PILLAR 3 RISK DISCLOSURES **2013**

Arion Bank

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DISCLAIMER

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1 INTRODUCTION

1 INTRODUCTION

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

1.1 ARION BANK AT A GLANCE

Arion Bank, with roots dating back to 1930, is built on a strong heritage and infrastructure. Arion Bank is a strong, well capitalized bank which offers a full range of universal banking services to its customers through various distribution channels. The Bank operates an extensive nationwide branch network with a focus on the capital area in Iceland. In addition, the Bank operates a service centre, and offers online and mobile banking, which provides a wide range of self-service options.

Arion Bank is a relationship bank with its prime emphasis on corporations and individuals seeking a variety of financial solutions. The Bank focuses on building and strengthening long-term customer relationships by delivering excellent service and tailored solutions. Arion Bank is at the forefront of the domestic financial market in regards to return on equity, operational efficiency and service offering.

Arion Bank has taken important funding and market initiatives in recent years. In 2013 the Bank completed its first international bond offering, the first among Icelandic banks since 2007. The bond offering further diversified the Bank's funding profile. As a relationship bank, a strong focus is placed on product development, not least on the mortgage market. The Bank became the first of the Icelandic banks to offer non-indexed mortgages with fixed interest for five years as well as with mixed loans.

The Bank was named "Bank of the Year 2013" in Iceland by the Banker magazine, which is published by the Financial Times. This is the first time since 2007 that the magazine has presented the award to an Icelandic bank.

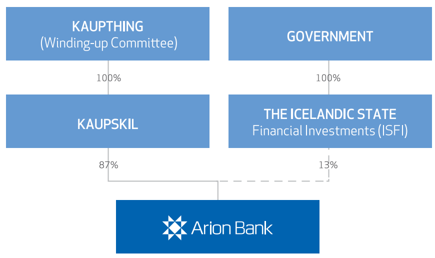
Arion Bank consists of six main business segments: Asset Management, Investment Banking, Corporate Banking, Retail Banking, Treasury, and Other Divisions and Subsidiaries. At year end 2013 the number of full-time equivalent positions at Arion Bank and its subsidiaries was 1,145.

Arion Bank has two shareholders. Kaupthing hf., on behalf of its creditors, holds 87% stake in the Bank through its subsidiary Kaupskil ehf. The remaining 13% share is held by the Icelandic State Financial Investments on behalf of the Icelandic government.

The Bank's Annual Report 2013 provides further information about the Bank, such as strategy and vision, and corporate governance.

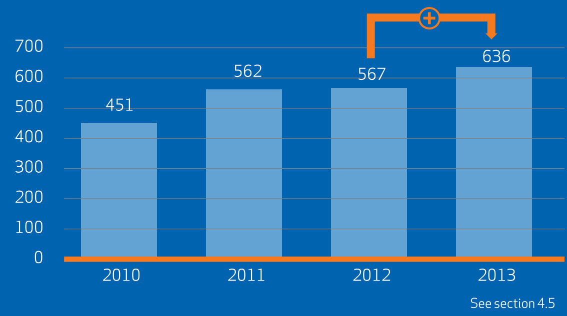
FIGURE 1.1 Arion Bank's branch network

FIGURE 1.2 Ownership structure

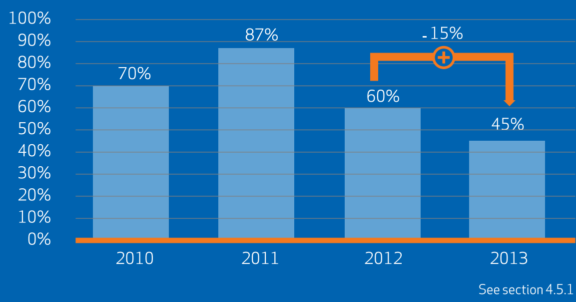


RISK METRICS OVERVIEW

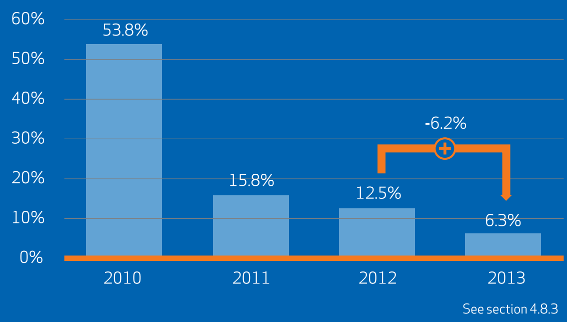
Loans to customers



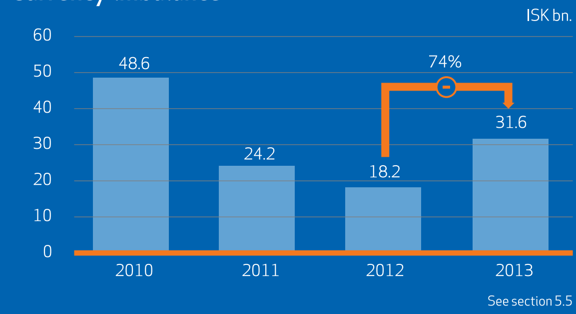
Sum of large exposure



Problem loans

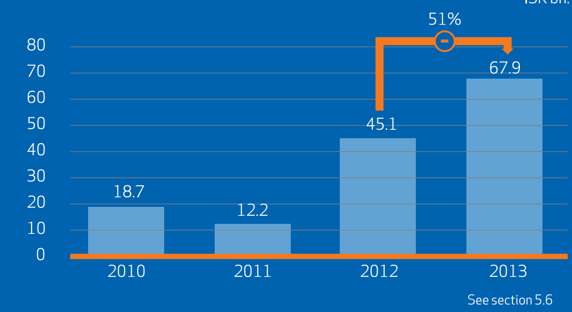


Currency imbalance

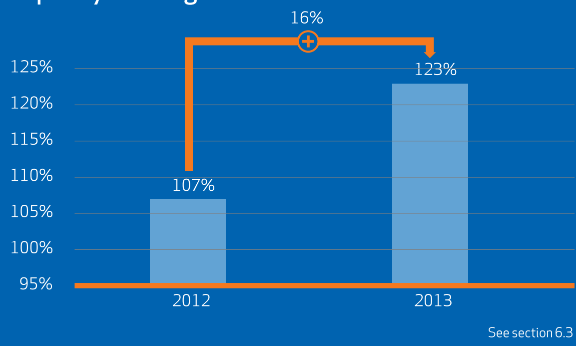


Consumer Price Index imbalance

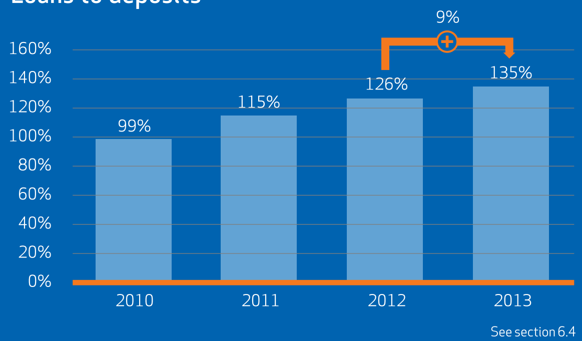
ISK bn.



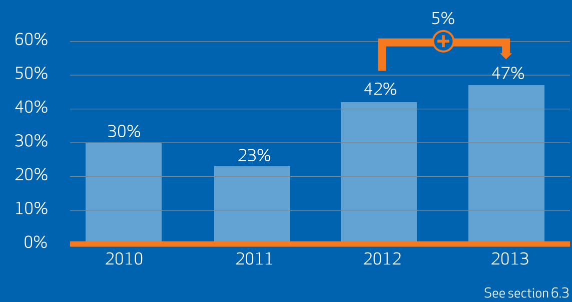
Liquidity Coverage Ratio



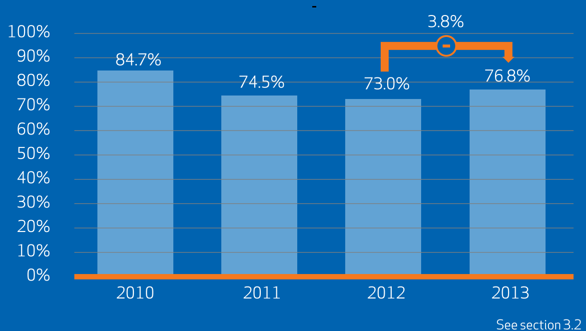
Loans to deposits



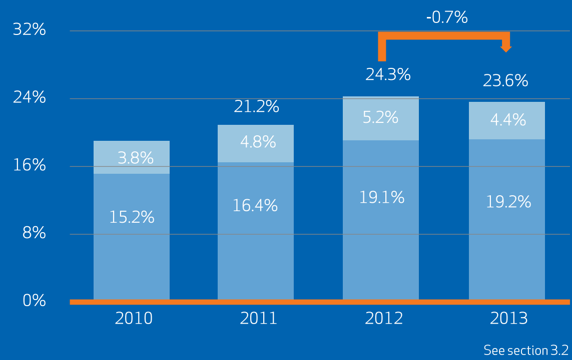
Term deposits



RWA divided by Total assets



CAD ratio



▶ INTRODUCTION

1.2 MAJOR CHANGES IN 2013

Several developments influenced Arion Bank's risk profile in 2013. Highlights include:

PREPARATION FOR THE LIFTING OF CAPITAL CONTROLS

For more than five years now 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 complicated access to funding. It remains uncertain what and when the next step of the Icelandic government will be in lifting the capital controls. During 2013 the Bank has strengthened its liquidity position and diversified its funding base in the short term and long term, with particular focus on foreign currency, to meet any potential outflow of deposits that would be expected if the capital controls were to be lifted.

INTERNATIONAL FUNDING

In July, Arion Bank's NOK 500 million bond was admitted to trading on the Oslo Stock Exchange. The bond, issued in February, had been the first international bond issued by an Icelandic financial institution since 2007. The event marked an important step in expanding Arion Bank's access to foreign funding.

GOVERNMENT PLAN FOR HOUSEHOLD DEBT RELIEF

In November 2013 the Icelandic government announced its action plan for household debt relief. The plan involves writing down CPI-indexed mortgages to an amount equivalent to capping the CPI at 4.8% during the period from December 2007 to August 2010. The maximum amount of the write-down per household will be ISK 4 million and previous debt-relief remedies will be deducted from the amount of the correction. The write-down, which will occur over a four-year period, will be funded by the Icelandic government via a special tax levied against Icelandic banks, including those that are in winding-up proceedings. Although this plan reduces political risk related to political pressure for household debt relief it comes at the cost of a threefold increase in the bank levy compared with the previous year end is nine times the levy initially presented for the year.

NEW LIQUIDITY RULES

On 1 December 2013 the Central Bank of Iceland issued new Rules on Liquidity Ratio, No. 1055/2013. The rules are based on the Liquidity Coverage Ratio (LCR) standard developed by the Basel Committee on Banking Supervision and incorporated into EU law in 2013 via the Capital Requirements Directive (CRD IV). The Central Bank rules include special requirements on foreign currency liquidity and the consideration given to risks related to the winding-up of the old banks. Arion Bank satisfies the Central Bank's requirements, exceeding 100% both for the LCR and the special LCR for foreign currency.

SETTLEMENT OF DRÓMI BOND

At the end of 2013 an agreement was reached between Arion Bank and the Central Bank of Iceland Holding Company ehf. (ESÍ) on the settlement of the Drómi bond from 2009. The bond was paid with assets including three portfolios of loans to individuals originated by two small failed banks, SPRON savings bank and Frjálsi Investment Bank. The transfer of these loan portfolios cements the business relationship with customers whose deposits were transferred to the Bank as a result of a 2009 decision by the Icelandic Financial Supervisory Authority (FME). The effect of the agreement on the balance sheet and income statement can be seen in the transfer of assets from securities holdings over

At the end of 2013 an agreement was reached between Arion Bank and the Central Bank of Iceland Holding Company ehf. (ESÍ) on the settlement of the Drómi bond from 2009.

to loans to customers. The transferred loans increase the ratio of loans to individuals to 49% and the ratio of mortgages to 39% of loans to customers at the end of the year (42% and 30% respectively at end 2012), which fits in with the Bank's strategy of increasing the proportion of loans to individuals. The transferred portfolios raise the ratio of problem loans at the Bank, as the progress of resolving impairments lags that made by Arion Bank. From a risk perspective the deterioration of loan book quality is offset by the resolution of any uncertainty related to the settlement of the Drómi bond.

INTERNATIONAL CREDIT RATING

During 2013 the Bank undertook in a ratings process, with the aim to obtain an international credit ratings. On 10 January 2014 the credit ratings agency Standard & Poor's assigned Arion Bank a rating of BB+, with a stable outlook.

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1.3 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 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

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.

1.3.1 THE STATUS OF CRD IV IMPLEMENTATION IN ICELAND

In June 2013 the EU Council adopted the Capital Requirements Regulation (CRR, Regulation No. 575/2013) and the Capital Requirements Directive (CRD IV, Directive 2013/36/EU), the EU's implementation of the Basel III reforms. As an EEA member, Iceland has not yet implemented CRD IV. The status in Iceland is that the government established a working committee in November 2012. This committee has the role to present a proposal to the Ministry of Finance and Economic Affairs. The Ministry has announced that this will most likely be done in three steps and the first bill will probably be presented to the Parliament in the first quarter of 2014.

INTRODUCTION

1.4 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.

1.5 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 2013. 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 2013, 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 2013 and presented in ISK millions, unless otherwise stated. Due to rounding, numbers in the disclosures may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures.

The disclosures are published on an annual basis in the Pillar 3 Risk Disclosures and are available on the Bank's website following the annual general meeting.

1.6 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; 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. The main subsidiaries, in which Arion Bank held a direct interest at the end of 2013, are shown in Table 1.1. Where necessary, a distinction is made in the report between the group and parent entity.

TABLE 1.1 Main subsidiaries in which Arion Bank held a direct interest at the end of 2013, fully consolidated

Company	Business	Ownerhip %	Currency	Country	Operation
AFL- sparisjóður	Savings bank	99.3	ISK	Iceland	Core
ABMIIF	Mortgages fund	100.0	ISK	Iceland	Core
BG12 slhf.	Holding company	62.0	ISK	Iceland	Non-core
EAB 1 ehf.	Holding company	100.0	ISK	Iceland	Non-core
Eignabjarg ehf.	Holding company	100.0	ISK	Iceland	Non-core
Eignarhaldsfélagið Landey ehf.	Holding company	100.0	ISK	Iceland	Non-core
Landfestar ehf.	Holding company	100.0	ISK	Iceland	Non-core
Okkar líftryggingar hf.	Life insurance	100.0	ISK	Iceland	Core
Stefnir hf.	Asset management	100.0	ISK	Iceland	Core
Valitor Holding hf.	Credit card service	60.8	ISK	Iceland	Core

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 detail in this report.

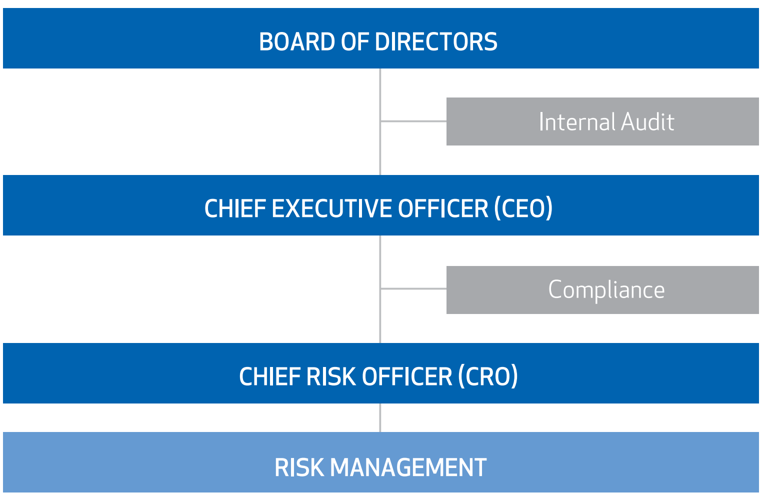
2.1 INTERNAL CONTROL AND LINES OF REPORTING

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.

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

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

FIGURE 2.1 Internal control structure



Acting within an authority delegated by the Board, the Board 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 BARC reviews the Bank's risk appetite and makes recommendations thereon to the Board when applicable.

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 No. 64/2006 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 with unhindered access to the Board. The CRO has overall day-to-day accountability for risk management in the Bank's parent company and periodic accountability for risk assessment in the Bank 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.

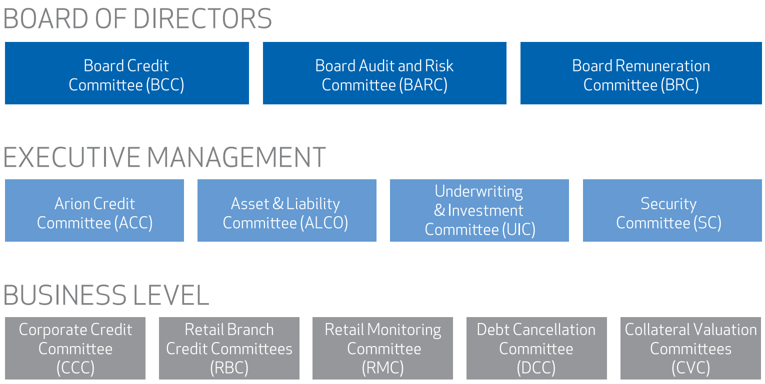
2.2 RISK COMMITTEES

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.

