Pillar 3 Risk Disclosures

2015

Arion Bank

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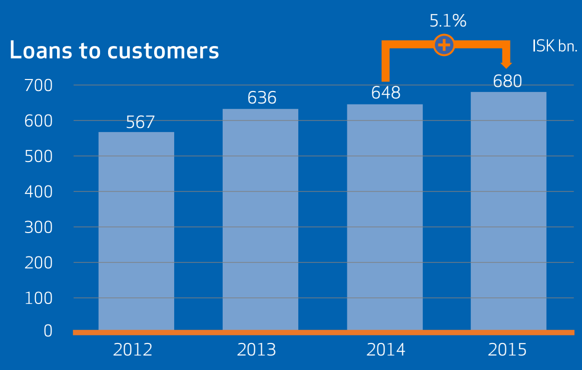
RISK METRICS OVERVIEW



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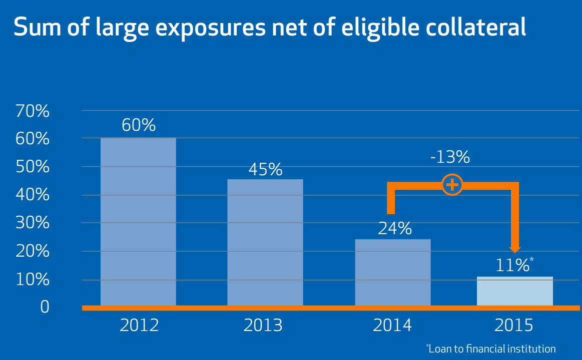

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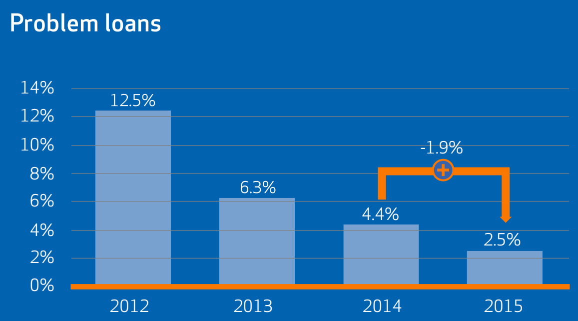

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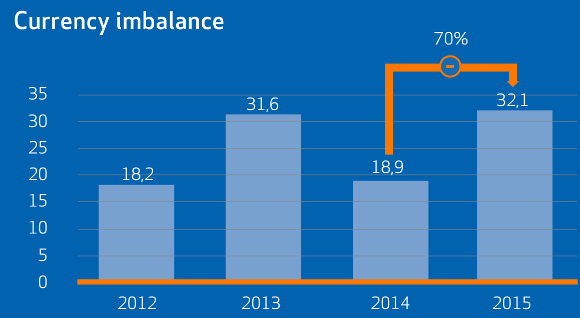

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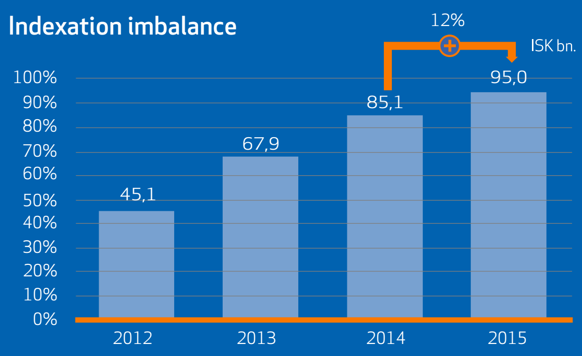

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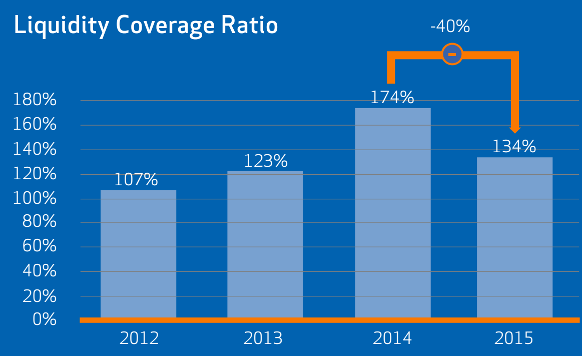

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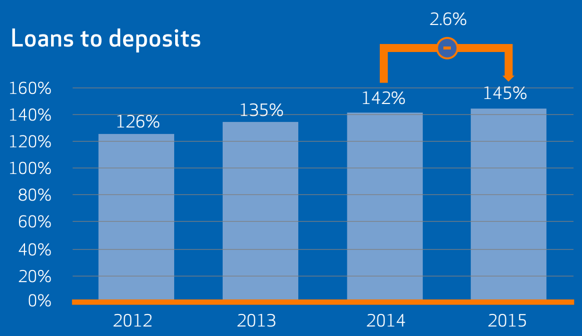

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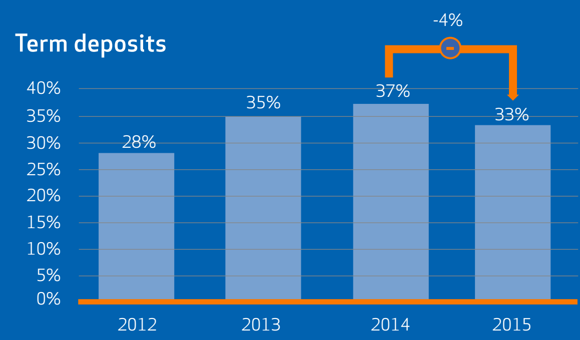

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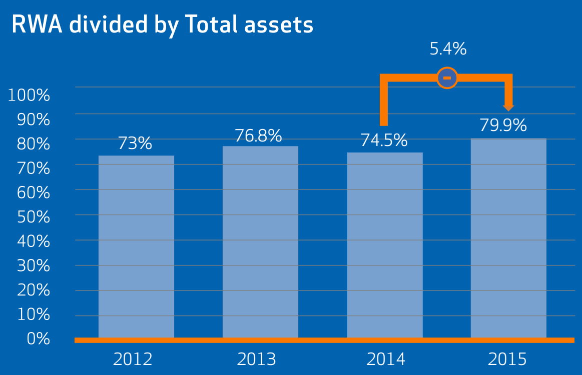

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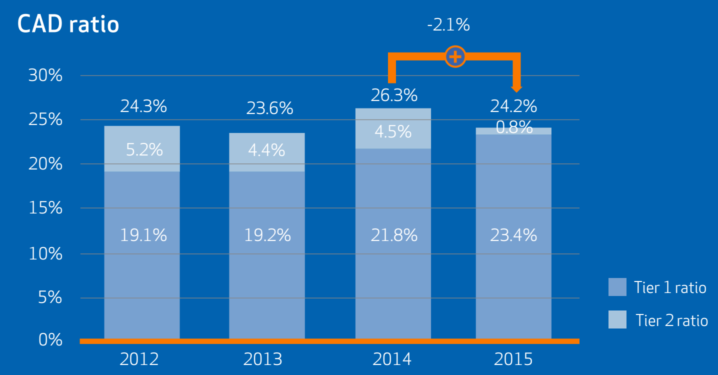

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1 INTRODUCTION

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 inform readers about Arion Bank's risk profile and risk management. The disclosures contain information on the governance of risk, 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, whose roots date 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 a number of branches across Iceland with a focus on the capital area. In addition, the Bank operates a customer service centre, and offers online and mobile banking, which provides a wide range of self-service options.

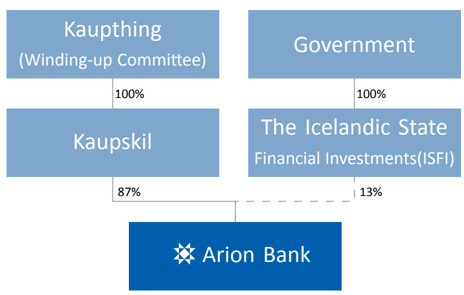
Figure 1.1 Arion Bank's branch network

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 2015 the Bank launched its inaugural euro senior unsecured benchmark issue, when it sold EUR 300 million of 3-year fixed rate bonds to around 100 international investors — the single largest transaction by an Icelandic bank in recent years, see section 1.2. As a relationship bank, a strong focus is placed on product development, not least on the mortgage market. The Bank became the first Icelandic bank to offer non-indexed mortgages with fixed interest for five years as well as with mixed loans.

The Bank consists of six main business segments: Asset Management, Corporate Banking, Investment Banking, Retail Banking, Treasury, and Other divisions and Subsidiaries. At year end 2015 the number of full-time equivalent positions at Arion Bank and its subsidiaries was 1,147.

Figure 1.2 Ownership structure



Arion Bank has two shareholders. Kaupthing hf., on behalf of its creditors, holds an 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 2015 provides further information about the Bank, such as strategy and vision, and corporate governance.

1.2 MAJOR CHANGES IN 2015

Several developments influenced Arion Bank's risk profile in 2015. Highlights include:

CHANGES IN THE GROUP STRUCTURE

The merger of the savings bank AFL - sparisjóður with Arion Bank was approved by the FME on 15 October and took effect immediately.

During 2015, the Bank acquired the remaining shares in Valitor Holding hf. which is now a wholly owned subsidiary.

Arion Bank reached a conditional share purchase agreement with Bank Nordik in October 2015 of a 51% shareholding in Vörður tryggingar including an option agreement for the remaining 49%, pending approval from relevant Icelandic authorities. The agreements have since been abandoned but continued discussions remain. If the acquisition is realised, Vörður Tryggingar hf. and Vörður Líftryggingar hf. will become subsidiaries of Arion Bank.

The subsidiary Eignabjarg ehf. was liquidated at year end, following the sale of its shareholding in Reitir fasteignafélag hf. (see below).

ASSET DIVESTMENT

A milestone in Arion Bank's operations was reached in 2015 when the Bank largely completed the sale of direct and indirect ownership which had been acquired during the process of restructuring its clients' debts. Arion Bank sold shares in three companies, Reitir fasteignafélag hf., Eik fasteignafélag hf. and Síminn hf., when they were listed on Nasdaq Iceland during the year. Arion Bank arranged the listing of these companies on the Icelandic stock market and they were all the IPOs in Iceland during the year. In addition a sizeable indirect holding in Refresco Gerber was sold during the year as the company was listed on the Euronext market in Amsterdam. At the end of the year the Bank also sold its interest in Klakki ehf. In January 2016 the Bank announced the sale by its subsidiary BG12 slhf. of a 46% shareholding in Bakkavor Group Ltd.

GLOBAL OIL AND OFFSHORE EXPOSURES

Arion Bank has not been unaffected by the prevailing situation on the global oil market as it has made loans to service companies in the industry. These loans are less than 1% of total loans to customers and have been adequately provisioned for in the Bank's accounts.

PREPARATION FOR THE LIFTING OF CAPITAL CONTROLS

Since the end of 2008, the Icelandic economy has been subject to capital controls on almost all monetary transactions to and from Iceland, which have entailed a low level of investment and complicated access to funding. On 8 June 2015 the Icelandic government announced a package of measures for the lifting of capital controls. The government's plan has gone mostly as scheduled. The Icelandic courts have approved stability contributions from the failed banks' estates and the government has already received part of these contributions from the estates, which are to be used exclusively towards the reduction of government debt. In its stability contribution, Kaupthing pledged to term out its foreign currency deposits at Arion Bank and to refinance Arion Bank's borrowings from the Icelandic Central Bank (see funding below). An auction releasing offshore ISK will likely be held this spring, after which capital controls will be lifted on the domestic economy.

► INTRODUCTION

FUNDING

In 2014, Arion Bank established an EMTN (Euro Medium Term Note) programme to issue bonds in foreign currency. The programme enables Arion Bank to issue bonds at short notice on the international market for the equivalent of up to EUR 1 billion. In March 2015 Arion Bank launched its inaugural euro senior unsecured benchmark issue, when the Bank sold EUR 300 million, or ISK 45 billion, of 3-year fixed rate bonds to around 100 international investors. It was the Bank's first public transaction in euros and the single largest transaction by an Icelandic bank in recent years, and the most important step taken by an Icelandic bank to re-enter the international capital markets since 2008.

Arion Bank launched its inaugural transaction from the EMTN programme in March 2015 when the Bank issued its euro senior unsecured benchmark transaction, the first by an Icelandic bank post 2008

At the end of June Arion Bank completed a 5-year bond issue of NOK 500 million, approximately ISK 8 billion. The Bank tapped this bond issue for an additional NOK 300 million in November, taking the overall issue size to NOK 800 million. The bonds bear floating NIBOR +2.95%. In relation to these bond issues Arion Bank has repurchased NOK 394 million of a NOK 500 million issue from 2013.

During the year Arion Bank prepaid ISK 20 billion of the approximately ISK 30 billion subordinated loan from the Icelandic treasury. The loan was granted in connection with the recapitalization of the Bank in 2010 and in settlement of a dividend in 2011.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. The Bank issued a total of ISK 23.6 billion of covered bonds in 2015 in the domestic market, of which ISK 15 billion were inflation-linked bonds and ISK 8.6 billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis on the domestic market in 2016.

At the beginning of 2016 the Bank concluded a funding agreement with Kaupthing – a part of the package of measures concerning Kaupthing and which are aimed at the lifting of the capital controls announced by the government on 8 June 2015. Under the agreement Arion Bank will issue a bond under the EMTN program, amounting to USD 747 million. The bond is a 7-year instrument and is callable on due interest dates the first two years. The bonds bear floating LIBOR + 2.6% margin in the first two years and after that the interest margin will be based on market rates. The bond will offset loans in foreign currency originally taken by the Bank from the Central Bank of Iceland and now owned by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. As a result of the terming out of Kaupthing's deposits, Arion Bank's liquidity risk due to entities in winding-up has been reduced.

ASSET ENCUMBERANCE

The aforementioned loan from the Icelandic Central Bank was secured by assets on the balance sheet of Arion Bank, mainly mortgage loans to individuals and other loans to large Icelandic corporates. With this loan settled the asset-encumbrance ratio of the Group decreases from 24% to 18%.

A DOMESTIC SYSTEMICALLY IMPORTANT BANK (D-SIB)

On 15 April 2015 the Icelandic Systemic Risk Committee published its methodology for determining which Icelandic Financial Institutions it would consider systemically important. According to this methodology, Arion Bank has been classified as a domestic systematically important bank.

CAPITAL BUFFERS

In July 2015 the CRD IV was partly adopted into Icelandic legislation (see section 1.3.1). Among the articles which were adopted were those pertaining to capital buffers. The legislation prescribes the adoption of the capital conservation buffer but places the responsibility for other buffers on Iceland's Financial Stability Council (FSC) and the Icelandic Financial Supervisory Authority (FME). On 1 March 2016 the FME implemented the FSC's 22 January 2016 recommendation for the required level of capital buffers, which, including the capital conservation buffer, are as follows:

- Capital conservation buffer: 1% of RWAs as of 1 January 2016 but increases to 1.75% on 1 June 2016 and 2.5% on 1 January 2017
- Capital buffer for systemic risk: 3% of domestic RWAs for D-SIBs as of 1 April 2016
- Capital buffer for systemically important financial institutions: 2% of RWAs as of 1 April 2016
- Countercyclical capital buffer: 1% of domestic RWAs as of 1 March 2017

Arion Bank already meets the combined Pillar 2 and fully implemented buffer requirements and does not expect to be required to increase its capital base in the coming years.

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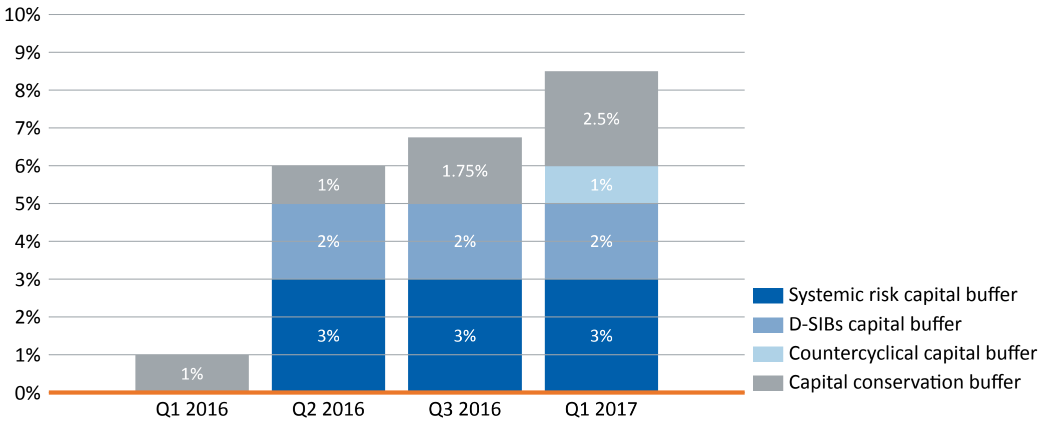
Figure 1.3 Rate of capital buffer adoption for Icelandic D-SIBs



IFRS 9

The Bank is preparing to adopt the new IFRS 9 accounting standard on 1 January 2018. Preparation involves developing systems and processes to support the IFRS 9 expected credit loss model. The new accounting requirements will likely lead to greater loss allowances and the Bank is in the process of conducting Quantitative Impact Studies to understand the magnitude of changes.

INTERNATIONAL CREDIT RATING – INVESTMENT GRADE

Standard & Poor's (S&P) recently upgraded Arion Bank's credit rating from BB+ to BBB- with a stable outlook. The upgrade followed the announcement of plans to lift the capital controls. The new credit rating makes Arion Bank investment grade.

At the beginning of 2016 S&P upgraded Iceland's sovereign credit rating to BBB+ with a stable outlook. At the same time it changed the outlook on Arion Bank's BBB- credit rating from stable to positive. The upgrade was primarily made on the basis of the brighter economic outlook in

At the beginning of 2016 the credit rating agency Standard & Poor's revised its rating of Arion Bank to BBB- with a positive outlook.

Iceland and S&P believes that this positive trend will continue with further ratings upgrades for both Iceland and Arion Bank as the government's plan to lift capital controls materializes and as debt continues to be reduced.

1.3 REGULATORY FRAMEWORK

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

The Basel framework encompasses three complementary pillars:

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

Under Pillar 3, capital adequacy must be reported through public disclosures that are designed to provide transparent information on capital structure, risk exposures, and the risk assessment process. The 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 incorporated 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 (FME) No. 215/2007 on the Capital Requirements and Risk Weighted Assets of Financial Undertakings with later amendments.

Arion Bank follows the legislative requirements 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 CRD IV package, which consists of 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. Preparation for implementation in Iceland has been underway since November 2012 when the government established a working committee. The Committee's role was to present a proposal for a bill implementing the Directive to the Ministry of Finance and Economic Affairs.

The Ministry submitted a bill of law implementing part of the CRD IV into Icelandic law and the bill was passed during the Parliament´s summer session. Act No. 57/2015, amending the Financial Undertaking Act (No. 161/2002) transposes the two EU legislative acts, due to become obligatory via the EEA-agreement and represent extensive reforms to the legal and regulatory framework of Iceland's financial markets. The amendments bring about changes e.g. on provisions concerning authorization, risk management, active ownership, management and employees of financial institutions, internal governance, remuneration and bonus policy, large exposures, equity and administrative sanctions. The amendments also introduce a special capital buffer into Icelandic law. The Act came into force on 17 July 2015, with new provisions on capital conservation buffer entering into force 1 January 2016, 1 June 2016 and 1 January 2017. Following this, several bills completing the implementation of the CRD IV package was submitted to the Parliament 9 March 2016, including amendments to provisions regarding equity, the supervisory review and evaluation process (SREP), sanctions and definitions laid out in the Act. The CRR is currently being translated and implementation is expected in the spring or autumn of 2016.

1.4 DISCLOSURE POLICY

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

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

1.5 PILLAR 3 RISK DISCLOSURES

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to 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 disclosure policy. The disclosures have not been subject to external audit but contain information from the Bank's audited Consolidated Financial Statements for 2015. 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 2015, 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 2015 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 2015, are shown in Table 1.1. Where necessary, a distinction is made in the report between the group and parent entity. Parent entity information includes the Arion Bank Mortgages Institutional Investor Fund (ABMIIF).

Table 1.1 Main subsidiaries in which Arion Bank held a direct interest at the end of 2015, fully consolidated

Company	Operating activity	Ownership %	Currency	Country	Operation
ABMIIF	Retail banking	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
Eignarhaldsfélagið Landey ehf.	Real estate	100.0	ISK	Iceland	Non-core
Kolufell ehf.	Real estate	68.9	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.	Payment solutions	100.0	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 Bank's risk management policy is to maintain a risk culture in which risk is everyone's business.

The Bank's strategy is to have 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 the Bank's risk. The Bank's risk is categorized in four types; credit, market, liquidity and operational risk. Each type will be discussed in detail in this report.

2.1 INTERNAL CONTROLS AND LINES OF REPORTING

The Bank is committed to the highest standards of corporate governance in its business, including risk management. The Bank's corporate governance framework is based on legislation, regulations and recognized guidelines in force at each time. The ultimate responsibility for setting the Bank's risk and governance policies and for ensuring effective internal control and management of risk rests with the Board of Directors. The enforcement of the Board's policies is delegated to the Chief Executive Officer (CEO) who in turn 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 2.6, 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 division'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 and the Risk Management function operate according to a charter for risk management defined by the Board of Directors. The CRO is a member of the Executive Management Committee and reports to the CEO with unhindered access to the Board. The CRO has overall day-to-day accountability for risk management in the Bank's parent company and periodic accountability for risk assessment in the Bank 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 overseeing and monitoring 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 2.4.

2.2 THREE LINES OF DEFENSE

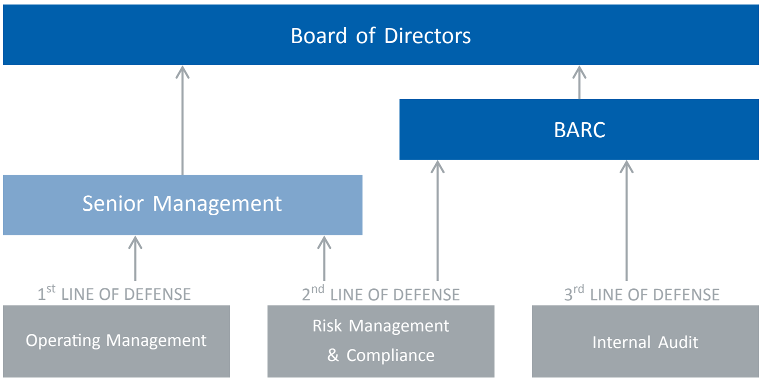
In order to ensure the effectiveness of the Bank's internal controls, to clarify responsibilities and coordinate essential risk management, and to foster the culture wherein risk is every employee's business, the Bank has adopted the three lines of defense model.

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

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

- Functions that own and manage risks
- Functions that oversee risk management
- Functions that provide independent assurance of effectiveness

Figure 2.2 Three lines of defense



FIRST LINE OF DEFENSE: OPERATING MANAGEMENT

Operational management, i.e. those in charge of overseeing and designing business operations, naturally serves as the first line of defense, which owns and manages risks, as controls are designed to fit into systems and processes under their guidance.

