2021

Pillar 3 Report

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Declaration and Risk Statement

Declaration

The Bank is exposed to various risks and the management of these risks is an integral part of the Bank's operations. The Bank has focused on building up a responsible internal risk culture among the Bank's employees although the ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's Risk Appetite Statement and risk management policies that are reviewed at least annually, and the CEO is responsible for ensuring that risks are managed within those limits.

The Board hereby declares that the Bank´s risk management arrangements are satisfactory in relation to the Bank´s profile and strategy.

Risk Statement

Íslandsbanki's purpose is to move Iceland forward by empowering customers to succeed and the Bank´s vision is to be #1 for service. Íslandsbanki is a universal bank, offering a full range of banking service to personal and corporate customers in Iceland. Outside Iceland, the Bank´s operations are limited to the extension of credit to a small number of corporate clients in the seafood industry. This means that the Bank´s core business is taking on risk through the extension of credit and the rendering of other financial services to its customers.

Risk assessment and the prudent evaluation and pricing of risk are key elements in Íslandsbanki's operations and value creation, and the business strategy is aligned with the risk appetite as set by the Board. The Board of Directors reviews the risk appetite and the risk management framework at least once a year. The risk management and internal control framework is based on the three lines of defence model and aims for informed decision-making and strong risk awareness throughout the Bank. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial disclosures, as well as compliance with law, regulations, supervisory requirements and the Bank's internal rules and decisions. Íslandsbanki promotes a strong risk culture as an important part of an effective risk management and internal control framework. Emphasis is placed on transparency, acknowledgement, responsiveness, and respect for risk throughout the Bank and open communication regarding risk is encouraged. 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. The level of authority needed to approve each business decision depends on the size, complexity, and risk involved.

Íslandsbanki was listed on Nasdaq Iceland Main Market in June 2021 after the successful completion of the Bank's IPO in which the Icelandic Government sold a 35% stake in the Bank, resulting in the largest shareholder base of any listed company in Iceland. The Bank's risk strategy has not changed although increased attention to capital optimisation can be expected.

The Bank has a healthy and well diversified funding base and a strong capital framework based on the regulatory Standardised Approach. In 2021, the Bank issued its inaugural Additional Tier 1 note as part of its plan for capital optimisation. At year-end the Bank's total capital ratio was 25.3%, which is 7.5 percentage points above the regulatory requirement. Íslandsbanki aims to have a management buffer of 0.5 – 2.0 percentage points in addition to the total regulatory requirement in order to cover volatility in risk exposure amount and earnings. The Bank has changed the approach for the calculation of capital requirement for operational risk from Basic Indicator Approach to the Standardised Approach. An increase in the countercyclical capital buffer from 0% to 2% is expected in September 2022.

The implementation of CRR II in Iceland caused a reduction in REA, the most material effect was the amendment of the SME supporting factor, lowering the REA by ISK 35bn.

The leverage ratio was 13.6% at the end of 2021 unchanged from 13.6% at year-end 2020, indicating low leverage.

The Bank is predominantly a **credit risk** operation with credit risk accounting for almost 90% of the Bank's REA. The credit risk policy aims for a modest credit risk profile resulting in a well-diversified loan book with conservative collateralisation. The Bank has a long-standing, conservative credit risk culture and is shifting most retail products to digital channels with data driven decision-making with significant risk management benefits. The Risk Appetite Statement includes tolerance thresholds for credit quality, a limit on non-primary lending activity and limits on concentration risk.

The COVID-19 pandemic has elevated the level of credit risk in the Bank´s loan portfolio. In particular, forbearance measures have been granted to customers in the tourism sector, but the ongoing uncertainty has been accounted for with sufficient impairment allowance. The ratio of loans with significant increase in credit risk (stage 2) fell from 15.6% to 9.6% in 2021 and the non-performing loans ratio (stage 3) fell from 2.9% to 2.0%. The growth in the loan book has mainly been in the form of residential real estate mortgages that now comprise 42% of loans to customers.

Market risk accounts for a small proportion of the Bank's REA but is carefully managed through limits, in particular for interest rate risk, currency and inflation risk, and equity risk that arises from a small portfolio of strategic equity investments and market making activities.

The Bank manages its **liquidity risk** in accordance with the liquidity risk policy and has internal limits for Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), and the encumbrance ratio. The Bank maintained a strong liquidity position throughout 2021 and all key metrics were well above limits. The Bank continued to be a leading bond issuer domestically in both covered and senior unsecured formats and continued its sustainable progress by tapping its green bond twice to fund the sustainable financing framework.

Operational risk, which covers reputational, legal, ICT & security, model, conduct and compliance risks, among other risk factors, is managed in accordance with the operational risk policy and a number of supplementary policies and guidelines. The Bank monitors and manages operational risk through Risk and Control Self-Assessment and Key Risk Indicators and the follow up of all significant operational risk events in the Loss Event Database.

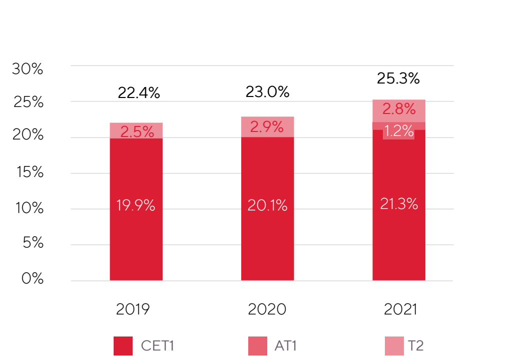
The Bank has emphasised ICT and security risk and business continuity management during the COVID-19 pandemic as the risk of cyber security events has increased. The Bank´s controls against such events have proven effective but the Bank is constantly seeking ways to strengthen its defences against cyber-attacks.

The latest addition to the risk management framework is **sustainability risk** which is managed in accordance with the sustainability policy and risk appetite. In 2021 the Bank continued to emphasise sustainability risk and further develop its methods to identify, measure, and manage sustainability risk. The highlights of the year include incorporating an ESG risk assessment to assess corporate customers, joining the Science Based Targets initiative (SBTi), and finishing the measurement of downstream scope 3 financed emissions.

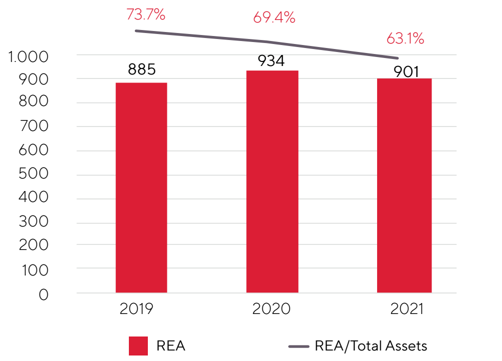
Board of Directors
10 February 2022

Key metrics

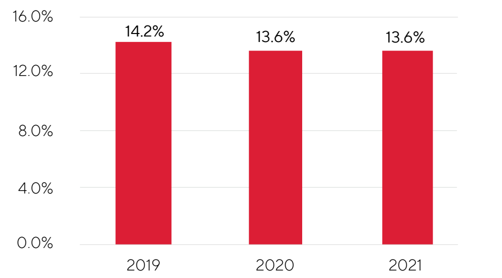
Capital ratios



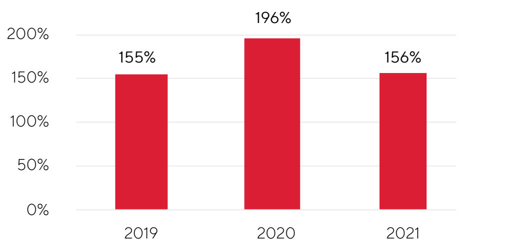
Risk Exposure Amount (ISK bn)



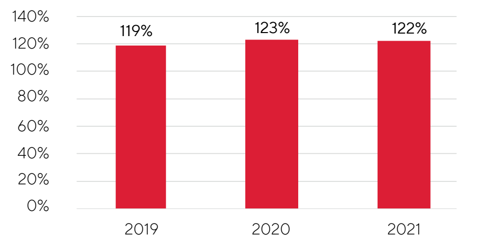
Leverage Ratio



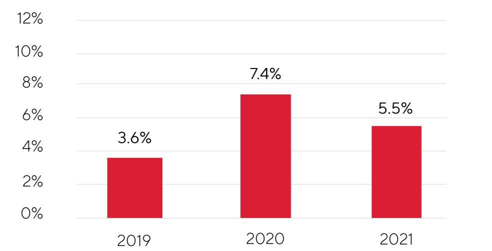
Liquidity Coverage Ratio (LCR)



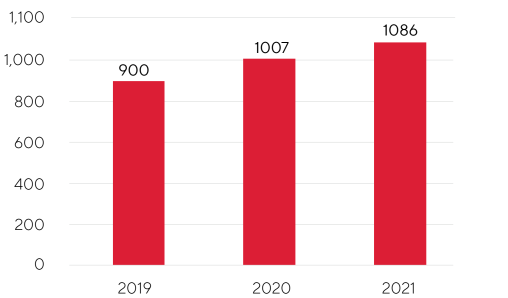
Net Stable Funding Ratio (NFSR)



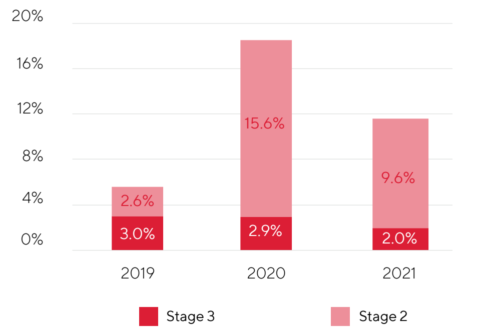
Market risk as a percentage of total capital base, year-end



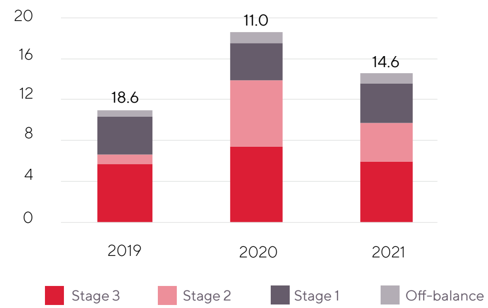
Loans to customers (ISK bn)



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 regulation 575/2013/EU and the EU Regulation on Prudential Requirements for Credit Institutions and Investment Firms regulation 575/2013/EU(CRR), hereafter referred to together as CRD IV , have been transposed into Icelandic law by amendments made to the Act no. 161/2002 on Financial Undertakings and with the Regulation no. 233/2017 on the Prudential Requirements for Financial Undertakings. 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, market risk and operational risk, the Bank uses the Standardised Approach to calculate the capital requirements. This is a change from previous years when operational risk was calculated using 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 Pillar 3 Report is in accordance with Commission Implementing Regulation 637/2021/EU on disclosure requirements under Part Eight of the CRR. This Pillar

3 Report contains information in accordance with the disclosure requirements in the form of standardised tables and templates. They are included in an Excel sheet on the Bank's website and will hereafter be referred to as 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.

Additional Pillar 3 Disclosure

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 Bank or parent. Names and primary businesses of major subsidiaries at year-end 2021 are listed in Exhibit 1.1. Further details on the Bank´s subsidiaries can be seen in LI3 in the Additional Pillar 3 Disclosure.

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.

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 2021.

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 1.1. Íslandsbanki's major subsidiaries at year-end 2021.

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

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

Overview of risk management, key metrics and risk-weighted assets	Additional Pillar 3 Disclosure	Format	Frequency of Disclosure	Reference in Pillar 3 Report
EU OV1: Overview of RWA	OV1	Template	Quarterly	Chapter 3
EU KM1: Key metrics template	KM1	Template	Quarterly	Chapter 1
EU OVA: Institution risk management approach	OVA	Table	Annual	Chapter 2
EU OVB: Disclosure on governance arrangements	OVB	Table	Annual	Chapter 2
EU OVC: ICAAP information	OVC	Table	Annual	Chapter 3
Composition of capital				
EU CC1: Composition of regulatory own funds	CC1	Template	Semi-annual	Chapter 3
EU CC2: reconciliation of regulatory own funds to balance sheet in the audited financial statements	CC2	Template	Semi-annual	Chapter 3
EU CCA: Main features of regulatory own funds instruments and eligible liabilities instruments	CCA	Table	Annual	Chapter 3
Comparison of own funds, capital and leverage ratios in regards to IFRS 9 (IFRS 9 - FL)	IFRS9	Template	Quarterly	Chapter 3
Countercyclical capital buffer				
EU CCyB1: Geographical distribution of credit exposures relevant to the calculation of the countercyclical buffer	CCyB1	Template	Semi-annual	Chapter 3
EU CCyB2: Amount of institution-specific countercyclical capital buffer	CCyB2	Template	Semi-annual	Chapter 3
Scope of application				
EU LI1: Diff. between accounting and regulatory scopes of consolidation and mapping of financial statement categories with regulatory risk categories	LI1	Template	Annual	Chapter 3
EU LI2: Main sources of differences between regulatory exposure amounts and carrying values in financial statements	LI2	Template	Annual	Chapter 4
EU LI3: Outline of the differences in the scopes of consolidation	LI3	Template	Annual	Chapter 1
EU LIA: Explanations of differences between accounting and regulatory exposure amounts	LIA	Table	Annual	Chapter 3
EU LIB: Other qualitative information on the scope of application	LIB	Table	Annual	Chapter 3
Credit risk				
EU CRA: General qualitative information about credit risk	CRA	Table	Annual	Chapter 4
EU CRB: Additional disclosure related to the credit quality of assets	CRB	Table	Annual	Chapter 4
EU CR1: Performing and non-performing exposures and related provisions	CR1	Template	Semi-annual	Chapter 4
EU CR1-A: Credit quality of exposures by exposure classes and instruments	CR1-A	Template	Semi-annual	Chapter 4
EU CR2: Changes in stock of non-performing loans and advances	CR2	Template	Semi-annual	Chapter 4
EU CQ1: Credit quality of forborne exposures	CQ1	Template	Semi-annual	Chapter 4
EU CQ3: Credit quality of performing and non-performing exposures by past due days	CQ3	Template	Annual	Chapter 4
EU CQ4: Quality of non-performing exposures by geography	CQ4	Template	Semi-annual	Chapter 4
EU CQ5: Credit quality of loans and advances by industry	CQ5	Template	Semi-annual	Chapter 4
EU CQ7: Collateral obtained by taking possession and execution processes	CQ7	Template	Semi-annual	Chapter 4
EU CRC: Qualitative disclosure requirements related to credit risk mitigation techniques	CRC	Table	Annual	Chapter 4
EU CR3: Credit risk mitigation techniques – overview	CR3	Template	Semi-annual	Chapter 4
EU CRD: Qualitative disclosure requirements on institutions' use of external credit ratings under the Standardised Approach for credit risk	CRD	Table	Annual	Chapter 4
EU CR4: Standardised approach – credit risk exposure and Credit Risk Mitigation (CRM) effects	CR4	Template	Semi-annual	Chapter 4
EU CR5: Standardised approach	CR5	Template	Semi-annual	Chapter 4
Counterparty credit risk				
EU CCRA: Qualitative disclosure requirements related to counterparty credit risk	CCRA	Table	Annual	Chapter 4
EU CCR1: Analysis of the counterparty credit risk (CCR) exposure by approach	CCR1	Template	Semi-annual	Chapter 4

