements. Group Internal Audit is, however, not involved in the design or selection of models or other risk management tools.

The work of Group Internal Audit is performed in accordance with a risk-based audit plan which is approved by the Board Audit Committee. Group Internal Audit is furthermore responsible for internal investigations on suspected fraudulent activities.

Group Internal Audit reports directly to the Board on its findings and suggestions for material improvements to internal controls. All audit recommendations are subject to a formal follow-up procedure by the appropriate levels of management to ensure and report their resolution.

2.2.13 External Audit

As is provided for in the Articles of Association, the Group's external audit firm is generally elected at the Annual General Meeting (AGM) for a term of five years. External audit is responsible for the auditing of the annual accounts in accordance with accepted auditing standards and rules set by the Central Bank.

2.2.14 Senior Management Committees

The Bank's committee structure is divided into two categories, executive committees and business committees. There are two executive committees, the Executive Board and All Risk Committee (ARC). They are responsible for overseeing the implementation of the business strategy, risk appetite and policies. The business committees are five in total, the Asset and Liability Committee (ALCO), the Senior Credit Committee (SCC), the Investment Committee (IC), Operations and Security Committee (OSC) and Sustainability Committee. They are responsible for the approval of business proposals and the Bank's operational framework and implementation subject to internal rules and guidelines issued by the executive committees and the Board.

The members of all the senior management committees are appointed by the CEO, and each committee's mandate and rules of procedure is documented in a charter. The organisation of the Bank's committees is shown in Exhibits 2.1 and 2.2.

Exhibit 2.2. The Bank's senior committees and the number of meetings in the year 2020. In addition, the Credit Committee which is a sub-committee of the Senior Credit Committee had 129 meetings discussing credit proposals for lower exposure.

Committee	Role	Number of meetings
Executive Board	Business strategy, finances, IT strategy, marketing, governance and human resources	51
All Risk Committee	Risk strategy and risk appetite	21
Asset and Liability Committee	Funding and liquidity, market risk, capital management and internal and external pricing	51
Senior Credit Committee	Credit proposals	91
Investment Committee	Investment proposals	21
Operations and Security Committee	Product approval, operations, security and business continuity	33
Sustainability Committee	New committee. Reviews ESG related matters and business opportunities	3

Executive Board

The Executive Board, chaired by the CEO, is responsible for implementing the Board-approved business strategy, maintaining oversight for and coordinating the Bank's operations and human resources. The Executive Board also coordinates key aspects of the Bank's activities and holds decision-making power in matters entrusted to it by the CEO in accordance with the Bank's strategy, policies and risk appetite.

All Risk Committee

The All Risk Committee (ARC) is responsible for reviewing and overseeing the implementation of risk management and internal control policies issued by the Board. ARC translates the Board-approved risk policies into risk limits or guidelines for individual business units, desks or portfolios and approves methods and assumptions used for calculating risk measures, capital and liquidity requirements and targets, impairment, and internal and external pricing. The committee reviews and confirms proposals regarding risk assessment, impairments and capital and liquidity requirements prior to submission to the Board of Directors for approval

Business Committees

The business committees decide on individual business proposals in accordance with the rules and procedures issued by the Executive Board, ARC and the Board. All business proposals discussed in the business committees are initiated and owned by a business or support unit and although authorisation has been given by a committee, the business decision itself is made and owned by the relevant unit.

Representatives from Risk Management attend all meetings of business committees. Their attendance is intended to ensure effective communication of risk in the decision-making process, to ensure that the risks inherent in individual proposals are adequately addressed by the business units and to give an independent view on the risk inherent in the proposals and whether the risk is in line with the Bank's risk appetite.

The Risk Management representatives do not take part in the final decision of the business committees but can veto or escalate certain risk decisions if they consider them to be inconsistent with the Bank's risk appetite, policies or procedures.

2.3 Risk Culture

The Bank promotes strong risk culture as an important part of an effective risk management and internal control framework. The Bank's risk culture is reflected in the Bank's values and human resources strategy and is developed and maintained through the training of staff regarding policies, procedures and their responsibilities for risk. Emphasis is placed on transparency, acknowledgement, responsiveness and respect for risk throughout the Bank and open communication regarding risk is encouraged.

2.3.1 Ownership, Transparency and Accountability

A key feature of a strong risk culture is that every member of the organisation knows and understands their responsibilities relating to risk management. The *Risk Management and Internal Control Policy*, the *Risk Appetite Statement* along with other risk management policies outline these roles and responsibilities at Íslandsbanki.

All business decisions and the resulting risks are initiated and owned by a business unit and go through a clearly defined review and control process. As part of that process, the business units are responsible for identifying and describing the risks inherent in their proposals and for ensuring that all information regarding these risks is made available in a clear and comprehensive format before proposals are presented to the relevant authority within the Bank.

The business units are also responsible for ensuring that all information regarding risk exposures is correctly registered in the Bank's information systems to facilitate complete transparency, oversight and correct reporting of the Bank's overall risk exposures.
The meetings of business committees provide a formal platform for the communication of risk before a final decision is reached regarding individual business proposals.

The managing directors are responsible for ensuring that their employees have the necessary knowledge, resources and systems to monitor and manage their respective risk positions within the approved risk limits. All breaches of risk limits are reported through a formal limit breach process.

2.3.2 Training and Incentives

The Bank's performance and talent management aims at encouraging and reinforcing risk awareness and a healthy risk culture. The Bank has in place a comprehensive training programme managed by the Human Resources Department. The programme includes mandatory training on the Bank's internal policies and procedures tailored to the responsibilities of individual employees.

In 2020, the Bank recorded over 8300 registrations for over 200 different in-house training courses, on-demand courses online and live online courses, an average of 12 courses per employee. All employees are required to read and confirm their knowledge of the Bank's operational procedures, code of conduct, security policies and rules on measures against money laundering. The ratio of confirmation is monitored by the Bank's Human Resources Department and lack of participation is escalated to the appropriate managing directors.

2.3.3 Incident Reporting

The Bank has implemented a framework to capture both actual and potential operational risk losses. The Bank emphasises a "no-blame" culture and encourages employees to register all mistakes or failures, irrespective of financial losses, into the Bank's operational risk database. All registered events are analysed and recorded, and the information used for continuous improvements to the Bank's operations and control framework.

2.3.4 Internal Alert Procedures

The Bank has an independent reporting channel enabling employees to report anonymously suspicion of fraudulent activities or actual breaches of regulatory or internal requirements. This reporting channel, which is referred to as a whistleblowing service, is provided by an external partner to ensure anonymity and whistle-blower protection. Information stored in the system is only accessible to the Bank's Group Internal Audit Fraud Investigation Team.

Exhibit 2.3 Risk types and corresponding metrics in the Risk Appetite Statement.

Type of risk	Metrics
Profitability	Minimum rate of return on capital Cost-to-income ratio Target dividend ratio
Capital adequacy	CET1 Capital ratio Total Capital target
Credit risk	Annual credit losses Non-primary lending activity Concentration risk
Market risk	Market risk as a ratio of the Group's total capital Market value of listed and unlisted equities Equity and bond underwriting exposures
Liquidity risk	Liquidity coverage ratio Net stable funding ratio Encumbrance ratio
Operational risk	Operational losses as a percentage of capital
Sustainability risk	Alignment with Sustainability Principles

2.4 Risk Management Framework

The Bank's risk policies, rules and procedures, limits and reports form the Bank's risk management framework. The policies apply to the Bank and are implemented throughout the Group as applicable.

As described before, all business decisions and the resulting risks are initiated and owned by a business unit and go through a clearly defined internal review and control process. The level of authority needed to approve each business decision depends on the size, complexity and risk involved. The responsibilities regarding such decisions are outlined in the Bank's risk policies and investment policies and for material decisions summarised in the Bank's Matrix for Material Bank Actions.

2.4.1 Risk Appetite Statement

The Board defines the Bank's risk appetite, tolerance, and financial targets in the *Risk Appetite Statement*. The *Risk Appetite Statement* is intended to support the Bank's business strategy by defining high-level limits and targets for core factors in the Bank's risk profile and operations.

The measures include target return on equity, target capitalisation level and capital composition, maximum credit losses, concentration limits, maximum amounts at risk for market risk and target liquidity ratios. Exhibit 2.3 shows the risk types and corresponding metrics in the *Risk Appetite Statement*.

2.4.2 Risk Policies and Limits

The *Risk Appetite Statement* is further implemented through risk policies, approved by the Board, and other rules, procedures and limits approved by ARC which provide more details specific to each risk type. In addition, the *Risk Assessment Framework* and the *Stress Testing Framework*, approved by the Board, describe the processes for identifying and assessing the risks inherent in the Bank's operations.

The risk policies such as the *Credit Risk Policy*, the *Market Risk Policy,* the *Liquidity Risk Policy* and the *Operational Risk Policy*, outline in further detail the Bank's strategy for risk identification, management and control within the three lines of defence framework. Finally, the risk appetite is translated into limits on individual desks, portfolios or risk positions. The risk policies are all subject to an annual review managed by Risk Management. The policy review process focuses on changes in the regulatory environment, changes in the Bank's operations and gaps that have been identified after an assessment of policy effectiveness.

2.4.3 Risk Identification

Identification of risks in the Bank's operations is made both bottom up, through the process for new products and material changes, the risk and control self-assessment process, and approval of individual transactions or portfolio and desk limits; and top-down through the annual risk assessment procedure as part of the Internal Capital Adequacy Assessment Process (ICAAP).

The process for new products and material changes and approval of individual transactions, or portfolios, is intended to ensure early detection and full oversight of risks in the Bank's operations. Each business unit is responsible for identifying the risks inherent in their operations and the products and services they offer.

The *New Products and Material Changes Policy* outlines the synchronisation, review and control process necessary to ensure successful implementation of new products and material changes. The main objective is to ensure that the implementation of products and operations complies with the Bank's policies and the relevant legal requirements. In addition, as a part of the ICAAP, a formal and comprehensive assessment of the risks inherent in the Group´s operations is made annually. This review is described in the *Risk Assessment Framework* which is approved by the Board of Directors.

Risk Management is responsible for managing the annual risk assessment process. The assessment is done at the business unit level and then consolidated throughout the Group. The results from the risk assessment process are compared to the Bank's business strategy and risk appetite and used as input to the annual review of the *Risk Appetite Statement*.

For the key risk types identified through the assessment, a specific risk policy is defined and approved by the Board of Directors. The need for a specific risk policy is based on the assessment of the proportionality of the respective risk factors to the Bank's operations and business strategy.

Currently, the following five risk types have been defined as key to the Group's operations and business strategy according to the Bank´s Risk Taxonomy. Their assessment, management, mitigation techniques, and overall limits are defined in specific policies:

- Credit risk (Chapter 4)
- Market risk (Chapter 5)
- Liquidity risk (Chapter 6)
- Operational risk (Chapter 7)
- Sustainability risk (Chapter 8)

Concentration risk is defined as material but currently managed according to the source of concentration. Concentration risk is considered in the *Credit Risk Policy*, the *Market Risk Policy* and the *Liquidity Risk Policy*. Anti-money laundering is considered a part of operational risk in this context.

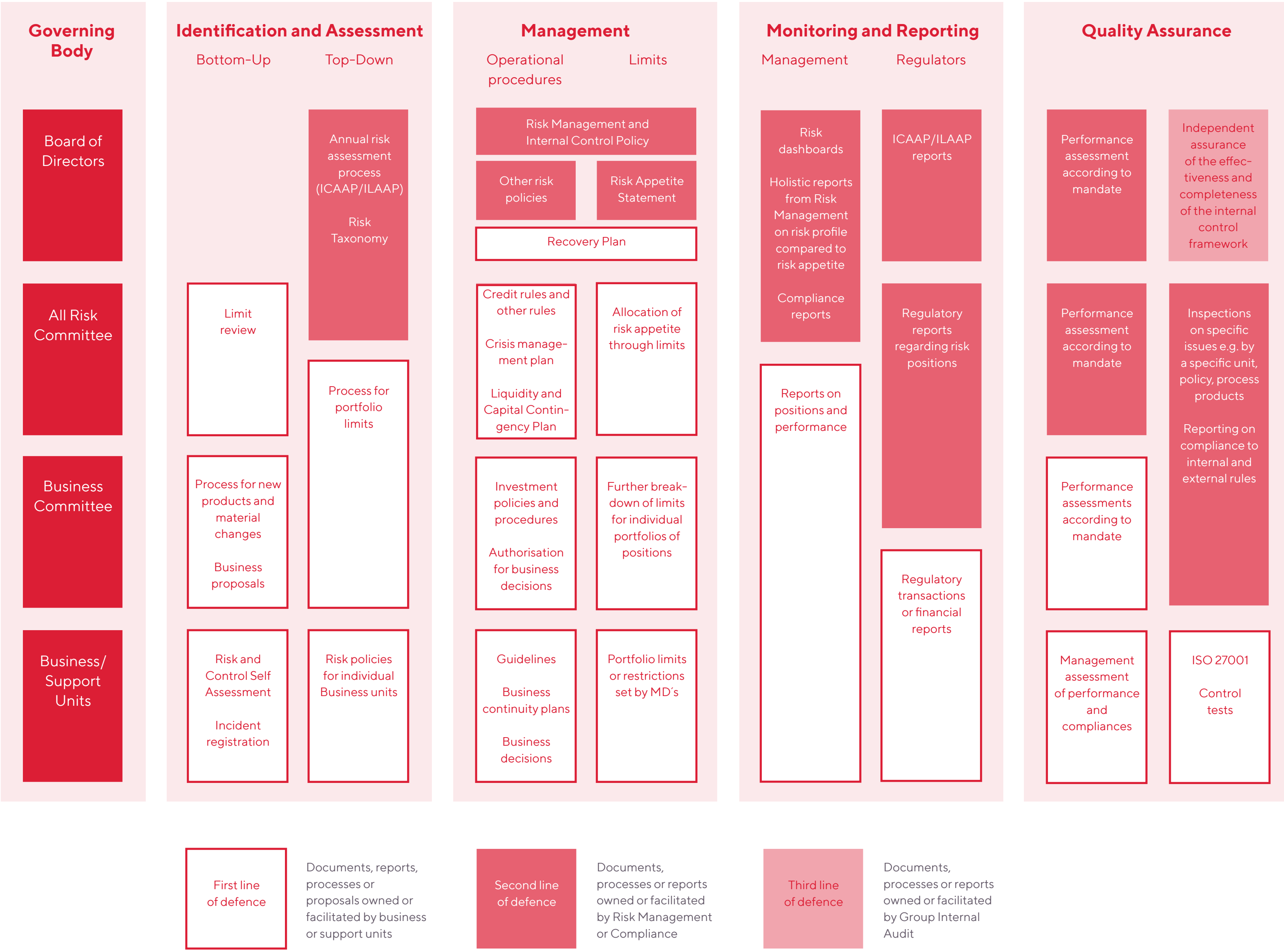
Risk types that are not covered in separate risk policies are assessed through the annual ICAAP process based on the Bank's Risk Taxonomy and addressed in other risk policies and management reports in accordance with their nature and importance.

2.4.4 Risk Monitoring and Reporting

Risk Management provides a holistic view on risk and compliance to limits, to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches. Business and support units are however, responsible for maintaining their independent view on the risks inherent in their operations, implementation of controls and other mitigating actions where needed, and reporting to senior management any present or foreseeable breaches from limits, policies or strategic direction. Exhibit 2.4 provides an overview of the risk governance framework.

The strategic targets are further defined in the Group's business plan, approved by the

Exhibit 2.4. Íslandsbanki's risk governance framework.



Board of Directors. The business plan gives a 5-year view of the development of the Group's operations and provides a basis for stress testing and capital planning.

The ICAAP / ILAAP aims at identifying and assessing the risk inherent in the Group's operations and for integrating the Bank's business strategy and business plan on one hand and its risk profile and risk appetite on the other hand. This is to ensure that the Bank holds enough capital and liquidity to support its risk profile and business strategy.

Íslandsbanki's *Risk Assessment Framework* outlines the Bank's framework for identifying the risks inherent in its operations and assessing its capital and liquidity adequacy. The scope of the Bank's risk assessment framework encompasses all material risks to which the Bank and its subsidiaries are exposed.

2.4.5 Liquidity and Capital Contingency Plan

The Bank's *Liquidity and Capital Contingency Plan* describes the process for assessing the liquidity risk and capital adequacy position according to five different levels of severity, i.e. contingency stages. The main purpose of the contingency plan is to identify liquidity or funding problems as early as possible and thereby improve the Bank's ability to respond to such situations in a timely and operationally effective manner. The contingency stages are determined based on both predefined risk indicators and on qualitative assessment. The indicators facilitate monitoring of development in capital, liquidity, profitability and asset quality as well as relevant macro-economic and market-based indicators. As an integrated part of the Bank's risk management framework, the indicators are reported bi-weekly to ALCO that determines the current contingency stage. ALCO will then consider and act upon any adverse development based on Treasury's recommendation. For each contingency stage, management and reporting actions have been defined and communicated to the relevant parties, including the Board of Directors and the Central Bank. The *Liquidity and Capital Contingency Plan*, which forms a part of the Bank's *Recovery Plan*, is tested regularly and findings from the tests are used to improve the contingency plan if needed.

2.4.6 Recovery Plan and Resolution

The Bank has implemented a comprehensive framework to ensure the viability of its operations in the unlikely event of significant financial stress. In accordance with the Act on Financial Undertakings, the Bank has in place a *Recovery Plan* setting out the relevant measures to be taken by the Bank to restore its financial position following a significant deterioration in capital or liquidity. The Recovery Plan contains several recovery options that have been tested against different stress scenarios to ensure that the Bank is able to recover under different circumstances and return its core business lines and critical functions to business as usual. The Recovery Plan builds on the existing business as usual liquidity, capital and risk management and governance framework and extends those with an escalation governance for recovery.
The activation of recovery options can include extraordinary measures subject to the Board's or even the shareholder's approval. The status of the Bank's contingency indicators and contingency stages is reported monthly to the All Risk Committee and the Board of Directors as a part of the Risk Dashboard. The Board is responsible for the approval and submission of the Recovery Plan to the Central Bank.

A new act nr. 70/2020 on the resolution of credit institutions and investment firms was approved in 2020 in Iceland. The Act implements the second part and main body of the Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms. The Regulatory Technical Standards on Minimum Requirement for own funds and Eligible Liabilities (MREL) has however not been implemented yet.

2.4.7 Internal Reporting

The Bank aims to have clearly defined and efficient reporting lines to ensure compliance with the approved risk limits and targets. Timely and accurate reporting on material risk factors is an essential part of the risk management and internal control governance.

Risk Management is responsible for providing ARC, the Board's Risk Management Committee and the Board with comprehensive and understandable information on the

Exhibit 2.5. Risk reporting and frequency to the Board of directors and All Risk Committee.

Reporting	Details	Frequency
Risk dashboard	The report provides a review of risk measures that summarise the main risk positions as compared to the risk appetite, internal tolerance and regulatory limits. This includes utilisation of limits set by the Board or Executive and Business Committees. The report also includes the status of the Bank's contingency indicators. On a quarterly basis the report includes an assessment of capital adequacy in light of changes in risk profile (ICAAP review).	Monthly
Compliance report	The report provides an overview of the main supervisory tasks of the compliance unit, identified deficiencies and reactions.	Semi-annual
ICAAP report (Internal Capital Adequacy Assessment Process)	The ICAAP report includes a detailed description of how the Bank identifies, measures and assesses its capital adequacy in relation to its risk profile and business model. The scope of the assessment encompasses all material risks to which the Bank and its subsidiaries are exposed.	Annual
ILAAP report (Internal Liquidity Adequacy Assessment Process)	The ILAAP report includes a detailed description of how the Bank identifies, measures and assesses its liquidity adequacy in relation to its risk profile. The report also includes a forward looking analysis based on contractual inflows and outflows, planned issuance and new lending according to the Bank's business plan.	Annual
Recovery plan	The document provides a comprehensive recovery plan for the Bank that sets out measures to be taken for the recovery of the Banks's financial position following a significant deterioration to restore financial stability.	Annual

overall risk profile of the Group, including a comparison with the approved policies and limits. Exhibit 2.5 provides an overview of risk reporting and frequency to the ARC and the Board of Directors.