SECOND LINE OF DEFENSE: RISK MANAGEMENT & COMPLIANCE

The second line of defense is established to ensure that the first line of defense is properly designed, in place, and operating as intended. The Bank's Risk Management and Compliance divisions are the primary second line of defense, but other divisions may also have limited second line of defense duties.

THIRD LINE OF DEFENSE: INTERNAL AUDIT

Internal Audit provides the Board of Directors and the senior management with comprehensive assurance based on the highest level of independence and objectivity within the Bank.

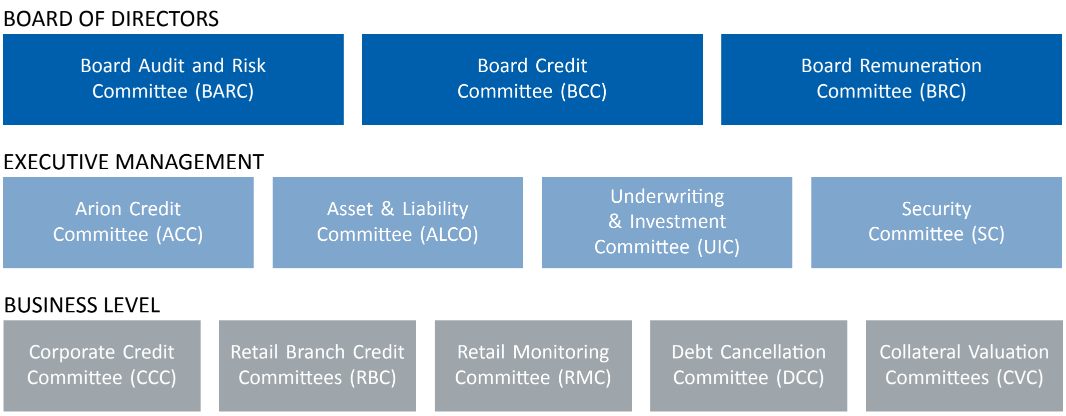
Internal Audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives.

2.3 RISK COMMITTEES

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

Figure 2.3 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 Board Audit and Risk Committee provides guidance to the Board on the alignment of the Bank's risk policy, high-level strategy and risk appetite, and risk management structure. The BARC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BARC supervises accounting procedures, the auditing of the annual accounts and the Bank's consolidated accounts. The BARC assesses whether incentives which may be contained in the Bank's remuneration system, including variable remuneration, are consistent with the Bank's risk policy.
Board Credit Committee (BCC)	The Board Credit Committee is the Bank's supreme authority in granting of credit and makes decisions on credit, debt cancellations, investments and underwriting in accordance with its authority framework, as decided by the Board. The BCC can delegate specific authority to the CEO to be used in extraordinary circumstances. The committee periodically reviews reports on various aspects of the credit portfolio.
Board Remuneration Committee (BRC)	The Board Remuneration Committee prepares a remuneration policy for the Bank that shall be reviewed by the Board at least annually and submitted to the AGM for approval. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor and on the Bank's incentive scheme and other work-related payments. The CEO proposes a salary framework for Managing Directors, the Compliance Officer and Chief Internal Auditor in consultation with the BRC.

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

Table 2.2 Executive level committees

Committee	Responsibilities
Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases below BCC's credit granting limits. 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 observer in committee meetings.
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. The CRO or his deputy is a non-voting observer in committee meetings.
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 observer in committee meetings.
Security Committee (SC)	The Security Committee is a consultation forum on security matters. The committee formulates, reviews and approves security goals and policies, monitors compliance with security policies and implements information security rules. The committee is chaired by the CRO.

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

Table 2.3 Business level committees

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.

2.4 THE RISK MANAGEMENT DIVISION

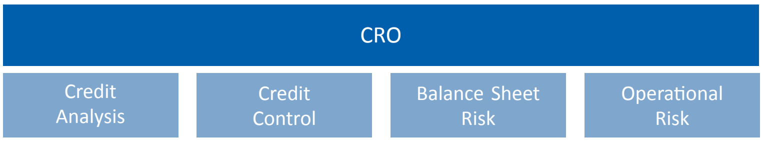
The Risk Management division focuses on the identification, monitoring and control of risk. Risk Management ensures compliance with internal and external limits, standards and regulations, such as CRD, and a strong emphasis is placed on reporting risk to the relevant stakeholders in a clear and meaningful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

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

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 four departments.

Figure 2.4 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 CONTROL

The Credit Control department monitors weak and impaired credit exposures on a customer by customer basis. 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 also 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.

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.

BALANCE SHEET RISK

The Balance Sheet Risk department is responsible for analyzing, monitoring and reporting on market risk, liquidity risk and capital requirements. Within the scope of market risk are risks resulting from balance sheet mismatches, i.e. interest rate risk and foreign exchange risk, and risks stemming from the Bank's trading activities. The department reports its analysis and stress testing results for market, funding and liquidity risk to ALCO and relevant business units on a regular basis.

Balance Sheet Risk is responsible for the design, implementation and management of the Bank's ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP) 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 and stress tests, which are the basis for the internal assessment of capital and liquidity requirements. The department interfaces primarily with the Bank's Treasury, Proprietary Trading and Capital Markets and reports its findings to the ALCO. Additionally the department collaborates closely with the Bank's Asset Management division on various reporting and limit surveillance and 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 Bank's 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.

SECURITY OFFICER

The Bank's Security Officer is a part of the Risk Management division and reports directly to the CRO. The Security Officer's main task is to devise a strategy on security issues, supervise security issues and report to the Security Committee and the Executive Management. The Security Officer is also responsible for the Bank's contingency plans.

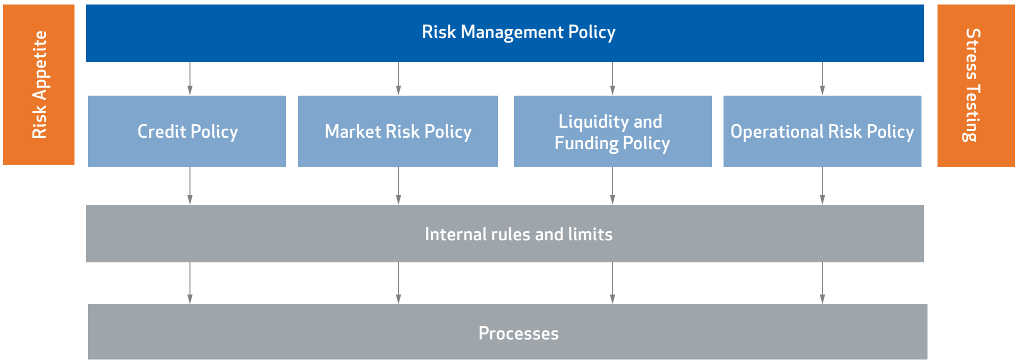
2.5 RISK POLICIES

In pursuance of ensuring that existing and potential material risks are identified, managed and monitored the Bank has a risk management policy in place. The policy is reviewed and approved by the Board of Directors annually. The policy outlines, at high level, the key aspects of the Bank's risk management. The Bank recognizes that risk taking is an integral part of its business activities and must therefore be managed in an effective manner and in line with the Bank's risk appetite, see section 2.6.

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

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

Figure 2.5 Risk policies implementation



2.6 RISK APPETITE

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

The objective of the risk appetite framework is to provide a common framework to the Board and the management to communicate, understand, and assess the types and level of risk that the Board is willing to accept in pursuit of the Bank's strategy. The framework furnishes an appropriate understanding of the Bank's risk profile relative to its risk appetite. The risk appetite framework is reviewed and approved by the Board at least semi-annually. Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits.

The Bank's risk appetite is articulated through a risk appetite statement and translated into risk limits developed and approved by the CEO or relevant 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 BARC are promptly notified if any risk appetite metrics are exceeded. Internal and external limits are monitored by the Risk Management division in accordance with the Bank's procedures.

Table 2.4 Risk appetite metrics

Risk type	Metric
Credit risk	• Sum of large exposures • Single name exposure • Expected loan loss rates • Sector concentration
Market risk	• Equity exposure • Unlisted equity exposure • Indirect equity exposure
Funding and liquidity risk	• Liquidity coverage ratio • Loans to deposits ratio • Encumbered asset ratio
Operational risk and regulatory compliance	• Tolerance statements for various compliance breaches
Asset and liability management	• Currency imbalance • Interest rate risk
Capital management	• Capital ratios • Leverage ratio

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

2.7 REPORTING

The Bank's aim is to provide relevant stakeholders with accurate and transparent risk information. Therefore, Risk Management places a strong emphasis on reporting risk and allocating sufficient resources to ensure the 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 2.5 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 developments, secured liquidity, funding measures, currency and indexation imbalances, margin trading activities, and other relevant liquidity and market risk information.	Monthly	ALCO
Risk report	An aggregate report containing the credit risk portfolio report and the liquidity and market risk report, as well as information on the Bank's risk appetite 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 its 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 and statutory deductions that determine the capital base of a financial institution are defined in Articles 84 and 85 of Act No. 161/2002 on Financial Undertakings and Rules No. 215/2007, in which the EU Capital Requirement Directives (CRD) have been transposed. Tier 1 capital comprises of share capital, share premium, other reserves, retained earnings, and non-controlling minority interests, with statutory deductions of intangible assets and tax assets. 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. in 2010 and the settlement of a dividend in 2011.

At the end of 2015, Arion Bank's capital base amounted to ISK 195,729 million of which 97% was Tier 1 capital

Table 3.1 Capital base

31 December [ISK m]	2015	2014
Total equity	**201,895**	**162,212**
Non-controlling interest not eligible for inclusion in CET1 capital	(9,108)	(1,385)
Intangible assets	(9,285)	(9,596)
Tax assets	(205)	(655)
Other statutory deductions	(3,151)	(111)
Common equity Tier 1 capital	**180,146**	**150,465**
Additional Tier 1 capital	9,108	1,385
Tier 1 capital	**189,254**	**151,850**
Subordinated liabilities	10,365	31,639
Other statutory deductions	(3,890)	(101)
Tier 2 capital	**6,475**	**31,538**
Capital base	**195,729**	**183,388**

The Bank's capital base is composed of Tier 1 and Tier 2 capital as shown in Table 3.1. At the end of 2015, Arion Bank's capital base amounted to ISK 195,729 million of which 97% was Tier 1 capital. The Bank's Tier 1 capital grew by ISK 37,403 million between year-end 2014 and 2015 mainly due to the Bank's increased earnings in 2015. In 2015, the Bank prepaid two thirds of its subordinated loans resulting in a ISK 20 billion reduction of Tier 2 capital. The remaining subordinated liabilities are denominated in EUR, USD and GBP and start maturing in 2020. At year-end 2015, the Group's share in VISA Europe was deducted 50% from Tier 1 capital and 50% from Tier 2 capital, as it is a minority holding in a financial sector entity.

It is expected that the capital requirements regulation (CRR) and directive (CRD IV), which introduces a Basel III based supervisory framework in Europe, will be fully adopted in Iceland in 2016. Own funds under CRR consist of Common Equity Tier 1 (CET1), Additional Tier 1 and Tier 2 capital. The Bank estimates its CET1 capital, for which non-controlling interest in non-banks are ineligible, at ISK 180,145 million at the end of 2015. Under CRR, the Bank's general provisions, which amounted to ISK 4,984 million at year-end 2015, will be accounted for as Tier 2 capital.

3.2 CAPITAL REQUIREMENTS

The Bank's capital requirements calculations are determined in accordance with the Act No. 161/2002 on Financial Undertakings and FME's Rules No. 215/2007 on Capital Requirements and Risk Weighted Assets of Financial Undertakings. The regulatory capital requirements are outlined under Pillar 1 and the Bank's own internal assessment of capital adequacy (ICAAP) is determined under Pillar 2.

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 further discussion on the segmentation of Pillar 2 and its interplay with capital buffers in section 3.3.

Capital buffers have been incorporated into Icelandic law with the partial adoption of CRD IV into the Act of Financial Undertakings in 2015 and became legally valid on 1 January 2016. On 1 March 2016, FME confirmed the proposed buffer levels given by the Financial Stability Council. The implementation plan is shown in Figure 1.3. The capital buffers are the following, with fully implemented requirements shown in parenthesis:

- Capital conservation buffer (2.5%)
- Systemic buffer (3%, only to be applied the domestic part of the Bank's RWA)
- Buffer for systematically important institutions (2%)
- Countercyclical capital buffer (1%)

Financial institutions are required to maintain CET1 capital to meet the combined buffer requirement, which is determined by applying the aggregated buffer percentage requirements to the Bank's RWA. Taking into account that domestic exposures are currently the source of 84% of the Bank's RWA, the combined buffer requirement reaches about 8% on 1 March 2017 when the buffers have been fully implemented.

Ever since its establishment, the Bank's capital base has grown consistently 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 Bank's RWA are calculated using the approaches described in Table 3.3.

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 Common Equity Tier 1 capital. The Bank's Tier 1 ratio and capital adequacy ratio at year-end 2015 was 23.4% and 24.2% 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. At year-end 2015, the carried an average risk weight of 79.9% of its total assets compared with 74.5% 2014. The average risk weight was reduced following the sale of Bakkavör Group Ltd in January 2016.

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

For information regarding the status of the implementation of CRR and CRD IV see section 1.3.1.

Table 3.2 Key capital adequacy figures

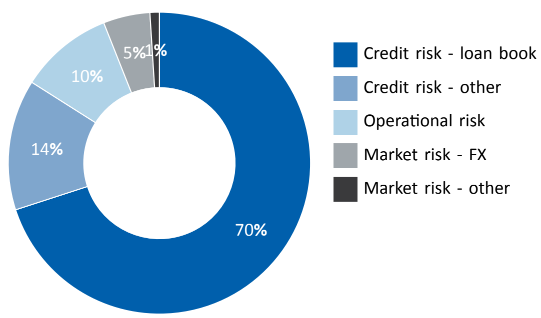
31 December [ISK m]	2015	2014	2013	2012
Tier 1 capital	189,253	151,850	138,627	125,474
Capital base	195,729	183,388	170,439	159,694
Risk-weighted assets (RWA)	807,911	696,010	720,822	657,763
Pillar 1 capital requirement	64,632	55,681	57,666	52,621
Tier 1 capital ratio	23.4%	21.8%	19.2%	19.1%
Total capital ratio	24.2%	26.3%	23.6%	24.3%
RWA divided by Total assets (on balance sheet)	79.9%	74.5%	76.8%	73.0%

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 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 capital requirements for market risk. This approach entails using a standard risk weight of 150% for equities and risk weights ranging from 0% to 100% for specific risk from traded debt instruments. The general risk is calculated in accordance with the maturity based approach. The capital requirements for currency imbalance is calculated based on the total net long position or the total net short position, which ever is the higher.
Operational risk	The Bank uses the standardized approach to calculate capital requirements for operational risk, a change from last year when the Bank applied the basic indicator method. Under the standardized approach the own funds requirements are determined on the basis of average three year earnings from the Bank's core activities. Different weights are applied for each business line, i.e. Corporate finance, Trading and sales, Retail brokerage, Commercial banking, Retail banking, Payment and settlement, Agency service and Asset management.

Risk-weighted assets amounted to ISK 807,911 million at the end of 2015 compared to ISK 696,010 million at the end of 2014. The effects of the sale of Bakkavor Group Ltd. in January 2016 were the main driver behind the increase in RWA as the retroactive valuation increase for the financial statement at year-end 2015 resulted in an increase in the Group's currency imbalance and equity positions on the banking book. The effects have been reversed in Q1 of 2016 following the disposition of the shares, resulting in higher capital ratios compared to year-end 2015.

Figure 3.1 RWA 2015



The average risk weight increased in 2015 following a decrease in 2014. The main reasons for the increase are the aforementioned effect of the Bakkavor sale on RWA and a reduction in deposits at the Central Bank of Iceland, which carry 0% risk weight, due to a decrease in wholesale deposits with the Group.

At the end of 2015 credit risk accounted for 84% of RWA, operational risk 10% and market risk 6%.

Figure 3.2 Change in RWA in 2015 [ISK m]

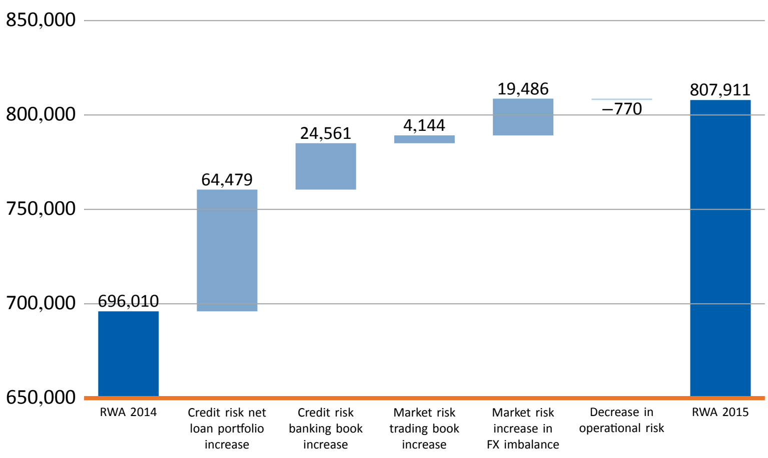
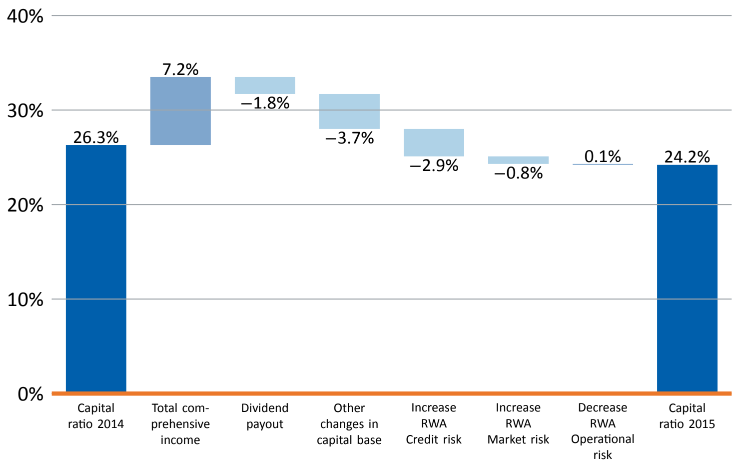


Figure 3.3 Change in capital ratio in 2015



In Table 3.4 the Bank's exposure at default, RWA and minimum capital requirements under Pillar 1 for the end of 2015 and 2014 are broken down by different risk types, and exposure classes. In Table 3.5 on-balance sheet items are then broken down by sectors. The total figures for each sector differ slightly from the Bank's financial statement due to a different handling of subsidiaries and general provisions.

Table 3.5 shows the Bank's on-balance sheet credit exposure broken down by exposures classes and by sectors. The aggregated amounts for each sector differ slightly from that of the Bank's financial statement due to a different handling of subsidiaries and general provisions.

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

31 December 2015 [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	3,593	-	-	-
Regional government	3,857	2,977	1,439	21.1%	115
Administrative bodies	266	10	279	100.9%	22
Institutions	87,427	2	37,466	42.9%	2,997
Corporate	126,691	37,960	142,471	86.5%	11,398
Retail	57,693	15,467	57,057	78.0%	4,565
Real estate individuals	269,151	722	111,458	41.3%	8,917
Real estate corporate	205,358	9,786	202,461	94.1%	16,197
Past due	14,098	3	14,612	103.6%	1,169
Other assets	55,976	-	51,696	92.4%	4,136
Equity, banking book	33,366	-	43,115	129.2%	3,449
Debt instruments, banking book	76,256	-	16,998	22.3%	1,360
Counterparty credit risk	2,401	-	1,983	82.6%	159
Credit risk total	**932,566**	**70,520**	**681,034**	**67.9%**	**54,483**
Market risk					
Debt instruments, trading book	4,893	-	2,598	53.1%	208
Equity, trading book	2,225	-	4,437	199.4%	355
Foreign exchange			38,401		3,072
Market risk total	**7,118**	**-**	**45,436**		**3,635**
Operational risk total			**81,441**		**6,515**
Total	**939,684**	**70,520**	**807,911**	**80%**	**64,633**

31 December 2014 [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	24,614	70	-	-	-
Regional government	5,989	1,378	1,555	21.1%	124
Administrative bodies	278	5	282	100.0%	23
Institutions	108,792	24	26,738	24.6%	2,139
Corporate	128,421	23,344	138,330	91.1%	11,066
Retail	53,292	12,301	48,867	74.5%	3,909
Real estate individuals	256,181	565	104,700	40.8%	8,376
Real estate corporate	174,640	6,225	168,691	93.3%	13,495
Past due	22,727	1	22,834	100.5%	1,827
Other assets	44,293	-	44,063	99.5%	3,525
Equity, banking book	23,694	-	32,002	135.1%	2,560
Debt instruments, banking book	63,318	-	3,549	5.6%	284
Counterparty credit risk	1,026	-	381	37.1%	30
Credit risk total	**907,265**	**43,914**	**591,994**	**62.2%**	**47,360**
Market risk					
Debt instruments, trading book	8,625	-	583	6.8%	47
Equity, trading book	1,538	-	2,307	150.0%	185
Foreign exchange		-	18,915		1,513
Market risk total	**10,164**	**-**	**21,805**		**1,744**
Operational risk total			**82,211**		**6,577**
Total	**917,429**	**43,914**	**696,010**	**72.4%**	**55,681**

Table 3.5 Exposure at Default (on-balance sheet) split by exposure class and by sector

	Exposure at Default - On Balance Sheet									
31 December 2015 [ISK m]	Central government	Regional government	Administrative bodies	Institutions	Corporate	Retail	Real estate	Past due	Other credit risk related exposure	Total on-balance sheet
Credit risk										
Agriculture	-	-	-	-	57	543	5,166	70	-	5,836
Financial and insurance services	-	-	-	87,427	26,524	1,317	5,285	104	-	120,657
Fishing industry	-	-	-	-	58,429	1,586	15,069	293	-	75,377
Individual	-	-	-	-		40,364	268,157	11,972	-	320,492
Industry, energy and manufacturing	-	57	-	-	2,234	862	18,194	172	-	21,519
Information and communication technology	-		-	-	11,620	1,361	18,007	1	-	30,989
Public administration, human health and social act.	25	3,801	266	-	33	472	3,352	109	-	8,058
Real estate and construction	-	-	-	-	6,426	2,621	93,405	672	-	103,124
Services	-	-	-	-	3,474	4,149	12,252	316	-	20,190
Transportation	-	-	-	-	953	649	4,627	21	-	6,251
Wholesale and retail trades	-	-	-	-	16,940	3,769	30,997	368	-	52,074
Other assets	-	-	-	-	-	-	-	-	55,976	55,976
Banking book - Traded debt instruments	-	-	-	-	-	-	-	-	76,256	76,256
Banking book - Equity	-	-	-	-	-	-	-	-	33,366	33,366
Counterparty credit risk	-	-	-	-	-	-	-	-	2,401	2,401
Credit risk total	**25**	**3,857**	**266**	**87,427**	**126,691**	**57,693**	**474,509**	**14,098**	**168,000**	**932,566**

	Exposure at Default - On Balance Sheet									
31 December 2014 [ISK m]	Central government	Regional government	Administrative bodies	Institutions	Corporate	Retail	Real estate	Past due	Other credit risk related exposure	Total on-balance sheet
Credit risk										
Agriculture	-	-	-	-	54	673	4,039	84	-	4,973
Financial and insurance services	21,060	-	-	108,792	24,004	466	2,718	141	-	158,525
Fishing industry	-	-	-	-	63,548	1,326	12,734	12	-	79,897
Individual	-	-	-	-	-	38,273	256,205	16	-	314,604
Industry, energy and manufacturing	3,509	1,754	-	-	7,798	860	12,826	49	-	25,713
Information and communication technology	-	-	-	-	4,102	1,365	18,657	991	-	23,734
Public administration, human health and social act.	45	3,263	278	-	24	616	3,342	18,839	-	7,794
Real estate and construction	-	-	-	-	5,171	2,830	73,801	252	-	81,862
Services	-	972	-	-	2,337	2,984	10,429	759	-	16,041
Transportation	-	-	-	-	1,246	531	4,442	185	-	5,548
Wholesale and retail trades	-	-	-	-	20,138	3,368	31,629	1,398	-	56,241
Other assets	-	-	-	-	-	-	-	-	44,293	44,293
Banking book - Traded debt instruments	-	-	-	-	-	-	-	-	63,318	63,318
Banking book - Equity	-	-	-	-	-	-	-	-	23,694	23,694
Counterparty credit risk	-	-	-	-	-	-	-	-	1,026	1,026
Credit risk total	**24,614**	**5,989**	**278**	**108,792**	**128,421**	**53,292**	**430,821**	**22,727**	**132,332**	**907,265**

Table 3.6 shows the on-balance sheet credit risk exposure broken down by exposure classes and maturity at book value. Table 3.7 shows collateral types broken down by exposure classes.