The committees define lines of responsibility and accountability within 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 Audit and Risk Committee (BARC)	The main task of the Board Audit and Risk Committee is to examine issues concerning auditing and risk which the Board needs to make a decision on. The regular tasks of the committee include examining reports of internal regulators, reviewing the risk policy, examining the annual and interim financial statements to ensure the quality of the information contained in them and the independence of the company's auditors.
Board Credit Committee (BCC)	The main task of the Board Credit Committee is to attend to credit, investment and underwriting issues which exceed the credit limits of its sub-committees.
Board Remuneration Committee (BRC)	The main task of the Board Remuneration Committee is to advise the Board on the terms of remuneration to the CEO. Regular tasks at committee meetings are to review the remuneration policy, the human resources policy, salary distribution and the incentive system if one is in place.

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
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 advisory 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 advisory member of the committee.
Security Committee (SC)	The Security Committee is the Bank's authority on security matters. The committee formulates, reviews and approves security goals and policies, monitors compliance with security policies and implements information security rules.

TABLE 2.3 Business level committees

Committee	Responsibilities
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.
Debt Cancellation Committee (DCC)	The Debt Cancellation Committee deals with applications to reach composition with debtors.
Collateral Valuation Committees (CVC)	Five Collateral Valuation Committees set guidelines on collateral assessment and valuation.

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

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 is 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 a comment for all credit applications that are submitted to 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.

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.

RISK MANAGEMENT

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 calculates the regulatory capital requirements and manages 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

The Credit Control department 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 and is responsible for collateral and covenant supervision and reporting.

PORTFOLIO RISK

The Portfolio Risk department is responsible for analyzing, monitoring and reporting on risks resulting from balance sheet mismatches, particularly market risk and liquidity risk. This involves surveillance of the Bank's margin trading activities. Portfolio Risk interfaces primarily with the Bank's Treasury, Proprietary Trading and Capital Markets 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 various quantitative support to the Bank's business units.

OPERATIONAL RISK

The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk at Arion Bank. Operational Risk is also responsible for providing leadership and support to every business unit regarding the implementation of operational risk tools, processes, and ongoing improvements of the control environment.

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

The Operational Risk Framework comprises a number of elements which allows the Bank to manage and measure its operational risk profile and to evaluate the amount of operational risk capital that the Bank needs to hold to absorb potential losses such as the Risk and Control Self-Assessment (RCSA) and loss data collection.

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 Board and the BARC is promptly notified 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 2.5.

The Bank's Annual Report, Financial Statements, and Pillar 3 Risk Disclosures are all available on the Bank's website. Furthermore the Bank delivers regular reports to the 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.

TABLE 2.4 Risk appetite metrics

Risk type	Metric
Credit risk	• Sum of large exposures • Single name exposure • Expected loan loss rates
Market risk	• Equity exposure • Unlisted equity exposure • Indirect equity exposure • Currency imbalance
Funding and liquidity risk	• Liquidity coverage ratio • Loans to deposits ratio • Encumbered asset ratio
Operational risk and compliance	• Tolerance statements for various compliance breaches
Solvency and earnings	• Capital ratios • Target return on equity

TABLE 2.5 Primary reporting within the Bank

Primary reporting	Contents	Frequency	Recipient
Credit risk portfolio report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the loan's portfolio quality.	Monthly	ACC
Liquidity and market risk report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit 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 the Bank's risk appetite and ICAAP status, 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.

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 statutory deductions according to Article 84 of Act No. 161/2002. Tier 2 capital can be up to a maximum of 50% of Tier 1 capital and Tier 3 can be up to a maximum of 50% of Tier 1 capital. Furthermore, Tier 3 capital can be up to a maximum of 4.8% of the risk-weighted assets of the trading book, as provided in Article 28 of Act No. 161/2002, and currency risk.

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. The non-controlling minority interests are due to the Bank's 60.8% holdings in Valitor Holding hf. which is fully consolidated within the Bank's accounts. 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. Other statutory deductions made from Tier 1 and 2 are mainly due to minority holdings in financial institutions. The minority holdings are deducted 50% from Tier 1 and 50% from Tier 2. Arion Bank has no Tier 3 capital in its capital base.

At the end of 2013 Arion Bank's capital base amounted to ISK 170,439 million of which 81% is Core Tier 1 capital.

CAPITAL MANAGEMENT

TABLE 3.1 Capital base

31 December [ISK m]	2013	2012
Share capital	2,000	2,000
Share premium	73,861	73,861
Other reserves	1,637	1,639
Retained earnings	62,591	49,572
Non-controlling interests	4,858	3,806
Total equity	**144,947**	**130,878**
Intangible assets	(5,383)	(4,941)
Tax assets	(818)	(463)
Other statutory deductions	(119)	-
Tier 1 capital	**138,627**	**125,474**
Subordinated liabilities	31,918	34,220
Other statutory deductions	(106)	-
Tier 2 capital	**31,812**	**34,220**
Capital base	**170,439**	**159,694**

At the end of 2013, Arion Bank's capital base amounted to ISK 170,439 million, of which core Tier 1 capital is ISK 138,627 million or 81% of the total capital base. The Bank's core Tier 1 capital grew by ISK 13,153 million between year-end 2012 and 2013 mainly due to the Bank's earnings in 2013 of ISK 12,655 million.

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 FME's 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 Bank's own internal assessment of capital adequacy (ICAAP).

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 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 Internal Capital Adequacy Assessment process (ICAAP) and the FME's Supervisory Review and Evaluation Process (SREP). 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. Table 3.2 outlines the development of the Bank's key capital and risk weighted assets figures. The increase in average risk weight at year-end is mainly due to the settlement of the Drómi bond, see section 1.2 for further information. The bond was issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. The bond was secured with all Drómi's assets and also with a hold harmless statement from the Ministry of Finance and Economic Affairs. Based on the hold harmless statement the bond was risk weighted by a 0% risk weight. However, the assets transferred base on the settlement carry an average risk weight of 68%.

TABLE 3.2 Key capital adequacy figures

31 December [ISK m]	2013	2012	2011	2010
Tier 1 capital	138,627	125,474	109,069	104,889
Capital base	170,439	159,694	141,174	131,146
Risk-weighted assets (RWA)	720,822	657,763	664,956	688,649
Pillar 1 capital requirement	57,666	52,621	53,197	55,092
Tier 1 capital ratio	19.2%	19.1%	16.4%	15.2%
Total capital ratio	23.6%	24.3%	21.2%	19.0%
RWA divided by Total assets (on balance sheet)	76.8%	73.0%	74.5%	84.7%

TABLE 3.3 Method of calculation of minimum capital requirements

Method of calculation of minimum capital requirements	
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, whichever is the higher.
Operational risk	The Bank uses the basic indicator approach to calculate capital requirements for operational risk. This approach entails using 15% of a three-year average of the sum of net interest income and net non interest income.

The Bank's RWA are calculated using the approaches described in Table 3.3. In Table 3.4 the Bank's exposure at default, RWA and minimum capital requirements under Pillar 1 for the end of 2013 and 2012 are broken down by different risk types, and exposure classes.

At the end of 2013 credit risk accounted for 84% of RWA, operational risk accounted for 11% and market risk 5%.

At the end of 2013 credit risk accounted for 84% of RWA, operational risk accounted for 11% and market risk 5% of the minimum capital requirements.

FIGURE 3.1 RWA 2013

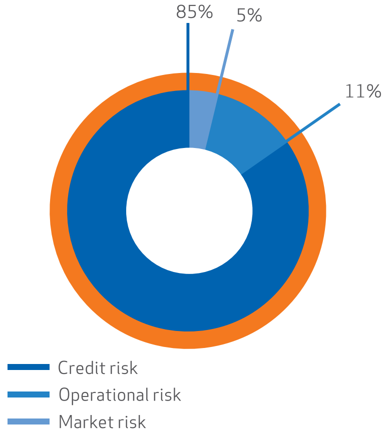


TABLE 3.4 Exposure, risk-weighted assets and capital requirements split by exposure class

31 December 2013 [ISK m]	Exposure at Default (EAD) On-balance sheet	Exposure at Default (EAD) Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	38,027	3,258	-	-	-
Regional government	5,768	2,092	1,662	21.1%	133
Administrative bodies	57	3	61	100.0%	5
Institutions	102,307	24	22,624	22.1%	1,810
Corporate	177,064	19,312	171,139	87.1%	13,691
Retail	63,688	12,320	56,641	74.5%	4,531
Real estate	360,765	3,913	230,795	63.3%	18,464
Past due	28,402	5	30,368	106.9%	2,429
Other assets	70,028	-	69,736	99.6%	5,579
Equity, banking book	16,245	-	22,831	140.5%	1,826
Traded debt instruments, banking book	57,512	-	1,654	2.9%	132
Counterparty credit risk	1,070	-	517	48.3%	41
Credit risk total	**920,935**	**40,928**	**608,029**	**63.2%**	**48,642**
Market risk					
Traded debt instruments, trading book	7,495	-	3,187	42.5%	255
Equity, trading book	1,204	-	1,806	150.0%	144
Foreign exchange	31,630	-	31,703	100.2%	2,536
Market risk total	**40,329**		**36,696**	**91.0%**	**2,936**
Operational risk total			**76,097**		**6,088**
Total	**961,264**	**40,928**	**720,822**	**71.9%**	**57,666**

31 December 2012 [ISK m]	Exposure at Default (EAD) On-balance sheet	Exposure at Default (EAD) Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	25,286	3,423	-	-	-
Regional government	6,387	1,603	1,782	22.3%	143
Administrative bodies	55	3	58	100.0%	5
Institutions	101,091	18	23,319	23.1%	1,866
Corporate	184,046	9,730	176,779	91.2%	14,142
Retail	53,533	13,184	49,833	74.7%	3,987
Real estate	285,711	661	186,582	65.2%	14,927
Past due	33,481	5	33,697	100.6%	2,696
Other assets	60,105	-	59,949	99.7%	4,796
Equity, banking book	16,471	-	23,483	142.6%	1,879
Traded debt instruments, banking book	112,152	-	1,784	1.6%	143
Counterparty credit risk	698	-	698	100.0%	56
Credit risk total	**879,015**	**28,627**	**557,964**	**61.5%**	**44,637**
Market risk					
Traded debt instruments, trading book	10,734	-	6,847	63.8%	548
Equity, trading book	374	-	561	150.0%	45
Foreign exchange	20,063	-	20,063	100.0%	1,605
Market risk total	**31,171**	**-**	**27,470**	**88.1%**	**2,198**
Operational risk total			**72,329**		**5,786**
Total	**910,186**	**28,627**	**657,763**	**70.1%**	**52,621**

FIGURE 3.2 Change in RWA in 2013

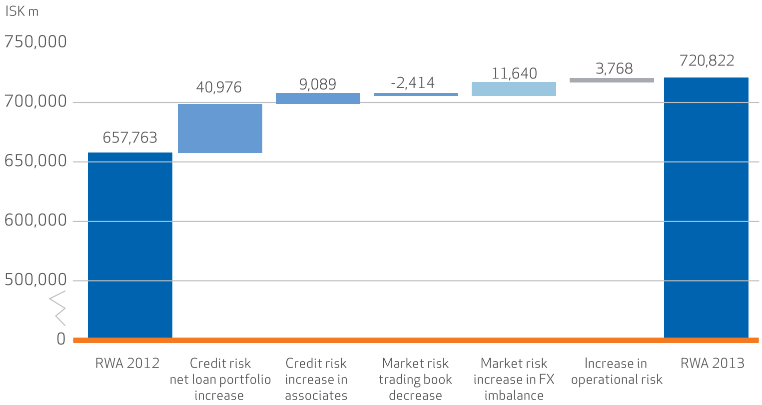
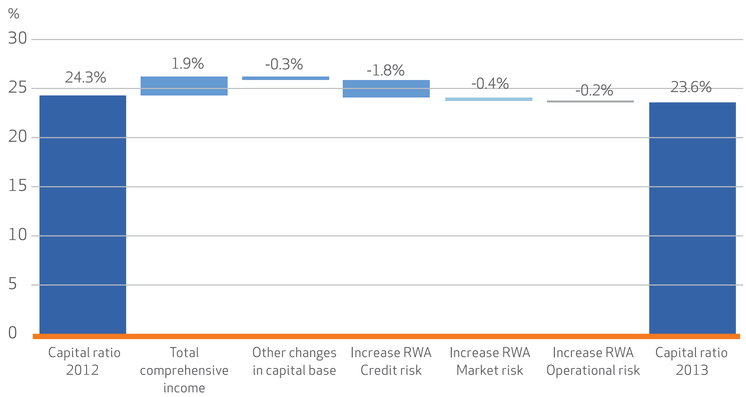


FIGURE 3.3 Change in capital ratio in 2013



Risk-weighted assets amounted to ISK 720,822 million at the end of 2013 compared to ISK 657,763 million at the end of 2012. The main factors behind the change in RWA and the increase of the capital adequacy ratio in 2013 are shown in Figure 3.2 and 3.3 respectively.

Table 3.5 shows the average exposure at default, RWA and minimum capital requirements for the year 2013. Table 3.6 shows the Bank's on-balance sheet credit exposure broken down by exposures classes and by sectors.

TABLE 3.5 Average exposure, risk-weighted assets and capital requirements split by exposure class

Average 2013 [ISK m]	Exposure at Default (EAD) On-balance sheet	Exposure at Default (EAD) Off -balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	28,014	3,324	-	-	-
Regional government	6,224	1,940	1,749	21.4%	140
Administrative bodies	52	3	55	100.0%	4
Institutions	107,171	21	24,834	23.2%	1,987
Corporate	167,234	20,381	167,945	89.5%	13,436
Retail	57,357	12,391	51,951	74.5%	4,156
Real estate	322,812	2,810	211,538	65.0%	16,923
Past due	30,689	5	31,858	103.8%	2,549
Other assets	69,336	-	68,606	98.9%	5,488
Equity, banking book	16,107	-	22,801	141.6%	1,824
Traded debt instruments, banking book	107,907	-	1,592	1.5%	127
Counterparty credit risk	1,040	-	572	55.0%	46
Credit risk total	**913,944**	**40,875**	**583,500**	**61.1%**	**46,680**
Market risk					
Traded debt instruments, trading book	9,098	-	4,803	52.8%	384
Equity, trading book	1,119	-	1,679	150.0%	134
Foreign exchange	25,251	-	27,219	107.8%	2,177
Market risk total	**35,468**		**33,700**	**95.0%**	**2,696**
Operational risk total			**76,097**		**6,088**
Total	**949,412**	**40,875**	**693,298**	**70.0%**	**55,464**

TABLE 3.6 Exposure split by exposure class and by sector

	Exposure at Default - On Balance sheet									
31 December [ISK m]	Central Govern-ment	Regional Govern-ment	Admin-istrative Bodies	Institu-tions	Corporate	Retail	Real Estate	Past Due	Other Credit risk related exposure	Total On Balance Sheet
Credit risk										
Agriculture	-	-	-	-	314	573	2.879	92	-	3.859
Financial and insurance services	37.999	-	-	102.307	24.968	518	232	1.591	-	167.616
Fishing industry	-	-	-	-	42.314	994	18.389	645	-	62.342
Individual	-	-	-	-	-	49.463	235.667	22.523	-	307.653
Industry, energy and manufacturing	-	66	-	-	12.125	1.108	9.912	16	-	23.226
Information and communication technology	-	-	-	-	24.315	642	635	29	-	25.621
Public administration, human health and social act.	28	4.715	57	-	98	707	2.960	30	-	8.596
Real estate and construction	-	-	-	-	7.558	3.777	69.808	1.398	-	82.542
Services	-	988	-	-	10.793	2.481	2.426	826	-	17.514
Transportation	-	-	-	-	15.165	222	4.568	1	-	19.956
Wholesale and retail trades	-	-	-	-	39.414	3.202	13.289	1.250	-	57.155
Other assets	-	-	-	-	-	-	-	-	70.028	70.028
Banking book - Traded debt instruments	-	-	-	-	-	-	-	-	57.512	57.512
Banking book - Equity	-	-	-	-	-	-	-	-	16.245	16.245
Counterparty credit risk	-	-	-	-	-	-	-	-	1.070	1.070
Credit risk total	**38.027**	**5.768**	**57**	**102.307**	**177.064**	**63.688**	**360.765**	**28.402**	**144.856**	**920.935**

3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

The ICAAP is the Bank's internal assessment of its capital needs. The ICAAP is carried out in accordance with the CRD's Pillar 2 requirement with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure and manage the Bank's total risk exposure.

The 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 its SREP. Arion Bank's capital base exceeds both the internal assessment of capital requirements and the FME's SREP requirements.

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

- Raise risk-awareness to all the Bank's activities and to ensure that the Board of Directors and the Executive Management Committee understand the Bank's risk profile
- Carry out a process to adequately identify and measure the Bank's risk factors
- Carry out a process to monitor that the Bank's capital is adequate and used in relation to its risk profile
- Review the soundness of the Bank's risk management systems and controls that are used to assess, quantify and monitor the Bank's risks

Managing Directors with their key personnel and key personnel from the subsidiaries participate in the process of identifying and evaluating their high risk areas, in cooperation with Risk Management. The result from the identification phase serves as the basis for the risk identification within the Bank's ICAAP. Risk categories identified for the business units are shown in Table 3.7.

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

TABLE 3.7 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 divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓	✓

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 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
- Industry sector concentration of credit risk
- Interest rate risk in the banking book (IRRBB)
- Legal risk
- Assorted stress scenarios related to credit risk and market risk

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 has not received the final results of the SREP for 2013, based on year end 2012. The Bank is in a dialog with the FME regarding its preliminary results. This dialog is expected to be completed in March 2014. The Bank exceeds the FME's preliminary SREP result by a comfortable margin.

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 impact is estimated on the Bank's profit and loss and the capital base as well as for 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 analyses 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. The Bank is investigating two economic scenarios within the ICAAP 2014, the lifting of the capital controls and a bubble in asset prices.

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.

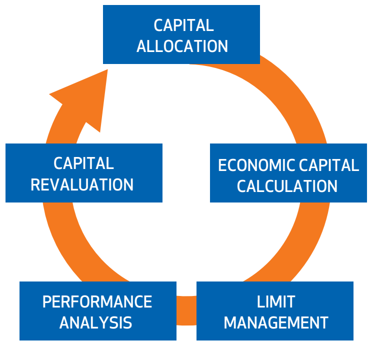
The ALCO is responsible for formalizing, implementing and maintaining the Bank's capital contingency plan.

