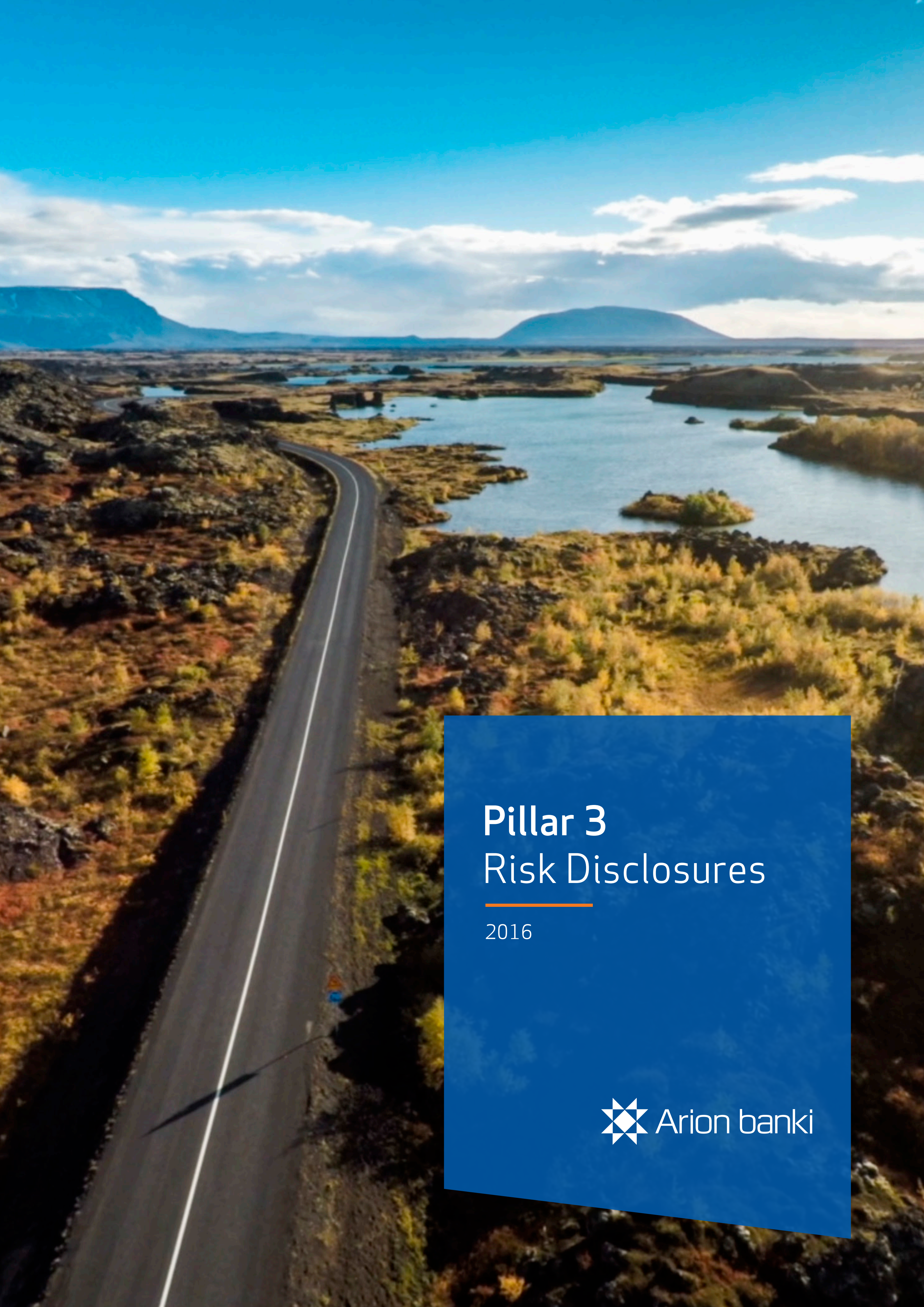


Pillar 3
Risk Disclosures

2016

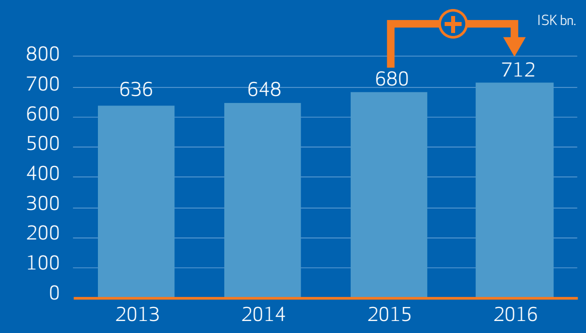
Arion banki

DISCLAIMER

The information in these Pillar 3 Risk Disclosures is obtained from different sources, not all of which are controlled by Arion Bank, but which Arion Bank deems to be reliable. All views expressed herein are those of the Bank at the time of writing and may be subject to change without notice. Whilst reasonable care has been taken to ensure that the contents of this publication are not untrue or misleading, no representation is made as to its accuracy or completeness. These disclosures are informative in nature and shall under no circumstances be used or considered as investment advice or investment research, or an offer to sell, or a solicitation of any offer to buy any securities. It does not refer to the specific investment objectives, financial situation or the particular needs of any person who may receive the report. Arion Bank accepts no liability whatsoever for any direct or consequential loss arising from the use of this publication or its contents.