Table 3.6 On-balance sheet credit risk exposure broken down by exposure classes and maturity, book value

31 December 2015 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	9	16	-	-	25
Regional government	1,792	324	1,742	-	3,857
Administrative bodies	2	260	4	-	266
Institutions	87,427	-	-	-	87,427
Corporate	40,891	64,377	21,423	-	126,691
Retail	19,725	20,012	17,957	-	57,693
Real estate	50,067	105,551	318,891	-	474,509
Past due	2,591	309	11,197	-	14,098
Other assets	-	-	-	55,976	55,976
Equity, banking book	-	-	-	33,366	33,366
Traded debt instruments, banking book	5,683	59,553	11,020	-	76,256
Counterparty credit risk	-	-	-	2,401	2,401
Total on-balance sheet credit risk exposure	**208,187**	**250,402**	**382,234**	**91,743**	**932,566**

31 December 2014 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	21,091	3,523	-	-	24,614
Regional government	2,648	1,224	2,116	-	5,989
Administrative bodies	228	47	3	-	278
Institutions	108,792	-	-	-	108,792
Corporate	57,850	61,638	8,933	-	128,421
Retail	22,914	15,918	14,460	-	53,292
Real estate	40,958	113,107	276,756	-	430,821
Past due	4,704	566	17,456	-	22,727
Other assets	-	-	-	44,293	44,293
Equity, banking book	-	-	-	23,694	23,694
Traded debt instruments, banking book	2,020	54,594	6,704	-	63,318
Counterparty credit risk	877	149	-	-	1,026
Total on-balance sheet credit risk exposure	**262,084**	**250,766**	**326,427**	**67,987**	**907,265**

Table 3.7 Collateral types broken down by exposure classes

31 December 2015 [ISK m]	Cash and securities	Real estates	Fishing	Other	Total
Central government	-	-	-	-	-
Regional government	-	563	-	-	563
Administrative bodies	3	2	-	-	5
Corporate	17,252	1,480	44,671	31,274	94,677
Retail	1,446	3,677	1,118	10,301	16,543
Real estate	554	421,424	12,657	25,994	460,630
Past due	19	16,841	376	305	17,540
Derivatives	7,474	-	-	-	7,474
Total collateral	**26,748**	**400,903**	**57,817**	**68,406**	**597,433**

31 December 2014 [ISK m]	Cash and securities	Real estates	Fishing	Other	Total
Central government	3,510	-	-	-	3,510
Regional government	1,766	524	-	-	2,291
Administrative bodies	1	1	-	-	2
Corporate	13,599	9,219	47,186	27,014	97,017
Retail	1,011	2,652	745	2,754	7,162
Real estate	452	364,416	9,133	38,480	412,481
Past due	115	24,090	754	157	25,117
Derivatives	3,330	-	-	-	3,330
Total collateral	**23,785**	**400,903**	**57,817**	**68,406**	**550,911**

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 Board of Directors, the CEO and the CRO and submitted to the FME. The FME reviews the Bank's ICAAP report and sets capital requirements following its supervisory and review process (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 .

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

Managing Directors with their key personnel and key personnel from the Bank's subsidiaries participate in the process of identifying and evaluating high risk areas, 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 3.8.

Table 3.8 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	✓	✓	✓	✓	✓	✓	✓	✓

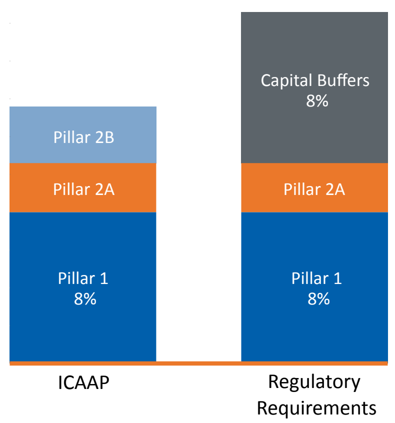
The Bank's ICAAP methodology involves assessing key risks that are not believed to be adequately addressed under Pillar 1. For each such risk, a capital add-on is applied on top of the regulatory capital requirements, which are 8% of RWA. The main risk elements for which additional capital is required are:

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

With the introduction of capital buffers into the capital regulatory framework, the Bank separates the assessment of additional capital requirements under Pillar 2 into two parts. The first part, often referred to as Pillar 2A, addresses risks that are not captured, or not fully captured, under Pillar 1 and are not within the scope of the capital buffers. The second part, Pillar 2B, addresses systemic risks that are addressed in the arguments of the Financial Stability Board, which recommends the size of three of the four capital buffers. Under Pillar 2B, the Bank also assesses additional capital need in order to remain a going concern under adverse economic conditions. Such future risk is assessed via stress testing and macro-economic analysis.

Arion Bank's policy is to not disclose the result from ICAAP/SREP at this point in time due to uncertainties regarding the overlap of risk factors, currently accounted for both in Pillar 2 and capital buffers.

Figure 3.4 Interaction between Pillar 2 and Capital Buffers



3.4 STRESS TESTING

Stress tests provide an important management tool for the Bank. The results of stress tests raise risk awareness and improve general understanding of the Bank's operations and are be considered for strategic, capital and contingency planning. The results of stress tests are incorporated into the review of the risk appetite and the Bank's limit framework.

The Bank's stress testing is carried out in parallel to ICAAP and ILAAP according to the Bank's stress testing framework, which is aligned with FME's guidelines no. 2/2015 which are based on EBA's Guidelines on Stress Testing (GL32). Stress testing at the Bank consists of sensitivity analysis and scenario analysis.

The impact is estimated on the Bank's earnings and the capital base as well as for the Bank's capital and liquidity ratios and other risk appetite metrics. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers and suggests relevant stressed scenarios. 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. Reverse stress testing is part of the process, where scenarios posing possible threats to the solvency of the Bank are identified.

Scenario analyses are carried out on the Bank's business plan. One of the two stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FME. 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 design of the bank-wide internal stress test is challenged and reviewed by the Executive Committee and the Board of Directors.

3.5 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 periodically 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 3.6 Allocated capital at end of September 2015

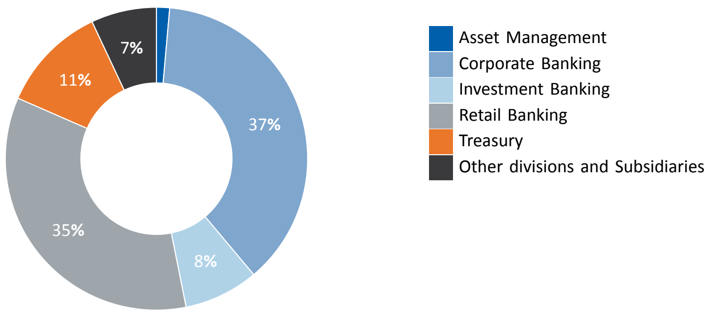
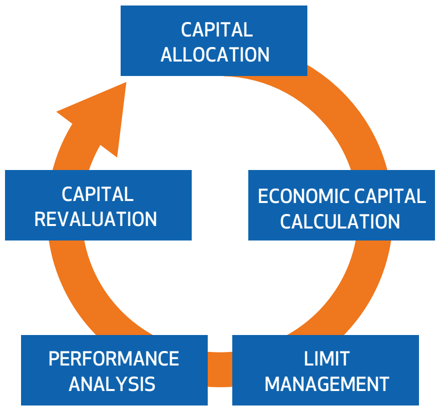


Figure 3.5 Capital planning and monitoring process



3.6 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. 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 acceptable levels, the Bank will need to take appropriate actions.

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

3.7 LEVERAGE RATIO

As part of the Basel III framework that is to be implemented by CRD IV, leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting the Bank's Tier 1 capital against a measure of its exposures, with special treatment for derivatives, securities financing transactions and off-balance sheet items, aimed at revealing hidden leverage on banks' balance sheets. At year-end 2015, the Bank has a strong leverage ratio of 16.7%, significantly higher than the 3% benchmark minimum currently used by the Basel Committee.

Table 3.9 The Bank's leverage ratio

31 December [ISK m]	2015	2014	2013
On balance-sheet exposures	982,348	912,303	921,079
Derivative exposures	3,789	1,348	1,929
Securities financing transaction exposures	16,287	10,044	10,381
Off balance-sheet exposures	127,675	59,922	25,199
Total exposure	**1,130,099**	**983,617**	**958,588**
Tier 1 capital	**189,253**	**151,850**	**138,627**
Leverage ratio	**16.7%**	**15.4%**	**14.5%**

4 **CREDIT** RISK

4 CREDIT RISK

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

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

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

Table 4.1 Sources of credit risk

Source	Description
Loan portfolio	The loan portfolio is the Bank's main asset. To maintain and improve the quality of the loan portfolio it is imperative to constantly monitor the performance of loans, counterparties and collateral, both individually and at the portfolio level.
Commitments and guarantees	The Bank often commits itself to ensuring that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on overdrafts on checking accounts, credit cards and credit lines.
Counterparty credit risk	The Bank offers financial derivative instruments to professional investors, e.g. FX, interest and securities derivatives. The Bank also uses hedging derivatives and engages in securities lending. For further information on counterparty credit risk see, section 4.9.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made 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 5.6.

4.1 CREDIT POLICY

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) is the supreme authority in the granting of credit. The Arion Credit Committee (ACC), which acts below BCC's granting limits, has the right to delegate authority within its own credit limits 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.

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.

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 Credit Control 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 and the BARC monthly, and the Board of Directors before each meeting. Credit Control 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.

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 rating 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, in portfolio monitoring and in collective provisioning. The Bank uses three credit rating models for three types of borrowers:

- Larger corporates. Defined as corporate clients with a) individual exposure over ISK 160 million (approx. EUR 1 million) or b) individual exposure over ISK 65 million and related exposure over ISK 160 million. The model is run manually, based on quantitative information drawn from financial statements as well as qualitative data entered by account managers. The rating result requires approval from the Credit Analysis department. The model was last updated and recalibrated in June 2013 with the aim of improving its predictive power.
- Retail corporates. Defined as corporate clients with a) individual exposure below ISK 65 million or b) individual exposure between ISK 65 million and ISK 160 million and related exposure below ISK 160 million. The model is statistical, run automatically, using quantitative internal and external information found to have predictive power about the customer. The model was last updated and recalibrated in December 2014.
- Individuals. The model is statistical, run automatically, based on similar methodologies as the model for retail corporates. The model was last updated and recalibrated in August 2014.

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

As other Icelandic banks, Arion will have to implement IFRS 9 before 2018. Furthermore, the Bank is considering applying for advanced IRB for parts of its portfolio. Current rating models do not satisfy every IFRS 9/IRB requirement so there is a need for a rating system upgrade. As a part of that process, Risk Management has redifined its defintion of default especially with regards to multiple defaults and cure. Risk management is currently updating the rating models to make them IFRS 9 compliant.

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 2015, the Bank's total credit risk exposure was ISK 1,094,624 million (2014: 958,299 million). Loans to customers increased by 5.1% between 2014 and 2015 and represent the largest part of the Bank's total credit exposure or 62%. Government bonds or government secured bonds represent the majority of the total bonds and debt instruments. The Bank's loans to financial institutions consist to a large extent of the Bank's deposits placed with other banks and short term money market loans or 94%. Table 4.2 shows the Bank's credit risk exposure. The average exposure during 2015 is calculated from four quarterly interim financial statements.

Loans to customers represent the largest part of the Bank's total credit exposure or 62%

Table 4.2 Breakdown of credit risk exposure

	2015		2014	
[ISK m]	31 December	Average	31 December	Average
On-balance sheet items:				
Cash and balances with Central Bank	48,102	54,539	21,063	22,626
Loans to credit institutions	87,491	102,569	108,792	113,102
Loans to customers	680,350	668,844	647,508	644,883
Bonds and debt instruments	78,794	70,746	66,466	67,562
Derivatives	6,457	3,150	2,949	1,648
Bond and debt instruments, hedging	1,519	2,440	3,212	2,068
Other assets with credit risk	4,581	8,339	3,514	5,263
Credit risk exposure on-balance sheet	**907,294**	**910,626**	**853,504**	**857,152**
Off-balance sheet items:				
Financial guarantees	19,162	15,080	9,542	10,024
Unused overdraft	42,100	40,105	38,890	38,538
Loan commitments	126,068	91,801	56,363	66,918
Credit risk exposure off-balance sheet	**187,330**	**146,985**	**104,795**	**115,480**
Total credit risk exposure	**1,094,624**	**1,057,611**	**958,299**	**972,632**

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]	2015	2014	2013	2012
Cash and cash balances with Central Bank	48,102	21,063	37,999	29,746
Thereof cash with Central Bank	43,181	6,873	24,913	17,514
Loans to credit Institutions	87,491	108,792	102,307	101,011
Thereof bank accounts, and	74,531	79,592	70,671	84,164
money market loans	7,976	23,007	26,197	13,763
Loans to customers	680,350	647,508	635,774	566,610
Total loans	**815,943**	**777,363**	**776,080**	**697,367**

The growth in loans to customers between year end 2014 and 2015 is due to organic growth, especially in SME lending. 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	2015	2014	2015	2014	2015	2014
Overdrafts	16,840	17,955	24,248	24,420	41,088	42,375
Credit cards	10,842	11,065	1,054	943	11,896	12,008
Mortgage loans	271,895	271,639	12,889	10,406	284,784	282,045
Other loans	38,058	33,763	334,849	303,998	372,907	337,761
Loans to customers pre provision	**337,635**	**334,422**	**373,040**	**339,767**	**710,675**	**674,189**
Provision on loans	(13,016)	(13,111)	(17,309)	(13,570)	(30,325)	(26,681)
Loans to customers net of provision	**324,619**	**310,491**	**355,731**	**326,197**	**680,350**	**647,508**

Loans to individuals represent 48% of total loans to customers and have increased by 1% year on year. The largest part of lending to individuals is mortgage lending or 81% of total loans to individuals, which equals to 40% of total loans to customers pre-provision.

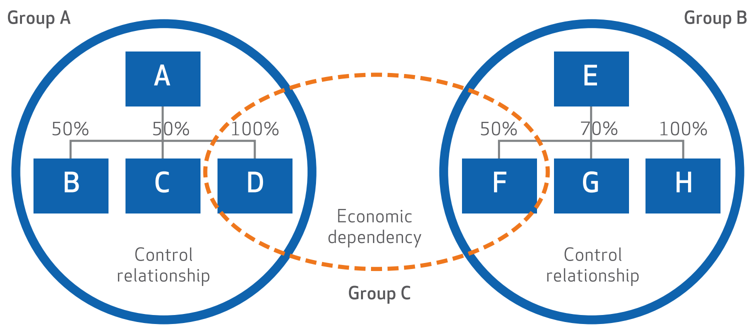
4.5.1 RELATED PARTIES AND LARGE EXPOSURE

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.

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.

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

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

At year end 2015 the Bank had one large exposures compared to two at the end of 2014 net of eligible collaterals. The largest exposure to a group of related parties at the end of 2015 was ISK 22 billion, before taking account of eligible collateral, see Table 4.5.

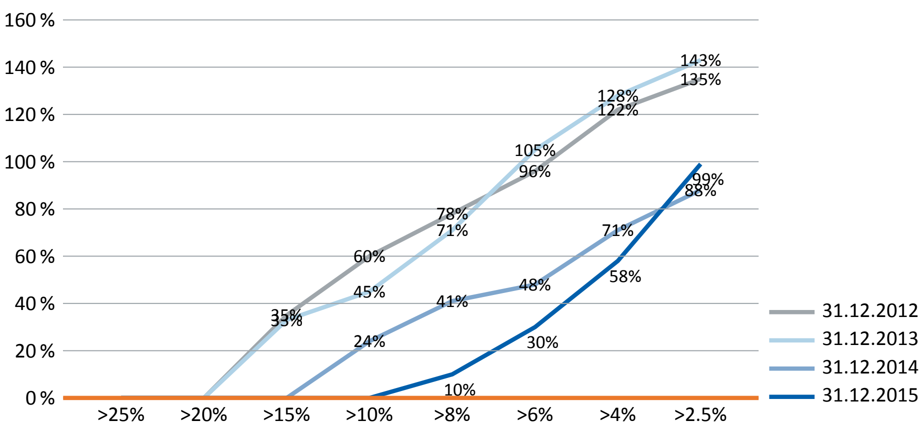
Table 4.5 The Bank's largest exposures

	2015		2014	
Related Parties	Gross	Net	Gross	Net
Group 1	11%	11%	<10%	<10%
Group 2	<10%	<10%	14%	14%
Group 3	<10%	<10%	11%	10%
Sum of large exposures > 10%	**11%**	**11%**	**25%**	**24%**

The Bank's single-name concentration continues to decrease, see Figure 4.2. For example, there was no large exposure among loans to customers at end 2015 (11% if loans to financial institutions are included). By comparison, large exposure among loans to customers were 24% at the end of 2014. The sum of large exposures exceeding 2.5%, net of eligible collateral, has increased from 88% to 99% year-on-year.

The Bank's single-name concentration decreased during 2015

Figure 4.2 Total of net exposures to a group of related parties (excluding loans to financial institutions)



4.5.2 CREDIT RISK EXPOSURE BY SECTOR

The Bank's loan book is diversified with regard to individuals and industry sectors. Of loans to customers, 48% are loans to individuals, of which 83% are mortgage loans. Credit exposure towards individuals represents 32% of the total credit risk exposure. Real estate activities and construction is the largest industry sector comprising 15% of loans to customers or 13% of the Bank's total credit risk exposure. According to the Bank's analysis, this distribution mirrors closely the sector distribution of credit from all lenders in the Icelandic economy. Thus, sector diversification is as good as can be expected for a bank which primarily operates in Iceland.