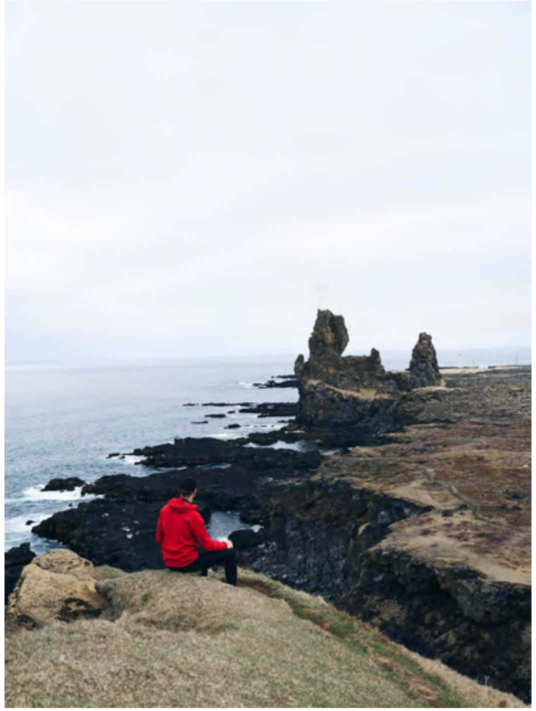
2.4.8 External Reporting

The Group publishes financial information mainly through the Annual Report, Consolidated Financial Statements, the Pillar 3 Report, Sustainability Report and in investor presentations. These are all available on the Bank's website.

Reports 2020

The Group's financial accounts are prepared in accordance with International Financial Reporting Standards (IFRS). Regulatory reports are prepared based on CRD IV along with discretionary rules and requirements set by the Central Bank of Iceland.

In addition, the Group works and reports according to the guidelines issued by Nasdaq Iceland for listed companies, since Íslandsbanki is an issuer of listed securities both on Nasdaq Iceland and on the Irish Stock Exchange. The framework for public disclosure regarding the Bank's risk and financial positions is described in the *Disclosure and Communication Policy* approved by the Board.



3 Capital Management

Íslandsbanki´s capital position remained strong throughout 2020 and at year-end the Group´s capital ratio was 23.0%, exceeding both the capital target and regulatory requirements.

The Bank aims at managing its capital position and the corresponding capital ratios at a margin above the overall regulatory capital requirement. The resulting long-term capital target assumes that the Bank maintains a capital management buffer of about 0.5-2.0% in excess of the overall capital requirements. Due to the uncertainty in relation to the COVID-19 pandemic, the Bank temporarily aims to have an ample buffer in excess of the current target until there is further clarity regarding public health restrictions, international travel and other sources of uncertainty.

3.1 Strategy, Organisation and Responsibility

Banks' capital is intended to provide a buffer for unexpected losses or volatility in earnings and thereby provide protection for depositors and other creditors as well as promoting the stability of the financial system. The eligible capital for calculating the capital ratio is defined by law and further outlined in relevant rules and regulations. The applicable Icelandic laws defines both the type of eligible capital and restrictions to the reliance on specific instruments. The Bank's capital management framework is based on the CRD IV as transposed into Icelandic laws.

The Board of Directors is responsible for the Bank's capital management framework and for ensuring that the Bank's capitalisation is adequate in relation to the risk inherent in the operations considering the Bank's business strategy and operating environment. The Board defines the capital governance framework and the adequate capitalisation through the *Risk Management and Internal Control Policy*, the *Risk Appetite Statement* and the *Capital Management and Pricing Policy*.

The All Risk Committee (ARC) governs the capital management of the Bank in accordance with the capital targets set by the Board and reviews proposals to the Board regarding issues related to capital management, including the dividend policy.

The Asset and Liability Committee (ALCO) is responsible for capital allocation to the business units within the framework set by the Board. ALCO reviews and approves the contingency stage assessment as a part of the Bank's *Liquidity and Capital Contingency Plan* and reviews information about the capital adequacy position of the Bank with respect to targets and limits.

Risk Management is responsible for internal and external reporting on the Bank's capital adequacy. Risk Management is also responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and for the calculations of the allocated capital to individual business units.

Treasury is responsible for the management of the Bank's capital in accordance with the targets set by the Board. Finance is responsible for reporting on the risk-adjusted performance down to individual business units.

3.2 Total Capital and Capital Ratios

At year-end 2020 the Bank's common equity Tier 1 (CET1) amounted to ISK 188bn as compared to ISK 176bn at year-end 2019. The main factors contributing to the increase in CET1 is the ISK 8bn profit for the year and the implementation of regulation EU 2017/2395, as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds into Icelandic law in May 2020. The regulation allows for the phasing in of capital impacts due to IFRS 9, allowing institutions to include a predefined level of provisions as part of CET1 capital. Íslandsbanki elected to make use of the transitional arrangements, which added ISK 5bn to CET1. The level of provisions included in CET1 is currently 70% of the incremental provision for credit risk, and will decrease to 50% in 2021, 25% in 2022 and finally to 0% in 2023.

As a response to the COVID-19 pandemic, the Bank did not pay any dividend during 2020. The Central Bank issued a statement in the first half of 2020 endorsing EBA's call to institutions to refrain from the distribution of dividends, both to ensure that banks maintain a sound capital base and to provide the lending needed to support the economy.

The Bank's Tier 2 capital increased from ISK 23bn to ISK 27bn during the year due to the depreciation of the ISK against SEK. All the Bank's Tier 2 issuance is denominated in SEK. A breakdown of the Bank's total capital base is shown in Exhibit 3.1.

The Bank's minimum capital requirements, the corresponding risk exposure amount (REA) under Pillar 1, and the resulting capital ratios are shown in Exhibit 3.2.

The REA increased by ISK 48bn or around 5% during the year. The largest increase was due to growth in the mortgage loan portfolio (ISK 42bn), exposures to Financial institutions (ISK 7bn) stemming from the FX liquidity portfolio, and increase in market risk exposure (ISK 9bn), mainly due to a shift in the liquidity portfolio to bonds and debt instruments when the Central Bank halted one-month term deposits. Finally, the implementation of IFRS 9 transitional arrangements contributed to an ISK 5bn increase in REA. The REA fell by ISK 14bn when Article 501 in the CRR came into effect in Iceland on 1 January 2020. This article introduces the SME supporting factor that stipulates capital requirements deduction for credit risk on exposures to small and medium-sized enterprises. The main components contributing to changes in REA can be seen in Exhibit 3.3

Exhibit 3.1. Breakdown of the capital base at year-end 2020 and 2019 (ISK m).

Capital	31.12.2020	31.12.2019
Common equity Tier 1 Capital	187,869	175,648
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	6,181	7,065
Retained earnings	113,529	105,569
Non-controlling interests	1,494	2,428
Fair value changes due to own credit standing	238	392
Tax assets	(259)	(476)
Intangible assets	(3,478)	(4,330)
IFRS 9 reversal due to transitional rules	5,164	-
Tier 2 capital	27,194	22,674
Qualifying subordinated liabilities	27,194	22,674
Total capital base	**215,063**	**198,322**

3.3 Capital Requirements

The Board of Directors sets a minimum capital target for the Bank, expressed as the ratio between capital and risk exposure amount. The minimum capital target is intended to reduce the likelihood that the regulatory overall capital requirement is breached. The target is based on the results from ICAAP, the views expressed by the regulator through the Supervisory Review and Evaluation Process (SREP), implementation of the capital buffers and other factors such as uncertainties in the operating environment, a possible target rating, or other external factors. The following

Exhibit 3.2. Pillar 1 capital requirements, REA and capital ratios at year-end 2020 and 2019 (ISK m).

	31.12.2020		31.12.2019	
Íslandsbanki's capital requirements and REA	**Minimum capital requirements**	**REA**	**Minimum capital requirements**	**REA**
Credit risk	66,411	830,141	63,134	789,180
Central governments or central banks	0	1	-	-
Regional governments or local authorities	171	2,137	189	2,358
Administrative bodies and non-commercial undertakings	92	1,147	75	940
Financial institutions	1,856	23,201	1,275	15,940
Corporates	40,643	508,032	39,731	496,642
Retail	10,828	135,352	10,753	134,408
Secured by real estate property	8,555	106,943	6,484	81,048
Exposure in default	2,436	30,445	2,166	27,072
Collective investment undertakings	91	1,140	94	1,172
Fair value shares, investment in associates and shares held for sale	690	8,630	1,073	13,412
Property, equipment, non-current assets held for sale and other assets	1,049	13,113	1,295	16,188
Market risk	1,330	16,626	634	7,919
Traded debt instruments	692	8,655	218	2,719
Shares and equity instruments	212	2,651	302	3,769
Foreign exchange	426	5,320	114	1,431
Credit valuation adjustment	138	1,728	162	2,027
Operational risk	6,802	85,026	6,834	85,424
Total	**74,682**	**933,521**	**70,764**	**884,550**
CET1 capital		187,869		175,648
Capital base		215,063		198,322
CET1 ratio		**20.1%**		**19.9%**
Total capital ratio		**23.0%**		**22.4%**

sections describe each component in more detail.

3.3.1 Pillar 1 Minimum Capital Requirements

The first pillar of the CRD IV defines the minimum capital requirements for credit risk, market risk, and operational risk. The minimum capital requirement under Pillar 1 is 8%, calculated as the ratio between the capital base and risk exposure amount.

Risk Exposure Amount

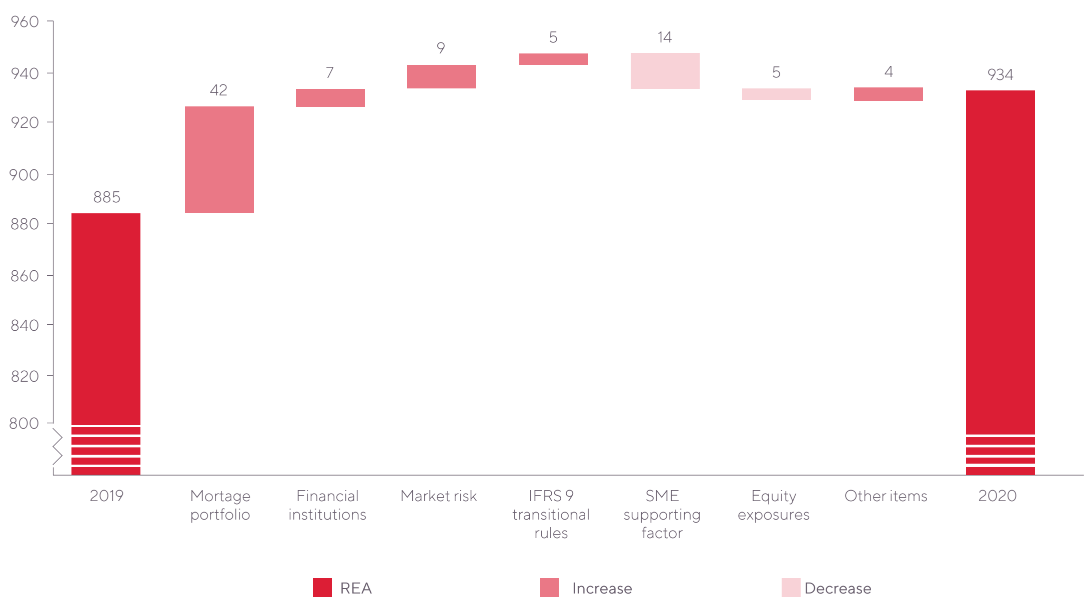
For each of the Pillar 1 risk factors, the CRD IV allows for different methods to be used for calculating the minimum capital requirements and thereby REA. For credit risk and market risk, the Bank uses the standardised approach to calculate the capital requirements, and for operational risk the Basic Indicator Approach.

The total REA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of REA for credit risk.

Credit risk

The REA for credit risk is derived by assigning a risk weight, in the range of 0–150%, to the Bank's assets depending on the creditworthiness of the counterparty, the underlying collateral and the type and term of the exposure.

Exhibit 3.3. Changes in risk exposure amount (ISK bn).



Market risk

For traded debt instruments, the capital requirement is generally in the range of 0–12% of the net exposure, based on the creditworthiness of the issuer and the term of the instrument. For traded equity instruments, the capital requirement is 16% of the net exposure. For foreign exchange risk, the minimum capital requirement is 8% of the maximum of the Bank's total long and total short positions in foreign currencies.

Operational risk

The minimum capital requirement for operational risk is equal to 15% of the relevant indicator, where the relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

3.3.2 Pillar 2 Required Add-On (Pillar 2-R)

In addition to the minimum capital requirements for credit risk, market risk and operational risk under Pillar 1, financial institutions are required to make their own assessment of the overall capital requirements in the ICAAP/SREP process. These additional capital requirements, taking into account the risk profile of the institution, are referred to as Pillar 2-R capital requirements. The sum of Pillar 1 and Pillar 2-R is referred to as total SREP capital requirement (TSCR).

In the ICAAP 2020, the main factors contributing to additional capital requirements under Pillar 2-R for Íslandsbanki were:

- Additional capital requirements for risk factors underestimated under Pillar 1: Credit risk and market risk.
- Additional capital requirements for risk factors not addressed under Pillar 1: Credit concentration risk, interest rate risk in the banking book (IRRBB), market risk arising from equities in the banking book, and the inflation imbalance.

The Pillar 2-R capital requirements are presented as a proportion of REA and come as an addition to the regulatory capital minimum of 8% under Pillar 1. The Bank's Pillar 2-R results are reviewed by the Central Bank through the SREP. The financial uncertainty caused by the COVID-19 pandemic has made it unusually difficult for the Central Bank to determine asset quality and assess other risk in the Bank's operations. The Financial Supervision Committee therefore announced in September 2020 that the results of the 2019 SREP assessment concerning Pillar 2-R capital requirements shall remain unchanged. Developments in key risks in the Bank's operations will be monitored closely, and the additional capital requirement will be reviewed if need be, but no later than during the 2021 SREP. Based on the 2019 SREP, the additional capital required for Íslandsbanki under Pillar 2-R was 1.7% of REA. The breakdown of the Pillar 2-R capital and the total SREP capital requirements can be seen in Exhibit 3.4.

3.3.3 Combined Capital Buffer Requirement

Four capital buffers are introduced through the CRD IV and applicable for Icelandic financial institutions:

1. Capital conservation buffer
2. Institution specific countercyclical buffer
3. Buffer for systemically important institutions
4. Systemic risk buffer.

Together these buffers form the combined buffer requirement. The capital buffers are generally intended to enhance banks' ability to withstand adverse changes in the environment and reduce fluctuations related to the business cycle.

The size of the capital conservation buffer is fixed by law at 2.5%. The size of the other capital buffers is stipulated in rules issued by the Central Bank (Rules 227/2020, 323/2020 and 324/2020).

In March 2020, the Central Bank reduced the countercyclical capital buffer from 2% to 0% as a response to the COVID-19 pandemic. According to the Central Bank's statement, the countercyclical buffer will not be increased for at least 12 months and will therefore remain unchanged at 0% at least until the first quarter of 2022.

As the systemic risk buffer only applies to domestic exposures, the effective risk buffer rate is calculated by multiplying the proportion of the domestic credit risk exposure by the domestic systemic risk buffer rate.

Exhibit 3.4. Breakdown of the total SREP capital requirement. The Pillar 2-R requirements for 2020 are based on unchanged results from 2019.

SREP capital requirement	2020	2019
Pillar 1	8.0%	8.0%
Credit risk	7.1%	7.1%
Market risk	0.2%	0.1%
Operational risk	0.7%	0.8%
Pillar 2-R	1.7%	1.7%
Credit risk	0.6%	0.6%
Credit concentration risk	0.5%	0.5%
Market risk	0.5%	0.5%
Subsidiaries	0.1%	0.1%
Total SREP capital requirement	**9.7%**	**9.7%**

The institution-specific countercyclical capital buffer rate applies to institution-wide total REA. The institution's specific buffer add-on amount is calculated as the weighted average of the countercyclical capital buffer rate applicable in jurisdictions in which an institution has private sector credit exposures, multiplied by the total risk exposure amount. The calculations of the institution specific buffer rates are displayed in Exhibit 3.5 while Exhibit 3.6 shows combined buffer requirement for Íslandsbanki at year-end 2020 and 2019. The sum of Pillar 1, Pillar 2-R and the combined capital buffers forms the overall capital requirement.

Exhibit 3.5. Calculation of effective buffers for Íslandsbanki (ISK bn).

	Contributing credit risk REA	Contributing market risk REA	Total contributing REA	Buffer rate	Institution specific buffer rate
Countercyclical capital buffer					
Iceland	764.2	2.2	766.3	0.00%	0.00%
Norway	2.5	0.0	2.5	1.00%	0.00%
Other countries with effective CCB	0.1	-	0.1	0.33%	0.00%
Other countries	36.9	0.0	36.9		
Total	**803.7**	**2.2**	**805.8**		**0.00%**
Systemic risk buffer					
Iceland	768.5	-	768.5	3.00%	2.78%
Other countries	61.7	-	61.7	0.00%	0.00%
Total	**830.1**	**-**	**830.1**		**2.78%**

Exhibit 3.6. Combined capital buffer requirement.

	31.12.2020	31.12.2019
Capital conservation buffer	2.50%	2.50%
Countercyclical capital buffer	0.00%	1.68%
O-SII buffer	2.00%	2.00%
Systemic risk buffer	2.78%	2.81%
Combined buffer requirement	**7.28%**	**8.99%**

3.3.4 Pillar 2 Guidance for Stressed Conditions (Pillar 2-G)

The Pillar 2-G is based on future risk and is subject to the regulators' assessment of stress tests performed on the financial institutions (supervisory stress testing). The Central Bank can add the Pillar 2-G as a capital reference if the results from the supervisory assessment indicate that a financial institution might not be able to meet the total SREP capital requirements over the projected economic cycle. Currently no Pillar 2-G is applicable for the Bank.

3.3.5 Management Buffer

The Bank aims at managing its capital position and the corresponding capital ratios at a comfortable margin above the overall regulatory capital requirement. This margin is referred to as the management buffer in the Bank's capital management framework. The size of the management buffer is based on factors such as views from the regulator through the SREP, volatility in the Bank's REA due to currency fluctuation, volatility in the Bank's REA due to lumpy asset growth, the Bank's target rating, competitive issues, funding terms, uncertainty in the operating environment not accounted for in the ICAAP, and uncertainty in the regulatory environment. Currently, the management buffer is set by the Board of Directors at 0.5%-2.0%.

3.3.6 Capital Target

The Bank's capital target set by the Board of Directors assumes that the Bank keeps a management buffer of about 0.5–2.0% in excess of the overall capital requirement resulting from the SREP. Based on the most recent SREP results, this translates to a target capital ratio of 17.0–19.5%. In addition to the call from the Central Bank to refrain from dividend disbursement, due to the uncertainty in relation to the effects of COVID-19 on the capital base, the Bank aims to have an ample buffer in excess of the current target until there is further clarity regarding public health restrictions, international travel and other sources of uncertainty.

In January 2021 the Central Bank issued a new statement expressing no general objections to payment of dividends but urges financial institutions to be guided by certain prudent considerations on capital position.

3.3.7 Capital Composition

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

- CET1 at a minimum 4.5% of REA
- Tier 1 capital including Additional Tier 1 (AT1) at a minimum 6.0% of REA
- A total capital ratio including Tier 2 debt at a minimum 8.0% of REA

The capital held under Pillar 2-R is subject to the same proportional restrictions as capital held under Pillar 1, the CRD IV capital buffers shall be comprised of CET1 capital only, whereas the composition of the management buffer is at the Bank's discretion.

Exhibit 3.7 shows Íslandsbanki's current regulatory requirements and how they contribute to the Group's capital target as well as the composition of the Bank's capital, the minimum requirements for CET1 capital, and the resulting room for issuing AT1 or Tier 2 capital.

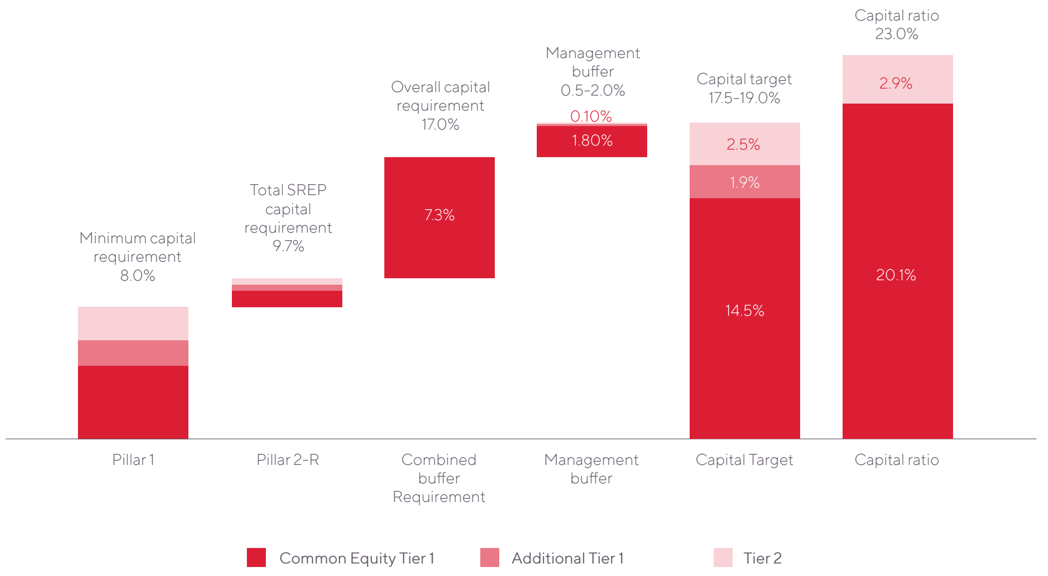
3.4 Stress Testing

Íslandsbanki's stress testing framework aims at detecting the sensitivity of the Bank's operations to changes in the operating environment and to ensure that the Bank holds sufficient available capital and liquid funds to meet minimum requirements, even under stressed operational conditions.