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

Counterparty credit risk	Additional Pillar 3 Disclosure	Format	Frequency of Disclosure	Reference in Pillar 3 Report
EU CCR2: Transactions subject to own funds requriements for CVA risk	CCR2	Template	Semi-annual	Chapter 4
EU CCR3: Standardised approach – CCR exposures by regulatory portfolio and risk.	CCR3	Template	Semi-annual	Chapter 4
EU CCR5 – Composition of collateral for CCR exposures	CCR5	Template	Semi-annual	Chapter 4
EU CCR6: Credit derivatives exposures	CCR6	Template	Semi-annual	Chapter 4
EU CCR8: Exposures to central counterparties	CCR8	Template	Semi-annual	Chapter 4
Operational risk				
EU ORA – Qualitative information on operational risk	ORA	Table	Annual	Chapter 7
EU OR1: Operational risk own funds requirements and risk-weighted exposures amounts	OR1	Template	Annual	Chapter 7
Market risk				
EU MRA: Qualitative disclosure requirements related to market risk	MRA	Table	Annual	Chapter 5
EU MR1: Market risk under standardised approach	MR1	Template	Semi-annual	Chapter 5
Leverage ratio				
EU LR1 – LRSum: Summary reconciliation of accounting assets and leverage ratio exposures	LR1	Template	Semi-annual	Chapter 3
EU LR2 – LRCom: Leverage ratio common disclosure	LR2	Template	Annual	Chapter 3
EU LR3: Split-up of on balance sheet exposures	LR3	Template	Semi-annual	Chapter 3
EU LRA: Dislosure of Leverare ratio qualitative information	LRA	Table	Annual	Chapter 3
Liquidity ratio				
EU LIQ1: LCR disclosure template, on quantitative information of LCR which complements Article 435(1)(f) of Regulation (EU) No 575/2013	LIQ1	Template	Quarterly	Chapter 6
EU LIQA – Liquidity risk management	LIQA	Table	Annual	Chapter 6
EU LIQB on qualitative information on LCR, which complements template EU LIQ1	LIQB	Table	Quarterly	Chapter 6
EU LIQ2: Net stable funding ratio (NSFR)	LIQ2	Template	Semi-annual	Chapter 6
Remuneration				
EU REMA: Remuneration policy	REMA	Table	Annual	Chapter 9
EU REM1: Remuneration awarded for the financial year	REM1	Template	Annual	Chapter 9
EU REM2: Special payment to staff whose professional activities have a material impact on institutions´risk profile (identified staff)	REM2	Template	Annual	Chapter 9
EU REM3 – Deferred remuneration	REM3	Template	Annual	Chapter 9
EU REM4 – Remuneration of 1 million EUR or more per year	REM4	Template	Annual	Chapter 9
EU REM5 – Information on remuneration of staff whose professional activities have a material impact on institutions' risk profile (identified staff)	REM5	Template	Annual	Chapter 9
Asset encumbrance				
EU AE1: Encumbered and unencumbered assets	AE1	Template	Annual	Chapter 6
EU AE2: Collateral received and own debt securities issued	AE2	Template	Annual	Chapter 6
EU AE3: Sources of encumbrance	AE3	Template	Annual	Chapter 6
EU AE4 – Accompanying narrative information	AE4	Table	Annual	Chapter 6
COVID-19				
COVID-19 1 – Information on loans and advances subject to legislative and non-legislative moratoria	COVID-19 1	Template	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	Template	Quarterly	Chapter 4
COVID-19 3 – Info on newly originated loans and advances provided under newly applicable public guarantee schemes introduced in response to COVID-19 crisis interest rate risk of non-trading book activities	COVID-19 3	Template	Quarterly	Chapter 4
EU IRRBB1 – Interest rate risk of non-trading book activities	IRRBB1	Template	Annual	Chapter 5

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 risk management function and the compliance function. They 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 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.

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

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

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 and compliance 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 Chief Compliance Officer

The Chief Compliance Officer (CCO) 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 CCO is responsible for monitoring the risk management and compliance framework specific to measures concerning securities transactions and anti-money laundering in accordance with Icelandic law.

The Bank's CCO is selected and appointed by the CEO, subject to Board confirmation, and reports directly to the CEO and to the Board of Directors. The CCO 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 CCO. The CCO 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 or making material changes to the Bank's operations.

Where necessary, Risk Management makes recommendations to senior management and the Board for revisions 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 CCO, which is a part of the second line of defence.

Compliance is responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures concerning securities transactions and anti-money laundering in accordance with the applicable law. Compliance reports to the All Risk Committee, Operations and Security Committe and the Board of Directors on all relevant compliance risk related information. 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 new products and new procedures comply with laws and regulations pertaining to securities transactions and anti-money laundering.

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 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 (SC). They are responsible

Exhibit 2.2. The Bank's senior committees and the number of meetings in the year 2021. In addition, the Credit Committee which is a sub-committee of the Senior Credit Committee had 122 meetings discussing credit proposals for lower exposure.

Committee	Role	Number of meetings
Executive Board	Business strategy, finances, IT strategy, marketing, governance and human resources	43
All Risk Committee	Risk strategy and risk appetite	18
Asset and Liability Committee	Funding and liquidity, market risk, capital management and pricing	50
Senior Credit Committee	Credit proposals	97
Investment Committee	Investment proposals	16
Operations and Security Committee	Product approval, operations, security and business continuity	19
Sustainability Committee	Review's sustainability related matters and business opportunities	23

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.

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 a 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 undergo 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 2021, the Bank recorded over 7,200 registrations for over 140 different in-house training courses, on-demand courses online and live online courses which is an average of 10 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.

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*.

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	Average 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

2.4.2 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 significant 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 significant 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 Significant Changes Policy outlines the synchronisation, review and control process necessary to ensure successful implementation of new products and significant 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.

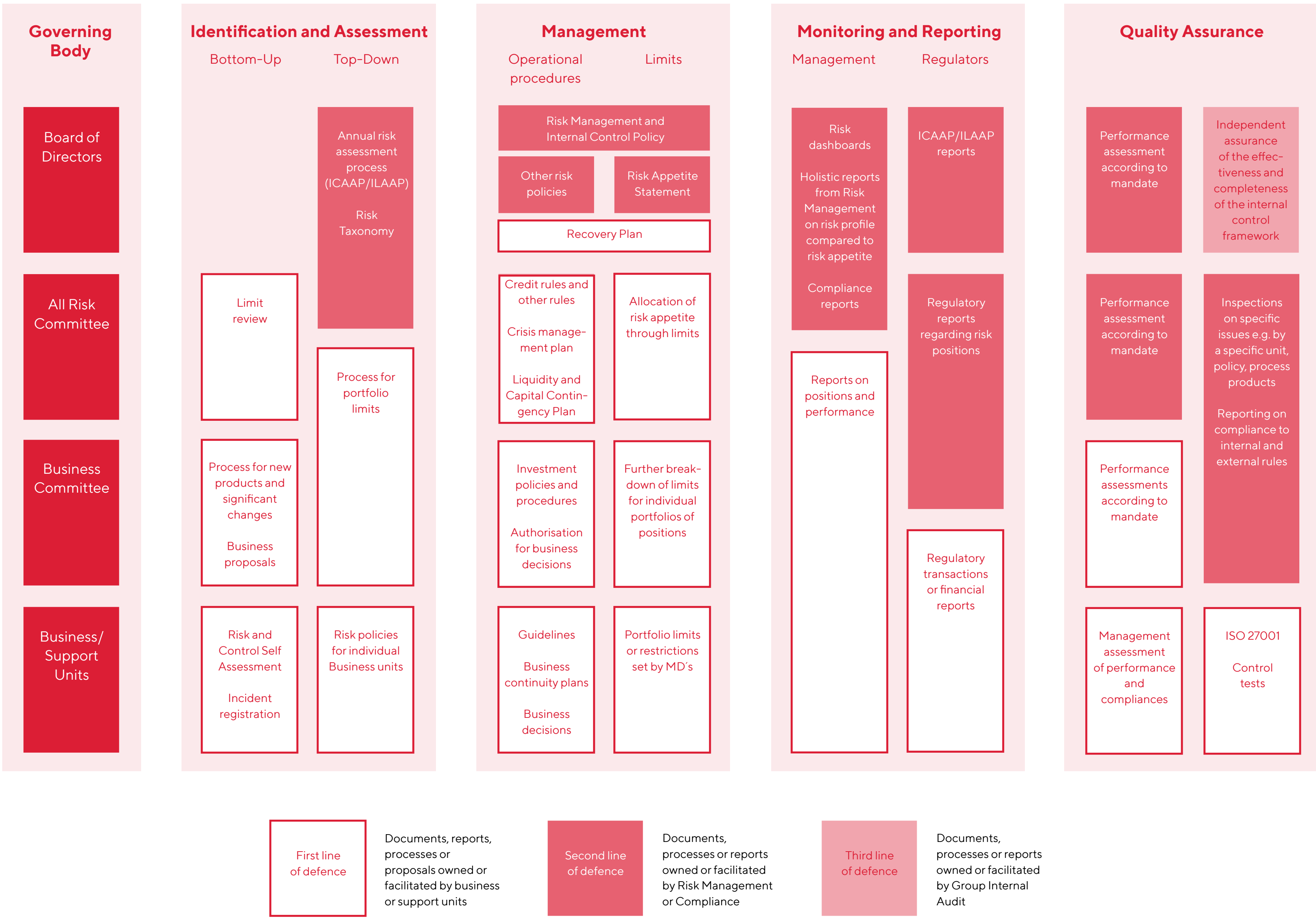
Risk types that are not covered in separate risk policies are assessed through the annual ICAAP process based on the Bank's Risk Taxonomy and addressed in other risk policies and management reports in accordance with their nature and importance.

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 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 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.

Exhibit 2.4. Íslandsbanki's risk governance framework.



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 three different levels of severity called contingency stages. The main purpose of the contingency plan is to provide the Bank's management with an instrument that identifies actions and contingency options to restore financial strength and viability of the Bank in case it should come under capital or liquidity stress. Moreover, it defines the internal roles and responsibilities at each contingency stage and the contingency options the Bank may take at each stage in order to return to normal business conditions. The plan also defines the management of internal and external disclosure, communication and reporting at each contingency stage. The *Liquidity and Capital Contingency Plan* is tested regularly and findings from the tests are used to improve the contingency plan if needed.

2.4.6 Recovery Plan

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 Icelandic law, 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 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.

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 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 and Sustainability Report, Consolidated Financial Statements, the Pillar 3 Report and in investor presentations. These are all available on the Bank's website.

Reports 2021

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.

Exhibit 2.5. Risk reporting and frequency to the Board of directors, Board´s Risk Committee 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

3 Capital Management

Íslandsbanki's capital position remained strong throughout 2021 and at year-end the Group's capital ratio was 25.3%, exceeding both the capital target and regulatory requirements. The CET1 ratio was 21.3%, well above the long-term target of 16.5%. The capital management strategy is to aim for the long-term target of CET1 while satisfying various conditions set by the risk framework. This can lead to an optimisation of the capital structure by adjusting the share of AT1 or Tier 2 capital through further issuance and lowering CET1 through dividend payments or similar methods.

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 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 define 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, Risk Assessment Framework,* and the *Capital Management and Pricing Policy*.

In addition to the current internal requirement of adequate capitalisation, the Board has defined a long-term capital target as a part of the business strategy.

The All Risk Committee (ARC) governs the capital management of the Bank in accordance with the risk appetite 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 business targets and risk 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 2021 the Bank's common equity Tier 1 (CET1) amounted to ISK 192bn as compared to ISK 188bn at year-end 2020. The main factor contributing to the increase in CET1 is the ISK 23.7bn profit for the year. The presentation of the capital has been restated where expected dividend, based on 50% of profit in line with dividend policy, is now deducted from CET1. Therefore, only half of the profit leads to an increase in capital. An ISK 3.4bn dividend disbursed in the first quarter, however, lowered CET1 capital as it was not deducted in the reported capital at year-end 2020. The level of IFRS 9 provisions included in CET1 is currently 50% of the incremental provision for credit risk compared to 70% in 2020, contributing to an ISK 2.4bn decrease in CET1. The percentage will decrease to 25% in 2022 and finally to 0% in 2023.

In September 2021, the Bank issued for the first time Additional Tier 1 (AT1) notes as part of its plan to optimise its capital structure. The issue amounted to SEK 750m or ISK 11bn. The transaction pays a quarterly coupon for the life of the notes and features a loss absorption mechanism with temporary write-down structure triggered at 5.125% CET1 ratio.

