PILLAR 3 RISK DISCLOSURES **2012**

Arion Bank

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TABLE OF CONTENTS

1 INTRODUCTION

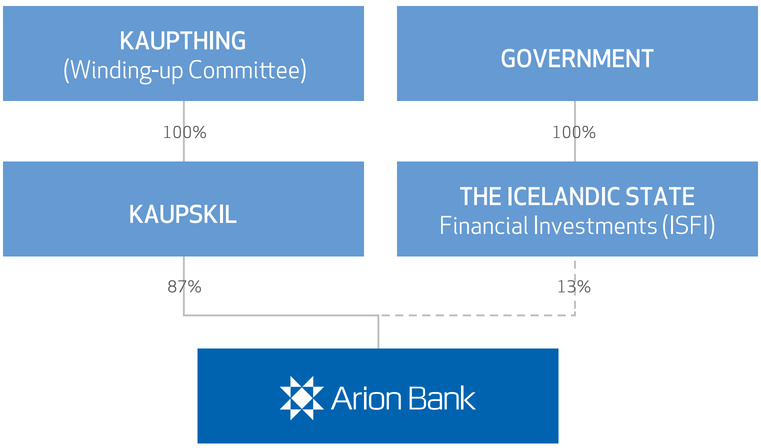
1 INTRODUCTION

Arion Bank is one of the leading banks in Iceland, with roots dating back to 1930. Arion Bank is a full-service domestic bank with a strong heritage and infrastructure. Arion Bank operates an extensive nationwide branch network with a focus on the capital city area. The Bank is growing in all business segments.

Following the onset of the global financial crisis in October 2008, Arion Bank was founded in accordance with the Icelandic Financial Supervisory Authority's (FME) decision from 21 October 2008. The FME's decision concerned the disposal of certain assets and liabilities of the failed Icelandic bank Kaupthing Bank hf. ('Kaupthing'), to New Kaupthing Bank hf. (now Arion Bank). With the decision, the domestic operations of Kaupthing were transferred to Arion Bank.

Following an agreement between the Icelandic government and Kaupthing's Resolution Committee in July 2009, the Resolution Committee announced that it intended to exercise its option to purchase 87% of the Bank's equity, and a subsequent capital injection took place in January 2010. Kaupthing, through its subsidiary Kaupskil ehf., now holds an 87% stake in the Bank. The remaining shareholding of 13% is held by the Icelandic State Financial Investments on behalf of the Icelandic government, see Figure 1.1. The Resolution Committee has been dissolved, according to an amendment to the Act on Financial Undertakings, and Kaupthing's Winding-up Committee has assumed all responsibility for managing the Kaupthing estate.

FIGURE 1.1 Ownership structure



INTRODUCTION

Arion Bank has been faced with numerous challenges, many of which are directly related to the way the Bank came into being. The previously mentioned transfer of domestic assets and liabilities from Kaupthing to the Bank created some unfavourable risk exposures for the Bank. Considerable success has been made in reducing these risk exposures down to an acceptable level. The Bank has focused on restructuring its loan portfolio, reducing credit concentration towards large and related parties, and expanding its sources of funding as well as reducing other mismatches and maintaining a high level of liquidity and capital.

Despite the progress made since its establishment the Bank still faces some challenges that need to be addressed. The ratio of problem loans in the total loan portfolio is still high. At the end of 2012 the ratio was 12.5% and progress has slowed over the past months. Single-name concentration in the Bank's loan portfolio is relatively high; the total sum of large exposure net of eligible collateral at the end of 2012 was 60% of capital base.

Sources of new long-term funding have been limited due to market conditions. The Bank has predominantly been funded through customer deposits which have largely been on demand deposits, 57% at the end of 2012. The Bank seeks to strengthen and diversify its funding base by increasing term deposits and securing alternative funding sources.

In January 2010 the Central Bank of Iceland granted the Bank a loan secured with certain assets which were transferred to the Bank from Kaupthing. At the end of 2011 the Bank took over as issuer of Kaupthing's structured covered bond program. The bonds in questions are covered bonds with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund (ABMIIF). Furthermore the Bank set up a statutory covered bond program in February 2012 after having been granted a licence from the FME. Arion Bank issued both inflation-linked bonds and fixed rate (non inflation-linked) bonds from the statutory program in 2012. These funding sources have contributed to the diversification of the Bank's long-term funding profile.

Since late 2008 the Icelandic economy has been subject to capital controls on almost all monetary transactions to and from Iceland, which have entailed low level of investment and limited access to funding. It remains uncertain when the capital controls will be lifted. The Bank has a strong liquidity position to meet any potential outflow of deposits that would be expected if the capital controls were to be lifted immediately.

Further information about the Bank is available in the Bank's 2012 Annual Report.

1.1 REGULATORY FRAMEWORK

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

The Basel II framework encompasses three complementary pillars:

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

INTRODUCTION

Under Pillar 3, capital adequacy must be reported through public disclosures that are designed to provide transparent information on capital structure, risk exposures, and the risk assessment process. The Basel II framework was implemented at European Union level by Directive 2006/48 on the taking up and pursuit of the business of credit institutions and Directive 2006/49 on the capital adequacy of investment firms and credit institutions, together referred to as the Capital Requirements Directive (CRD). The Directives were adopted into the EEA Agreement and implemented into Icelandic legislation with Act No. 170/2006 and Act No. 75/2010 amending Act No. 161/2002 on Financial Undertakings and Rules of the Icelandic Financial Supervisory Authority No. 215/2007 on the Capital Requirements and Risk Weighted Assets of Financial Undertakings with later amendments.

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

1.2 DISCLOSURE POLICY

The Bank has in place a formal Pillar 3 disclosure policy, approved by the Board of Directors, to address the requirements laid down in the CRD. The Bank may omit information if it is not regarded as material. Information is regarded as material in disclosures if its omission or misstatement could change or influence the assessment or economic decisions of a user relying on the information. Hence, where the Bank has considered information to be immaterial, it has not been disclosed.

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

1.3 PILLAR 3 RISK DISCLOSURES

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfil the aforementioned legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures have been reviewed, verified and approved internally in line with the Bank's Pillar 3 disclosure policy. The disclosures have not been subject to external audit but contain information from the Bank's audited Consolidated Financial Statements for 2012. Summarized information on risk management and capital adequacy is presented in the Bank's Annual Report and regulatory capital information is provided quarterly in the Bank's interim reports. The Bank's annual Financial Statements are audited by the Bank's external auditors, the half-year Financial Statements are reviewed by the Bank's external auditors but the Q1 and Q3 Financial Statements are unaudited.

The Pillar 3 Risk Disclosures have been prepared in accordance with regulatory capital adequacy rules and may differ from similar information in the Bank's Consolidated Financial Statements for 2012, which are prepared in accordance with International Financial Reporting Standards (IFRS). Therefore some information in these disclosures may not be directly comparable with the information in the Financial Statements.

All financial figures, calculations and information in the disclosures are based on 31 December 2012 and presented in ISK millions, unless otherwise stated. The disclosures are published on an annual basis in the Pillar 3 Risk Disclosures and are available on the Bank's website[1] following the annual general meeting.

http://www.arionbanki.is/english/about-us/investor-relations/financial-information/

INTRODUCTION

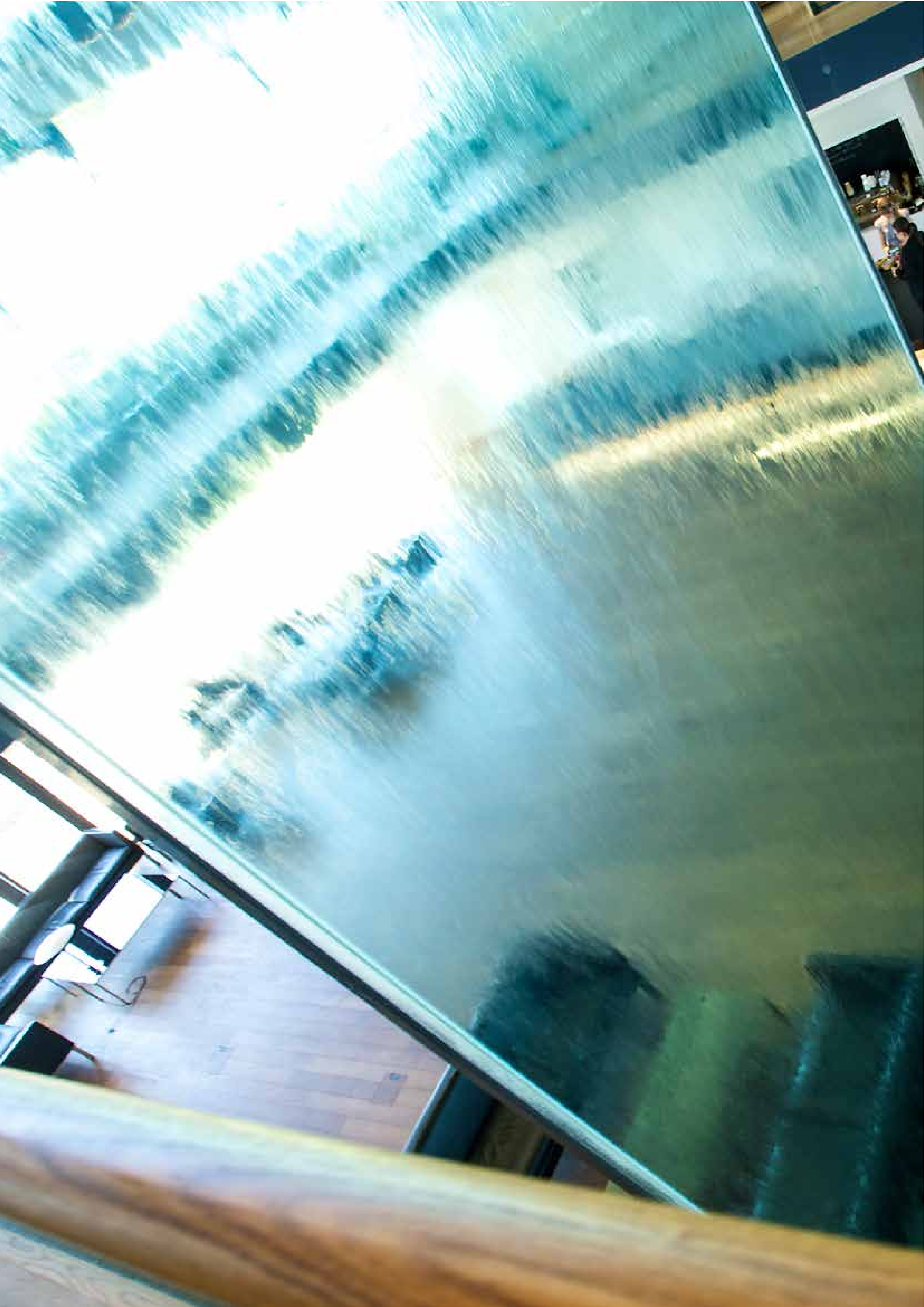
1.4 SCOPE OF APPLICATION

Information in the Pillar 3 Risk Disclosures refers to the Arion Bank Group, which consists of the parent entity, Arion Bank and its subsidiaries; henceforth together referred to as 'the Bank'. The Bank is subject to consolidated supervision by the FME. The basis of consolidation for financial accounting purposes is the same as for regulatory capital reporting purposes. All subsidiaries are fully consolidated. Subsidiaries, in which Arion Bank held a direct interest at the end of 2012 and are included in the consolidation, are shown in Table 1.1. Where necessary, a distinction is made in the report between the group and parent entity.

TABLE 1.1 Subsidiaries at the end of 2012, fully consolidated

Company	Business	Ownership %	Currency	Country
AFL - sparisjódur	Savings bank	99.3	ISK	Iceland
ALT ehf.	Asset management	100.0	ISK	Iceland
ABMIIF	Mortgages fund	100.0	ISK	Iceland
EAB 1 ehf.	Holding company	100.0	ISK	Iceland
Eignabjarg ehf.	Holding company	100.0	ISK	Iceland
Eignarhaldsfélagid Landey ehf.	Holding company	100,0	ISK	Iceland
Einkaklúbburinn ehf.	Discount club	100.0	ISK	Iceland
Gen hf.	Asset management	100.0	ISK	Iceland
GIR Fund Management Ltd.	Fund management	100.0	ISK	Cayman Isl.
Kaupthing Management Co. S.A.	Asset management	100.0	EUR	Luxemb.
Landfestar ehf.	Holding company	100.0	ISK	Iceland
NS1 ehf.	Holding company	100.0	ISK	Iceland
Okkar líftryggingar hf.	Life insurance	100.0	ISK	Iceland
Stefnir hf.	Asset management	100.0	ISK	Iceland
Tekjuvernd ehf.	Insurance sales company	100.0	ISK	Iceland
Valitor Holding hf.	Credit card service	60.8	ISK	Iceland

Core operation
Non-core operation



2 RISK MANAGEMENT

2 RISK MANAGEMENT

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

Risk transparency for senior managers helps them make better decisions. The risk management policy is to create and maintain a risk culture at the Bank whereby risk is everyone's business.

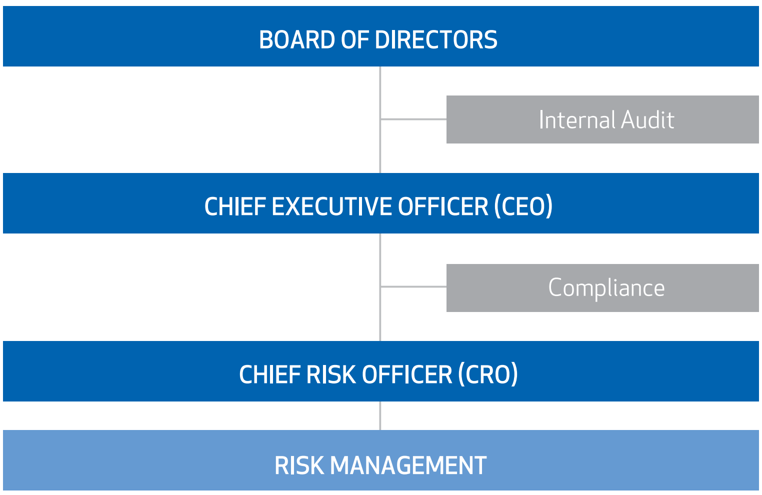
The Bank's strategy is to have effective risk control which includes the identification of significant risks, the quantification of the risk exposure, actions to limit risk and monitoring risk. The Executive Management Committee devotes a significant portion of its time to the management of these risks. The Bank's risk is most often categorized in four types; credit, market, liquidity and operational risk. Each type will be discussed in details in this report.

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

2.1 INTERNAL CONTROL AND LINES OF REPORTING

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

FIGURE 2.1 Internal control structure



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

Acting within an authority delegated by the Board, the Board Audit and Risk Committee (BARC), see Table 2.1, is responsible for the overseeing and reviewing of prudential risks including, but not limited to, credit, market, capital, liquidity, operational and reputational risk. The BARC reviews the Bank's risk appetite, see section 2.4, and makes recommendations thereon to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls and considering the implications of material regulatory change proposals.

The Compliance unit's objective is to reduce the Bank's risks of legal or regulatory sanctions, material financial loss, or loss to the Bank's reputation as a result of failure to comply with laws, regulations, or sound business practices applicable to its investment services. Furthermore, the Compliance Officer is also the Bank's Money Laundering Reporting Officer (MLRO), and as such is responsible for supervising the Bank's measures in accordance with the Act on Measures against Money Laundering and Terrorist Financing.

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

The CRO is a member of the Executive Management Committee and reports to the CEO. The CRO has overall day-to-day accountability for risk management in the Bank's parent company and periodic accountability for risk assessment in the Bank through the ICAAP.

Reporting to the CRO, and working in the Risk Management division, are department heads responsible for the management of retail and corporate credit risk, market risk, liquidity risk and operational risk. Along with their teams, the department heads are responsible for establishing a framework for overseeing the risks and controls of their risk type. The departments interact with each business unit as part of the monitoring and management processes, see section 2.3.

2.2 RISK COMMITTEES

The structure of risk committees within the Bank can be split into three levels. The committees define lines of responsibility and accountability within the Bank. They are charged with overseeing risk and the delegation of authority and form a control environment for the Bank.

▶ RISK MANAGEMENT

FIGURE 2.2 Risk committee structure

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

TABLE 2.1 Board level committees

	Committee	Responsibilities
Board Level Committees	Board Audit and Risk Committee (BARC)	The Board Audit and Risk Committee provides guidance to the Board on the Bank's strategy and risk appetite, and internal risk management structure. The committee gives the Board an overview of the Bank's risk management. The nomination of an external auditor to the Board is one of the committee's responsibilities, as is ensuring its independence. The committee supervises accounting procedures, the annual accounts and interim accounts.
	Board Credit Committee (BCC)	The Board Credit Committee is the Bank's supreme credit, investment and underwriting authority. The committee is authorized to delegate limited authority to the ACC and UIC. The committee periodically reviews reports on various aspects of the credit portfolio.
	Board Remuneration Committee (BRC)	The Board Remuneration Committee provides guidance to the Board on the Bank's remuneration policy. The committee advises the Board on the remuneration of the CEO, Internal Auditor and Compliance Officer, and formulates the remuneration framework for the Managing Directors as proposed by the CEO.

The Board committees delegate limited authority to executive level committees which are composed of the CEO and Managing Directors or their designated representative.

TABLE 2.2 Executive level committees

	Committee	Responsibilities
Executive Level Committees	Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases within limits delegated by the BCC. The committee delegates limited authority and sets forth credit rules to lower credit granting bodies. ACC reviews reports concerning the credit portfolio. The CRO or his deputy is a non-voting member of the committee.
	Asset and Liability Committee (ALCO)	The Asset and Liability Committee is responsible for strategic planning relating to the developments of the Bank's balance sheet as well as the planning of liquidity and funding, and capital activities.
	Underwriting and Investment Committee (UIC)	The Underwriting and Investment Committee decides on underwriting and principal investments. The CRO or his deputy is a non-voting member of the committee.
	Security Committee (SC)	The Security Committee is a consultation forum on security matters. The committee formulates, reviews and approves security goals and policies, monitors compliance with security policies and implements information security rules.