The Bank does not anticipate any challenges in meeting requirements of the CRD IV.

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 3.4 Capital planning and monitoring process



3.7 NEW CAPITAL REQUIREMENTS REGULATION (CRR) AND DIRECTIVE (CRD IV)

The Bank does not anticipate any challenges in meeting requirements of the CRD IV. The Bank has a strong capital base that consists mainly of Core Tier 1 capital. The Bank's Tier 1 ratio and capital adequacy ratio at year end 2013 was 19.2% and 23.6% respectively. Furthermore the Bank does not expect that the implementation will lead to a large increase in risk weighted assets resulting in a lower capital adequacy ratio. The Bank is applying the standardized approach and carries an average risk weight of 76.8% of its total assets.

For information regarding the status of the implementation of CRR and CRD IV see section 10.2.

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 a 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 4.9.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made in short term trading purpose and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 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 risk appetite towards credit exposure, the Bank's credit rules and its credit procedures and controls.

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 or by the business unit if within its credit authority. The emphasis is on keeping a high quality credit portfolio by maintaining a strict credit process and seeking business with financially strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in 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 Arion Credit Committee (ACC) which again delegates the lending authorities and sets credit granting rules and 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 controversial credit committee decisions to a higher authority.

Credit proposals related to large 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, the 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 creditworthiness is the customers' ability to service the debt.

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

4.3 CREDIT RISK MANAGEMENT

Managing credit risk entails diversification of risk, well informed lending decisions, good oversight of the portfolio performance and a clear identification of any sign of weaknesses for a timely recovery.

In ensuring well informed lending decisions, Risk Management's Credit Analysis department 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 the registration of all relevant information regarding the loan and collaterals into the Bank's IT systems.

During the repayment phase Risk Management monitors the credit portfolio. The 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. The Credit Control department analyzes loans that have been classified at risk and maintains an independent and centralized overview of distressed credits. Credit Control, based on its analysis, suggests provisions and reviews write-offs.

Credit proposals related to large exposures are presented to the BCC for approval.

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 result 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.

4.5 CREDIT RISK EXPOSURE

The Bank's 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 2013, the Bank's total credit risk exposure was ISK 941,435 million (2012: 902,106 million). Loans to customers increased by 12% between 2012 and 2013 and represent the largest part of the Bank's total credit exposure or 68%. Government bonds or government secured bonds represent 96% of the total bonds and debt instruments. The decrease between year end 2012 and 2013 is due to the settlement of the Drómi bond, see section 1.2 for further information. The Bank's loans to financial institutions consist to a large extent of the Bank's deposits placed with other banks and short term money market loans or 95%. Table 4.2 shows the Bank's credit risk exposure. The average exposure during 2013 is calculated from four quarterly interim financial statements.

Loans to customers represent the largest part of the Bank's total credit exposure or 68%.

TABLE 4.2 Breakdown of credit risk exposure

	2013		2012	
[ISK m]	31 December	Average	31 December	Average
On-balance sheet items:				
Cash and balances with Central Bank	37,999	27,983	29,746	20,021
Loans to credit institutions	102,307	107,171	101,011	81,686
Loans to customers	635,774	586,190	566,610	575,534
Bonds and debt instruments	62,171	112,988	117,730	127,193
Derivatives	1,070	1,040	788	1,108
Bond and debt instruments, hedging	490	660	1,460	965
Other assets with credit risk	5,746	4,988	5,030	5,368
Credit risk exposure on-balance sheet	**845,557**	**841,020**	**822,375**	**811,875**
Off-balance sheet items:				
Financial guarantees	9,922	9,990	9,185	10,016
Unused overdraft	37,371	36,546	34,545	34,519
Loan commitments	48,585	49,455	36,001	32,388
Credit risk exposure off-balance sheet	**95,878**	**95,991**	**79,731**	**76,923**
Total credit risk exposure	**941,435**	**937,011**	**902,106**	**888,798**

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]	2013	2012	2011	2010
Cash and balances with Central Bank	37,999	29,746	29,200	30,628
Thereof balances with Central Bank	*24,912*	*17,514*	*17,686*	*13,250*
Loans to credit institutions	102,307	101,011	69,103	67,846
Thereof bank accounts; and	*70,671*	*84,164*	*62,175*	*57,704*
money market loans	*26,197*	*13,763*	*4,720*	*1,294*
Loans to customers	635,774	566,610	561,550	451,219
Total loans	**776,080**	**697,367**	**659,853**	**549,693**

The growth in loans to customers between year end 2012 and 2013 is largely due to the settlement of the Drómi bond, coupled with a strong organic growth mainly in mortgage lending towards individuals. Other growth is to the largest extent due to the acquisition of a mortgage portfolio from Kaupthing in 2011. The breakdown of the Bank's loans to customers is as follows in Table 4.4.

TABLE 4.4 Loans to customers specified by types of loans

31 December [ISK m]	Individuals		Corporates		Total	
Type	2013	2012	2013	2012	2013	2012
Overdrafts	18,205	17,236	19,669	18,470	37,874	35,706
Credit cards	11,296	10,302	878	769	12,174	11,071
Mortgage loans	258,065	190,897	8,103	4,376	266,168	195,273
Subordinated loans	-	-	531	573	531	573
Other loans and receivables	36,133	43,560	312,120	340,208	348,253	383,768
Loans to customers pre-provision	**323,699**	**261,995**	**341,301**	**364,396**	**665,000**	**626,391**
Provision on loans	(13,208)	(19,222)	(16,018)	(40,559)	(29,226)	(59,781)
Loans to customers net of provision	**310,491**	**242,773**	**325,283**	**323,837**	**635,774**	**566,610**

Loans to individuals represent 49% of total loans to customers and have increased by 24% year on year. The largest part of lending to individuals is mortgage lending or 80% of total loans to individuals, which equals to 39% of total loans to customers pre-provision.

4.5.1 RELATED PARTIES AND LARGE EXPOSURE

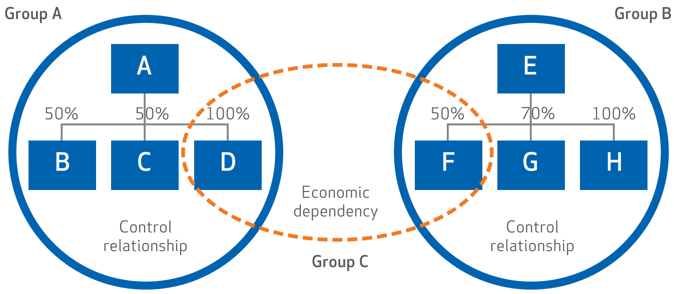
A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's capital base according to FME Rules No. 625/2013. The legal maximum for individual large exposures, net of eligible collateral, is 25% of the capital base and the sum of all large exposures, net of eligible collateral, 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 lower than the legal limits.

The Bank connects related parties according to internal rules that conform to

FME rules and the EBA 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 relationship 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.

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 the ACC and to the BARC.

At year end 2013 the Bank had three large exposures compared to four at the end of 2012 net of eligible collaterals. The largest exposure to a group of related parties at the end of 2013 and 2012 was ISK 29 billion , before taking account of eligible collateral, excluding the claim on Drómi, see Table 4.5.

TABLE 4.5 The Bank's largest exposures

	2013		2012	
Related parties	Gross	Net	Gross	Net
Group 1 (Drómi)	-	-	43%	0%
Group 2	17%	17%	18%	17%
Group 3	16%	16%	18%	18%
Group 4	12%	12%	14%	14%
Group 5	10%	<10%	11%	11%
Group 6	10%	<10%	<10%	<10%
Sum of large exposure > 10%	**65%**	**45%**	**104%**	**60%**

The largest exposure (gross) at the end of 2012 in Table 4.5 is a bond claim on Drómi hf. The Ministry of Finance had pledged that Arion Bank would be held harmless from this exposure and the FME ruled that the bond should be risk weighted at 0%. At the end of 2013 the Bank reached an agreement with Eignasafn Seðlabanka Íslands ehf. (ESÍ) regarding the settlement of the bond

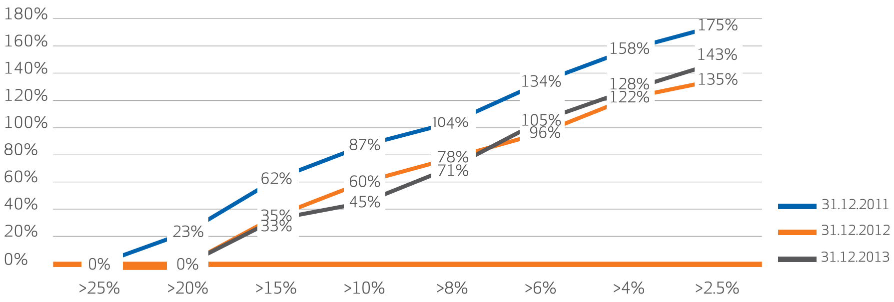
Risk Management monitors party relations both prior to the granting of the loan and during the lifetime of the loan.

with a transfer of assets. The Drómi bond is thus, at year end, no longer a part of the Bank's balance sheet.

The Bank's single-name concentration decreased during 2013, see Figure 4.2. For example, the sum of large exposures, net of eligible collateral, was 45% at the end of 2013 compared with 60% and 87% at the end of 2012 and 2011 respectively. The sum of large exposures exceeding 2.5%, net of eligible collateral, has decreased from 175% at the end of year 2011 down to 143% at year end 2013.

The Bank's single-name concentration decreased during 2013.

FIGURE 4.2 Total of net exposure to a group of related parties (without loans to financial institutions due to the Bank's own deposits)



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, 49% are loans to individuals, of which 80% are mortgage loans. Credit exposure towards individuals represents 35% of the total credit risk exposure. Real estate activities and construction is the largest industry sector comprising 13% of loans to customers or 10% of the Bank's total credit risk exposure.

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. An internal reclassification is made for some subclasses, mainly holding companies, the Bank applies this see-through principal to better locate the underlying sector risk.

FIGURE 4.3 Sector distribution of total credit risk exposure

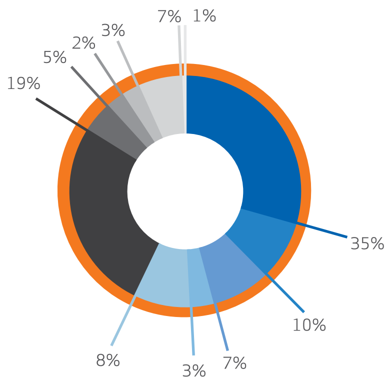
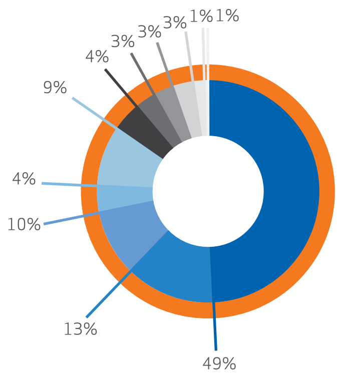


FIGURE 4.4 Sector distribution of loans to customers



CREDIT RISK

TABLE 4.6 Credit risk exposure broken down by industry

31 December 2013 [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 manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	37,999	-	-	-	-	-	37,999
Loans to credit insitutions	-	-	-	-	-	102,307	-	-	-	-	-	102,307
Loans to customers	310,491	83,002	60,906	24,025	55,061	27,535	22,661	18,966	19,793	8,682	4,652	635,774
Bonds and debt instruments	-	26	-	7	-	2,307	967	6	47	58,811	-	62,171
Derivatives	3	1	1	-	42	653	369	-	-	1	-	1,070
Bond and debt instruments, hedging	-	-	-	-	-	-	-	-	467	23	-	490
Other assets with credit risk	295	312	78	15	835	3,636	23	1	506	45	-	5,746
Credit risk exposure on-balance sheet	**310,789**	**83,341**	**60,985**	**24,047**	**55,938**	**174,437**	**24,020**	**18,973**	**20,813**	**67,562**	**4,652**	**845,557**
Off-balance sheet items:												
Financial guarantees	387	1,781	534	769	1,328	1,183	2,539	500	833	60	8	9,922
Unused overdrafts	22,282	1,433	395	591	4,095	1,951	1,653	298	2,005	2,298	371	37,371
Loan commitments	205	6,651	2,895	2,617	12,517	5,536	16,529	837	778	20	-	48,585
Credit risk exposure off-balance sheet	**22,874**	**9,865**	**3,824**	**3,977**	**17,940**	**8,670**	**20,721**	**1,635**	**3,616**	**2,378**	**379**	**95,878**
Total credit risk exposure	**333,663**	**93,206**	**64,809**	**28,024**	**73,878**	**183,107**	**44,741**	**20,608**	**24,429**	**69,940**	**5,031**	**941,435**

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 manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	29,746	-	-	-	-	-	29,746
Loans to credit insitutions	-	-	-	-	-	101,011	-	-	-	-	-	101,011
Loans 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, 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**

4.5.3 CREDIT RISK EXPOSURE BY MATURITY

TABLE 4.7 Credit risk exposure broken down by maturity

31 December 2013 [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	37,999	28,666	-	9,333	-	-
Loans to credit institutions	102,307	47,197	55,110	-	-	-
Loans to customers	635,774	2,151	56,696	85,340	221,979	269,608
Bonds and debt instruments	62,171	5,952	1,151	13,148	38,236	3,684
Derivatives	1,070	447	89	201	333	-
Bond and debt instruments, hedging	490	490	-	-	-	-
Other assets with credit risk	5,746	53	4,013	693	973	13
Credit risk exposure on-balance sheet	**845,557**	**84,956**	**117,058**	**108,715**	**261,522**	**273,305**
Off-balance sheet items:						
Financial guarantees	9,922	2,216	2,698	2,650	1,106	1,252
Unused overdraft	37,371	949	8,909	16,108	11,345	60
Loan commitments	48,585	3,301	25,011	14,198	6,075	
Credit risk exposure off-balance sheet	**95,878**	**6,466**	**36,618**	**32,956**	**18,526**	**1,312**
Total credit risk exposure	**941,435**	**91,422**	**153,676**	**141,671**	**280,048**	**274,617**

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 to credit institutions	101,011	84,033	16,721	-	257	-
Loans 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
Derivatives	788	-	693	23	72	-
Bond and debt instruments, 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 overdraft	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**

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. At year end 10% of the loan portfolio, parent company, was unrated. This is primarily due to newly formed entities where no financial or historical information is available and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and some holding companies. Customers are assigned a DD rating (default) when they have been defaulting for over 90 days or provision for losses has been made against the customer's exposure. This is the Basel II definition of default. Note that the DD rating is an indication of a default event. It is not an assigned credit rating from the Bank's rating models. It is noteworthy that 5% of the corporate portfolio was assigned a default rating at the year end compared with 25% at the end of year 2011.

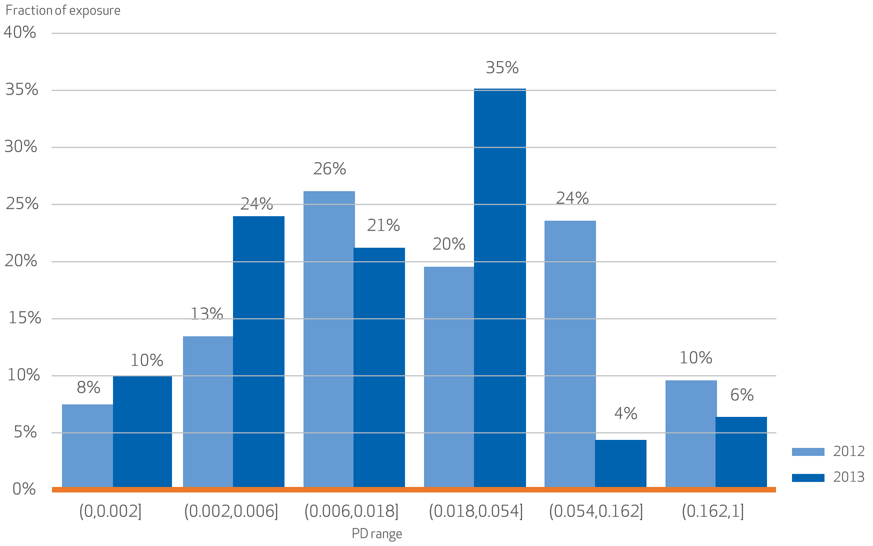
TABLE 4.8 Breakdown of rating by number of customers, parent company

Rating model	% Active credit rating	%DD	%Unrated
Corporate credit rating model	74%	5%	21%
Retail credit rating model			
SMEs	91%	6%	3%
Individuals	89%	11%	0%
Total	**82%**	**8%**	**10%**

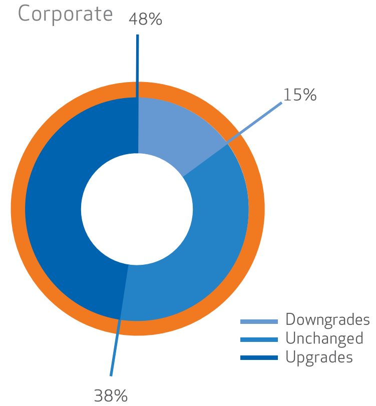
CORPORATE PORTFOLIO

Figure 4.5 shows the corporate portfolio broken down by different PD-range. The distribution of PD values has shifted significantly towards better values between 2012 and 2013. In terms of exposure about 48% of customers have been upgraded towards a lower PD-range, in contrast to 15% that have been downgraded. The exposure-weighted average PD for corporate customers was 4.5% in year end 2013 compared to 6.2% in 2012. The change in rating distribution can mainly be attributed to pure migration, i.e. an overall improvement in the rating of existing customers.