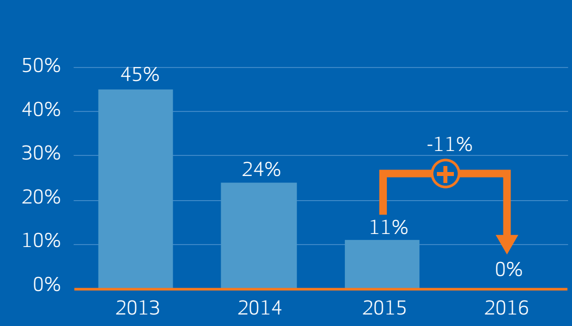
RISK METRICS OVERVIEW

Loans to customers



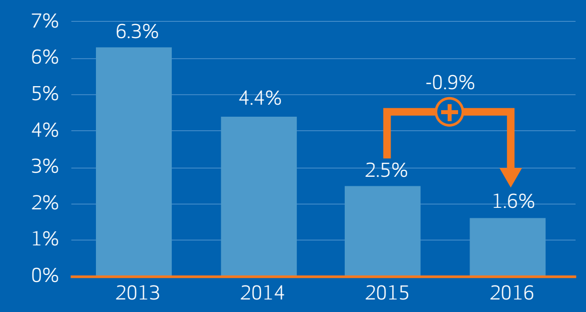
See section 4.4

Sum of large exposures net of eligible collateral



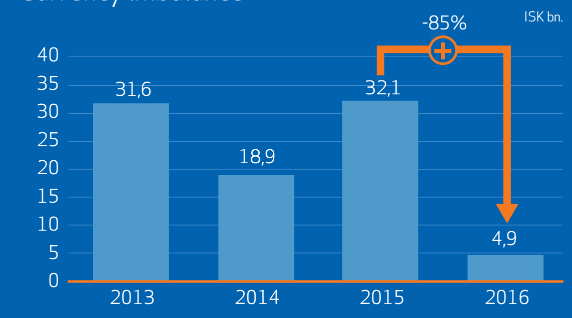
See section 4.4.1

Problem loans



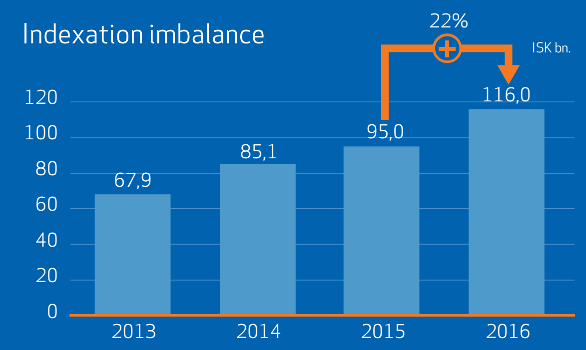
See section 4.8.5

Currency imbalance



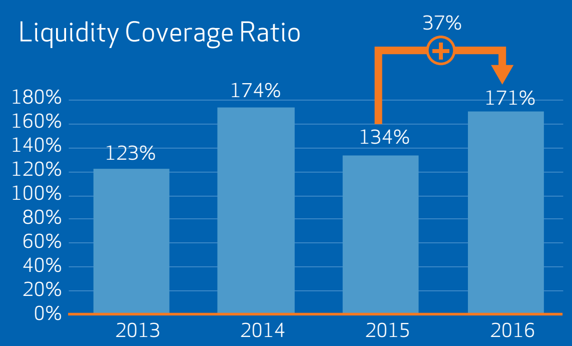
Section 5.4

Indexation imbalance



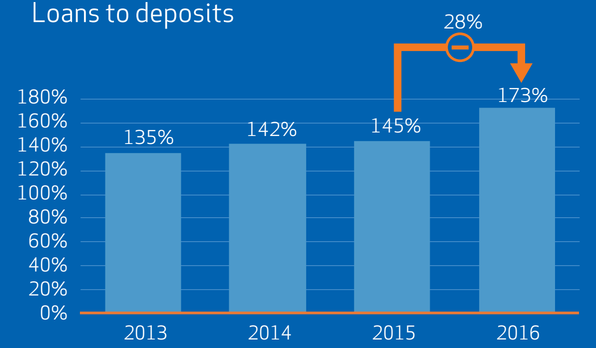
See section 5.5

Liquidity Coverage Ratio



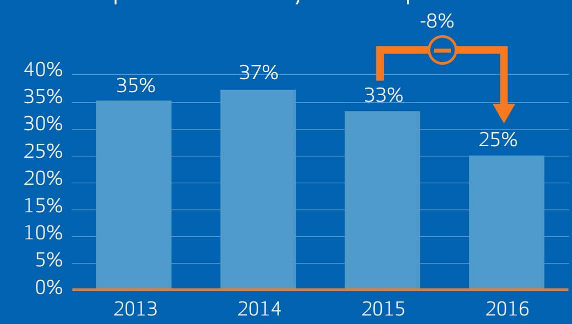
See section 6.4

Loans to deposits



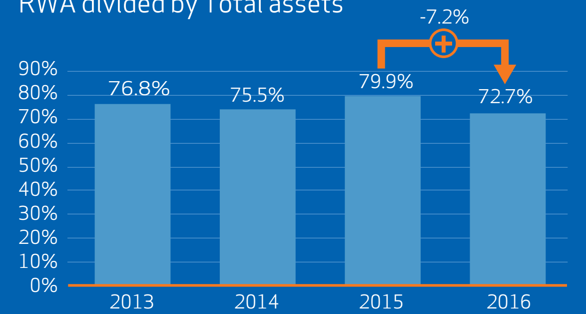
See section 6.5

Term deposits divided by Total deposits



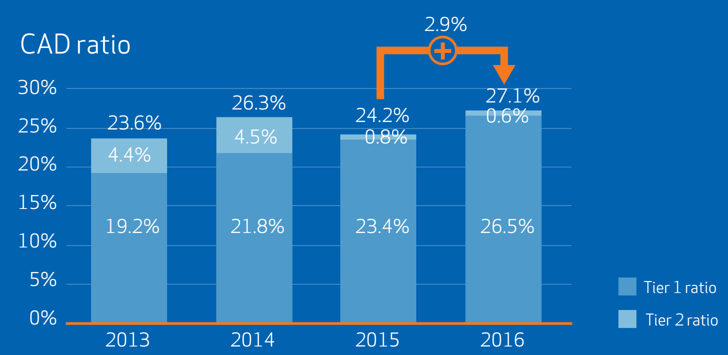
See section 6.4.2

RWA divided by Total assets



See section 3.2

CAD ratio



See section 3.2

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1 INTRODUCTION

1.1 ARION BANK AT A GLANCE
1.2 MAJOR CHANGES IN 2016
1.3 REGULATORY FRAMEWORK
1.4 DISCLOSURE POLICY
1.5 PILLAR 3 RISK DISCLOSURES
1.6 SCOPE OF APPLICATION

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 ('the Bank') is an Icelandic universal bank, classified as a domestic systematically important bank (D-SIB) by the Icelandic authorities.

The 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.

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, product development and service offering, with high focus on digital services.

Arion Bank has taken important funding and market initiatives in recent years, see section 1.2.