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

TABLE 2.3 Business level committees

	Committe	Responsibilities
Business Level Committees	Corporate Credit Committee (CCC)	The Corporate Credit Committee makes decisions on credit cases within authorized limits and according to credit rules.
	Retail Branch Credit Committees (RBC)	Seven Retail Branch Credit Committees make decisions on credit cases within authorized limits and according to credit rules.
	Retail Monitoring Committee (RMC)	The Retail Monitoring Committee monitors that branch employees adhere to set credit rules and supervises credit limits of branch employees and specialist employees in Retail Banking.
	Composition Committee (CC)	The Composition Committee deals with applications to reach composition with individual debtors and small business enterprises.
	Collateral Valuation Committees (CVC)	Four Collateral Valuation Committees set guidelines on collateral assessment.

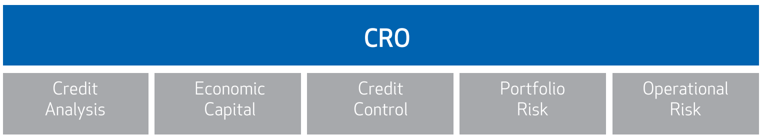
2.3 THE RISK MANAGEMENT DIVISION

The Risk Management division focuses on the identification, monitoring and control of risk. Risk Management ensures compliance with internal and external limits standards and regulations, such as Basel II, and a strong emphasis is placed on reporting risk to the relevant stakeholders in a clear and meaningful manner.

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

The Risk Management division has five departments.

FIGURE 2.3 Structure of Risk Management division



Credit Analysis

Credit Analysis monitors and provides support for the Bank's credit decisions and credit granting processes from loan application to loan disbursement.

The department is Risk Management's primary interface with the Bank's credit committees. Credit Analysis prepares an opinion for all credit applications that go before the BCC, the ACC and the CCC. The CRO or his designated representative from Credit Analysis participates in the meetings of CCC, ACC and BCC as a non-voting advisor. Credit Analysis monitors the activities of the RBC. Credit Analysis ensures that credit decisions are within a committee's credit granting authority and is authorized to escalate controversial credit decisions from one committee to a committee with higher authority.

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

Economic Capital

The Economic Capital department is responsible for the design, implementation and management of the Bank's ICAAP and interfacing with the FME in the Supervisory Review and Evaluation Process (SREP). The department is responsible for the development of credit rating models and the Bank's economic capital model, which are the basis for the internal assessment of capital requirements.

Economic Capital monitors the portfolio credit risk such as single name and industry-sector concentrations as well as monitoring financial relationships of obligors and the large exposures to financially related obligors. The department classifies the loan portfolio according to the Bank's internal classification of borrowers, which is referred to as the Early Warning System (EWS).

Credit Control

Credit Control monitors weak and impaired credit exposures on a customer by customer basis, including large exposure. The department analyzes credit exposures according to the Bank's EWS, see section 4.7.1, and operates as a gatekeeper in determining when problematic loans should enter a restructuring process or legal collection. Credit Control determines the appropriate level of provisioning and reports impairments and write-offs to the ACC.

Credit Control ensures that the book value of distressed loans accurately reflects the expected recovery value of loans.

Portfolio Risk

The Portfolio Risk department is responsible for monitoring, analyzing and reporting on market risk and liquidity risk. Portfolio Risk interfaces primarily with the Bank's Treasury and Proprietary Trading departments and reports its findings to the ALCO. The department analyzes and models the behaviour of the Bank's deposit base and reports to the ALCO. Additionally the department collaborates closely with the Bank's Asset Management division on various reporting and limit surveillance.

Portfolio Risk also provides miscellaneous quantitative business support to the Bank's various business units.

Operational Risk

Operational Risk monitors risks associated with the daily operation of the Bank. The department conducts a regular risk and control self-assessment (RCSA) with all the Bank's divisions and monitors remedial actions. Operational Risk collects loss data for all loss events and near misses. Serious events are investigated to find and remedy a root cause. The department assists divisions in accurately documenting and periodically revising their work processes. The Bank's Security Officer is a member of the Operational Risk department.

2.4 RISK APPETITE

Risk Management ensures compliance with internal and external limits. The Bank's strategy towards risk exposure is outlined in the Bank's risk appetite statement. The statement, which is approved by the Bank's Board of Directors, sets out the level of risk that the Board is willing to take in pursuit of the Bank's strategy. It is furthermore intended to provide guidance and set limits for the Executive Management Committee. The Bank's risk appetite is monitored by the Risk Management division to ensure that the Bank's risk profile remains within its risk appetite. The BARC is notified immediately if any risk appetite metrics are exceeded. The Board of Directors reviews the risk appetite statement at least annually. Limits are based on the risk appetite statement and are set by the Board of Directors or other authorities to which the Board delegates limit-setting responsibilities. Limits are monitored by the Risk Management division.

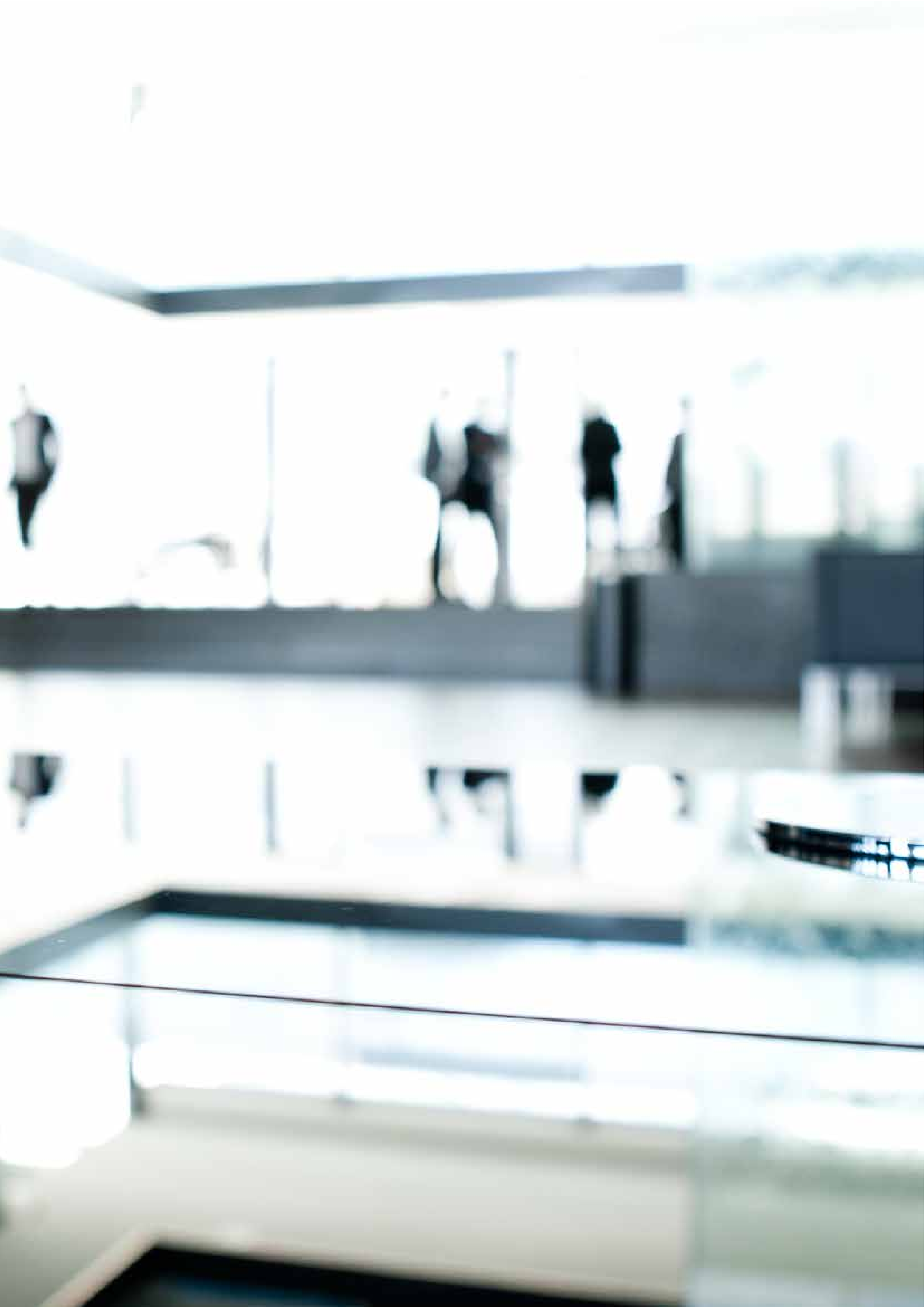
2.5 REPORTING

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

TABLE 2.4 Primary reporting within the Bank

Primary reporting	Contents	Frequency	Recipient
Credit risk portfolio report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the loan's portfolio quality.	Monthly	ACC
Liquidity and market risk report	A report containing analysis of the Bank's liquidity ratios, information on deposit development, secured liquidity, currency and inflation imbalances, and other relevant liquidity and market risk information.	Bi-weekly	ALCO
Risk report	An aggregate report containing the credit risk portfolio report and the liquidity and market risk report, as well as information on operational risk and other risk management concerns.	Monthly	Board, BARC, Exec. Com.
ICAAP	Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval.	Annually	Board, BARC, Exec. Com.

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



3 CAPITAL MANAGEMENT

3 CAPITAL MANAGEMENT

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

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

3.1 CAPITAL STRUCTURE

The elements of the capital base of a financial institution are defined in Article 84, Act No. 161/2002 on Financial Undertakings and Rules No. 215/2007, in which the EU Capital Requirement Directives (CRD) have been transposed. According to the definition, the capital base comprises Tier 1, Tier 2 and Tier 3 capital with the following restrictions. Tier 1 capital shall amount to a minimum of one-half of the capital base prior to deductions according to Article 84 of Act No. 161/2002 of intangible assets and tax assets for example. Tier 2 capital can be up to a maximum of 50% of Tier 1 capital and Tier 3 shall amount to a maximum of 50% of Tier 1 capital. Furthermore, Tier 3 capital shall amount to a maximum of 4.8% of the risk-weighted base with respect to market exposures of trading book items, as provided in Article 28 of Act No. 161/2002, and currency risk.

The Bank's ICAAP is the cornerstone of the Bank's capital adequacy estimations.

The Bank's capital base is composed of core Tier 1 and Tier 2 capital as shown in Table 3.1. Tier 1 capital comprises of share capital, share premium, other reserves, retained earnings, and non-controlling minority interests. Intangible assets and tax assets are deducted from Tier 1 capital. The Bank's Tier 2 capital consists of subordinated liabilities provided to the Bank by the Icelandic government as a part of its sale of an 87% share in the Bank to Kaupskil hf. The Bank's subordinated liabilities mature in 2020 and are denominated in EUR, USD and GBP. The Bank may only retire them with the permission of the FME. Arion Bank has no Tier 3 capital in its capital base.

TABLE 3.1 Capital base

31 December [ISK m]	2012	2011
Share capital	2,000	2,000
Share premium	73,861	73,861
Other reserves	1,639	1,637
Retained earnings	49,572	32,950
Non-controlling interests	3,806	4,110
Total equity	130,878	114,558
Intangible assets	(4,941)	(4,765)
Tax assets	(463)	(724)
Tier 1 capital	125,474	109,069
Tier 2 capital (subordinated liabilities)	34,220	32,105
Capital base	159,694	141,174

▶ CAPITAL MANAGEMENT

At the end of 2012, Arion Bank's capital base amounted to ISK 159,694 million (24.3%), of which core Tier 1 capital is ISK 125,474 million (19.1%).

3.2 CAPITAL REQUIREMENTS

The Bank's capital requirements calculations are based on the aforementioned EU Capital Requirements Directive (CRD), which is originated in the Basel committee, Act No. 161/2002 on Financial Undertakings and Rules No. 215/2007 on Capital Requirements and Risk Weighted Assets of Financial Undertakings that are based on the CRD. The CRD separates the calculation of a bank's capital requirements into two parts; Pillar 1 which outlines the regulatory capital requirements and Pillar 2 which is the internal assessment of capital adequacy.

According to the Icelandic rules on capital requirements, the capital base of a financial undertaking is required to correspond to a minimum of 8% of the sum of risk-weighted assets (RWA) of credit risk, market risk, and operational risk as calculated under Pillar 1. Additional capital requirements and other factors are determined under Pillar 2, see section 3.3.

According to Article 84 of Act No. 161/2002, the FME can specify a higher minimum capital requirements than the 8%. Following the Bank's initial capitalization in 2009 the FME raised the minimum capital requirements temporary and required a minimum core Tier 1 ratio of 12% and a minimum capital adequacy ratio of 16%. The FME further restricted the Bank, for three years, from paying dividends, divesting shares and conducting share buybacks.

These conditions expired in 2012. The Bank's capital requirements are now determined by the Bank's ICAAP and SREP processes. The legal minimum capital requirements of 8% are, nevertheless, still in effect.

The Bank's capital base has grown consistently from its establishment due to strong profit generation and dividend payment restrictions.

At the end of 2012, Arion Bank's capital base amounted to ISK 159,694 million (24.3%), of which core Tier 1 capital is ISK 125,474 million (19.1%).

TABLE 3.2 Key capital adequacy figures

31 December [ISK m]	2012	2011	2010	2009
Tier 1 capital	125,474	109,069	104,889	87,191
Capital base	159,694	141,174	131,146	87,191
Risk-weighted assets	657,763	664,956	688,649	635,511
Pillar 1 capital requirements	52,621	53,197	55,092	50,841
Tier 1 capital ratio	19.1%	16.4%	15.2%	13.7%
Total capital ratio	24.3%	21.2%	19.0%	13.7%
Average risk-weight	73.0%	74.5%	84.7%	83.9%

CAPITAL MANAGEMENT

The Bank's RWA are calculated using the approaches described in Table 3.3.

TABLE 3.3 Method of calculation of minimum capital requirements

Method of calculation	
Credit risk	The Bank uses the standardized approach to calculate the capital requirements for credit risk. This approach entails using standard risk weights from 0% to 150%, on the Bank's assets depending on the creditworthiness of the borrower, the collateral and the type of the exposure. Replacement risk and future risk is used to calculate the capital requirements for counterparty credit risk in combination with the counterparty's risk weights.
Market risk	The Bank uses the standardized approach to calculate the capital requirements for market risk. This approach entails using a standard risk weight of 150% for equities and risk weights ranging from 0% to 100% for specific risk from traded debt instruments. The general risk is calculated in accordance with the maturity based approach. The capital requirements for currency imbalance is calculated based on the total net long position or the total net short position, which ever is the higher.
Operational risk	The Bank uses the basic indicator approach to calculate capital requirements for operational risk. This approach entails using three-year average of a 15% of the sum of net interest income and net non-interest income.

In Table 3.4 the Bank's minimum capital requirements under Pillar 1 and RWA for the end of 2012 and 2011 are broken down by different risk types, and exposure classes.

At the end of 2012 credit risk accounted for 85% of RWA, operational risk accounted for 11% and market risk 4% of the minimum capital requirements.

A reclassification of securities was made in 2012, from the trading book into the banking book in accordance with the Basel II standard. Now only securities in the Bank's proprietary trading book are classified in the trading book, while other securities are classified in the banking book.

FIGURE 3.1 RWA 2012

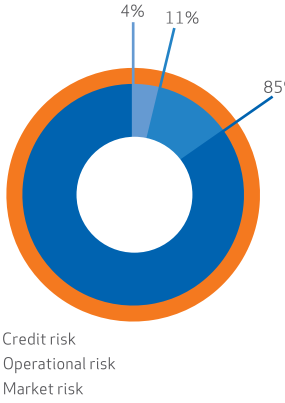
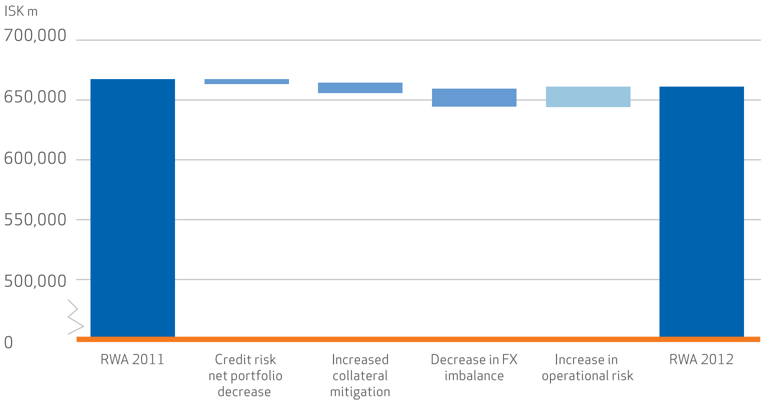


TABLE 3.4 Risk-weighted assets and capital requirements

31 December [ISK m]	2012			2011		
	Risk-weighted assets	Average risk weights (%)	Pillar 1 capital requirements	Risk-weighted assets	Average risk weights (%)	Pillar 1 capital requirements
Credit risk						
Central government	-	-	-	-	-	-
Regional government	1,782	22.3%	143	3,919	69.2%	314
Administrative bodies	58	100.0%	5	1	100.0%	0
Institutions	23,319	23.1%	1,866	16,209	23.5%	1,297
Corporate	176,779	98.4%	14,142	179,202	98.4%	14,336
Retail	49,833	75.0%	3,987	53,657	75.0%	4,293
Real estate	186,582	65.2%	14,927	158,398	63.4%	12,672
Past due	33,697	108.5%	2,696	62,441	111.7%	4,995
Other assets	59,949	99.7%	4,796	60,280	86.4%	4,822
Equity, banking book	23,483	142.6%	1,879	8,771	100.0%	702
Traded debt instruments,banking book	1,784	1.6%	143	-	-	-
Counterparty credit risk	698	-	56	355	-	28
Credit risk total	557,964	62.6%	44,637	543,233	55.1%	43,459
Market risk						
Traded debt instruments, trading book	6,846	63.8%	548	9,689	52.5%	775
Equity, trading book	561	150.0%	45	21,068	150.0%	1,685
Foreign exchange	20,063	110.5%	1,605	31,990	75.0%	2,559
Market risk total	27,470	93.8%	2,198	62,747	83.5%	5,019
Operational risk total	72,329		5,786	58,976		4,718
Total	657,763	73.0%	52,677	664,956	74.5%	53,197

RWA amounted to ISK 657,763 million at the end of 2012 compared to ISK 664,956 million at the end of 2011. The main factors behind the change in RWA are shown in Figure 3.2.

FIGURE 3.2 Change in RWA in 2012



3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP)

In accordance with the CRD's Pillar 2 requirement the Bank carries out an on-going capital adequacy assessment process, the ICAAP, with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure.