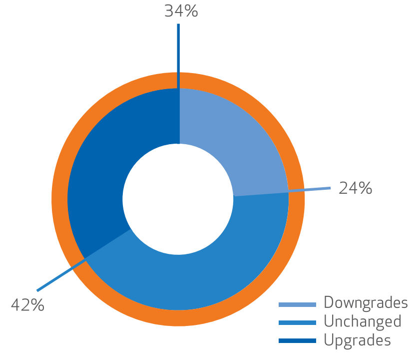
FIGURE 4.5 Distribution of exposure rated by the corporate credit rating model



Rating migration by loan amount between 2012 and 2013 Corporate



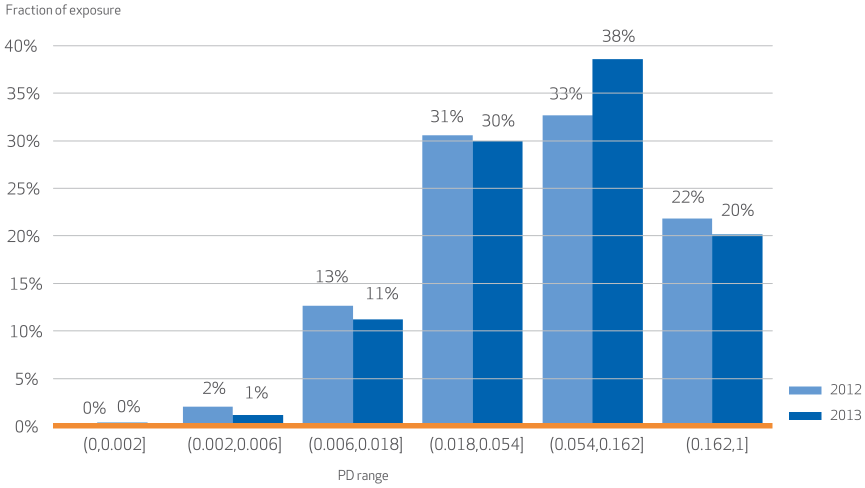
Rating migration by customer between 2012 and 2013 Corporate



RETAIL PORTFOLIO - SMEs

Figure 4.6 shows the SME portfolio broken down by different PD-range. There is not a significant shift in the distribution of PD-values between 2012 and 2013. In terms of exposure about 22% of customers have been upgraded towards a lower PD-range whereas 26% have been downgraded. The exposure-weighted average PD for SME portfolio was 11.1% in year end 2013 compared to 10.9% in 2012. The small increase in the average PD is mainly due to new lending as the current credit rating model gives unfavorable ratings to customers with short credit history and newly increased exposure. The Bank believes that there are anomalies within the data set, used to calibrate the rating model, that give false positive indications of the PD due to e.g. technical defaults around illegal FX loans.

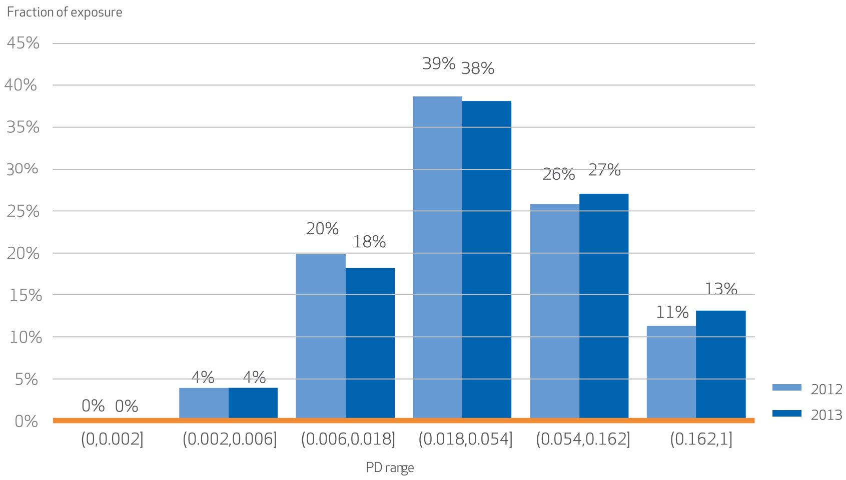
FIGURE 4.6 Distribution of exposure rated by the credit rating model for SMEs



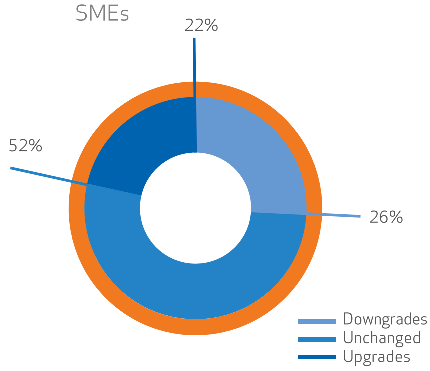
RETAIL PORTFOLIO - INDIVIDUALS

Figure 4.7 shows the Individuals portfolio broken down by different PD-range. There is a slight shift in the distribution of PD-values towards worse values between 2012 and 2013. In terms of exposure 16% of customers have been upgraded towards a lower PD-range but 24% have been downgraded. The exposure-weighted average PD for individuals portfolio was 8.3% in year end 2013 compared to 7.3% in 2012. The increase in the average PD between years is largely due to the Drómi transaction. As for the SME, the credit rating of individuals is considered pessimistic due to the technical defaults in the dataset.

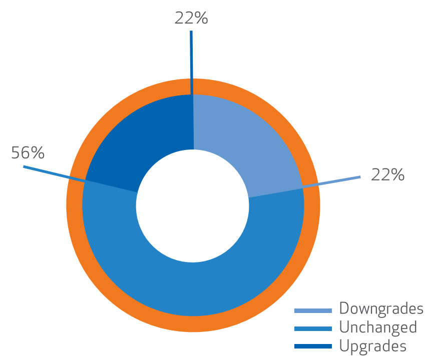
FIGURE 4.7 Distribution of exposure rated by the credit rating model for individuals



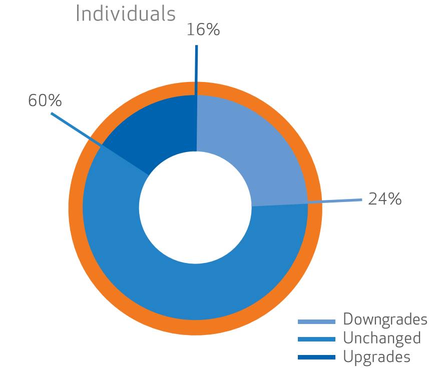
Rating migration by loan amount between 2012 and 2013 SMEs



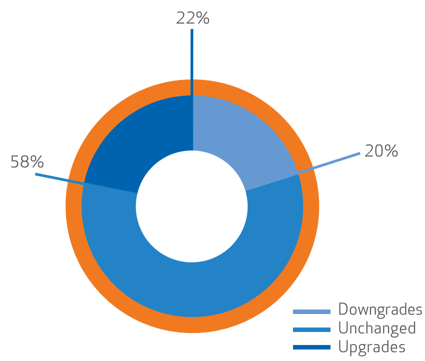
Rating migration by customer between 2012 and 2013 SMEs



Rating migration by loan amount between 2012 and 2013 Individuals



Rating migration by customer between 2012 and 2013 Individuals



4.5.5 CREDIT RISK EXPOSURE BY GEOGRAPHIC AREA

The Bank is not significantly exposed to foreign countries other than foreign credit institutions, which is mainly due to the Bank's deposits placed with other banks and short time money market loans. Loans to customers outside Iceland amounted to ISK 37,284 million or 6% of the total loans to customers of which ISK 7,193 million are due to individuals currently domiciled outside Iceland.

TABLE 4.9 Geographic distribution of credit risk exposure

31 December 2013 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	37,999	-	-	-	-	37,999
Loans to credit institutions	24,946	26,858	38,937	7,100	4,466	102,307
Loans to customers	598,490	18,061	15,209	3,058	956	635,774
Bonds and debt instruments	47,960	2,841	7,919	3,451	-	62,171
Derivatives	1,048	-	22	-	-	1,070
Bonds and debt instruments, hedging	490	-	-	-	-	490
Other assets with credit risk	5,184	6	549	6	1	5,746
Credit risk exposure on-balance sheet	**716,117**	**47,766**	**62,637**	**13,614**	**5,423**	**845,557**
Off-balance sheet items:						
Financial guarantees	9,917	4	-	0	-	9,922
Unused overdraft	36,600	399	224	68	81	37,371
Loan commitments	48,448	40	98	0	-	48,585
Credit risk exposure off-balance sheet	**94,965**	**442**	**321**	**69**	**81**	**95,878**
Total credit risk exposure	**811,082**	**48,208**	**62,958**	**13,683**	**5,504**	**941,435**

31 December 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 to credit institutions	26,565	20,011	37,859	14,520	2,056	101,011
Loans 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**

FIGURE 4.8 Geographic distribution of total credit risk exposure by country

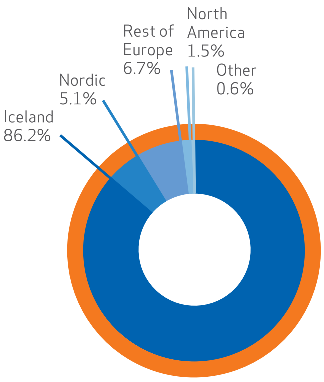
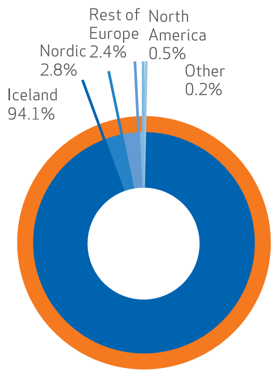


FIGURE 4.9 Geographic distribution of loans and receivables to customers



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, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

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

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

- Agriculture
- Fishing Vessels and Fishing Quota
- Real Estate
- Securities
- Inventory and Trade Receivables

The Bank operates a collateral management system (CMS) to consolidate the Bank's collateral data. Table 4.10 shows the collateral held by the parent company, broken down by business sector. Collateral held at year end is to the largest extent real estate collateral making up 70% of total collateral. The unsecured ratio of the total credit portfolio is 41% the largest difference from the end of year 2012 being the changes around the Drómi transaction. At the end of year 2013 loans to customers are secured by collateral, conservatively valued at ISK 514,148 million, for a collateral coverage ratio of 77% compared with 74% at the end of 2012. The credit exposure towards the Central Bank and financial institutions is unsecured as it is due to the Bank's own deposits accounts and money market loans.

The collateral coverage ratio at end 2013 is 77% compared with 74% at the end of 2012.

Collateral by type

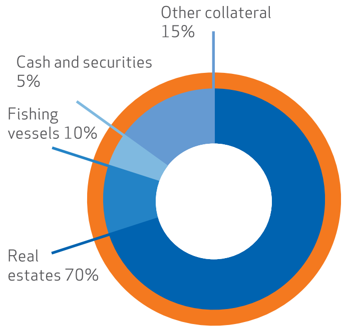


TABLE 4.10 Collateral, parent company

31 December 2013 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans to credit institutions	-	-	-	-	-	100.0%
Loans to customers	24,302	358,588	53,140	78,120	514,150	22.7%
Individuals	659	269,700	49	362	270,770	16.2%
Real estate activities and construction	3,887	55,427	12	1,053	60,378	31.7%
Fishing industry	89	3,039	52,878	2,361	58,368	9.1%
Information and communication technology	26	1,842	-	20,452	22,320	30.2%
Wholesale and retail trade	6,664	10,095	5	28,447	45,212	28.0%
Financial and insurance services	12,416	441	-	9,116	21,973	29.5%
Industry, energy and manufacturing	180	8,645	46	10,719	19,590	17.1%
Transportation	69	563	51	2,310	2,995	84.3%
Services	285	3,314	98	2,994	6,691	63.1%
Public sector	22	3,190	-	170	3,382	62.3%
Agriculture and forestry	5	2,331	-	136	2,472	48.5%
Bond, debt instruments and derivatives	2,867	-	-	-	2,867	95.5%
Total	**27,169**	**358,587**	**53,139**	**78,120**	**517,015**	**41.1%**

31 December 2012 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans to credit institutions	-	-	-	-	-	100.0%
Loans to customers	15,573	287,991	50,754	45,786	400,103	27.6%
Individuals	560	208,967	39	84	209,650	12.7%
Real estate activities and construction	677	46,229	5	267	47,178	31.2%
Fishing industry	642	2,311	50,528	6,020	59,502	11.6%
Information and communication technology	78	625	-	17,981	18,684	35.5%
Wholesale and retail trade	1,900	13,793	-	17,489	33,181	40.1%
Financial and insurance services	11,141	526	-	884	12,551	28.7%
Industry, energy and manufacturing	222	7,014	50	1,058	8,344	63.2%
Transportation	65	493	76	688	1,322	93.9%
Services	249	2,911	57	1,215	4,432	74.2%
Public sector	28	3,263	-	91	3,382	62.1%
Agriculture and forestry	10	1,858	-	9	1,876	51.8%
Bond, debt instruments and derivatives	1,219	-	-	68,628	69,847	41.1%
Total	**16,792**	**287,991**	**50,754**	**114,414**	**469,950**	**41.4%**

Figure 4.10 shows the mortgage portfolio broken down to LTV bands. At the end of 2013, 61% of the mortgages, by value, had loan-to-value below 80% compared to 55% at the end of 2012. As shown in figure 4.11 the mortgage property is primarily located in the greater Reykjavík area or 73% of the portfolio, by value.

FIGURE 4.10 Loan to value of mortgage loans [ISK m]

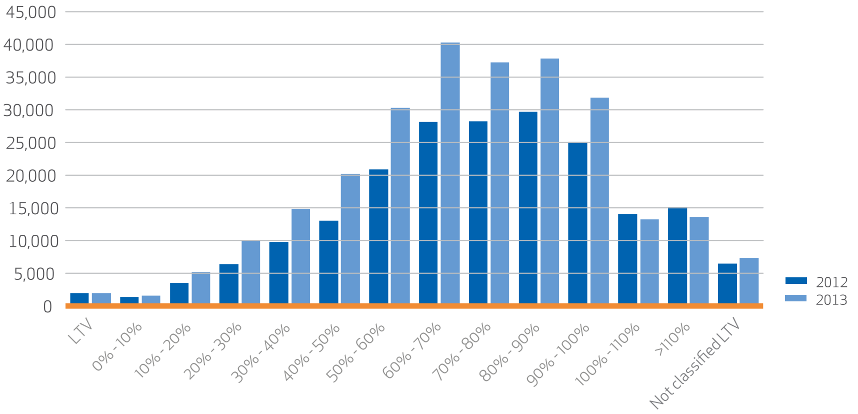
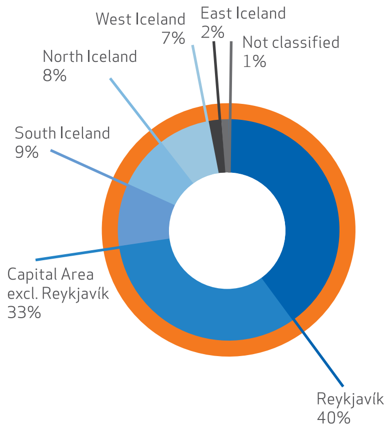


FIGURE 4.11 Mortgage portfolio location



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 likely loss has been identified in the case of the borrowers in the Red category. The EWS attempts to anticipate 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 ratios and credit rating with different criteria applied to different industrial sectors. Table 4.11 shows an aggregation of the EWS to illustrate the different categories and underlying criteria.

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

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.

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 intentionally strict since it main purpose is to draw attention to plausible evidence of impairment e.g. payment difficulties of borrowers with resulting credit loss by the bank. Risk Management has the authority to reassess the classification if an account manager has solid arguments for the change.

4.7.2 CREDIT MONITORING AND PROVISIONS

The 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. Credit monitoring consists of quarterly review by the Credit Control department which usually involves communication with borrowers' account managers. Semi-annual valuation reports are made for borrowers with credit exposure above 10% of capital base and for borrowers in the Orange and Red category with credit exposure above ISK 500 million. 64% of total loans, by value, are individually analyzed, see Table 4.12. 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.

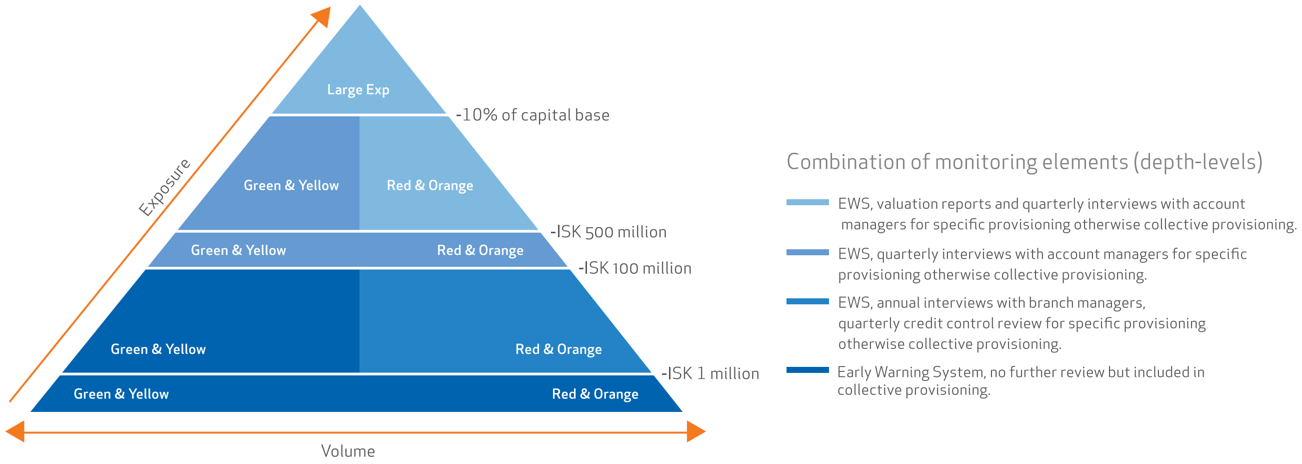
64% of total loans, by value, are individually analyzed.