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

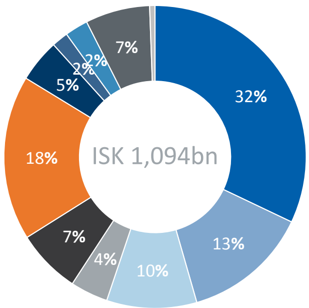


Figure 4.4 Sector distribution of loans to customers

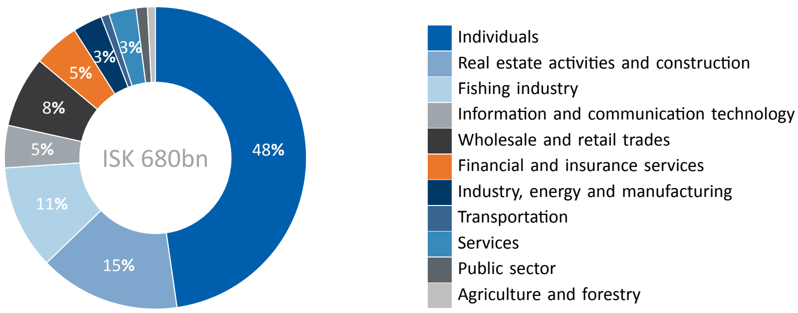


Table 4.6 Credit risk exposure broken down by industry

31 December 2015 [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	-	-	-	-	-	48,102	-	-	-	-	-	48,102
Loans to credit institutions	-	-	-	-	-	87,491	-	-	-	-	-	87,491
Loans to customers	324,629	102,624	75,850	30,802	51,784	33,460	21,384	6,001	19,864	8,193	5,759	680,350
Financial instruments	135	175	72	11	-	14,894	9,430	29	400	61,624	-	86,770
Other assets with credit risk	289	564	29	80	67	3,018	3	1	455	65	10	4,581
Credit risk exposure on-balance sheet	**325,053**	**103,363**	**75,951**	**30,893**	**51,851**	**186,965**	**30,817**	**6,031**	**20,719**	**69,882**	**5,769**	**907,294**
% of Credit risk exposure on-balance sheet	35.8%	11.4%	8.4%	3.4%	5.7%	20.6%	3.4%	0.7%	2.3%	7.7%	0.6%	100.0%
Off-balance sheet items:												
Financial guarantees	1,352	3,032	1,253	1,225	4,145	729	3,299	2,244	1,855	22	6	19,162
Unused overdrafts	24,373	1,977	596	632	5,093	1,622	2,013	377	2,403	2,639	375	42,100
Loan commitments	188	39,196	27,711	11,463	14,083	3,544	14,017	10,618	2,183	3,000	65	126,068
Credit risk exposure off-balance sheet	**25,913**	**44,205**	**29,560**	**13,320**	**23,321**	**5,895**	**19,329**	**13,239**	**6,441**	**5,661**	**446**	**187,330**
% of Credit risk exposure off-balance sheet	13.8%	23.6%	15.8%	7.1%	12.4%	3.1%	10.3%	7.1%	3.4%	3.0%	0.2%	100.0%
Total credit risk exposure	**350,966**	**147,567**	**105,511**	**44,213**	**75,172**	**192,860**	**50,146**	**19,270**	**27,160**	**75,543**	**6,215**	**1,094,624**
% of Total credit risk exposure	32.1%	13.5%	9.6%	4.0%	6.9%	17.6%	4.6%	1.8%	2.5%	6.9%	0.6%	100.0%

31 December 2014 [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	-	-	-	-	-	21,063	-	-	-	-	-	21,063
Loans to credit institutions	-	-	-	-	-	108,792	-	-	-	-	-	108,792
Loans to customers	321,311	81,228	76,340	23,314	55,034	27,693	25,284	5,529	18,382	7,746	5,647	647,508
Financial instruments	82	80	86	12	-	6,181	1,189	529	1,235	63,233	-	72,627
Other assets with credit risk	399	440	34	22	24	1,854	9	15	626	87	4	3,514
Credit risk exposure on-balance sheet	**321,792**	**81,748**	**76,460**	**23,348**	**55,058**	**165,583**	**26,482**	**6,073**	**20,243**	**71,066**	**5,651**	**853,504**
% of Credit risk exposure on-balance sheet	37.7%	9.6%	9.0%	2.7%	6.5%	19.4%	3.1%	0.7%	2.4%	8.3%	0.7%	100.0%
Off-balance sheet items:												
Financial guarantees	390	2,300	784	573	1,128	1,201	1,322	709	1,101	27	7	9,542
Unused overdrafts	22,621	2,007	578	561	4,554	1,491	1,952	264	2,038	2,384	440	38,890
Loan commitments	392	7,281	9,010	3,587	9,040	1,797	6,183	10,679	970	7,392	32	56,363
Credit risk exposure off-balance sheet	**23,403**	**11,588**	**10,372**	**4,721**	**14,722**	**4,489**	**9,457**	**11,652**	**4,109**	**9,803**	**479**	**104,795**
% of Credit risk exposure off-balance sheet	22.3%	11.1%	9.9%	4.5%	14.0%	4.3%	9.0%	11.1%	3.9%	9.4%	0.5%	100.0%
Total credit risk exposure	**345,195**	**93,336**	**86,832**	**28,069**	**69,780**	**170,072**	**35,939**	**17,725**	**24,352**	**80,869**	**6,130**	**958,299**
% of Total credit risk exposure	36.0%	9.7%	9.1%	2.9%	7.3%	17.7%	3.8%	1.8%	2.5%	8.4%	0.6%	100.0%

4.5.3 CREDIT RISK EXPOSURE BY MATURITY

Table 4.7 Credit risk exposure broken down by maturity

31 December 2015 [ISK m]	Book value	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	48,102	35,467	-	12,635	-	-
Loans and receivables to credit institutions	87,491	50,151	37,340	-	-	-
Loans and receivables to customers	680,350	3,984	42,429	90,014	234,035	309,888
Bonds and debt instruments	78,794	3,246	1,302	10,804	52,572	10,872
Derivatives	6,456	-	1,877	264	3,896	419
Bond and debt instruments, hedging	1,519	1,519	-	-	-	-
Other assets with credit risk	4,581	1,017	2,597	174	793	-
Credit risk exposure on-balance sheet	**907,294**	**95,384**	**85,545**	**113,891**	**291,295**	**321,179**
% of Credit risk exposure on-balance sheet	100.0%	10.5%	9.4%	12.6%	32.1%	35.4%
Off-balance sheet items:						
Financial guarantees	19,162	3,402	2,371	7,589	3,954	1,846
Unused overdraft	42,100	842	10,071	14,984	15,768	435
Loan commitments	126,068	-	50,628	35,542	34,506	5,392
Credit risk exposure off-balance sheet	**187,330**	**4,244**	**63,070**	**58,115**	**54,228**	**7,673**
% of Credit risk exposure off-balance sheet	100.0%	2.3%	33.7%	31.%	28.9%	4.1%
Total credit risk exposure	**1,094,624**	**99,628**	**148,615**	**172,006**	**345,523**	**328,852**
% of Total credit risk exposure	100.0%	9.1%	13.6%	15.7%	31.6%	30.0%

31 December 2014 [ISK m]	Book value	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	21,063	12,285	-	8,778	-	-
Loans to credit institutions	108,792	52,119	56,673	-	-	-
Loans to customers	647,508	11,678	50,642	89,332	230,055	265,801
Bonds and debt instruments	66,466	4,350	-	2,068	52,378	7,670
Derivatives	2,949	-	2,133	391	425	-
Bond and debt instruments, hedging	3,212	3,212	-	-	-	-
Other assets with credit risk	3,514	47	2,283	46	1,121	17
Credit risk exposure on-balance sheet	**853,504**	**83,691**	**111,731**	**100,615**	**283,979**	**273,488**
% of Credit risk exposure on-balance sheet	100.0%	9.8%	13.1%	11.8%	33.3%	32.0%
Off-balance sheet items:						
Financial guarantees	9,542	2,373	1,234	2,389	1,753	1,793
Unused overdraft	38,890	658	10,163	17,738	10,273	58
Loan commitments	56,363	2,432	21,419	15,705	16,807	-
Credit risk exposure off-balance sheet	**104,795**	**5,463**	**32,816**	**35,832**	**28,833**	**1,851**
% of Credit risk exposure off-balance sheet	100.0%	5.2%	31.3%	34.2%	27.5%	1.8%
Total credit risk exposure	**958,299**	**89,154**	**144,547**	**136,447**	**312,812**	**275,339**
% of Total credit risk exposure	100.0%	9.3%	15.1%	14.2%	32.6%	28.7%

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, broken down by book value, for each type of rating model. In some cases, companies are temporarily unrated. At the end of 2015 only 1.5% of the loan portfolio, parent company, was unrated compared to 2.9% the year before. This 1.5% 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 in arrears 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. Overall the number of active ratings is increasing and defaulting exposure is decreasing. It is noteworthy that less than 4% of the portfolio, by book value, was assigned a default rating at the end of the year compared to 7% at the end of year 2014. Active PD values are translated into an internal rating scale of letters from CCC- to A+, seen in table 4.9. The Bank has standardized five risk classes which group the internal rating scale, shown in the same table. The Retail Banking uses these risk classes in their lending processes. The rating distributions of each model are discussed below.

Table 4.8 Breakdown of rating status by book value

	2015			2014		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Corporate credit rating model	96.4%	0.6%	3.0%	89.8%	3.8%	6.4%
Retail credit rating model						
Retail corporates	93.0%	5.5%	1.5%	94.3%	4.7%	1.0%
Individuals	93.3%	6.7%	0.0%	89.7%	10.3%	0.0%
Total	**94.7%**	**3.9%**	**1.5%**	**90.0%**	**7.0%**	**2.9%**

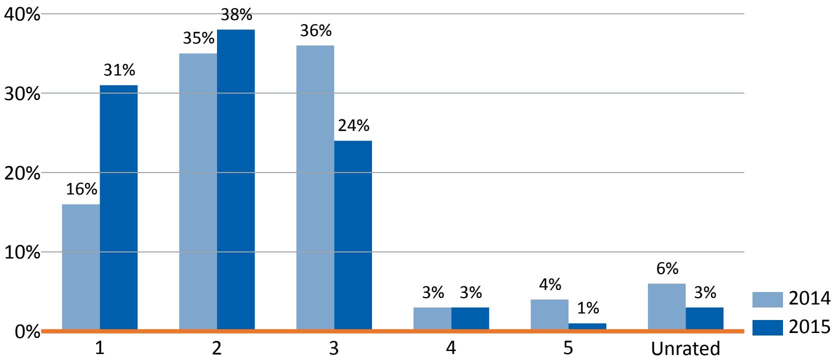
Table 4.9 Rating scale

Risk class	Rating	Lower PD	Upper PD
1	A+	0.00%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
	BBB+	0.17%	0.26%
	BBB	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	31.00%
	CCC-	31.00%	99.99%
5	DD	100.00%	100.00%

CORPORATE PORTFOLIO

Figure 4.5 shows the corporate portfolio broken down by risk classes. As seen in table 4.8 the number of unrated corporates at year end was 3% compared to 6.4% the year before. This partly explains the overall positive shift between 2014 and 2015. The book value-weighted average PD for corporate customers was 2.6% in year end 2015 compared to 2.9% in 2014. In terms of book value about 41% have been upgraded towards a better risk class, in contrast to 10% that have been downgraded. Migration analysis does not cover defaulting customers or customers that were previously unrated or rated by the model for retail corporates. The change in rating distribution can mainly be attributed to pure migration, i.e. an overall improvement in the rating of existing customers. The model is partly based on quantitative information drawn from the financial statements and most of the largest corporates have been improving steadily over the past years. However, the decreased number of unrated and defaulting corporates also plays a part.

Figure 4.5 Distribution of book value rated by the corporate credit rating model



RETAIL PORTFOLIO - RETAIL CORPORATES

Figure 4.8 shows the retail corporates portfolio broken down by risk classes. The distributions of PD values at the end of 2014 and 2015 look very similar. In terms of customers about 17% have been upgraded towards a better risk class whereas 16% have been downgraded. In terms of book value 14% have been upgraded whereas 19% have been downgraded and the book value-weighted average PD was 9.3% at the end of 2014 compared to 10.3% at the end of 2015. Migration analysis does not cover defaulting customers or customers that were previously unrated or rated by the model for large corporates. The change in rating distribution can mainly be attributed to pure migration. However, the fact that some of the corporates were previously rated by the model for large corporates also plays a part.

Figure 4.8 Distribution of book value rated by the credit rating model for Retail Corporates

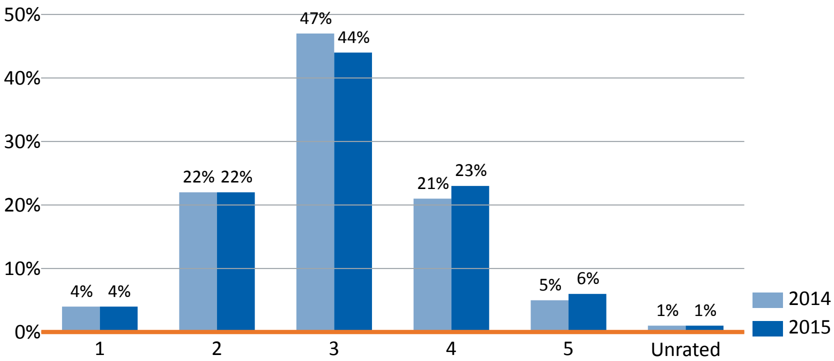


Figure 4.6 Rating migration by book value between 2014 and 2015 – Corporate

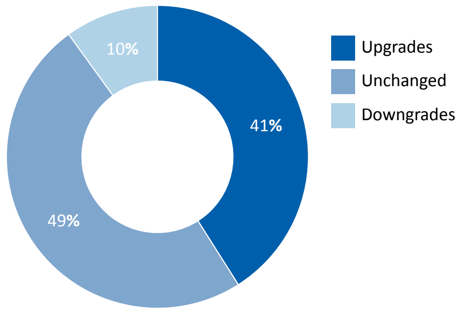


Figure 4.7 Rating migration by customer between 2014 and 2015 – Corporate

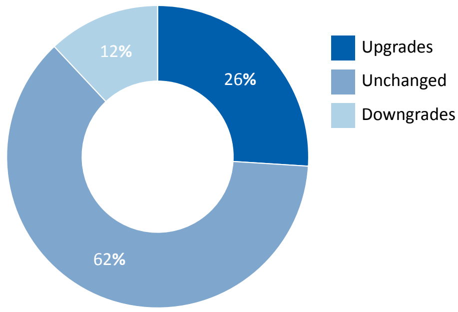


Figure 4.9 Rating migration by book value between 2014 and 2015 – Retail Corp.

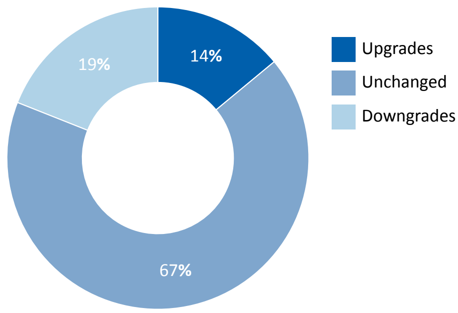
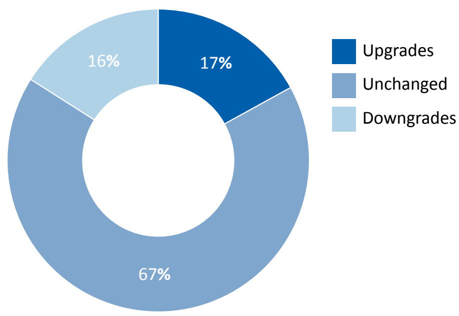


Figure 4.10 Rating migration by customer between 2014 and 2015 - Retail Corp.



RETAIL PORTFOLIO - INDIVIDUALS

Figure 4.11 shows the Individuals portfolio broken down by risk classes. The distribution of PD values has slightly shifted towards better values between 2014 and 2015. In terms of book value about 18% have been upgraded towards a better risk class whereas 16% have been downgraded. The book value-weighted average PD for individuals portfolio was 4.6% in year end 2015 compared to 4.7% in 2014. Migration analysis does not cover defaulting customers or customers that were previously unrated. The change in rating distribution can mainly be attributed to pure migration. However, the decreased number of defaulting individuals also plays a part.

Figure 4.11 Distribution of book value rated by the credit rating model for individuals

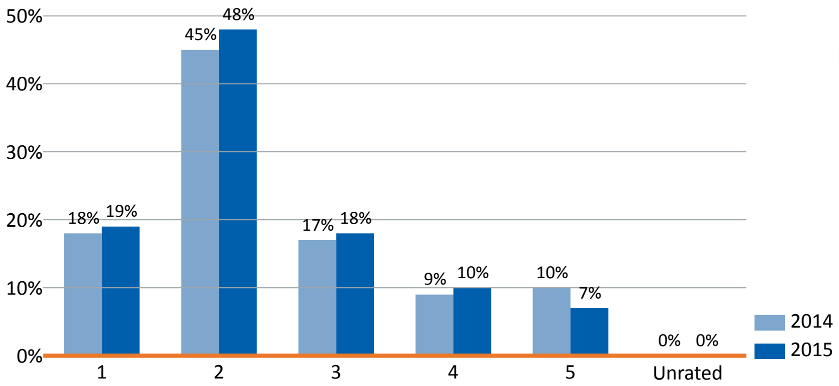


Figure 4.12 Rating migration by book value between 2014 and 2015 - Individuals

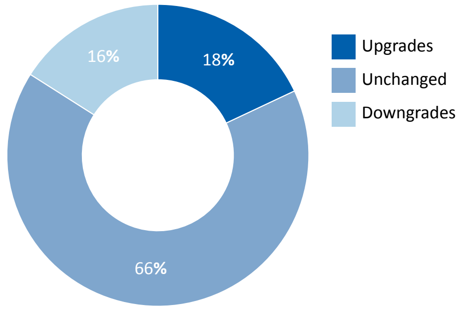
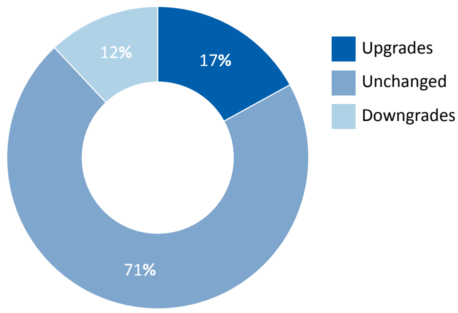


Figure 4.13 Rating migration by customer between 2014 and 2015 – Individuals



MODEL PERFORMANCES

All three rating models in use passed internal validation tests at the end of 2015 and the discriminatory power is in line with or exceeds the Bank's internal requirements. Furthermore, the prediction accuracy is satisfactory as the average PD estimates are generally close to the observed default rates. The average default rate for individuals in 2015 was 3.4% compared to 2.9% predicted by the rating model for individuals. The default rate for retail corporates in 2015 was 4.4% compared to the 6.1% predicted by the rating model for retail corporates. For the corporate portfolio the default rate was 5.2% compared to 4% predicted. Note that here the default rate is measured by number of customers, not book value weighted, and as soon as the number of days in arrears exceeds 90 the customer is assigned a DD rating even though he returns to non default status in short period of time. Figures 4.14 and 4.15 compare actual default rate in 2015 with predicted default probability for individuals, retail corporates and large corporates.

Even though current models have passed internal validation tests they are not fully IFRS 9 compliant. As the Bank will have to implement IFRS 9 before 2018 Risk Management has already started working on adjusting the models to fulfill the financial reporting standard.

Figure 4.14 Comparison of actual default rate in 2015 and predicted default probability - Individuals

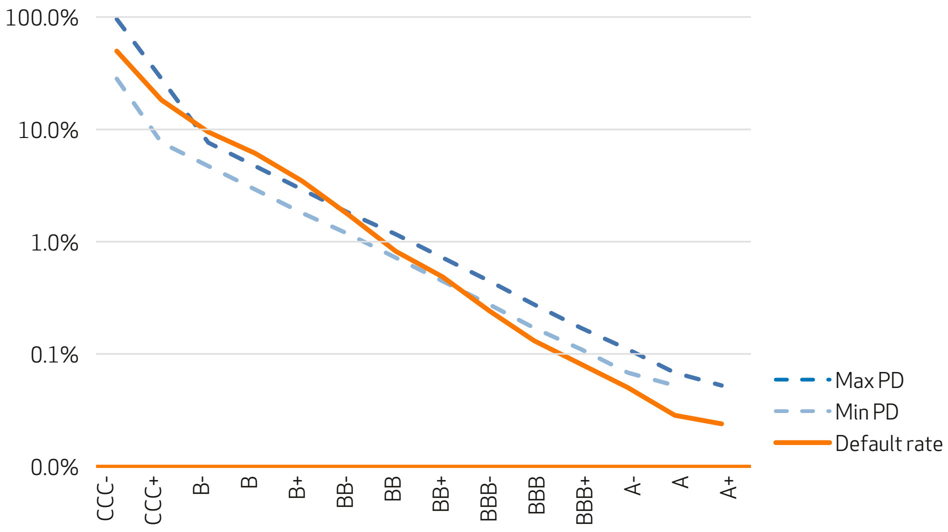
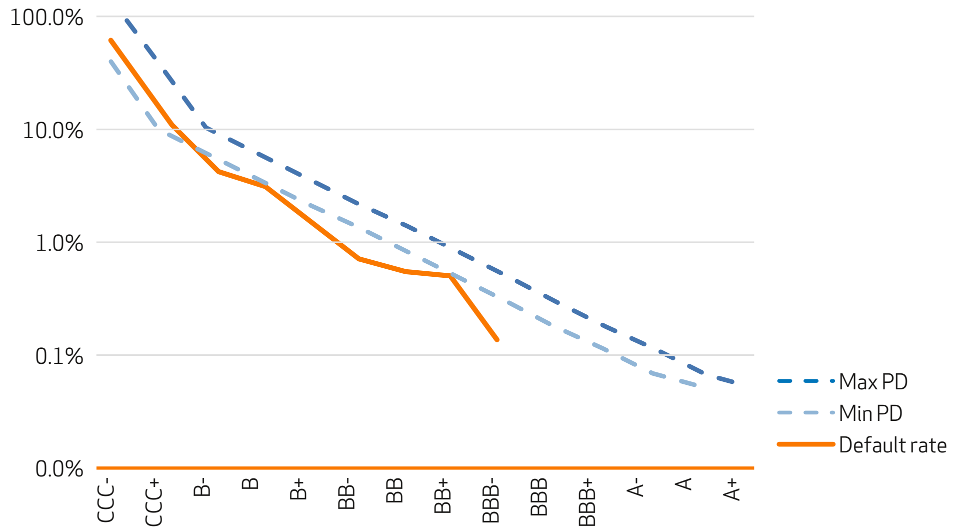


Figure 4.15 Comparison of actual default rate in 2015 and predicted default probability - Retail Corporates and Corporates. No defaults were observed for grades BBB- or better



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 37,700 million or 6% of the total loans to customers of which ISK 9,427 million are due to individuals currently domiciled outside Iceland.

Table 4.10 Geographic distribution of credit risk exposure

31 December 2015 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	48,102	0	0	0	0	48,102
Loans to credit institutions	31,340	15,131	30,151	10,590	279	87,491
Loans to customers	642,650	13,897	12,967	10,374	463	680,350
Bonds and debt instruments	52,004	6,857	14,076	5,857	0	78,794
Derivatives	3,470	463	2,523	0	0	6,456
Bonds and debt instruments, hedging	1,519	0	0	0	0	1,519
Other assets with credit risk	4,428	7	70	72	4	4,581
Credit risk exposure on-balance sheet	**783,513**	**36,355**	**59,788**	**26,892**	**745**	**907,293**
% of Credit risk exposure on-balance sheet	86.4%	4.0%	6.6%	3.0%	0.1%	100.0%
Off-balance sheet items:						
Financial guarantees	19,015	116	24	6	1	19,162
Unused overdraft	41,311	432	206	101	49	42,100
Loan commitments	113,411	205	8,807	3,645	0	126,068
Credit risk exposure off-balance sheet	**173,738**	**753**	**9,037**	**3,752**	**49**	**187,330**
% of Credit risk exposure off-balance sheet	92.7%	4.0%	4.8%	2.0%	0.0%	100.0%
Total credit risk exposure	**957,251**	**37,108**	**68,825**	**30,644**	**795**	**1,094,623**
% of Total credit risk exposure	87.5%	3.4%	6.3%	2.8%	0.1%	100.0%

31 December 2014 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	21,063	-	-	-	-	21,063
Loans to credit institutions	34,540	21,550	32,869	10,763	9,070	108,792
Loans to customers	607,977	24,161	13,579	867	924	647,508
Bonds and debt instruments	46,155	1,752	11,506	7,053	-	66,466
Derivatives	2,688	83	178	-	-	2,949
Bonds and debt instruments, hedging	3,212	-	-	-	-	3,212
Other assets with credit risk	3,021	53	349	86	5	3,514
Credit risk exposure on-balance sheet	**718,656**	**47,599**	**58,481**	**18,769**	**9,999**	**853,504**
% of Credit risk exposure on-balance sheet	84.2%	5.6%	6.9%	2.2%	1.2%	100.0%
Off-balance sheet items:						
Financial guarantees	9,238	304	-	-	-	9,542
Unused overdraft	38,158	379	213	81	58	38,890
Loan commitments	48,553	16	7,794	-	-	56,363
Credit risk exposure off-balance sheet	**95,949**	**698**	**8,007**	**81**	**58**	**104,795**
% of Credit risk exposure off-balance sheet	91.6%	0.7%	7.6%	0.1%	0.1%	100.0%
Total credit risk exposure	**814,605**	**48,297**	**66,488**	**18,850**	**10,057**	**958,299**
% of Total credit risk exposure	85.0%	5.0%	6.9%	2.0%	1.0%	100.0%

Figure 4.16 Geographic distribution of total credit risk exposure by country

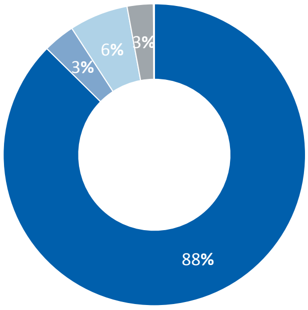
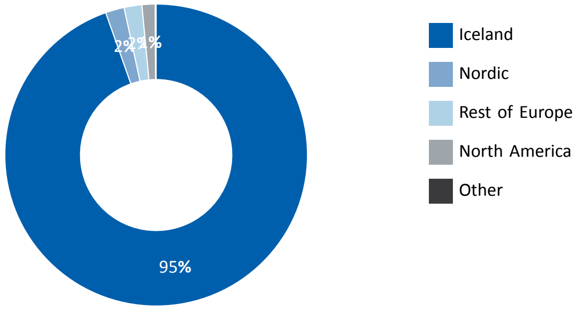


Figure 4.17 Geographic distribution of loans to customers



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: Real estate properties, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

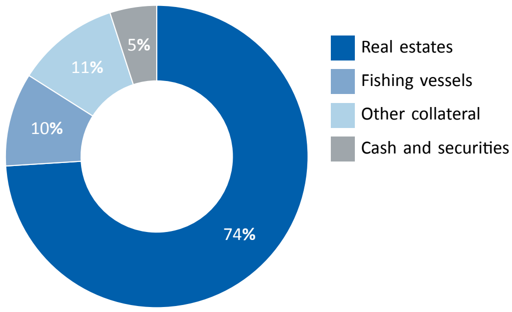
Other instruments used to mitigate credit risk include pledges, guarantees and master netting agreements.