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank has sufficient capital for its risk profile. The Bank's ICAAP report is approved annually by the CEO, the CRO and Board of Directors and submitted to the FME. The FME reviews the Bank's ICAAP report and sets capital requirements following the SREP. Arion Bank's capital base exceeds both the internal assessment of capital requirements and the FME's SREP requirements.

The purpose of the ICAAP is to:

- Introduce risk-awareness to all the Bank's activities and to ensure that the Board of Directors and the Executive Management Committee understand the Bank's risk profile
- Implement a process to adequately identify and measure the Bank's risk factors
- Implement a process to monitor that the Bank's capital is adequate and used in relation to its risk profile
- Implement the use of sound risk management systems to assess, quantify and monitor the Bank's risks at all times

All Managing Directors and their key personnel participate in the process of identifying and evaluating their high risk areas, in cooperation with Risk Management. The result from the identification phase is used in the Bank's ICAAP. Risk categories identified for the business units are shown in Table 3.5.

TABLE 3.5 Risk identification down to business units

Business Units	Credit risk	Market risk	Liquidity risk	Operational risk	Legal risk	Reputational risk	Business risk	Political risk
Asset Management	✓			✓	✓	✓	✓	✓
Corporate Banking	✓			✓	✓	✓	✓	✓
Investment Banking	✓	✓		✓	✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓	✓	✓	✓
Retail Banking	✓			✓	✓	✓	✓	✓
Other	✓			✓	✓	✓	✓	✓

Arion Bank's policy is to not publish the result from its ICAAP because it regards the ICAAP and the SREP as a confidential dialog between the Bank and the FME. The Bank's ICAAP methodology involves assessing key risks which are not believed to be adequately addressed by Pillar 1. For each such risk, a capital add-on is applied on top of the regulatory capital requirements, which are 8% of RWA. The 2013 ICAAP result will be reviewed by the FME under the SREP process. The risk elements for which additional capital is required are:

- Anticipated regulatory changes associated with Basel III and CRD IV
- Single-name concentration of credit risk
- Sector concentration of credit risk
- Interest rate risk in the banking book (IRRBB)
- Legal risk
- Assorted stress scenarios

3.4 STRESS TESTING

The Bank's stress testing is carried out within the ICAAP. The Bank's stress test consists of sensitivity analysis and scenario analysis.

Sensitivity analysis, i.e. where one risk driver is stressed to assess the potential risk/sensitivity to that driver, is carried out for:

- Credit risk: several risk drivers are stressed within the loan portfolio such as changes in the credit quality due to e.g. the economic environment and high inflation as well as a single sector shock
- Operational/Legal risk: such as illegality of loans and new/or changed legislation
- Market risk: such as price risk due to a decline in value of liquid and illiquid assets
- Liquidity risk: such as outflow of deposits and liquidity coverage tests

The Bank's stress testing is carried out within the ICAAP. The Bank's stress test consists of sensitivity analysis and scenario analysis.

The impact is estimated on the Bank's capital and liquidity ratios. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers. Estimation of risk drivers is a qualitative discussion between Risk Management and each business unit where key risks, i.e. risk factors that can result in a loss of ISK 1,000 million or more, and their possible outcome are discussed.

Scenario analysis are carried out on the Bank's business plan. The Bank's Economic Research department contributes an economic base case projection as well as stressed projections that are used in the Bank's capital planning and in preparation of the Bank's five year business plan. In 2012 the Bank has investigated two economic scenarios, *Poorer terms of trade and depreciation of the ISK* and *Lifting of the capital controls in early 2014*.

3.5 CAPITAL CONTINGENCY PLAN

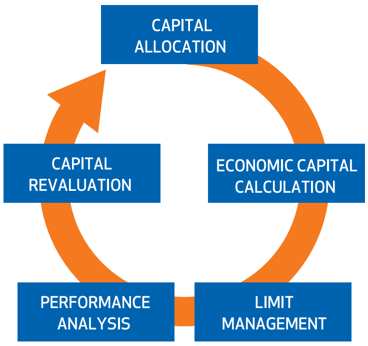
The Bank monitors its capital position and capital adequacy as a part of its on-going ICAAP. The Bank identifies risk factors that are likely to have a serious effect on the Bank's capital, estimates their affect and allocates an appropriate capital buffer. The Bank, however, recognizes that it might encounter unexpected scenarios resulting in losses exceeding capital buffers. In worst case scenarios, where the capital adequacy ratio could fall below the legal minimum requirement, the Bank will need to take appropriate actions.

The ALCO is responsible for formalizing, implementing and maintaining the Bank's capital contingency plan.

3.6 CAPITAL ALLOCATION AND CAPITAL PLANNING

The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP. The risk-adjusted performance of the business units is evaluated quarterly based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning based on the capital requirements of the business units.

FIGURE 3.3 Capital planning and monitoring process



4 CREDIT RISK

4 CREDIT RISK

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

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

The main sources of credit risk can be divided into four categories; loan portfolio, commitments and guarantees, counterparty credit risk, and equity risk in the banking book, see Table 4.1.

TABLE 4.1 Sources of credit risk

Source	Description
Loan portfolio	The loan portfolio is the Bank's main asset. To maintain and improve the quality of the loan portfolio it is imperative to constantly monitor the performance of loans, counterparties and collateral, both individually and at the portfolio level.
Commitments and guarantees	The Bank often commits itself to ensuring that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on overdrafts on checking accounts, credit cards and credit lines.
Counterparty credit risk	The Bank offers financial derivative instruments to professional investors, e.g. FX, interest and securities derivatives. For further information on counterparty credit risk, see section 4.10.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made in short term trading purpose and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 5.4.2.

4.1 CREDIT STRATEGY

The Bank's credit policy contains high-level criteria for credit granting as well as outlining the roles and responsibility for further implementation and compliance. The Bank's credit policy is the base for the Bank's credit strategy as integrated in the business plan, the Bank's credit rules and its credit procedures and control.

Arion Bank is a universal bank offering companies and individuals tailored solutions. Counterparties on the credit side are approved by the respective credit committee on an individual basis. The emphasis is on keeping a high quality credit portfolio by maintaining a strict credit process and seeking business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Loans where the underlying collateral are security instruments issued by Arion Bank are prohibited as is the granting of any credit that is prohibited by law.

4.2 CREDIT GRANTING

The Board Credit Committee (BCC), which acts on the behalf of the Board of Directors, is the supreme authority in the granting of loans. The BCC delegates lending authorities to the ACC which again delegates the lending authorities and sets credit granting guidelines for the business units.

Risk Management is present at credit committee meetings in an advisory role ensuring that all credit decisions are in line with the Bank's credit policy. Risk Management has the power to escalate a controversial credit committee decisions to a higher authority.

Risk Management has the power to escalate a controversial credit committee decisions to a higher authority.

The largest exposures are presented to the BCC for approval.

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

The Bank generally requires collateral but a central element in the assessment of the creditworthiness is the customers' ability to service debt.

4.3 CREDIT RISK MANAGEMENT

Managing credit risk entails diversification of risk and well informed lending decisions.

In ensuring well informed lending decisions, Credit Analysis monitors credit risk before a credit decision is made and participates in credit committee meetings as an adviser. Various controls ensure that a loan is only disbursed following a thorough review of all documents and all relevant information regarding the loan and collaterals has been entered into the Bank's IT systems.

During the repayment phase Risk Management monitors the credit portfolio. The Economic Capital department aggregates the portfolio monthly on the basis of consistent criteria to analyze the outstanding risk, collateral level as well as the portfolio quality. Loans at risk are identified for further inspection and credit reports are sent to the ACC, the BARC and the Board of Directors monthly. Credit Control analyzes loans that have been classified at risk. Credit Control maintains an independent and centralized overview of distressed credits. Credit Control suggests provisions and reviews write-offs.

4.4 CREDIT RATING

As outlined in Chapter 3, the Bank uses the standardized method to calculate capital requirements for credit risk. Nevertheless, it is the Bank's policy to apply sophisticated credit models to monitor the development of credit risk and to estimate customers default probability and expected loss. These estimates come into play when evaluating a loan application and in portfolio monitoring.

The Bank uses three credit rating models for three types of borrowers:

- Individuals. The model is statistical, run automatically, using the information found to have predictive power about the customer. The model is calibrated using data in the period January 2003 to December 2010.
- SMEs. Defined as retail, corporate clients with individual exposure below ISK 40 million and related exposure below ISK 100 million. The model is statistical, run automatically, based on similar methodologies as the model for individuals. The model is calibrated using data in the period January 2003 to December 2010.
- Larger corporates. Defined as corporate clients with individual exposure over ISK 40 million or related exposure over ISK 100 million. The model is run manually, based on quantitative information drawn from the financial statements as well as qualitative data entered by account managers. The rating requires approval from the Credit Analysis department. The model is statistically calibrated using data in the period January 2006 to December 2012.

The rating distribution of the Bank's loan book is discussed further in section 4.5.4.

The Bank uses three credit rating models for three types of borrowers.

4.5 CREDIT RISK EXPOSURE

Credit risk exposure consists of an on-balance sheet exposure and an off-balance sheet exposure. The on-balance sheet exposure is the book value of assets whereas the off-balance sheet exposure represents the amount that the Bank has committed to customers i.e. undrawn credit limits, unused overdrafts and guarantees.

At the end of 2012, the Bank's total credit risk exposure was ISK 902,106 million (2011: 871,628 million). Loans to customers increased by 1% between 2011 and 2012 and represent the largest part of the Bank's total credit exposure or 63%. Government bonds or government secured bonds represent 98% of the total bonds and debt instruments. The Bank's loans to financial institutions consist to a large extent of the Bank's deposits placed with other banks or 83%. Table 4.2 shows the Bank's credit risk exposure. The average exposure during 2012 is calculated from four quarterly interim financial statements.

TABLE 4.2 Breakdown of credit risk exposure

	2012		2011
[ISK m]	31 December	Average	31 December
On-balance sheet items:			
Cash and balances with Central Bank	29,746	20,021	29,200
Loans and receivables to credit institutions	101,011	81,686	69,103
Loans and receivables to customers	566,610	575,534	561,550
Bonds and debt instruments	117,730	127,193	140,568
Derivatives	788	1,108	674
Bond and debt instruments, used for hedging	1,460	965	1,922
Other assets with credit risk	5,030	5,368	8,004
Credit risk exposure on-balance sheet	822,375	811,875	811,021
Off-balance sheet items:			
Financial guarantees	9,185	10,016	8,662
Unused overdrafts	34,545	34,519	34,258
Loan commitments	36,001	32,388	17,687
Credit risk exposure off-balance sheet	79,731	76,923	60,607
Total credit risk exposure	902,106	888,798	871,628

The development of the Bank's loan portfolio is as follows in Table 4.3.

TABLE 4.3 Development of the loan portfolio

31 December [ISK m]	2012	2011	2010	2009
Cash and cash balances with Central Bank	29,746	29,200	30,628	41,906
Thereof cash with Central Bank	*17,514*	*17,686*	*13,250*	*28,521*
Loans to credit institutions	101,011	69,103	67,846	38,470
Thereof bank accounts; and	*84,164*	*62,175*	*57,704*	*24,037*
money market loans	*13,763*	*4,720*	*1,294*	*4,733*
Loans to customers	566,610	561,550	451,219	357,734
Total loans	697,367	659,853	549,693	438,110

The growth in loans to customers is to the largest extent due to the acquisition of a mortgage portfolio from Kaupthing in 2011 as well as the re-capitalization of the Bank on 8 January 2010. Breakdown of the Bank's loans and receivables to customers is as follows in Table 4.4.

TABLE 4.4 Loans and receivables to customers specified by types of loans

31 December [ISK m]	Individuals		Corporates		Total	
Type	2012	2011	2012	2011	2012	2011
Overdrafts	17,236	16,353	18,470	11,375	35,706	27,728
Credit cards	10,302	14,679	769	771	11,071	15,450
Mortgage loans	190,897	192,869	4,376	3,603	195,273	196,472
Subordinated loans	-	-	573	550	573	550
Other loans and receivables	43,560	28,208	340,208	349,431	383,768	377,639
Provision on loans and receivables	(19,222)	(12,821)	(40,559)	(43,468)	(59,781)	(56,289)
Grand total	242,773	239,288	323,837	322,262	566,610	561,550

Loans to individuals represent 43% of total loans to customers and have increased by 4% year over year. The largest part of lending to individuals is mortgage lending or 79% of total loans to individuals, which equals to 34% of total loans to customers.

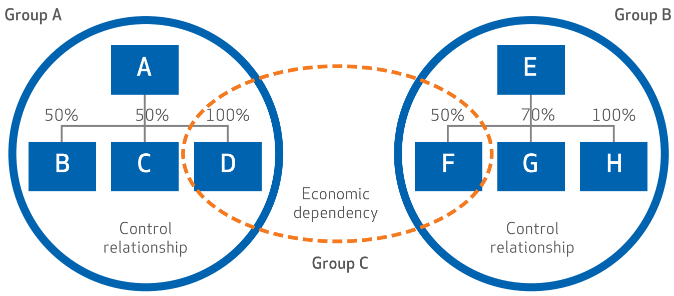
4.5.1 RELATED PARTIES AND LARGE EXPOSURE

A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's capital base net of eligible collateral according to FME rules No. 216/2007. The legal maximum for individual large exposures is 25% of the capital base and the sum of all large exposures cannot exceed 400% of the capital base.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio by limiting large exposures to groups of related parties. No single large exposure or sum of large exposures shall exceed the Bank's internal limits, both of which are considerably lower than the legal limits.

The Bank connects related parties according to internal rules that conform to FME rules and the CEBS guidelines from 2009, both of which define the groups of related parties. The rules define the Bank's interpretation on conditions a. and b. in the FME rules and describe the roles and responsibilities in relation to the interpretation and maintenance of related parties. The rules are approved by the Board of Directors. The Bank evaluates the customers' relationship both with respect to control and economic dependencies. Economic dependencies between two companies within different groups do not necessarily combine these groups into one. This relation is illustrated in Figure 4.1.

FIGURE 4.1 Related parties



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

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

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

At year end 2012 the Bank had four large exposures compared to five at the end of 2011. The largest exposure to a group of related parties at the end of 2012 was ISK 29 billion compared to ISK 33 billion at the end of 2011, before taking account of eligible collateral, excluding the claim on Drómi, see Table 4.5.

TABLE 4.5 The Bank's largest exposures

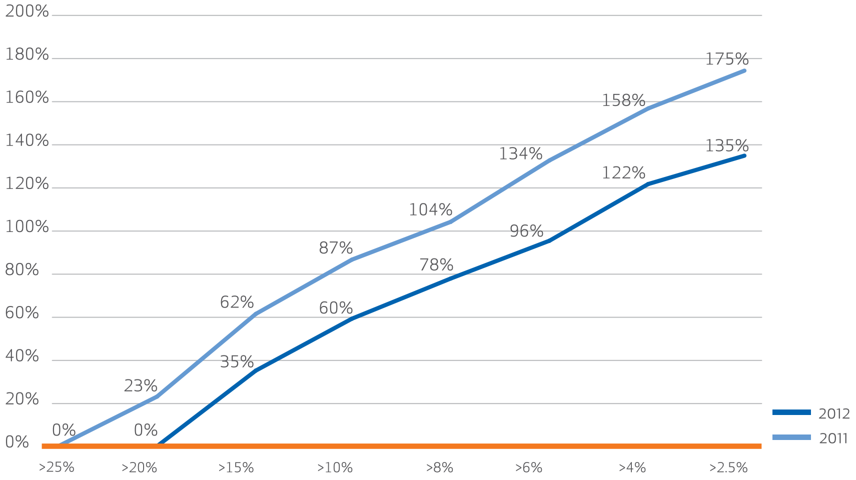
	2012		2011	
Related parties	Gross	Net	Gross	Net
Group 1 (Drómi)	43%	0%	49%	0%
Group 2	18%	18%	20%	20%
Group 3	18%	17%	23%	23%
Group 4	14%	14%	19%	19%
Group 5	11%	11%	14%	14%
Group 6	<10%	<10%	11%	11%
Sum of exposure gross > 10%	104%	60%	137%	87%

The largest exposure (gross) in Table 4.5 is a bond claim on Drómi hf. The Ministry of Finance has pledged that Arion Bank will be held harmless from this exposure and the FME has ruled that the Bank can use a 0% risk weight for the Drómi bond. Consequently, the Bank finds that the net exposure is zero.

The Bank's single-name concentration decreased during 2012.

The Bank's single-name concentration decreased during 2012, see Figure 4.2. For example, the sum of related exposures exceeding 2.5% of the Bank's capital base was 135% at the end of 2012 compared with 175% at the end of 2011.

FIGURE 4.2 Total of net exposures to a group of related parties (without financial institutions)



4.5.2 CREDIT RISK EXPOSURE BY SECTOR

The Bank's loan book is diversified, with regard to individuals and industry sectors. Of loans to customers, 43% are loans to individuals, of which 79% are mortgage loans. Real estate activities and construction is the largest industry sector comprising 12% of loans to customers.

The Bank uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard. The internal industry classification combines NACE subclasses and singles out others to better represent the nature of the Icelandic economy and the Bank's business environment e.g. the two NACE subclasses fishing and seafood production are combined into one sector, fishing industry.