TABLE 4.12 Credit monitoring

Credit size	Total exposure	Total analyzed	Interview	Valuation report	Total customers	Customers analyzed
≥ 10% of capital base	17%	17%	All quarterly	All	60	60
≥ 500 million	33%	33%	All quarterly	Red+Orange	328	328
≥ 100 million	5%	5%	All annually	none	588	588
≥ 1 million	43%	10%	Red+Orange annually	none	25,192	4,324
< 1 million	2%	0%	none	none	52,403	0
Total	**100%**	**64%**			**78,571**	**5,300**

Figure 4.12 describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.

FIGURE 4.12 Monitoring of exposures



As a result of the Credit Control's analysis a specific provision for impairment is determined based on the customer's aggregate exposure, the realizable value of collateral in accordance with the valuation committees' guidance (see section 4.6) etc. 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.

Collective provisioning is applied to credits other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default but have been determined not to require specific impairment. 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.

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio.

4.8.1 DEFAULTS

Figures 4.13 and 4.14 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 and the resolution of the legal uncertainty surrounding the FX loans.

FIGURE 4.13 Development of default on individuals, parent company

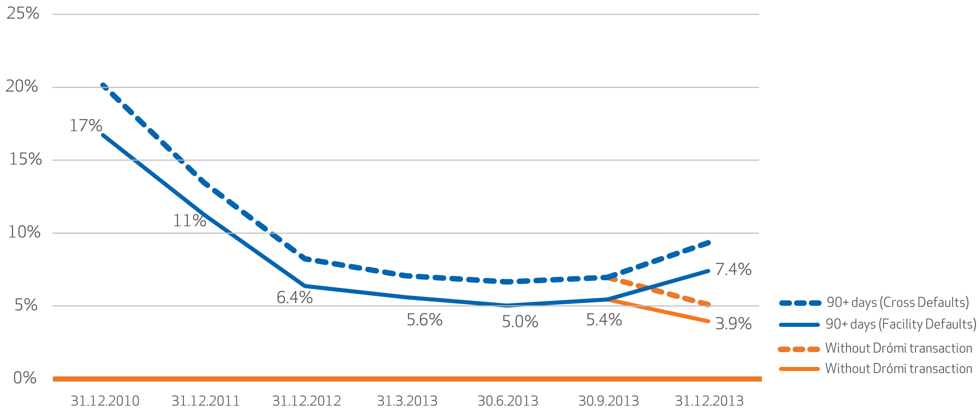
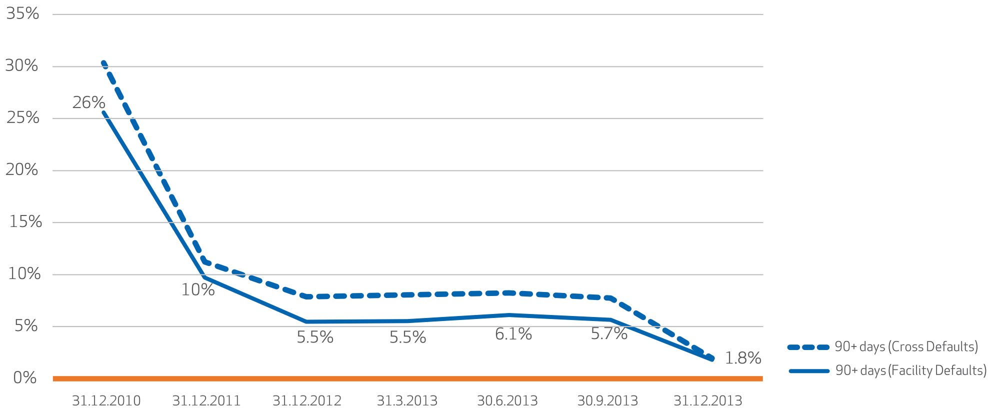


FIGURE 4.14 Development of default on companies, parent company



Customer loans that are past due more than 90 days are 4.5% of the total loan book at year end if measured at facility level. The cross default ratio more than 90 days is 5.5%, at the parent company level, 9.3% for individuals (5.1% without the Drómi transaction) and 2.0% for corporates. The Bank expects this ratio to continue to decrease during 2014. Table 4.13 shows the breakdown of facility and cross-default for the parent company down to sectors.

Customer loans that are past due more than 90 days are 4.5% of the total loan book at year end if measured at facility level.

TABLE 4.13 Defaults by sector, parent company

31 December 2013	Facility level: Past due > 90 days as a % of total loans within sector	Facility level: % contribution to past due > 90 days	Cross default: Past due > 90 days as a % of total loans within sector	Cross default: % contribution to past due > 90 days
Individuals	7.4%	78.8%	9.3%	81.3%
Real estate activities and construction	1.7%	5.6%	2.0%	5.5%
Financial and insurance activities	5.9%	5.5%	4.1%	4.6%
Wholesale and retail trade	2.3%	4.3%	2.3%	3.7%
Services	4.8%	2.9%	4.9%	2.4%
Fishing industry	1.1%	2.3%	1.2%	2.0%
Agriculture and forestry	2.4%	0.3%	2.6%	0.3%
Public sector	0.4%	0.1%	0.4%	0.1%
Information and communication technology	0.1%	0.1%	0.1%	0.1%
Industry, energy and manufacturing	0.1%	0.0%	0.3%	0.2%
Transportation	0.0%	0.0%	0.0%	0.0%
Total past due > 90 days as a % of loans to customers	**4.5%**	**100.0%**	**5.5%**	**100.0%**

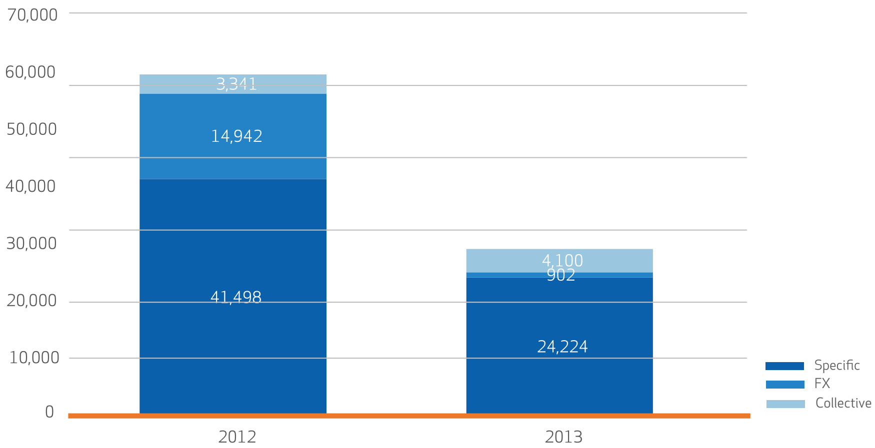
31 December 2012	Facility level: Past due > 90 days as a % of total loans within sector	Facility level: % contribution to past due > 90 days	Cross default: Past due > 90 days as a % of total loans within sector	Cross default: % contribution to past due > 90 days
Individuals	6.4%	45.3%	8.2%	42.8%
Real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

4.8.2 IMPAIRMENT AND PROVISIONS

Loan impairment is recognized when credit monitoring has shown that there is objective evidence of credit losses and has made appropriate provision for these losses (see section 4.7.2). Note that loans which were acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

At the end of 2013 the Bank's total provision for impairment on loans to customers amounted to ISK 29,226 million. Figure 4.15 shows the development of provisions between 2012 and 2013 were the 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.

FIGURE 4.15 Changes in the provision for losses on loans to customers [ISK m]



At year end 2012, a provision of ISK 14,942 million had been made for losses due to court rulings for illegal FX loans, in addition to ISK 4,625 million that were transferred to liabilities. The provision is reduced to ISK 902 million at year end 2013 which reflects that the process of recalculating illegal FX loans is nearing completion. Specific provisions due to borrower credit quality have been similarly reduced by 42% year on year, largely due to progress in corporate-loan restructuring. This also explains the relative increase of the collective provisions since a larger part of the loan portfolio at year end does not have specific provisions.

Specific provisions due to borrower credit quality have been reduced by 42% year on year.

The sum of specific loan impairments and FX-loan impairments at the end of 2013 was ISK 25,126 million, compared with ISK 56,440 million at year end 2012. Table 4.14 shows the carrying amount of impaired loans to customers as well as the specific impairment and FX-ruling impairment to this amount broken down by industry sector.

TABLE 4.14 Impaired loans to customers by sector

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
31 December 2013 [ISK m]	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
Individuals	11,538	18,496	173	614	11,711	19,110
Real estate activities and construction	1,726	3,755	37	113	1,763	3,868
Fishing industry	617	1,899	612	1,870	1,229	3,769
Information and communication technology	164	190	-	-	164	190
Wholesale and retail trade	4,020	5,941	14	44	4,034	5,985
Financial and insurance services	4,513	6,080	-	-	4,513	6,080
Industry, energy and manufacturing	446	996	17	33	463	1,029
Transportation	65	356	6	9	71	365
Services	775	1,865	43	53	818	1,918
Public sector	8	35	-	-	8	35
Agriculture and forestry	352	790	-	-	352	790
Total	**24,224**	**40,403**	**902**	**2,736**	**25,126**	**43,139**

TABLE 4.14 Impaired loans to customers by sector

31 December 2012 [ISK m]	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impairment amount	Total loan carrying amount
	Impairment amount	Loan carrying amount	Impairment amount	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**

Table 4.15 shows the geographical distribution of impaired loans to customers.

TABLE 4.15 Impaired loans to customers by geographic area

31 December 2013 [ISK m]	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impairment amount	Total loan carrying amount
	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount		
Iceland	18,826	32,239	897	2,723	19,723	34,962
Nordic	613	970	5	13	618	983
Rest of Europe	2,058	2,171	-	-	2,058	2,171
North America	2,710	4,998	-	-	2,710	4,998
Other	16	26	-	-	16	26
Total	**24,224**	**40,403**	**902**	**2,736**	**25,126**	**43,139**

31 December 2012 [ISK m]	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impairment amount	Total loan carrying amount
	Impairment amount	Loan carrying amount	Impairment amount	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 4.16 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 4.16 Credit quality by class of financial asset

31 December 2013 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to corporates	304,880	9,789	10,614	325,283
Loans to individuals	268,485	34,607	7,399	310,491
Financial instruments	63,731	-	-	63,731
Other assets with credit risk	5,746	-	-	5,746
Credit quality	**783,148**	**44,396**	**18,013**	**845,557**

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 to credit institutions	101,011	-	-	101,011
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Financial instruments	119,978	-	-	119,978
Other assets with credit risk	5,030	-	-	5,030
Credit quality	**731,682**	**40,696**	**49,997**	**822,375**

Table 4.17 shows a breakdown of loans to individuals and corporates which are past due but not impaired, by the number of days in default.

TABLE 4.17 Number of days in default for loans which are not impaired

31 December 2013 [ISK m]	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,100	923	111	2,655	9,789
Loans to individuals	11,224	3,751	543	19,089	34,607
Total past due but not impaired loans	**17,325**	**4,673**	**655**	**21,744**	**44,396**

31 December 2012 [ISK m]	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,285	951	322	10,293	17,851
Loans to individuals	8,719	3,558	287	10,281	22,845
Total past due but not impaired loans	**15,004**	**4,509**	**609**	**20,574**	**40,696**

The Bank defines as *problem loans,* loans that are more than 90 days past due and loans that are not past due but individually impaired. This corresponds to the Basel II definition of default. The ratio of problem loans has steadily decreased since its peak in 2010 mostly due to the progress made in problem-loan restructuring and the resolution of the legal uncertainty surrounding FX loans.

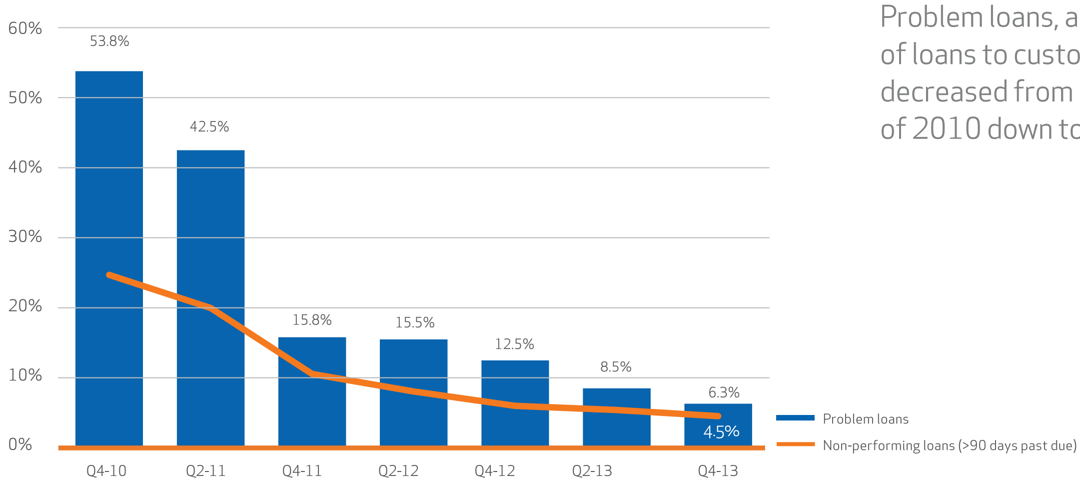
At year end 2013 problem loans constitute 6.3% of loans to customers of which 1.9% are due to loans received in the Drómi transaction, see Figure 4.16. This same transaction is affecting loans past due >90 days but not impaired, which have increased by 6% between year end 2012 and 2013 as shown in Table 4.17. Two third of problem loans, by value, at year end 2013 are due to individuals and one third is due to corporates.

The ratio of problem loans has steadily decreased since its peak in 2010 mostly due to the progress made in problem-loan restructuring and the resolution of the legal uncertainty surrounding FX loans.

Problem loans, as a percentage of loans to customers, have decreased from 53.8% at the end of 2010 down to 6.3% or by 88%. At the end of 2013, problem loans had fallen to 4.4% of loans to customers, but rose to 6.3% with the Drómi transaction. Similarly, loans past due more than 90 days had fallen to 2.6%, but rose to 4.5%. The development of problem loans is as shown in Figure 4.16.

Problem loans, as a percentage of loans to customers, have decreased from 53.8% at the end of 2010 down to 6.3% or by 88%.

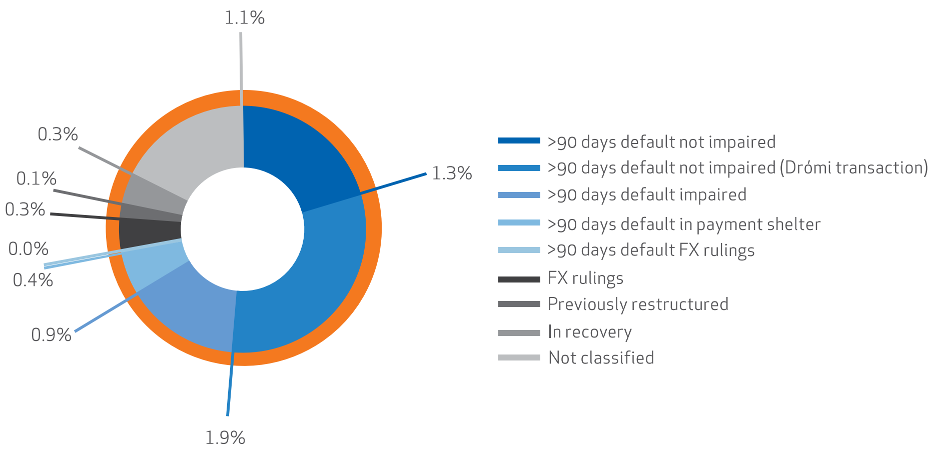
FIGURE 4.16 Development of problem loans

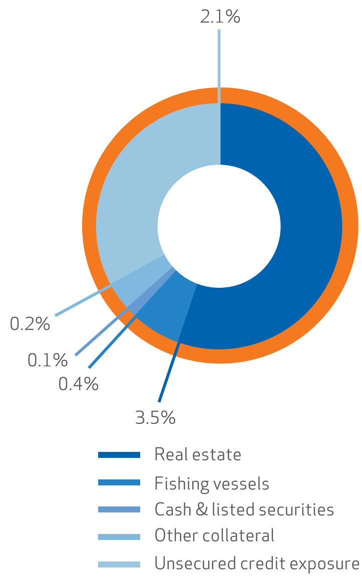


The breakdown of problem loans as a percentage of loans to customers by status and collateral are shown in Figure 4.17. The status-breakdown demonstrates that approximately 28% of the problem loans are impaired without being over 90 days past due. This is primarily explained by provision for losses from loans in restructuring or recently restructured loans where the borrower has not yet demonstrated full recovery. Clarification of the FX uncertainty is nearing completion. At year end only 5% of the problem loans were due to uncertainty around currency linked loans compared to 37% at year end 2012.

The total collateral amount that secures the total problem loans is ISK 27,025 million that corresponds to a collateral coverage of 68%. Real estate collateral represents 83% of the total collateral amount; fishing vessels represent 10% and other collateral the remaining 7%.

FIGURE 4.17 Breakdown of problem loans by status and collateral





4.8.4 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 4.18.

TABLE 4.18 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 4.18 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, had fallen from approximately 50% to 8.7% but rose to 10.5% with the Drómi transaction.

The loan portfolio is analyzed monthly based on the FME's LPA standard and reported to the FME.

Figure 4.19 shows a breakdown of non-performing loans into its subcategories at the end of 2013. During 2013, there were no new cases transferred to work-out. At the end of 2013 all the cases in workout were in the negotiation phase, which supports the view that the Bank's restructuring efforts have been winding down. Loans in restructuring have decreased from 2.4% to 0.7% between year end 2012 and 2013.