The main types of stress tests performed at Íslandsbanki are:

1. Sensitivity analysis: Sensitivity analyses provide information about key risks and enhance understanding about concentrations in one or several risk factors. Sensitivity analysis stresses one risk driver, with different degrees of severity, to assess the sensitivity of the Bank's operations to that particular risk driver.

Exhibit 3.7. Current regulatory requirements compared with Íslandsbanki's minimum capital target, as well as the composition of the capital target.



2. Reverse stress test: Reverse stress testing consists of defining a significant and pre-defined negative outcome and then identifying causes and consequences that could lead to such an outcome. The purpose is to identify possible combinations of events and risk concentrations that might not be included in other stress tests performed within the Bank. Thus, the reverse stress test could reveal weaknesses in the Bank's operations that might otherwise be overlooked.

3. Scenario analysis: Scenario analysis can be defined as multiple sensitivity analyses performed at the same time which assess the resilience of an institution. A stress scenario is supposed to be forward looking and identify possible events or changes in market conditions that could adversely impact the Bank. The scenario should address the main risk factors that the Bank may be exposed to. The scenario should be severe but plausible and at the same time be consistent internally as well as economically. The Bank has recently added climate risk as one of the risk factors in the scenario analysis.

4. Specific events: Under this type of stress testing, the Bank assesses specific current or imminent events that could have an extensive impact on its operations, the risk mitigating actions that can be taken to reduce the likelihood of these events materialising and to minimise the impact for the Bank.

5. Reputational risk stress test: Qualitative stress testing due to reputational risk are performed by experts from across the Bank. The experts devise a scenario that could damage the Bank's reputation and analyse how the scenario affects the Bank's reputation, the impact it has on different stakeholders, the likelihood that it would have this effect and discuss possible countermeasures. The discussions are documented and summarised in the Bank's ICAAP Stress Testing Results.

The key assumptions for a scenario analysis and other significant stress tests are developed in cooperation with the Bank's Chief Economist, business units, ARC and the Board. The results from stress tests are compared with the Bank's capital target, other risk appetite measures and risk limits. If the results indicate a breach in the Bank's capital targets or other risk appetite or strategic measures, remedial actions may be suggested, depending on the severity and likelihood of such a breach.

3.5 Leverage Ratio

The leverage ratio is a measure supplementing the risk-based capital requirements. A lower leverage ratio indicates higher leverage. The leverage ratio is calculated by dividing Tier 1 capital by the sum of total assets and adjusted off-balance sheet exposures. According to law, the minimum leverage ratio is 3%.

Exhibit 3.8 shows the breakdown of the exposures and the leverage ratio. The increase in the total exposure measure is due to a larger balance sheet whereas the increase in the Tier 1 capital is due to retained earnings. As a result, the leverage ratio decreased slightly between years.

Exhibit 3.8. Leverage ratio (ISK bn).

	31.12.2020	31.12.2019
On-balance sheet exposures	1,334	1,189
Off-balance sheet exposures	41	39
Derivative exposures	10	9
Leverage ratio total exposure measure	1,385	1,237
Tier 1 capital	188	176
Leverage ratio	**13.6%**	**14.2%**

4 Credit Risk

The Bank undertakes credit risk by offering loans, guarantees, and other credit products. Credit risk is the primary risk factor in the Bank's operations and taking on credit risk is a core activity of the Bank. The Bank has policies and procedures for accepting, measuring, and managing credit risk. The objective of credit risk management is to achieve an appropriate balance between risk and return along with minimising potential adverse effects of credit risk on the Bank's financial performance.

At the end of 2020, the Bank's maximum exposure to credit risk amounted to ISK 1,470bn compared to ISK 1,305bn at year-end 2019. The loan portfolio grew by 11.9% in 2020 after a 6.3% increase in the previous year. Due to the COVID-19 pandemic, customers that experienced a temporary reduction in income were offered moratoria or other forbearances measures. This led to a substantial change in share of loans with significant increase in credit risk, currently at 15.6% up from 2.6% the year before. Credit risk accounted for 89% of capital requirements under Pillar 1 and credit risk and credit concentration risk accounted for 85% of the total capital requirements, as determined in SREP.

This chapter provides a description of the Bank's credit process, risk assessment models, and a detailed breakdown of the loan portfolio that gives an indication of credit concentration and credit quality

4.1 Strategy, Organisation, and Responsibility

Credit risk is defined as the current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank.

Credit concentration risk is the increase in risk that is driven by common underlying factors, such as sector, economy, geographical location, type of financial instrument, or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose probability of default is driven by common underlying factors.

The ultimate responsibility for ensuring an adequate credit risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines the credit risk governance framework and the acceptable level of credit risk through the *Risk Management and Internal Control Policy*, the *Risk Appetite Statement*, and the *Credit Risk Policy*.

The Bank's strategy is to maintain a modest credit risk profile and it aims to have long-term average annual credit losses less than 0.9% of the loan portfolio, excluding the liquidity portfolio and the qualified retail mortgage portfolio. This risk appetite is reflected in the credit risk limit structure and guided through the use of credit risk assessment models.

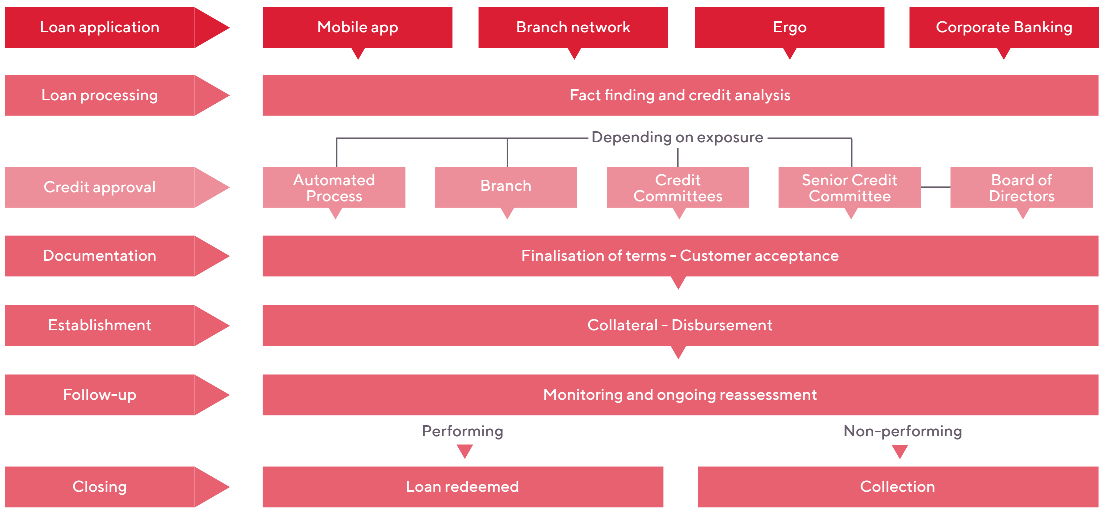
Credit risk activities are controlled through exposure limits applied to counterparties, countries, sectors, and products.

As the second line of defence, Risk Management monitors the adherence to credit risk limits and reports on credit risk to the All Risk Committee and to the Board of Directors, including current and prospective risk position compared to the risk appetite.

The Bank's credit process, shown in Exhibit 4.1, is based on a committee structure where the Senior Credit Committee has the authority to approve credit proposals within authorisation limits set by the Board of Directors. The Senior Credit Committee then appoints and allocates credit authorisation limits to its subcommittees and to individual employees such as branch managers and credit managers. Credit authorisation limits can have reference to the risk class of the counterparty or to specific credit products. For certain retail products, such as mortgages, overdrafts and credit cards to individuals, credit decisions are in part based on an automated approval process.

The All Risk Committee approves frameworks for rule-based and automated approval processes. The frameworks include appropriate control mechanisms, continuous monitoring and reporting, assessment of the risk associated with the process, and mitigating actions. To further strengthen the quality of frameworks for rule-based or automated approval processes, they shall be reviewed annually with the results presented to the Board of Directors. Automated approval processes do not relieve the business units granting the credit of their responsibilities

Exhibit 4.1. Schematic overview of the Bank's credit process. Loan applications can be received through the Bank's Contact Centre as well as the Bank's mobile and online banking platforms.



regarding credit quality or accountability.

The Bank's Credit Rules outline the principles governing loans, guarantees, and other products that expose the Bank to credit risk. Trust between the Bank and its customers is a prerequisite for all lending, as well as the customer's ability and willingness to repay in a timely manner. Sufficient collateral alone cannot justify lending to customers with insufficient payment capacity. According to the Bank's *Sustainability Policy* it is required that sustainability and ESG risk is evaluated in the credit granting and risk assessment process. To mitigate risk, the Bank requires collateral that is appropriate for the product offered. For some products, such as relatively small overdrafts to individuals, no collateral is required, given that the customer's creditworthiness meets the Bank's criteria. Since the Bank does not seize collateral unless a borrower faces serious repayment difficulties, the valuation of collateral focuses on its future expected value at the time of default. The Bank has appointed a Collateral Council that reviews and proposes guidelines for the valuation of collateral and pledged assets. The objective is to ensure that the valuation of collateral is coordinated throughout the Bank.

As the first line of defence, the business units continuously monitor their loan portfolio and periodically re-assess customers' performance. Collection procedures are set to be agile and swift to keep arrears at minimum. Loan covenants are monitored, and appropriate actions are taken to protect the Bank's interests if there are covenant breaches.

Customers that show signs of financial difficulties are placed on an internal watchlist and monitored carefully. When restructuring measures are more appropriate than collection procedures, the Bank can offer several measures and restructuring frameworks for customers in financial difficulties. Forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In cases when these measures are not sufficient, they may be precursors to a more formal restructuring process. Formal legal collection and liquidation of collateral is the final step of the collection process if other measures are not successful.

In 2020, the Bank entered into an agreement with other lenders in Iceland to provide a uniformly executed moratorium for corporate and household customers that faced a temporary reduction in income due to COVID-19. In accordance with guidelines from EBA and the Central Bank, moratoria of this kind do not trigger classification as forbearance.

4.2 Measurement and Monitoring

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

To ensure that the Bank charges an adequate interest rate and that it has sufficient capital reserves to ensure long-term sustainability, the Bank estimates expected and unexpected losses of its loan portfolio.

The long-term expected credit loss on the loan portfolio is covered by a part of the interest rate margin. Due to various underlying factors, the observed annual losses can fluctuate significantly around the long-term average, sometimes up to an order of magnitude. To be able to cover these unexpected losses at any time, the Bank holds a substantial capital buffer against these fluctuations. An adequate return on this capital buffer also needs to be covered by the interest rate margin.

The annual expected credit loss (ECL) for a single obligor depends on the probability that the obligor defaults within the horizon of one year (PD), the expected exposure at time of default (EAD), and the loss given default (LGD), expressed as a fraction of the exposure at default:

$$ECL = PD \cdot LGD \cdot EAD$$

Under IFRS 9, all loans are required to carry an impairment allowance of either 12-month expected credit loss or, in case of a significant increase in credit risk since origination, lifetime expected credit loss. This impairment allowance is calculated using several different scenarios for the future economic development and the final result is the probability-weighted average of the ECL in these scenarios. The calculation of the impairment allowance under IFRS 9 is further discussed in Note 67.4 in the Consolidated Financial Statements.

The main drivers for the unexpected portfolio loss are correlations between obligor defaults within the portfolio. These correlations may be due to common dependencies on macro-economic factors or due to business relations between individual obligors.

4.2.1 Definition of Default

The Bank's definition of default has been updated so that it simultaneously satisfies the requirements in the definition of stage 3 according to IFRS 9, the definition of default according to article 178 of CRR, and the definition of non-performing exposure used in FINREP. Obligors are considered to be in default according to the current definition if (a) it is the opinion of the Bank that it is unlikely that they will fulfil the terms of their contracts or (b) they are more than 90 days past due on a material credit obligation. Defaults are defined on the obligor level rather than the facility level.

The assessment under point (a) is based on a defined set of triggers, some of which are fully objective whereas others are based on assessment. The general rule is that if any one of these triggers is activated then the customer is deemed to be in default. Furthermore, there are requirements that a customer actively demonstrates that there is no longer any reason for the Bank to say that they are in default.

Among the triggers which activate default are: that the revenues of the customer do not sustain their level of indebtedness, that the customer is in serious breach of covenants in their loan contracts, that the Bank has initiated serious collection measures, that the customer has been given a serious registration on an internal watchlist, and registrations on a credit bureau watchlist.

Among the triggers which indicate that a customer should no longer be considered in default are that the customer has maintained normal repayments over a certain period, that a period of probation has been completed and that the customer has improved their financial position, e.g. by the injection of new capital.

4.2.2 Probability of Default

The way an obligor's probability of default (PD) is assessed depends on the obligor type. Exhibit 4.2 shows the methods used to assess the risk for different obligor types and the number of obligors and the relative size of exposure for each obligor type.

The Bank uses internal rating models to assess the probability of default for companies and individuals. The rating of large companies is based on a company's most recent financial statements, together with a qualitative assessment of its management, market position, and industry sector. The model assigns each obligor to one of ten risk classes. Risk class 10 is for obligors in default and risk classes 1–9 for other obligors.

For individuals and small companies, the Bank uses two different statistical rating models. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits, and demographic variables to assess the probability that a customer will default on any of their obligations within 12 months of the rating assessment.

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

Exhibit 4.2. Methods used to assess the default risk of different obligor types, approximate number of obligors and relative size of on-balance-sheet exposure at year-end 2020.

Obligor type	PD assessment	Number of obligors	Exposure
		(approx. count)	(%)
Individuals	Statistical model	87,000	34.0%
Small companies	Statistical model	9,000	7.2%
Large companies	Hybrid model	400	34.9%
Credit institutions	External rating agencies or expert model	50	8.6%
Regional governments	Expert model	20	0.8%
Sovereigns	External rating agencies	10	14.4%

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

Risk group	Risk class	Large companies	Small companies	Individuals
		(%)	(%)	(%)
Low	1	0.3	0.2	0.1
	2	0.4	0.4	0.2
	3	0.8	0.8	0.4
	4	1.3	1.7	0.9
Medium	5	2.3	2.7	1.7
	6	4.1	5.0	2.6
Increased	7	7.1	8.5	4.0
	8	12.5	17.0	7.3
High	9	21.8	41.1	23.4

4.2.3 Observed Default Frequency

The Bank's PD models predict the long-term average of the one-year default rate while the observed default frequency (ODF) depends on the current state of the economy. The year 2020 was extraordinary because of the COVID-19 pandemic and measures were taken to avoid unnecessary defaults for customers with a temporary reduction in income. Since the PD models were fitted on regular business cycle data, a discrepancy between ODF and predicted default rates should not be a cause for concern.

In 2020 there were 18 observed defaults for large companies, which translates to a 3.9% default frequency compared to a predicted default probability of 5.3%. The defaults were so few that a meaningful comparison of the observed default frequency and the predicted probability of default per risk class is not possible.

For individuals and small companies, however, the number of defaults allow for a meaningful breakdown by risk classes, as shown in Exhibits 4.4 and 4.5. Risk classes 1 through 4 are grouped together due to few defaults in those classes. In the case of individuals, the mapping from PD to risk classes for years 2018 to 2020 differ from those of previous years, due to a recalibration of the rating model in 2018. As expected, due to COVID-19 measures, the observed default frequency is lower than the predicted long-term default rate. The observed default frequency was 2.0% compared to the 3.7% predicted probability of default for individuals, while corresponding rates were 4.2% and 6.9% for small companies, respectively.

4.2.4 Loss Given Default

The loss given default (LGD) represents the percentage of exposure which is expected to be lost if an obligor goes into default. The loss given default mostly depends on collateralisation and other credit mitigants but in many cases defaulted customers become performing again without the need to seize collateral. To take historically observed loss experience into account, while also allowing for a risk-sensitive differentiation of the portfolio, loss given default is modelled using loss severity in several different scenarios. One of the scenarios considered is that the facility becomes performing again without intervention by the Bank and the probability of that scenario is the so-called cure rate. The other scenarios assume that recoveries are based on the seizing of collateral and apply different haircuts according to the type of collateral and scenario. The haircuts are applied to the most current and appropriate valuation of the pledged collateral. The haircuts take into account cost of sale, depreciation of value, and discounting of recovery cash flows. The resulting amounts are allocated to eligible exposures by maximising the total collateralisation of the exposure amount subject to constraints imposed by the collateral agreements. For facilities and obligors, where collateral is generally not pledged, the estimate of LGD may be based on a specific assessment.

Exhibit 4.4. Observed default frequency (dots) and the range of the predicted through-the-cycle probability of default (vertical lines) by risk class for individuals in 2020, results from other years shown for comparison. Logarithmic scale.

Exhibit 4.5. Observed default frequency (dots) and the range of the predicted through-the-cycle probability of default (vertical lines) by risk class for small companies in 2020, results from other years shown for comparison. Logarithmic scale.

4.2.5 Exposure at Default

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

$$EAD = \text{Drawn amount} + CCF \cdot \text{Undrawn amount}$$

The Bank has also developed models for exposure at default that take the expected amortisation schedule into account and these models are used in calculations of both the 12-month and lifetime expected credit losses in IFRS 9. The EAD shown here is, however, the one found for capital requirement purposes and not for IFRS 9.

4.3 Credit Concentration

The Bank monitors credit concentration risk which arises from the unequal and granular distribution of exposure to borrowers, industry sectors, and geographic regions. The portfolio concentration is monitored and constrained by limits set in the *Risk Appetite Statement*.

4.3.1 Borrower Concentration

The Bank actively seeks to limit large exposures. A large exposure is defined as an exposure to a group of connected clients that is 10% or more of the Bank's total capital base. The exposure is evaluated both before and after application of eligible credit risk mitigating effects according to relevant rules. When assessing the exposure, both on-balance sheet items and off-balance sheet items from all types of financial instruments are included. The Bank has internal criteria that define connections between clients in line with Icelandic law and EBA guidelines, where groups of connected clients are defined.

At year-end 2020, the Bank had one large exposure which after eligible credit risk mitigating effects amounted to 10% of capital base. This is an increase from last year when the Bank had no large exposure.

The Bank seeks to limit borrower concentration risk and has an internal limit on the aggregated exposures to the 20 largest groups of connected clients.

4.3.2 Industry Sector Concentration

The Bank defines industry sectors as groups of entities that have similar primary activities, underlying risk factors, and behaviour characteristics. A see-through principle is applied for holding companies that own other companies but do not produce goods or services, i.e. a holding company may be classified in the sector of its investments and not as an investment company if all the investments are in the same sector. This is done to capture the underlying risk of economic industry sectors.

The Bank has limits on both the exposure to any single economic industry sector as well as the aggregated exposure to the three largest economic industry sectors as a percentage of the Bank's total credit exposure. Exposure to individuals, as an economic industry sector, is also considered separately.

The tourism industry is an important economic sector in Iceland but due to the nature of tourism, its effects are not limited to hotels, car rentals and tour guides. The Bank therefore monitors the tourism industry internally as a quasi-sector instead of a new separate sector.

4.3.3 Geographic Concentration

Country risk is the risk of losses that may occur, for example, due to economic difficulties or political unrest in countries to which the Bank has exposures. Country risk includes political risk, exchange rate risk, economic risk, sovereign risk, and transfer risk, i.e. economic factors that could have significant influence on the business environment.

Specific geographical limits are established to manage country risk. The geographical limits apply to the country from where the credit risk arises. Iceland is considered to be a home market and is as such not subject to geographical limits.

Most of the Bank's activities are in Iceland but the Bank maintains a certain amount of international activities. The overseas strategy is built on a heritage of servicing the core industries in Iceland, primarily focusing on the seafood industry. The strategy focuses on the North Atlantic region, including Canada, the United States, and Norway.

4.3.4 Product Concentration and Collateral Concentration

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

4.4 Settlement Risk

Settlement risk is the risk that a party will fail to deliver on the terms of a contract at the time of settlement. Settlement loss can occur because of a default at settlement and because of any timing differences in settlement between two parties. The amount at risk or the potential loss is the principal of the transaction.

To mitigate settlement risk on counterparties, the Bank utilises the services of clearing houses and applies the general rule of delivery versus payment. If such a rule is not applicable due to the nature of the business relationship, a settlement limit is assigned to the counterparty to limit the risk.