FIGURE 4.3 Sector distribution of total credit risk exposure

FIGURE 4.4 Sector distribution of loans and receiv. to customers

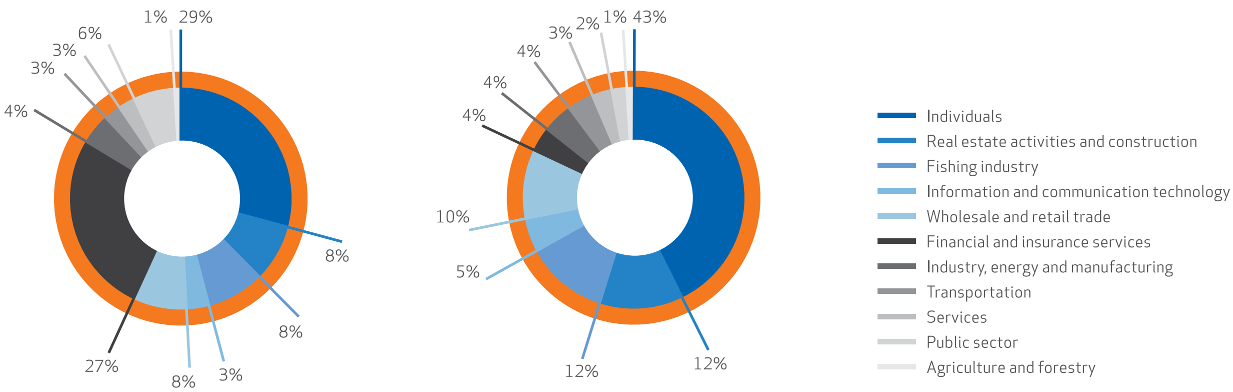


TABLE 4.6 Credit risk exposure broken down by industry

31 December 2012 [ISK m]	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry energy and manufact.	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	29,746	-	-	-	-	-	29,746
Loans and receivables to credit insitutions	-	-	-	-	-	101,011	-	-	-	-	-	101,011
Loans and receivables to customers	242,775	68,834	67,752	28,754	55,621	24,693	22,794	21,692	18,745	9,952	4,998	566,610
Bonds and debt instruments	-	25	-	28	-	73,865	1,210	7	1	42,594	-	117,730
Derivatives	-	-	-	-	-	765	-	-	23	-	-	788
Bonds and debt instruments, used for hedging	-	-	-	-	-	-	-	-	1,209	251	-	1,460
Other assets with credit risk	316	1,569	15	83	80	2,388	47	1	501	19	11	5,030
Credit risk exposure on-balance sheet	243,091	70,428	67,767	28,865	55,701	232,468	24,051	21,700	20,479	52,816	5,009	822,375
Off-balance sheet items:												
Financial guarantees	388	919	348	592	1,879	1,510	2,294	466	677	95	17	9,185
Unused overdrafts	21,499	1,143	295	463	3,548	1,666	1,555	305	1,606	2,209	256	34,545
Loan commitments	118	2,214	5,298	215	10,300	5,634	11,375	837	-	-	10	36,001
Credit risk exposure off-balance sheet	22,005	4,276	5,941	1,270	15,727	8,810	15,224	1,608	2,283	2,304	283	79,731
Total credit risk exposure	265,096	74,704	73,708	30,135	71,428	241,278	39,275	23,308	22,762	55,120	5,292	902,106

31 December 2011 [ISK m]	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial ans insurance activities	Industry energy and manufact.	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	29,200	-	-	-	-	-	29,200
Loans and receivables to credit insitutions	-	-	-	-	-	69,103	-	-	-	-	-	69,103
Loans and receivables to customers	239,289	71,579	76,673	26,753	50,582	19,853	26,969	20,384	17,197	7,613	4,658	561,550
Bonds and debt instruments	-	10	-	54	-	70,953	7,501	8	-	62,042	-	140,568
Derivatives	8	92	-	-	39	87	7	-	3	438	-	674
Bonds and debt instruments, used for hedging	-	-	-	-	-	-	-	-	-	1,922	-	1,922
Other assets with credit risk	283	4,192	5	139	82	1,860	65	2	1,323	52	1	8,004
Credit risk exposure on-balance sheet	239,580	75,873	76,678	26,946	50,703	191,056	34,542	20,394	18,523	72,067	4,659	811,021
Off-balance sheet items:												
Financial giranteess	418	1,717	367	746	617	1,568	276	432	690	1,821	10	8,662
Unused overdrafts	21,553	1,128	148	288	2,200	2,977	1,511	290	1,521	2,412	230	34,258
Loan commitments	113	118	7,127	55	1,903	5,545	1,985	838	-	-	3	17,687
Credit risk exposure off-balance sheet	22,084	2,963	7,642	1,089	4,720	10,090	3,772	1,560	2,211	4,233	243	60,607
Total credit risk exposure	261,664	78,836	84,320	28,035	55,423	201,146	38,314	21,954	20,734	76,300	4,902	871,628

4.5.3 CREDIT RISK EXPOSURE BY MATURITY

TABLE 4.7 Credit risk exposure broken down by maturity

31 December 2012 [ISK m]	Carrying amount	On demand	Up to 3 months	3 - 12 months	1 - 5 years	Over 5 years
On-balance sheet items:						
Cash and balances with Central Bank	29,746	21,121	-	8,625	-	-
Loans and receivables to credit institutions	101,011	84,033	16,721	-	257	-
Loans and receivables to customers	566,610	3,000	47,511	92,258	208,232	215,609
Bonds and debt instruments	117,730	7,034	-	25	69,087	41,584
Derivsatives	788	-	693	23	72	-
Bond and debt instruments, used for hedging	1,460	1,460	-	-	-	-
Other assets with credit risk	5,030	64	2,500	2,047	401	18
Credit risk exposure on-balance sheet	822,375	116,712	67,425	102,978	278,049	257,211
Off-balance sheet items:						
Financial guarantees	9,185	1,806	3,639	1,462	939	1,339
Unused overdrafts	34,545	691	8,971	11,768	13,035	80
Loan commitments	36,001	1,051	19,201	5,816	9,932	1
Credit risk exposure off-balance sheet	79,731	3,548	31,811	19,046	23,906	1,420
Total credit risk exposure	902,106	120,260	99,236	122,024	301,955	258,631

31 December 2011 [ISK m]	Carrying amount	On demand	Up to 3 months	3 - 12 months	1 - 5 years	Over 5 years
On-balance sheet items:						
Cash and balances with Central Bank	29,200	20,640	-	8,560	-	-
Loans and receivables to credit institutions	69,103	62,155	6,703	-	245	-
Loans and receivables to customers	561,550	13,694	49,872	71,108	230,773	196,103
Bonds and debt instruments	140,568	3,994	515	15,256	80,125	40,678
Derivatives	674	-	188	3	483	-
Bonds and debt instruments, used for hedging	1,922	1,922	-	-	-	-
Other assets with credit risk	8,004	598	6,003	492	843	68
Credit risk exposure on-balance sheet	811,021	103,003	63,281	95,419	312,469	236,849
Off-balance sheet items:						
Guarantees	8,662	343	420	1,273	5,108	1,518
Unused overdrafts	34,258	808	7,685	12,465	13,272	28
Loan commitments	17,687	1	2,892	8,385	4,409	2,000
Credit risk exposure off-balance sheet	60,607	1,152	10,997	22,123	22,789	3,546
Total credit risk exposure	871,628	104,155	74,278	117,542	335,258	240,395

4.5.4 CREDIT EXPOSURE BY RATING

As was discussed in section 4.4 Arion Bank rates customers using one of three different rating models. Table 4.8 shows the rating status of the portfolio, for each type of rating model. In some cases, companies are temporarily unrated because no financial or historical information is available. As can be seen in Table 4.8 only 1% of customers within the loan portfolio are unrated. Customers are assigned a DD rating (default) when they have been defaulting for over 90 days or provision for losses has been made. This is the Basel II definition of default. Note that the DD rating is an indication of a default event. It is not a credit rating from a rating model.

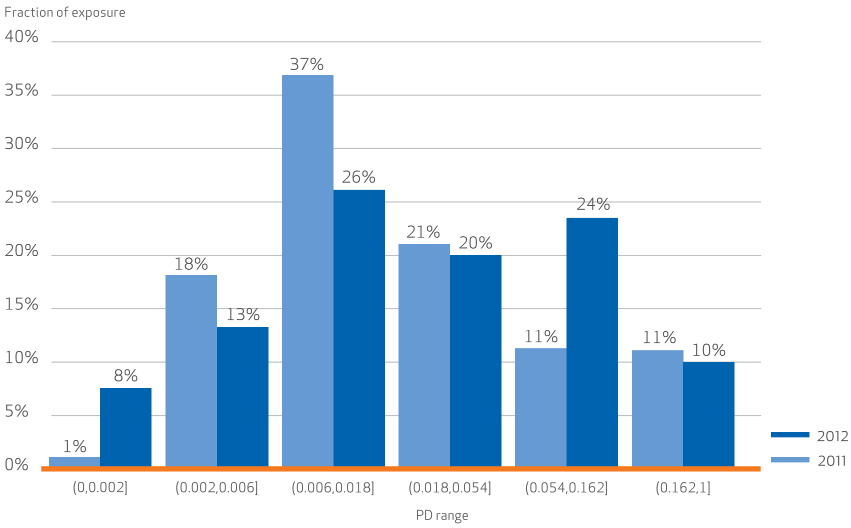
TABLE 4.8 Breakdown of rating by number of customers, parent company

Rating model	% Active credit rating	%DD	%Unrated
Corporate credit rating model	64%	25%	11%
Retail credit rating model			
SMEs	75%	8%	17%
Individuals	95%	5%	-
Total	93%	6%	1%

Corporate Portfolio

Figure 4.5 shows the corporate portfolio broken down by different PD-range. Ratings from 2011 are based on a model which had not been successfully recalibrated since the banking crisis, due to a lack of reliable default data. A post-crisis recalibration of the model has resulted in a model which captures better the polarization of corporate clients into strong, often export-based customers and weaker customers affected by the difficulties in the Icelandic economy.

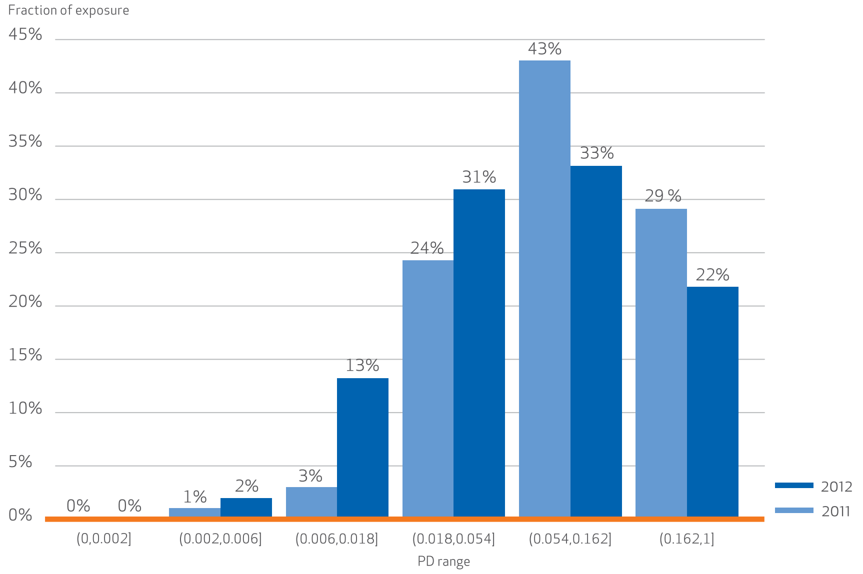
FIGURE 4.5 Distribution of exposure rated by the corporate credit rating model



Retail Portfolio - SMEs

Figure 4.6 shows the SME portfolio broken down by different PD-range. The model is currently being recalibrated. The Bank believes that due to technical defaults, e.g. defaults of customers which stopped making payments on illegal FX loans, that there are data anomalies within the data set that give false positive indications of the probability of default for financially sound customers.

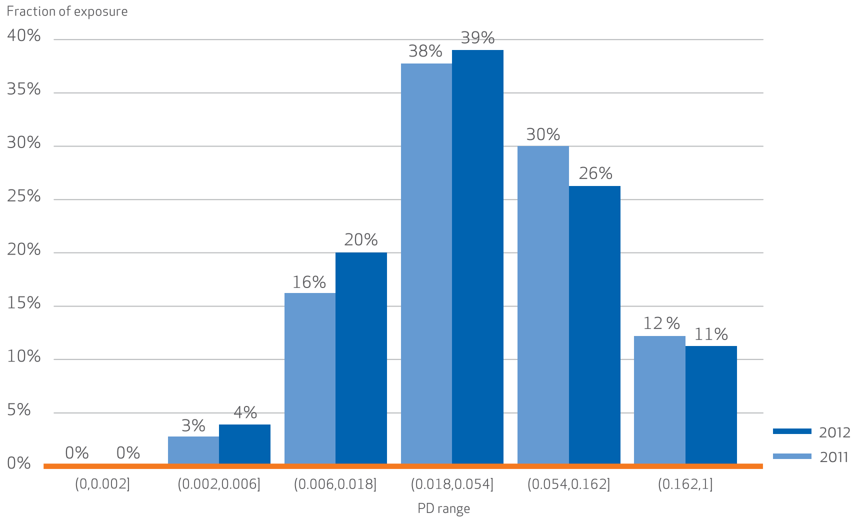
FIGURE 4.6 Distribution of exposure rated by the credit rating model for SMEs



Retail Portfolio - Individuals

Figure 4.7 shows the individuals portfolio broken down by different PD-range. As for the SME, the credit rating of individuals is considered pessimistic due to the technical defaults in the dataset.

FIGURE 4.7 Distribution of exposure rated by the credit rating model for individuals



4.5.5 CREDIT RISK EXPOSURE BY GEOGRAPHIC AREA

TABLE 4.9 Geographic distribution of credit risk exposure

2012 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	29,746	-	-	-	-	29,746
Loans and receivables to credit institutions	26,565	20,011	37,859	14,520	2,056	101,011
Loans and receivables to customers	533,988	15,428	13,390	2,913	891	566,610
Bonds and debt instruments	117,703	27	-	-	-	117,730
Derivatives	619	109	60	-	-	788
Bonds and debt instruments, hedging	1,460	-	-	-	-	1,460
Other assets with credit risk	4,952	1	44	31	2	5,030
Credit risk exposure on-balance sheet	715,033	35,576	51,353	17,464	2,949	822,375
Off-balance sheet items:						
Financial guarantees	9,181	4	-	-	-	9,185
Unused overdraft	33,794	420	192	64	75	34,545
Loan commitments	35,954	44	3	-	-	36,001
Credit risk exposure off-balance sheet	78,929	468	195	64	75	79,731
Total credit risk exposure	793,962	36,044	51,548	17,528	3,024	902,106

The Bank is not significantly exposed to foreign countries. Loans to customers outside Iceland amounted to ISK 32,621 million or 6% of the total loans to customers of which ISK 8,015 million are due to individuals currently domiciled outside Iceland.

4.6 COLLATERAL MANAGEMENT AND VALUATION

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

- Retail loans to individuals: mortgages in residential properties
- Corporate loans: charges over real estate properties, fishing vessels and other fixed and current assets, inventory and trade receivables, cash and securities
- Derivative exposures: cash or treasury bills

Besides collateral, other important mitigating techniques for credit risk are pledges, guarantees and master netting agreements.

To harmonize collateral value assessment, the Bank operates four collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The four committees' areas of expertize are:

- Agriculture
- Fishing Vessels and Quota
- Real Estates
- Securities

FIGURE 4.8 Geographic distribution of total credit risk exposure

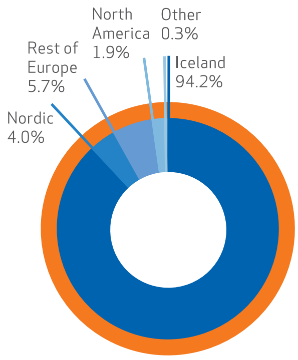
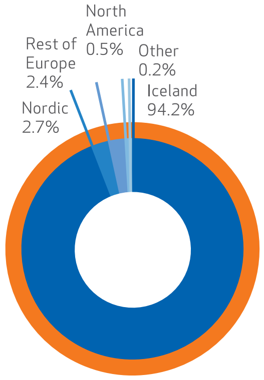


FIGURE 4.9 Geographic distribution of loans and receivables to customers



The Bank operates a collateral management system (CMS) to consolidate the Bank's collateral data. Over 97% of all collateral agreements are centrally managed using this system. Table 4.10 shows the collateral positions in the parent company, broken down by business sector. Real estate represents the primary collateral type, at 61%. The unsecured ratio of the total credit portfolio is 40%, but disregarding unsecured exposures to the Central Bank and financial institutions, the unsecured ratio of the remaining credit exposures is 26%. It should be noted that the unsecured ratio could be overestimated due to the lack of collateral data registration.

Over 97% of all collateral agreements are centrally managed in the Bank's collateral management system.

TABLE 4.10 Collateral, parent company

31 December 2012 [ISK m]	Cash securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans and receivables to credit institutions	-	-	-	-	-	100.0%
Loans and receivables to customers						
Individuals	556	212,357	40	219	213,172	11.3%
Real estate activities and construction	675	49,416	6	702	50,799	25.9%
Fishing industry	1,877	2,325	58,274	6,222	68,698	0.0%
Information and communication technology	78	547	-	18,312	18,937	34.7%
Wholesale and retail trades	1,909	12,705	-	8,550	23,164	58.2%
Financial and insurance activities	9,924	532	-	8,876	19,333	0.0%
Industry, energy and manufacturing	140	6,659	1	1,189	7,989	64.8%
Transportation	71	503	19	904	1,497	93.1%
Services	252	2,785	57	1,973	5,067	70.5%
Public sector	29	3,261	-	91	3,381	62.1%
Agriculture and forestry	10	1,569	-	12	1,591	59.1%
Bond, debt instruments and derivatives	1,219	-	-	68,628	69,847	42.0%
Total	16,740	292,659	58,397	115,678	483,474	40.1%

4.7 CREDIT MONITORING AND VALUATION

The Bank is highly focused on the performance of the loan portfolio. To monitor the performance the Bank relies on an Early Warning System (EWS) – a forward-looking classification system for loans and borrowers. The monthly EWS-classification is a prelude to the credit review by the Credit Control department. The need for impairment and/or financial restructuring is identified and evaluated during the review.

4.7.1 THE EARLY WARNING SYSTEM

The loan portfolio is grouped into four categories according to the borrowers' financial strength and behaviour: Green, Yellow, Orange and Red. In this system, borrowers in the Green category are financially the strongest whereas a possible loss has been identified in the case of the borrowers in the Red category. The EWS attempts to anticipate a deterioration in the customer credit quality.

The EWS attempts to anticipate a deterioration in the customer credit quality.

The classification is based on borrowers' contractual arrangement with the Bank, i.e. timeliness of payments and loan terms, financial indicators from the borrowers' financial statements and credit rating. The financial indicators vary based on industry sector of the borrower, both in type and ratios. Property and construction companies are measured on Loan-to-Value but companies in the service sector are measured on Net Interest Bearing Debt over annual EBITDA. Equity ratio is a factor within all sectors but with different requirements. Table 4.11 shows an aggregation of the EWS to illustrate the different categories and underlying criteria.