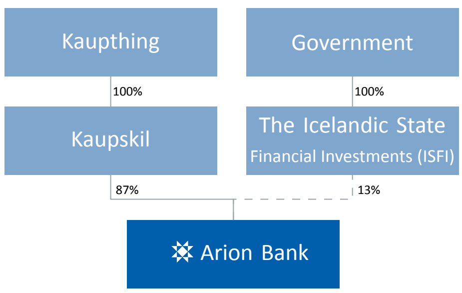
The Bank consists of the following main business segments: Asset Management, Corporate Banking, Investment Banking, Retail Banking, Treasury, and Other divisions. Furthermore, the Bank owns strategic subsidiaries which are important for its service offerings. At year end 2016 the number of full-time equivalent positions at Arion Bank was 869 with an additional 370 FTEs in the subsidiaries.

Arion Bank has two shareholders. Kaupthing ehf., now a holding company, 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. In the summer of 2016 Kaupthing ehf. and Arion Bank issued a joint statement in which it was announced that Arion Bank and Kaupthing ehf. were examining the options regarding Kaupthing's shareholding in the Bank. An IPO was cited as one of the options being examined. Arion Bank and Kaupthing ehf. continue to explore all options with respect to Kaupthing's shareholdings.

The Bank's Annual Report 2016 provides further information about the Bank, such as strategy and vision, and corporate governance.

Figure 1.1 Arion Bank's branch network

Figure 1.2 Ownership structure



1.2 MAJOR CHANGES IN 2016

Several developments influenced Arion Bank's risk profile in 2016. Highlights include:

CHANGES IN THE GROUP STRUCTURE

At the end of September 2016 Arion Bank completed the acquisition of 100% shareholding in Vörður Tryggingar hf., the fourth largest insurance company in Iceland, which subsequently became a subsidiary of the Bank. Work is under way to merge Okkar lítryggingar hf. the Bank's existing life insurance company with Vörður líftryggingar hf., which is a subsidiary of Vörður tryggingar hf.

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. Asset divestment continued in 2016 when in January 2016 the Bank announced the sale by its subsidiary BG12 slhf. of a 46% shareholding in Bakkavor Group Ltd. In November 2016 Arion Bank sold shares in Skeljungur hf., when it was listed on the Icelandic stock market in a listing arranged by Arion Bank – the only IPO of the year in Iceland.

PREPARATION FOR THE LIFTING OF CAPITAL CONTROLS

At the end of 2008, the Icelandic economy became subject to capital controls on almost all monetary transactions to and from Iceland, which entailed a low level of investment and limited access to funding. Since then, Iceland has seen a gradual easing of the capital controls.

On 8 June 2015 the Icelandic government announced a package of measures for the lifting of capital controls. The government's plan went mostly as scheduled. The Icelandic courts have approved the composition of the estates of the failed banks and the government has already received part of the stability contributions pledged by the estates, which will be used 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 in foreign currency from the Icelandic Central Bank. Agreements to this effect were completed in January 2016 (see funding below).

In 2016 the Central Bank of Iceland continued executing its liberalization strategy of the capital controls through currency auctions releasing offshore ISK and amendments to the Rules on Foreign Exchange. Capital controls on the domestic economy are expected to be largely lifted before the end of 2017.

FUNDING

In 2014, Arion Bank established an EMTN (Euro Medium Term Note) bond programme. The programme enables Arion Bank to issue bonds at short notice on the international market for the equivalent of up to EUR 2 billion. The Bank did two benchmark EMTN bond issues during 2016. The first was a EUR 300 million three year bond in April that was sold at terms equivalent to a 2.70% margin over interbank rates. The latter one was a EUR 300 million five year bond in December sold at terms equivalent to a 1.65% margin over interbank rates, this issue was tapped for additional EUR 200 million in the beginning of 2017 bringing the total issue size to EUR 500 million. The Bank did series of smaller EMTN private placements in Romanian Leu, Swedish Krona, Norwegian Krone and US Dollars. The total amount of EMTN private placements equaled ISK 13.8 billion (EUR 116 million).

At the beginning of 2016 the Bank concluded a funding agreement with Kaupthing – a part of the package of measures agreed upon between the government and Kaupthing and which are aimed at the lifting of the capital controls. Under the agreement Arion Bank issued 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 offset loans in foreign currency originally taken by the Bank from the Central Bank of Iceland 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.