FIGURE 4.18 Development of the LPA

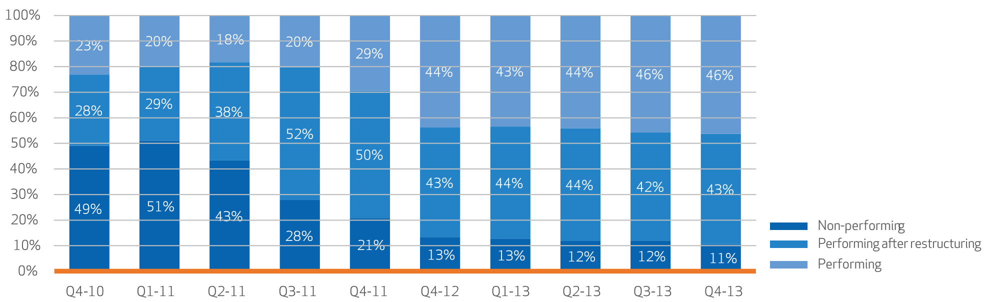
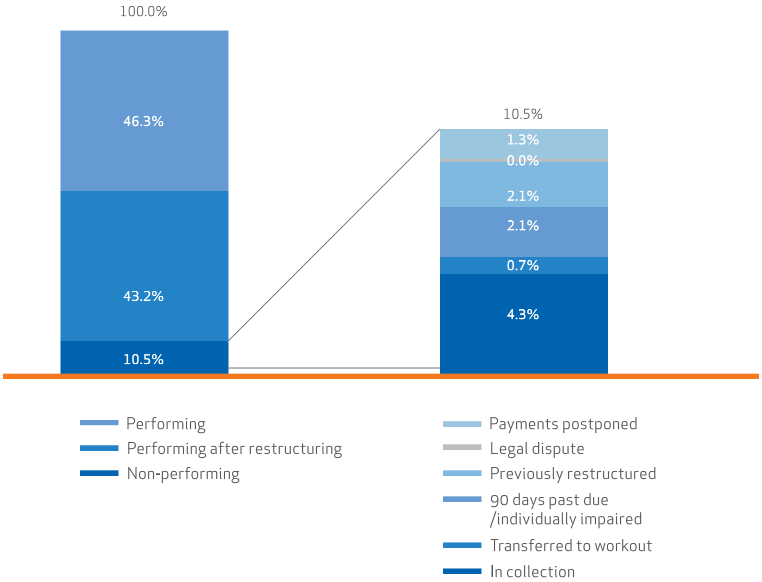


FIGURE 4.19 Breakdown of LPA metric



4.9 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 4.19 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 4.19 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.

Table 4.20 shows the Bank's exposure towards counterparty credit risk gross and net of collateral. Comparative information for the year 2012 is not available.

TABLE 4.20 Counterparty credit risk exposure gross and net of collateral

31 December 2013 [ISK m]			
Type	Position	Collateral	Exposure
Financial Institution	449	-	449
Funds	(10)	1,213	-
Corporate	349	288	61
Retail Corporate	(288)	1,327	-
Retail Individuals	(192)	386	-
Central Bank	1	-	1
Total	**309**	**3,214**	**511**

The margin-call process is monitored by Risk Management.

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, derivatives, and any other commitments 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.

The Portfolio Risk department is responsible for enforcing the limits which have been set.

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 for market risk measurement

Market risk type	Measurement methods
Equity price risk	Exposure in equity is measured with 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 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. The Value-at-Risk method is used to quantify possible losses.

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, associates and securing the value of foreclosure assets until they are sold.

Securities on the Bank's balance sheet are at 31 December 2013 shown in Table 5.2 and the corresponding figures for 2012 are shown in Table 5.3.

TABLE 5.2 Securities on the Bank's balance sheet at year end 2013

31 December 2013 [ISK m]	Bonds	Equity	Total
Trading book			
Listed	1,821	1,204	3,025
Unlisted	-	-	-
Trading book total	**1,821**	**1,204**	**3,025**
Banking book			
Listed	55,675	7,856	63,531
Unlisted	1,838	25,699	27,537
Funds	2,231	4,145	6,376
Banking book total	**59,744**	**37,700**	**97,444**
Grand total	**61,565**	**38,904**	**100,469**

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

TABLE 5.3 Securities on the Bank's balance sheet at year end 2012

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.

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 2013 average and maximum exposure in both equity and bonds.

TABLE 5.4 The Bank's trading exposure

	Bonds		
31 December 2013 [ISK m]	Long	Short	Net
Year-end	4,657	(2,837)	1,820
Average	5,440	(4,316)	1,125
Maximum	12,585	(7,182)	8,336

	Equity		
31 December 2013 [ISK m]	Long	Short	Net
Year-end	1,204	-	1,204
Average	964	-	964
Maximum	2,022	-	2,022

5.4.2 EQUITY IN THE BANKING BOOK

Exposure limits for the banking book are set in the Bank's risk appetite statement. 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 by the Bank. Strategies for various types of exposure are set, such as a disposal schedule for non-core assets.

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 by the Bank.

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 22 in the Consolidated Financial Statements of Arion Bank for 2013.

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

TABLE 5.5 Equity exposure in the banking book

31 December 2013 [ISK m]	Listed	Unlisted	Total
Investments in associates	-	17,929	17,929
Equities in assets held for sale	5,457	300	5,757
Equity instruments with variable income	2,399	7,470	9,869
Fund shares	675	3,470	4,145
Total equity exposure in the banking book	**8,531**	**29,169**	**37,700**
Market value	15,748		
Realized gain/loss in 2013			178
Unrealized gain/loss in 2013			6,503

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 2013 the Bank has an effective net position in foreign currency of ISK 31,630 million so that a 10% depreciation of the Icelandic krona, for example, would result in a profit of ISK 3,163 million for the Bank. The opposite would be true for a 10% appreciation of the Icelandic krona.

The increase in the Bank's currency imbalance is primarily due to changes in the accounting currency of one of the Bank's subsidiaries. The parent company's currency imbalance of ISK 19,504 million has been relatively stable and 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 2013. Table 5.7 shows the Value-at-Risk for the net currency positions.

TABLE 5.6 Net position of assets and liabilities by currency

Foreign currency [ISK m]	Net Exposure
EUR	11,903
USD	6,302
CHF	1,242
GBP	8,024
JPY	1,498
Other	2,661
Total net position	**31,630**

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.

FIGURE 5.1 Development of the Bank's currency imbalance [ISK m]

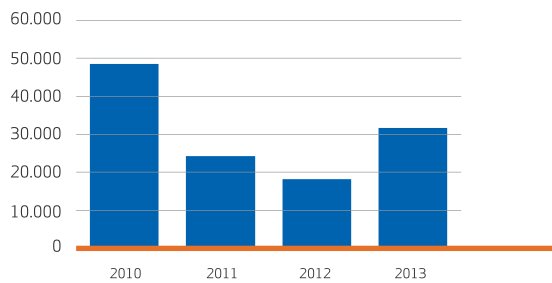


TABLE 5.7 Value-at-Risk for net currency positions with a 99% confidence level over a 10 day horizon

Foreign currency [ISK m]	10 day 99% VaR
EUR	282
USD	277
CHF	58
GBP	289
JPY	87
Nordic	81
Other	15
Total uncorrelated Value-at-Risk	**1,089**
Total correlated Value-at-Risk	**746**

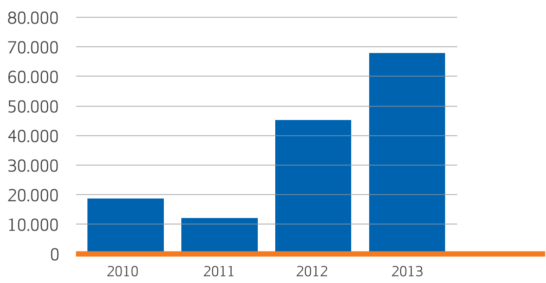
It should be noted that the historical data used for VaR calculations is collected over a period when capital controls have been in place and the result should be interpreted as risk given the current circumstances. Additional currency risk should be expected in relation to the removal of capital controls.

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 291,581 million and the total amount of CPI-linked liabilities amounted to ISK 223,705 million at the end of 2013. Therefore, the net CPI- linked imbalance was ISK 67,876 million, which means that deflation would result in a loss for the Bank.

The Bank's inflation balance increased in 2013 primarily due to the transfer of the loan portfolios of Drómi hf., Frjálsi hf. and Hilda hf. to Arion Bank in relation to the settlement of Drómi's liabilities with the Bank, see section 1.2 for further information. The Bank strives to reduce its inflation imbalance.

FIGURE 5.2 Development of the Bank's indexation imbalance [ISK m]



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 5.8 shows the Bank's interest-bearing assets and liabilities by interest-fixing period at the end of 2013. 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.

TABLE 5.8 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 w ith Central Bank	37,999	-	-	-	-	-	-	-	37,999
Loans to credit institutions	102,307	-	-	-	-	-	-	-	102,307
Loans to customers	291,544	93,903	22,696	73,462	3,128	33,177	117,863	-	635,774
Bonds	55,709	757	26	554	2,110	2,062	953	-	62,171
Derivatives and hedging securities*	-	-	-	-	-	-	-	6,920	6,920
Total interest-bearing assets	**487,560**	**94,659**	**22,721**	**74,016**	**5,239**	**35,240**	**118,817**	**6,920**	**845,171**
Non-interest-bearing assets	-	-	-	-	-	-	-	93,679	93,679
Total	**487,560**	**94,659**	**22,721**	**74,016**	**5,239**	**35,240**	**118,817**	**100,599**	**938,850**

Liabilities and Equity [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	27,505	495	-	-	-	-	-	-	28,000
Deposits from customers	442,846	26,174	56	2,791	-	-	-	-	471,866
Covered bonds	-	-	-	4,378	4,453	22,807	101,858	-	133,496
Other borrowings	53,105	14,715	-	319	-	-	2,932	-	71,071
Subordinated liability	-	31,918	-	-	-	-	-	-	31,918
Bonds - short positions	-	2,644	61	-	132	-	-	-	2,837
Derivatives and hedging securities*	-	-	-	-	-	-	-	8,960	8,960
Total interest-bearing liabilities	**523,456**	**75,946**	**116**	**7,488**	**4,585**	**22,807**	**104,790**	**8,960**	**748,149**
Non-interest-bearing liabilities	-	-	-	-	-	-	-	45,754	45,754
Equity	-	-	-	-	-	-	-	144,947	144,947
Total	**523,456**	**75,946**	**116**	**7,488**	**4,585**	**22,807**	**104,790**	**199,661**	**938,850**

Derivatives and hedging securities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(1,990)	(5,463)	1,696	3,717	-	-	-	(2,040)

Total [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y
Net position	(37,887)	13,250	24,301	70,244	654	12,433	14,027

* 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 5.9 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 2013.

TABLE 5.9 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	(1)	(8)	(61)	(92)	-	(163)
ISK, CPI-indexed	(11)	2	(0)	(34)	(92)	(134)
EUR	1	-	-	-	-	1
Other	1	-	-	-	-	1
Banking book [ISK m]	**0-1Y**	**1-5Y**	**5-10Y**	**10-20Y**	**>20Y**	**Total**
ISK, non-indexed	(103)	(480)	(28)	(29)	(17)	(656)
ISK, CPI-indexed	(44)	(823)	32	(557)	(1,129)	(2,520)
EUR	63	(1)	-	-	-	62
GBP	3	-	-	-	-	3
CHF	(6)	-	-	-	-	(6)
USD	(17)	-	-	-	-	(17)
JPY	(2)	-	-	-	-	(2)
Other	(14)	-	-	-	-	(14)

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

To further analyze 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[1] (EBA). A perpetual shift is assumed for all interest rates, but as real interest rates are correlated with economic cycles and show mean reverting behaviour a shock period for the CPI-linked interest rate can conservatively be assumed not to exceed four years. A 1% perpetual shift is assumed following that period in case the net effect of long-term economic cycles are unfavour-able for the Bank. Table 5.10 shows the sensitivity of the banking book to the aforementioned shock at the end of 2013.

TABLE 5.10 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	(429)	(1,785)	(105)	(100)	(51)	(2,470)
ISK, CPI-indexed	217/100	4 years/Perpetual	(77)	(1,502)	90	(781)	(1,566)	(3,836)
EUR	200	Perpetual	122	(2)	-	-	-	120
GBP	200	Perpetual	9	-	-	-	-	9
CHF	200	Perpetual	(12)	-	-	-	-	(12)
USD	200	Perpetual	(34)	-	-	-	-	(34)
JPY	200	Perpetual	(4)	-	-	-	-	(4)
Other	200	Perpetual	(23)	-	-	-	-	(23)
All currencies total			**(448)**	**(3,289)**	**(14)**	**(881)**	**(1,617)**	**(6,249)**

[1] CEBS guidelines,Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process, 3 October 2006

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.

The domestic equity market is markedly growing following a relatively inactive period subsequent to the financial crisis in 2008. Volume has increased following successful IPOs and a broader range of investment opportunities is helping the market back on its feet. Derivative trading activity related to the domestic equity market has markedly increased.

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.

The Bank's derivative position is shown in table 5.11.

TABLE 5.11 Derivatives

31 December 2013 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	31	68	20	48	11,849	Market risk
Interest rate and exchange rate agreements	15	518	42	476	19,861	Market risk
Bond swap agreements	28	4	54	(50)	5,872	Credit risk
Share swap agreements	141	33	632	(599)	5,640	Credit risk
Options	6	447	13	434	574	Market risk
Total	**221**	**1,070**	**761**	**309**		

31 December 2012 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	17	250	92	158	11,935	Market risk
Interest rate and exchange rate agreements	20	71	792	(721)	16,065	Market risk
Bond swap agreements	38	17	42	(25)	8,612	Credit risk
Share swap agreements	22	16	49	(33)	1,039	Credit risk
Options	1	434	0	434	434	Market risk
Total	**98**	**788**	**975**	**(187)**		

Counterparty credit risk is the risk of the Bank's counterparty in a derivative contract defaulting before final settlement of the derivative contract's cash flows. This risk is addressed in section 4.9.

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 diversify the funding profile of the Bank by establishing access to domestic and international debt markets and prudently manage the 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.

On 1 December 2013 the Central Bank of Iceland adopted new liquidity rules which are based on the liquidity risk framework under the Basel III Accord. Under the new rules, Icelandic financial institutions are required to maintain a Liquidity Coverage Ratio (LCR) above 70% from 1 January 2014, with that limit increasing annually by ten percentage points until a 100% requirement takes effect in 2017. The rules also require a minimum of a 100% Liquidity Coverage Ratio for foreign currency positions, effective from 1 December 2013.

At year end 2013, Arion Bank's strong liquidity position was reflected in high LCR values, namely 123% and 274% for the respective total and foreign currency balances.

At year end 2013, Arion Bank's strong liquidity position was reflected in high LCR values, namely 123% and 274% for the respective total and foreign currency balances.

TABLE 6.1 Liquidity Coverage Ratio at year end 2013

31 December 2013	FX	Total
Liquidity Coverage Ratio	274%	123%
LCR Central Bank requirements	100%	70%

The high liquidity reserve requirements reflect the uncertainty of the stickiness of deposits 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. Furthermore, Icelandic banks are faced with extraordinary uncertainties due to expected deposit outflow in relation to the lifting of capital controls.

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. Furthermore, a large part of the Bank's deposits in foreign currency is owned by entities in winding-up proceedings and due to uncertainties concerning the resolution process of those estates the Bank holds liquid assets to match all possible outflows in relation to these deposits. Indeed, the Bank's foreign deposit base is entirely covered by foreign cash and liquid assets.

The Bank actively monitors its liquidity reserve and has made progress in understanding and modelling the behaviour of its deposit base. The Bank's liquidity risk strategy is reviewed at least annually.

The Bank's foreign deposit base is entirely covered by foreign cash and liquid assets.

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 coverage 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 short-term 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

In December 2010 the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks. The Central Bank of Iceland has implemented LCR requirements but the timing of the adoption of NSFR requirements is yet to be decided by the regulatory authorities. The Bank reports the LCR and NSFR measures to the Central Bank of Iceland on a monthly basis.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions in a period of 30 days. Different outflow weights are applied to each deposit category and the measure is thus dependent on the stickiness of each bank's deposit base. The ratio is therefore comparable throughout the banking sector.

High quality liquid assets consist of cash on hand, cash balance with the Central Bank of Iceland, Treasury notes, Icelandic Housing Fund bonds and other eligible bonds for repo transactions with the Central Bank of Iceland, along with foreign government bonds. In addition, as part of the settlement with ESÍ hf. and Drómi hf., see section 1.2 for further information, the Bank extended its agreement with the government allowing the Bank to borrow repo-eligible government bonds against collateral, such as real-estate loans. In order to prevent banks from being overdependent on each other, a bank's deposits with other banks are not classified as liquid assets but rather as inflow against the expected outflow of funds in the replicated stressed scenario.

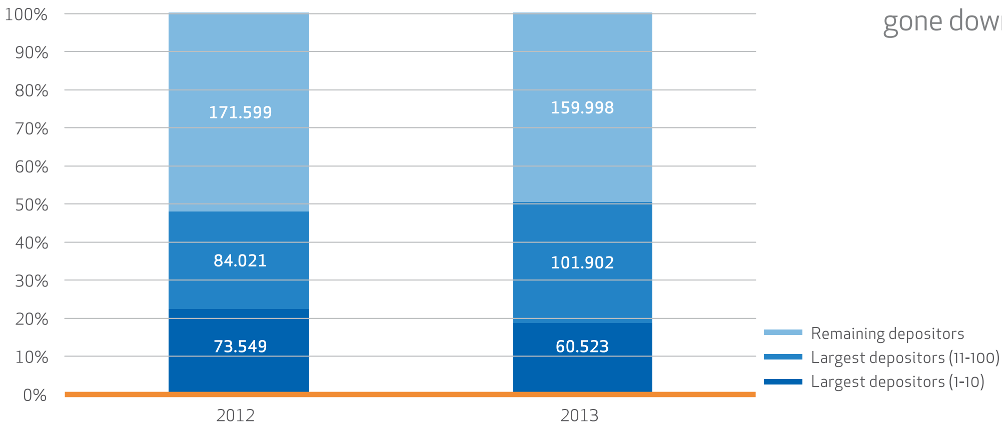
At the end of 2013 the Bank's Liquidity Coverage Ratio was 123% for its total balance and 274% for its position in foreign currency. The Bank's LCR measures are well above the regulatory limits.