TABLE 4.11 The Early Warning System - an aggregate review

Category	Provision	Default	(Debt/EBITDA)/LTV	Equity ratio	Credit rating	Covenant breach
Green	No	< 30	< 4.0 - 5.0 / < 75%-80%	> 15% - 25%	≥ B -	None
Yellow	No	30 - 90	4.0 - 6.0 / < 75%-90%	10% - 25%	CCC+	Minor
Orange	No	> 90	> 5.0 - 6.0 / 90% - 100%	< 10% - 20%	< CCC+	Serious
Red	Yes	> 90	> 5.0 - 6.0 / 90% - 100%	< 10% - 20%	< CCC+	Serious
< ISK 100 million	x	x			x	

The classification is made on a customer basis; all conditions must be met for all loans of each borrower for the borrower to be classified as Green. Only borrowers with sufficient collateral to cover existing loan can be classified as Orange if any of the borrower's loans is more than 90 days in default. Borrowers with less than ISK 100 million of loans are classified based on existing provisions, days-in-default, and credit rating. Borrowers that are more than 90 days in default cannot reach a better classification than Orange.

Figure 4.10 shows the steady improvement of the EWS classification of loans to customers since the end of 2010. Loans classified as Red and Orange are reviewed for impairment and have decreased from 51.8% at the end of 2010 to 23.6% at the end of 2012.

FIGURE 4.10 Breakdown of the loan portfolio at book value by the EWS

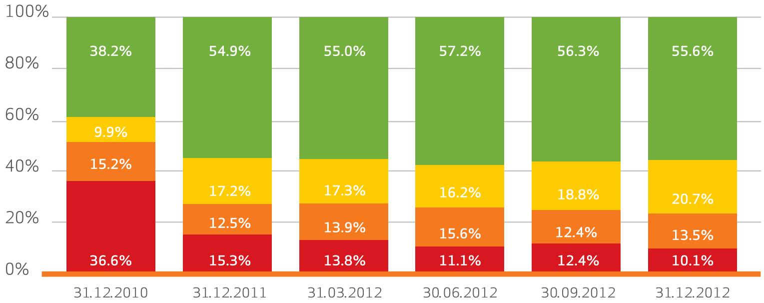


Table 4.12 shows the actions taken for each category of the EWS.

TABLE 4.12 Action taken for each category of the Early Warning System

Category	Action taken
Green	No action is necessary. Borrower is financially strong and fully performing.
Yellow	No action is taken by Risk Management but increased monitoring within the lending departments.
Orange	Review is made for possible impairment. Companies are monitored closely on a quarterly basis, see further section 4.7.2.
Red	Review is made quarterly of existing impairment and changes made if needed based on new information, see further section 4.7.2.

4.7.2 CREDIT MONITORING

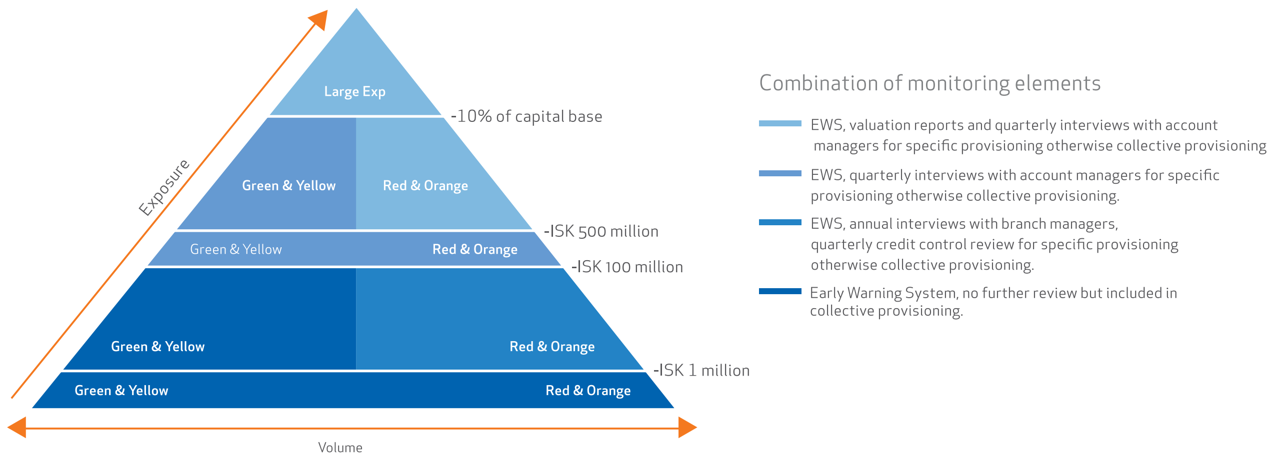
Risk Management's Credit Control department monitors individual credits based on selected samples. The samples are determined by the size of the exposure and its risk. The risk measurements are based on the EWS as described previously. The level-of-detail in credit monitoring depends on credit size and loan volume. 68% of total loans, by value, are individually analyzed, see Table 4.13. In addition to the analysis statistics, the table shows whether the monitoring involves interviewing the responsible account manager and whether a detailed valuation report for the credit is required.

TABLE 4.13 Credit monitoring

Credit size	Total exposure	Total analyzed	Interview	Valuation report	Total customers	Customers analyzed
≥ 10% of capital base	14%	14%	All quarterly	All	62	62
≥ 500 million	41%	41%	All quarterly	Red+Orange	64	64
≥ 100 million	6%	5%	All quarterly	none	228	157
≥ 1 million	37%	9%	Red+Orange annually	none	22,193	4,148
< 1 million	2%	0%	none	none	57,873	2,599
Total	100%	69%			80,420	7,030

The largest exposures get the most thorough analysis. Figure 4.11 describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.

FIGURE 4.11 Monitoring of exposures



The monitoring utilizes semi-annual reports, quarterly interviews with account managers, annual interview with branch managers and other communication in addition to the Credit Control's review. The legend for the figure describes the combination of monitoring elements which is applied for the different areas in the pyramid.

4.7.3 PROVISION

A claim is considered impaired when there is objective evidence that the Bank will not be able to collect all amounts due, according to the original contractual terms or the equivalent value. Allowances and provisions for credit losses are evaluated at a counterparty specific level and a collective basis.

Special provisioning is based on the FME's rules No. 834/2003 on the Annual Accounts of Credit Institutions and shall reflect estimated loss on loans. Loans in estimations are based on the credit monitoring criteria described. The estimations are based on the value of the underlying collateral which is individually assessed and in accordance with valuation committees' guidance.

Collective provisioning is applied to credits that are not subject to special provisioning. Collective provisions are estimates of expected loss based on the borrower's probability of default (PD), standardized loss given default values (LGD) and exposure at default (EAD). The probability of default is based on the Bank's internal rating system, see section 4.4.

4.8 PORTFOLIO CREDIT QUALITY

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio. To this end, it follows the development of credit rating, defaults, loan impairments and the progress of the recovery of distressed loans.

FIGURE 4.12 Development of default on individuals, parent company

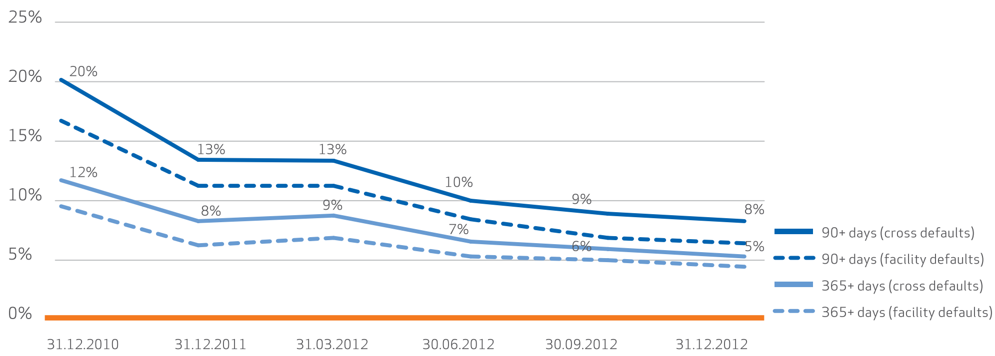
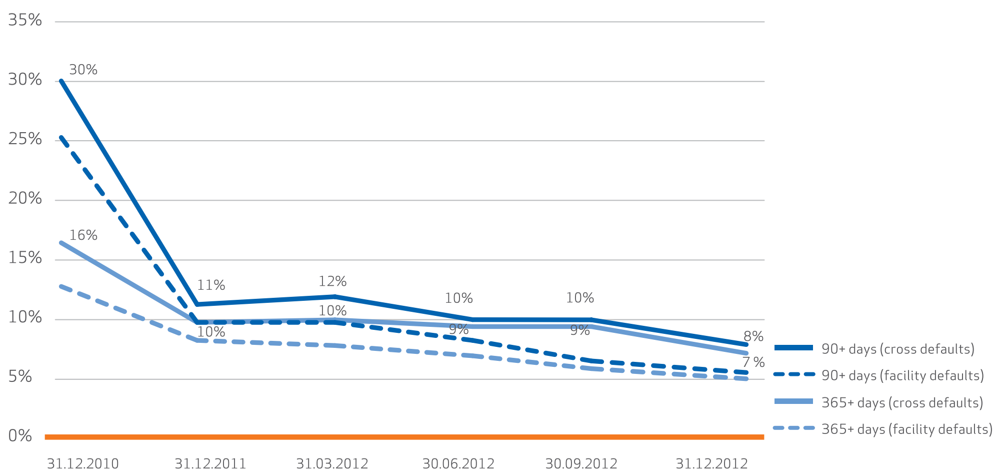


FIGURE 4.13 Development of default on companies, parent company



4.8.1 DEFAULTS

Figures 4.12 and 4.13 show the development of serious defaults from the end of 2010 for individuals and corporates, using the facility default and cross default methods. In the latter method, all exposure to the customer is considered in default if one facility is in default. Defaults have steadily decreased during the period mainly due to the progress made in restructuring problem loans.

Customer loans that are past due more than 90 days are 6.0% of the total loan book at year-end if measured at facility level or 5.8% for the parent company only. The facility default ratio more than 90 days, at the parent company level, is 6.4% for individuals and 5.5% for corporates. The Bank expects this ratio to decrease during 2013 due to the progress made in recalculating loans subject to the latest FX rulings and further restructuring of loans.

Defaults have steadily decreased during the period mainly due to the progress made in restructuring problem loans.

Customer loans that are past due more than 90 days are 6.0% of the total loan book at year-end if measured at facility level.

TABLE 4.14 Defaults by sector, parent company

	Facility level		Cross default	
31 December 2012 [%]	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Agriculture and forestry	7.4%	0.9%	7.5%	0.6%
Financial and insurance activities	8.9%	5.9%	36.8%	17.8%
Fishing industry	8.9%	17.8%	10.1%	14.7%
Individuals	6.4%	45.3%	8.2%	42.8%
Industry. energy and manufacturing	1.5%	1.0%	2.0%	1.0%
Information and communication technology	0.1%	0.1%	0.2%	0.1%
Public sector	2.0%	0.7%	2.1%	0.5%
Real estate activities and construction	8.2%	20.3%	8.9%	16.1%
Services	2.4%	1.4%	2.8%	1.1%
Transportation	0.0%	0.0%	0.0%	0.0%
Wholesale and retail trade	4.1%	6.6%	4.3%	5.1%
Total past due > 90 days as a % of loans to customers	5.8%	100.0%	8.0%	100.0%

	Facility level		Cross default	
31 December 2011 [%]	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Agriculture and forestry	6.1%	0.3%	7.4%	0.3%
Financial and insurance activities	13.6%	6.5%	23.9%	9.7%
Fishing industry	12.5%	16.0%	13.4%	14.7%
Individuals	11.3%	43.0%	13.5%	43.9%
Industry. energy and manufacturing	10.1%	4.7%	10.2%	4.0%
Information and communication technology	0.1%	0.0%	0.1%	0.0%
Public sector	9.3%	1.4%	9.4%	1.2%
Real estate activities and construction	14.5%	22.2%	15.5%	20.2%
Services	6.8%	1.7%	7.1%	1.5%
Transportation	0.4%	0.2%	0.5%	0.1%
Wholesale and retail trade	4.8%	4.1%	5.9%	4.3%
Total past due > 90 days as a % of loans to customers	10.3%	100.0%	12.1%	100.0%

4.8.2 IMPAIRMENT AND PROVISIONS

Loan impairment is recognized when credit monitoring has determined that there is objective evidence of credit losses and has made appropriate provision for these losses. Note that loans which were acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

Table 4.15 shows the development of provisions for losses on loans and receivables to customers during 2012 and 2011. Provisions have been divided into specific provisions, where the provision is due to the borrower's credit quality, FX rulings, where the provision is primarily due to losses from the legal uncertainty for foreign currency loans, and collective provisions, which are calculated for all loans that do not have specific provisions, to account for expected loss rates.

At the end of 2012, a provision of ISK 19,567 million had been made for losses due to court rulings on illegal FX loans, out of which ISK 14,942 million are due to loans with a carrying value of ISK 41,359 million that are still on the Bank's balance sheet. Write-offs during the year, ISK 4,625 million, is due to loans which have been paid up and is accounted for in the Statement of Financial Position as other liabilities. This balance will be paid out following a recalculation of the loans.

A large transfer of provisions from collective to specific between 2011 and 2012 deserves mention. Since its acquisition, a portfolio of retail loans had been managed as a homogeneous pool with the acquisition discount and impairments managed on a portfolio basis. In 2012 this portfolio was dissolved and discounts and impairments were distributed to individual loans.

TABLE 4.15 Changes in the provision for losses on loans and receivables to customers

31 December 2012 [ISK m]	Specific	FX rulings	Collective	Total
Balance at the beginning of the year	32,953	13,823	9,513	56,289
Provision for losses during the year	11,818	5,744	(118)	17,444
Write-offs during the year	(3,830)	-	(6,054)	(9,884)
Transferred to liabilities	-	(4,625)	-	(4,625)
Payments of loans previously written off	557	-	-	557
Balance at the end of the year	41,498	14,942	3,341	59,781

31 December 2011 [ISK m]	Specific	FX rulings	Collective	Total
Balance at the beginning of the year	39,083	-	2,760	41,843
Provision for losses during the year	6,649	13,823	6,753	27,225
Write-offs during the year	(13,230)	-	-	(13,230)
Payments of loans previously written off	451	-	-	451
Balance at the end of the year	32,953	13,823	9,513	56,289

▶ CREDIT RISK

During 2012, ISK 11,818 million of additional specific provisions were made for borrower's credit quality and an additional ISK 5,744 were provisioned for additional losses from the legal uncertainty for foreign currency loans. Collective provisions of ISK 118 million were reversed.

The sum of specific loan impairments and FX-loan impairments at the end of 2012 was ISK 56,440 million, compared with ISK 46,776 million a year earlier. Table 4.16 shows the carrying amount of loans and receivables to customers as well as the specific impairment and FX-ruling impairment to this amount broken down by industry sector.

TABLE 4.16 Impaired loans and receivables to customers by sector

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
31 December 2012 [ISK m]	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
Individuals	13,143	19,397	5,032	18,626	18,175	38,023
Real estate activities and construction	4,684	10,091	1,586	4,139	6,270	14,230
Fishing industry	2,361	4,343	2,648	6,913	5,009	11,256
Information and communication technology	7,561	11,192	187	307	7,748	11,499
Wholesale and retail trade	5,295	8,399	2,639	5,638	7,934	14,037
Financial and insurance services	6,405	8,363	1,142	1,492	7,547	9,855
Industry, energy and manufacturing	604	1,152	483	999	1,087	2,151
Transportation	35	40	36	120	71	160
Services	744	1,168	505	1,328	1,249	2,496
Public sector	30	38	262	406	292	444
Agriculture and forestry	636	895	422	1,391	1,058	2,286
Total	41,498	65,078	14,942	41,359	56,440	106,437

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
31 December 2011 [ISK m]	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
Individuals	6,901	7,114	5,761	23,278	12,662	30,392
Real estate activities and construction	6,171	12,836	1,407	3,980	7,578	16,816
Fishing industry	2,218	10,073	2,339	3,318	4,557	13,391
Information and communication technology	7,344	7,619	151	453	7,495	8,072
Wholesale and retail trade	3,121	8,285	2,173	9,981	5,294	18,266
Financial and insurance services	4,706	9,013	50	111	4,756	9,124
Industry, energy and manufacturing	636	3,356	359	2,919	995	6,275
Transportation	35	99	47	121	82	220
Services	906	3,194	488	1,001	1,394	4,195
Public sector	154	876	610	970	764	1,846
Agriculture and forestry	761	673	438	1,488	1,199	2,161
Total	32,953	63,138	13,823	47,620	46,776	110,758

Table 4.17 shows the geographical distribution of the same information.

TABLE 4.17 Impaired loans and receivables to customers by geographic area

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
31 December 2012 [ISK m]	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
Iceland	36,516	57,254	14,713	40,435	51,229	97,689
Nordic	469	644	140	514	609	1,158
Rest of Europe	1,941	2,139	46	223	1,987	2,362
North America	2,561	4,987	34	129	2,595	5,116
Other	11	54	9	58	20	112
Total	41,498	65,078	14,942	41,359	56,440	106,437

4.8.3 PROBLEM LOANS

The basic elements of loan quality are whether the loan is past due or individually impaired. Table 4.18 shows the impairment and past due status of the Bank's various asset classes. Past-due loans are not impaired if they are sufficiently collateralized.

TABLE 4.18 Credit quality by class of financial asset

31 December 2012 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	29,746	-	-	29,746
Loans and receivables to credit institutions	101,011	-	-	101,011
Loans and receivables to customers				
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Bonds and debt instruments	117,730	-	-	117,730
Derivatives	788	-	-	788
Bonds and debt instruments used for hedging	1,460	-	-	1,460
Other assets with credit risk	5,030	-	-	5,030
Credit quality	731,682	40,696	49,997	822,375

31 December 2011 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers				
Loans to corporates	274,604	17,758	46,252	338,614
Loans to individuals	182,089	23,117	17,730	222,936
Bonds and debt instruments	140,568	-	-	140,568
Derivatives	674	-	-	674
Bonds and debt instruments used for hedging	1,922	-	-	1,922
Other assets with credit risk	8,004	-	-	8,004
Credit quality	706,164	40,875	63,982	811,021

Table 4.19 shows a breakdown of loans to individuals and corporates which are past due but not impaired, by the number of days in default.