The Bank partially used the proceeds from its Euro Benchmark issuance to make two prepayments to Kaupthing of total USD 490 million in 2016, bringing the outstanding amount of the bond to USD 258 million at year end 2016.

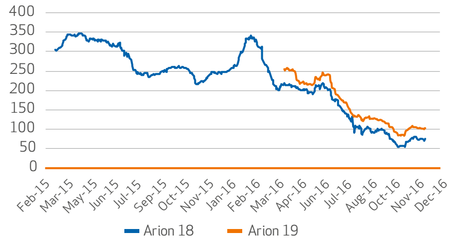
During the year Arion Bank prepaid the remaining ISK 10.4 billion subordinated loan from the Icelandic treasury. The loan was granted in connection with the recapitalization of the Bank in 2010 and in settlement of a dividend in 2011. The prepayment reduced the funding cost of the Bank as the interest rates on the subordinated loan was 5.00% over interbank interest rates.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. The Covered Bond Programme was established in 2012 and is listed in Luxembourg. The Bank issued a total of ISK 24.8 billion of covered bonds in 2016 in the domestic market and will continue to issue covered bonds on a regular basis on the domestic market in 2017.

The Bank also continues issuing short term commercial paper in the domestic market. The Bank sold commercial paper for a total of ISK 23.5 billion in 2016, the outstanding amount at year end was ISK 13.9 billion.

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

Figure 1.3 Development of the market spread for the Bank's EUR bond issue [Basis points]



INTRODUCTION

CAPITAL BUFFERS

In July 2015 the CRD IV was partly adopted into Icelandic legislation. 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).

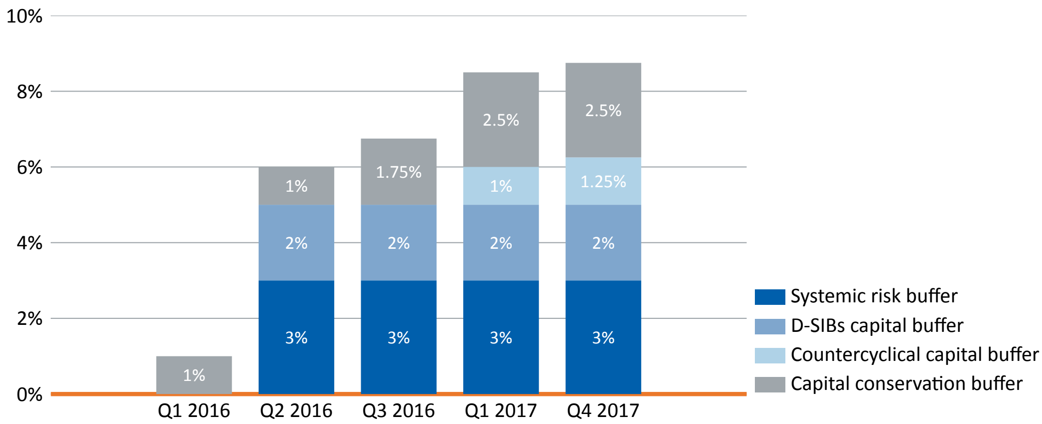
On 1 March 2016 the FME implemented the FSC's recommendation for the required level of capital buffers and amended it on 1 November 2016, by implementing a FSC's recommended 25bps hike in the Countercyclical capital buffer. The schedule for the implemented capital buffers to take effect is as follows:

- 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, rising to 1.25% as of 1 November 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.

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

Figure 1.4 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 impairment model and other IFRS 9 requirements. A Quantitative Impact Study which was conducted in 2016 concluded that, in the contemporaneous economic environment, a non-material increase in loan loss allowances is expected in order to meet the new accounting requirements, see section 4.9.

INTERNATIONAL CREDIT RATING – INVESTMENT GRADE

In January 2016 the credit rating agency Standard & Poor's upgraded Iceland's sovereign credit rating to BBB+ with a stable outlook and subsequently changed the outlook on Arion Bank's BBB- credit rating from stable to positive. In November 2016 S&P upgraded Arion Bank's rating to BBB with a positive outlook.

Upgrades are primarily made on the basis of the brighter economic outlook in 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.

On January 13 2017 S&P upgraded Iceland's sovereign credit rating to A- with a stable outlook.

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

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.