4.5 Counterparty Credit Risk

Counterparty credit risk (CCR) is the risk arising from the possibility that the counterparty may default on amounts owed on a derivative transaction.

The Bank takes on CCR when entering into derivatives transactions. This includes, but is not limited to, interest rate swaps and futures, cross-currency swaps, equity forwards, and options.

Customers enter into derivatives contracts with the Bank either to take on speculative positions or to hedge risk for the customer's own risk mitigation purposes. Derivatives contracts with customers are generally done on margin where customers post collateral to the Bank. The Bank's objective in setting margin requirements is to have adequate collateral to absorb any losses that the position could suffer before the Bank is able to close the position. Margin requirements are decided based on the underlying product and its characteristics, such as volatility and liquidity. In addition to cash, the Bank accepts selected stocks and bonds as collateral posted for margin trades. Non-cash collateral is subject to haircuts depending on risk characteristics such as the issuer and duration in the case of bonds and volatility and liquidity in the case of stocks.

The Bank uses netting across contracts of the same counterparty to allow profits in one contract to offset collateral requirement in another contract. Information on the extent of netting is provided in Table CCR5-A. To mitigate wrong-way risk, the Bank generally does not accept collateral that is correlated with the asset underlying the respective customers' derivatives contracts. The Bank may waive collateral requirements where the purpose of the derivatives contract is to mitigate the customer's own risk, subject to certain conditions, including an approved credit limit based on the customer's creditworthiness. Limits are also set to manage the concentration risk towards single issuers or instruments and thus to manage the risk of the instruments becoming illiquid.

The Bank actively uses derivatives to hedge currency, interest, and inflation exposures. Such derivatives contracts are generally subject to ISDA master agreements with a Credit Support Annex, or similar terms, with collateral in the form of cash and eligible bonds. Counterparties in these contracts are also subject to approved credit limits.

When setting credit limits for counterparties in derivatives contracts, the Bank follows the same process as for other credit exposure and, as for credit concentration risk in general, credit limits for counterparties are constrained by various concentration limits, many of which are defined in terms of the Bank's capital base. This is discussed further in Section 4.3.

Information on CCR exposures, broken down by various characteristics, is provided in Tables CCR1, CCR2, CCR3, CCR5-A, CCR5-B and CCR6 in the Additional Pillar 3 Disclosures.

4.6 Credit Risk Exposures

Credit risk exposure comprises both on-balance sheet and off-balance sheet items. Exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the Consolidated Financial Statements. The exposure for off-balance sheet items is the amount that the Bank might have to pay

Exhibit 4.6. The main sources of credit risk.

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

out against financial guarantees and loan commitments, less the impairment the Bank has made for these items. The credit exposure for capital requirement purposes does not reconcile with the net carrying amount in the Consolidated Financial Statements mostly due to the contribution of off-balance sheet items, see Table LI2 in the Additional Pillar 3 Disclosures for details on the difference. For capital requirement purposes, credit conversion factors are applied to guarantees and undrawn commitments. For derivative contracts, the exposure is calculated by adding potential future credit exposure to the positive market value of the contract. The Bank currently has no direct credit exposure to securitisation.

Exhibit 4.6 summarises and describes the main sources of credit risk, while Exhibit 4.7 shows the main sources for credit risk at year-end 2020 and 2019.

4.6.1 Balances with the Central Bank and Loans to Credit Institutions

Cash and balances with the Central Bank and loans to credit institutions can fluctuate considerably between periods due to liquidity management. Exhibit 4.8 shows a breakdown

Exhibit 4.7. The main sources for credit risk at year-end 2020 and 2019 (ISK bn).

	31.12.2020	31.12.2019
Loans to customers	1,006.7	899.6
Balances with the Central Bank and loans to credit institutions	168.9	201.0
Bonds and debt instruments	128.2	52.9
Off-balance sheet items	152.4	135.8
Derivatives	9.9	9.5
Other financial assets	3.7	5.8
Total	**1,469.8**	**1,304.6**

Exhibit 4.8. Cash and balances with the Central Bank and loans to credit institutions at year-end 2020 and 2019, by credit quality step (net carrying amount, ISK bn).

Type of institution	31.12.2020	31.12.2019
Central Bank	78.9	146.6
Domestic credit institutions	2.2	1.6
Foreign credit institutions	87.8	52.7
thereof in credit quality step 1	24.0	30.6
thereof in credit quality step 2	45.5	13.8
thereof in credit quality step 3	18.3	8.3
Total	**168.9**	**201.0**

of these exposures at year-end 2020 and 2019. Cash and balances with the Central Bank include CB deposits, minimum reserve requirements and other balances with the CB.

The Bank has exposures to domestic and foreign credit institutions, mostly in the form of money-market deposits and nostro accounts.

Exposures are only granted to credit institutions that have been allocated a credit limit by the Senior Credit Committee. When applying for a credit limit for a specific credit institution, a thorough analysis of the institution is presented to the committee, including credit ratings from rating agencies, as appropriate.

4.6.2 Bonds and Debt Instruments

The Bank is exposed to credit risk as a result of trading and investing in bonds and debt instruments, for example as part of the Bank's liquidity management and as a result of restructuring activities. Exhibit 4.9 presents the Bank's position in bonds and debt instruments.

4.6.3 Off-Balance Sheet Items

The Bank's exposure deriving from off-balance sheet items totalled ISK 152bn at year-end 2020 compared to ISK 136bn the year before. For regulatory purposes a credit conversion factor is applied to calculate the exposure under the credit risk framework. Calculated in this way, the regulatory credit exposure deriving from off-balance sheet items totalled ISK 48bn at year-end 2020 compared to ISK 39bn at year-end 2019.

4.6.4 Derivatives

The Bank uses derivatives to hedge currency, interest, and inflation exposure. The Bank carries relatively low exposure due to margin trading with clients and in these cases, the Bank holds collateral to cover possible losses. Credit risk for derivatives amounted to ISK 9.9bn at year-end 2020 compared to ISK 9.5bn the year before.

See also discussion on derivatives in Sections 4.5 and 5.3.5.

4.6.5 Country Risk Exposure

Exposure to countries other than Iceland amounted to ISK 136bn at year-end 2020. This exposure relates mainly to the management of the Bank's foreign liquidity reserves. The Bank has no retail lending activities outside of Iceland but maintains a modestly sized portfolio of lending to companies in the United States, Canada, and Norway within its North-Atlantic strategy. The exposure to companies within this portfolio was ISK 28bn at year-end 2020

4.7 Loans to Customers

Loans to customers, both individuals and companies, represent the largest part of

Exhibit 4.9. Bonds and debt instruments at year-end 2020 and 2019 (carrying amount, ISK bn).

Bonds and debt instruments	31.12.2020	31.12.2019
Icelandic government and regional government guaranteed bonds	67.7	6.4
Foreign government bills	43.9	30.8
Domestic corporates	2.3	2.8
Domestic credit institutions	14.3	12.9
Total	**128.3**	**52.9**

the Bank's credit risk exposure. This section describes the portfolio of loans to customers and its development.

4.7.1 Development of the Loan Portfolio

At year-end 2020 the net carrying amount of the portfolio of loans to customers was ISK 1,007bn, having grown from ISK 900bn at year-end 2019. This growth of 11.9% is mainly due to the increase in the mortgage portfolio which grew by ISK 96bn on the back of ISK 206bn in lending, a part of which was refinancing of outstanding mortgages due to more favourable interest rates.

Exhibit 4.10 shows the development of the loan portfolio through 2020.

4.7.2 Currency Composition of Loans to Customers

As a principle, the Bank aims to have the currency composition of loans to customers in balance with customer needs. In particular, loans to customers whose income is predominantly in ISK should be denominated in ISK. The Bank has in place rules regarding lending in foreign currency, ensuring management of this risk. Exhibit 4.11 shows a breakdown of loans to customers by industry sector and currency types. Loans to customers are categorised into three currency types, Non-indexed ISK, Consumer Price Index (CPI) linked ISK, and Foreign currency (FX).

4.7.3 Loans to Individuals

Loans to individuals amounted to ISK 437bn

Exhibit 4.10. The main sources of changes in the net carrying amount of loans to customers from year-end 2019 to year-end 2020. Outstanding loans that are refinanced within the Bank are shown both as an increase and a decrease in the carrying amount. Regular instalments, pre-payments and loans that are fully repaid are all shown as instalments in this chart. The effect of facilities that do not have a fixed repayment schedule such as overdrafts and credit cards is in Other changes. (ISK bn).

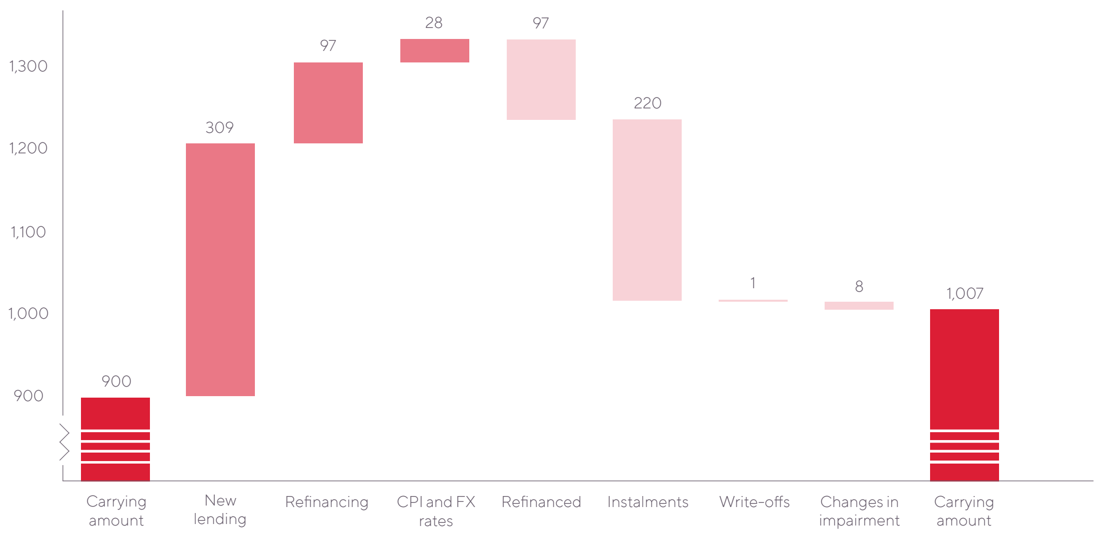


Exhibit 4.11. Currency composition of loans to customers at year-end 2020 (net carrying amount, ISK bn).

Industry sector	Non-indexed	CPI-linked	Foreign currency	Total
Individuals	250.5	186.7	0.2	437.4
Commerce & Services	99.5	12,.7	12.1	124.3
Construction	38.8	3.4	0.2	42.4
Energy	4.5	4.0	0.1	8.7
Financial services	1.5	-	0.0	1.5
Industrials & Transportation	46.2	4.1	28.3	78.6
Investment companies	10.1	2.7	10.6	23.4
Public sector & non-profit organisations	9.8	1.1	0.0	10.9
Real estate	92.3	52.9	12.3	157.5
Seafood	8.3	0.2	113.7	122.1
Total	**561.4**	**267.8**	**177.5**	**1,006.7**
Total as %	55.8%	26.6%	17.6%	100%
Total at year-end 2019	49.6%	32.9%	17. 5%	100%

at year-end 2020 compared to ISK 349bn the year before. New loans and refinancing amounted to ISK 224bn.

In 2020, a fully digital and automatic credit score evaluation and refinancing of mortgages was launched. The customer permits the Bank to gather information from third parties, such as other financial institutions and tax authorities and receives a credit score within three minutes. The loan application is now fully automated, from the customer's selection of a property, through the selection of a loan structure and to the submittal of loan application. Applicants can track the status of their application and most signatures in the process are now electronic.

Following the reduction in the Central Bank's key interest rates from 3.0% to 0.75%, as a response to the pandemic, a noticeable part of the Bank´s customers refinanced their loans from CPI-linked mortgages to non-indexed, both from the Bank's own CPI-linked products and from pension funds. This explains the material 25% increase in loans to individuals.

Loans to individuals derive from lending activities to individuals and households and can be broken down into five product types, i.e. mortgages, term loans, credit cards, overdrafts, and leasing.

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

Term loans to individuals are often secured with residential real estate but do not satisfy all the requirements needed to be classified as the product type mortgages. These loans may have a non-standard term structure, or the purpose of the loan may not have been to acquire the underlying property. These term loans are generally not as well collateralised as mortgages. Other examples are uncollateralised consumer loans granted by an automated process through the Bank's app. A last group of term loans are loans provided to individuals for purchases of vehicles, mostly cars and campers. These loans are usually well collateralised.

Credit cards and overdrafts to individuals are usually uncollateralised short-term consumer loans. They are used to meet fluctuations in cash flows and the outstanding amounts per customer are typically low. It is expected that future earning-ability of individuals is sufficient for repayment without a formal collateral.

Leasing agreements are provided to individuals for purchases of vehicles, mostly cars and campers. These agreements are usually well collateralised. For credit risk purposes these leasing agreements are very similar to loans provided for the same purpose.

Note 48 in the Consolidated Financial Statements shows a breakdown of the maximum credit exposure by these product types.

The loan-to-value (LTV) ratio is an important factor when measuring the risk of a mortgage portfolio. The LTV for a single mortgage is the current net carrying amount of the loan divided by the value of the property. The value of the property is usually taken as the tax value obtained from Registers Iceland but for newly granted mortgages, the purchase price of the property can be used as a valuation in the beginning while it is considered more accurate. For mortgages that are not on the first lien, the cumulative loan to value (CLTV) is the sum of the current carrying amount of the loan under consideration and the outstanding balance of all previous liens, divided by the value of the property. For a portfolio of mortgages, however, the LTV can be represented in various ways depending on the intended usage. Here, two such representations are presented.

The first representation is from the property point of view. To find the average LTV of a mortgage portfolio, each property is assigned the maximum CLTV value of the Bank's mortgages on that property and that value is weighted with the total carrying amount

Exhibit 4.12. Breakdown of the mortgage portfolio by the LTV calculated for each property, year-end 2020 and 2019 (net carrying amount, ISK bn).

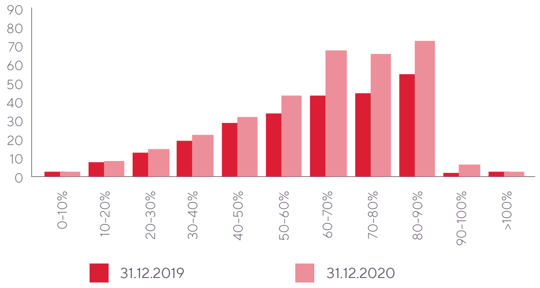
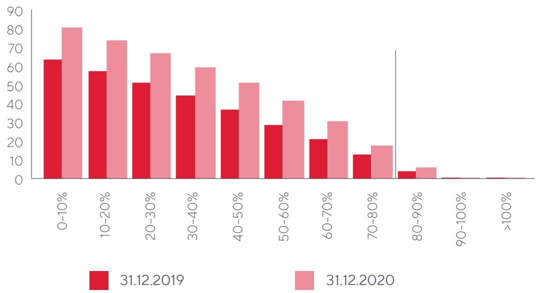


Exhibit 4.13. Breakdown of the mortgage portfolio by LTV bands, year-end 2020 and 2019 (net carrying amount, ISK bn). See main text for further explanation.



of the Bank's loans on the property. The weighted average LTV, calculated in the manner described, was 64% at year-end 2020 compared to 62% at year-end 2019.

Exhibit 4.12 shows the LTV distribution by categorising the total carrying amount of the Bank's loans on each property in the mortgage portfolio by the maximum CLTV for that property. Note that the calculation is based on available data at year-end and for newly granted mortgages there is a few weeks lag in the official lien registration. The classification for loans with over 90% CLTV is temporary and not descriptive for long-term collateralisation.

Another way to represent the LTV of a mortgage portfolio is to consider how each part of the loan amount is distributed in loan-to-value bands. In the breakdown, each part of the loan amount is categorised according to its ranking in the total debt on the property. The first band represents the part of the portfolio that falls in the 0–10% LTV band, the second represents the part that falls in the 10–20% LTV band and so on. Exhibit 4.13 shows how the mortgage portfolio is distributed in loan-to-value bands defined in this way.

For capital requirement assessment purposes, residential real estate mortgages to individuals are divided into two segments, the part that is covered up to 80% LTV and the amount that exceeds 80% LTV. The part with an LTV below 80% is potentially eligible for a 35% risk weight when calculating the capital requirements as compared to 75% for the remaining part. One of the benefits of the representation shown in Exhibit 4.13 is that the part of the mortgage portfolio that is potentially eligible for a 35% risk weight is on the left side of a vertical line drawn at 80% LTV in Exhibit 4.13, this amount cannot be inferred from Exhibit 4.12.

4.7.4 Loans to Companies

The category loans to companies includes loans to companies as well as municipalities and public sector entities. These loans comprise a significant part of the Bank's balance sheet and operation. Loans to companies amounted to ISK 569bn at year-end 2020 compared to ISK 550bn at year-end 2019. New loans and refinancing of outstanding loans amounted to ISK 182bn in 2020.

Credit policies are in place to ensure that companies have the capacity to repay their loans. The Bank also takes collateral to minimise loss in case of default.

Notes 48 and 49 in the Consolidated Financial Statements show the maximum credit risk exposure for loans to companies, broken down by industrial sectors, product types, and whether the facilities are in stage 3 or not. Note 49 furthermore shows the type of collateral held against these exposures.

The Bank's exposure to companies operating in the tourism industry sector is 9% of the loan portfolio. Due to public health restrictions and restriction on international travel, the tourism sector was greatly affected by the COVID-19 pandemic. This is discussed in some detail in Section 4.10.

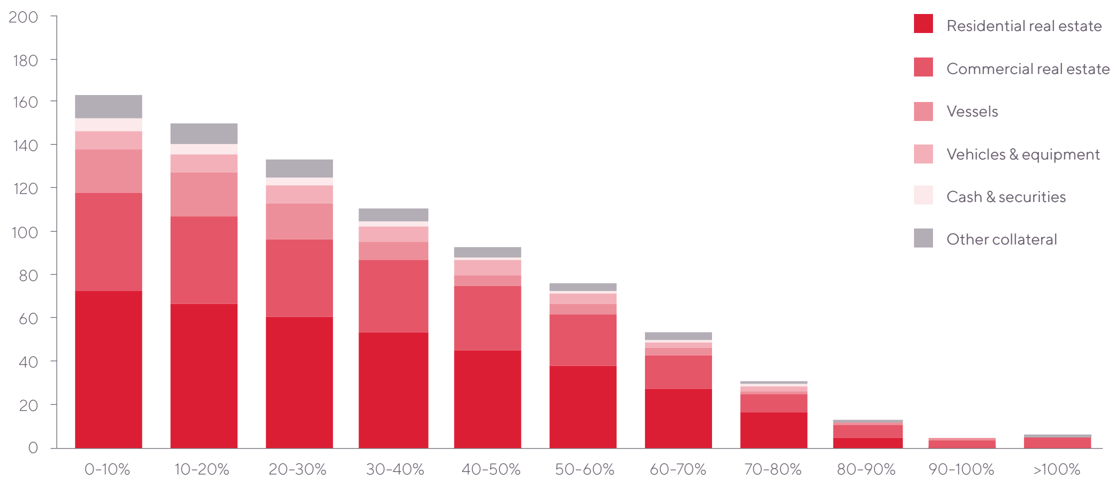
4.8 Loans Covered by Collateral

Collateral and other credit risk mitigants vary between types of obligors and credit facilities. Loans to eligible credit institutions are usually unsecured. For loans to individuals, the principal collateral pledged is residential property against mortgages. Unsecured loans to individuals are mostly short-term consumer loans such as overdrafts and credit cards. In the case of large companies, pledged collateral includes real estate, fishing vessels, cash and securities, as well as other collaterals such as accounts receivable, inventory, vehicles, and equipment. Loans to government entities and municipalities are generally unsecured. The measured credit risk exposure of loans is not affected by the pledged collateral.

In some cases, the Bank uses guarantees as credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in exposure to credit risk although they may strengthen its quality. The guarantees which the Bank accepts are from parties which have some association with the obligor, e.g. direct ownership. Thus, the Bank does not use general credit derivatives to mitigate credit risk. Covenants in loan agreements are also an important credit enhancement though they do not reduce credit exposure.

In 2020, the Bank temporarily offered support loans and supplementary facilities with full or partial Government guarantee as part of official actions to counteract the impact of COVID-19. These Treasury guarantees are, from credit quality standpoint, treated as collateral unlike other third-party guarantees and are shown here as Other collateral.

Exhibit 4.14. The continuous LTV distribution of the portfolio of loans to customers by type of underlying asset at year-end 2020 (ISK bn).