The Bank's Tier 2 capital fell from ISK 27bn to ISK 25bn during the year due to the appreciation of the ISK against SEK in which all of the Tier 2 issuance is denominated. A breakdown of the Bank's total capital base is shown in Exhibit 3.1.

The capital requirements and capital ratios are presented in terms of the Risk Exposure Amount (REA) that 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 the risk weighted assets for credit risk (see more in Section 3.4).

The Bank's minimum capital requirements and the corresponding risk exposure amounts are shown in Exhibit 3.2, and the resulting capital ratios in Exhibit 3.3. Details regarding the Bank's capital requirements can be found in Section 3.4.

The REA fell by ISK 32bn during the year and the main components contributing to the changes can be seen in Exhibit 3.4. The largest increase was due to growth in the mortgage loan portfolio (ISK 18bn) while other growth in the loan portfolio did not lead to an increase since the average risk weight of new loans was lower than the average risk weight of reimbursed loans. The EU regulation 2019/876 was implemented in Iceland 28 June 2021 by amending regulation no. 33/2017. The most material effect was the amendment of the SME supporting factor, which relaxes the conditions for obligors to be classified as small or medium sized enterprises allowing the supporting factor to be applied to a larger part of the Bank's loan portfolio, lowering the REA by ISK 37bn. The Bank has reviewed the methodology for operational risk and calculates the capital requirements according to the Standardised Approach instead of the Basic Indicator Approach. This led to an ISK 4bn decrease in REA.

Exhibit 3.1. Breakdown of the capital base at year-end 2021 and 2020 (ISK m).

Capital	31.12.2021	31.12.2020
Common equity Tier 1 Capital	192,224	187,869
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,986	6,181
Retained earnings	132,624	113,529
Non-controlling interests	-	1,494
IFRS 9 reversal due to transitional rules	2,768	5,164
Fair value changes due to own credit standing	1,054	238
Target dividend payment	(11,863)	-
Tax assets	(94)	(259)
Intangible assets	(3,352)	(3,478)
Tier 1 Capital	202,850	187,869
Additional Tier 1 capital	10,626	-
Tier 2 Capital	25,136	27,194
Total capital base	**227,986**	**215,063**

3.3 Internal Capital Adequacy Assessment Process

The internal capital adequacy assessment process (ICAAP) aims at identifying and assessing the risk inherent in the Bank's operations and for integrating the Bank's business strategy and business plan on one hand and the risk profile on the other hand to ensure that the Bank holds enough capital to support

Exhibit 3.2. Pillar 1 capital requirements and REA at year-end 2021 and 2020 (ISK m).

	31.12.2021		31.12.2020	
Íslandsbanki's capital requirements and REA	Minimum capital requirements	REA	Minimum capital requirements	REA
Credit risk	64,153	802,147	66,411	830,141
Market risk	1,368	17,100	1,330	16,626
Credit valuation adjustment	146	1,830	138	1,728
Operational risk	6,446	80,570	6,802	85,026
Total	**72,113**	**901,646**	**74,682**	**933,521**

Exhibit 3.3. REA and capital ratios at year-end 2021 and 2020.

	31.12.2021		31.12.2020	
	ISK m	% of REA	ISK m	% of REA
REA	901,646		933,521	
CET1 capital	192,223	21.3%	187,869	20.1%
Tier 1 capital	202,848	22.5%	187,869	20.1%
Capital base	227,985	25.3%	215,063	23.0%

its risk profile and business strategy through a period of severe stress.

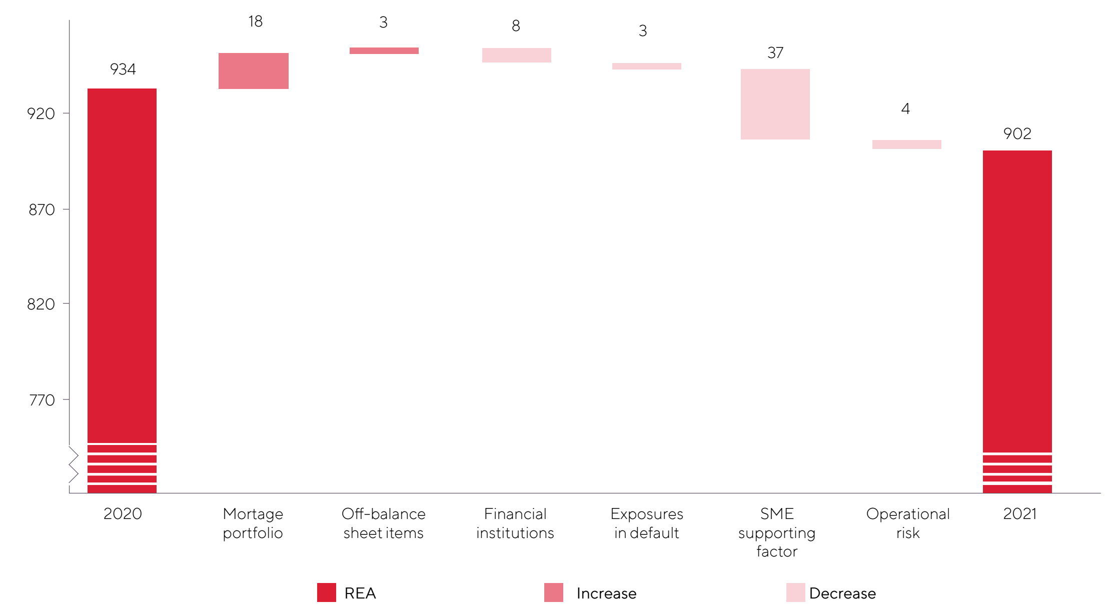
The Board of Directors is ultimately responsible for the ICAAP and is actively involved in the assessment process. The process is carried out by Risk Management with active participation of the business and support units through risk identification and appropriate reviewal of the capital adequacy assessment and stress testing results.

In an annually revised 5-year business plan, the Bank's risk strategy is aligned with the business strategy, and the financial targets are translated into a base case projection of the financial results under normal business conditions. The business plan forms the basis for pro forma financial statements that allow for a comprehensive business and strategic stress testing whereby the impact of all relevant risk drivers is assessed.

3.4 Capital Requirements

The Board of Directors sets minimum capital thresholds for the Bank, expressed as the ratio between capital and risk exposure amount. The minimum capital thresholds are intended to reduce the likelihood that the regulatory overall capital requirement is ever breached. The minimum is based on the results from ICAAP, the views expressed by the regulator through the Supervisory Review and Evaluation Process (SREP), implementation and announced changes of the capital buffers, and other factors such as uncertainties in the operating environment or other external factors. The following sections describe each component in more detail.

Exhibit 3.4. Changes in risk exposure amount (ISK bn).



3.4.1 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% of the 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.

Credit Risk

The Bank uses the Standardised Approach for credit risk where the REA 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.

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 (FX) 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 Bank has at year-end 2021 changed the approach for calculation of capital requirements for Pillar 1 from Basic Indicator Approach to Standardised Approach. The minimum capital requirement for operational risk varies by business lines and equals 12-18% of the average over three full calendar years of the sum of net interest income, net fee and commission income and net other financial income in that business line.

3.4.2 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 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.

In the ICAAP 2021, 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. Based on the 2021 SREP, the additional capital required for Íslandsbanki under Pillar 2-R was 2.5% of REA, an increase of 0.8% since before the COVID-19 pandemic. Pillar 2-R for credit risk increased as a result of COVID-19, mostly due to loans in the tourism portfolio with forbearance or with other indications of deterioration in credit quality. Pillar 2-R for market risk increased with interest rate risk in the banking book resulting from a larger portion of mortgages having fixed interest rates. The breakdown of the Pillar 2-R capital and the total SREP capital requirements can be seen in Exhibit 3.5.

3.4.3 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 and (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 no. 227/2020, 323/2020 and 324/2020).

The Central Bank of Iceland has announced an increase of the countercyclical capital buffer from 0% to 2%, effective from September 2022. The buffer had previously been reduced from 2% to 0% as a response to COVID-19.

Exhibit 3.5. Breakdown of the total SREP capital requirement.

SREP capital requirement	2021	2020
Pillar 1	8.0%	8.0%
Credit risk	7.1%	7.1%
Market risk	0.2%	0.1%
Operational risk	0.7%	0.7%
Pillar 2-R	2.5%	1.7%
Credit risk	1.2%	0.6%
Credit concentration risk	0.4%	0.5%
Market risk	0.9%	0.5%
Subsidiaries	-	0.1%
Total SREP capital requirement	**10.5%**	**9.7%**

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.

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 calculation of the institution specific countercyclical capital buffer rate is displayed in sheet CCyB2 in the Additional Pillar 3 Disclosures. Exhibit 3.6 shows combined buffer requirement for Íslandsbanki at year-end 2021 and 2020.

The sum of Pillar 1, Pillar 2-R and the combined capital buffers forms the overall capital requirement.

3.4.4 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.

Exhibit 3.6. Combined capital buffer requirement.

	31.12.2021	31.12.2020
Capital conservation buffer	2.50%	2.50%
Countercyclical capital buffer	0.00%	0.00%
O-SII buffer	2.00%	2.00%
Systemic risk buffer	2.84%	2.78%
Combined buffer requirement	**7.34%**	**7.28%**

3.4.5 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 0.5%-2.0% as defined in the *Risk Appetite Statement* set by the Board of Directors.

3.4.6 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, while the CRD IV capital buffers shall be comprised of CET1 capital only. Exhibit 3.7 shows the composition of the overall capital requirement.

3.4.7 Capital Target

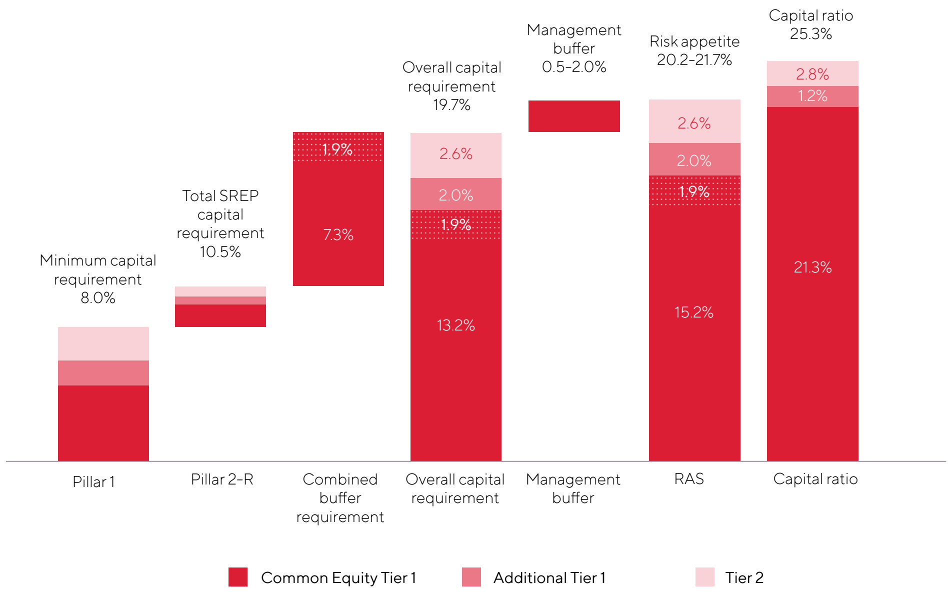
The Bank's risk management framework stipulates a management buffer of 0.5-2.0% above of the overall capital requirement resulting from the SREP. Based on the most recent SREP results, this translates to total capital thresholds of 20.2 -21.7% with the composition of the capital satisfying the constraints presented above.

In addition to the total capital thresholds defined in the *Risk Appetite Statement*, the Board of Directors

Exhibit 3.7. Composition of the regulatory capital requirements (including the institution specific countercyclical capital buffer effective in September 2022 in the last row).

SREP capital requirement	CET1	AT1	Tier 2	Total
Pillar 1	4.5%	1.5%	2.0%	8.0%
Pillar 2-R	1.4%	0.5%	0.6%	2.5%
Combined buffer requirement	7.3%	-		7.3%
Overall capital requirement	**13.2%**	**2.0%**	**2.6%**	**17.8%**
Overall capital requirement including CCyB	**15.1%**	**2.0%**	**2.6%**	**19.7%**

Exhibit 3.8. Regulatory requirements (including the institution specific countercyclical capital buffer effective in September 2022 shown with dottet red colour) compared with Íslandsbanki's risk appetite as well as the composition of the Bank's current capital ratio.



has set a long-term CET1 capital target for the business plan of 16.5%.

The capital management strategy is then to aim for the long-term target of CET1 while satisfying the conditions set by the risk framework. This can lead to an optimisation of the capital structure by adjusting the share of AT1 or Tier 2 capital though further issuance and lowering CET1 through dividend payments or similar canals.

3.5 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.

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 the Bank. 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 is conducted by experts from across the Bank. The experts come up with 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.

3.6 Leverage Ratio

The leverage ratio is a measure supplementing the risk-based capital requirements 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%. The leverage ratio is monitored monthly through the Risk dashboard. The level of the Bank's overall requirement as well as the current RWA density deter excessive leverage.

The leverage ratio was 13.6% at year-end 2021, unchanged between years. The increase in exposure was offset with higher Tier 1 capital. Template LR2 in the Additional Pillar 3 Disclosures shows the components of the leverage ratio calculations.

3.7 Minimum Requirements for Own Funds and Eligible Liabilities

In addition to the previously discussed capital requirements that are intended to ensure that the Bank holds enough capital to support its risk profile and business strategy through a period of severe stress, new regulatory requirements are being implemented with the intension to ensure that the Bank maintains a minimum amount of equity and debt to support an effective resolution. These are called Minimum Requirements for Own Funds and Eligible Liabilities (MREL). In December 2021, the Icelandic Resolution Authority published its MREL policy for Icelandic banks and in January 2022 a draft requirement was presented to Íslandsbanki. The Bank currently fulfils the draft requirement that is in line with the published policy.