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

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

The Bank operates a collateral management system (CMS) to consolidate the Bank's collateral data. Table 4.11 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 74% of total collateral. At the end of 2015 loans to customers are secured by collateral, conservatively valued at ISK 582,774 million, for a collateral coverage ratio of 86% compared with 81% at the end of 2014. 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.

Figure 4.18 Collateral by type



The collateral coverage ratio of loans to customers at end 2015 is 86% compared with 81% at the end of 2014

Table 4.11 Collateral, parent company

31 December 2015 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2015	Unsecured ratio % 2014
Individuals	428	289,862	24	4,107	294,421	9.3%	14.8%
Real estate activities and construction	1,032	89,039	8	1,025	91,104	11.2%	13.8%
Fishing industry	53	7,956	57,945	7,037	72,991	3.8%	11.8%
Information and communication technology	76	2,369	-	18,630	21,075	31.6%	12.7%
Wholesale and retail trade	210	20,424	7	22,912	43,553	15.9%	14.8%
Financial and insurance services	15,947	4,367	-	1,577	21,891	34.6%	49.2%
Industry, energy and manufacturing	461	12,792	3	4,416	17,672	17.4%	19.3%
Transportation	91	875	173	3,891	5,030	16.2%	30.9%
Services	13	4,847	40	2,623	7,523	62.1%	72.4%
Public sector	73	3,732	-	99	3,904	52.3%	50.2%
Agriculture and forestry	5	3,493	-	112	3,610	37.3%	54.6%
Total	**18,389**	**439,756**	**58,200**	**66,429**	**582,774**	**14.3%**	**18.8%**

Figure 4.19 shows the mortgage portfolio broken down to LTV bands. At the end of 2015, 77% of the mortgages, by value, had loan-to-value below 80% compared to 68% and 61% at the end of 2014 and 2013, respectively. As shown in figure 4.20 the mortgage property is primarily located in the Greater Reykjavik area or 73% of the portfolio, by value.

Figure 4.19 Loan to value of mortgage loans

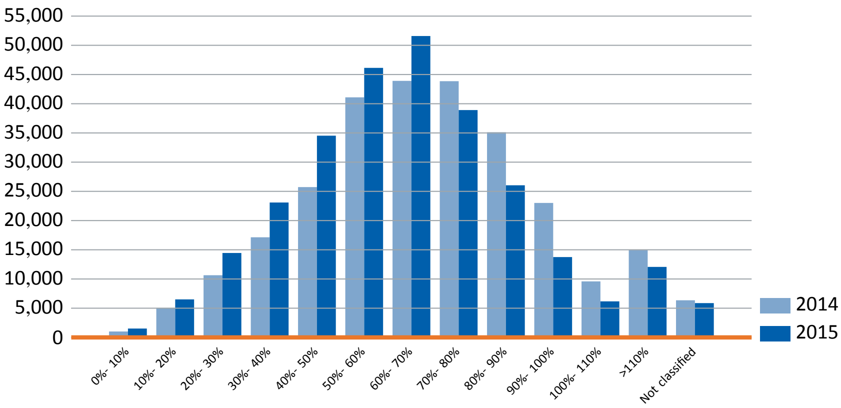
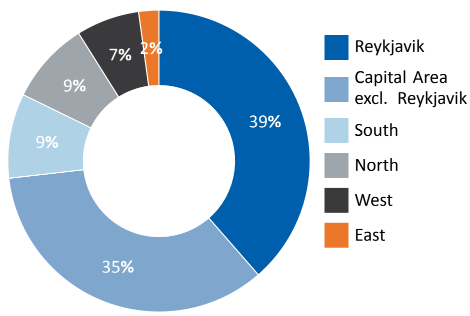


Figure 4.20 Mortgage portfolio location



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 deteri-

The EWS attempts to anticipate deterioration in the customer credit quality oration 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 4.12 shows an aggregation of the EWS to illustrate the different categories and underlying criteria.

Table 4.12 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 / > 100%	< 10% - 20%	< CCC+	Serious
< ISK 100 million	x	x			x	

The classification is made on a customer basis; all conditions must be met for all loans of each borrower for the borrower to be classified as Green.

The classification is intentionally strict since its 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. Borrowers in the Red and Orange category with mortgages undir ISK 50 million and other loans under 10 million are automatically analyzed along with individual samples. 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 1 billion. 52% of total loans, by value, are analyzed, see Table 4.13. In addition to the analysis statistics, the table shows whether the monitoring involves interviewing the responsible account manager and whether a detailed valuation report for the credit is required.

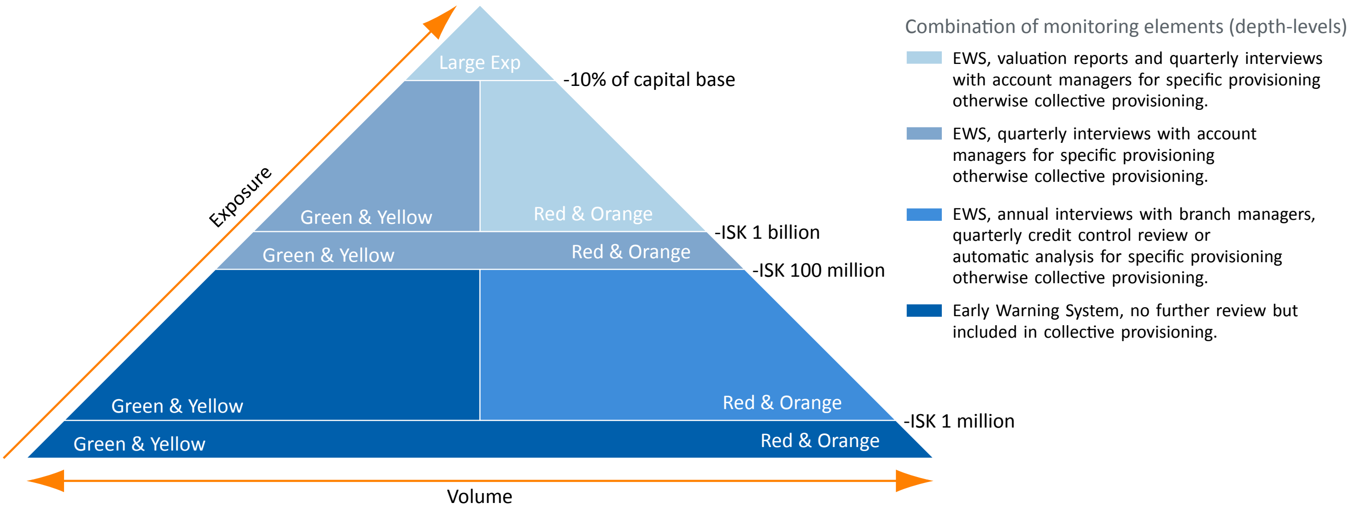
52% of total loans, by value, are individually analyzed

Table 4.13 Credit monitoring

Credit size	Total exposure	Total analyzed	Interview	Valuation report	Total customers	Customers analyzed
≥10% of capital base	0%	0%	All quarterly	All	0	0
≥1000 million	37%	37%	All quarterly	Red+Orange	210	210
≥100 million	12%	12%	Quarterly	none	720	720
≥1 million	50%	3%	Red+Orange annually	none	24,572	1,802
< 1 million	1%	0%	none	none	48,287	0
Total	**100%**	**52%**			**73,789**	**2,732**

Figure 4.21 describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.

Figure 4.21 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.

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, see section 4.8.3 based on the borrower's probability of default (PD), 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, and the LGD is is based on the Bank's own model for loss given default, see section 4.8.3.

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 4.22 and 4.23 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 4.22 Development of default on individuals, parent company

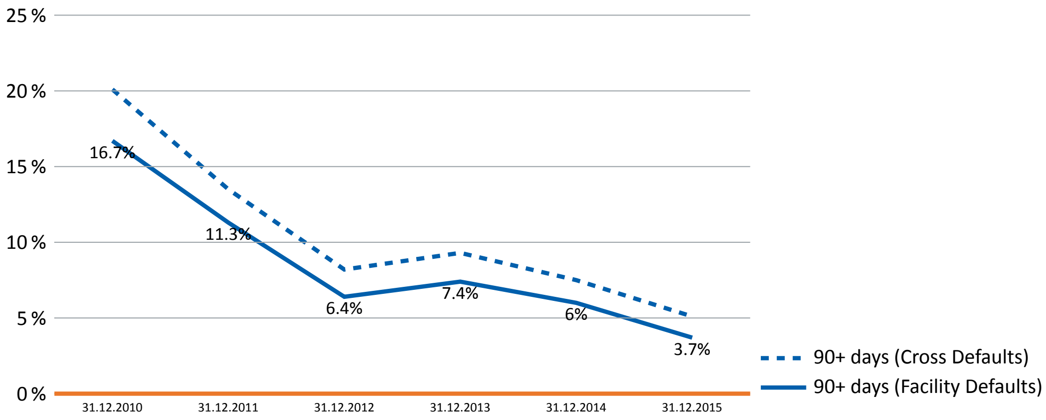
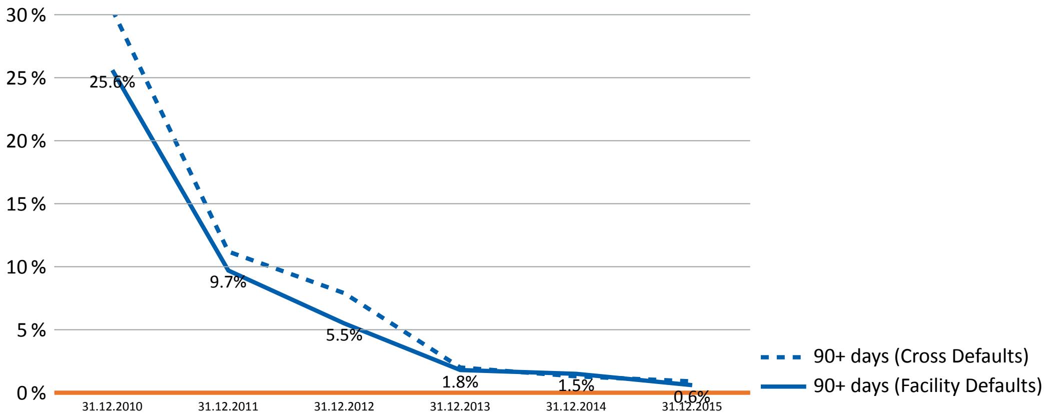


Figure 4.23 Development of default on companies, parent company



Customer loans that are past due more than 90 days are 2.1% of the total loan book at year end if measured at facility level. The cross default ratio more than 90 days is 2.9%, at the parent company level, 5.1% for individuals and 0.9% for corporates. Table 4.14 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 2.1% of the total loan book at year end if measured at facility level

Table 4.14 Defaults by sector, parent company

31 December 2015 [ISK m]	Facility level		Cross default	
	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Individuals	3.7%	85.0%	5.1%	83.9%
Wholesale and retail trade	0.7%	2.6%	1.0%	2.5%
Real estate activities and construction	0.7%	4.7%	0.8%	4.0%
Fishing industry	0.4%	2.1%	0.4%	1.5%
Public sector	1.4%	0.8%	2.6%	1.1%
Agriculture and forestry	1.2%	0.5%	10.2%	3.0%
Services	1.6%	2.2%	1.8%	1.8%
Financial and insurance activities	0.3%	0.7%	0.3%	0.5%
Industry. energy and manufacturing	0.8%	1.2%	1.3%	1.5%
Transportation	0.4%	0.2%	0.7%	0.2%
Information and communication technology	0.0%	0.0%	0.0%	0.0%
Total past due > 90 days as a % of loans to customers	**2.1%**	**100%**	**2.9%**	**100%**

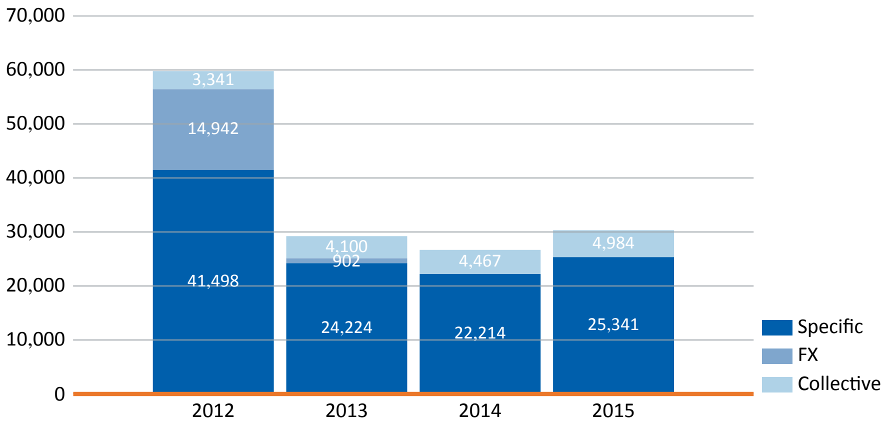
31 December 2014 [ISK m]	Facility level		Cross default	
	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Individuals	6.0%	82.1%	7.5%	82.9%
Wholesale and retail trade	2.5%	6.1%	3.1%	5.9%
Real estate activities and construction	1.4%	5.3%	1.6%	4.7%
Fishing industry	1.0%	3.3%	1.3%	3.5%
Public sector	3.2%	1.1%	3.2%	0.9%
Agriculture and forestry	3.7%	0.8%	4.0%	0.7%
Services	0.9%	0.6%	1.0%	0.5%
Financial and insurance activities	0.3%	0.4%	0.3%	0.3%
Industry. energy and manufacturing	0.2%	0.2%	0.2%	0.2%
Transportation	0.3%	0.1%	1.3%	0.3%
Information and communication technology	0.1%	0.1%	0.1%	0.0%
Total past due > 90 days as a % of loans to customers	**3.6%**	**100%**	**4.4%**	**100%**

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 2015 the Bank's total provision for impairment on loans to customers amounted to ISK 30,325 million. Figure 4.24 shows the development of provisions from 2012 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 4.24 Changes in the provision for losses on loans to customers [ISK m]



At the end of 2015 the Bank has no provision for losses to court rulings for illegal FX loans. Specific provisions due to borrower credit quality have been similarly reduced by 39% from 2012, 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.

The sum of specific loan impairments at the end of 2015 was ISK 25,341 million, compared with ISK 22,214 million at year end 2014. Table 4.15 shows the gross carrying amount of impaired loans to customers as well as the specific impairment to this amount broken down by industry sector.

Table 4.15 Impaired loans to customers by sector

	2015		2014	
31 December [ISK m]	Impairment amount	Gross carrying amount	Impairment amount	Gross carrying amount
Individuals	10,593	17,403	11,016	21,621
Real estate activities and construction	1,515	1,867	1,396	1,981
Fishing industry	257	373	1,115	2,366
Information and communication technology	308	332	251	251
Wholesale and retail trade	681	893	751	831
Financial and insurance services	5,953	6,011	6,739	6,756
Industry, energy and manufacturing	828	1,025	296	474
Transportation	4,433	4,440	18	18
Services	504	682	375	641
Public sector	143	215	27	35
Agriculture and forestry	126	186	230	340
Total	**25,341**	**33,427**	**22,214**	**35,314**

Table 4.16 shows the geographical distribution of impaired loans.

Table 4.16 Impaired loans to customers by geographic area

31 December [ISK m]	2015 Impairment amount	2015 Gross carrying amount	2014 Impairment amount	2014 Gross carrying amount
Iceland	18,947	26,417	21,103	33,371
Europe	5,983	6,344	977	1,732
North America	159	252	92	98
Other	251	414	40	112
Total	**25,341**	**33,427**	**22,213**	**35,314**

4.8.3 EXPECTED LOSS

Expected Loss is defined as the amount of credit loss which the Bank expects, on average, during a typical business year. The Bank budgets for expected loss and holds capital for unexpected loss (see chapter 3.2).

The Bank has refined its Expected Loss (EL) model, taking advantage of enhanced collateral management within the Bank and the experience gained from the economic difficulties in the past few years. Among the areas which benefit from these refined EL calculations are the determination of collective provisions (see section 4.8.2), impairment predictions in the annual budget and the pricing of credit, where credit spreads take into account the exposure's expected loss, cost of capital and operational cost.

Expected Loss is calculated using the formula $EL = PD \cdot LGD \cdot EAD$ where each credit exposure's EL is derived from the customer probability of a Basel II default (PD), the loss given default (LGD) for the credit type and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see sections 4.4 and 4.5.4.

The main components of LGD are:

- the *cure-rate* of the exposure, which describes the probability that the customer returns to performing after a Basel II default and for all defaulted loans there is no write-off and time to resolution is less than or equal one year, and
- the *collateral gap* of the defaulted exposure

The collateral gap was estimated based on collateral value with the appropriate haircut. Table 4.17 shows the Expected Loss rate for various types of performing loans at end 2015.

Table 4.17 Expected loss down to exposure type

Exposure Class	PD	LGD	EL
Corporate	3%	16%	0.5%
SME	10%	17%	1.8%
Individual - Mortgage	4%	7%	0.4%
Individual - Other	6%	42%	2.4%
Total	**4%**	**14%**	**0.68%**

4.8.4 PROBLEM LOANS

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

Table 4.18 Credit quality by class of financial asset

31 December 2015 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				-
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Credit equivalent of derivatives	4,056			4,056
Other assets with credit risk	4,581	-	-	4,581
Credit quality	**855,374**	**43,834**	**8,086**	**907,294**

31 December 2014 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	21,063	-	-	21,063
Loans to credit institutions	108,792	-	-	108,792
Loans to customers				-
Loans to corporates	308,588	15,114	2,495	326,197
Loans to individuals	277,859	32,847	10,605	321,311
Financial instruments	70,704	-	-	70,704
Credit equivalent of derivatives	1,923			1,923
Other assets with credit risk	3,514	-	-	3,514
Credit quality	**792,443**	**47,961**	**13,100**	**853,504**

Table 4.19 shows a breakdown of loans to individuals and corporates which are past due but not impaired, by the number of days in default. Note that loans more than 90 days in default are down by 30% from the previous year.

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

31 December 2015 [ISK m]	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Total past due but not impaired loans	**13,344**	**13,216**	**6,918**	**1,216**	**9,140**	**43,834**

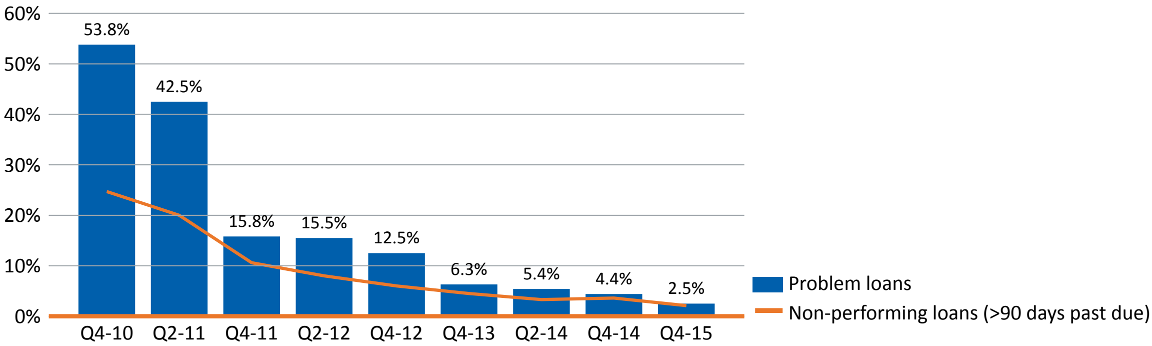
31 December 2014 [ISK m]	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,553	2,434	2,267	565	3,295	15,114
Loans to individuals	3,436	10,589	5,974	847	12,001	32,847
Total past due but not impaired loans	**9,989**	**13,023**	**8,241**	**1,412**	**15,296**	**47,961**

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 2015 problem loans constitute 2.5% of loans to customers and have decreased from 53.8% from 2010 or by 95%, see Figure 4.25. 80% of problem loans, by value, at year end 2015 are due to individuals and 20% is due to corporates. 2.1% of loans to customers are more than 90 days default.

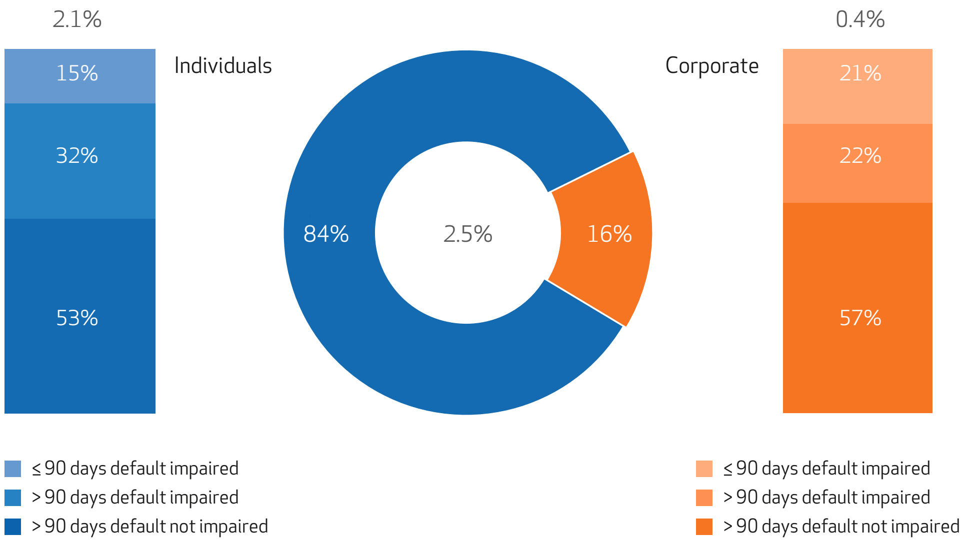
Problem loans, as a percentage of loans to customers, have decreased from 53.8% at the end of 2010 down to 2.5% or by 95%

Figure 4.25 Development of problem loans



The breakdown of problem loans by status is shown in Figure 4.26. Approximately 16% 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.