Valuation of collateral is based on market price, an official valuation from Registers Iceland, or the expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels, the assigned fishing quota is included in the valuation, based on a valuation by the Bank's Collateral Council. Valuations can only be valid for a certain amount of time and must therefore be reassessed regularly. Since the price volatility differs between asset classes it is interesting to consider how the LTV distribution of the portfolio is split between these classes. This LTV distribution is shown in Exhibit 4.14.

To assess the financial effect of collateral on maximum credit exposure, the Bank allocates collateral to loans using an optimisation algorithm. Among other things, the algorithm ensures that collateral is not assigned in excess of its estimated value, in excess of any maximum amount stipulated in a collateral agreement, in excess of the claim value of the relevant loans, or the maximum potential exposure in case of facilities with an undrawn component. The last constraint means that if some loans have collateral values in excess of their claim value, then the excess is removed in this assessment in order to reflect the Bank's actual exposure to credit risk.

Exhibit 4.15 shows the financial effect of allocated collateral at year-end 2020 broken down by sector and type of collateral.

4.9 Risk Profile

As described in Section 4.2.2, each obligor is assigned a risk class depending on how

Exhibit 4.15. Financial effect of allocated collateral for loans to customers at year-end 2020 (ISK bn).

Collateral	Residential real estate	Commercial real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Individuals	381.0	7.7	0.0	0.2	14.6	0.0	403.5
Commerce and services	9.1	53.5	0.9	5.3	26.8	22.4	118.0
Construction	17.7	19.2	0.0	0.8	3.8	0.4	41.9
Energy	-	6.6	-	-	0.0	0.0	6.6
Financial services	0.1	0.4	-	0.0	-	1.6	2.0
Industrial and transportation	1.1	30.7	1.6	2.6	8.6	15.6	60.3
Investment companies	1.4	6.3	-	14.9	0.1	1.4	24.1
Public sector and non-profit organisations	0.1	0.9	-	-	0.0	-	1.0
Real estate	18.0	132.3	0.0	2.1	0.4	0.3	153.1
Seafood	0.3	15.0	92.6	0.0	0.1	20.8	128.9
Total	**428.8**	**272.4**	**95.2**	**25.9**	**54.5**	**62.6**	**939.4**

likely they are considered to default in the next 12 months. Note 50 in the Consolidated Financial Statements shows the breakdown of loans to customers, off-balance sheet loan commitments, and financial guarantees into risk class groups and stages. Exhibits 4.16 and 4.17 show the breakdown of loans to customers graphically where in addition, exposure to individuals and exposure to companies are shown separately. Exhibit 4.18 shows the migration of customers between risk classes in 2020.

According to IFRS 9, the impairment allowance, i.e. the difference between the gross and the net carrying amount, is the expected credit loss (ECL). Exhibit 4.19 shows the breakdown of the ECL for loans to customers by IFRS 9 stages. The columns show the contribution to the ECL from the probability of default (PD) and the loss given default (LGD). For facilities in stage 3, the PD does not apply since default has already occurred. Additionally, the LGD contribution is divided into the probability that the default will not cure, and thus lead to an economical loss (loss rate), and the expected size of the eventual economic loss (loss severity). Finally, for facilities in stage 2, the loss allowance is equal to the expected loss for any events occurring during the lifetime of the facility, the contribution of this is shown in the column Effect of lifetime loss.

Exhibit 4.16. Loans to individuals by risk groups and stage at year-end 2020 (net carrying amount, ISK bn).

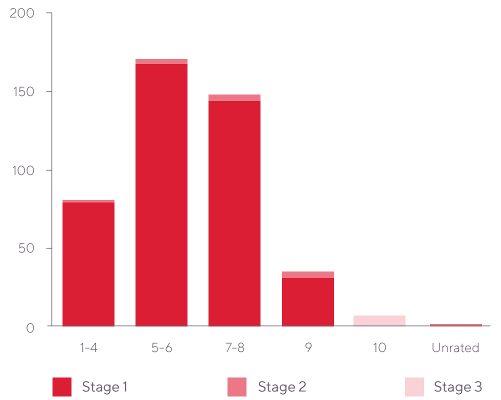
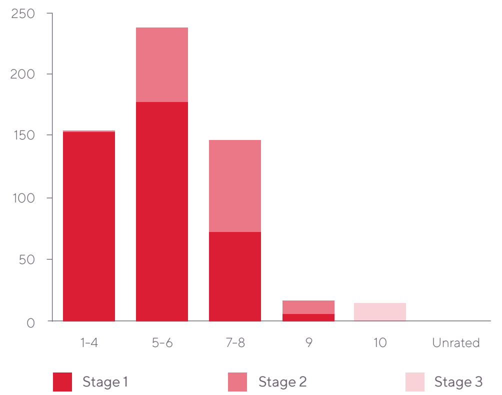


Exhibit 4.17. Loans to companies by risk groups and stage at year-end 2020 (net carrying amount, ISK bn).



The Bank monitors the non-performing loans

(NPL) ratio but due to the adoption of IFRS 9 it has been necessary to change the definition. The non-performing ratio that the Bank uses, depicted in Exhibit 4.21, is based on the gross carrying amount of loans to customers that are in default (i.e. stage 3), see Section 4.2.1 for further details on the Bank's definition of default. When doing comparisons on NPL ratios between different banks it must be borne in mind that an industry standard has not yet emerged on how to define the NPL. The NPL ratio will usually not be comparable between banks unless they use the exact same definition. The exposure amounts used to calculate the NPL ratio can be seen in Note 50 in the Consolidated Financial Statements. The Bank's NPL ratio was 2.9% at year-end 2020 compared with 3.0% at year-end 2019.

4.10 COVID-19 considerations

The COVID-19 pandemic has had a significant impact on the Bank's customers, although the impact varies significantly across sectors, with tourism being the hardest hit corporate sector. While some customers' cash flow has been significantly negatively affected, the Bank has been mindful not to exacerbate the crisis unduly, as its interests, as well as those of the broader Icelandic economy, generally lie with supporting viable firms through the COVID-19 crisis, which is generally perceived to be temporary. This section describes two general measures that the Bank participated in and how exposures to the tourism sector were analysed for impairment and capital purposes.

Exhibit 4.18. Migration of risk classes in 2020 (net carrying amount, ISK bn).

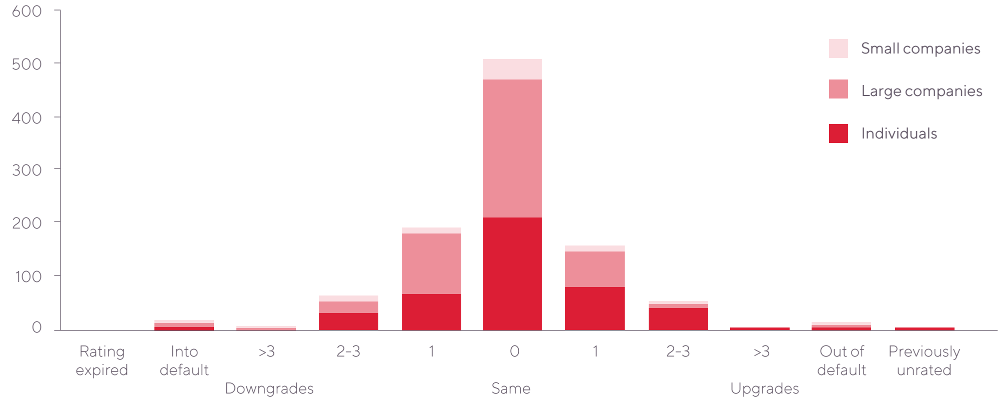


Exhibit 4.19. The expected credit loss for loans to customers at year-end 2020. See Section 4.9 in the main text for further details.

Stage	Gross carrying amount	PD	LGD loss rate	LGD loss severity	Effect of lifetime loss	ECL
	(bn)	(%)	(%)	(%)	(%)	(%)
Stage 1	835.4	5	38	21	100	0.4
Stage 2	159.5	13	63	18	266	4.1
Stage 3	29.2	100	68	37	100	25.3

Exhibit 4.20. The expected credit loss for loans to customers at year-end 2019.

Stage	Gross carrying amount	PD	LGD loss rate	LGD loss severity	Effect of lifetime loss	ECL
	(bn)	(%)	(%)	(%)	(%)	(%)
Stage 1	858.8	5	39	21	100	0.4
Stage 2	23.8	15	39	28	246	4.0
Stage 3	27.3	100	63	33	100	20.9

Exhibit 4.21. The Bank's definition of non-performing assets indicated by the highlighted cells.

Asset classes	Exposure	Cross default	Non-performing criteria
(can choose many)	(choose one)	(choose one)	(can choose many)
Loans to customers	Gross carrying amount	Per facility	90 days past due
Loans to Credit institutions	Net carrying amount	Per customer	Unlikeliness to pay
Off-balance sheet items	Payment in arrears	Per group of connected clients	Forbearance
Other financial assets			Cure period

4.10.1 COVID-19 moratoria

In March 2020, the Bank entered into an agreement with other financial institutions and lenders in Iceland to provide a moratorium for corporate customers, uniformly executed across institutions. Similarly, the Bank entered into a separate agreement for a moratorium for households and individuals. In accordance with guidelines from EBA and the Central Bank of Iceland, these moratoria did not trigger classification as forbearance. The agreement expired on 30 September 2020 and the maximum length of the moratoria was to the end of 2020. Further extensions of moratoria may be granted on a case-by-case basis, but such extensions will be classified as forbearance.

Exhibits 4.22 and 4.23 show the weekly development of COVID-19 moratoria under these agreements. For companies, the amount in active moratorium grew to around ISK 165bn but then tapered off, with around half resuming regular payment schedule or being refinanced, while around half were granted extensions that led to classification as forbearance. The extensions have mostly been to companies in the tourism industry that do not foresee any real uptick in income until mid-year 2021. For individuals, the maximum exposure with COVID-19 moratoria was around ISK 30bn, but thereof only around 20% requested further extensions which amounts to 1.5% of all loans to individuals.

Exhibit 4.22. Development of loans to companies granted COVID-19 moratorium. (Gross carrying amount, ISK bn).

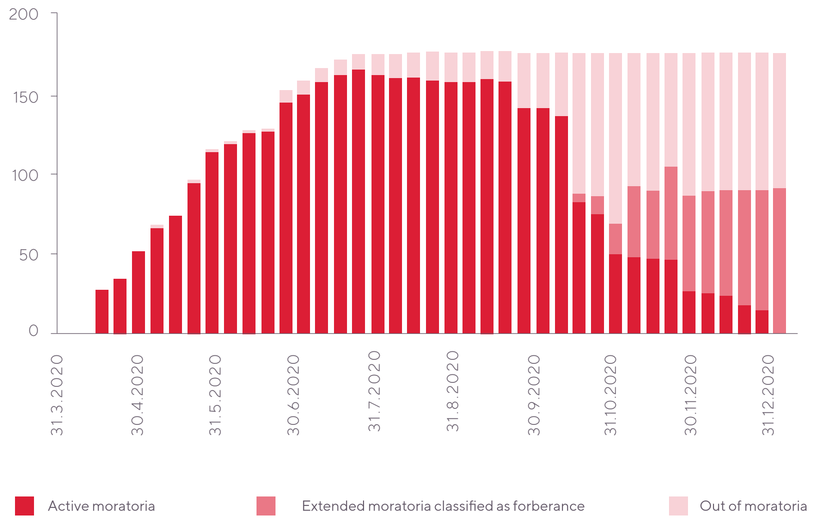
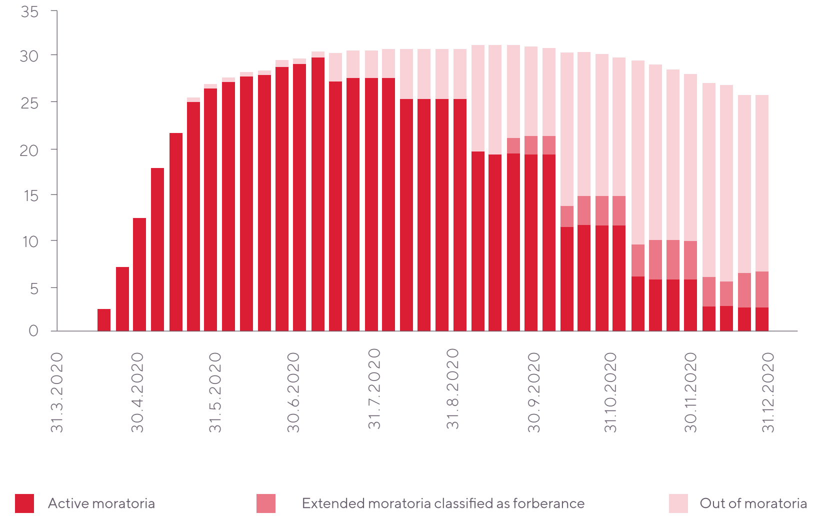


Exhibit 4.23. Development of loans to individuals granted COVID-19 moratorium. (Gross carrying amount, ISK bn).



4.10.2 Public Guarantee Schemes

In response to the pandemic, the Icelandic Government offered guarantees, full or partial, on new bank loans to companies, whose revenues had fallen by at least 40% as a result of COVID-19. The support loans were available to small and medium sized companies with 100% Treasury guarantee for the first ISK 10m and 85% guarantee up to ISK 40m. The supplemental lending was targeted at larger companies with 70% Treasury guarantee.

The Bank originated ISK 3.7bn of the government guaranteed loans in 2020. The breakdown by industry sector is shown in Exhibit 4.24.

4.10.3 The Tourism Industry Sector

In Iceland, tourism has been the sector hardest hit by the COVID-19 pandemic. While the Bank expects the crisis to be temporary and that tourism will emerge strongly from it, the main uncertainty lies in how long the crisis lasts and how long individual companies can withstand the current situation.

If it becomes evident that existing or expected risk factors have not been appropriately considered in the credit risk rating or modelling process, the Group's impairment process allows for temporary changes to the impairment model to account for these circumstances. The COVID-19 pandemic has caused such unprecedented circumstances, especially for the tourism industry, and therefore such adjustment is warranted.

Exhibit 4.24. Support loans and supplemental lending with Treasury guarantees, by industry sector. (Gross carrying amount, ISK bn).

To account for the uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they have been further classified into four impact groups based on an assessment of how vulnerable they are to various assumptions on when international tourists begin visiting Iceland again. This classification, shown in Exhibit 4.25, is based on the Bank's best assessment and will be updated as needed. The base case assumes around 700 thousand tourists in Iceland in 2021, compared to around 2 million in 2019 and 500 thousand in 2020.

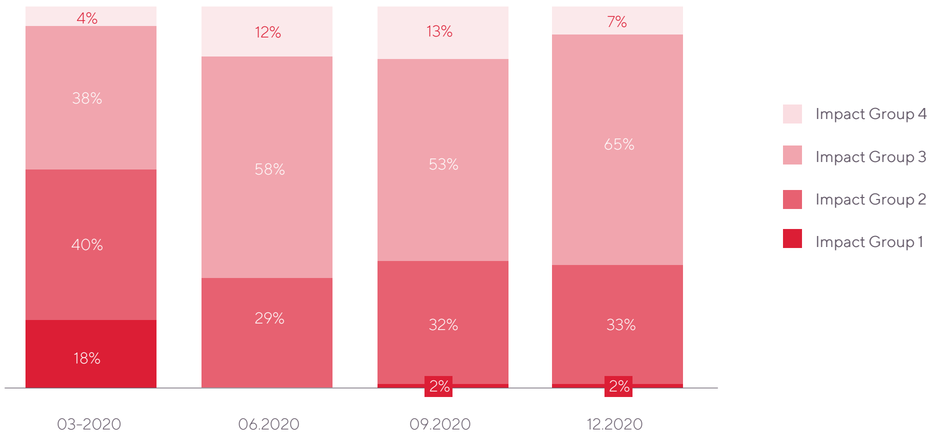
4.11 Exposures in Default and Exposures with Forbearance

The Bank's definition of default is described in detail in Section 4.2.1. Details on exposure amounts in default can be seen in Note 50 of the Consolidated Financial Statements where stage 3 corresponds to amounts in default. Furthermore, Exhibits CR1-A, CR1-B, CR1-C, CQ1, CQ3 and CQ4 disclosures show these amounts broken down by asset class, industry sector, and geographic region.

Exhibits CR2-A and CR2-B of the Additional Pillar 3 Disclosures show the development of impairment amounts and the stock of defaulted loans throughout the year. Forbearance measures can be granted to customers facing temporary challenges or financial difficulties. For a loan to be considered as forborne, two conditions need to apply: (1) the Bank has agreed to make changes to the terms of the loan that would normally not be offered to the customer and (2) the customer was in financial difficulties, making it hard for them to uphold the loan contract at the time the terms were changed. Such forbearance measures include temporary payment holidays, capitalisation of arrears, extension of loan terms, and waiving of covenants. Generally, forbearance measures are less severe than recovery actions for defaulted exposures and they do not lead to economic loss for the Bank. When the restructuring of loans corresponds to an economic loss then the obligor is classified as in default and any subsequent forbearance actions are classified as forbearance on non-performing facilities.

For households, forbearance measures are used to accommodate temporary changes in household income, for instance due to illness

Exhibit 4.25. Exposure to tourism by impact group. The focus in the beginning of the year was on the 2020 tourist season while at year-end the definition shifted towards 2021 as described in the text. Net carrying amount, a proportion of approximately ISK 100bn.



Impact Group 1: Viable even though significantly fewer tourists arrive in 2021

Impact Group 2: Viable with forbearance even though significantly fewer tourists arrive in 2021

Impact Group 3: Viable if the number of tourists in 2021 is similar to the base case

Impact Group 4: Viable if 2021 turns out to be better than the base case

or unemployment. Temporary changes in terms are also granted to companies when needed, for example to meet adverse changes in the operating environment, which affect revenue and cash flows or to meet necessary but unforeseen capital expenditures. The customer is expected to resume normal repayments after the concession period. Furthermore, when covenants are waived due to minor difficulties of customers then it may be classified as a forbearance measure.

Note 52 in the Consolidated Financial Statements provides a summary of the Bank's forborne assets.

4.12 Capital Requirements

The Bank reports its Pillar 1 capital requirements for credit risk according to the standardised approach of the CRD IV. Exhibit CR5 of the Additional Pillar 3 Disclosures shows exposure amounts, risk weights and corresponding risk-exposure amounts for the different portfolios at year-end 2020. Capital add-on for credit risk under Pillar 2-R is estimated in the annual ICAAP process. This add-on includes concentration risk and underestimation of credit risk under Pillar 1. The ICAAP discussion with the regulator in Iceland has matured considerably in recent years, resulting in a stable basis for calculating the add-on for credit risk in Pillar 2-R. This includes an increased risk weight for certain asset classes where the standardised approach may not be representative of the inherent risk. These asset classes comprise municipalities with low payment capacity, loans to holding companies to buy shares in operating companies, high volatility commercial real estate, and customers with forbearance agreements. Furthermore, additional capital is held against loans to customers that are in stage 2 or have been more than 30 days past due in the last 12 months.

5 Market Risk

The domestic stock market yielded a return of 21.9% in 2020 according to the stock market index OMXI10GI, but only after the index had, at its lowest point in 2020, fallen by 23% from the beginning of the year. The return of the domestic bond market was 6.1%, as measured by the NOMXIBB index, with a total turnover increasing by 26% in 2020 compared to 2019. The Central Bank cut its policy rate four times in 2020, lowering the rate from 3.0% to 0.75% during the year. Inflation was above the Central Bank's target in 2020 as the Consumer Price Index rose by 3.6% and the ISK depreciated by 10.4% based on the Central Bank main trade-weighted ISK index.

Market risk accounted for 6.4% of the Group's total SREP capital requirement and was unchanged from the previous year as the Central Bank's Financial Supervision Committee announced that new SREP capital requirements would not be assessed in 2020. The Group's market risk increased in 2020, mainly due to rising interest rate risk, but equity risk decreased.

5.1 Strategy, Organisation and Responsibility

Market risk is defined as the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, inflation, equity prices and foreign exchange rates.

Market risk has been identified as one of the key risk factors in the Bank's operations. The Bank takes on market risk as a part of its business strategy and aims to maintain a moderate market risk profile. The objective of the Bank's market risk management framework is to manage and control market risk exposures and ensure that the market risk profile is within the Board's approved risk appetite.

Market risk at Íslandsbanki is split into two categories, the trading book and the banking book. Market risk due to mismatches in assets and liabilities with respect to currencies, interest reset dates and CPI-indexation falls in the banking book. Market risk in the banking book also includes exposures held for long-term investment purposes, in unlisted securities and holdings in subsidiaries or affiliates. Market risk exposures in the trading book are related to short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. The positions are undertaken mainly as a part of the Bank's flow trading, through the Bank's liquidity portfolio and as hedges against customers' derivatives contracts.