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 2021, the Bank's maximum exposure to credit risk amounted to ISK 1,568bn, compared to ISK 1,470bn at year-end 2020. The loan portfolio grew by 7.9% in 2021, compared to an 11.9% increase in the previous year. In 2021, the uncertainty that followed the COVID-19 pandemic was reduced and economic conditions improved. This led to a lower share of loans with significant increase in credit risk, currently at 9.6% compared to 15.6% the year before. Credit risk accounted for 89% of capital requirements under Pillar 1 and credit risk and credit concentration risk accounted for 79% 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 obligors 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.

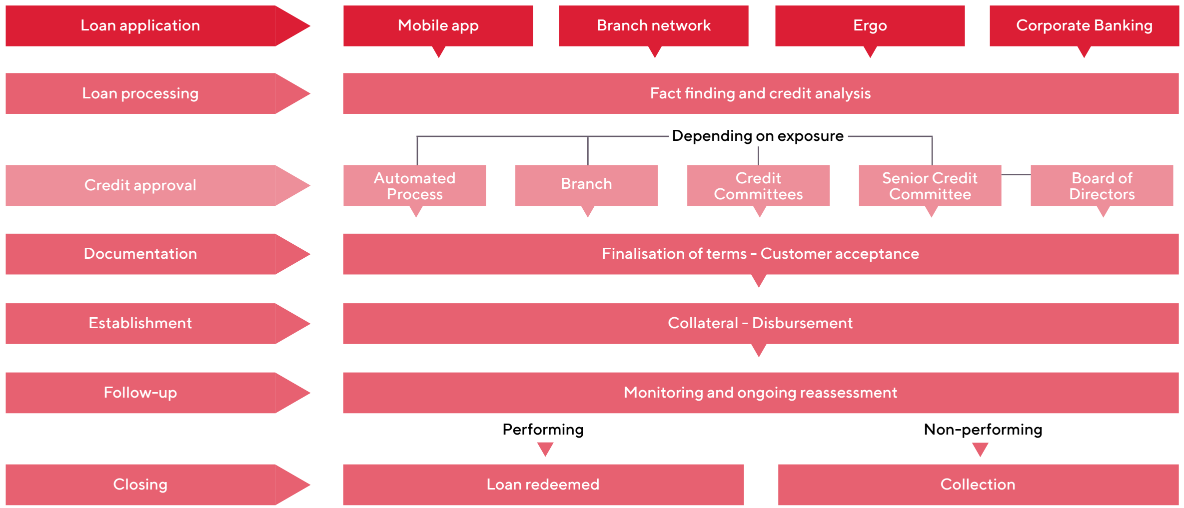
As the second line of defence, Risk Management monitors the adherence to credit risk limits and reports on credit risk to the All Risk Committee and to the Board of Directors, including current and prospective risk position compared to the risk appetite.

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 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.

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



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, based on both internal and external data. 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.

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 66.4 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 designed 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 changed due to an event such as a merger or acquisition of the customer or any other similar transaction that significantly improved their financial position.

At the end of September 2021, the Central Bank set for the first time a harmonised level for the materiality threshold for credit obligations that are past due in Iceland. The harmonised threshold has an absolute component of ISK 15,000 for retail obligors and ISK 75,000 for others and a relative component of 1% of the obligor's total exposure. Íslandsbanki has been using a very similar absolute component in its definition of default under point (b) but the relative component has not been used. The Bank's definition is therefore currently stricter than necessary; however, the difference is not expected to be significant.

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 reserved for obligors in default and risk classes 1–9 for other obligors.

Exhibit 4.2. Methods used to assess the default risk of different obligor types, approximate number of obligors and relative size of exposure at year-end 2021.

Obligor type	PD assessment	Number of obligors	Exposure
		(approx. count)	(%)
Individuals	Statistical model	88,000	37.8%
Small companies	Statistical model	9,000	6.8%
Large companies	Hybrid model	400	32.9%
Credit institutions	Expert model	60	6.2%
Regional governments	Expert model	20	0.8%
Sovereigns	Expert model	10	15.4%

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.

A new model for the risk assessment of loans to individuals was introduced in the third quarter of 2021. The new model utilises new data from the fully-digital lending process for mortgages, which enhances the model's diagnostic ability. This led to a general shift to better risk classes and an overall reduction in probability of default. The PD model for small companies was recalibrated in the fourth quarter of 2021, also leading to a general shift in risk classes and an overall reduction in probability of default.

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 4.3. Average long-term PD levels per risk class for the different rating models at end of year 2021.

Risk group	Risk class	Large companies	Small companies	Individuals
		(%)	(%)	(%)
Low	1	0.3	0.2	0.1
	2	0.4	0.4	0.4
	3	0.8	0.8	0.9
	4	1.3	1.6	1.4
Medium	5	2.3	2.7	2.1
	6	4.1	4.2	3.1
Increased	7	7.1	7.3	5.4
	8	12.5	15.3	11.9
High	9	21.8	37.1	35.4

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 2021 was extraordinary because of the ongoing COVID-19 pandemic and measures that 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 2021 there were a handful of observed defaults for large companies, which translates to a 1.6% default frequency compared to a predicted default probability of 5.7%. 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 2021 differ from those of previous years, due to a recalibration of the rating model in 2018. The long-term average of the probability of default for each risk class is based on the rating models in use at the beginning of each year and therefore recalibrations that were implemented during the year and are shown in Exhibit 4.3 will not be visible here until the next report.

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 2021, results from other years shown for comparison. Logarithmic scale.

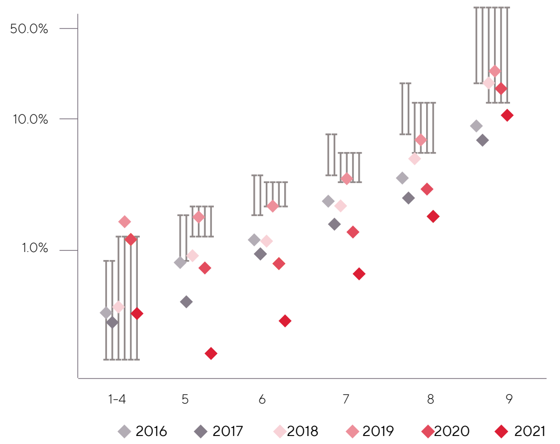
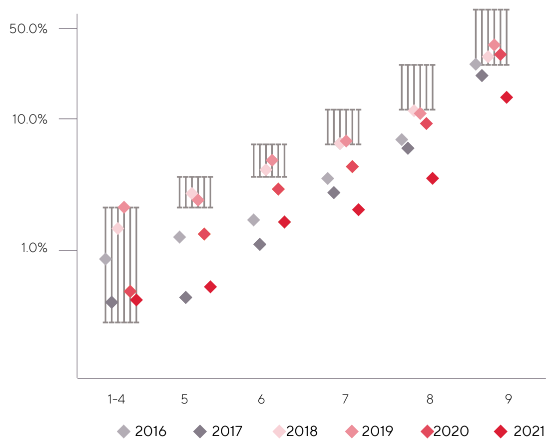


Exhibit 4.5. Observed default frequency (dots) and the range of the predicted through-the-cycle probability of default (vertical lines) by risk class for small companies in 2021, results from other years shown for comparison. Logarithmic scale.



As expected, due to prolonged COVID-19 measures such as moratoria, the observed default frequency is lower than the predicted long-term default rate. This can also be attributed to the reduction in the Central Bank's key interest rates in 2020, as a significant set of customers enjoyed lower debt service through variable interest rates or refinancing. Furthermore, the purchasing power of wages is relatively high in historical context, despite considerable inflation in recent months. The observed default frequency was 1.0% compared to the 2.0% predicted probability of default for individuals, while corresponding rates were 2.1% and 4.2% 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.

4.2.5 Exposure at Default

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

EAD = Drawn amount + CCF · Undrawn amount

The Bank has 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 Tier 1 capital. 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 2021, the Bank had no large exposure after eligible credit risk mitigating effects. The number of large exposures has therefore reduced by one between years even though the definition changed in 2021. Previously the threshold was compared to 10% of Total capital base but now the Tier 1 capital should be used.

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. The sector classification is generally based on information from the tax authorities although the Bank has the possibility to reclassify customers internally based on a "see-trough principle" when another sector is more descriptive of the underlying risk.

In the case of real estate companies, this can be appropriate if the real estate is specialised and the credit risk depends more on the operations located in the building than general real estate or rental prices. In the second quarter 2021, around ISK 40bn was reclassified from real estate, mostly to commerce and services (hotel buildings), and industrial and transportations.

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 activity. 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.

Credit exposure that is not a part of the Bank´s principal lending activity is limited in the Bank's *Risk Appetite Statement*. Primarily, this includes lending to holding companies collateralised by shares in operating companies.

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. 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 CCR1, CCR2, CCR3, CCR5 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

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.

Exhibit 4.7. The main sources for credit risk at year-end 2021 and 2020 (ISK bn). Consolidated.

	31.12.2021	31.12.2020
Loans to customers	1,086.3	1,006.7
Balances with the Central Bank and loans to credit institutions	157.7	168.9
Bonds and debt instruments	132.3	128.2
Off-balance sheet items	164.3	153.4
Derivatives	21.5	9.9
Other financial assets	5.6	3.7
Total	**1,567.7**	**1,470.8**

is the amount that the Bank might have to pay 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 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 2021 and 2020.

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 of these exposures at year-end 2021 and 2020.

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 164bn at year-end 2021 compared to ISK 153bn 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 34bn at year-end 2021 compared to ISK 48bn at year-end 2020.

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

Exhibit 4.8. Cash and balances with the Central Bank and loans to credit institutions at year-end 2021 and 2020, by credit quality step (net carrying amount, ISK bn). Consolidated.

Type of institution	31.12.2021	31.12.2020
Central Bank	113.7	78.9
Domestic credit institutions	1.0	2.2
Foreign credit institutions	43.0	87.8
thereof in credit quality step 1	6.1	24.0
thereof in credit quality step 2	33.1	45.4
thereof in credit quality step 3	0.2	18.3
Total	**157.7**	**168.9**

Exhibit 4.9. Bonds and debt instruments at year-end 2021 and 2020, by credit quality step (carrying amount, ISK bn). Consolidated.

Bonds and debt instruments	31.12.2021	31.12.2020
Icelandic government and regional government guaranteed bonds	78.2	67.7
Foreign government bills	28.9	43.9
Domestic corporates	2.5	2.3
Domestic credit institutions	22.7	14.3
Total	**132.3**	**128.2**

in these cases, the Bank holds collateral to cover possible losses. Credit risk for derivatives amounted to ISK 21.5bn at year-end 2021 compared to ISK 9.9bn 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 94bn at year-end 2021. This exposure relates mainly to the management of the Bank's foreign liquidity reserves. The Bank has no retail lending activities outside 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 31bn at year-end 2021.

4.7 Loans to Customers

Loans to customers, both individuals and companies, represent the largest part of 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 2021 the net carrying amount of the portfolio of loans to customers was ISK 1,086bn, having grown from ISK 1,007bn at year-end 2020. This growth of 7.8% is mainly due to the increase in the mortgage portfolio which grew by ISK 81bn on the back of ISK 184bn in lending, a part of which was refinancing of outstanding mortgages due to more favourable interest rates and strong growth in the housing market.

Exhibit 4.10 shows the development of the loan portfolio through 2021.

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).

Exhibit 4.10. The main sources of changes in the net carrying amount of loans to customers from year-end 2020 to year-end 2021. 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). Consolidated.

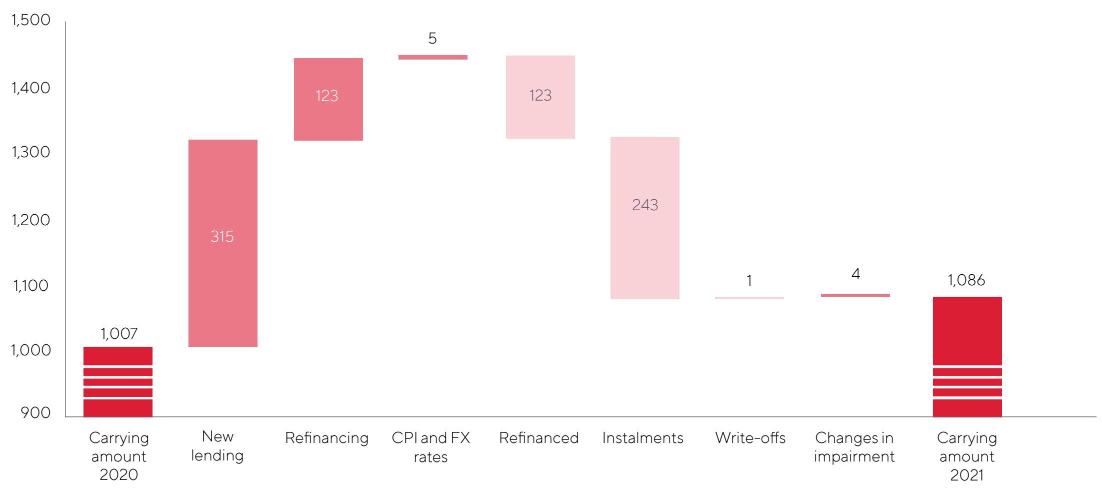


Exhibit 4.11. Currency composition of loans to customers at year-end 2021 (net carrying amount, ISK bn). Consolidated.

Industry sector	Non-indexed	CPI-linked	Foreign currency	Total
Individuals	334.9	185.7	0.1	520.7
Commerce & Services	130.8	20.9	13.5	165.2
Construction	35.6	1.1	0.1	36.8
Energy	6.7	2.7	0.1	9.5
Financial services	2.0	-	-	2.0
Industrials & Transportation	47.1	3.7	38.8	89.6
Investment companies	13.5	1.2	9.0	23.7
Public sector & non-profit organisations	9.1	0.9	0.0	10.0
Real estate	75.2	30.8	3.3	109.3
Seafood	3.0	0.2	116.4	119.5
Total	**657.9**	**247.1**	**181.3**	**1,086.3**
Total as %	60.6%	22.7%	16.7%	100%
Total at year-end 2020	55.7%	26.6%	17.6%	100%

4.7.3 Loans to Individuals

Loans to individuals amounted to ISK 518bn at year-end 2021 compared to ISK 437bn the year before. New loans and refinancing amounted to ISK 201bn.