TABLE 4.19 Number of days in default for loans which are not impaired

31 December 2012 [ISK m]	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans and receivables to corporates	6,285	951	322	10,293	17,851
Loans and receivables to individuals	8,719	3,558	287	10,281	22,845
Total past due but not impaired loans and receivables	15,004	4,509	609	20,574	40,696
31 December 2011 [ISK m]					
Loans and receivables to corporates	5,649	824	834	10,451	17,758
Loans and receivables to individuals	2,950	3,422	2,512	14,233	23,117
Total past due but not impaired loans and receivables	8,599	4,246	3,346	24,684	40,875

The Bank defines as *problem loans*, loans that are either individually impaired or are more than 90 days past due and not impaired. This corresponds to the Basel II definition of deault. The Bank monitors its loan book quality by tracking the problem loan ratio.

Problem loans constitute 12.5% of loans to customers of which 4.6% are due to loans with impairment made due to FX-loan court rulings, see Figure 4.14. Loans past due >90 but not impaired have decreased by 20% between 2011 and 2012, from ISK 24,684 million down to ISK 20,574 million. Problem loans to individuals represent 43% of total problem loans by value, while 57% are due to corporates.

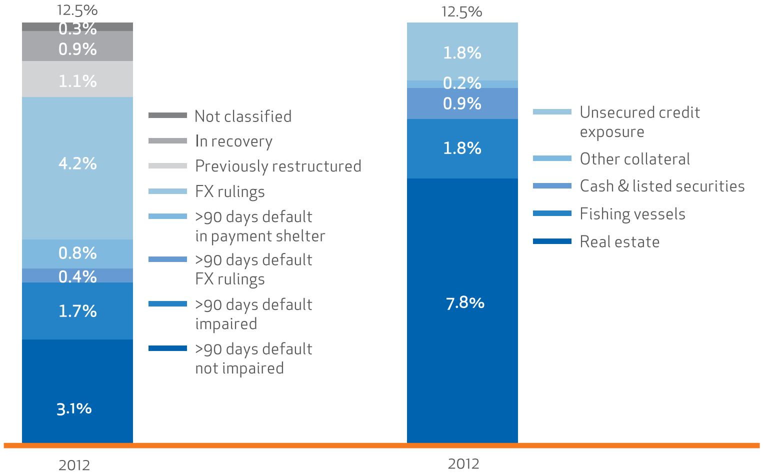
The total collateral amount that secures the total problem loans is ISK 61,826 million that corresponds to a collateral coverage of 86%. Real estate collateral represents 73%; fishing vessels represent 17% and other collateral the remaining 10%.

The breakdown of problem loans as a percentage of loans to customers by status and collateral are shown in Figure 4.14. The status-breakdown demonstrates that approximately half of the problem loans are impaired without being over 90 days past due. This is primarily explained by provision for losses from the legal uncertainty for foreign currency loans (FX rulings) and provisions for losses from loans in restructuring or recently restructured loans where the borrower has not yet demonstrated full recovery. Clarification of the FX uncertainty is expected to reduce this portion of problem loans in the coming months.

Figure 4.14 highlights loans that are more than 90 days past due, because the borrower is in payment shelter, (a measure provided by the government's Debtors' Ombudsman) and foreign currency loans subject to legal uncertainty. The legal collection of this category of loans is temporarily suspended.

The Bank defines as problem loans, loans that are either individually impaired or are more than 90 days past due and not impaired.

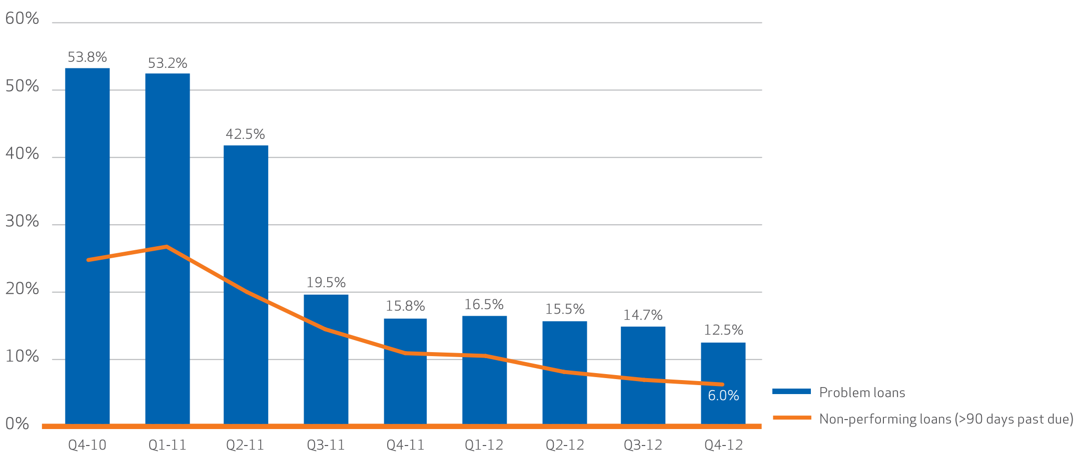
FIGURE 4.14
Breakdown of problem loans



Problem loans as a percentage of loans to customers have decreased from 53.8% at the end of 2010 down to 12.5% or by 77%. The development of problem loans is as shown in Figure 4.15.

Problem loans as a percentage of loans to customers have decreased from 53.8% at the end of 2010 down to 12.5%.

FIGURE 4.15 Development of problem loans



4.9 LOAN RESTRUCTURING AND FME'S LOAN PORTFOLIO ANALYSIS (LPA)

Following the bank crisis in late 2008 the FME introduced a loan classification system designed to monitor the Icelandic banks' progress in restructuring the debt of distressed borrowers, which had increased significantly in the wake of the crisis. The system, which is called Loan Portfolio Analysis (LPA), categorizes borrowers, not individual exposures, into three groups; performing, performing after restructuring and non-performing. Each group is divided into subcategories, as shown in Table 4.20.

TABLE 4.20 FME's categorization

Category	Subcategory
Performing	No restructuring
Performing after restructuring	NPV swap
	Extension of term only
	Debt-equity swap
	Partial write-off
Non-performing	Payments postponed
	Legal dispute
	Previously restructured
	90 days past due
	Transferred to workout
	In collection

The loan portfolio is analyzed monthly based on the FME's LPA standard and reported to the FME. Figure 4.16 show the development of the LPA ratio for the total loan portfolio, by quarter, since the end of 2010. During the period, non-performing loans to customers, as defined by the LPA, have fallen from approximately 50% to 13%.

FIGURE 4.16 Development of the LPA

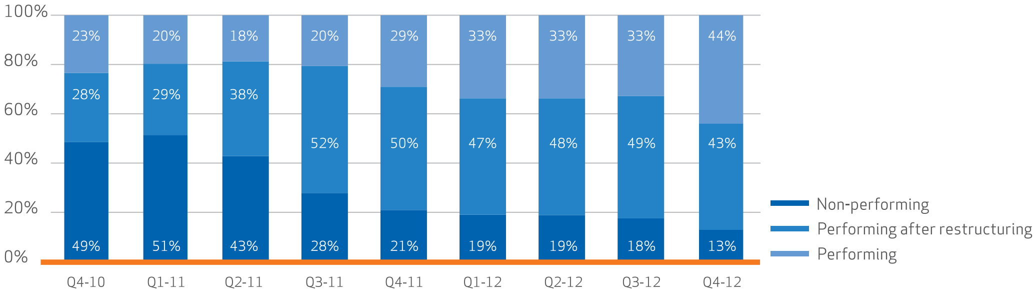
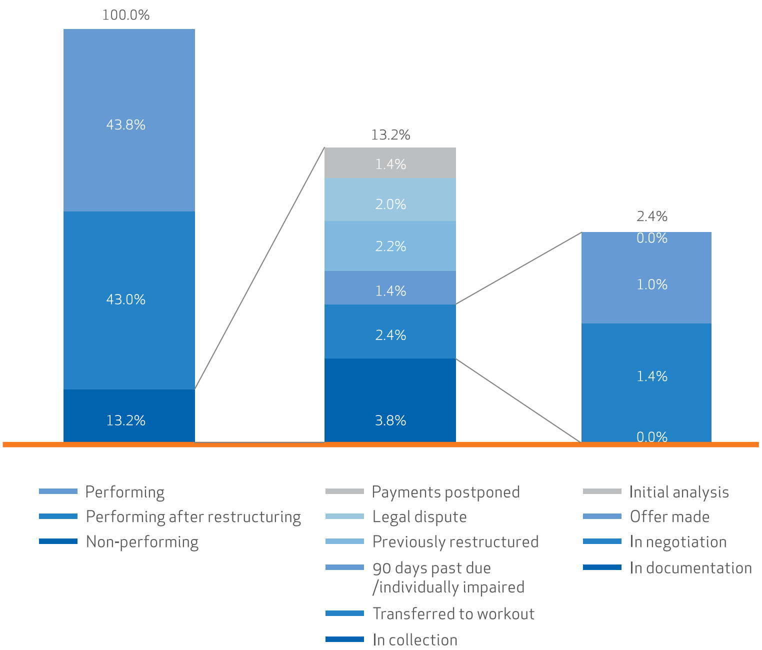


Figure 4.17 shows a breakdown of non-performing loans into its subcategories at the end of 2012, with a further breakdown of loans that have been transferred to work-out into the phases which have been defined for the restructuring work in the Bank. At the end of 2012, there were no cases in the Initial analysis and In documentation phases, which supports the view that the Bank's restructuring efforts have been winding down. Loans in restructuring have decreased from 10.1% to 2.4% between 2011 and 2012.

FIGURE 4.17 Breakdown of LPA metric



4.10 COUNTERPARTY CREDIT RISK

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

The Bank offers financial derivative instruments to professional investors. Table 4.21 shows derivative trading activities that are currently permitted. The derivative instruments are classified according to primary risk factor and the type of derivative instrument.

TABLE 4.21 Derivative trading activities

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

Value-changes are made in response to changes in interest rates, exchange rates, security prices and commodity prices. Counterparty credit risk arising from derivative financial instruments is the combination of the replacement cost of instruments with a positive fair value and the potential for future credit risk exposure. Replacement risk and future risk is used to calculate the capital requirement for counterparty credit risk in combination with the counterparty's risk weights.

The Bank sets limits on the total exposure and on the customer's negative value, net of collateral, to control the Bank's risk towards these instruments. These limits are generally client-specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. The margin-call process is monitored by Risk Management. As shown in section 3.2, capital requirements for counterparty credit risk in the Bank's current operations are quite limited.

5 MARKET RISK

5 MARKET RISK

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flow of financial instruments. The risk arises from market making, dealing, and position taking in bonds, equities, currencies, commodities, derivatives, and any other commitment depending on market prices and rates. Market risk consists of price risk, currency risk, inflation risk and interest rate risk.

5.1 MARKET RISK STRATEGY

The Bank's market risk strategy is to invest its own capital on a limited and carefully selected basis in transactions, underwritings and other activities that involve market risk, i.e. interest rate risk, equity price risk in the trading book and foreign exchange risk.

5.2 MARKET RISK MANAGEMENT

Risk Management's Portfolio Risk department is responsible for measuring and monitoring market risk exposure and price fluctuations in markets. The department takes proactive steps towards market risk management, which involves reviewing exposures and potential shortfalls and analyzing scenarios with traders. Issues of concern are escalated to the relevant Managing Director (MD) and the CRO.

The performance, exposure and relevant risk measures are summarized and reported to the relevant employees and MDs on a daily basis. Exposures and relevant risk measures are reported on a regular basis to the Board of Directors.

Market risk controls vary between trading and banking (non-trading) books where the trading book holds positions with trading intent, according to the EU Capital Requirements Directive, Annex VII, that are actively managed on a daily basis. For example, the limit framework for the trading book is explicit and is monitored daily, but such a framework does not apply to the banking book due to the nature of the exposure. However, the banking book market risk exposure is monitored and reported on a monthly basis. The Board of Directors has set limits on various market risk exposures in the Bank's risk appetite statement.

The Portfolio Risk department is responsible for enforcing the limits which have been set. This entails daily monitoring and reporting usage and breaches of limits to relevant parties such as the CEO, CFO, CRO, relevant MDs or traders.

5.3 MARKET RISK MEASUREMENT

Market risk exposure and price fluctuations in markets are measured on an end-of-day basis. The Bank uses various risk measures to calculate market risk exposure, see Table 5.1.

TABLE 5.1 Methods of market risk measurement

Market risk type	Measurement methods
Equity price risk	Exposure in equity is measured by net and gross positions.
Interest rate risk	Interest rate risk is quantified by using parallel shifts in yield curves and is measured as the difference in value between the original market value and the calculated market value after shifting the yield curve. This is done for all positions sensitive to interest rates and all yield curves.
Foreign exchange risk	Foreign exchange risk is quantified by using the net balance of assets and liabilities in each currency, and their total sum. The assets and liabilities must include current positions, forward positions, delta positions in FX derivatives and the market value of derivatives in foreign currency.

5.4 PRICE RISK

Price risk is defined as the risk that arises due to possible losses from adverse movements in the price at which securities in the Bank's holding are valued. The Bank divides its security exposure, i.e. equities, bonds, fund shares etc., into two portfolios or books:

- Trading book: securities used in the Bank's proprietary trading.
- Banking book: other types of security exposure such as for the purpose of liquidity reserve, strategic investments, subsidiary investments, associates and securing the value of foreclosure assets until they are sold.

Securities on the Bank's balance sheet are as shown in Table 5.2.

TABLE 5.2 Securities on the Bank's balance sheet

31 December 2012 [ISK m]	Bonds	Equity	Total
Trading book:			
Listed	(3,043)	374	(2,669)
Unlisted	3,461	-	3,461
Trading book total	418	374	792
Banking book:			
Listed	42,453	7,751	50,204
Unlisted	69,699	14,010	83,709
Funds	4,306	3,835	8,141
Banking book total	116,458	25,596	142,054
Grand total	116,876	25,970	142,846

Note bond fund shares are included in shares and equity instruments with variable income on the Bank's balance sheet.

Table 5.3 shows the banking book assets which constitute the Bank's liquidity reserve.

TABLE 5.3 Banking book by liquidity reserve

31 December 2012 [ISK m]	Bonds	Equity	Total
Listed	11,201	-	11,201
Unlisted	68,628	-	68,628
Total liquidity reserve in the banking book	79,829	-	79,829

Unlisted exposure in the trading book arises from underwriting activities relating to IPOs that are yet to be completed. Unlisted bonds that are part of the Bank's liquidity reserve will be used as collateral in conjunction with the government liquidity facility, see section 6.3.1.

5.4.1 EQUITY IN THE TRADING BOOK

The trading book is subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD and trader. The entire exposure is in domestic securities. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2012 average and maximum exposure in both equity and bonds.

TABLE 5.4 The Bank's trading exposure

31 December 2012 [ISK m]	Bonds		
	Long	Short	Net
Year-end	5,576	(5,158)	418
Average	3,514	(3,891)	(377)
Maximum	6,454	(8,617)	(6,349)

31 December 2012 [ISK m]	Equity		
	Long	Short	Net
Year-end	374	-	374
Average	307	-	307
Maximum	531	-	531

5.4.2 EQUITY IN THE BANKING BOOK

Exposure limits for the banking book are set in the Bank's risk appetite. The risk appetite acknowledges the fact that equity positions in the banking book are, to a large extent, foreclosure assets due to the post 2008 restructuring process and therefore not all voluntarily taken the Bank. Strategies for various types of exposure are set, such as a disposal schedule for non-core assets.

Securities listed on an active market are priced at their quoted price but for securities with infrequent transactions or low trading volume the price is determined by using valuation techniques. Such techniques include net present value techniques, comparison to similar instruments for which observable market prices exist and other valuation models. For more information on the accounting techniques regarding securities in the banking book, see Note 71 in the Consolidated Financial Statements of Arion Bank for 2012.

The equity exposure in the banking book is shown in Table 5.5.

TABLE 5.5 Equity exposure in the banking book

31 December 2012 [ISK m]	Listed	Unlisted	Total
Investments in associates	-	7,050	7,050
Equities in assets held for sale	6,020	361	6,381
Equity instruments with variable income	1,730	6,600	8,330
Fund shares	716	3,120	3,836
Total equity exposure in the banking book	8,466	17,131	25,597
Market value	11,193		
Realized gain/loss in 2012			2,665
Unrealized gain/loss in 2012			2,384

The reason for the difference in the book value and the market value of listed equities in the banking book is that the Bank does not consider the relevant market liquid enough for the positions the Bank holds.

5.5 CURRENCY RISK

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to the currency imbalance between assets and liabilities where FX denominated assets are a greater part of the Bank's balance sheet than liabilities. As of the end of 2012 the Bank has an effective net position in foreign currency of ISK 18,163 million so that a 10% depreciation of the Icelandic krona, for example, would result in a profit of ISK 1,816 million for the Bank. The opposite would be true for a 10% appreciation of the Icelandic krona. The Bank's currency exposure is within the limit set by the Central Bank of Iceland.

The Bank has strived to decrease the currency risk of its borrowers by limiting lending in foreign currency to customers with foreign exchange linked revenues.

Table 5.6 shows the net position of assets and liabilities by foreign currency at the end of 2012.

TABLE 5.6 Net position of assets and liabilities by currency

Foreign currency [ISK m]	Net exposure
EUR	7,611
USD	4,925
CHF	(1,245)
GBP	3,595
JPY	(284)
Nordic	2,674
Other	887
Total net position	18,163

5.6 INFLATION RISK

Inflation risk is defined as the risk of loss due to movements in the Consumer Price Index (CPI), i.e. inflation or deflation. The Bank is exposed to inflation risk due to a mismatch between CPI-linked assets and liabilities. The total amount of CPI-linked assets amounted to ISK 262,000 million and the total amount of CPI-linked liabilities amounted to ISK 216,900 million at the end of 2012. Therefore, the net CPI- linked imbalance was ISK 45,100 million, which means that deflation would result in a decrease of revenues for the Bank.

5.7 INTEREST RATE RISK

Interest rate risk is the risk of losses caused by changing interest rates and it normally increases with increasing interest-fixing periods of asset and liabilities. The Bank's operations are subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods. A large amount of liabilities such as deposits have floating interest rates while assets in general have longer interest-fixing periods. This mismatch results in an interest rate risk for the Bank.