The ultimate responsibility for ensuring an adequate market risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines the market risk governance framework and the acceptable level of market risk through the *Risk Management and Internal Control Policy*, the *Risk Appetite Statement* and the *Market Risk Policy*.

The All Risk Committee (ARC) is responsible for the review and implementation of the *Market Risk Policy* and the market risk appetite. The Asset and Liability Committee

(ALCO) decides on individual proposals for assuming and pricing market risk on behalf of the Bank within the appetite and limits approved by the Board and ARC. The managing director of Corporate & Investment Banking and the managing director of Finance & Treasury (CFO) are responsible for the market risk taken on or owned by their units and for earning an acceptable level of return on these risks. The directors of business units that take on market risk on behalf of the Bank are responsible for identifying and managing the risk in their portfolios within limits approved by the Board, ARC or ALCO.

5.2 Measurement and Monitoring

The Bank uses various tools to measure, monitor and limit market risk exposures. These tools include conventional risk measures, limits on notional and sensitivity measures. The Bank's overall market risk exposure is measured according to the Bank's Market Risk Measurement Framework (MRMF) and the Risk Appetite Statement mandates that the Bank's market risk shall not exceed 15% of the Bank's capital base. The MRMF uses stress tests to calculate potential losses from extreme but plausible market events for each risk exposure, both for the current position of each portfolio, as well as the maximum position within the limits for the given portfolio. Limits are also set to manage the concentration risk towards single issuers or instruments, as well as to manage trading liquidity risk. The Bank is also exposed indirectly to market risk through customers' derivative positions. Those

Exhibit 5.1. Main types of market risk within Íslandsbanki.

Risk type	Description	Origination	Main limit types
Interest rate risk	Current or prospective risk to earnings or capital arising from adverse movements in interest rates. Main sources of interest rate risk are as follows: **Repricing risk:** Arising from differences between the timing of rate changes and the timing of cash flows. **Yield curve risk:** Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve). **Basis risk:** Arising from changing rate relationships among yield curves that affect the Bank's activities. **Optionality risk:** Arising from interest rate related options embedded in the Bank's products.	- Bonds and debt instruments. - Interest rate derivatives. - Loans and deposits.	- BPV (basis point value). - Total long and short positions in underlying securities. - Open delta position of underlying securities. - Duration of underlying securities.
Inflation risk	The risk that earnings or capital may be negatively affected from unexpected changes in inflation.	- Inflation-linked bonds and debt instruments. - Inflation-linked loans and deposits. - Inflation-linked derivatives.	- Size of the inflation imbalance.
Credit spread risk	The risk that earnings or capital may be negatively affected from adverse movements in bond risk premium for an issuer.	- Bonds and debt instruments.	- Issuer-specific notional limits.
Currency risk	The risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or holding assets or liabilities in foreign currencies.	- Spot positions in currencies. - Foreign exchange derivatives. - Foreign-currency-denominated loans and deposits.	- Total currency imbalance. - Total open position per currency. - Total notional in underlying derivatives.
Price risk	The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of debt instruments or equity instruments.	- Equities. - Bonds and debt instruments. - Interest rate and equity derivatives.	- Total position in equities. - Total position in individual securities.
Trading liquidity risk	The risk that the Bank is unable to easily liquidate or offset a particular position without moving market prices due to inadequate market depth or market disruption, thus negatively affecting the earnings or capital.	- Bonds and debt instruments. - Equities. - Derivatives.	- Total position in individual securities. - Total notional of foreign exchange derivatives.

positions are subject to strict margin and monitoring requirements.

The business units, as the first line of defence, are responsible for continuous monitoring of the market risk inherent in their operations, for maintaining their view on these risks and for notifying senior management of any foreseeable breaches of limits, policies or strategic direction. Risk Management, as the second line of defence, monitors the overall market risk profile of the Group, ensures proper escalation of limit breaches and provides an independent view on all market risk taken on by the Group.

Exhibit 5.1 shows the main types of market risk in the Group's operations, the source of the risk and main limit types.

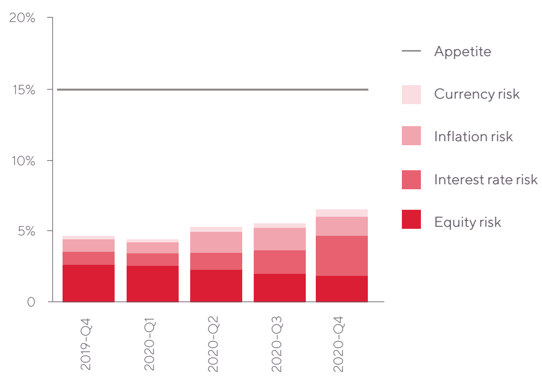
5.3 Market Risk Exposure

Market risk, as measured by the MRMF, increased in 2020. This was mainly due to an increase in the Bank's inflation imbalance in the first half of the year and increased interest rate risk in the second half of the year as the Bank's portfolio of fixed rate mortgages grew. The overall market risk remains moderate and well within the Group's risk appetite, as Exhibit 5.2 shows.

5.3.1 Equity Risk

The Group's equity risk arises from flow trading, market making, shares acquired through restructuring of companies, and strategic investments.

Exhibit 5.2. Market risk exposure and market risk appetite as a percentage of total capital base, average positions.



The equity risk is managed through limits on aggregate market value and maximum exposure or market share in single securities. Equity risk includes bonds with equity-like features but excludes hedges against customers' equity forward positions. The quarter-end figures for the Group's equity risk in 2020 are presented in Exhibit 5.3. Equity exposure in the trading book decreased in 2020 with an average position of ISK 1.3bn compared to ISK 1.7bn in 2019. The maximum equity exposure in the trading book was ISK 2.3bn in 2020 compared to ISK 3.0bn in 2019. Equity exposure in the banking book, including fair value shares and shares held for sale, also declined from ISK 8.7bn at the end of 2019 to ISK 5.8bn at the end of 2020. The Group had no equity underwriting positions at the end of the year but had a ISK 3.0bn underwriting position in September.

Exhibit 5.3. Quarter-end development of equity risk in 2020. (ISK m).

5.3.2 Interest Rate Risk

In 2020, the Central Bank of Iceland cut its key interest rate four times, taking the rate from 3.0% to 0.75% as a response to the COVID-19 pandemic. The Central Bank's Monetary Policy Committee also decided to stop offering one-month term deposits with the aim to increase liquidity in circulation and further strengthen monetary policy transmission. This change caused Íslandsbanki to move a large share of its liquidity portfolio in ISK out of Central Bank deposits to interest rate sensitive bonds. The impact of this change in liquidity management is discussed further in the section on interest rate risk in the trading book below, as well as in Chapters 3 and 4.

To manage interest rate risk, the Bank uses sensitivity measures like basis point value (BPV). The BPV measures the effect of a 0.01

Exhibit 5.4. Quarter-end development of interest rate risk in 2020. Presented as the change in fair value that results from a 100 basis points parallel upward shift in yield curves (100 BPV in ISK m).

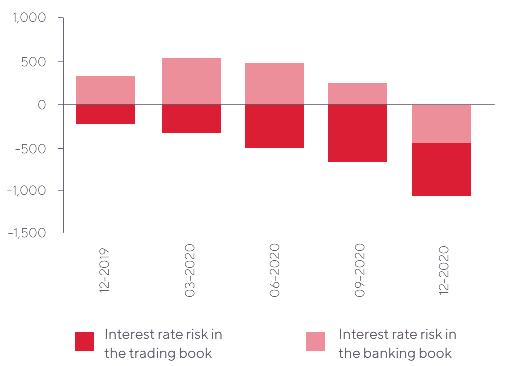
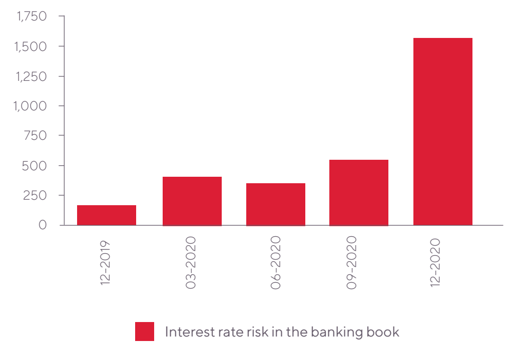


Exhibit 5.5. Quarter-end development of interest rate risk in the banking book in 2020 (weighted adverse 100 BPV in ISK m).



percentage point (1 basis point) parallel upward shift in the yield curve on the fair value of the underlying position. The quarter-end figures for the Group's interest rate risk in 2020 are presented in Exhibit 5.4. The Group's total interest rate risk increased in 2020 as interest rate risk in the trading book increased and interest rate risk in the banking book changed from being net long duration on the liability side to being net long duration on the asset side.

Interest Rate Risk in the Trading Book

The Group's interest rate exposure in the trading book arises mainly from flow trading, market making and liquidity management. All positions in the trading book are subject to BPV or duration limits, both intraday and end-of-day limits. In addition to BPV limits, there are limits on the total short and long positions in underlying bonds. For foreign bonds and bills in the liquidity portfolio there are issuer rating and maturity limits. Interest rate risk in the trading book rose as the Bank moved a larger share of its liquidity portfolio in ISK out of Central Bank deposits to interest rate sensitive bonds. This was mainly triggered by the Central Bank lowering its key interest rate and by the Central Bank's decision to stop offering one-month term deposits. The maximum interest rate risk, measured as the absolute value of the effect of a 100 basis points parallel adverse shift in yield curves, was ISK 759m in 2020 compared to ISK 263m in 2019. An overview of the Bank's interest rate risk in the trading book is provided in Note 60 in the Consolidated Financial Statements.

Interest Rate Risk in the Banking Book

Interest rate risk in the banking book (IRRBB) arises from the Group's core banking activities. It represents the risk of loss from fluctuations in future cash flows or fair value of financial instruments as market rates change over time, reflecting the fact that the Group's assets and liabilities are of different maturities and are priced relative to different interest rates. The Group's main sources of interest rate risk in the banking book are fixed rate mortgage loans, covered bond debts and fixed-term deposits.

Interest rate risk in the banking book is managed by limits on the sensitivity of the fair value of the Bank's assets and liabilities to changes in market rates. All interest-bearing assets and liabilities are bucketed according to their next interest rate reset date, and the effect of a 100 basis points upward parallel shift on the interest rate exposure is measured. The sensitivity calculations are based on the duration of the underlying assets and liabilities. The calculations exclude non-performing loans since the valuation of such loans is based on the expected recovery and is not affected by changes in the underlying interest rates. An overview of the Bank's interest rate risk in the banking book is provided in Note 60 in the Consolidated Financial Statements.

In addition to a parallel shift in yield curves, the Group measures the effect of a so-called weighted adverse shift in yield curves. This entails that different weights are used to shift each yield curve in a direction that results in

Exhibit 5.6. Quarter-end development of the banking book inflation imbalance in 2020 (ISK bn).

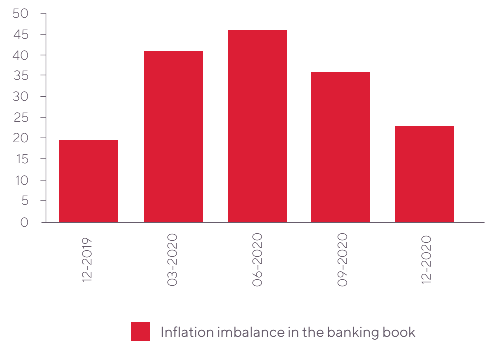
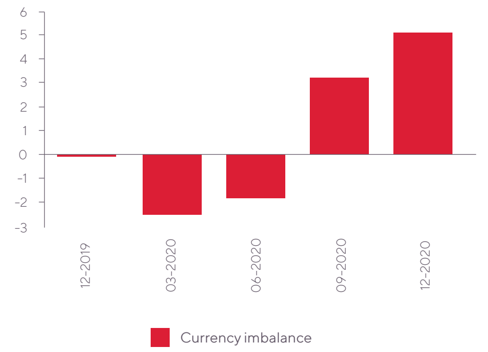


Exhibit 5.7. Quarter-end development of the currency imbalance in 2020 (ISK bn).



a loss for the Group, and the effect per yield curve is then added up to a single amount. The development of the Group's interest rate risk in the banking book in 2020 based on this weighted adverse 100 BPV is shown in Exhibit 5.5. Interest rate risk in the banking book rose in the last quarter of 2020 as the Bank's fixed rate mortgage portfolio grew rapidly.

5.3.3 Inflation Risk

The Group is exposed to inflation risk since assets linked to the CPI exceed liabilities linked to the CPI. The net carrying amount of all CPI-linked assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI affect the Group's profit and loss through interest income. The inflation risk inherent in the trading book positions is captured through the interest rate risk of the positions.

In 2020, the Bank adjusted its policy regarding inflation imbalance so that it now aims to maintain an inflation imbalance that minimises the effect of unanticipated changes in the CPI on the Bank's capital ratio and considers such a position as neutral. The Bank still allows the imbalance to vary around the neutral position, but the adjusted policy means the Bank tends to maintain a positive inflation imbalance rather than keeping the size of CPI-linked assets and liabilities matched. The inflation imbalance in the banking book rose in the first half of 2020 but fell again in the second half of the year, amounting to ISK 21.8bn at the end of the year compared to ISK 19.6bn at year-end 2019. Exhibit 5.6 shows the development of the Group's banking book inflation imbalance in 2020.

5.3.4 Currency Risk

Currency risk arises when financial instruments are not denominated in the Group's reporting currency, especially if there is a mismatch in the currency denomination of assets and liabilities.

Currency risk is managed within regulatory and internal limits, with separate limits for the banking book and the trading book. Exhibit 5.7 shows the development of the Group's currency imbalance in 2020. The size of the currency imbalance was modest throughout the year but increased somewhat in the second half of the year. The overall consolidated currency imbalance was ISK 5.1bn at year-end 2020 compared to ISK -0.1bn at year-end 2019.

5.3.5 Derivatives

The Bank offers various types of derivative products to its customers and uses derivatives to hedge risks on its own balance sheet. The main products offered to customers are interest rate swaps (IRS), cross-currency interest rate swaps (CIRS), foreign exchange swaps (FX swaps), outright forwards (FX forwards) as well as equity and bond forwards. The Bank uses derivatives to hedge imbalances with respect to currency exposure, interest rate risk and inflation risk in the banking book. Other derivatives in the Group are insignificant.

All derivatives positions that carry direct market risk are subject to risk limits. The overall position in interest rate swaps and cross currency interest rate swaps is subject to both BPV and duration limits, while options are subject to several limits, including a limit

on the open delta position in each underlying instrument. Derivatives positions that are fully hedged do not carry direct market risk but are exposed to indirect market risk due to counterparty credit risk. These positions include customers' forward contracts on equities, bonds and foreign exchange. Such positions are subject to notional limits that cap the Bank's indirect exposure to the underlying risk factors. The Bank's counterparty credit risk management is discussed in Section 4.5. For further information on derivative contracts see Note 25 in the Consolidated Financial Statements.

5.4 Capital Requirements

The Bank reports its Pillar 1 capital requirements for market risk according to the standardised approach of the CRD IV. An overview of the Pillar 1 capital requirements for market risk is displayed in the MR1 table in the Additional Pillar 3 Disclosures. Capital add-on for market risk under Pillar 2-R is estimated in the annual ICAAP process and reviewed by the regulator through the supervisory review and evaluation process (SREP). In 2020 the main add-on for market risk under Pillar 2-R was due to underestimation of equity risk and interest rate risk in the trading book under Pillar 1 and due to risk factors not addressed under Pillar 1, namely market risk arising from equities in the banking book, interest rate risk in the banking book and inflation risk.

6 Liquidity Risk

The Bank maintained a strong liquidity position throughout 2020 and all regulatory metrics were well above limits. At year-end 2020 the Bank's Liquidity Coverage Ratio (LCR) was 196% and the Net Stable Funding Ratio (NSFR) was 123%.

The year-end balance of deposits rose by approximately ISK 70bn from 2019 to 2020. The change was mainly due to an increase in retail deposits (ISK 53bn), deposits from corporation (ISK 6bn) and in deposits from domestic and foreign financial institutions (ISK 7bn) during the year. The rise in deposits matched that of loans so that the loan-to-deposit ratio for households and non-financial corporations did not change significantly between years.

The Bank continued to be a leading bond issuer domestically whether in covered or senior unsecured formats. In November 2020, the Bank issued the first Sustainable Bond by an Icelandic bank. The issue, a EUR 300 million benchmark 3-year senior was issued off the Bank´s newly signed Sustainable Financing Framework to an enthusiastic reception from investors. An ISK green bond soon followed marking the Bank´s decisive step into green and sustainable funding. In April 2020 S&P downgraded the credit ratings of all three of Iceland´s major banks from BBB+ to BBB with a stable outlook.

6.1 Strategy, Organisation and Responsibility

The Bank defines liquidity risk as the risk of not being able to meet its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

Sound and efficient management of liquidity risk is a key factor to ensure the viability of the Bank's operations and to achieve and maintain a target credit rating. The Bank takes a conservative and prudent approach to managing liquidity risk and its liquidity strategy assumes that the Bank always fulfils regulatory requirements, internal thresholds and can sustain a prolonged period of stress. Following are the key principles on which the Bank's liquidity risk management framework is based:

- Clear responsibilities and ownership of liquidity risk and liquidity risk control.
- The definition, categorisation and management of liquid assets shall be clear.
- The Bank maintains a portfolio of liquid assets to be able to service its liabilities even if access to funding markets is impaired.
- The Bank has in place a Liquidity and Capital Contingency Plan which shall be tested regularly.

The Bank's liquidity risk appetite is reflected in the liquidity risk framework and guided through the liquidity limit structure.

The ultimate responsibility for ensuring an adequate liquidity risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines the liquidity risk governance framework and the acceptable level of liquidity risk through the *Risk Management and Internal Control Policy*, the *Risk Appetite Statement* and the *Liquidity Risk Policy*.

The All Risk Committee (ARC) is responsible for the review and implementation of the *Liquidity Risk Policy, Liquidity and Capital Contingency Plan* and the liquidity risk appetite. The Asset and Liability Committee (ALCO) decides on individual proposals for internal and external pricing, subject to the policies and models approved by the Board and ARC. ALCO also reviews and approves investment policies for managing the Bank's liquid assets, reviews and approves the contingency stage assessment as part of the Bank's *Liquidity and Capital Contingency Plan* and reviews information about the liquidity position of the Bank with respect to targets and limits.

The Chief Financial Officer (CFO), as the managing director for Treasury, is responsible for ensuring the necessary resources and training of employees for understanding, identifying, measuring or assessing, monitoring, mitigating and reporting on funding and liquidity risk. Treasury is responsible for the liquidity management of the Bank, in line with the internal and regulatory limits and policies, and the associated risks. Treasury is also responsible for the Bank's funding operations and the internal pricing framework.

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

6.2 Measurement and Monitoring

Key measures for the assessment of liquidity risk are the LCR and NSFR ratios introduced by the Basel Committee on Banking Supervision in 2010 and incorporated into European law through the CRD IV.

The Central Bank of Iceland, which is the supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the *Rules on Liquidity Ratio* and the *Rules on Funding Ratio in Foreign Currencies*.[3] At the end of 2019, the CB announced amendments to the Rules on Liquidity Coverage Requirement that implement a 50% minimum liquidity coverage ratio in Icelandic króna. The requirement is introduced in stages, beginning at 30% through 2020 and 2021, increasing to 40% in 2022 and finally reaching the full 50% at the beginning of 2023. The new minimum requirements do not pose any challenge for the Bank as the ISK LCR has been well above 50% throughout 2020.

Act no. 70/2020 on the resolution of credit institutions and investment firms amended the amount guaranteed in the deposit guarantee scheme. Payments to each depositor are now guaranteed up to the equivalent of EUR 100.000 in ISK. This regulatory change increases the amount of stable deposits reported for LCR and NSFR.

The minimum standard for the NSFR has been implemented in foreign currencies and the CB has issued a plan regarding implementing the standard in Iceland for all currencies that will take effect in 2021. In addition, the CB receives additional liquidity monitoring metrics (AMM)[4] to obtain a comprehensive view of the Bank's liquidity risk profile. The AMM cover a wide array of monitoring metrics, including a maturity ladder, funding concentration, concentration of counterbalancing capacity and rollover of funding.

According to the CB's rules on liquidity ratios, the Bank submits monthly reports on the LCR and NSFR ratios along with AMM reports to the CB. As the COVID-19 pandemic started in spring 2020, the CB increased the reporting frequency to weekly in order to better monitor the liquidity status. In addition to these regulatory measures, the Bank monitors several quantitative and qualitative liquidity measures, both static and forward-looking, to assess and quantify its liquidity position and thereby its liquidity risk. These include predefined triggers for the assessment of liquidity stage and forecasts of the development of the LCR. The assumptions for the internal liquidity measures are reviewed regularly.