In June 2013 the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive (CRD IV, Directive 2013/36/EU) and the Capital Requirements Regulation (CRR, Regulation No. 575/2013), and represents the EU's implementation of the Basel III reforms. The framework constitutes the cornerstone of the so-called European Single Rule Book for financial regulation.

Preparation for implementation in Iceland has been underway for some time, beginning in November 2012, when the government established a working committee on CRD IV/CRR implementation.

The CRD IV/CRR framework has now mostly been transposed to Icelandic law, which, has taken place via a few amending Acts to the Financial Undertaking Act (No. 161/2002), broadly outlined below:

- Act No. 57/2015 brought 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 introduced special capital buffers into Icelandic law.
- Act No. 58/2015 increased competences of financial sector authorities to impose administrative sanctions.
- Act No. 96/2016 brought e.g. more detailed definitions of concepts to the Financial Undertaking Act, provisions on leverage ratio requirements as a new monitoring tool for authorities to assess excessive leverage in respective financial institutions, a more transparent legal basis for the Supervisory Review and Evaluation Process (SREP) and the Internal Capital Adequacy Assessment Process (ICAAP), changes concerning capital requirements, and, lastly, a legal basis for the Ministry of Finance and Economic Affairs to adopt the CRR regulation as secondary legislation. According to recent communication from the ministry, the CRR is currently being translated and implementation is expected in spring 2017.

Remaining issues yet to be implemented of the CRD IV/CRR framework concern 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. For a further review of these, see section 10.2.

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

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 2016. 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 2016, 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 2016 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 2016, 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 2016, 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
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
Vörður tryggingar hf.	Insurance	100.0	ISK	Iceland	Core

2 **RISK** MANAGEMENT

2.1 INTERNAL CONTROLS AND LINES OF REPORTING
2.2 THREE LINES OF DEFENSE
2.3 RISK COMMITTEES
2.4 THE RISK MANAGEMENT DIVISION
2.5 RISK POLICIES
2.6 RISK APPETITE
2.7 REPORTING

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.

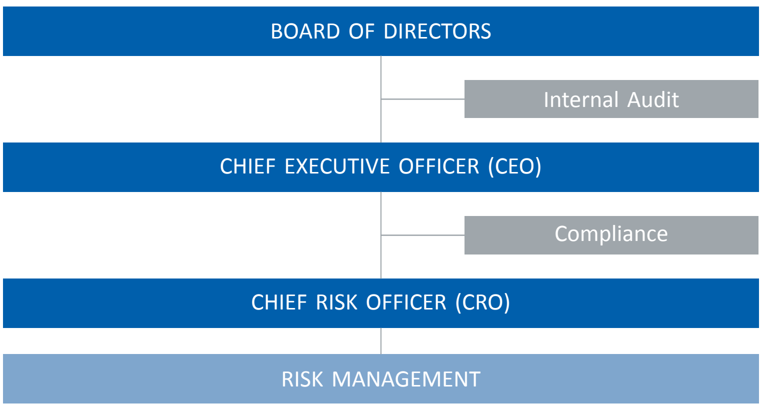
2.1 INTERNAL CONTROLS AND LINES OF REPORTING

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) and Internal Liquidity Adequacy Assessment Process (ILAAP), 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 Risk Committee (BRIC), 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 BRIC 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 BRIC reviews the Bank's risk appetite and makes recommendations thereon to the Board when applicable

The Compliance Officer and the Compliance function operate according to a charter for compliance defined by the Board of Directors. The Compliance Officer reports to the CEO with unhindered access to the Board. Compliance also reports quarterly to the Board Audit Committee (BAC) and the Board of Directors. The BAC reviews and approves Compliance's plans and resources, and evaluates the effectiveness of Compliance.

The role of Compliance is to apply effective precautionary measures to ensure that Arion Bank complies at all times with the law, regulations and good business practices, and to foster an affirmative corporate culture in this respect.

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 against money laundering and the financing of terrorism.