The Bank's strategy for managing its interest rate risk is to strive for an interest rate balance between assets and liabilities. The Bank does this by targeting lending practices. Table 5.7 shows the Bank's interest-bearing assets and liabilities by interest-fixing period at the end of 2012. Assets and liabilities with zero duration, such as overdrafts and general deposit accounts, are included in the 0-1M time bucket. The interest-fixing period is not to be confused with the maturity of assets and liabilities.

MARKET RISK

TABLE 5.7 Interest bearing assets and liabilities by interest-fixing period

Assets [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not specified	Total
Cash and balances with Central Bank	29,746	-	-	-	-	-	-	-	29,746
Loans to credit institutions	101,011	-	-	-	-	-	-	-	101,011
Loans to customers	241,411	109,286	11,188	57,051	4,405	30,329	112,940	-	566,610
Bonds	110,987	-	-	560	3,374	681	2,128	-	117,730
Derivatives and hedging securities*								3,226	3,226
Other assets	82,352	-	-	-	-	-	-	-	82,352
Total	565,507	109,286	11,188	57,611	7,779	31,010	115,068	3,226	900,675

Liabilities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not specified	Total
Due to Central Bank and credit institutions	32,990	-	-	-	-	-	-	-	32,990
Deposits from customers	403,241	41,967	67	3,408	-	-	-	-	448,683
Covered bonds	-	-	-	-	2,540	4,948	117,504	-	124,992
Other borrowings	63,368	6,417	-	-	308	-	-	-	70,093
Subordinated liability	-	34,220	-	-	-	-	-	-	34,220
Bonds - short positions	5	4,214	-	547	284	113	-	-	5,163
Derivatives and hedging securities*								8,302	8,302
Other liabilities	45,354	-	-	-	-	-	-	-	45,354
Equity	130,878	-	-	-	-	-	-	-	130,878
Total	675,836	86,818	67	3,955	3,132	5,061	117,504	8,302	900,675

Derivatives and hedging securities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(4,938)	(6,757)	44	2,074	4,501	-	-	(5,076)

Total [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y
Net position	(115,267)	15,711	11,165	55,730	9,148	25,949	(2,436)

*Derivatives and hedging securities can only be broken down by interest-fixing period by viewing net positions.

Interest rate risk in the trading book is subject to an exposure limit framework and limits for the banking book are set in the Bank's risk appetite.

Table 5.8 shows the first order sensitivity of the economic values of interest-bearing assets and liabilities to a shift of all yield curves upwards by 100 basis points (1%) for both trading and banking books by currency and interest-fixing period at the end of 2012.

TABLE 5.8 First order sensitivity of interest bearing assets and liabilities

Trading book [ISK m]	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	Total
ISK, non-indexed	(50)	(17)	(8)	(36)	-	(111)
ISK, CPI-indexed	-	(19)	(80)	(5)	(270)	(374)
EUR	(5)	-	-	-	-	(5)
Other	(2)	-	-	-	-	(2)
Total	(57)	(36)	(88)	(41)	(270)	(492)

TABLE 5.8 cont.

Banking book [ISK m]	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	Total
ISK, non-indexed	(102)	(433)	57	-	(10)	(488)
ISK, CPI-indexed	(35)	(603)	(282)	(1,980)	811	(2,089)
EUR	71	(3)	-	-	-	68
GBP	9	(6)	-	-	-	3
CHF	(20)	-	-	-	-	(20)
USD	(13)	-	(50)	-	-	(63)
JPY	(10)	-	-	-	-	(10)
Other	-	-	-	-	-	-
Total	(100)	(1,045)	(275)	(1,980)	801	(2,599)

The trading book exposure is dominated by CPI-linked and non CPI-linked Icelandic government bonds. The banking book exposure is mainly due to CPI-linked mortgages with fixed interest rates.

To further analyze the interest rate risk in the banking book, the Bank applies a parallel shift to the yield curves based on guidelines from the European Banking Authority (EBA) and the FME. A perpetual shift is assumed for all interest rates, but according to the Bank's analysis, the CPI-linked interest rate shows a strong mean reversion and a time-series analysis indicates that a shock peri-od can conservatively be assumed not to exceed four years. Table 5.9 shows the sensitivity of the banking book to the aforementioned shock at the end of 2012.

The Bank applies a parallel shift to the yield curves based on guidelines from the European Banking Authority (EBA) and the FME.

TABLE 5.9 Sensitivity of banking book to standard interest rate shock

Currency [ISK m]	Shift (bps)	Period	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	All periods
ISK, non-indexed	400	Perpetual	(453)	(1.599)	209	-	(27)	(1.870)
ISK, CPI-indexed	240	4 years	(56)	(1.346)	(380)	(1.194)	109	(2.867)
EUR	200	Perpetual	138	(5)	-	-	-	133
GBP	200	Perpetual	18	(12)	-	-	-	6
CHF	200	Perpetual	(40)	-	-	-	-	(40)
USD	200	Perpetual	(26)	-	(100)	-	-	(126)
JPY	200	Perpetual	(20)	-	-	-	-	(20)
Other	200	Perpetual	(2)	-	-	-	-	(2)
All currencies total			(441)	(2.962)	(271)	(1.194)	82	(4.786)

5.8 DERIVATIVES

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

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

6 LIQUIDITY RISK

6 LIQUIDITY RISK

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

An important source of funding for the Bank is deposits from individuals, corporations and institutional investors. The Bank's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits.

6.1 LIQUIDITY RISK AND FUNDING STRATEGY

The Bank's liquidity and funding strategy is to diversity the funding profile of the Bank by establishing access to domestic and international debt markets and prudently manage maturity profile of liabilities. Additionally the Bank's strategy is to always maintain sufficient liquidity by maintaining a high level of liquid assets and available funding to near term liabilities and expected payment outflows. An important part of the liquidity strategy is to pre-fund what the Bank estimates to be the likely cash-need during a liquidity crisis and hold such excess liquidity in the form of highly marketable securities that may be sold or pledged to provide funds.

The Bank's secured liquidity ratio[2] and cash ratio[3] should not go below the internal limit according to the Bank's risk appetite. The FME requires a minimum secured liquidity ratio of 20% and a minimum cash ratio of 5%. The high requirements of a liquidity reserve reflect the uncertainty of the stickiness of deposits at Icelandic banks and the fact that a large part of the Bank's liabilities are short-term or demand deposits, while the contractual maturity of assets is longer. The Bank actively monitors its liquidity reserve and has made progress in understanding and modelling the behaviour of its deposit base. The Bank must also adhere to liquidity limits set by the Central Bank of Iceland.

It is evident, since the Central Bank of Iceland is not a lender of last resort in foreign currency, that it is prudent for the Bank to hold even higher reserves in foreign currency than in Icelandic krona.

The Bank's liquidity risk strategy is reviewed at least annually.

[2]Ratio of total liquidity reserves to total deposits
[3]Ratio of cash and cash-like reserves to demand deposits

LIQUIDITY RISK

6.2 LIQUIDITY RISK MANAGEMENT

Liquidity risk is a key risk factor and emphasis is placed on managing it. The Bank's liquidity risk is managed by the Treasury department on a day-to-day basis and monitored by the Portfolio Risk department. The Treasury department provides all divisions with funds for their activities against a charge of internal interest.

The Bank's ALCO is responsible for liquidity management within the risk appetite set by the Board. Processes and reports regarding the liquidity status are regularly reviewed by the committee.

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

The Bank mitigates liquidity risk at all times by staying within liquidity risk limits for secured liquidity and demand deposits. This is reflected by the Bank's risk appetite. In addition to this, the Bank has taken active measures to increase term deposits from institutional investors and retail and SME clients.

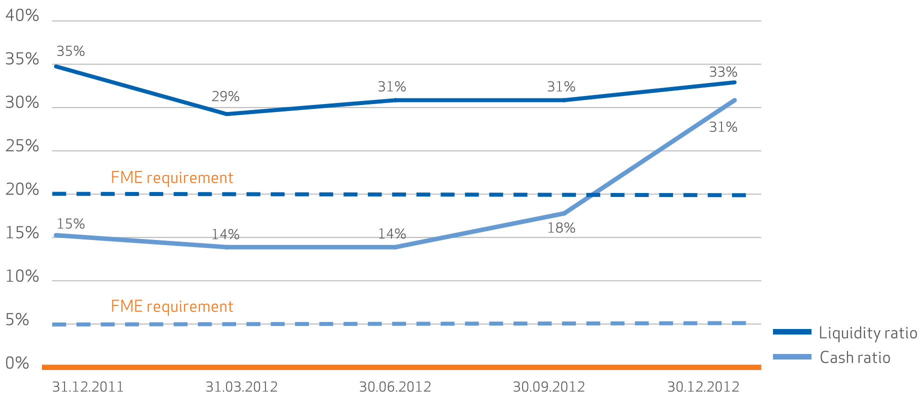
6.3 LIQUIDITY RISK MEASUREMENT

Secured liquidity consists of cash on hand, cash balance with the Central Bank of Iceland, the Bank's deposits with foreign banks, Treasury notes, Housing Fund bonds and other eligible bonds for repo transactions with the Central Bank of Iceland. A haircut is applied to all repo eligble securities according to the requirements of the Central Bank.

At the end of 2012 the secured liquidity ratio stood at 32.9% compared to 34.7% at the end of 2011, which would enable the Bank to withstand an instantaneous outflow in excess of the FME requirement of 20%. The cash ratio at the end of 2012 was 30.8%, compared to 15.0% at the end of 2011, exceeding the FME requirement of 5%. The increase in the cash ratio is due to the fact that the ratio of demand deposits to total deposits was considerably lower at the end of 2012 than it had been at the end of 2011, 57% compaired to 77%. That development is in accordance with the aforementioned strategy to lengthen the maturity profile of deposits.

▶ LIQUIDITY RISK

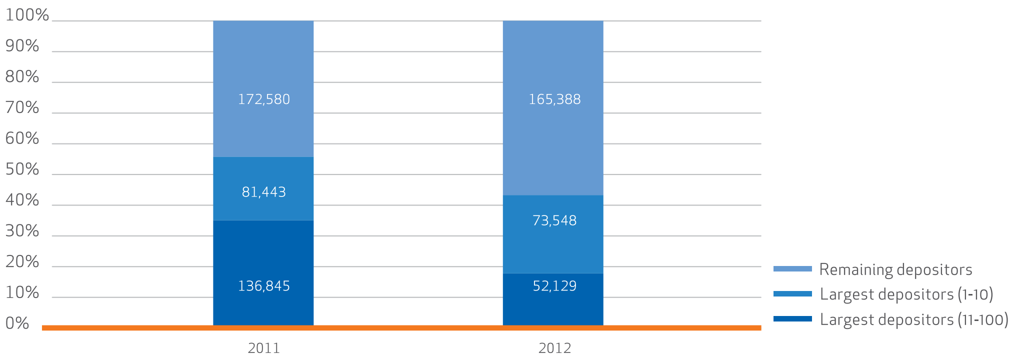
FIGURE 6.1 Development of secured liquidity- and cash ratios



In addition to lowering the proportion of demand deposits in the total deposit base, concentration of the Bank's demand deposits has been reduced significantly. At the end of 2011 35% of the Bank's demand deposits belonged to the 10 largest depositors. At the end of 2012 this ratio had gone down to 18%. The proportion of the next ninety largest depositors increased slightly from 21% to 25%, while the proportion of the remaining smaller depositors went up from 44% to 57%.

In addition to lowering the proportion of demand deposits in the total deposit base, concentration of the Bank's demand deposits has been reduced significantly.

FIGURE 6.2 Concentration of demand deposits [ISK m]



6.3.1 BREAKDOWN OF SECURED LIQUIDITY AND DEPOSITS

Table 6.1 shows a breakdown of the Bank's secured liquidity and deposits, along with the liquidity and cash ratios. A haircut is applied to the government liquidity facility and other repo-eligible bonds.

TABLE 6.1 Secured liquidity and deposits, parent company

31 December 2012 [ISK m]	ISK	FX	Total
Cash on hand and Central Bank deposits	22,514	5,082	27,596
Deposits at credit institutions	-	62,177	62,177
Total cash	22,514	67,259	89,773
Government liquidity facility (haircut applied)	67,176	-	67,176
Other repo-eligible bonds (haircut applied)	12,577	-	12,577
Total secured liquidity	102,267	67,259	169,526
Demand deposits	243,933	47,132	291,065
Term deposits	182,806	40,850	223,656
Total deposits	426,739	87,982	514,721
Liquidity ratio	24.0%	76.4%	32.9%
Cash ratio	9.2%	142.7%	30.8%

6.4 DEPOSIT STICKINESS

The Bank classifies its deposit base into seven different internal deposit-stickiness categories. Stickiness defines the estimated stability of deposits and their projected behaviour over time. A deposit is described as sticky if it is likely to be a stable funding source for the Bank in the future.

All depositors within a specific group share common characteristics that can be used as a measure of stickiness. The criteria for different levels of stickiness include, but are not limited to; behaviour of depositors over time, behaviour of depositors under stressed conditions and depositors' business relationship with the Bank.

Table 6.2 shows the distribution of the Bank's deposit base along with the stickiness categories, as a percentage of total deposits. The least sticky deposits are assigned a rating of 1, while the stickiest deposits are assigned a rating of 7.

TABLE 6.2 Distribution of deposits by stickiness rating

Rating	Category	2012	2011
1	Capital controls	2%	9%
2	Resolution process	16%	11%
3	Investors	29%	25%
4	Deposits - legal entities	12%	16%
5	Deposits - retail individuals	10%	11%
6	Deposits - legal entities with business relationship	15%	11%
7	Deposits - retail individuals with business relationship	16%	17%
Total		100%	100%

6.5 BASEL III LIQUIDITY MEASUREMENTS

In December 2010 the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity ratios, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks. The adoption of LCR in Iceland is planned in 2013 and the Central Bank of Iceland and the FME have engaged with the Bank in a dialogue aimed at clarifying and interpreting the Basel rules and observing the new ratios. The timing of the adoption of NSFR is yet to be decided by the regulatory authorities.

6.6 FUNDING

Significant progress has been made over the past three years in diversifying the Bank's funding profile.

At the end of 2011 Arion Bank replaced Kaupthing hf. as the issuer under Kaupthing hf.'s ISK 200 billion structured covered bond program. This meant that Arion Bank acquired all assets and liabilities in relation to the program. The covered bond program consists of four series of CPI-linked annuity bonds with final maturities from 2031 to 2048. The Bank has the right to prepay the bonds before final maturity. At the end of 2012 the outstanding balance of the issue was ISK 131,804 million.

In connection with Kaupskil's equity injection on 8 January 2010, the Bank received a loan secured with a portfolio of assets, equivalent to ISK 61,300 million, from the Central Bank of Iceland. The loan is denominated in foreign currencies and the currency composition can be adjusted to balance the FX position of the Bank. At the same time the Bank received a subordinated loan from the Icelandic government of ISK 29,500 million, as a Tier 2 capital injection. In addition the Bank paid the Icelandic government a dividend of ISK 6,074 million in 2011 but was granted a subordinated loan at the same time for the same amount. At the end of 2012 the outstanding balance of the subordinated liability was ISK 34,220 million.

The Bank has also set up a statutory covered bond program based on Icelandic covered bond legislation. The program is arranged by Barclays Capital and covered bonds issued under the program can be admitted to trading on the Luxembourg Stock Exchange's regulated market and listed on the Official List of the Luxembourg Stock Exchange. The first transaction from the covered bond program was to domestic institutional investors, mostly pension funds and insurance companies. The Bank is expected to issue between ISK 5,000 to 10,000 million of covered bonds to the same investor base in 2013. A further step was taken in May 2012 when the Bank became the first Icelandic bank to issue non-indexed covered bonds. The bonds bear 6.5% non-indexed interest rates and mature in 2015. The Bank issued a total of ISK 5 billion in covered bonds in 2012. The Bank is open to issuing both inflation-linked and fixed rate bonds. Likely maturities will range from 3 to 10 years depending on market demand. The covered bond program allows for issuance in other currencies than ISK but such bond issues are not expected in the near term future.

LIQUIDITY RISK

A milestone was reached at the end of February 2013 when Arion Bank completed a senior unsecured bond offering denominated in Norwegian kroner, arranged by Pareto Öhman. This is the first time the Bank has raised funding on the international markets and it is also the first international bond offering by an Icelandic financial institution since 2007. A total of NOK 500 million (ISK 11.2 billion) of bonds were placed with more than 60 investors in Norway, Sweden, Finland, the United Kingdom, continental Europe and Asia. The issue was oversubscribed. The aim is to list the bonds on the Oslo Stock Exchange. The bonds are floating rate notes with NIBOR plus 5.0% floating interest, maturing in 2016.

Table 6.3 shows the breakdown of funding by type.

Figure 6.3 shows the long term development of the Bank's funding profile. It shows progress has been made in diversifying the profile, particularly in the development of total deposits and the lengthening of the maturity of deposits: 72% of the Bank's funding where demand deposits at the end of 2009 compared to 33% in the end of 2012.

A milestone was reached at the end of February 2013 when Arion Bank completed a senior unsecured bond offering denominated in Norwegian kroner.

FIGURE 6.3 Development of funding by type - long term

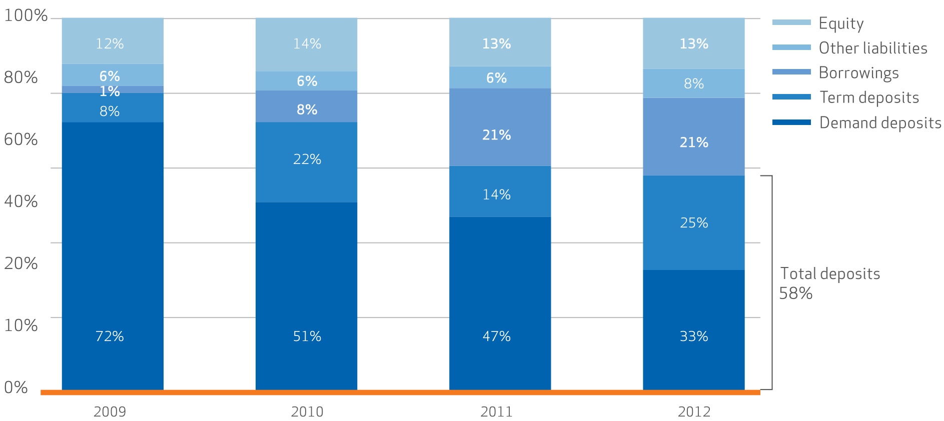


TABLE 6.3 Breakdown of funding by type - short term

31 December [%]	2012	2011
Due to credit institutions and Central Bank	3.3%	2.1%
Customer deposits	54.6%	58.9%
Borrowings	21.0%	20.7%
Subordinated loans	3.7%	3.7%
Financial liabilities	2.1%	0.2%
Tax liabilities	0.2%	0.3%
Other liabilities	1.9%	1.6%
Equity	13.2%	12.5%
Total	100.0%	100.0%

▶ LIQUIDITY RISK

Tables 6.4 and 6.5 show the breakdown by maturity of assets and liabilities.