Treasury, as a first line of defence, is responsible for continuous monitoring of the liquidity risk inherent in the Bank's operations and for notifying senior management of any foreseeable breaches from either internal thresholds, regulatory limits or strategic direction. Risk Management, as the second line of defence, is responsible for providing

[1] FME Guidelines no. 2/2010 for Sound Liquidity Risk Management and Supervision
[2] Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision
[3] Central Bank Rules no. 266/2017 and no. 1032/2014
[4] EBA draft implementing standards on additional liquidity monitoring metrics

an independent view on liquidity risk on a consolidated basis to internal and external stakeholders and for managing the annual Internal Liquidity Adequacy Assessment Process (ILAAP). The Bank's ILAAP report is approved by the Board of Directors and submitted to the Central Bank which then reviews the report in its Supervisory and Review Process (SREP).

6.3 Liquidity Position

The Bank maintained a strong liquidity position throughout 2020 and all regulatory and internal metrics were above limits. The Bank continues to steer its liquidity ratios with the aim of reducing liquidity cost further while keeping the ratios comfortably above minimum requirements.

Exhibits 6.1–6.4 show the development of the LCR and NSFR ratios for Íslandsbanki in 2020 as compared to the regulatory minimum where applicable. The following chapters provide further details on the composition of the LCR and NSFR.

6.3.1 Liquidity Coverage Ratio

The LCR is defined as the proportion of *High-Quality Liquid Assets* (HQLA) to net cash outflow over the next 30 calendar day period. The formula for the LCR is

$$LCR = \frac{\textit{Stock of HQLA}}{\textit{Cash outflow - min (Cash inflow, 75\% Cash outflow)}}$$

Exhibit 6.1. LCR for all currencies.

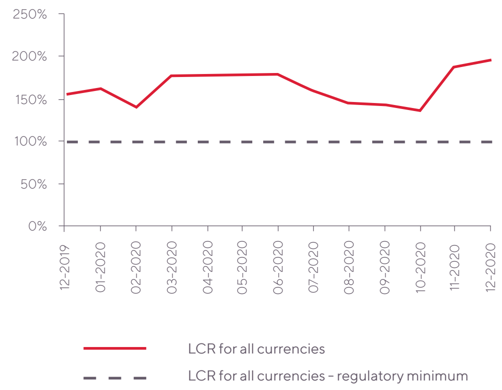


Exhibit 6.2. LCR in ISK.

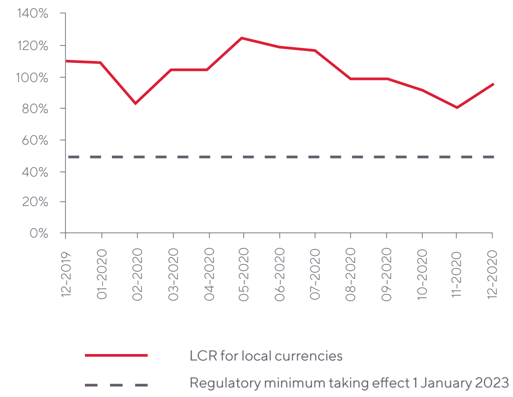


Exhibit 6.3. LCR in foreign currency.

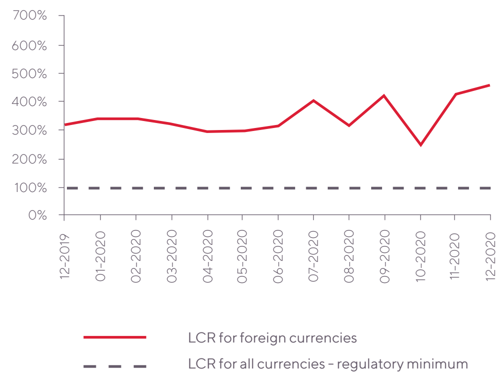
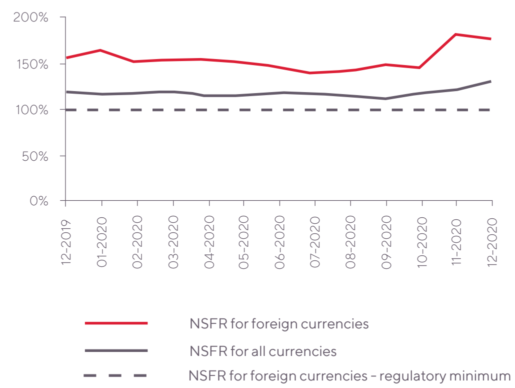


Exhibit 6.4. NSFR for all currencies and NSFR in foreign currency.



HQLA are defined as assets that can be easily and immediately converted into cash at little or no loss of value. These include cash, CB deposits, government bonds and corporate debt securities. The main outflow factors include on-demand deposits, committed credit and liquidity facilities, contractual lending obligations within a 30-day period, derivative cash outflow and other contractual cash outflows. This is offset by contractual cash inflows from outstanding exposures that are fully performing and derivative cash inflows.

To prevent banks from relying too much on anticipated inflows to meet their liquidity requirements, the amount of inflows that can offset outflows is capped at 75% of total expected cash outflows. Banks are therefore required to maintain a minimum stock of HQLA equal to 25% of the total cash outflows.

The EU LIQ1 in the Additional Pillar 3 Disclosure shows the breakdown of the Group's positions underlying the LCR at year-end 2020. According to the LCR disclosure standards, the figures show the average of end-of-month positions throughout 2020 as opposed to the year-end figures in Note 57 in the Consolidated Financial Statements.

6.4 Funding

The Bank continues to be predominantly funded by deposits although borrowings through bond issuance amount to 38% of the total funding. The Bank has been gradually increasing its borrowing in recent years with the issuance of covered bonds and unsecured bonds in foreign and local currencies, as well as subordinated debt. Note 36 in the Consolidated Financial Statements gives an overview of the terms of outstanding bonds issued by the Bank at year-end.

6.4.1 Net Stable Funding Ratio

A key metric for assessing the long-term viability of the Bank's funding structure is the NSFR. The ratio measures the proportion of stable funding to long-term assets for a time horizon of over one year. In particular, the NSFR is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities and thus to limit over-reliance on short-term wholesale funding.

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

The amount of *Available Stable Funding* (ASF) is measured based on the assumed relative stability of an institution's funding sources reflected in the corresponding ASF factor. The available amount of stable funding is composed mostly of retail deposits, wholesale deposits with remaining maturity of greater than one year, borrowings with a residual maturity over one year and equity.

The amount of *Required Stable Funding* (RSF) is measured based on the liquidity risk profile of an institution's assets and off-balance sheet exposures. The required amount of stable funding is mainly in the form of encumbered and unencumbered assets with maturity of more than one year and other on- and off-balance sheet exposures. All categories are weighted by the appropriate RSF factor.

The EU LIQ2 in the Additional Pillar 3 Disclosure shows the breakdown of the Group's positions underlying the NSFR at year-end 2020 while the development in 2020 can be seen in Exhibit 6.4.

6.4.2 Deposits

The Loan-to-deposit ratio for households and non-financial corporations was 183% at year-end 2020 which is very similar to the 186% ratio at year-end 2019. The ratio is expected to remain in this range and deposits to continue to be the largest source of funding for the Bank in the years ahead.

The deposit balance rose by approximately ISK 70bn over the course of the year 2020 as shown in Exhibit 6.5. The change was mainly due to an increase in retail deposits (ISK 53bn), deposits from corporation (ISK 6bn) and an increase in deposits from domestic and foreign financial institutions (ISK 7bn) during the year.

The proportion of term deposits fell from 28% of total deposits at year-end 2019 to 25% at year-end 2020. This was mainly due to an increase in total deposits while term deposits remained stable. For a more detailed composition of deposits by LCR categories and term see Note 57 in the Consolidated Financial Statements.

Deposit concentration is monitored since a substantial amount of the Bank's deposits are held by relatively few counterparties. The Bank's highest deposit concentrations are in wholesale deposits from foreign and domestic financial institutions and pension funds. As shown in Exhibit 6.6, deposit concentration has

Exhibit 6.5. Deposits by liquidity coverage ratio category in 2020 (ISK bn) and the Loan-to-deposit ratio for households and nonfinancial corporations.

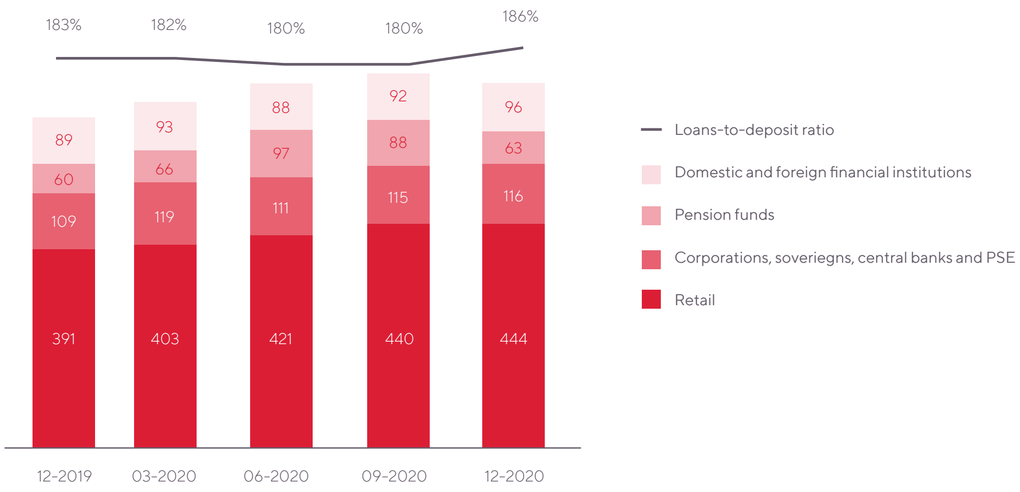
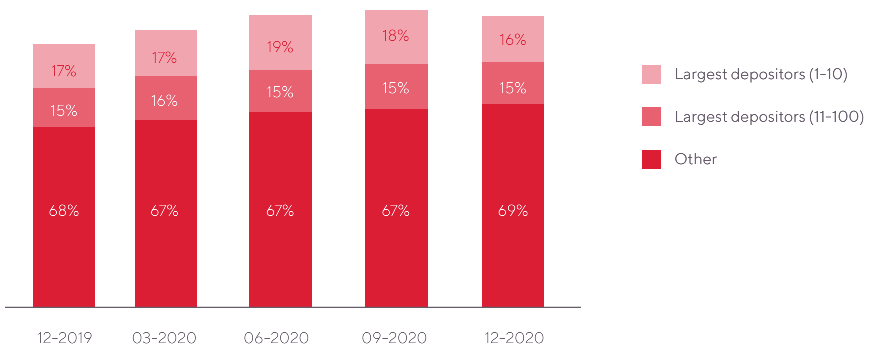


Exhibit 6.6. Development of the deposit concentration throughout 2020.



remained stable in the past year with 16-19% of the Bank's deposits belonging to the 10 largest depositors and 31- 34% belonging to the 100 largest depositors.

6.4.3 Capital Markets Activity

Íslandsbanki is one of the largest issuers of covered bonds in the domestic market. Domestically, the Bank is also an issuer of unsecured senior bonds. The Bank's USD 2,500m Global Medium-Term Note (GMTN) Programme is the Bank's platform for funding in international markets.

Íslandsbanki has an ISK 220bn covered bond programme in place, issued under Act 11/2008 on Covered Bonds. Issuance is regulated by the Central Bank which additionally appoints an independent inspector to monitor the issues. Íslandsbanki sold ISK 25bn of covered bonds in 2020, compared to ISK 29bn in 2019. This activity was in line with the domestic issuance plan for 2020 which assumed new covered bond volumes of ISK 20-25bn. Liquidity has remained strong in the Bank's covered bonds and yields fell during the year. The total outstanding nominal of covered bonds at year-end 2020 was ISK 167bn, thereof ISK 124bn CPI-linked.

In December the Bank issued the first green bond in ISK with an issue of ISK 2.7bn 3.5% five-year fixed rate bond. The transaction was well received by the local investor community and marked an important milestone in the build-up of the domestic capital markets.

During 2020 the COVID-19 pandemic made itself felt in most financial markets and Iceland was not immune from its influence. In funding terms, one consequence was that in April the international credit rating agency Standard & Poor's downgraded the main Icelandic banks by one notch to BBB/A-2 (stable outlook) from BBB+/A-2 (negative outlook.), while acknowledging the strength of the Icelandic banks' strong capitalisation levels. S&P's rationale for the change is mostly derived from its view that economic activity will reduce in Iceland and Europe in 2020 as a result of the pandemic and thus could impair Íslandsbanki's asset quality, increase credit losses, reduce business and revenue generation, and potentially erode its capital. S&P's view is that Iceland's operating environment will remain challenging, affected by the 2020 economic recession, declining interest rates, stiff competition from pension funds in mortgage lending and thus contributing to the declining profitability of Icelandic banks. Information on the credit rating history for Íslandsbanki is available on the Bank´s investor relations webpage.

The effect of the downgrade was difficult to quantify as secondary credit spreads had already universally increased in response to widespread risk aversion. The secondary spread on the Bank's €300 million 2024 benchmark bond had risen from mid-swaps +120 in February to reach a peak nearer +350 basis points in May. This same bond then closed the year back down at mid-swaps + 110 basis points. The whole Icelandic bank "complex" of EUR-denominated bonds followed much the same trajectory over the course of 2020, following a tendency for the cash market to overshoot at times of risk aversion.

In November, the Bank signed Iceland's first Sustainable Financing Framework. A product of the Bank's strategy to create with customers and investors a more sustainable business environment and society, it allows for the proceeds of a "Sustainability Instrument" - whether it be a bond or a loan - to be used for eligible assets which support the transition towards sustainability in accordance with the Icelandic Climate Action Plan and the UN's Sustainable Development Goals.

On 12 November, the Bank issued a €300 million 0.50% sustainable senior unsecured bond with a maturity of 3 years. This inaugural sustainable issue was placed at spread of mid-swaps +100 basis points with over 80 investors from an order book that was more than three times over-subscribed. It was particularly noteworthy that the composition of the investors was distinctly different from preceding "brown" issues. In this instance a much larger proportion of investors were drawn from Spain and Portugal, Germany/Austria/Switzerland and Benelux countries than previously. The issue was managed by ABN AMRO, Barclays Bank, Goldman Sachs and UBS.

Exhibit 6.7 provides a summary of how the maturity of outstanding bond issues is distributed over the coming years and Note 36 in the Consolidated Financial Statements gives an overview of the terms of outstanding bonds issued by the Bank at year-end.

6.4.4 Asset Encumbrance

The asset encumbrance ratio is critical when monitoring the consequences of changes in funding sources and the ability to withstand funding stress. The Bank's asset encumbrance predominately consists of:

- Loans and securities serving as collateral for covered bond issuance which is one of the Bank's strategic long-term funding sources
- Cash and securities as collateral for currency swap agreements
- Central Bank (CB) term deposits for the payment system

Íslandsbanki asset encumbrance ratio was 18.7% at year-end 2020 and Exhibit 6.8 shows the development of the reported encumbrance in 2020.

6.4.5 Funding Outlook

The Bank estimates that total issuance of covered bonds will be between ISK 30-35bn in 2021. In addition, the Bank plans to continue its issuance of senior bonds in ISK in a continued effort of developing and promoting the domestic bond market. The timing and size of such issues will depend on the Bank´s funding need and market conditions. Issuance under

Exhibit 6.7. Maturity profile of long-term funding (ISK bn) as of year-end 2020.

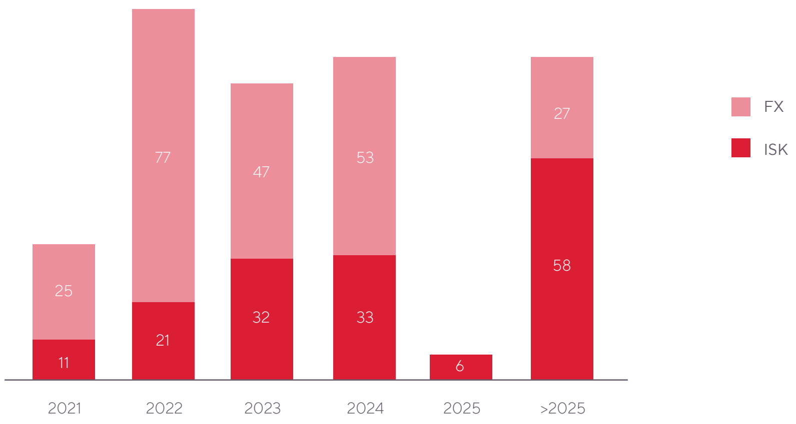
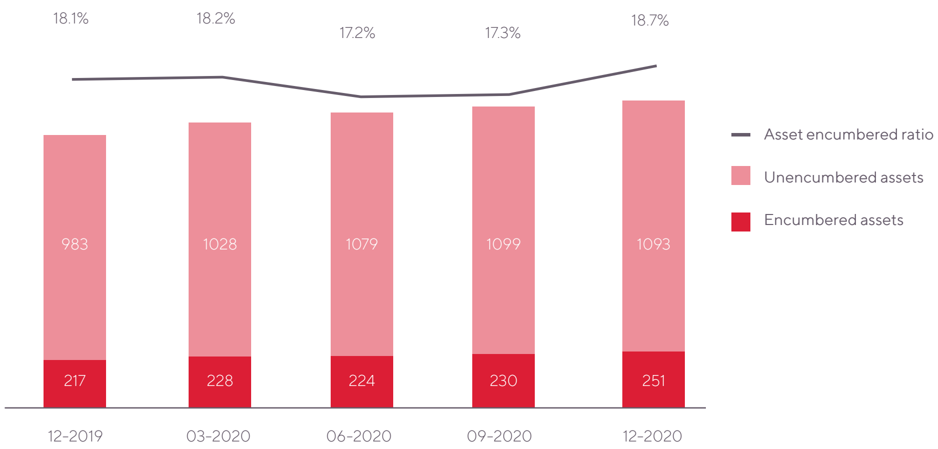


Exhibit 6.8. Development of asset encumbrance in 2020 (ISK bn).



the Banks GMTN Programme will depend largely on the Bank´s loan growth in foreign currencies as well as on upcoming maturities. The Bank is contemplating issuing Additional Tier 1 capital instruments in foreign or local currency, whereas the Bank´s Tier 2 bucket is currently full.

Due to the Bank's strong liquidity position, both in ISK and foreign currencies, the Bank may explore buybacks or refinancing of outstanding transactions in 2021 in a continuing effort to maintain a strong balance sheet position while efficiently applying surplus liquidity.

7 Operational Risk

The Bank has demonstrated operational resilience throughout the COVID-19 pandemic. Preparations that started at the early signs of the outbreak, with testing and updating of contingency plans and remote working procedures, supported a swift and efficient response when the first cases were detected in Iceland and into the government measures that followed. A special task force has been operating focusing on the safety and wellbeing of all employees and customers. During this period the risk of cyber security events has increased. The Bank's controls against such events have proven effective. Financial loss that can be directly or indirectly linked to COVID-19 related operational events was insignificant for the Bank in 2020.

7.1 Strategy, Organisation and Responsibility

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or external events. The Bank's definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at Íslandsbanki lies with the Board of Directors.

The operational risk management framework is based on the following principles:

- Clear responsibilities and ownership of operational risk and operational risk controls.
- The Bank accepts no unnecessary operational risk, meaning that it only assumes operational risk when the cost of mitigating that risk and preventing possible losses outweighs the benefits.
- With the aim of ensuring business continuity and minimising customer impact the Bank shall have adequate processes, procedures and resources to ensure quick discovery, analysis and termination of IT incidents; define and meet service-level objectives for digital solutions, in line with the Bank's vision to be #1 in service; and protect information and data from loss of confidentiality.
- The Bank promotes a strong risk culture, emphasising compliance to internal and external laws and regulations.
- The Bank has no appetite for compliance risk that can lead to financial loss or loss of reputation.
- A key feature of a strong risk culture is to foster a "no blame" environment where operational risk events are recognised and registered to enable continuous improvement to the Bank's operations.
- The Bank takes appropriate measures, in all its operations, to ensure the safety and health of its customers and employees.

The All Risk Committee (ARC) is responsible for the review and implementation of the operational risk framework. The Operations and Security Committee (OSC) decides on individual proposals for assuming and mitigating operational risk on behalf of the Bank within the appetite and limits approved by the Board and ARC. The OSC also reviews and approves proposals for new products, services, new outsourcing or other high-risk changes of systems or procedures within the Bank.

The managing directors for individual business and support units are responsible for the operational risk inherent in their business. This entails identifying the sources of operational risk in their operations, assessing whether the cost of avoiding the risk outweighs the benefits and ensuring that unacceptable operational risks are mitigated, and losses prevented.