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 BAC 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 and the ILAAP. 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

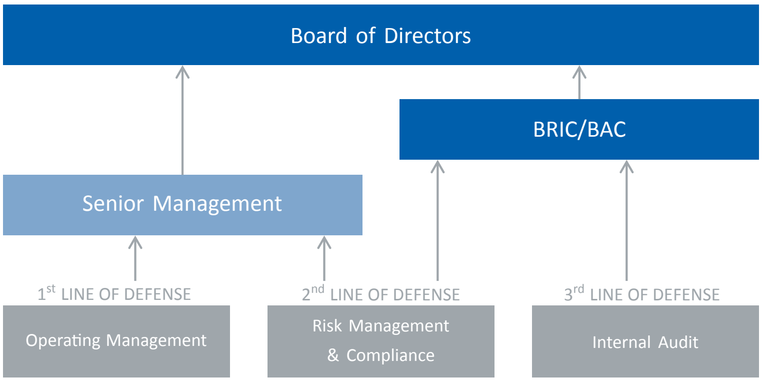
In order to ensure the effectiveness of the Bank's internal controls, to clarify responsibilities and coordinate essential risk management, and to foster the culture wherein risk is every employee's business, the Bank has adopted the three lines of defense model.

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 OF DIRECTORS				
Board Audit Committee (BAC)	Board Risk Committee (BRIC)	Board Credit Committee (BCC)	Board Remuneration Committee (BRC)	
EXECUTIVE MANAGEMENT				
Arion Credit Committee (ACC)	Asset & Liability Committee (ALCO)	Underwriting & Investment Committee (UIC)	Security Committee (SC)	Arion Composition & Debt Cancellation Committee (ADC)
BUSINESS LEVEL				
Corporate Credit Committee (CCC)	Retail Branch Credit Committees (RBC)	Loan Monitoring Committee (LMC)	Composition & Debt Cancellation Committee (CDC)	Collateral Valuation Committees (CVC)

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 Committee (BAC)	The Board Audit Committee assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance and for meeting its external financial reporting obligations under applicable laws and regulations. The BAC supervises accounting procedures, the organization and function of the Bank's internal controls, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The Board 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 BRIC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BRIC 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.
Data Committee (DC)	The Data Committee was instituted in 2016. The Committee serves as a central governing body for all matters relating to data quality and data management. The Data Officer works on behalf of the Data Committee to advance the level of data quality within the Bank in line with the principles for effective risk data aggregation and risk reporting set forth in BCBS 239.
Arion Composition and Debt Cancellation Committee (ADC)	The Arion Composition and Debt Cancellation Committee deals with applications to reach composition with debtors.

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)	Four Retail Branch Credit committees make decisions on credit cases within authorized limits and according to credit rules.
Lending Monitoring Committee (LMC)	The Lending Monitoring Committee reviews compliances with credit rules and credit committees' decisions in relation to disbursements.
Composition and Debt Cancellation Committee (CDC)	The Composition and Debt Cancellation Committee deals with applications to reach composition with debtors within authorized limits.
Collateral Valuation Committees (CVC)	Five Collateral Valuation Committees set guidelines on collateral assessment and valuation.

2.4 THE RISK MANAGEMENT DIVISION

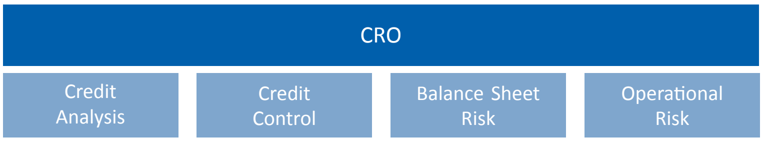
The Risk Management division focuses on the identification, monitoring and control of risk. Risk Management ensures compliance with internal and external limits, standards and regulations, such as CRD, and a strong emphasis is placed on reporting risk to the relevant stakeholders in a clear and meaningful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

Risk Management'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.

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

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 4.6.1. 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, and is responsible for quantitative functions, including credit modelling and stress testing.

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 interfaces primarily with the Bank's Treasury, Proprietary Trading and Capital Markets and reports its analysis and stress testing results for market, funding and liquidity risk to ALCO.

The department is responsible for the development of credit rating models, the calculation of the regulatory capital requirements and managing the Bank's economic capital models, allocated capital model and stress tests. Balance Sheet Risk is responsible for the design, implementation and management of the Bank's ICAAP and ILAAP, and interfacing with the FME in the Supervisory Review and Evaluation Process (SREP).

Additionally the department is in a supportive role for Stefnir Fund Management and the Bank's Asset Management with regards to risk reporting, risk systems 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.