The strong rise in residential real estate prices continued in year 2021, where the 12-month price increase in the capital area, its neighbouring municipalities, and elsewhere in Iceland all showed a similar trend of around 20% increase. This trend, together with customers' continued appetite to refinance their loans, explains the material 19% 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. The Bank utilises a fully digital and automatic credit score evaluation for mortgages. 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 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 electronic.

In September 2021, the Central Bank's Financial Stability Committee decided to adopt rules on maximum debt service to income (DSTI) ratios, as is provided for in Article 27 of the Act on Mortgage Lending to Consumers with the aim of containing long-term systemic risk due to rapid rise in housing prices. In general, the maximum DSTI ratio in Iceland shall be 40% for first-time buyers and 35% for all other borrowers. When assessing individual's ability to pay, the Bank adheres to maximum 35% ratio for all borrowers, thus no changes in credit standards were required by Íslandsbanki.

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. The 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.

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

Exhibit 4.12. Breakdown of the mortgage portfolio by the LTV calculated for each property, year-end 2021 and 2020 (net carrying amount, ISK bn). Consolidated.

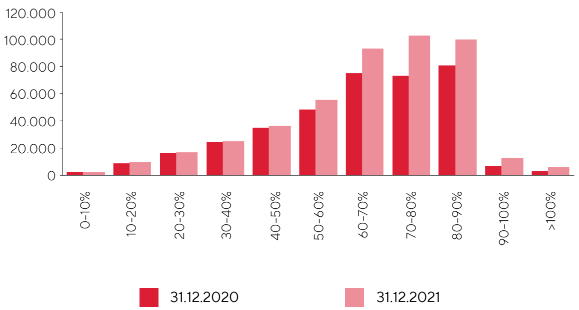
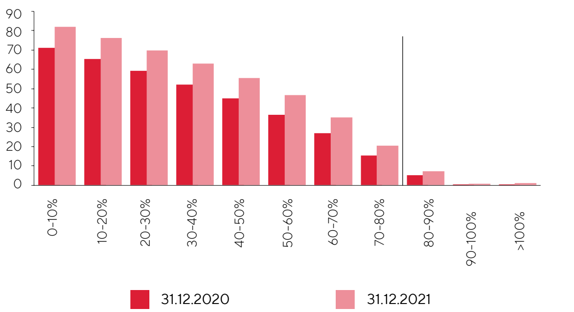


Exhibit 4.13. Breakdown of the mortgage portfolio by LTV bands, year-end 2021 and 2020 (net carrying amount, ISK bn). See main text for further explanation. Consolidated.



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 of the Bank's loans on the property. The weighted average LTV, calculated in the manner described, was 66% at year-end 2021 compared to 64% at year-end 2020.

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 a 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 566bn at year-end 2021 compared to ISK 569bn at year-end 2020. New loans and refinancing of outstanding loans amounted to ISK 237bn in 2021.

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.

Note 48 in the Consolidated Financial Statements shows the maximum credit risk exposure for loans to companies, broken down by industrial sectors, and the type of collateral held against these exposures.

The Bank's exposure to companies operating in the tourism industry sector is around 9% of the loan portfolio. The tourism sector continues to be affected by the COVID-19 pandemic, due to ongoing public health restrictions and reduction in foreign tourists. 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.

Valuation of collateral is based on market price, an official valuation from Registers Iceland, or the expert assessment 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.

4.9 Risk Profile

As described in Section 4.2.2, each obligor is assigned a risk class depending on how likely they are considered to default in the next 12 months. Note 49 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 4.15 and 4.16 show the breakdown of loans to customers graphically where in addition, exposure to individuals and exposure to companies are shown separately. Exhibit 4.17 shows the migration of customers between risk classes in 2021.

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 4.18 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

Exhibit 4.14. The continuous LTV distribution of the portfolio of loans to customers by type of underlying asset at year-end 2021 (ISK bn). Consolidated.

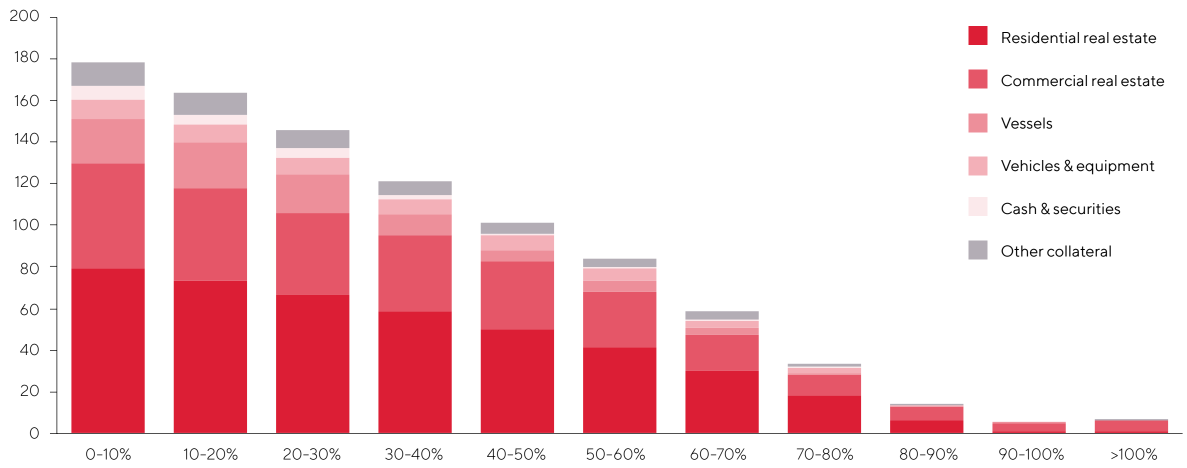


Exhibit 4.15. Loans individuals by risk groups and stage at year-end 2021 (net carrying amount, ISK bn). Consolidated.

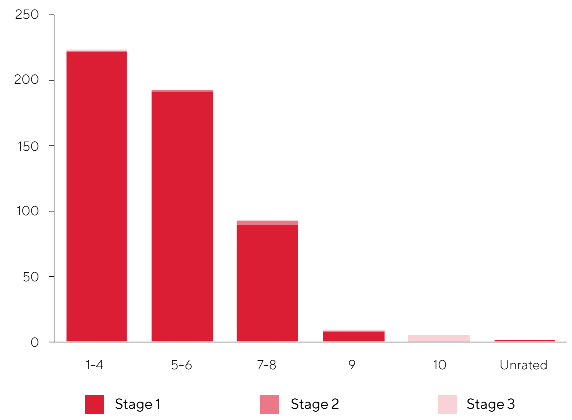
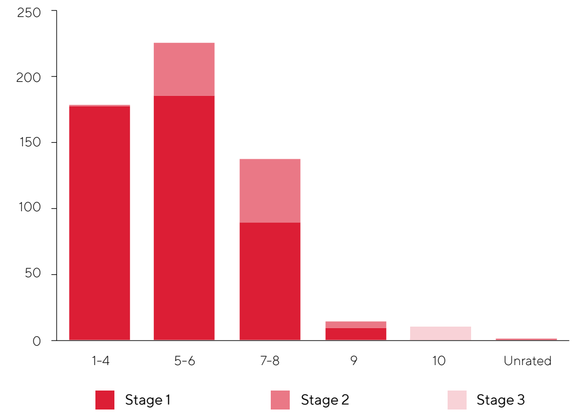


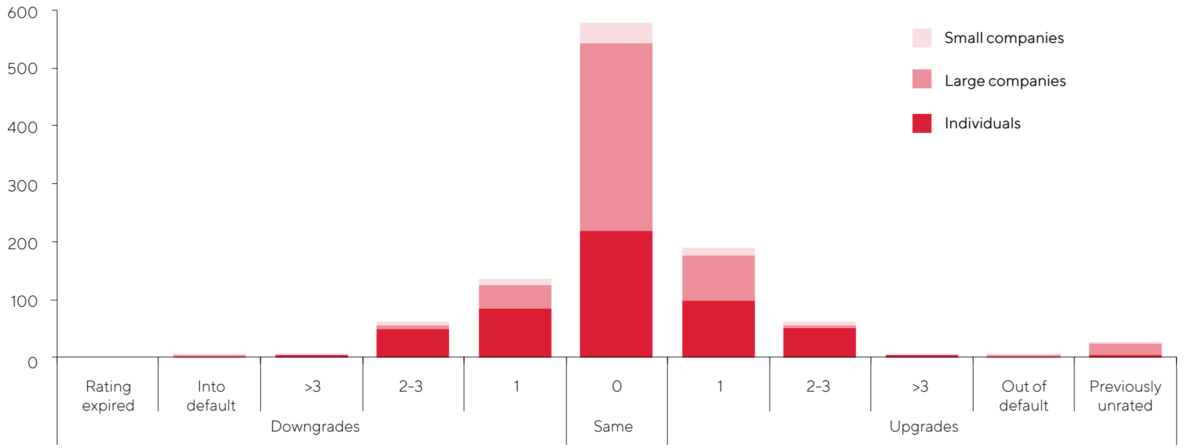
Exhibit 4.16. Loans companies by risk groups and stage at year-end 2021 (net carrying amount, ISK bn). Consolidated.



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.

The non-performing ratio that the Bank uses, depicted in Exhibit 4.20, 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. The Bank monitors the non-performing loans (NPL) ratio on a regular basis, however when comparing 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 49 in the Consolidated Financial Statements. The Bank's NPL ratio was 2.0% at year-end 2021 compared with 2.9% at year-end 2020, largely due to repayments in full of loans in stage 3.

Exhibit 4.17. Migration of risk classes in 2021 (net carrying amount, ISK bn). Consolidated.



4.10 COVID-19 Considerations

The COVID-19 pandemic has had a pronounced 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 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.

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. As of year-end 2021, the Bank had loans amounting to ISK 2,453m subject to 100% Government guarantee, ISK 1,195m subject to 85% Government guarantee and ISK 558m to 70% Government guarantee.

In 2020, the Bank entered into a temporary agreement with other financial institutions and lenders in Iceland to provide a moratorium for both households and corporate customers, uniformly executed across institutions. In accordance with

Exhibit 4.18. The expected credit loss for loans to customers at year-end 2021. See Section 4.9 in the main text for further details. Consolidated.

Stage	Gross carrying amount	PD	LGD loss rate	LGD loss severity	Effect of lifetime loss	ECL
	(bn)	(%)	(%)	(%)	(%)	(%)
Stage 1	972.5	4	41	23	100	0.4
Stage 2	105.8	10	49	24	309	3.6
Stage 3	21.6	100	62	44	100	27.5

Exhibit 4.19. The expected credit loss for loans to customers at year-end 2020. Consolidated.

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 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

guidelines from EBA and the Central Bank of Iceland, these moratoria did not trigger classification as forbearance. After the agreement expired, further extension of moratoria has been granted on a case-by-case basis, but such extensions are classified as forbearance. The definition of forbearance includes a 24-month probation period and therefore loans are classified with forbearance even after normal payments have resumed. At the end of 2021, loans amounting to ISK 94bn are classified as performing with orbearance, of which 58%, ISK 54bn, have resumed repayments. Performing loans with forbearance that have not yet started regular payments are almost exclusively in the tourism industry.

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 strong 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 Bank'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 an adjustment is warranted.

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 the pandemic subsides and international tourists begin visiting Iceland again. This classification reflects an assessment of how much an increase in credit risk these companies face in the short, medium, and long term.

All loans to customers in groups 2-4 were transferred to Stage 2 and thus carry a life-time expected credit loss. In addition, an overlay factor has been applied to the expected credit loss, comparable to an increase in up to three risk classes. A higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios.

The formal risk class is under continuous review and as the current risk class is updated to reflect the present status of the customers the overlay from the impact group is less important. In addition, the financial performance of the companies has been better than initially expected and therefore the distribution in impact groups has been improving. The proportion of exposure in impact groups 3 and 4 has decreased from 70% to 19% in 2021. The classification, shown in Exhibit 4.21, is based on the Bank's best assessment, and will be updated as needed.

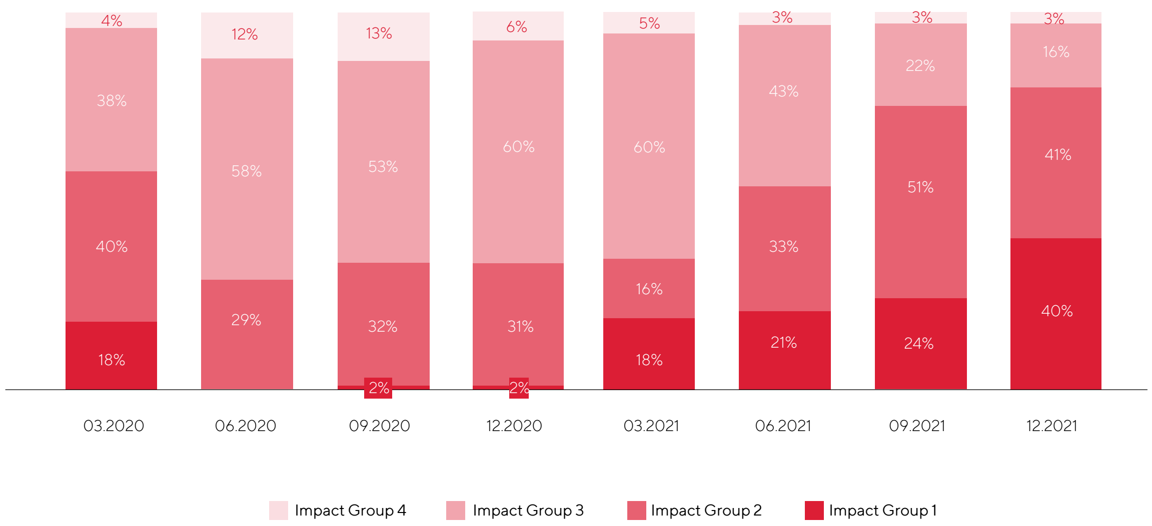
Impact Group 1: Viable even though fewer tourists arrive than expected

Impact Group 2: Viable with forbearance even though fewer tourists arrive than expected

Impact Group 3: Viable if the number of tourists is similar to general expectations

Impact Group 4: Viable only if the tourism industry fairs better than expected

Exhibit 4.21. Exposure to tourism by impact group from the start of the pandemic. The focus in the beginning was on the 2020 tourist season while at year-end 2021 the definition had shifted towards 2022. Net carrying amount, a proportion of approximately ISK 100bn.