Risk Management is responsible for implementing the Bank's operational risk framework, for developing and maintaining the *Operational Risk Policy* and for communicating the policy to the Bank's employees. Key risk factors related to operational risk are addressed in other policies such as the *Security Policy, Outsourcing Policy* and *New Products and Material Changes Policy*. These policies outline the risk management and internal controls specific to these risk categories.

Risk Management monitors the overall operational risk profile of the Bank, ensures proper escalation and reporting of operational risk issues and provides an independent view on the overall operational risk inherent in the Bank's operations. Furthermore, Risk Management is responsible for reporting on operational risk events and limit breaches to senior management, the Board of Directors and to the competent authorities in accordance with internal procedures and regulatory requirements.

In 2020 the responsibility for the Bank's compliance risk framework was transferred from the Compliance function to Risk Management. The Compliance function continues to be responsible for monitoring compliance risk regarding anti money laundering laws[1] and regulations, and the Bank's compliance with its obligations as stated in the Act on Securities Transactions[2].

7.2 Measurement and Monitoring

The Bank has implemented an operational risk management framework which fulfils the criteria for the standardised approach according to the Capital Requirements Directive (CRD IV). For capital requirement calculations, the Bank currently uses the Basic Indicator Approach as further described in Section 7.5.

The main processes for measuring and managing operational risk are the Business Continuity Framework including the *Crisis Management Plan*, the Risk and Control Self-Assessment, development and monitoring of Key Risk Indicators and the follow up and reporting of all significant operational risk events in the Bank's Loss Event Database (LED).

Aggregated registered operational risk losses in any given quarter shall not exceed a given percentage the of Bank's capital, as defined in the *Risk Appetite Statement*. The *Operational Risk Policy* describes the reporting limits on operational risk losses in any given quarter to the Board of Directors.

A part of the monitoring framework are regular assessments and monitoring of compliance with risk policies and underlying procedures. Model validation is also an important part of this framework to identify and mitigate model risk.

A significant increase in cyber security and fraudulent events has been observed worldwide in 2020. The Bank has placed special focus on reviewing and strengthening its controls in that area and on offering extensive training to employees and customers on how to respond to fraudulent incidents to minimise possible losses.

7.3 Management

The Bank maintains an operational risk insurance covering loss events where insurance is deemed to be a cost-effective mitigation of operational risk. The insurance coverage limits financial loss caused by serious unexpected events or legal liabilities that occur despite other operational risk management procedures. The Bank's insurance also offers coverage for wrongful act claims brought solely against directors and officers of the Bank.

7.4 Operational Risk Exposure

In 2020, there was a 25% decrease in the number of registered risk events in the Bank's

[1] Act no. 140/2018 on Measures against Money Laundering and Terrorist Financing
[2] Act no. 108/2007 on Securities Transactions

LED compared to the year 2019 and a 70% decrease in registered losses. Most of the recorded operational risk events occurred without financial loss. Further statistics for registered loss events are presented in Exhibit 7.1.

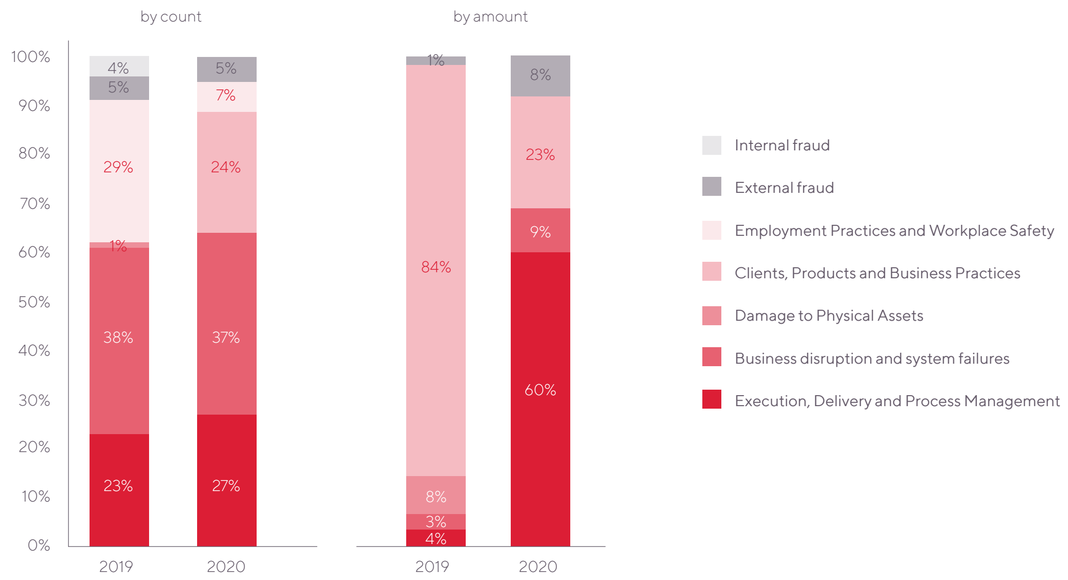
The loss events in the category "Business disruption and system failures" accounted for 37% of the total number of events in 2020. The loss events in the category "Execution, delivery and process management" accounted for 60% of the total loss amount attributed to operational risk in 2020.

7.5 Anti-Money Laundering

In September 2019, the Financial Action Task Force (FATF) reassessed Iceland´s measures to prevent money laundering and terrorist financing. Although several actions had been taken by Icelandic authorities to address previous made observations by FATF, the task force concluded that authorities had not yet ensured full compliance on all recommendations. As a result, FATF placed Iceland on the list of cooperative jurisdictions with strategic deficiencies. In October 2020 Iceland was removed from the list after FATF had found the supplementary measures taken by the government to by satisfactory.

Money laundering risks are identified in accordance with the Icelandic Act on Measures against Money Laundering and Terrorist Financing[3]. Procedures for monitoring money laundering risks include the collection and review of customer information and the monitoring of transactions in accordance with a risk-based approach.

Exhibit 7.1. Categorisation of loss events in 2019 and 2020 by CRD IV event types. The two columns on the left show the number of events of each event type as a percentage of the total number of events for that year, the two columns on the right show the loss amounts for each event type as a percentage of the total loss amount for that year. Parent.



All employees receive regular training and information regarding changes in regulations and new trends and patterns, as well as regarding methods that may be used for money laundering and terrorist financing. The Bank has a process for providing information regarding suspicion of money laundering to the Icelandic Financial Intelligence Unit[4].

7.6 Capital Requirement

The Bank uses the Basic Indicator Approach of CRD IV to calculate the capital requirements for Pillar 1 operational risk, in accordance with Icelandic law and regulations.[5] Under the Basic Indicator Approach the risk exposure amount for operational risk is equal to 15% of the relevant indicator multiplied by 1250%. The relevant indicator is the average over three years of the sum of net interest income and net non-interest income. According to the Supervisory Review and Evaluation Process (SREP) results, Operational risk remains unchanged from the previous year.

[3] Act no. 140/2018 on Measures against Money Laundering and Terrorist Financing
[4] Independent administrative unit within the District Prosecutor's Office
[5] Regulation no. 233/2017 on the Capital Requirement of Financial Undertakings

8 Sustainability Risk

Sustainability risk is the risk of being directly or indirectly negatively affected by externalities within the areas of environmental and climate considerations, anti-corruption, human rights, labour conditions, or business ethics.

Direct exposure includes the Bank's social licence to operate since damage to the Bank's reputation can cause customers or employees to leave the Bank for sustainability reasons. The Bank is indirectly exposed to sustainability risks in connection to its lending and investment activities.

8.1 Introduction

The Bank has defined sustainability risk as a separate risk factor in its risk taxonomy and therefore the Pillar 3 report includes a chapter on the risk factor. This chapter is based on recommendations from the Task Force on Climate-related Financial Disclosures (TCFD) and thus comprises sections on Governance, Strategy, Risk Management, and Metrics and Targets.

8.2 Governance

The Board of Directors has approved the *Sustainability Policy* and sets the Bank's strategy and risk appetite in terms of sustainability risk. The Board is regularly updated on corporate sustainability matters and the usage of the Bank's Sustainable Financing Framework. The *Corporate Governance and Human Resource* subcommittee of the Board assists the Board in fulfilling its oversight responsibilities concerning sustainability.

ESG stands for Environment, Social and Governance

Environment

Social

Governance

Sustainable Financing Framework

The CEO is responsible for executing the strategy and has appointed a Sustainability Committee as a main building block of the governance structure. The Committee is the formal forum for discussions on all issues related to sustainability risk, sustainable procurement, and business opportunities. The Committee is independent from credit committees and needs to approve proposals for credit cases before they are included in the Sustainable Financing Framework. The committee is chaired by the CEO and manned by the CFO, Head of Sustainability, senior representatives from business departments and Risk Management.

8.3 Strategy

Íslandsbanki will focus on integrating sustainability considerations into its activities, in addition to its profit objectives. The Bank intends to initiate broad collaboration and increase awareness on responsible business practices that both contribute to sustainable development in the Icelandic economy, supporting the Icelandic government's Climate Action Plan, and supporting the UN

Sustainable Development Goals. The Bank has specifically selected UN SDGs no. 4, 5, 9, and 13 to guide its sustainability efforts.

At the same time Íslandsbanki seeks to set a positive precedent by taking immediate action, thereby gaining and maintaining customers' trust. As part of this, the Bank has defined seven main sustainability goals to be achieved in the year 2025 and will set and disclose annual targets for each main goal.

The seven main goals in 2025

1. Become carbon neutral in its operations
2. Offer its customers a wide range of sustainability products
3. Balance gender ratios in the Bank's operations
4. Create a working culture that celebrates diversity and inclusion
5. Work with suppliers and partners that champion sustainability
6. Assess and disclose sustainability risks and build a robust sustainability governance framework
7. Support four of the UN SDGs in the areas of education, gender equality, innovation and climate action

In 2020, Íslandsbanki implemented a Code of Ethics for its Suppliers based on criteria on Environment, Social and Governance (ESG). The aim of the Code is that the Bank and its suppliers can work together on implementing ESG considerations into their operations, based on the Bank's Sustainability Policy and UN SDGs. By implementing the Code, the Bank ensures that purchases of goods and services are efficient, non-discriminating, and transparent.

8.3.1 Sustainable Financing Framework

Íslandsbanki was the first Icelandic bank to publish a sustainable financing framework in late 2020. This Sustainable Financing Framework follows ICMA's Green Bond Principles from 2018, Social Bond Principles from 2020, and the Sustainability Bond Guidelines from 2018. It is based on best practices in Europe and benchmarked with similar frameworks from financial institutions that have been leading the way in sustainability and sustainable finance activities.
Under this Framework, Íslandsbanki will use funding options from public and private, listed and non-listed instruments, referred to as "Sustainability Instruments". These Sustainability Instruments may be issued under the terms Green, Blue, Social, and/or Sustainability Instruments.

An amount equal to the net proceeds of the Sustainability Instruments will be used for Eligible Assets which support the transition towards sustainability. These Eligible Assets must comply with at least one of the Project Categories, classified as either Green: for the environment; Blue: for sustainable fisheries; and Social: for supporting social initiatives.

Following the publication of the Framework, the Bank issued the first sustainable and green bonds in international and domestic markets.

Íslandsbanki is part of the following networks:

Both issues were received favourably by investors and demonstrate the rising interest in the asset class.

8.3.2 Sustainability Policy

As part of the *Sustainability Policy*, credit granting at the Bank is always carried out in compliance with the relevant regulatory instruments, including consumer protection provisions and anti-money laundering and anti-corruption rules and the policy reiterates that this applies to the credit process and the credit risk culture as a whole at the Bank. The Policy further states that loans shall always be processed without reference to nationality, gender, race, religious beliefs, or other comparable factors. In addition, the Policy states that the Bank shall consider sustainability and ESG criteria, as well as other risk factors, when taking credit decisions and pricing risk. Through its lending activity, the Bank is committed to supporting companies and households in their efforts to adopt more sustainable practices.

The principles in the Sustainability Policy aim to align the Bank and its business model with society's goals as expressed in the *United Nations Sustainable Development Goals* (SDGs) and the *Paris Climate Agreement*.

8.4 Risk Management

The Bank continues to improve further and develop how sustainability risk is identified, assessed, and managed within the Bank. Sustainability risk is a part of the Bank's Risk Taxonomy and entails both physical and transitional climate risk, as well as social and governance risk.

Climate-related risks consist of two major categories that are often called transition risks and physical risks. Transition risks include policy, legal, technology, reputational, and market changes due to adoption of new requirements related to climate change and a transition to a low carbon economy. Physical risks are related to physical impacts of climate change such as extreme weather and long-term shift in sea temperature and acidity.

Transition risks can disrupt the business models of the Bank's customers due to changes in demand for products and services. The expectation of impending changes in demand will also need to drive business decisions and in sectors where this does not happen organically, tax incentives, and disincentives are likely to play a role. For example, during the transition towards cleaner energy in the transport sector, tax incentives are expected to be given for cars which use cleaner energy whereas carbon tax may be significantly increased.

The Bank's customers are exposed to physical risk related to climate change, for instance in the seafood industry where the availability of fish and shellfish might diminish due to temperature and acidity changes in the ocean around Iceland. Physical risks can have direct financial impact through damaged assets and supply chain disruptions. As awareness of the potential impact increases, exposed assets are liable to a fall in value and higher insurance premiums.

Supervisors have been directing attention to climate risk globally and its effect on financial stability and in some place's country-wide climate risk stress tests are planned. Íslandsbanki has started to perform exploratory climate stress tests scenarios against its portfolio. The aim of the analysis is to identify which sectors of the Bank´s portfolio may have high adverse impacts on the environment and in which we have a significant number of customers. The sectors are then further analysed in comparison to the Climate Action Plan of the Government of Iceland. The Bank will continue to enhance further the climate stress testing methodologies in the year 2021.

The Risk Appetite Statement now includes a qualitative statement on sustainability risk which is in line with the Bank's Sustainability Principles as stated in the Sustainability Policy. All new business or evaluating proposals in relation to existing business relationships shall aim for full alignment with the Sustainability Principles.

The Bank conducts regular training sessions for employees on climate risk to further enhance their abilities to engage with customers and to identify opportunities and threats related to climate related matters. Approximately 20 percent of the Bank's employees have received training on climate risk. The Bank intends to broaden the scope of the training to include social and governance matters as well.

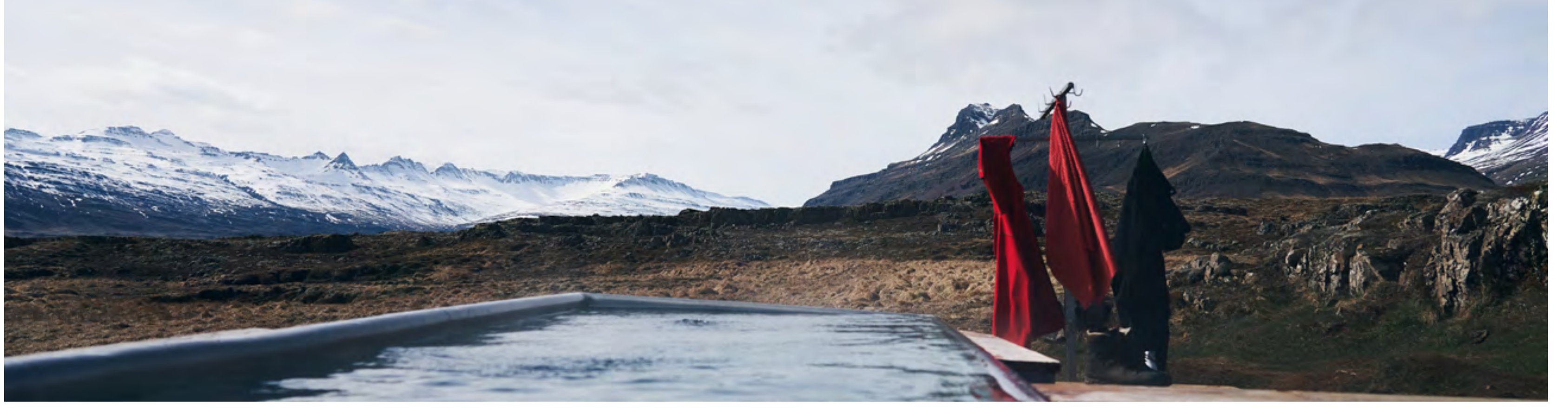
Sustainalytics, a leading international company in the field of sustainability, is of the opinion that the Bank is well positioned to manage and mitigate ESG risk through the Sustainable Financing Framework by complying with policies, standards, and assessment on ESG related issues

8.5 Metrics and Targets

The Bank has measured its emission of greenhouse gases, both direct and indirect, and has done so from the year 2017. In 2019 the Bank reported, for the first-time, detailed information about the environmental, social, and governance impact of its operation in accordance with the Nasdaq ESG Guidelines and relevant GRI standards. The Bank's disclosure on metrics and targets related to climate risk is in the Annual and Sustainability Report.

8.6 Next steps

The Bank intends to further enhance its capabilities to identify, manage, and mitigate ESG related issues. In 2021, steps will be taken to measure financed emissions using the new standard from PCAF and continue the ESG assessment of the Bank's customers. Based on a more detailed climate risk identification, metrics will be defined, and targets set.



9 Remuneration

The Bank's Compensation Policy states that the Board of Directors shall not make or authorise agreements for variable compensation without the shareholders' consent and on terms agreed by shareholders at a shareholders' meeting.

9.1 Regulatory Framework

The Central Bank of Iceland publishes rules regarding remuneration in financial undertakings. The rules reflect a conservative framework for remuneration schemes within the financial sector. According to the rules, a bank intending to pay variable remuneration to one or more employees is required to have in place a compensation policy approved by its board of directors. The compensation policy shall be reviewed at least annually, and the bank shall account for the policy to the Central Bank.

9.2 Compensation Policy

The Bank's Compensation Policy states that the Board of Directors shall not prepare or authorise any contracts for variable remuneration. An exception can be made if a prior approval has been obtained from the shareholders, and the terms are in accordance with the terms agreed upon at shareholders' meeting.

Compensation Policy

9.3 Remuneration in 2020

Exhibit 8.1 shows a breakdown of remuneration for the Board of Directors and the Executive Board in 2020. The only variable remuneration in 2020 relates to agreements that were made before the current Compensation Policy came into effect. For further information on the previous remuneration scheme please refer to the 2016 Pillar 3 Report. No deferred remuneration is outstanding from previous remuneration scheme.

The salaries and other benefits of the Bank's management and the Board of Directors are disclosed in Note 13 in the Consolidated Financial Statements. Please note that the amounts displayed in Exhibit 9.1 are not fully comparable to the figures in the Annual Report as the basis for preparation differs.

Exhibit 9.1. Total remuneration for the Board of Directors and the Executive Board broken down by fixed and performance-based remuneration (ISK m).

Total remuneration earned in the financial year 2020 broken down by fixed and performance-based remuneration	Board of Directors	Executive Board
Total annual remuneration	67	344
Number of beneficiaries	11	7
Total fixed remuneration	67	327
Total variable remuneration	-	17
Cash	-	17
Other	-	0
Variable remuneration % of fixed	-	5.2%

10 Abbreviations

AGM	Annual General Meeting
ALCO	Asset and Liability Committee
AML	Anti-Money Laundering
AMM	Additional Monitory Metrics
ARC	All Risk Committee
ASF	Available Stable Funding
AT1	Additional Tier 1
BPV	Basis Point Value
CAE	Chief Audit Executive
CB	Central Bank of Iceland
CCF	Credit Conversion Factor
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CFO	Chief Financial Officer
CIRS	Cross-Currency Interest Rate Swaps
CIU	Collective Investment Undertakings
CLTV	Cumulative Loan to Value
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CRO	Chief Risk Officer
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
ECL	Expected credit loss
EL	Expected loss
ESG	Environmental, social and governance
EU	European Union
FME	The Icelandic Financial Supervisory Authority of the Central Bank of Iceland
FS	Financial Statements
FX	Foreign Currency
GMTN	Global Medium-Term Note
HQLA	High Quality Liquid Assets
IAS	International Accounting Standard
IC	Investment Committee
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRRBB	Interest Rate Risk in the Banking Book
IRS	Interest Rate Swaps
ISDA	International Swaps and Derivatives Association
ISK	Icelandic Króna
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LCCP	Liquidity and Capital Contingency Plan
LED	Loss Event Database
LGD	Loss Given Default
LTV	Loan-to-Value
MRMF	Market Risk Measurement Framework
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NSFR	Net Stable Funding Ratio
ODF	Observed Default Frequency
OSC	Operations and Security Committee
O-SII	Other Systemically-Important Institutions
PCAF	Partnership for Carbon Accounting Financials
PD	Probability of Default
RCSA	Risk and Control Self-Assessment
RSF	Required Stable Funding
REA	Risk Exposure Amount
SCC	Senior Credit Committee
SICR	Significant Increase in Credit Risk
SME	Small and Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
TCFD	Task Force on Climate-related Financial Disclosures
TSCR	Total SREP Capital Requirement