Figure 4.26 Breakdown of problem loans by status



4.9 COUNTERPARTY CREDIT RISK

Counterparty credit risk is the risk of the Bank's counterparty in derivative, securities lending or repurchase agreement defaulting before final settlement of the contract's cash flows.

The Bank offers financial derivative instruments to professional investors. Table 4.20 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 4.20 Permitted 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 risks associated with derivatives trading. 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.

The margin-call process is monitored by Risk Management

Table 4.21 shows the Bank's exposure towards counterparty credit risk gross and net of collateral.

Table 4.21 Counterparty credit risk exposure gross and net of collateral

31 December 2015 [ISK m]	Position	Collateral	Exposure
Financial institution	359	30	329
Funds	(913)	2,959	-
Corporate	956	1,048	-
Retail Corporate	(960)	4,701	-
Retail Individuals	(34)	608	-
Total	**(591)**	**9,345**	**329**

31 December 2014 [ISK m]	Position	Collateral	Exposure
Financial institution	500	110	390
Funds	(260)	1,874	-
Corporate	(93)	463	-
Retail Corporate	(41)	2,192	-
Retail Individuals	15	315	-
Total	**121**	**4,954**	**390**

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 and dealing, and positions 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 POLICY

The Bank's market risk policy 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 Balance Sheet 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 ALCO and 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 Balance Sheet Risk department is responsible for monitoring compliance with the limits that 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 Balance Sheet Risk department is responsible for monitoring compliance with the limits that 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 of market risk measurement

Market risk type	Measurement methods
Equity risk	Exposure in equity is measured with net and gross positions. VaR and stressed VaR is used to assess risk of loss under current and severe circumstances.
Interest rate risk	Interest rate risk is quantified by modeling yield curve movement and is measured as the difference in value between the original market value and the calculated market value after moving 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 VaR method is used to quantify possible losses.
Indexation risk	Indexation risk is quantified using the net balance of CPI-linked assets and liabilities. When modeling the effect of indexation, the CPI is simulated in conjunction with interest rate movement.

5.4 FOREIGN EXCHANGE RISK

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to 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 2015 the Bank has an effective net position in foreign currency of ISK 32,119 million so that a 10% depreciation of the Icelandic krona, for example, would result in a profit of ISK 3,212 million for the Bank. The opposite would be true for a 10% appreciation of the Icelandic krona.

The consolidated currency imbalance has reduced in 2015 although the end of year positions reflects the retroactive valuation increase in Bakkavör Group Ltd. The proceeds of the sale were converted into ISK in January 2016. Excluding the revaluation of Bakkavör Group Ltd. the end of year net position in foreign currency is ISK 11,308 million. The parent company's currency imbalance of ISK (8,157) million has been relatively stable and is within the limit set by the Central Bank of Iceland.

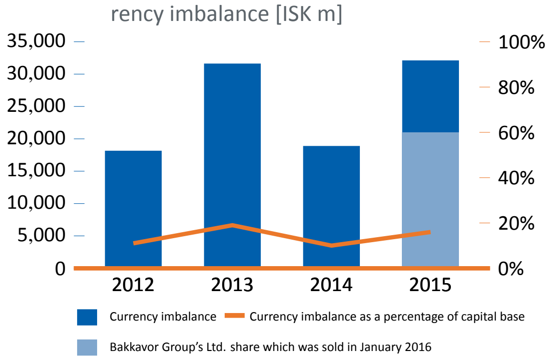
The Bank has strived to decrease the currency risk of its borrowers by limiting lending in foreign currency to customers with foreign exchange linked revenues.

Table 5.2 shows the net position of assets and liabilities by foreign currency at the end of 2015. Table 5.3 shows the Value-at-Risk for the net currency positions.

Table 5.2 Net position of assets and liabilities by currency

Foreign currency [ISK m]	Net Exposure
EUR	11,053
GBP	24,248
USD	2,090
DKK	(2,208)
NOK	(3,036)
Other	(28)
Total net position	**32,119**

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



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 5.3 VaR for net currency position with a 99 percent confidence level over a 10 day horizon

Foreign currency [ISK m]	10 day 99%VaR
EUR	232
USD	86
CHF	29
GBP	118
JPY	23
Nordic	191
Other	23
Diversification	(442)
Total Value-at-Risk	**259**

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. The Bank uses stressed VaR to assess future currency risk.

5.5 INDEXATION RISK

Indexation risk is defined as the risk of loss due to movements in the Consumer Price Index (CPI), i.e. inflation or deflation. A considerable part of the Bank's balance sheet consists of indexed assets and liabilities, the value of which is directly linked to the CPI. This risk factor should not be mistaken for inflation risk which represents the risk of loss in real value due to inflation.

At the end of 2015, the total amount of CPI-linked assets amounted to ISK 311,608 million and the total amount of CPI-linked liabilities amounted to ISK 216,591 million. Therefore, the net CPI-linked imbalance was ISK 95,017 million, which means that deflation would result in a loss for the Bank. The indexation imbalance has increased in 2015 by ISK 9,891 million. The Bank's inflation-linked loans to customers and borrowings increased largely at the same rate but in other respects derivatives are the main factor behind the net increase in the Bank's indexation imblance during the year.

The Bank strives to keep its indexation imbalance stable. The Bank views the imbalance as an important hedge against loss of equity in real value terms. The price of the hedge is reflected in higher volatility of earnings in nominal terms. With the current imbalance at 47% of equity, a stable economic environment with low inflation is ideal for the Bank.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. However the economy is currently in uncharted territory with unprecedented levels of low inflation. The Bank measures its capital requirements due to indexation risk in conjunction with interest rate risk as inflation is a dominant factor in the dynamics of interest rates and therefore cannot be viewed independently.

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

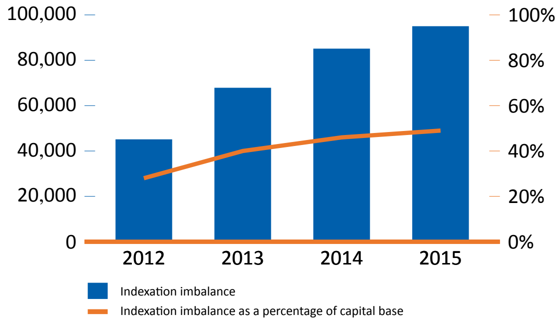


Figure 5.3 Twelve month inflation in Iceland.

5.6 EQUITY RISK IN THE BANKING BOOK

Equity positions in the banking book are mostly associates, strategic investments and foreclosed equity holdings.

Exposure limits for the banking book are set in the Bank's risk appetite statement. Strategies for various types of exposure are set, such as a disposal schedule for non-core assets. Unlisted exposures are expected to be reduced significantly in 2016 mainly due to the sale of 98% of non-core investments in associates in the first month of the year and other planned disposals.

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 calculations, 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 2015.

The equity exposure in the banking book is shown in Table 5.4.

Table 5.4 Equity exposure in the banking book

31 December 2015 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core	-	26,817	26,817
Equity instruments with variable income	13,515	14,105	27,620
Fund shares - Bonds	-	1,312	1,312
Fund shares - Other	354	4,080	4,434
Total equity exposure in the banking book	**13,869**	**46,314**	**60,183**
Realized gain/loss in 2015	-	-	8,910
Unrealized gain/loss in 2015	-	-	11,806

5.7 INTEREST RATE RISK IN THE BANKING BOOK

Interest rate risk is the risk of losses caused by changing interest rates and it normally increases with longer 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 interest rate risk is to strive for an interest rate balance between assets and liabilities. The Bank does this by targeting lending practices. Table 5.5 shows the Bank's interest-bearing assets and liabilities by interest-fixing period at the end of 2015. 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.

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

Table 5.5 Assets and liabilities at fair value by interest fixing period

Assets [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not specified	Total fair value	Total book value
Balances with Central Bank	43,181	-	-	-	-	-	-	-	43,181	43,181
Loans to credit institutions	87,491	-	-	-	-	-	-	-	87,491	87,491
Loans to customers	288,313	96,949	26,903	127,907	5,255	28,212	114,657	-	688,196	680,350
Bonds	40,492	12,144	5,326	11,416	8,603	662	151	-	78,794	78,794
Derivatives and hedging securities*	-	-	-	-	-	-	-	18,894	18,894	18,894
Total interest bearing-assets	**459,477**	**109,093**	**32,229**	**139,323**	**13,858**	**28,874**	**114,808**	**18,894**	**916,556**	**908,709**
Non-interest-bearing assets	-	-	-	-	-	-	-	102,334	102,334	102,334
Total	**459,477**	**109,093**	**32,229**	**139,323**	**13,858**	**28,874**	**114,808**	**121,227**	**1,018,889**	**1,011,043**

Liabilities and Equity [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not specified	Total fair value	Total book value
Due to Central Bank and credit institutions	11,387	-	-	-	-	-	-	-	11,387	11,387
Deposits from customers	451,559	14,378	2,562	848	-	-	-	-	469,347	469,347
Covered bonds	-	-	-	4,409	12,982	36,259	90,373	-	144,023	136,049
Other borrowings	68,182	8,337	-	44,297	-	-	-	-	120,816	120,008
Subordinated liability	-	10,365	-	-	-	-	-	-	10,365	10,365
Bonds - short positions	-	-	807	-	155	21	217	-	1,200	1,200
Derivatives and hedging securities*	-	-	-	-	-	-	-	7,609	7,609	7,609
Total interest bearing-liabilities	**531,128**	**33,080**	**3,369**	**49,554**	**13,137**	**36,280**	**90,590**	**7,609**	**764,747**	**755,965**
Non-interest-bearing liabilities	-	-	-	-	-	-	-	53,183	53,183	53,183
Equity	-	-	-	-	-	-	-	201,895	201,895	201,895
Total	**531,128**	**33,080**	**3,369**	**49,554**	**13,137**	**36,280**	**90,590**	**262,687**	**1,019,825**	**1,011,043**

Derivatives and hedging securities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(41,170)	32	51,609	(332)	-	-	1,146	11,285

Total [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(112,821)	76,045	80,469	89,437	721	(7,406)	25,364	151,809

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

Table 5.6 shows the sensitivity of the fair value of interest-bearing assets and liabilities in the banking book to a shift of all yield curves upwards by 100 basis points (1%), by currency and interest-fixing period at the end of 2015. Note that the Bank's book value is not affected in the same way as the fair value.

Table 5.6 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book

31 December 2015 [ISK m]	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	Total
ISK, non-indexed	(146)	(886)	320	(3)	(19)	(735)
ISK, CPI-indexed	(34)	(2,127)	96	1,350	(1,049)	(1,763)
EUR	(812)	669	(35)	-	-	(178)
GBP	(21)	-	-	-	-	(21)
CHF	(5)	-	-	-	-	(5)
USD	(46)	(16)	(355)	-	-	(417)
JPY	(1)	-	-	-	-	(1)
Other	(49)	-	-	-	-	(49)

To further analyze interest rate risk in the banking book, the Bank applies a stressed parallel shift to the yield curves based on guidelines from the European Banking Authority (EBA)[1]. Table 5.7 shows the loss in fair value in the banking book due to the aforementioned shock at the end of 2015. The shock movements for the krona rates reflect their respective historical volatilties.

Table 5.7 Loss in fair value in banking book due to interest rate shock movements

Currency	Shift (bps)	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	All periods
ISK, non-indexed	400	(583)	(3,345)	1,142	(9)	(51)	(2,847)
ISK, CPI-indexed	180	(61)	(3,765)	168	2,262	(1,716)	(3,112)
EUR	200	(1,600)	(1,320)	(68)	-	-	(348)
GBP	200	(42)	-	-	-	-	(42)
CHF	200	(9)	-	-	-	-	(9)
USD	200	(90)	(33)	(686)	-	-	(808)
JPY	200	(2)	-	-	-	-	(2)
Other	200	(97)	-	-	-	-	(97)
All currencies total		**(2,486)**	**(5,823)**	**557**	**2,253**	**(1,768)**	**(7,267)**

Loans in the banking book are held at amortized cost, not fair value, and some loans carry a considerable amount of unrealized gain, particularly CPI-indexed mortgages under the structured covered bonds programme (see Note 22 in the Bank's consolidated statements). A fair-value loss does not translate into a book-value loss until the unrealized gain has been consumed. Table 5.8 attempts to illustrate this by translating the total loss in fair value from Table 5.7 to a loss in book value.

Table 5.8 Loss due to interest rate shock movements on fair value and book value basis

Currency [ISK m]	Fair value	Book value
ISK, non-indexed	(2,847)	(2,670)
ISK, CPI-indexed	(3,112)	-
FX	(1,308)	(1,308)
Total loss	**(7,267)**	**(3,978)**

[1]EBA/GL/2015/08, Guidelines on the management of interest rate risk arising from non-trading activities, 22 May 2015

Capital requirements due to interest risks and indexation risk are calculated through simulations of movements in interest rates and the value of the CPI. The connection between interest rates and the CPI are calibrated to historical data and economic fundamentals. Significant diversification is observed due to the close connection between inflation and interest rates.

5.8 TRADING BOOK

The trading book is defined as the Bank's proprietary trading positions and non-strategic derivatives positions and associated hedge positions. The purpose of strategic derivatives is to reduce imbalances on the balance sheet and hedge against market risk. Non-strategic derivatives are however offered to the Bank's customers to meet their investment and risk management needs. Financial instruments on the trading book are exposed to price risk, i.e. the risk that arises due to possible losses from adverse movements in the market prices at which securities in the Bank's holding are valued.

5.8.1 PROPRIETARY TRADING

Securities positions within the Bank's proprietary trading activities are shown in Table 5.9.

Table 5.9 Positions within the Bank's proprietary trading

31 December [ISK m]	2015	2014
Bonds	1,196	(2,331)
Equity	2,138	1,538
Total	**3,335**	**(793)**

Proprietary trading is subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD and trader. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2015 average and maximum exposure in both equity and bonds.

Table 5.10 The Bank's proprietary trading exposure

	Bonds		
31 December 2015 [ISK m]	Long	Short	Net
Year-end	2,505	(1,309)	1,196
Average	2,185	(2,117)	68
Maximum	5,176	(7,004)	(5,092)

	Equity		
31 December 2015 [ISK m]	Long	Short	Net
Year-end	2,138	-	2,138
Average	2,134	(2)	2,132
Maximum	3,729	(60)	3,729

5.8.2 TRADING DERIVATIVES

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

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

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

Table 5.11 Derivatives

31 December 2015 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	72	33	75	(42)	8,504	Market risk
Interest rate and exchange rate agreements	49	452	266	186	33,420	Market risk
Bond swap agreements	18	43	28	14	3,836	Credit risk
Share swap agreements	312	178	1,934	(1,756)	13,412	Credit risk
Options	21	1	34	(33)	1,247	Market risk
Total	**472**	**707**	**2,337**	**(1,630)**		

31 December 2014 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	50	21	171	(150)	6,664	Market risk
Interest rate and exchange rate agreements	14	140	271	(131)	9,539	Market risk
Bond swap agreements	17	40	34	6	4,473	Credit risk
Share swap agreements	198	230	397	(167)	6,576	Credit risk
Options	20	478	31	447	2,026	Market risk
Total	**299**	**909**	**904**	**5**		

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

5.8.3 INTEREST RATE RISK IN THE TRADING BOOK

Interest rate risk in the trading book is subject to an exposure limit framework. Table 5.12 shows the first order sensitivity of the value of long and short positions on the trading book to a shift of all yield curves upwards by one basis point (0.01%) by currency at the end of 2015. The trading book exposure is dominated by CPI-indexed and non CPI-indexed Icelandic Government bonds, along with cross-currency swaps.

Table 5.12 First order sensitivity of long and short bond positions and swaps in the Bank's trading book

Long positions [ISK m]	MV	Duration	BPV
ISK, CPI-indexed	4,544	3,6	(1,6)
ISK, non-indexed	5,849	(1,8)	1,1
FX	64,226	(0,6)	3,9
Total	**74,618**	**(0,5)**	**3,4**

Short positions [ISK m]	MV	Duration	BPV
ISK, CPI-indexed	393	9,7	(0,4)
ISK, non-indexed	7,953	0,3	(0,3)
FX	64,172	(0,5)	2,9
Total	**72,518**	**(0,3)**	**2,3**

5.8.4 TRADING BOOK RISK

The trading book's profit or loss is calculated daily. Table 5.13 shows the 10 day 99% Value-at-Risk for the trading book position at the end of 2015, based on historical data collected over the previous 250 business days. The risk of loss is calculated for each instrument and portfolio within the trading book, as well as for the aggregate portfolio. Loss due to currency risk is not taken into account in the loss distribution as it is covered in the Bank's VaR calculations for currency risk which covers both the banking book and the trading book.

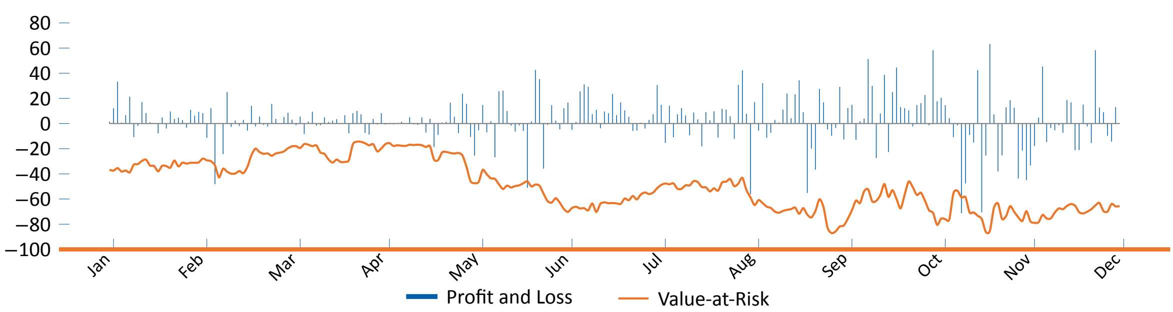
Table 5.13 Value-at-Risk for the trading book with a 99 percent confidence level over a 1 day and 1 year horizon

31 December 2015 [ISK m]	10 day 99%VaR
Equities	152
Equity Options	51
Bonds	66
Interest Rate Swaps	139
Diversification effects	(200)
Trading Book Total	**207**

The result shows that there is 1% likelihood of a loss in the trading book exceeding ISK 207 million over a 10 day period.

Figure 5.4 further shows the daily profit and loss of the Bank's trading book for 2015 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss exceeds the VaR three times during the 250 businees days, in other words very close to once every hundred days.

Figure 5.4 Development of the Bank's trading book profit and loss and one-day 99 percent Value-at-Risk for 2015 [ISK m]



6 **LIQUIDITY** RISK

6 LIQUIDITY RISK

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

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 to 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.

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 Balance Sheet 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 for each ALCO meeting liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, appropriate stress tests and any relevant information or risk management concern regarding liquidity and funding 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.

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

6.3 LIQUIDITY AND FUNDING RISK MEASUREMENT

In December 2010, the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks. The Central Bank of Iceland has implemented LCR requirements for total and foreign currency positions as well as NSFR requirements for foreign currencies. 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.

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

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

6.4 LIQUIDITY POSITION

The Bank's liquidity buffer amounts to ISK 192,183 million, or 19% of total assets and 40% of total deposits. Composition of the Bank's liquid assets is shown in table 6.1. The Bank's ISK 30 billion liquidity facility with the Icelandic government is set to expire at the end of 2016. This has been taken into consideration in the Bank's liquidity strategy and management.

The Bank's liquidity buffer amounts to ISK 192,183 million, or 19% of total assets and 40% of total deposits

Table 6.1 Composition of the Bank's liquid assets [ISK m]

31. December 2015	ISK	USD	EUR	Other	Total
Cash and Cenral Bank deposits	46,521	349	531	759	48,160
Short term deposits with other banks	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligable as collateral at the Central Bank	22,614	-	-	-	22,614
Foreign government bonds	-	10,658	8,700	3,984	23,342
Liquidity facility	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA-	-	-	2,122	4,783	6,905
Total liquidity reserve	**102,416**	**27,748**	**32,177**	**29,842**	**192,183**

At year-end 2015, the Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 134% and 218% for the respective total and foreign currency balances. Under the liquidity rules issued by the Central Bank of Iceland, financial institutions are required to maintain a Liquidity Coverage Ratio (LCR) above 80% from 1 January 2015 and 90% from 1 January 2016, finally a 100% requirement takes effect on 1 January 2017. The rules also require a minimum of a 100% Liquidity Coverage Ratio for foreign currency positions.

At year end 2015, Arion Bank's strong liquidity position was reflected in high LCR values, namely 134% and 218% for the respective total and foreign currency balances

Table 6.2 Liquidity Coverage Ratio

31 December 2015	FX	Total
Liquidity Coverage Ratio	218%	134%
LCR Central Bank requirements (2015)	100%	80%
LCR Central Bank requirements (2016)	100%	90%

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. A large part the Bank's deposits in foreign currency has been owned by entities in winding-up proceedings, primarily Kaupthing hf. In January 2016 the Bank issued a USD denominated bond, which is held by Kaupthing, replacing all of its FX denominated deposits. The bond matures in 7 years, with a pre-payment option during the first 2 years. By this, FX denominated deposits were reduced by ISK 41 billion. Nonetheless, the Bank continues to maintain a strong reserve of FX denominated liquid assets and the Bank's foreign deposit base is entirely covered by 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.

6.4.1 BREAKDOWN OF LCR

Table 6.3 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. Figure 6.1 further shows the contribution of the Bank's main components to the LCR's weighted outflow, inflow and assets. Under the stressed scenario the Bank's weighted assets and inflow amount to ISK 229,796 million substantially exceeding the stressed outflow of ISK 196,584 million. Of the total stressed outflow, ISK 143,915 million are due to deposits which are futher analyzed in section 6.4.2.