4.11 Exposures in Default and Exposures with Forbearance

The Bank's definition of default is described in Section 4.2.1. Exposure amounts in default can be seen in Note 49 of the Consolidated Financial Statements where stage 3 corresponds to amounts in default. Furthermore, template CR1, CQ4, and CQ5 of the Additional Pillar 3 Disclosures show these amounts broken down by asset class, geographic region, and industry sector.

Template CR2 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 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 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 51 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. Template CR5 of the Additional Pillar 3 Disclosures shows exposure amounts, risk weights and corresponding risk-exposure amounts for the different portfolios at year-end 2021.

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. 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, land acquisition, development and construction exposures, 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 34.6% in 2021 according to the stock market index OMXI10GI. The return of the domestic bond market was 1.2%, as measured by the NOMXIBB index, with total turnover falling by 34% compared to 2020. The Central Bank raised its policy rate four times in 2021, raising the rate from a historical low of 0.75% to 2.00% during the year. Inflation was above the Central Bank's target in 2021 as the Consumer Price Index rose by 5.1% and the ISK appreciated by 2.5% based on the Central Bank main trade-weighted ISK index.

Market risk accounted for 10.5% of the Group's total SREP capital requirement in 2021, compared to 6.4% in the previous year. The Group's market risk fell somewhat in 2021, mainly due to a lower inflation imbalance as well as falling interest rate risk.

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, trading book and 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 and Investment Banking and the managing director of Finance and 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 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.

5.2.1 New Regulatory Limit on Positions in Financial Instruments and Commodities

On January 1, 2022 an amendment to Act No. 161/2002 on Financial Undertakings came into effect along with an accompanying regulation from the Central Bank meant to limit potential risk posed by investment banking activities of commercial banks in Iceland. The regulation defines a limit on positions in financial instruments and commodities, excluding bonds in the banking book. Specifically, the regulation places a limit of 15% of total capital base on the aggregate total capital requirement for (1) equities in the trading book, (2) equities in the banking book, (3) bonds in the trading book and (4) indirect positions in financial instruments and commodities. The total capital requirement shall be measured in line with the Central Bank's SREP Supervisory Benchmarks. The first three components fall directly under market risk whereas the fourth is defined as credit risk due to loans to holding companies with limited debt

Exhibit 5.1. Main types of market risk within Íslandsbanki.

Risk type	Description	Origination	Main limit types
Equity risk	The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of equity instruments	- Equities	- Total position in equities - Total position in individual securities
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: **Gap risk:** Arising from mismatches in the timing of cash flows of assets and liabilities in the banking book and the resulting effects of changes in the yield curve (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 **Price risk:** Arising from price changes of bonds due to changes in interest rates	- Loans and deposits - Bonds and debt instruments - Interest rate derivatives	- BPV (basis point value) - Total position in individual securities
Inflation risk	The risk that earnings or capital may be negatively affected from unexpected changes in inflation	- Inflation-linked loans and deposits - Inflation-linked bonds and debt instruments - Inflation-linked derivatives	- Size of the inflation imbalance
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
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

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

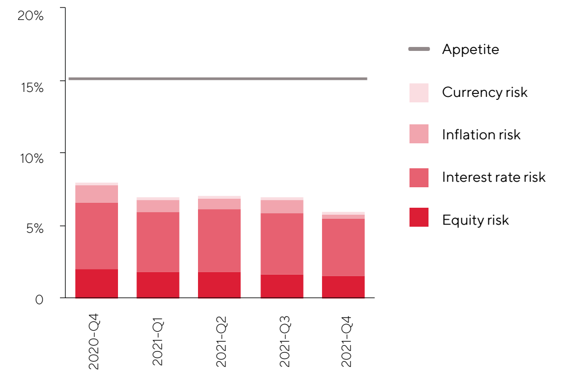
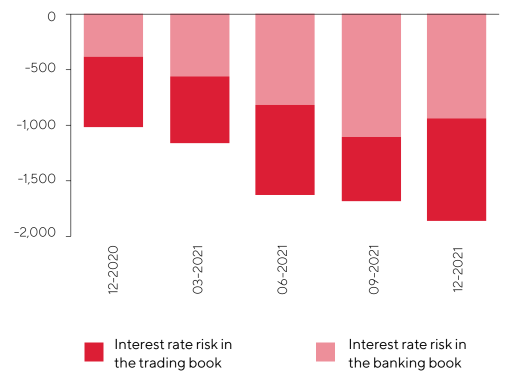


Exhibit 5.3. Quarter-end development of equity risk in 2021. (ISK m). Consolidated.

Exhibit 5.4. Quarter-end development of interest rate risk in 2021. 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). Consolidated.



repayment capacity. The Bank will measure and monitor this new ratio, but the regulatory limit is not expected to be constraining given the Bank's market risk profile and appetite. Based on Q2 2021 figures, the Central Bank has calculated the ratio as 3.7% which is well within the 15% limit.

5.3 Market Risk Exposure

Market risk, as measured by the MRMF, decreased in 2021. This was mainly due to a decreasing inflation imbalance in the second half of the year and lower interest rate risk in the banking book. 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.

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 2021 are presented in Exhibit 5.3. Equity exposure in the trading book increased in 2021 with an average position of ISK 1.9bn compared to ISK 1.3bn in 2020. The maximum equity exposure in the trading book was ISK 2.9bn in 2021 compared to ISK 2.3bn in 2020. Equity exposure in the banking book, including fair value shares and shares held for sale, was relatively stable during the 2021 and finished the year at ISK 5.8bn, unchanged from the end of 2020. The Group has no equity underwriting positions.

5.3.2 Interest Rate Risk

To manage interest rate risk, the Bank uses sensitivity measures like basis point value (BPV). The BPV measures the effect of a 0.01 percentage point (1 basis point) parallel upward shift in the yield curve on the fair value of the underlying position. In 2021, the Group's interest rate risk in the trading book rose and the duration of index-linked liabilities in the banking book fell. That increased the Group's net interest rate exposure as measured by a 100 bp parallel shift across currencies, shown in Exhibit 5.4.

Interest Rate Risk in the Trading Book

The Group's interest rate exposures in the trading book arise 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 in 2021 as the Bank grew its ISK liquidity bond portfolio, which has been the main source of interest rate risk in the trading book since the spring of 2020 when the Bank started to move a larger share of its ISK liquidity portfolio from Central Bank deposits to interest rate sensitive bonds. 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 975m in 2021 compared to ISK 759m in 2020. An overview of the Bank's interest rate risk in the trading book is provided in Note 59 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.

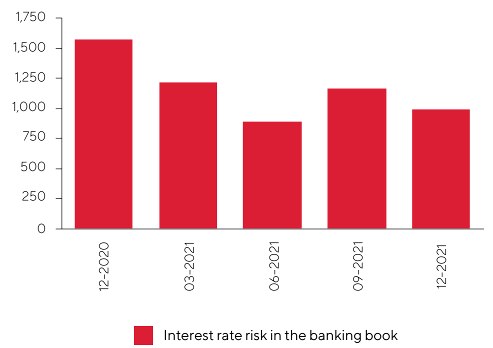
Interest rate risk in the banking book is managed by limits on the sensitivity of the fair value of the Bank's assets and liabilities to changes in market rates. All interest-bearing assets and liabilities are bucketed according to their next interest rate reset date, and the effect of a 100 basis points 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 59 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 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 2021 based on this weighted adverse 100 BPV is shown in Exhibit 5.5. Measured this way, interest rate risk in the banking book fell in 2021, as the gap between non-index-linked assets and liabilities narrowed and index-linked interest rate exposure changed from being long liabilities to being long assets.

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. The inflation imbalance in the banking book fell in 2021, mainly due to a shrinking portfolio of inflation-linked assets in the second half of the year. Exhibit 5.6 shows the development of the Group's banking book inflation imbalance in 2021.

Exhibit 5.5. Quarter-end development of interest rate risk in the banking book in 2021 (weighted adverse 100 BPV in ISK m). Consolidated.



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 2021. The size of the currency imbalance was modest throughout the year. The overall consolidated currency imbalance was ISK -0.3bn at year-end 2021 compared to ISK 5.1bn at year-end 2020.

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, 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

Exhibit 5.6. Quarter-end development of the banking book inflation imbalance in 2021 (ISK bn). Consolidated.

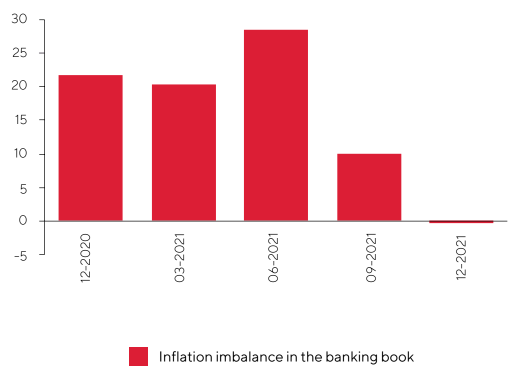
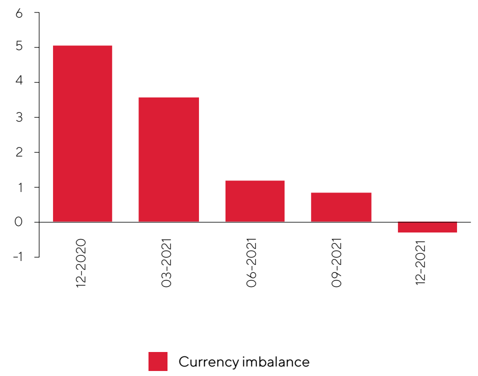


Exhibit 5.7. Quarter-end development of the currency imbalance in 2021 (ISK bn). Consolidated.



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.

In June 2021, Parliament passed a new Foreign Exchange Act, no. 70/2021. The act removes the last of the capital account restrictions imposed in November 2008. Accompanying the act were new rules on derivatives trading set by the Central Bank, restricting derivatives transactions in which the ISK is specified in a contract against foreign currency. The rules impose a limit on each bank's gross forward position in foreign currency against the ISK, both for individual counterparties and in aggregate, of 10% and 50% of a bank's total capital base, respectively. At year-end 2021, Íslandsbanki's aggregate gross forward position in foreign currency against the ISK amounted to 21% of the Bank's total capital base, well within the limit.

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 24 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 template 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 2021 the main add-on for market risk under Pillar 2-R was a result of 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 2021 and all regulatory metrics were well above limits. At year-end 2021 the Bank's Liquidity Coverage Ratio (LCR) was 156% and the Net Stable Funding Ratio (NSFR) was 122%.

The year-end balance of deposits rose by approximately ISK 38bn from 2020 to 2021. The change was mainly due to an increase in retail deposits (ISK 28bn) and deposits from corporation (ISK 40bn), offset by a fall in deposits from domestic and foreign financial institutions (ISK 30bn).

The Bank continued to be a leading bond issuer domestically in both covered and senior unsecured formats. The Bank continued its sustainable progress in 2021 tapping its green bond in ISK, the first Green Bond by an Icelandic bank, twice for a total of ISK 4.0bn, bringing the size of the bond to ISK 6.7bn.

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.

[1] FME Guidelines no. 2/2010 for Sound Liquidity Risk Management and 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 has incorporated the LCR and the NSFR based on the CRD IV standards into the *Rules on Liquidity Ratio* and the *Rules on Credit Institutions' Minimum Net Stable Funding Ratios.*[3] At the end of 2021, the minimum liquidity coverage ratio in Icelandic króna was 30%, increasing to 40% in 2022 and finally reaching 50% at the beginning of 2023.

The minimum of 100% for the overall NSFR was implemented in 2021. The new rule supersedes the previous rules that required the Bank to maintain a 100% funding ratio in foreign currencies. 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. As the COVID-19 pandemic started in spring 2020, the CB increased the LCR reporting frequency to weekly in order to better monitor the liquidity status but scaled the requirement back to monthly mid-2021. 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 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 2021 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 2021 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

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

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.