For comparison, applying the current LCR measure to the Bank's balance sheet at year end 2012 yields a result of 107% for the total position and 52% in foreign currency. The improved LCR in 2013 reflects on the Bank's actions for mitigating liquidity risk in the year 2013 and aligning the liquidity asset profile with the new liquidity requirements. The liquidity position in foreign currency has dramatically improved due to measures to increase term deposits, the greatest source of impact being deposits from counterparties in winding-up proceedings. Furthermore, the Bank has shifted its liquidity buffer reliance from account balances with other institutions to high quality liquid assets.

In addition to lowering the proportion of deposits maturing within 30 days of the total deposit base, concentration of those deposits has been reduced. At the end of 2012 22% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors. At the end of 2013 this ratio had gone down to 19%. The proportion of the next ninety largest depositors increased from 26% to 32%.

At the end of 2012 22% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors. At the end of 2013 this ratio had gone down to 19%.

FIGURE 6.1 Concentration of deposits on demand within 30 days [ISKm]



6.3.1 LIQUIDITY COVERAGE RATIO BREAKDOWN

Table 6.2 shows the key figures behind the Bank's Liquidity Coverage Ratios. In general, total inflow is capped at 75% of total outflow. As a result, the Bank's foreign currency position in nostro and money market accounts, which contribute to cash inflow under LCR, is not fully utilized for foreign currency LCR.

TABLE 6.2 Breakdown of LCR

31 December 2013 [ISK m]	FX	Total
Inflow from deposits at credit institutions	66,443	66,876
Other inflow	10,267	14,881
Total inflow	**76,710**	**81,757**
Deposit outflow	20,326	145,618
Other outflow	11,944	26,040
Total outflow	**32,270**	**171,658**
Net outflow	**8,067***	**89,902**
Cash on hand and Central Bank deposits	7,952	37,324
Government bonds and other repo-eligible bonds	14,190	33,969
Liquidity facility	0	39,350
Total level 1 assets	**22,142**	**110,643**
Liquidity Coverage Ratio	274%	123%

*Total inflow is capped at 75% of total outflow.

6.3.2 DEPOSIT CATEGORIES

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

Table 6.3 shows the distribution of the Bank's deposit base a broken down by deposit categories as per the LCR methodology. The associated LCR outflow weight is shown for each category. Table 6.4 shows the contribution of each category, in order by magnitude, to the stressed outflow under LCR. In table 6.5, the development of the deposit base is shown between years.

TABLE 6.3 Distribution of deposits by LCR categories. The expected stressed outflow weight is shown for each category.

31 December 2013 [ISK m]	Deposits maturing within 30 days					
Category	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits *	Total
Retail	75,385	10%	33,971	5%	30,224	139,580
SME	32,496	10%	3,723	5%	6,675	42,894
Operational relationship	847	25%	-	5%	530	1,377
Corporations	49,841	40%	742	20%	12,977	63,560
Sovereigns, central-banks and PSE	19,104	40%	-	-	7,206	26,310
Financial entities being wound up	17,616	100%	-	-	59,675	77,291
Deposit pension funds	4,346	100%	-	-	20,639	24,985
Pension funds	46,420	100%	-	-	20,299	66,719
Domestic financial entites	26,652	100%	-	-	13,636	40,288
Foreign financial entites	2,135	100%	-	-	495	2,630
Other foreign parties	3,830	100%	626	25%	250	4,706
Total	**278,672**		**39,062**		**172,606**	**490,340**

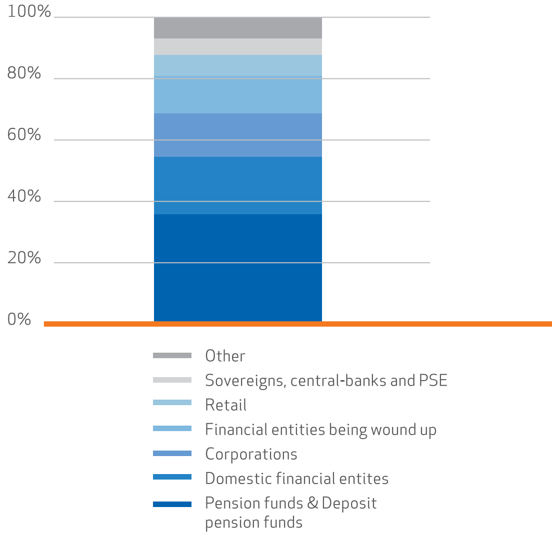
* As per the LCR methodology, no outflow is assumed from deposits with maturity longer than 30 days.

▶ LIQUIDITY RISK

TABLE 6.4 Distribution of deposits by LCR categories

31 December 2013		
Category	**2013**	**2012**
Retail	28.5%	29.9%
SME	8.7%	10.1%
Operational relationship	0.3%	0.3%
Corporations	13.0%	13.1%
Sovereigns, central-banks and PSE	5.4%	6.1%
Financial entities being wound up	15.8%	17.3%
Deposit pension funds	5.1%	5.0%
Pension funds	13.6%	11.6%
Domestic financial entites	8.2%	5.0%
Foreign financial entites	0.5%	1.0%
Other foreign parties	1.0%	0.5%
Total	**100.0%**	**100.0%**

FIGURE 6.2 Source of impact on LCR outflow from deposits categories



6.4 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 2013 the outstanding balance of the issue was ISK 122,062 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 2013 the outstanding balance of the subordinated liability was ISK 31,918million.

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 bonds can also be admitted to trading on the Icelandic Stock Exchange. The first transaction from the covered bond program was to domestic institutional investors, mostly pension funds and insurance companies. 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 and a total of ISK 6.3 billion in 2013, of which ISK 4.5 billion are indexed covered bonds with 2.5% interest rates and ISK 1.8 billion was added to the non-indexed issue from 2012. The Bank is open to issuing both indexed and fixed rate bonds. Likely maturities will range from 3 to 10 years depending on market demand. The covered bond

▶ LIQUIDITY RISK

program allows for issuance in other currencies than ISK but such bond issues are not expected in the near term future.

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 bonds were listed on the Oslo Stock Exchange on 2 July 2013. The bonds are floating rate notes with NIBOR plus 5.0% floating interest, maturing in 2016.

Table 6.5 shows the Bank's borrowings and subordinated liabilities as at 31 December 2013. The development of the Bank's total funding by type is shown in Table 6.6.

FIGURE 6.3 Development of the market spread for the Bank's NOK bond issue

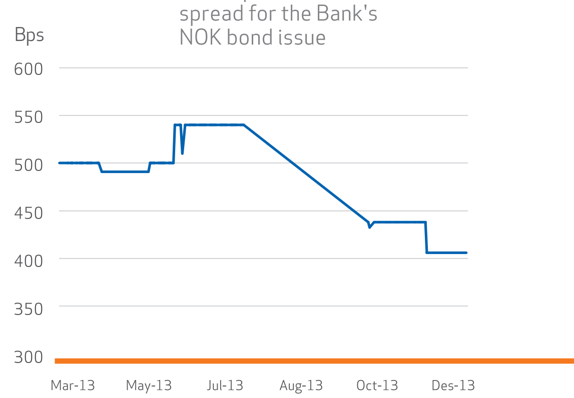


TABLE 6.5 List of borrowings and subordinated liabilities

31 December 2013	Issued	Maturity	Maturity type	Currency	Terms of interest	Amount
Covered bonds	2013	2019	At maturity	ISK	Fixed CPI linked, 2.5%	4,453
Covered bonds	2012	2015	At maturity	ISK	Fixed, 6.5%	4,378
Covered bonds	2012	2034	Amortizing	ISK	Fixed CPI linked, 3.6%	2,603
Covered bonds	2008	2045	Amortizing	ISK	Fixed CPI linked, 4.0%	21,361
Covered bonds	2008	2031	Amortizing	ISK	Fixed CPI linked, 4.0%	4,934
Covered bonds	2006	2048	Amortizing	ISK	Fixed CPI linked, 3.75%	77,894
Covered bonds	2005	2033	Amortizing	ISK	Fixed CPI linked, 3.75%	17,873
Senior unsecured bond	2013	2016	At maturity	NOK	Floating, NIBOR + 5%	9,356
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1%	2,662
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1%	2,202
Secured bond, Landfestar	2010	2044	Amortizing	ISK	Fixed CPI linked, 4.7%	2,932
Central Bank loan, secured	2010	2022	At maturity	Various FX	Floating, LIBOR + 3%	52,998
Other						922
Total borrowings						**204,568**
Tier 2 capital	2010	2020	At maturity	Various FX	Floating, LIBOR + 4%	31,918
Total borrowings and subordinated liabilities						**236,486**

TABLE 6.6 Breakdown of funding by type

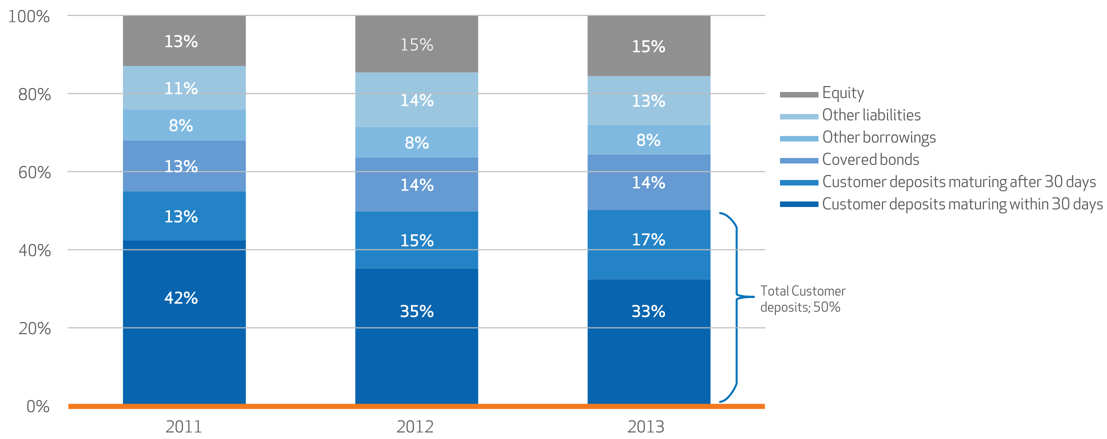
31 December	2013	2012	2011
Due to credit institutions and Central Bank	3.0%	3.7%	1.8%
Customer deposits	50.3%	49.8%	54.9%
Borrowings	21.8%	21.7%	21.0%
Subordinated loans	3.4%	3.8%	3.6%
Financial liabilities	1.0%	1.5%	0.6%
Tax liabilities	0.5%	0.4%	0.4%
Other liabilities	4.7%	4.7%	4.9%
Equity	15.4%	14.5%	12.8%
Total	**100.0%**	**100.0%**	**100.0%**

LIQUIDITY RISK

Figure 6.4 shows the 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: At the end of 2011 deposits maturing within 30 days accounted for 42% of the Bank's funding compared to 33% at the end of 2013.

At the end of 2011 deposits maturing within 30 days accounted for 42% of the Bank's funding compared to 33% at the end of 2013.

FIGURE 6.4 Development of funding by type



Tables 6.7 and 6.8 show the breakdown by maturity of assets and liabilities.

TABLE 6.7 Breakdown of assets by contractual maturity

Assets 31 December	2013	2012	2011
On demand	9.0%	13.0%	11.5%
Up to 3 months	12.5%	7.5%	7.0%
3 - 12 months	11.6%	11.4%	10.7%
1 - 5 years	27.9%	30.9%	35.0%
Over 5 years	29.2%	28.6%	26.5%
With no maturity	9.8%	8.6%	9.3%
Total	**100.0%**	**100.0%**	**100.0%**

TABLE 6.8 Breakdown of liabilities by contractual maturity

Liabilities 31 December	2013	2012	2011
On demand	33.3%	36.6%	50.1%
Up to 3 months	21.5%	22.3%	9.7%
3 - 12 months	11.5%	6.8%	7.1%
1 - 5 years	6.7%	8.0%	5.6%
Over 5 years	26.1%	25.4%	26.0%
With no maturity	0.9%	0.9%	1.5%
Total	**100.0%**	**100.0%**	**100.0%**

LIQUIDITY RISK

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 focal point of liquidity risk management. The settlement with ESÍ affects the Bank's loans to deposits ratio, which now reflects the transfer of both loans and deposits from the SPRON estate to the Bank, as the Drómi bond is replaced by the underlying pledged loans. The ratio of loans to deposits was 135% as at 31 December 2013. The development of the loans to deposits ratio is shown in Table 6.9. The increase from 2011 to 2012 is explained by the aforementioned acquirement of Kaupthing's structured covered bonds program. However the cash flow profile of mortgages pledged to the associated mortgage fund are well matched with that of the covered bonds liabilities and therefore pose limited funding risk.

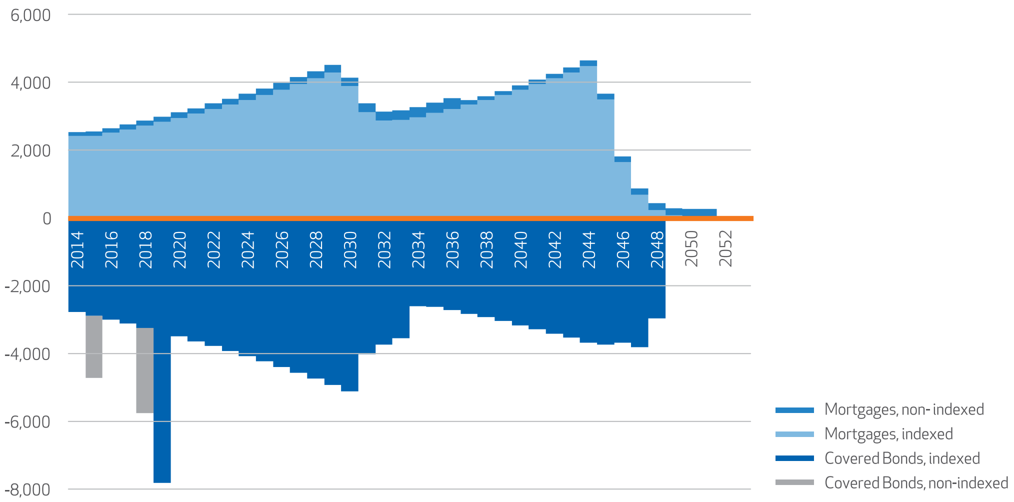
The covered bonds are also an important funding source and its payment profile is largely matched by the corresponding pledged mortgages, see Figure 6.5. Other liabilities are mostly foreign currency denominated with no significant redemption until 2020 as seen in Figure 6.6. As the Bank's foreign currency deposits are fully covered by liquid assets, these other FX liabilities are a source of funding for loans to customers in foreign currency. The duration of those liabilities is greater than that of the loans, so there is low maturity gap risk for the Bank's foreign currency position.

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

TABLE 6.9 Development of the Bank's loans to deposits ratio

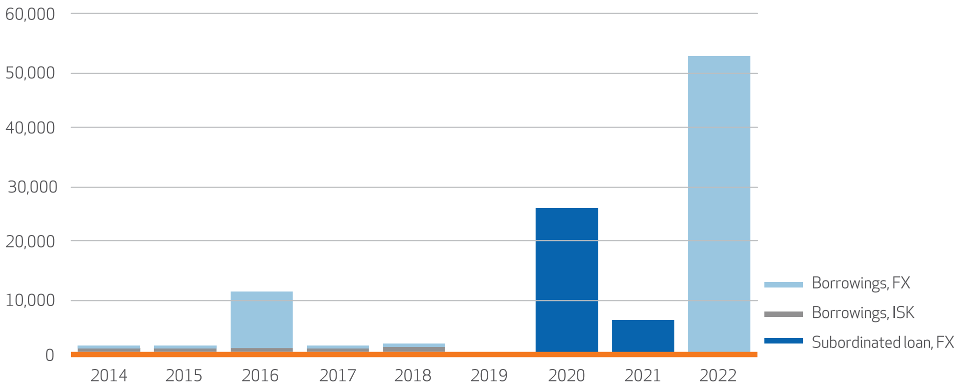
31 December	2013	2012	2011	2010
Loans to deposits ratio	135%	126%	115%	99%

FIGURE 6.5 Maturity profiles of covered bonds and corresponding pledgedmortgages [ISK m]



▶ LIQUIDITY RISK

FIGURE 6.6 Maturity profiles of borrowings and subordinated liability [ISK m]



In January 2014, the international credit ratings agency Standard & Poor's (S&P) assigned a BB+ rating to Arion Bank with stable outlook. S&P has partly attributed to its view the Bank's stable long-term funding and strong liquidity position, with high coverage of maturing debt.

For comparison, the current rating of the Icelandic Sovereign currently stands at Baa3, BBB-, BBB by Moody's, S&P and Fitch, respectively. All of the ratings outlooks were considered stable as at January 2014.

In January 2014, the international credit ratings agency Standard & Poor's (S&P) assigned a BB+ rating to Arion Bank with stable outlook.

6.5 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, Treasury 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.

LIQUIDITY RISK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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.

Reputational risk, IT risk and legal risk are, among others, considered sub-categories of operational risk. Operational risk is inherent in all activities within the Bank.