Figure 6.1 Breakdown of the Bank's weighted outflow, inflow and assets under LCR's stressed scenario [ISK m]

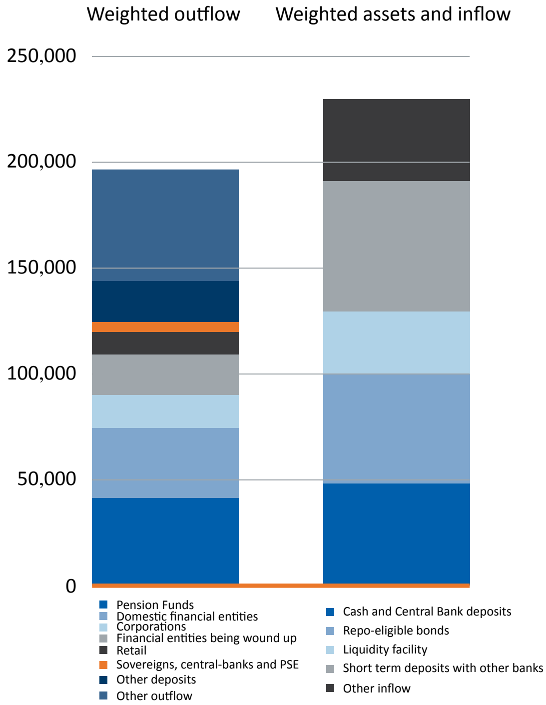


Table 6.3 Breakdown of LCR

31 December 2015 [ISK m]	FX	Total
Inflow from deposits at credit institutions	49,905	49,905
Other inflow	37,433	50,394
Total inflow *	**87,338**	**100,299**
Deposit outflow	21,640	143,915
Other outflow	34,871	52,669
Total outflow	**56,511**	**196,584**
Net outflow	**14,128**	**96,286**
Cash on hand and Central Bank deposits	1,639	11,082
Government bonds and other repo-eligible bonds	18,202	83,033
Liquidity facility	-	29,513
Total level 1 assets**	**24,981**	**123,628**
Total level 2 assets**	**5,869**	**5,869**
Total high quality liquid assets	**30,850**	**129,497**
Liquidity Coverage Ratio	218%	134%

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

**For detailed definition, see Central Bank Rules No. 1031/2014.

6.4.2 DEPOSIT CATEGORIES

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

Table 6.4 shows the distribution of the Bank's deposit base broken down by deposit categories as per the LCR methodology. The associated LCR outflow weight is shown for each category. Figure 6.2 shows the contribution of each category, in order of magnitude, to the stressed outflow under LCR. In Table 6.5, the development of the deposit base is shown between years.

Table 6.4 Distribution of deposits by LCR categories. The expected stressed outflow weight is shown for each category

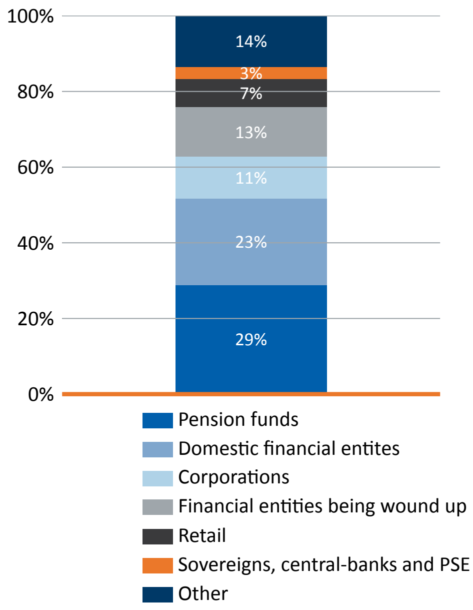
31 December 2015 [ISK m]	Deposits maturing within 30 days					
Category	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total
Retail	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
Operational relationship	-	25%	-	5%	-	-
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central-banks and PSE	11,900	40%	-	-	1,304	13,204
Financial entities being wound up	16,948	100%	-	-	47,062	64,010
Pension funds	41,609	100%	-	-	35,104	76,713
Domestic financial entites	32,727	100%	-	-	11,016	43,743
Foreign financial entites	5,193	100%	-	-	-	5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	**272,363**		**47,609**		**159,280**	**479,252**

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

Table 6.5 Distribution of deposits by LCR categories

Category	2015	2014
Retail	37.4%	35.8%
SME	9.6%	9.8%
Operational relationship	0.0%	0.3%
Corporations	8.8%	9.3%
Sovereigns, central-banks and PSE	2.8%	3.2%
Financial entities being wound up	13.4%	18.5%
Pension funds	16.0%	12.0%
Domestic financial entites	9.1%	8.4%
Foreign financial entites	1.1%	1.1%
Other foreign parties	1.9%	1.8%
Total	**100%**	**100%**

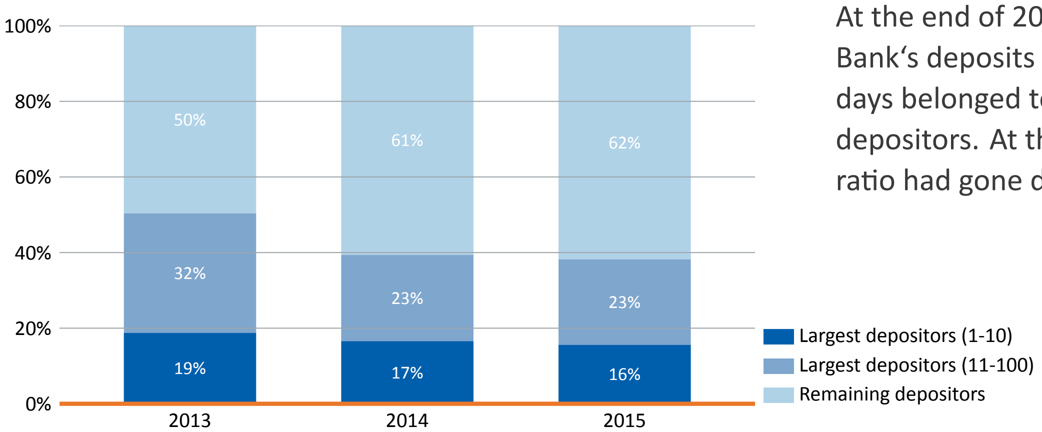
Figure 6.2 Source of impact on LCR outflow from deposits categories



6.4.3 CONCENTRATION OF DEPOSITS

Concentration of deposits maturing within 30 days remains similar to that of 2014, having been reduced somewhat since 2013. At the end of 2015, 16% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors, compared to 17% at the end of 2014. The proportion of the next ninety largest depositors remained unchanged at 23%.

Figure 6.3 Concentration of deposits on demand within 30 days



At the end of 2014, 17% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors. At the end of 2015 this ratio had gone down to 16%

6.5 FUNDING

The Bank has continued to diversify its funding profile.

In January 2015, the Bank repurchased NOK 59 million of its NOK 500 million (ISK 11.2 billion) senior unsecured bond issue. This issue, which was listed on the Oslo Stock Exchange in 2013, was at the time the first international bond offering by an Icelandic financial institution since 2007. The bonds were bought under favourable market conditions. In March 2015 the Bank completed a EUR 300 million (ISK 45 billion) bond issue under the Euro Medium Term Note programme at a fixed rate of 3.125%.

In June 2015 the Bank repurchased a further NOK 319 million of its NOK 500 million bond issue. At the same time the Bank issued a new NOK 500 million senior unsecured bond, maturing in 2020. The new bond pays NIBOR+2.95% as opposed to NIBOR+5% paid by the older bond, thus lowering the Bank's funding cost. That same month, following the announcement of the comprehensive strategy for capital account liberalisation, Standard & Poor's (S&P) increased the Bank's rating from BB+ to BBB-.

The Bank holds Tier 2 capital in the form of a subordinated loan from the Icelandic government, which it received in connection with the recapitalization in 2010 and in settlement of a dividend in 2011. In March and June 2015 the Bank exercised its right to prepay a total of EUR 165 million of the loan, amounting to two-thirds of the outstanding amount. The Bank aims to prepay the final third of the loan when conditions are favourable, contingent on approval from the FME. Prepayment of this loan is a part of the Bank's strategy to lower its funding cost.

In January 2016 the Bank reached an agreement with Kaupthing hf which involved the Bank issuing a USD 747 million bond under the EMTN programme, which will mature in 7 years, with a pre-payment option during the first 2 years. The bond will be held by Kaupthing and will replace Kaupthing's FX denominated deposits and the FX-denominated, secured loan from the Central Bank of Iceland. This bond issuance was an important part of the plan for lifting the capital controls.

Later that month S&P changed the Bank's outlook from stable to positive citing positive developments in the Icelandic economy and the recent steps being taken to prepare the lifting of the capital controls. For comparison, the current rating of the Icelandic sovereign currently stands at Baa2, BBB+, BBB+ by Moody's, S&P and Fitch, respectively. As at January 2015, the outlook of all ratings is stable.

The development of the Bank's total funding by type is shown in Table 6.6. Table 6.7 shows the Bank's borrowings and subordinated liabilities as at 31 December 2015.

In June 2015, the international credit ratings agency Standard & Poor's (S&P) increased Arion Bank's rating to BBB- and in January 2016 it changed the outlook from stable to positive.

Figure 6.4 Development of the market spread for the Bank's EUR bond issue [Basis points]

Table 6.6 Breakdown of funding by type

31 December	2015	2014	2013	2012
Due to credit institutions and Central Bank	1.1%	2.4%	3.0%	3.7%
Customer deposits	46.4%	48.7%	50.3%	49.8%
Borrowings	25.3%	21.5%	21.8%	21.7%
Subordinated loans	1.0%	3.4%	3.4%	3.8%
Financial liabilities	0.8%	1.0%	1.0%	1.5%
Tax liabilities	0.5%	0.5%	0.5%	0.4%
Other liabilities	4.9%	5.1%	4.7%	4.7%
Equity	20.0%	17.4%	15.4%	14.5%
Total	**100%**	**100%**	**100%**	**100%**

Table 6.7 List of borrowings and subordinated liabilities

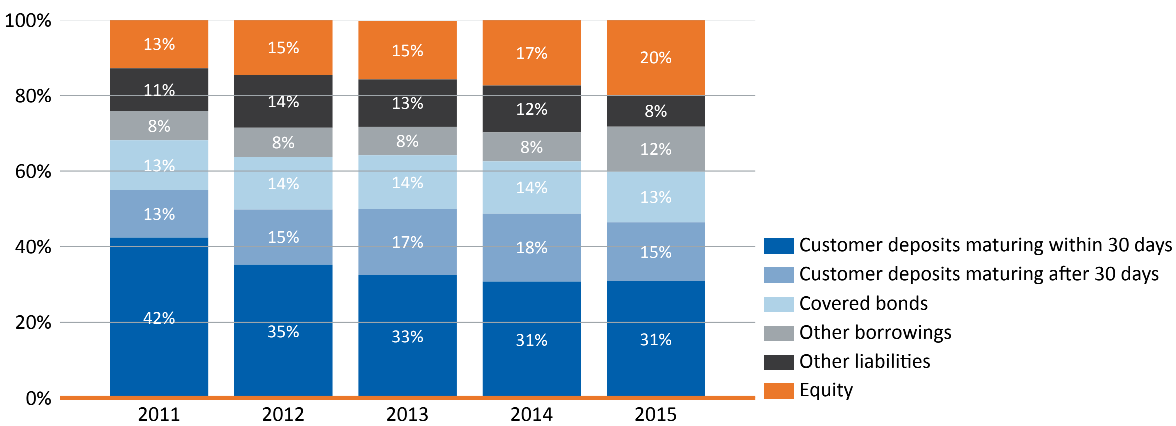
31 December 2015	Issued	Maturity	Maturity type	Currency	Terms of interest	Amount
Covered bonds	2013	2019	At maturity	ISK	Fixed CPI linked, 2.5%	4,483
Covered bonds	2014	2021	At maturity	ISK	Fixed CPI linked, 3.5%	5,096
Covered bonds	2015	2022	At maturity	ISK	Fixed, 6.5%	7,737
Covered bonds	2014	2029	At maturity	ISK	Fixed CPI linked, 3.5%	15,279
Covered bonds	2005	2033	Amortizing	ISK	Fixed CPI linked, 3.75%	17,108
Covered bonds	2012	2034	Amortizing	ISK	Fixed CPI linked, 3.6%	2,249
Covered bonds	2008	2045	Amortizing	ISK	Fixed CPI linked, 4.0%	6,182
Covered bonds	2006	2048	Amortizing	ISK	Fixed CPI linked, 3.75%	77,916
Senior unsecured bond	2013	2016	At maturity	NOK	Floating, NIBOR + 5%	1,547
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1%	1,177
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1%	1,600
Senior unsecured bond	2015	2018	At maturity	EUR	Fixed, 3.125%	43,350
Senior unsecured bond	2015	2020	At maturity	NOK	Floating, NIBOR + 2.95%	11,900
Central Bank loan, secured*	2010	2022	At maturity	Various FX	Floating, LIBOR + 3%	56,024
Bills issued						4,081
Other						329
Total borrowings						**256,058**
Subordinated liabilities	2010	2020	At maturity	Various FX	Floating, LIBOR + 5%	10,365
Total borrowings and subord. liab.						**266,423**

* Refinanced by Kaupthing under the EMTN program in January 2016.

Figure 6.5 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 31% at the end of 2015. The share of total deposits of the Bank's funding has also gone down, from 55% to 46%, over the same period.

At the end of 2011 deposits maturing within 30 days accounted for 42 % of the Bank's funding compared to 31 % at the end of 2015

Figure 6.5 Development of funding by type



Tables 6.8 and 6.9 show the breakdown by maturity of assets and liabilities.

Table 6.8 Breakdown of assets by contractual maturity

Assets 31 December	2015	2014	2013	2012
On demand	9.4%	9.0%	9.0%	13.0%
Up to 3 months	8.3%	11.8%	12.5%	7.5%
3 - 12 months	11.2%	10.7%	11.6%	11.4%
1 - 5 years	28.6%	30.5%	27.9%	30.9%
Over 5 years	31.7%	29.3%	29.2%	28.6%
With no maturity	10.6%	8.7%	9.8%	8.6%
Total	**100%**	**100%**	**100%**	**100%**

Table 6.9 Breakdown of liabilities by contractual maturity

Liabilities 31 December	2015	2014	2013	2012
On demand	36.5%	36.1%	33.3%	36.6%
Up to 3 months	15.2%	18.2%	21.5%	22.3%
3 - 12 months	12.9%	10.7%	11.5%	6.8%
1 - 5 years	11.5%	9.5%	6.7%	8.0%
Over 5 years	22.6%	24.5%	26.1%	25.4%
With no maturity	1.1%	1.1%	0.9%	0.9%
Total	**100%**	**100%**	**100%**	**100%**

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 ratio of loans to deposits was 145% as at 31 December 2015. The development of the loans to deposits ratio is shown in Table 6.10. The increase from 2011 to 2012 is explained by the 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 increase in 2013 was due to the settlement of the Drómi bond, reflecting the transfer of both loans and deposits from the SPRON estate to the Bank. The ratio increased in the beginning of 2016 following the restructuring of the Kaupthing's deposits in foreign currency with the Bank.

The covered bonds are also an important funding source and its payment profile is largely matched by the corresponding pledged mortgages, see Figure 6.6. Other liabilities are mostly foreign currency denominated with no significant redemption until 2018 as seen in Figure 6.7. As the Bank's foreign currency deposits are almost entirely 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

The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, has decreased from 27% to 23% in the year 2015. With the settlement of the loan from the Central Bank in January 2016 and the release of pledged assets, the encumberance ratio decreased to 18%. Table 6.10 shows the development of this ratio and the loans-to-deposits ratio.

Table 6.10 Development of the Bank's loans to deposits ratio and asset encumbrance ratio

31 December	2015	2014	2013	2012
Loans to deposits ratio	145%	142%	135%	126%
Asset encumbrance ratio	23%	27%	30%	31%

On 1 December 2014 the Central Bank of Iceland adopted new funding requirements for foreign currencies based on the Net Stable Funding Ratio (NSFR) introduced in the Basel III framework. The NSFR for financial institutions' foreign currency positions shall be greater than 80% until the end of year 2015, 90% in 2016 and 100% from 1 January 2017. The Bank's NSFR in foreign currencies is at 123% at year-end 2015 while the total NSFR is 105%.

The Bank's NSFR in foreign currencies is at 123% at year-end 2015 while the total NSFR is 105%

Table 6.11 Net Stable Funding Ratio

31 December 2015	FX	Total
Net Stable Funding Ratio	123%	105%
NSFR Central Bank requirements	80%	N/A

Table 6.12 shows a breakdown of the Bank's Net Stable Funding Ratio.

Table 6.12 Breakdown of NSFR, parent company and ABMIIF consolidated, other subsidiaries excluded

31 December 2015 [ISK m]	FX	Total
Equity and Tier II	5,182	176,311
Secured Financing	27,853	162,014
Unsecured Financing	55,950	57,507
Retail / SME deposits	10,691	207,230
Other deposits	29,595	67,062
Other liabilities	-	12
Available stable funding	**129,273**	**670,136**
Liquid assets	2,086	11,527
Loans to customers, performing	80,351	509,919
Securities	10,166	40,024
Other assets	2,355	71,584
Off-balance sheet	553	2,298
Required stable funding	**95,511**	**635,352**
Balance	**(11,363)**	**-**
Net stable funding ratio	123%	105%

Figure 6.6 Maturity profiles of covered bonds and corresponding pledged mortgages [ISK m]

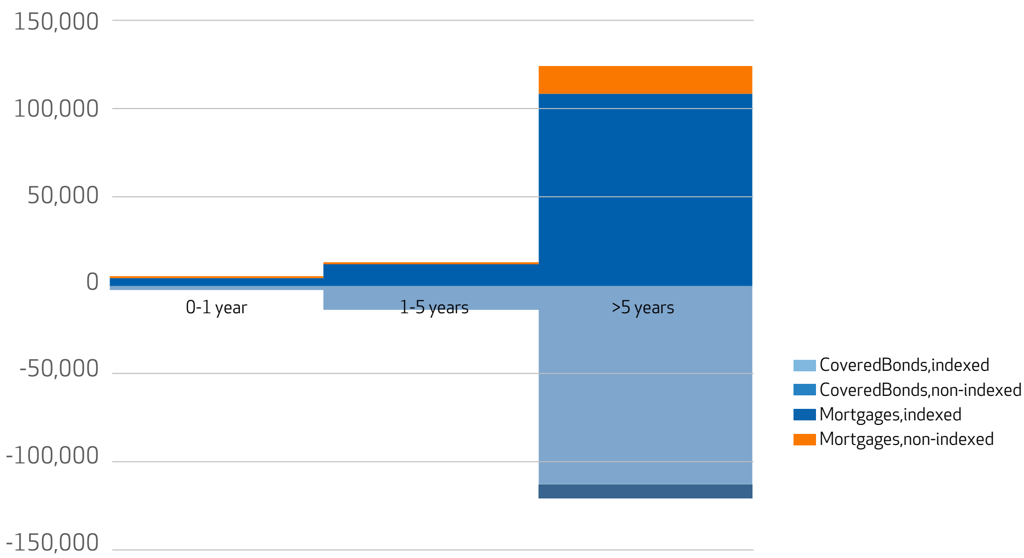
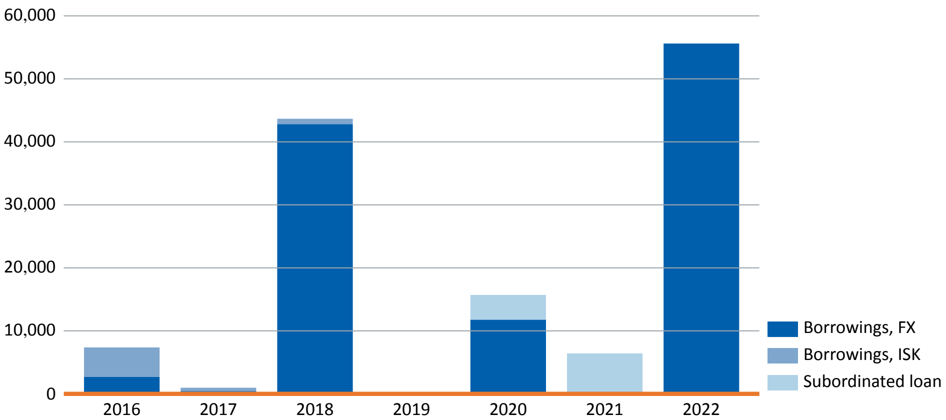


Figure 6.7 Maturity profiles of borrowings, other than covered bonds, and subordinated liabilities [ISK m]



6.6 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.

7 **OPERATIONAL** RISK

7 OPERATIONAL RISK

Operational risk is defined as 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.

7.1 OPERATIONAL RISK POLICY

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank reduces its exposure to operational risk with a selection of internal controls and quality management, and well-educated and qualified staff.

The policy defines operational risks at a high-level and delegates responsibility for further implementation and compliance within the Bank.

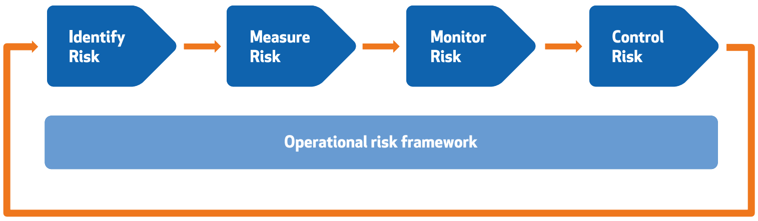
The Bank reduces its exposure to operational risk with a selection of internal controls and quality

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.

► OPERATIONAL RISK

Figure 7.1 Operational risk cycle



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

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

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.

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.

With increasingly powerful software and hardware, growing use, network connections and especially public access to the Internet, the need to ensure the security of data and equipment increases. To understand security risks better the Bank conducts a special Information Security Risk Assessment on the Bank's most important assets, according to Guidelines No. 2/2014 on the Information Systems of Regulated Parties published by the Financial Supervisory Authority (FME). Information security means that information is protected against a variety of threats in order to ensure business continuity, minimize damage and maximize performance. Information security includes ensuring confidentiality, integrity and availability.

Figure 7.2 Operational risk strategy

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. The Bank has insurance policies to cover operational risk exposure.

IT RISK

The Bank's Security Officer (SO) is a member of Risk Management. The SO is responsible for the day-to-day supervision of issues relating to the Bank's security, IT and data security, and operates on behalf 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.

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7.3 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.

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.

Figure 7.3 shows the distribution of reported events by number. Execution, Delivery & Process Management accounted for 60% of the total events in 2015.