Even though the LCR is fairly stable over time, significant changes can arise from new bond issues, large deposit changes and issues falling into the 30-day window. Throughout 2021 the net outflow changes were in line with the increase in HQLA. However, the LCR in domestic currency did show a steady increase in 2021 mainly due to increasing HQLA. Level 1 HQLA assets hold the most significant

[2] Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision
[3] Central Bank Rules no. 266/2017 and no. 750/2021
[4] EBA draft implementing standards on additional liquidity monitoring metrics

Exhibit 6.1. LCR for all currencies. Consolidated

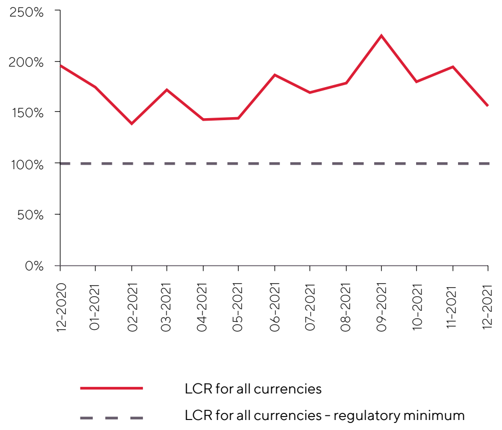
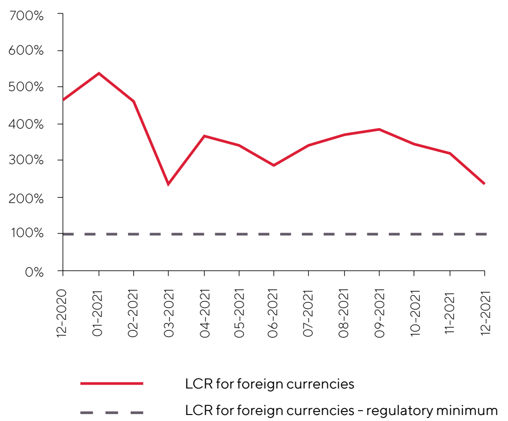


Exhibit 6.3. LCR in foreign currency. Consolidated.



portion of the Bank's total HQLA for the period. Level 1 assets primarily include cash and balances with the Central Bank and government bonds. Level 2A assets solely comprise covered bonds and amount to less than 10% of the HQLA. The Bank calculates and monitors LCR for all significant currencies (exposure

Exhibit 6.2. LCR in ISK. Consolidated.

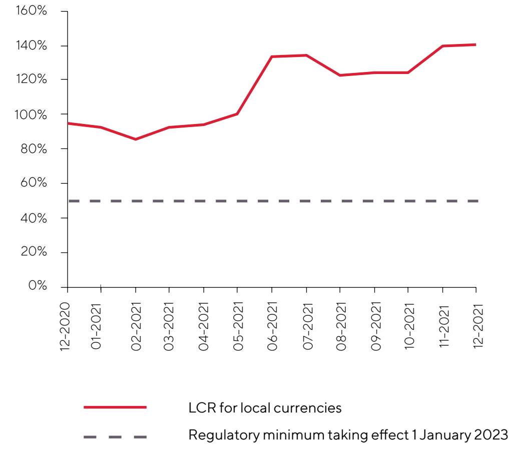
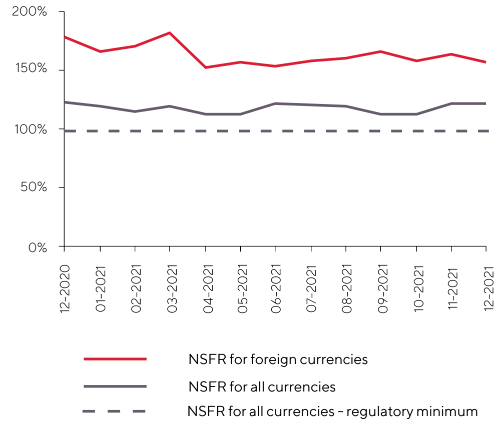


Exhibit 6.4. NSFR for all currencies and NSFR in foreign currency. Consolidated



over 5%) and foreign currencies combined. The currency mismatch risk is not considered a material driver for the LCR.

The EU LIQ1 in the Additional Pillar 3 Disclosure shows the breakdown of the Group's positions underlying the LCR in 2021. According to the LCR disclosure standards, the figures show the average of end-of-month positions throughout 2021 as opposed to the year-end figures in Note 56 in the Consolidated Financial Statements.

6.4 Funding

The Bank monitors the concentration of funding to avoid undue reliance on individual funding sources and continues to be predominantly funded by deposits although borrowings through bond issuance amount to 37% 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 35 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.

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

The amount of *Available Stable Funding* (ASF) is measured based on the assumed relative stability of an institution's funding sources reflected in the corresponding ASF factor. The available amount of stable funding is 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 2021 while the development in 2021 can be seen in Exhibit 6.4.

6.4.2 Deposits

The Loan-to-deposit ratio for households and non-financial corporations was 178% at year-end 2021 compared to 186% at year-end 2020. The reduction is mainly due to growth in loans to customers exceeding growth in deposits to customers. 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 38bn over the course of the year 2021 as shown in Exhibit 6.5. The change was mainly due to an increase in retail deposits (ISK 28bn) and deposits from corporations (ISK 40bn) which was offset by a fall in deposits from domestic and foreign financial institutions (ISK 30bn). In Q2 the deposits grew temporarily due to the settlement of the Bank's IPO.

The proportion of term deposits decreased from 25% of total deposits at year-end 2020 to 18% at year-end 2021. The decrease was mainly due to a reduction in term deposits from financial institutions and pension funds. For a more detailed composition of deposits by LCR categories and term see Note 56 in the Consolidated Financial Statements.

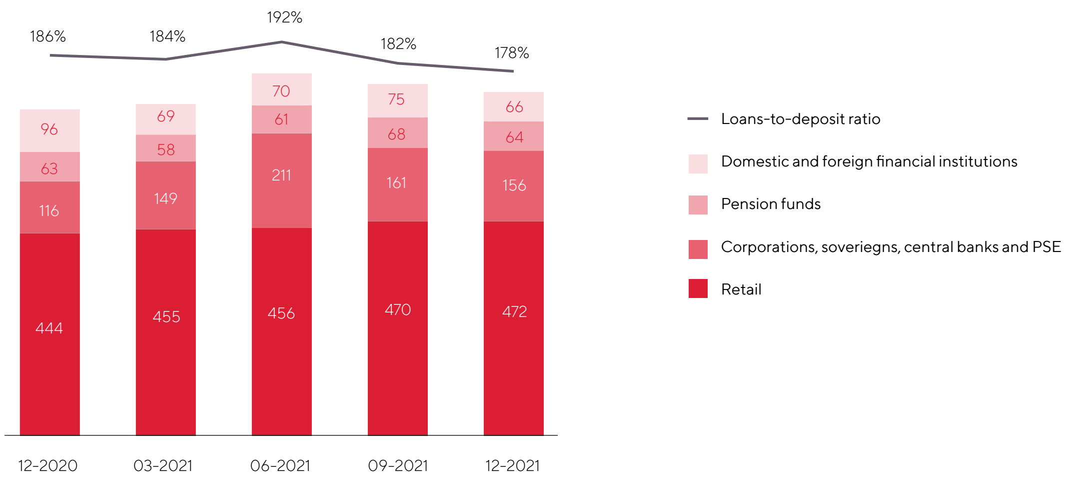
Deposit concentration is monitored since a substantial amount of the Bank's deposits are held by relatively few counterparties. The Bank's highest deposit concentrations are in wholesale deposits from foreign and domestic financial institutions and pension funds. The deposit concentration fell in 2021 from 16% to 12% of the Bank's deposits belonging to the 10 largest depositors and from 31% to 28% 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 270bn 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 covered bonds worth ISK 39bn in 2021, compared to ISK 29bn in 2020. This activity was in line with the domestic issuance plan for 2021 which assumed new covered bond volumes of ISK 30–35bn. Liquidity has remained strong in the Bank's covered bonds

Exhibit 6.5. Deposits by liquidity coverage ratio category in 2021 (ISK bn) and the Loan-to-deposit ratio for households and nonfinancial corporations. Consolidated.



and yields fell during the year. The total outstanding nominal amount of covered bonds at year-end 2021 was ISK 199bn, thereof ISK 121bn CPI-linked.

The Bank tapped its green bond in ISK, ISB GB 25 1,126, twice this year for a total of ISK 4.0bn, bringing the size of the bond to ISK 6.7bn.

In overseas funding markets, the main development over the course of most of the year was the steady tightening of Icelandic bank secondary bond spreads. This tightening not only reversed the widening of 2020 but went far beyond it. In November 2020 Íslandsbanki issued a €300m sustainable bond maturing in November 2023. The heavily oversubscribed issue was launched at a spread of mid-swaps +100 basis points (bps). This transaction, the most liquid that the Bank has outstanding in EUR, performed very steadily over the course of 2021, tightening eventually to mid-swaps +21 bps by mid-November.

Over the course of the COVID-19 pandemic the Icelandic economy demonstrated considerable resilience to the sharp reduction in tourist income. Íslandsbanki recorded strong quarterly results throughout 2021 and secondary markets rewarded this performance, as it did for the other Icelandic banks, with sustained spread compression. Only at the end of the year did spreads generally widen on the back of investor fatigue, anxieties around global inflation, the progress of the pandemic and disparate global geo-political concerns.

The most significant foreign currency issue that the Bank undertook in 2021 was its inaugural Additional Tier 1 (AT1) transaction. The deal, launched on 21 September, was a SEK 750m perpetual note, callable from year 10, that pays a coupon of 3-month STIBOR +475 basis points. The loss absorption mechanism was a 5.125% CET1 trigger, temporary write-down structure – the first time such a mechanism had been used in Iceland. The notes were placed with investors across the Nordic countries, France and Switzerland and were rated BB- by S&P.

Otherwise, the Bank issued a number of private placements of senior debt during the year, amounting to SEK 900m and NOK 1,375m in maturities ranging between 3 and 4 years.

Exhibit 6.6 provides a summary of how the maturity of outstanding bond issues is distributed over the coming years and Note 35 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:

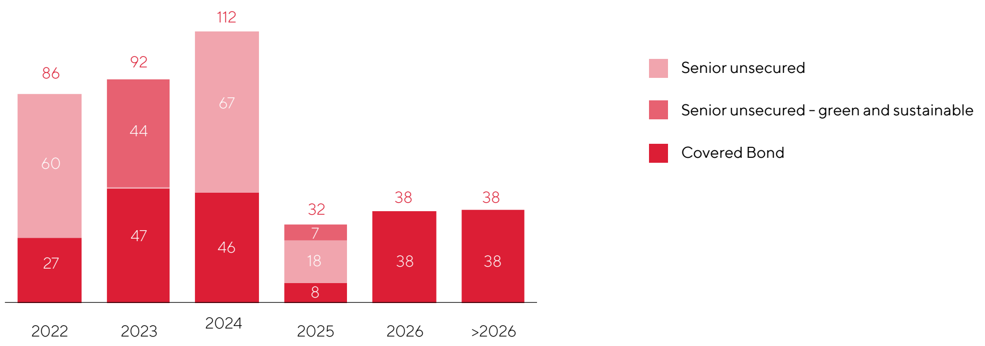
- Loans and securities serving as collateral for covered bond issuance which is one of the Bank's strategic long-term funding sources
- Cash and securities as collateral for currency swap agreements
- Central Bank (CB) term deposits for the payment system

Íslandsbanki asset encumbrance ratio was 19.6% at year-end 2021 and Exhibit 6.8 shows the development of the reported encumbrance in 2021.

6.4.5 Funding Outlook

The Bank estimates that issuance of covered bonds will be in line with previous years. In addition, the Bank plans to continue issuing senior bonds in ISK in a continued effort to promote and develop the domestic bond market. The timing and size of such issues depend on the Bank´s funding needs and market conditions.

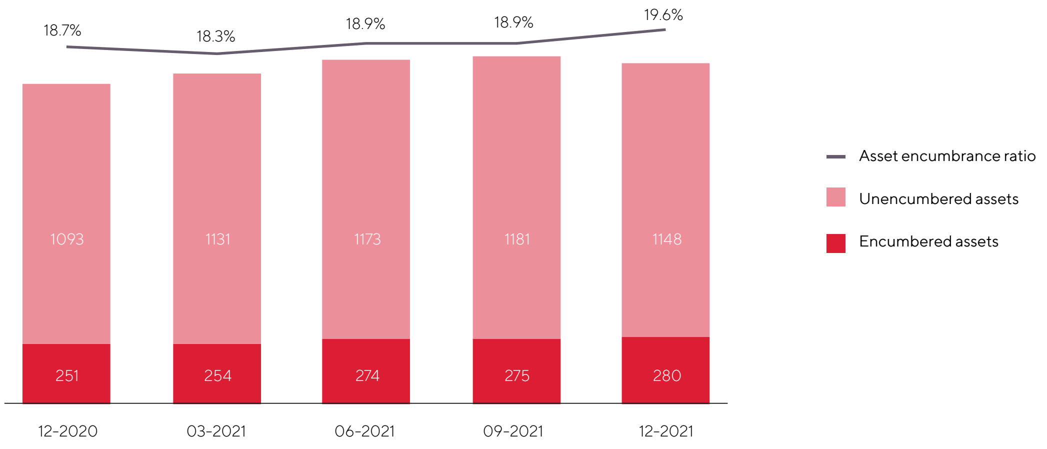
Exhibit 6.6. Maturity profile of long-term funding (ISK bn) as of year-end 2021. Parent.



Issuance under the GMTN Programme will depend largely on loan growth in foreign currencies as well as on upcoming maturities. The Bank aims to continue optimising its capital structure by issuing further Additional Tier 1 capital instruments. The Bank has currently fully utilised its capacity to issue Tier 2.

The Bank will look at further opportunities to diversify funding channels where appropriate. At the same time, green financing in 2022 will be in line with the Bank's strategy, both issuing new sustainability bonds and tapping existing issues.

Exhibit 6.7. Development of asset encumbrance in 2021 (ISK bn). Consolidated.



7 Operational Risk

As the COVID-19 pandemic has prolonged, the Bank has adjusted its operations to maintain operational resilience. A special task force that had been in place from the beginning of the pandemic was dissolved as the Bank´s governance is fully capable of managing its operations in a situation that has now become the new norm. During the pandemic, Business Continuity management has been prioritised, therefore the Bank has remained fully operational over the past two years. Extra effort has been taken to manage and monitor ICT and security risk as there has been increased risk of cyber security events. The Bank is constantly assessing and improving its defences against cyber attacks in order to adapt to the ever-evolving cyber threats. Financial loss that can be directly or indirectly linked to COVID-19 related operational events was insignificant for the Bank in 2021.

The Bank has changed the approach for calculation of capital requirements for Pillar 1 from Basic Indicator Approach to Standardised Approach.

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, ICT and security 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 which establishes both the Operational Risk Policy and the Risk Appetite for operational risk.