- IT risk is defined as the risk arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity.
- Legal risk is defined as the risk to the Bank's interests resulting from instability in the legal and regulatory environment, as well as risk arising from ambiguous contracts, laws or regulations.
- 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 to establish new, business relationships and continued access to sources of funding.

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

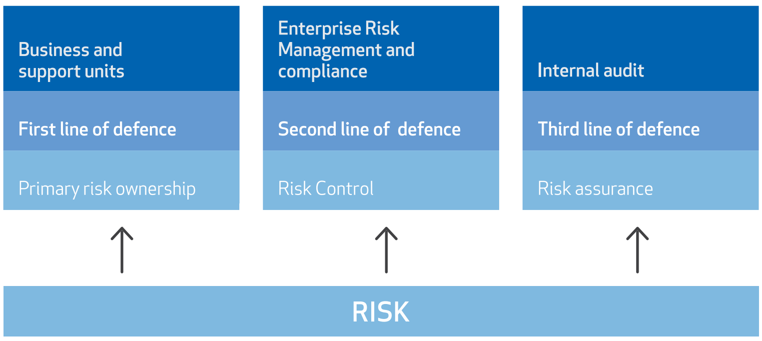
The Bank uses the Basel II basic indicator approach for the calculation of capital requirements for operational risk.

Enterprise Risk Management (ERM) utilizes three lines of defence to effectively govern and manage the Bank's approach to risk management.

7.1 OPERATIONAL RISK STRATEGY

Enterprise Risk Management (ERM) utilizes three lines of defence to effectively govern and manage the Bank's approach to risk management.

FIGURE 7.1 Three lines of defence



FIRST LINE OF DEFENCE

The first line of defence are the business and support units which apply internal controls and other risk mitigating responses to the risks they face in their line of business. They are responsible for identifying and assessing the risks and ensuring that the control activities and other responses that treat risks are enforced and monitored for compliance. They are also responsible for effectively communicating their risk profile and risk responses to the second and third line of defence.

▶ OPERATIONAL RISK

SECOND LINE OF DEFENCE

The second line of defence are the Bank's risk and compliance functions that provide oversight of the risk management activities of the first line of defence. The second line of defence is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling risks. It is also responsible for providing leadership and support to every business unit during the implementation of risk tools, policies and processes, and supports them in their on-going improvement of the control environment. The Bank's Board Audit and Risk Committee (BARC) serves as the second line of defence governance body.

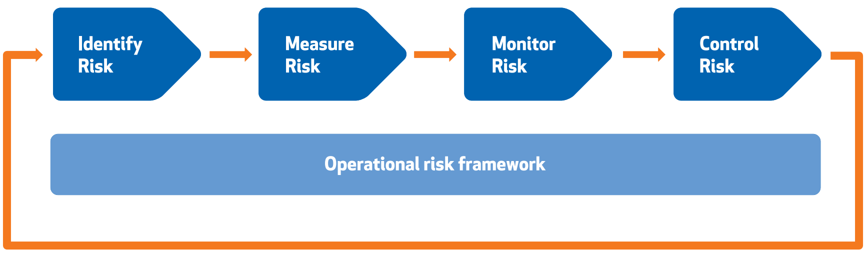
THIRD LINE OF DEFENCE

The third line of defence is the Bank's internal audit function who reports independently to the Board of Directors. Their main role is to review the first and second line of defence activities and results to ensure they are appropriately carrying out their roles and responsibilities in a complete and accurate manner.

7.2 OPERATIONAL RISK MANAGEMENT

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

FIGURE 7.2 Operational risk cycle



There are four main components to the Bank's operational risk framework:

- Loss Data Collection
- Key Risk Indicators
- Risk and Control Self-Assessment (RCSA)
- Issue Management

LOSS DATA COLLECTION

Internal operational risk events with a direct or indirect financial impact are captured in the Bank's loss database as well as near misses. The Bank chooses to not have a threshold amount on loss events as all events can enhance the Bank's understanding of its own operational risk. 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. It is analyzed to understand the root cause of the event in order to be able to mitigate the risk and enhance the Bank's internal controls. Operational Risk department reports these incidents and follows up on control enhancements if deemed necessary.

KEY RISK INDICATORS

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

RISK AND CONTROL SELF-ASSESSMENT

The Bank performs a Risk and Control Self-Assessment (RCSA) in order to identify risks, both inherent and residual. The risks are assessed based on severity and likelihood of an event occurring as well as the effectiveness of the internal control environment. The assessment of the severity of an event includes both financial losses and reputational damage. Actions are planned for risks with extreme, high or moderate impact due to insufficient controls. The goal is to bring relevant risks to acceptable levels by enhancing the control environment. The Operational Risk department follows up on the planned actions with the units.

ISSUE MANAGEMENT

Any issues arising from the RCSA, the auditing process, loss data collection or from any other internal or external event can result in remediation and enhancements of internal controls. Once the issues are identified, analyzed and assessed, the Operational Risk department is in charge of following up with the business and support units on planned actions.

7.3 THE SECURITY OFFICER

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

7.4 OPERATIONAL RISK MEASUREMENT

Operational risk is inherent in all activities of the Bank. The Bank aims to proactively manage its risks and to reduce the frequency and severity of operational risk events. The operational risk strategy is designed to align to the risk appetite set forth by the Bank's Board of Directors. 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.

FIGURE 7.3 Operational risk strategy

The primary controls in operational risk management are included but not limited to the following:

- Operational risk culture
- Segregation of duties
- Four-eyes principle
- Working processes
- Employee training
- New product process

The new product process is a process where a new product or service that is currently not offered to clients or a significant change to an existing product or service is introduced to all potential stakeholders where they are able to provide feedback. The new product process is in place to ensure appropriate level of cross communication with all stakeholders, and an adequate preliminary assessment prior to implementation

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

▶ OPERATIONAL RISK

Figure 7.4 shows the distribution of reported events by number. External fraud accounted for 42% of the total events in 2013.

FIGURE 7.4 Distribution of loss events by number

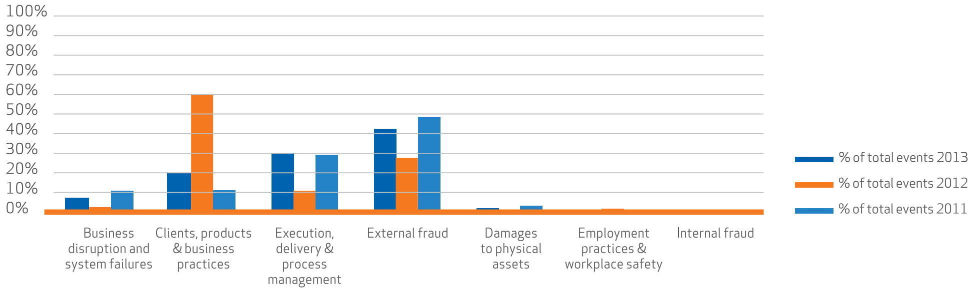
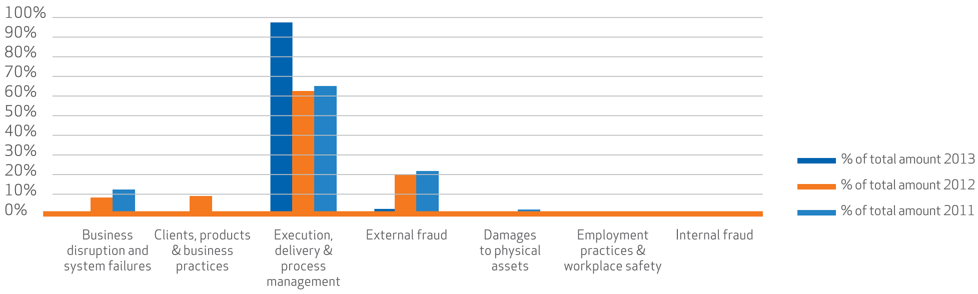


Figure 7.5 shows the distribution of reported events by amount. Execution, delivery and process management accounted for 97% of total losses in 2013.

FIGURE 7.5 Distribution of loss events by amount



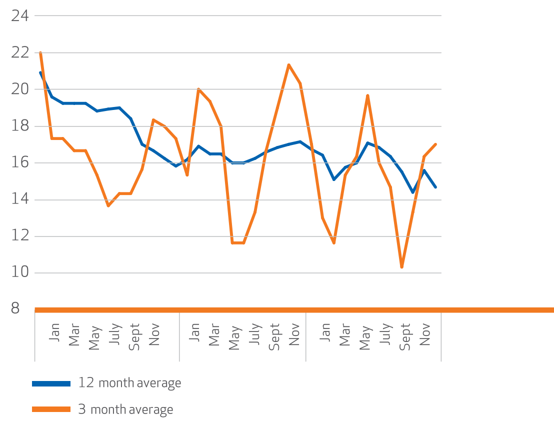
Loss data is also used to assess that the capital held aside for operational risk is sufficient under stressed conditions. This is done by stressing both the frequency and severity of the different Basel categories based on internal scenarios derived from the RCSA process.

The Bank collects a number of KRIs such as:

- Number of major incidents (MI) in IT
- Settlement failures
- Transaction rollbacks
- System downtime
- Internal audit recommendations not resolved within the given time-limit

Major Incident (MI) is an incident causing a serious operational interruption in IT or an operational failure in a system classified as an A-service. The purpose of the MI process is to ensure firm, coordinated and controlled action when a MI occurs, in order to restore service as soon as possible, with minimum damage to the business.

FIGURE 7.6 Development of major incidents in IT



OPERATIONAL RISK

The Bank uses external risk transfer in the form of insurance, including reinsurance, to cover certain aspects of crime risk and professional liability, including the liability of directors and officers.

KRIs as well as operational risk concerns are reported monthly to the Board of Directors, BARC and the Executive Management Committee. Operational reports are sent on a regular basis to the relevant business units within the Bank.

All issues that are identified through any of the operational risk framework tools are used to enhance the internal control environment of the Bank. The Operational Risk department follows up on planned actions and collects information on the internal control system of each unit.

Operational risk is reported monthly to the Board of Directors, BARC and the Executive Management Committee.

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.

8.1 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.

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

The Icelandic Competition Authority (ICA) has opened three formal investigations involving the Bank, all of them initiated by complaints. The first investigation involves a formal investigation into practices of all card issuers in Iceland, including the Bank, and by two card payment acquirers, including the Bank's subsidiary Valitor. The investigation was initiated by a complaint by Kortaþjónustan hf., a card payment acquirer, in 2009. The case concerns alleged concerted practices through associations of undertakings connected to decisions on multilateral interchange fees and alleged anti-competitive practices towards competitors in the field of acquiring.

The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The complaints from BYR hf. and MP banki hf. concern the terms of the Bank's mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition.

The ICA received a complaint from Tryggingamiðstöðin hf. in 2010. The complaint concerns the Banks' alleged tying of banking services and insurances.

The extent of the investigations and outcome of the cases before the ICA are still uncertain as well as any effect on the Bank. However, if the Bank or the Bank's subsidiary will be deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor for abusing its dominant position on the payment card market and violating conditions set in a decision No. 4/2008 of the Authority. Valitor appealed the decision to the Competition Appeals Committee. In August the Committee confirmed the decision of the Competition Authority.

In 2009 Valitor received a summons issued by Kortaþjónutan hf. claiming damages for the alleged loss suffered by Kortaþjónustan hf. due to alleged breaches of competition law and based on a settlement with the ICA published in ICA decision No 4/2008. The case is still being contested before the District Court of Reykjavík. In July 2013 the Bank and Valitor also received a summons issued by Kortaþjónustan hf. claiming damages for the alleged loss suffered by Kortaþjónustan hf. in relation to the alleged breaches of competition law based on the complaint to the ICA in 2009, stated above. The case is being contested before the District Court of Reykjavík.

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 the 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.

8.2 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 number of special Icelandic rules in the field of financial services 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 the Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

Arion Bank's remuneration policy is reviewed annually by the Board and submitted and voted on at the Bank's annual general meeting. Arion Bank's remuneration policy is published on its website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2013, see Note 10. 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 the Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, and other employees hired by the Board. The BRC also reviews the Bank's human resources policy, salary framework, and the incentive scheme if one is in place.

In 2013 a variable remuneration scheme was implemented within the Bank. The scheme is in accordance with rules established by the FME. A local consultancy company was hired to write the scheme in cooperation of the Bank's CEO, COO and the BRC committee. The scheme was presented to the FME.

About 100 employees were offered to take part in the scheme. They include the executive directors, many heads of divisions as well as several other key employees. Excluded are the CRO, the Internal Auditor, the Compliance Officer, the head of Research and all the employees they manage.

The objective of the scheme is to incentivize employees to help the Bank achieve its objectives. Well defined measures concerning risk and compliance are an integral part of the scheme. In accordance with the Rules on Remuneration Policy for Financial Undertakings issued by FME, Risk Management, Compliance and Internal Audit review and analyze whether the variable remuneration scheme complies with the aforementioned rules and the Bank's remuneration policy.

The objective of the scheme is to incentivize employees to help the Bank achieve its objectives.

According to FME's rules the maximum amount of a yearly variable remuneration is 25% of employee's annual salary. 40% of the amount is deferred by three years.

Parameters deciding the amount of the payments are on four levels:

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

REMUNERATION

In the year 2013 the Bank made provision for variable remuneration, including salary related expense.

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

Apart from the Bank itself, as of the end of 2013 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 comply with 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 any given time. The following section lists several factors the Bank deems necessary to mention in this regard.

10.1 NEW LEGISLATION

ACT ON CONSUMER LOANS

The new Consumer Loans Act imposes a stricter obligation on the lender to provide information, both prior to the loan agreement being made and in the loan agreement itself. A legal obligation is introduced to assess the credit-worthiness of the borrower, and to assess the borrower's ability to repay the loan, when certain monetary limits are reached. The Act came into force on 1 November 2013. The Act has entailed some costs for the Bank but at this stage it is difficult to assess any future effects of the Act.

ACT ON AMENDMENTS TO THE FINANCIAL UNDERTAKINGS ACT AND ACT IN THE OFFICIAL SUPERVISION OF FINANCIAL OPERATIONS

The Act contains provisions which oblige financial undertakings to disclose information on all owners of 1% or more of the financial undertaking. Where legal entities are owners of capital in excess of 1%, the beneficial owners of those entities shall be disclosed. The Act stipulates that there should be a minimum of two alternate board members. The Act came into force upon publication on 27 March 2013.

ACT ON AMENDMENTS TO THE SECURITIES TRANSACTIONS ACT

The requirements made on companies and financial undertakings in the EEA when they increase their share capital are lowered. At the same time investor protection is increased in such a way that information provided in a prospectus is designed to ensure that retail clients are informed when making investment decisions. The Act may entail some costs for the Bank, but at this stage it is difficult to assess any further effects of the Act.

ACT ON AMENDMENTS TO THE FOREIGN EXCHANGE ACT

A recent change to the Foreign Exchange Act, removes provisions on the limited period of validity for capital controls. The capital controls are now of unlimited length but certain restrictions have been eased, such as the authority to reinvest. The Central Bank's monitoring of compliance with the Act has also been increased and sanctions for violating the Act have been tightened.

ACT ON MEASURES TO RAISE REVENUE BUDGET PROPOSAL FOR 2014

With the introduction of the Act the financial sector tax rate was reduced from 6.75% to 5.5%. This provision came into force on 1 January 2014. The Act also extends the authorization to pay out private pension savings until 1 January 2015. The total amount that can be withdrawn was increased by ISK 2,750,000. These provisions came into force on 1 January 2014. At this stage it is difficult to assess any future effects of the Act on the Bank's operation.

UPCOMING AND NEW LEGISLATION

10.2 UPCOMING LEGISLATION

BILL ON THE IMPLEMENTATION OF A CAPITAL CORRECTION OF INDEXED MORTAGES

The Icelandic government plans to correct the capital of indexed mortgages and a bill to this effect is expected to be presented to the Parliament in the spring of 2014. Since the bill has not yet been published 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.

BILL AMENDING THE FINANCIAL UNDERTAKINGS ACT (CRD IV/CRR)

The Capital Requirements Directive is one of the two legal acts comprising the new CRD Directive. The other element of the CRD is the Capital Requirements Regulation (CRR). Iceland has not yet implemented CRD IV but the Government established a working committee in November 2012 with the role of presenting a proposal for the Ministry of Finance and Economic Affairs. The Ministry has announced that this will most likely be done in three steps and the first bill will be presented before the Parliament in February. The second bill will probably feature new rules concerning Capital Conservations Buffer and Countercyclical Capital Buffer, rules regarding SIFIs and penalty provisions. The third bill will address new rules that can be found in the CRR regulation regarding large exposures, equity, securitization etc. These bills have not yet been implemented and 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.

BILL AMENDING THE SECURITIES TRANSACTIONS ACT

The Act amends the Securities Transaction Act in accordance with remarks made by ESA regarding the implementation of the MIFID directive. Since the bill has not yet been implemented 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.

RESOLUTION CONCERNING MEASURES TO TACKLE DEBT PROBLEMS OF ICELANDIC HOUSEHOLDS

In June 2013 the Parliament approved a resolution concerning measures to tackle debt problems of Icelandic households. The resolution established a working committee instructed to come up with a proposal for the future of housing affairs. The Committee was also instructed to make a proposal for a new mortgage system with the main aim of ensuring effectiveness of the rental market and efficient social measures for those in need. The Committee's proposals were supposed to be published at the beginning of 2014. Since no official bill has yet been published 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
CEBS	Committee of European Banking Supervisors
CEO	Chief Executive Officer
CMS	Collateral Management System
COO	Chief Operating Officer
COREP	Common Reporting
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Customer Relationship Management
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
DCC	Debt Cancellation Committee
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
ERM	Enterprise Risk Management
ESÍ	Central Bank of Iceland Holding Company
EU	European Union
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 Indicator
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
SIFI	Systemically Important Financial Institution
SME	Small and Medium Enterprises
SO	Security Officer
SREP	Supervisory Review and Evaluation Process

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