TABLE 6.4 Breakdown of assets by contractual maturity

Assets 31 December [%]	2012	2011
On demand	13.0%	11.5%
Up to 3 months	7.5%	7.0%
3 - 12 months	11.4%	10.7%
1 - 5 years	30.9%	35.0%
Over 5 years	28.6%	26.5%
With no maturity	8.6%	9.3%
Total	100.0%	100.0%

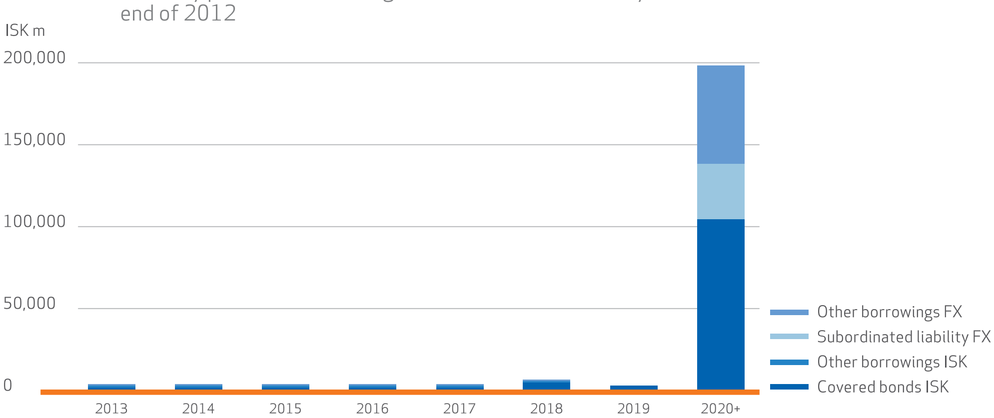
TABLE 6.5 Breakdown of liabilities by contractual maturity

Liabilities 31 December [%]	2012	2011
On demand	36.6%	50.1%
Up to 3 months	22.3%	9.7%
3 - 12 months	6.8%	7.1%
1 - 5 years	8.0%	5.6%
Over 5 years	25.4%	26.0%
With no maturity	0.9%	1.5%
Total	100.0%	100.0%

Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base will continue to be an important funding source and the focus point of liquidity risk management. The Bank's funding profile is strong and at the end of 2012 there is no significant redemption of long-term funding until 2020 as seen in figure 6.4.

The Bank's funding profile is strong and at the end of 2012 there is no significant redemption of long-term funding until 2020.

FIGURE 6.4 Maturity profile of borrowings and subordinated liability at the end of 2012



Note the bond issue in February 2013 increase the amount maturing in 2016 by ISK 11,2 billion.

The Bank is working on obtaining a credit rating from at least one of the three credit rating agencies, Moody's, S&P and Fitch. The current rating of the Icelandic Sovereign currently stands at Baa3, BBB-, BBB by the respective agencies. The sovereign ratings have been recently lifted to BBB by Fitch and taken off negative outlook by S&P. It is worth noting that the Icelandic banking system has a BB+ equivalent rating by S&P, using S&P BICRA methodology. This view of S&P is as of April 2013.

6.7 CONTINGENCY FUNDING PLAN

The Bank monitors its liquidity position and funding strategies on an on-going basis, but recognizes that unexpected events, economic or market conditions, earning problems or situations beyond its control could cause either a short or long-term liquidity crisis. To monitor liquidity and funding, the Treasury department prepares a monthly liquidity worksheet that projects sources and uses of funds. The worksheet is an integral component of the contingency funding plan. Although it is unlikely that a funding crisis of any significant degree could materialize, it is important to evaluate this risk and formulate contingency plans should one occur. Both general and limited bank runs are addressed in the contingency funding plan.

7 OPERATIONAL RISK

7 OPERATIONAL RISK

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

IT risk, legal, and reputational risk, are among others, considered subcategories of operational risk.

- IT risk is defined as the risk arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity, or arising from an inadequate IT strategy and policy or from inadequate use of the institution's information technology. The Bank's IT operation is subject to the FME's guidelines No. 1/2012 on operations of regulated entities' IT systems.
- Legal risk is defined as the risk to the Bank's interests resulting from instability in the legal and regulatory environment, as well as risk arising from uncertainty of the interpretation of contracts, laws or regulations. The Bank operates a legal division with lawyers that evaluate all legal risk and protect the Bank's interest. For further information regarding the Bank's main legal challenges, please see the Bank's Annual Report 2012.
- Reputational risk is defined as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors or regulators that can adversely affect the Bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding. In order to manage reputational risk effectively the Bank is in the process of implementing lean management to improve the customer's experience.

The Bank is in the process of implementing lean management to improve the customer's experience.

7.1 OPERATIONAL RISK STRATEGY

Operational risk is inherent in all activities at the Bank. The Bank's strategy is to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank aims to reduce its exposure to operational risk with a selection of internal control and quality management, and well-educated and qualified staff. The Bank has an open, no blame, operational risk culture and works to eliminate surprises by utilizing the Bank's operational tools and processes to the full extent. The Bank operates a no tolerance policy for internal fraud.

▶ OPERATIONAL RISK

7.2 OPERATIONAL RISK MANAGEMENT

The Board of Directors is ultimately responsible for overseeing the management of operational risk across the Bank. Each business unit within the Bank is primarily responsible for managing its own operational risk. The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk. Operational Risk is also responsible for providing leadership and support to every business unit during the implementation of operational risk tools, processes and policies, and supports them in their on-going improvement of the control environment. Operational Risk monitors and reports operational risk to the Board of Directors, Executive Management Committee and heads of departments.

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

The Bank manages operational risk within its operational risk management framework, which fulfils the Basel II requirements for standardized approach. The main techniques used to effectively manage operational risk in the Bank's business are:

- Registration of loss event data
- Risk control self-assessment throughout the Bank (RCSA)
- Key risk indicators (KRI's) measurements

Main operational risk concerns are reported monthly to the Board. Operational reports are sent on a regular basis to the relevant business units within the Bank.

The Bank uses various internal controls to minimize the risk of loss from operational risk events, and to promptly and readily identify them when they occur. The primary controls in operational risk management are included but not limited to the following:

- Operational risk culture
- Segregation of duties
- Four-eyes principle
- Documentation of working processes and process improvements
- Employee training
- Monitoring of operations
- New product process, which keeps track of new products being implemented in the Bank
- Surveillance software that monitors whether the Bank participates in possible market abuse acts

The Bank uses various internal controls to minimize the risk of loss from operational risk events.

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

For operational risk mitigation measures the Bank places emphasis on staff-training, process re-design and enhancement of the control environment. Operational risk is also well mitigated by transferring the risk through out-sourcing and by taking out insurances.

7.3 OPERATIONAL RISK MEASUREMENT

The Bank performs RCSA in order to identify risks, both inherent and residual, and assess the consequence and likelihood of an event occurring, and to assess the effectiveness of internal control environment and possible mitigation. The assessment of the impact of an event occurring includes both financial losses and reputational damage. Actions are planned for risks with extreme, high or moderate impact due to insufficient controls. The aim is to bring relevant risk to acceptable level by enhancing the control environment. Operational Risk follows up on the planned actions.

All internal operational risk events with a direct or indirect financial loss (or gain) are captured in the Bank's loss database as well as near misses. Losses are categorized according to the Basel II event categories for operational risk. The information is utilized for the identification, evaluation and monitoring of operational risk and on-going analysis of the costs that the Bank incurs due to operational risk incidents, as well as to understand the cause of the loss and reduce the risk of the event happening again. Operational Risk reports these incidents and follow-up on control enhancement if deemed necessary.

Figure 7.1 shows distribution of reported events by number. Categories clients, products and business practices, and external fraud accounted for 60% and 26%, respectively, of total reported loss events in 2012.

Figure 7.2 shows distribution of events reported by amount. Execution, delivery and process management accounted for 63% and external fraud accounted for 20% of the total losses in 2012. Execution, delivery and process management consists of events such as failed transaction processing. External fraud consists of events such as skimming and stolen credit cards.

The Bank uses KRI's to provide an early warning that may be indicative of increasing risk and/or ensure that risks remain within established tolerance levels. Examples of KRI's used in the Bank are: number of major incidents in IT, loss data events, settlement failures, transaction rollbacks, system downtime and internal audit recommendations which are not resolved within the given time-limit.

▶ OPERATIONAL RISK

FIGURE 7.1 Distribution of loss events by number

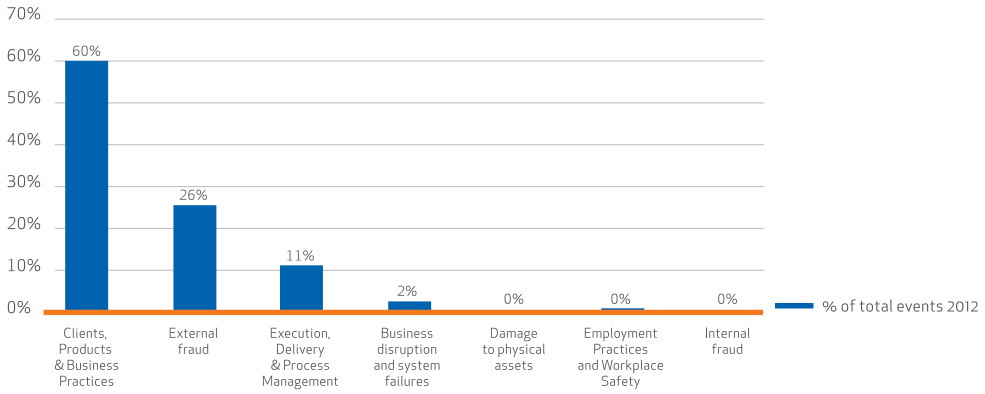
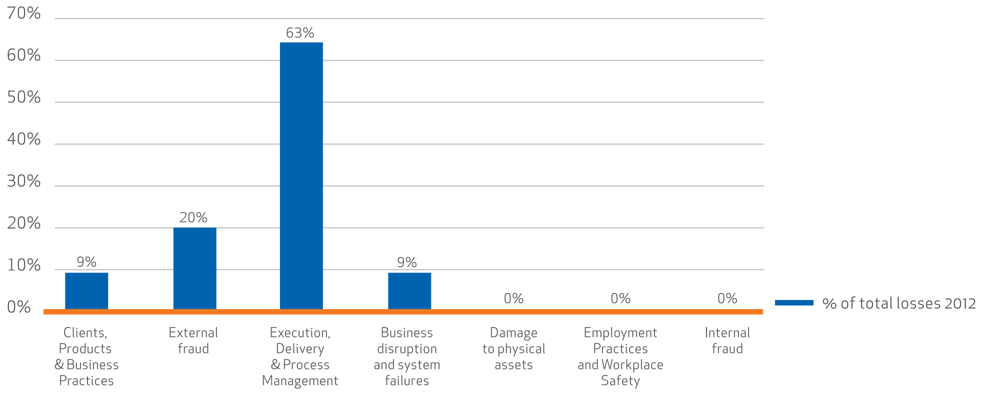


FIGURE 7.2 Distribution of loss events by amount



8 OTHER MATERIAL RISK

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

BUSINESS RISK

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

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

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The Icelandic Competition Authority (ICA) has opened three formal investigations involving the Bank all of them initiated by complaints. The first investigation involves alleged abuse of an alleged collective dominant position by the three largest retail banks, including the Bank. The case involves previously used terms of the Banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The second investigation involves card issuers, i.e. the three largest retail banks, Valitor and Borgun. The case relates to alleged collaboration through associations of undertakings in determining interchange reimbursement fees and alleged anti-competitive actions against competitors in the field of acquiring. The third investigation involves alleged tying of banking services and insurance. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Bank. However, if the Bank will be deemed to have violated the Competition Act is could result in a fine or restrictions set on the Bank by the ICA.

The Bank faces competition in the marketplace. Competition from less regulated financial institutions has been increasing in recent years, for example the use of specialized funds that are able to offer better terms for quality loans. The Icelandic State is also a large market player in retail services through its ownership in Landsbankinn, The Icelandic Housing Financing Fund and the Icelandic Student Loan Fund, standing behind majority of all loans to individuals. This heavy involvement by the State in the marketplace is to an extent a risk factor due to irrational market behaviour at times. The Bank responds by offering more versatile services. Another threat is competition from foreign banks that target strong Icelandic companies with revenues in foreign currency. The capital controls increase companies' incentives to move part or all of their business abroad.

OTHER MATERIAL RISK

POLITICAL RISK

Political risk is defined as the risk to the Bank's interests resulting from political instability, and therefore instability in the legal and regulatory environment. Considering the present political and economic environment in Iceland, the Bank faces political risk. Iceland is part of the EEA Agreement and applies therefore most of the European Union legislation in the financial services sector. In recent years the numbers of special Icelandic rules in the field of financial services have increased. Given discussions in the Icelandic Parliament there is a certain possibility that the Government will resort to regulatory restrictions that are different and even contradictory to reforms being discussed in the rest of Europe. Foreseeable changes in legislation that might affect the Bank are discussed in chapter 10. These risk factors are considered in the Bank's ICAAP.

9 REMUNERATION

Arion Bank has a remuneration policy in accordance with Act No. 2/1995, on Public Limited Companies that also complies with Act No. 161/2002, on Financial Undertakings and Rules No. 700/2011 on Remuneration Policy for Financial Undertakings. The policy is an integral part of Arion Bank's strategy to protect the long-term interests of Arion Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. Arion Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

Arion Bank's remuneration policy is reviewed annually and submitted and voted on at the annual general meeting. Arion Bank's remuneration policy is published on Arion Bank's website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2012, see Note 56.

The Bank's main objective with regard to employee remuneration is to offer competitive salaries in order to be able to attract and retain outstanding employees. The Bank's objective is also to ensure that jobs at the Bank are sought after by qualified people.

The Board Remuneration Committee (BRC), which is established by the Board of Directors of Arion Bank, provides guidance to the Board on Arion Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, Internal Auditor and Compliance Officer, and formulates the remuneration framework for the Managing Directors as proposed by the CEO. The BRC also provides guidance on an incentive scheme and other work-related payments for Arion Bank.

Boards of Directors of individual subsidiaries decide on an incentive scheme for the subsidiaries.

As of end 2012 the only entity in the Arion Bank Group subject to Rules No. 700/2011, which has an incentive scheme, is the asset management company Stefnir hf.

10 UPCOMING AND NEW LEGISLATION

As a financial undertaking, the Bank must adhere to various laws and regulations. The legal environment is dynamic and the Bank must therefore constantly monitor upcoming changes in legislation, in order to meet the requirements made at each time. The following section lists several factors the Bank deems necessary to mention in this regard.

10.1 CAPITAL REQUIREMENT DIRECTIVE – CRD IV

In July 2011 the European Commission issued a new capital requirement package ('CRD IV') replacing the current Capital Requirements Directives. The CRD IV reflects the Basel III capital proposals and also includes new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. The Directive will be implemented through national law within all EU member states and the EEA countries. Discussions and negotiations have taken place between the European Commission, the European Council and the European Parliament during autumn 2012 and the legislation is now expected to be finalized during spring 2013. The date of application will be 1 January 2014, with full implementation on 1 January 2019. However there is a possibility of it being postponed for several months. The Icelandic government has appointed a special committee which has the role of scrutinizing the implementation of the CRD IV in Iceland. The main changes following the implementation are the enhancement of capital quality, strengthening capital requirements for counterparty credit risk, the introduction of a leverage ratio, the introduction of new capital buffers, and new liquidity metrics.

10.2 ACT ON CONSUMER LOANS

On 18 March 2013, a bill on consumer loans to implement Directive No. 2008/48/EC of the European Parliament and of the Council on credit agreements for consumers was passed into law. The new Act on Consumer Loans entails substantial changes from the current legislation on consumer loans. The main changes are that the scope is broadened, lenders are obliged to disclose more information to borrowers, lenders must perform a credit rating and a credit appraisal when the loan amount exceeds a certain amount, consumers will have the permission to terminate the loan agreement without stating a reason within 14 calendar days and a special calculation rule is designed to ensure that the prepayment fee is never more than 0.5% - 1.0% of the amount being repaid. The Act will entail greater costs for the Bank but at this stage it is difficult to assess any further effects of the Act. The Act will enter into force on 1 September 2013.

10.3 FISHERIES MANAGEMENT ACT

The Icelandic Parliament has been discussing a bill concerning changes to the Fisheries Management Act. The changes represent a considerable change from the current legislation but it is uncertain when the bill will be passed. Therefore it is not possible at this stage to discuss the significance of possible changes to the system for the Bank's financial position and operations.

11 ABBREVIATIONS

ACC	Arion Credit Committee
ALCO	Asset and Liability Committee
ABMIIF	Arion Bank Mortgages Institutional Investor Fund
BARC	Board Audit and Risk Committee
BCC	Board Credit Committee
BCM	Business Continuity Management
BoD	Board of Directors
CCC	Corporate Credit Committee
CEO	Chief Executive Officer
CMS	Collateral Management System
CPI	Consumer Price Index
COREP	Common Reporting
CRD	Capital Requirements Directive
CRM	Customer Relationship Management
CRO	Chief Risk Officer
EAD	Exposure at Default
EBA	European Banking Authority
EWS	Early Warning System
FME	Financial Supervisory Authority Iceland
ICA	Icelandic Competition Authority
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRRBB	Interest Rate Risk in the Banking Book
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LPA	Loan Portfolio Analysis
MD	Managing Director
MLRO	Money Laundering Reporting Officer
NSFR	Net Stable Funding Ratio
RCSA	Risk Control Self-Assessment
PD	Probability of Default
RBC	Retail Branch Credit Committees
ROAC	Return on Allocated Capital
RWA	Risk-Weighted Assets
SME	Small and Medium Enterprises
SO	Security Officer
SREP	Supervisory Review and Evaluation Process

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