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 outweigh 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 resolution of IT incidents; define and meet service-level objectives for digital solutions, in line with the Bank's vision to be #1 for service; and protect information and data from loss of confidentiality.
- A key feature of the business continuity management framework is based on having clear overview of core business activities, and clear roles and responsibilities for business continuity management, with regular testing of all business continuity plans.
- 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 and significant changes, services, new outsourcing or new 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 *Significant 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.

The Compliance function is responsible for monitoring compliance risk regarding Anti-money laundering and to monitor that the Bank is always in compliance with its obligations as provided for in the Act on markets for financial instruments and Act on measures against market abuse.

7.2 Measurement and Monitoring

The main processes for measuring and managing operational risk are the business continuity management framework that is comprised of but not limited to 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).

The number of risk events in the Bank's LED increased by 9% in 2021 compared to 2020 and there was a 77% fall in registered losses, with most of the recorded operational risk events occurring without financial loss. Most of the recorded operational risk events occurred without financial loss. Loss events are is categorised according to the Basel event type classification. The loss events in the categories "Business disruption and system failures" and "Execution, delivery and Process Management" accounted for 63% of the total number of events in 2021. The loss events in the category "Execution, delivery and process management" accounted for 63% of the total loss amount attributed to operational risk in 2021.

Aggregated registered operational risk losses in any given quarter shall not exceed a given percentage of the 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.

Money laundering risks are identified in accordance with the Act on Measures against Money Laundering and Terrorist Financing[1]. 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. The Bank's employees are regularly trained to ensure knowledge of changes in the regulatory environment and of new patterns, trends and methods that could be used for money laundering and terrorist financing. The Bank's employees are regularly trained to ensure knowledge of changes in the regulatory environment and of new patterns, trends and methods that could be used for money laundering and terrorist financing.

A siginificant increase in cyber security threats, including supply chain attacks, and fraudulent events has been observed worldwide in 2020 and 2021. The Bank has placed special focus on reviewing and improving effectiveness of relevant controls and on offering training to employees and customers on how to respond to fraudulent incidents to minimise possible losses. Further information about online security is on the Bank´s website.

7.3 Mitigation

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

[1] Act no. 140/2018 on Measures against Money Laundering and Terrorist Financing

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 Capital Requirement

The Bank has moved to the Standardised Approach for the calculation of the capital requirement under Pillar 1, previously the Basic Indicator Approach was in place. The Bank's operational risk management framework already fulfils the criteria for the Standardised Approach according to the Capital Requirements Directive (CRD IV) and Icelandic law and regulations. Under the Standardised Approach, all activities of the Bank are mapped into the business lines according to Art 317 in CRR in a mutually exclusive and jointly exhaustive manner. The capital requirement for operational risk for each business line is then calculated as the product of the corresponding beta factor and the average over three full calendar years of the sum of net interest income, net fee and commission income and net other financial income in that business line. The Pillar 1 capital requirement for operational risk was ISK 6.4bn in 2021 compared to ISK 6.8bn in 2020. The reduction is mostly due to the change to the Standardised Approach.

8 Sustainability Risk

In 2021 the Bank continued to emphasise sustainability risk and further develop its methods to identify, measure and manage sustainability risk. The highlights of the year include incorporating an ESG risk assessment to assess corporate customers, joining the Science Based Targets initiative (SBTi), and finishing the measurement of downstream scope 3 emissions. Reitun, an Icelandic rating company in the field of sustainability, gave the Bank 90 points out of 100 in an ESG assessment, which is the highest rating the company has currently given in Iceland. Furthermore, the Bank received an annual reward called Kuðungurinn from the Government of Iceland in recognition for its contribution to environmental issues.

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. In addition, other non-climate related risks have been considered using the same structure.

Sustainability risk is the risk of being directly or indirectly negatively affected by externalities within the areas of environmental, social, and governance considerations, such as climate change, biodiversity, anti-corruption, human rights, labour conditions, data privacy, or business ethics.

8.1 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, Compensation*, and *Human Resource* subcommittee of the Board assists the Board in fulfilling its oversight responsibilities concerning sustainability. The monthly Risk Dashboard includes a section on current sustainability risk and the Bank's ICAAP methodology mandates a separate chapter on possible future sustainability risk, both at the Board-level.

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 related to sustainability. The Committee is independent from credit committees and needs to approve proposals for sustainable loans and investments 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. A separate Sustainability Working Group consists of employees from different business areas and departments within the Bank, and mainly focuses on educating members on important issues around sustainability.

The Board sets the *Risk Appetite Statement*, which includes a qualitative statement on sustainability risk which is in line with the Bank's Sustainability Principles, as stated in the Sustainability Policy.

When taking on new business or evaluating proposals, in relation to existing business relationships, the Bank shall aim for full alignment with the Sustainability Principles.

8.2 Strategy

Íslandsbanki will focus on integrating sustainability considerations into its activities, in addition to its profit objectives. The Bank continues 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 United Nations Sustainable Development Goals (UN SDGs). The Bank has specifically selected UN SDGs in the areas of education, gender equality, innovation, and climate action to guide its sustainability efforts.

Íslandsbanki´s sustainability objectives through 2025

1. Achieve full carbon neutrality no later than 2040.
2. Offer its customers a wide range of sustainability products.
3. Encourage equality and inclusion through products and services.
4. Further increase diversity and inclusion in the workplace.
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 2021, the Bank committed to net zero emissions by 2040. The commitment is mainly focused on the Bank´s financed emissions, as the operations have been carbon neutral since 2019. To honour the commitment the Bank joined PCAF in 2020, the Net Zero Banking Alliance in 2021 and committed to the Science Based Targets initiative in 2021. The PCAF partnership is aimed to harmonise greenhouse gas accounting methods and stipulate a consistent method to measure the emissions financed by its loans and investments. The initiative focuses on how companies achieve their carbon reduction targets so they align with the Paris agreement. For financial institutions the framework addresses the lending and investment activities.

Íslandssjóðir, a subsidiary of the Bank, is a member of UN Principles for Responsible Investments. The six principles, which include incorporating ESG issues into investment practices, encourage investors to use responsible investment to enhance returns and better manage risks.

The Bank has a Code of Ethics for its Suppliers based on ESG criteria. 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 utilising the Code, the Bank ensures that purchases of goods and services are efficient, non-discriminating, and transparent. In 2021, the Bank started assessing its suppliers according to ESG risk. The assessment is used both as a tool for the Bank to distinguish risk and to encourage suppliers to increase their focus on sustainability.

Equality and the participation of all are important to the Bank that strives to ensure equality and diversity within its ranks. A limit has been set to ensure that the proportion of any gender in the Bank's management team does not reach above 60%. Specific equality goals have been set in the Bank's investment banking and information technology departments where the gender proportion is currently not equal. The Bank has a Gender Equality Policy on equal pay, which supports wage decisions, based on informed decisions, and preventing gender-based discrimination. The Bank has a Gender Equality Policy on equal pay, which supports wage decisions, based on informed decisions, and preventing gender-based discrimination.

8.2.1 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.

8.2.2 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 overall credit process and the credit risk culture 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 activities, 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 UN SDGs and the *Paris Climate Agreement*.

8.3 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.

Even though the Bank's operations are not carbon intensive and climate change does not influence day-to-day operations, the Bank is exposed to climate risk through its customers. Both transition risk and physical risk can cause, for example, lower

Íslandsbanki is part of the following networks:

profitability in some sectors and decrease real estate value through specific acute events such as flooding and mudslides, resulting e.g. in higher probability of default and loss given default.

The Bank analyses the potential financial impact of both transition risk and physical risk across business sectors in the form of a heatmap. The heatmap is a qualitative assessment that maps out where possible climate related risk factors may lie in the portfolio. It is divided into two time periods, 1-5 years and 5 years and longer.

The Bank has performed exploratory climate stress tests scenarios against its portfolio. The aim of the analysis is to identify what sectors of the Bank´s portfolio may have high adverse impacts on the environment. The sectors are then further analysed in comparison to the Climate Action Plan of the Government of Iceland. The Bank will continue to further enhance the climate stress testing methodologies in the year 2022.

The Bank conducts regular training sessions for employees on climate risk to further enhance their abilities to engage with customers, as well as identify opportunities and threats related to climate related matters. The Bank also mitigates risk by offering a wide variety of educational courses on social and governance related matters. The aim of the courses is to educate staff, open the discussion and be an inclusive workplace for all of society, regarding both customers and staff.

8.3.1 ESG Risk Assessment

To identify systematically and manage ESG risks, the Bank has set up a framework that analyses borrowers based on environmental, social, and governance factors. The aim is to assess customers and counterparties behind most of the Bank's portfolio, including loans to customers, loans to credit institutions, bonds and debt instruments, equities, and investments. The ESG assessment should reflect risks that may lead to borrowers not being able to repay loans or the value of assets declining. It is therefore an assessment of financial risk for the Bank.

Exhibit 8.1. Climate risk drivers, transmission channels and how the can impact financial risk categories. Source: Adapted from EBA report on Management and supervision of ESG risks for Credit institutions and investment firms.

Climate risk

TRANSITION RISK
Policy and legal
Technology
Market behavior
Reputational

PHYSICAL RISK
Acute
Chronic

Transmission channels

Lower profitability
Lower real estate value
Lower household wealth
Lower asset performance
Increased cost of compliance
Increased legal cost

Financial risk

CREDIT RISK
Probabilitiy of default and loss given default increases
Lower collateral valuations

MARKET RISK
Shift in market prices
Stranded assets

OPERATIONAL RISK
Physical damage
Business continuity

LIQUIDITY AND FUNDING RISK
Clients withdrawing deposits
Refinancing risk

8.4 Metrics and Targets

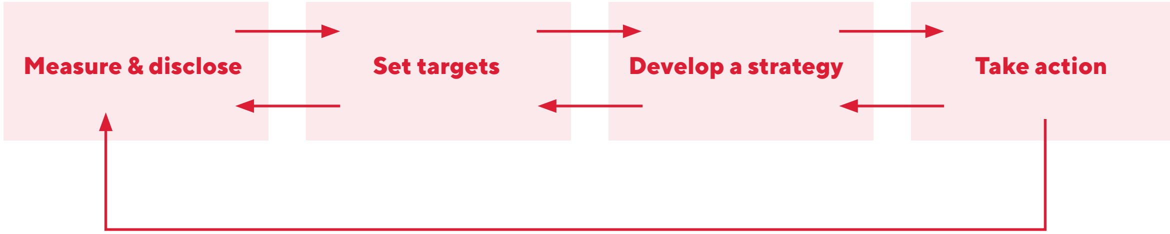
The Bank has measured its emission of greenhouse gases, both direct and indirect, and has done so from 2017. The Bank reports detailed information about the environmental, social, and governance impact of its operation in accordance with the Nasdaq ESG Guidelines and relevant GRI standards.
The Bank has recently measured and published its scope 3 financed emissions for the first time. The measurement was conducted according to the PCAF methodology for the years 2019 and 2020. The PCAF measurement will be used to assess climate related risks and opportunities and it lays the foundation for mapping the path to net zero emissions.

The Bank’s disclosure on metrics and targets related to climate risk is in the Annual and Sustainability Report as well in the PCAF report.

8.5 Next Steps

In 2021, the Bank took decisive steps to manage sustainability risk, including the ESG assessment for customers and suppliers, finishing the first PCAF measurement, joining SBTi, pledging to net-zero, and more. The Bank intends to further enhance its capabilities to identify, manage, and mitigate ESG related issues in the future, such as publishing an approved Science Based Target and continuing the ESG assessment of the Bank's customers. The plan for the Bank's path to net zero 2040 is already underway and will be aligned with the guidelines to ensure rigorous and transparent approach. Based on a more detailed climate risk identification, metrics will be defined, and targets set.

Exhibit 8.2: The path towards net-zero emissions described. Source: Adapted from PCAF's Global GHG Accounting and Reporting Standard for the Financial Industry, pg. 10.



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 Committee

The Corporate Governance and Human Resource Committee serves as the compensation committe. The committee comprises three members from the Board of Directors. The role of the committee is to guide the Board of Directors and CEO on deciding the terms of employment of senior management and other key employees, as well as ensuring that the terms of employment are in accordance with the Compensation Policy. The committee had seven meetings in the year 2021. Further information on composition of the committee and its mandate can be found on the Bank´s website.

Compensation Committee

9.3 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.

The Compensation Policy shall support sound operations in the long term and not encourage unreasonable risk-taking. It is the Bank's goal that the terms of employment of executives and other employees are competitive yet balanced without being leading in the market. In determining the terms of employment, responsibility and performance shall be taken into account, as well as equal rights perspectives.

Compensation Policy

9.4 Remuneration in 2021

Salary and other benefits of the Bank's management and the Board of Directors are disclosed in Note 12 in the Consolidated Financial Statements. No deferred remuneration is outstanding from previous remuneration scheme. Further information regarding remuneration can be found in the remuneration templates REM1 – 5 in the Additional Pillar 3 Disclosures.

10 Abbreviations

ALCO	Asset and Liability Committee
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
CLTV	Cumulative Loan to Value
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CRO	Chief Risk Officer
DSTI	Debt service to income
EAD	Exposure at Default
EBA	European Banking Authority
ECL	Expected credit loss
ESG	Environmental, social and governance
EU	European Union
FME	The Icelandic Financial Supervisory Authority of the Central Bank of Iceland
FX	Foreign Currency
GMTN	Global Medium-Term Note
GRI	Global Reporting Initiative
HQLA	High Quality Liquid Assets
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
NPL	Non Performing Loans
NSFR	Net Stable Funding Ratio
ODF	Observed Default Frequency
OSC	Operations and Security Committee
PCAF	Partnership for Carbon Accounting Financials
PD	Probability of Default
RSF	Required Stable Funding
REA	Risk Exposure Amount
SBTi	Science Based Targets initiative
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
UN SDGs	United Nations Sustainable Development Goals