Figure 7.3 Distribution of loss events by number

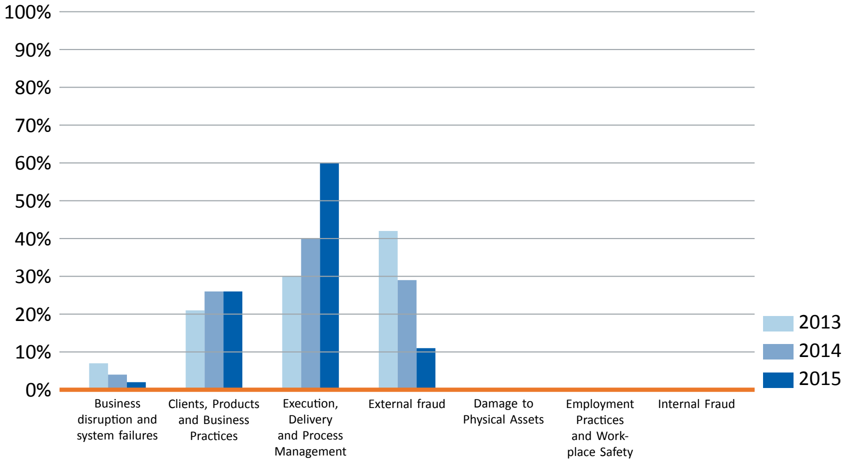
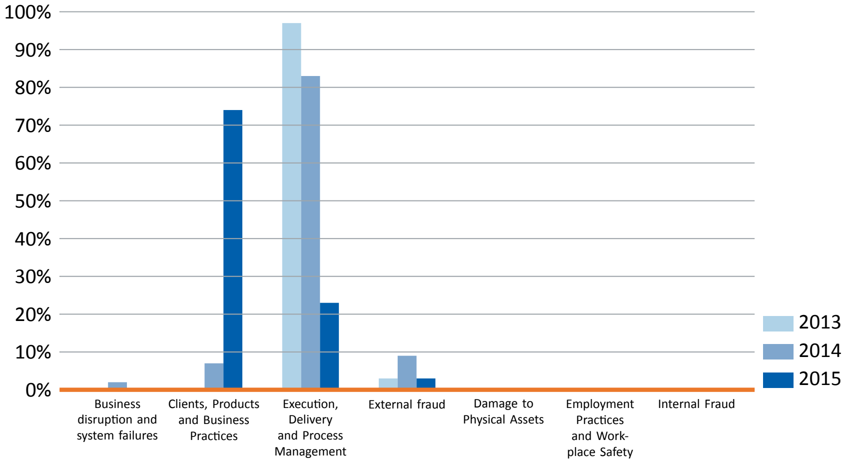


Figure 7.4 shows the distribution of reported events by amount. Clients, Products & Business Practices accounted for 74% of total losses in 2015, Clients, Products & Business Practices accounted for 74% of total losses in 2015, predominately due to a fine imposed on Arion Bank hf. in conjunction with a December 2014 settlement concerning changes to the way in which interchange fees, which card companies pay to the banks, are decided and the awarding of customer loyalty points.

Figure 7.4 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

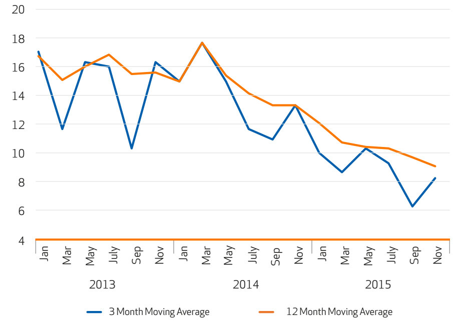
Major Incident - MI is a significant event causing serious operational interruption in IT or an operational failure in a system classified as important. The purpose of the MI Process is to ensure firm, coordinated and controlled action in the occurrence of MI, in order to restore service as soon as possible with minimum interruptions and damage to the business.

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.

Figure 7.5 Development of Major Incidents in IT



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.

In 2015, the legality of loans, linked to the Consumer Price-Index (CPI), were debated before the Supreme Court. It was also debated whether the lender had given the borrower adequate information prior to the loan being issued. With a judgment on 13 May 2015 (case no 160/2015), the Supreme Court sided with the lender and stated that there were no grounds to consider the price indexation terms of the debt instrument to be unfair. More importantly, the Court also considered that the lender in question had fulfilled its duty to provide information to the borrower in regards to said loan. With a judgment of 26 November 2015 (case no 243/2015), the Court came to a similar conclusion. The Bank is aware of at least one further case, which specifically deals with legal issues regarding the CPI-indexation of loans, and is now before the District Court.

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

With a writ issued in June 2013, Kortaþjónustan hf. claimed damages from the Arion Bank hf. Íslandsbanki hf. Landsbanki hf. Borgun hf. and Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortaþjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded acquittal of Kortaþjónustan's claims. The case has been put on hold as Kortaþjónustan's court-appointed evaluator prepares its report on Kortaþjónustan's alleged loss.

The Competition Authority (ICA) has 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. 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 extent of the investigation and the outcome is still uncertain. However, if the Bank were 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 hf. for abusing its dominant position on the payment card market and violating conditions set in an earlier decision of the Authority. Valitor hf. appealed the decision to the Competition Appeals Committee.The Committee confirmed the decision of the Competition Authority. Valitor hf. referred the case to the courts. In May 2015 the District Court of Reykjavík rejected Valitor´s reasoning that the decision be nullified, but agreed to its claim to lower the fine to ISK 400 million. The case has been appealed to the Supreme Court. The final judgement of the Supreme Court is expected in 2016.

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 hf., Íslandsbanki hf., The Icelandic Housing Financing Fund and the Icelandic Student Loan Fund, standing behind the majority of all loans to individuals. 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 has increased. Given discussions in the Icelandic Parliament there is a certain possibility that the government will resort to regulatory restrictions that are different and more stringent than reforms being discussed in the rest of Europe. Eiga tvær síðustu setningar að vera inni? 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 approved at the Bank's annual general meeting. Arion Bank´s remuneration policy is published on the Bank´s website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2015, 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, Managing Directors, the Compliance Officer and Chief Internal Auditor, and on the Bank's remuneration scheme and other work-related payments. The CEO decides on a salary framework for Managing Directors and the Compliance Officer in consultation with the Head of Human Resources taking into consideration the size of the relevant division and level of responsibility.

A perfomance based compensation system has been in place since 2013. The scheme is in accordance with Rules established by the FME on Variable Remuneration Policy for Financial Undertakings. Both BRC and BARC have a role as regards the scheme. BRC reviews and monitors the scheme, before submitting it to the Board, and BARC´s role is to assess annually whether incentives which may be contained in the Bank´s system are consistent with the Bank´s risk policy. About 100 employees take part in the scheme. They include the CEO, Managing Directors, many heads of divisions as well as several other 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 Variable 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 for three years.

REMUNERATION

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

In the year 2015 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. The Asset Management Company Stefnir hf. and the online and e-commerce payment solutions company Valitor have incentive schemes in place.

10 UPCOMING AND NEW LEGISLATION

As a financial undertaking the Bank, and many of its subsidiaries, 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

AMENDMENTS TO THE FINANCIAL UNDERTAKING ACT (NO. 161/2002)

The Act transposes two EU legislative acts, the CRD IV Directive and the CRR-regulation, representing extensive reforms to the legal and regulatory framework of Iceland's financial markets. The amendments bring about changes on provisions concerning, risk management, ownership, management and employees of financial institutions, internal governance, remuneration and bonus policy, large exposures, equity etc. The amendments also introduces capital buffers into Icelandic law. The EU acts in question constitute major steps by the EU towards the Basel III Global Regulatory Framework.

The Act came into force on 17 July 2015.

AMENDMENTS TO THE ACT ON MEASURES AGAINST MONEY LAUNDERING AND TERRORIST FINANCING (NO. 64/2006)

The amending Act brings greater emphasis on the identification of the beneficial owner, including an increased obligation on regulated entities to verify information regarding their customers and to monitor whether customers are representing themselves.

The Act came into force on 20 January 2016.

AMENDMENTS TO THE FOREIGN EXCHANGE ACT (NO. 87/1992)

The amendments are a part of the capital account liberalization plan. The amendments include a definition of the term contractual instalment payments to prohibit payments on loan agreements based on provisions resulting in accelerated repayments and changes to permitted trade concerning FX transactions by financial undertakings previously operating as commercial or savings banks and legal entities established in connection with the fulfilment of their composition agreements. Furthermore, the Act includes amendments concerning lending and borrowing between residents and non-residents, restriction to residents' purchases of FX and revocation of special exemptions of financial undertakings previously operating as commercial banks or savings banks in connection with fulfilment of their composition agreements.

The Act came into force on 7 June 2015

THE FINANCIAL SECTOR SANCTIONS ACT (NO. 58/2015), AMENDING AMONGST OTHERS THE FOREIGN EXCHANGE ACT (NO. 87/1992), THE FINANCIAL UNDERTAKINGS ACT (NO. 161/2002) AND THE SECURITIES TRANSACTIONS ACT (NO. 108/2007)

Taking note of legislative changes within the EU, notably the CRD IV Directive and the MiFID II Directive, the Act aims at harmonizing competences of financial sector authorities to impose administrative sanctions, including strengthening authorities' ability to impose administrative sanctions on legal entities. The Act also increases the authorized limit of fines on legal entities and on individuals as well as allowing fines and up to six years' incarceration for infractions against legal provisions vis-à-vis limits on large exposures.

The Act came into force 16 July 2015.

AMENDMENTS TO THE ACT ON MANDATORY INSURANCE OF PENSION RIGHTS AND ON ACTIVITIES OF PENSION FUNDS (NO. 129/1997)

Two acts amending the Act on Mandatory Insurance of Pension Rights and on Activities of Pension Funds were made by Parliament in 2015.

The first Act authorizes pension funds to invest in financial instruments on multilateral trading facilities, previously restricted to regulated markets.

The Act came into force on 9 July 2015.

The second Act brings forth changes to a temporary provision which in turn provides exemptions from required changes in a fund's Articles of Association if an actuarial assessment reveals a difference of more than 10% between asset items and pension obligations. As it now stands, the temporary provision permits up to a 15% differential between asset items and expected pension obligations based on actuarial assessment for 2011 and up to 13% differential for 2012, 2013 and 2014. The Act also allows for a difference in actuarial valuation between asset items and pension commitments up to 10% in 2012, 2013 and 2014, an exemption from required changes in a fund's Articles of Association should the difference between asset items and pension commitments exceed 5% for a continuous five-year period.

The Act came into force on 30 September 2015.

AMENDMENTS TO THE ACT ON INSURANCE CONTRACT (NO. 30/2004)

The Act includes changes to provisions of the Act on Insurance Contracts regarding the policyholder's right to terminate the insurance contract and the settlement when an insurance contract is canceled during the insurance period, making it easier for the policyholder to change insurance company and subsequently strengthening his position as a consumer.

The Act came into force on 1 July 2015.

AMENDMENTS TO THE FINANCIAL COLLATERAL ARRANGEMENTS ACT (NO. 46/2005)

The Act transposes Directive 2009/44/EC amending Directive 98/26/EC on Settlement Finality in Payment and Securities Settlement Systems and Directive 2002/47/EC on Financial Collateral Arrangements as regards Linked Systems and Credit Claims. The Act defines financial instruments, title transfer financial collateral arrangements, security financial collateral arrangements and credit claims in line with Directive 2009/44/EC.

The Act came into force 21 July 2015.

THE COMPOSITION AGREEMENT ACT (NO. 59/2015), AMENDING THE FINANCIAL UNDERTAKINGS ACT (NO. 161/2002), THE FOREIGN EXCHANGE ACT (NO. 87/1992) AND ACT ON THE CENTRAL BANK OF ICELAND (NO. 36/2001), AND THE STABILITY LEVY ACT (NO. 60/2015)

The two bills are to be read in concordance and in the wider context of the capital account liberalization strategy. These two Acts represent the first stage, a step towards addressing balance of payments issues of financial undertakings currently in winding-up proceedings.

Act No. 60/2015 legalizes a stability tax in order to create conditions for the capital account liberalization without compromising the economic and financial stability while Act No. 59/2015 was passed in order to facilitate the winding-up of financial undertakings, extending the Central Bank's authority to receive valuables etc. Subsequent steps of the strategy will address remaining offshore ISK holders by an auction format, with permitted resident flows to follow conditioned on balance of payments developments.

Both Acts came into force 16 July 2015.

AMENDMENTS TO THE DEPOSITORS' AND INVESTORS' GUARANTEE ACT (NO. 98/1999)

The amending Act makes clear that deposits from financial undertakings previously operating as commercial banks or savings banks are not covered for by the Depositors' and Investors' Guarantee Fund.

The Act came into force 16 July 2015.

AMENDMENTS TO THE TAX CODE ACT AND SEVERAL OTHER ACTS

Two acts amending the Tax Code Act and several other acts were made by Parliament in 2015.

The first Act amends several acts, including adding securities undertakings to the list of parties exempted from withholding tax on financial income, removing tax consequences for certificate holders in investment funds making no income tax levied as long as the holder only receives certificates of equal or lesser value. Furthermore, according to the amending act, should UCITS or investment funds become public limited companies and shareholders of the former only receive shares in the newly formed PLC, no taxable income is generated. With temporary provisions to the Social Security Tax Act and the Work Related Rehabilitation and Activities of Vocational Rehabilitation Funds Act pension funds are also required to withhold and remit 0.1% of mandatory contributions made by employers and business operators or self-employed persons in 2016 and 2017 to the Vocational Rehabilitation Fund.

The Act came into force on 1 January 2016.

The second Act brings about several amendments including a reduction in documentation obligations for domestic legal entities in accordance with recent rules on transfer pricing, extending an interim provision in the Tax Code Act concerning legal entities who have debt reduced due to payment difficulties, allowing for tax liability to carry over between the income years 2010 up to and including 2014. Furthermore, income levied on legal entities and individuals with limited tax liability in the coming tax year is increased to 20% from a previous rate of 18%. Lastly, electronic money undertakings will be taxed in accordance with the Financial Activities Tax Act.

The Act came into force on 26 June 2015.

AMENDMENTS TO THE ACT ON THE DEBTOR'S OMBUDSMANS (NO. 100/2010)

The amending Act strengthens the Ombudsman's authority to request information disclosure from authorities, undertakings and associations as well as authorizing the Ombudsman to impose daily fines on a party that fails to comply within a reasonable time.

The Act came into force on 25 February 2015.

10.2 UPCOMING LEGISLATION

10.2.1 BILLS SUBMITTED TO PARLIAMENT

BILL ON AMENDMENTS TO THE FINANCIAL UNDERTAKING ACT (NO. 161/2002)

The bill includes amendments to provisions of the Financial Undertaking Act concerning equity, the supervisory review and evaluation process (SREP), the penalty provisions and the definitions laid out in the Act. The bill aims at implementing the macro prudential rule presented in Art. 458 of Regulation 575/2013 (the CRR) into Icelandic law as well as transposing the majority of the EU's new regulatory framework for the banking industry, including CRD IV and CRR.

The bill was submitted to Parliament on 9 March 2016.

BILL ON AMENDMENTS TO THE ACT ON INTEREST AND PRICE INDEXATION (NO. 38/2001), THE ACT ON THE CENTRAL BANK OF ICELAND (NO. 36/2001) AND THE ACT ON CONSUMER CREDIT AGREEMENTS (NO. 33/2013)

The legislation aims at legalizing consumer credit in foreign currency, including that the same authority should apply to loans in foreign currencies and price indexed loans in local currency and that the Central Bank should be authorized to set a maximum barrier on this kind of lending.

The bill is currently under consideration by the Economic Affairs and Trade Committee.

BILL ON NEW ACT ON MORTAGE CREDIT FOR CONSUMERS

The bill aims at promoting responsible lending and ensuring consumer protection when promoting, counseling, granting and facilitating mortgages to consumers. The bill includes changes to required skills, knowledge and remuneration of a lender's employees, an increased emphasis on explanations made to the consumer before granting a loan and prohibits the tying of mortgages with agreements on other separate type of financial services. The bill also proposes that the FME is granted authority to regulate the maximum mortgage ratio of mortgage loans to consumers, after receiving recommendations from the Financial Stability Council as well as changes to the maximum barrier to a pre-payment fee. The bill represents a new legislative act while making minor alterations to the Act on Consumer Credit (No. 33/2013), Act on the Official Supervision of Financial Operations (No. 87/1998) and Act on Cross-Border Payments in Euros (No. 78/2014).

The bill was submitted to Parliament in October 2015 and is currently under consideration by the Economic Affairs and Trade Committee.

BILL ON NEW ACT ON INSURANCE ACTIVITIES

The bill aims at enhancing the protection provided to policyholders and the insured while ensuring stability in financial markets. The main changes made by the legislative bill concerns the financial strength of insurance companies and increased requirements for corporate governance. The bill is based on Directive 2009/138/EC on the establishment and operation of insurance companies, better known as the Solvency II Directive, and represents a new legislative act replacing the current Act on Insurance Activities (No. 56/2010).

The bill is currently under consideration by the Economic Affairs and Trade Committee.

BILL ON AMENDMENTS TO ACT ON THE CENTRAL BANK OF ICELAND (NO. 36/2001)

The Act aims to ensure a clear legal framework for the management of funds and assets deriving from contributions made by financial undertakings to financial stability. Furthermore, a separate entity under the governance and supervision of the Central Bank will be established with a mandate to receive and handle subsequent sale of assets.

The bill is currently under consideration by the Economic Affairs and Trade Committee.

BILL ON AMENDMENTS TO THE ACT ON FORCED SALES (NO. 90/1991)

The bill proposes an amendment to the Act on Forced Sales allowing a tenant to remain in a property that has been sold through a forced sale, the same way an owner in the same situation has been allowed to. The amendments are based on comments made by The Consumer's Organization.

The bill has been merged with the Minister of Social Affairs and Housing bill regarding housing which is currently being discussed by the Parliament.

BILL ON AMENDMENTS TO THE FINANCIAL UNDERTAKING ACT (NO. 161/2002)

The bill extends a provisional clause first introduced into the Act in 2008 allowing the FME to limit potential damage in financial markets by calling a shareholders meeting or, in extreme circumstances, assume the powers of the shareholders´ meeting. The bill recommends the clause to be extended until the end of 2017.

The bill is currently under consideration by the Economic Affairs and Trade Committee.

10.2.2 BILLS SCHEDULED TO BE SUBMITTED TO PARLIAMENT

BILL ON AMENDMENTS TO THE FINANCIAL UNDERTAKING ACT (NO. 161/2002)

The Ministry of Finance and Economic Affairs intends to submit a bill amending rules concerning activities of branches of financial undertakings and other financial services operating within the EEA, rules on group supervision as well as new rules on whistle blowing.

The bill is scheduled to be submitted to Parliament in spring 2016.

By transposing the bill as well as the bill amending provisions of the Financial Undertaking Act concerning equity, the supervisory review and evaluation process (SREP), the penalty provisions and the definitions laid out in the Act discussed above, Basel III and the CRD/CRR legislative package is fully implemented into Icelandic law. Subsequently, a comprehensive review on the Financial Undertakings Act is scheduled mid-2016.

BILL ON AMENDMENTS TO ACT ON THE OFFICIAL SUPERVISION OF FINANCIAL OPERATIONS (NO. 87/1998)

The bill is a part of implementing a new pan-European surveillance system into Icelandic law and introduces some parts of Regulations No. 1093/2010 (EBA), No. 1094/2010 (EIOPA) and No. 1095/2010 (ESMA). The bill includes authority granted to the EFTA Surveillance Authority (ESA) as well as granting ESA direct supervisory powers.

The bill is scheduled to be submitted to Parliament in spring 2016.

BILL ON NEW ACT ON MANAGERS OF ALTERNATIVE INVESTMENT FUNDS

The bill transposes Directive 2011/61/EU on Alternative Investment Fund Managers. The Directive introduces a legal framework for the authorization, supervision and oversight of managers of a range of alternative investment funds (AIFM), including hedge funds and private equity funds located and/or operated in EU countries requiring fund managers to obtain authorization from the competent authority as well as making them subject to supervision. Furthermore, the bill will repeal provisions of the Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and institutional investor funds regarding investment funds (No. 128/2011). The Ministry of Finance and Economic Affairs has established a committee with the task of working on the bill.

The bill is scheduled to be submitted to Parliament in spring 2016.

BILL ON NEW ACT ON SHORT SELLING

The bill introduces new requirements to notify competent authorities when a short position exceeds certain limits, restrictions on unprotected short selling as well as giving monitoring bodies the authority to temporarily ban short selling or publicly disclose the short position of a party in certain situations. The bill introduces new provisions into Icelandic law by implementing Regulation No. 236/2012 on short selling and is currently under consideration of a special committee appointed by the Minister of Finance and Economic Affairs.

The bill is scheduled to be submitted to Parliament in spring 2016.

UPCOMING AND NEW LEGISLATION

BILL ON SUPPLEMENTARY SUPERVISION OF FINANCIAL CONGLOMERATE

A committee has been established with the task of implementing Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The bill will transpose provisions of the CRD IV and Solvency II directives regarding conglomerates as well as legalizing FME's regulation No. 165/2014.

The bill is scheduled to be submitted to Parliament in spring 2016.

BILL ON OTC DERATIVES

The bill aims at enhancing transparency of OTC derivative trading and reducing counterparty and operational risk as well as increasing the activity of the derivative market through more effective procedures. The bill implements Regulation No. 648/2012/EB (EMIR) on OTC derivatives, central counterparties and trade repositories into Icelandic law. The bill is currently under consideration by a special committee appointed by the Minister of Finance and Economic Affairs.

The bill is scheduled to be submitted to Parliament in spring 2016.

BILL ON AMENDMENTS TO ACT ON THE CENTRAL BANK OF ICELAND (NO. 36/2001)

A committee with the task of reviewing the Act on the Central Bank of Iceland was established in 2014 and has already submitted its final report to the Ministry of Finance and Economic Affairs together with proposed amendments. The Committee's recommendation primarily include changes concerning the Bank's objective and its internal structure. The report as well as the Committee's proposals have been taken under consideration by the Ministry of Finance and Economic Affairs.

The bill is scheduled to be submitted to Parliament in spring 2016.

11 ABBREVIATIONS

ACC	Arion Credit Committee
AIFM	Alternative Investment Fund Managers
ALCO	Asset and Liability Committee
ASF	Available Stable Funding
BARC	Board Audit and Risk Committee
BCC	Board Credit Committee
BCM	Business Continuity Management
BPV	Basis Point Value
BRC	Board Remuneration Committee
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
CVC	Collateral Valuation Committees
DCC	Debt Cancellation Committee
D-SIB	Domestic Systemically Important Bank
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
EL	Expected Loss
EMIR	European Market Infrastructure Regulation
EMTN	Euro Medium Term Note
ESÍ	Central Bank of Iceland Holding Company
EU	European Union
EWS	Early Warning System
FME	Financial Supervisory Authority Iceland
FSC	Financial Stability Council Iceland
HFF	Housing Financing Fund
ICA	Icelandic Competition Authority
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRRBB	Interest Rate Risk in the Banking Book
ISFI	Icelandic State Financial Investments
ITIL	Information Technology Infrastructure Library
KRI	Key Risk Indicator
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LPA	Loan Portfolio Analysis
LTV	Loan to Value
MD	Managing Director
MI	Major Incident
MLRO	Money Laundering Reporting Officer
MV	Market Value
NSFR	Net Stable Funding Ratio
PD	Probability of Default
RCSA	Risk Control Self-Assessment
RBC	Retail Branch Credit Committees
RMC	Retail Monitoring Committee
ROAC	Return on Allocated Capital
RSF	Required Stable Funding
RWA	Risk-Weighted Assets
SC	Security Committee
SME	Small and Medium Enterprises
SO	Seurity Officer
SREP	Supervisory Review and Evaluation Process
UIC	Underwriting and Investment Committee
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value at Risk

LIST OF TABLES

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