DATA OFFICER

The Bank's Data Officer is a part of the Risk Management division and reports directly to the CRO. The role of the data officer is to organize and implement improvements in data management and data governance for the Bank as a whole.

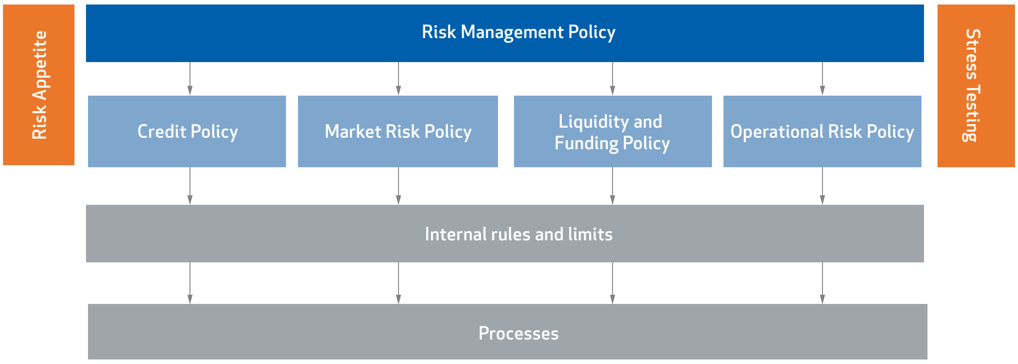
2.5 RISK POLICIES

In pursuance of ensuring that existing and potential material risks are identified, managed and monitored the Bank has an enterprise 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 BRIC 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.

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

The Bank's quantitative risk appetite metrics are shown in Table 2.4. Additionally, the risk appetite statement includes qualitative criteria such as tolerance statements for various operational risk and regulatory compliance breaches.

Table 2.4 Risk appetite metrics

31 December 2016	Value	Legal Limit	Within Risk Appetite
Credit Risk			
Largest exposure	8.6%	25.0%	✓
Sum of large exposure	0%	-	✓
Sum of 3 largest sectors*	65.0%	-	✓
Largest sector*	30.6%	-	✓
Expected loan loss rate*	0.60%	-	✓
Market Risk			
Total equity exposure*	13.8%	-	✓
Unlisted equity exposure*	6.9%	-	✓
Indirect equity exposure*,**	0.35%	-	✓
Funding and Liquidity Risk			
Liquidity coverage ratio*	169%	90.0%	✓
Loan-to-deposit ratio	173%	-	✓
Encumbered asset ratio	20.5%	-	✓
Capital Management			
Capital adequacy ratio	27.1%	18.8%	✓
Leverage ratio	18.0%	3.0%	✓
Assets and Liability Management			
Currency imbalance	2.4%	15.0%	✓
Interest rate risk***	3.4%	-	✓

* Parent level metric
** Indirect equity exposure is defined as the maximum capital loss to the Bank due to derivatives and margin lending in the event of an equity market stress event, based on assumptions which the Bank has adopted for such purposes.
*** Interest rate risk is defined as the amount at risk, which is calculated as a change in fair value due to yield curve movements that corresponds to the 99th percentile of the loss distribution.

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 an annual report on the Bank's ICAAP, ILAAP and stress testing.

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 • BRIC • 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 • BRIC • Exec. Com.
ILAAP	Evaluation of the Bank's total risk exposure and liquidity adequacy. The report is submitted for review and/or approval.	Annually	• Board • BRIC • Exec. Com.
Internal bank-wide stress testing	Evaluation of the impacts on the Bank's earnings and capital base, the Bank's capital and liquidity ratios and other risk appetite metrics under various stress scenarios. The report is submitted for review and/or approval.	Annually	• Board • BRIC • Exec. Com.

3 CAPITAL MANAGEMENT

3.1 CAPITAL STRUCTURE
3.2 CAPITAL REQUIREMENTS
3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS
3.4 STRESS TESTING
3.5 CAPITAL ALLOCATION AND CAPITAL PLANNING
3.6 CAPITAL CONTINGENCY PLAN
3.7 LEVERAGE RATIO

3 CAPITAL MANAGEMENT

An adequate amount of capital ensures that the Bank is able to absorb losses associated with the risks that 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 Bank's capital base are defined in the EU Capital Requirements Regulation (CRR). In September 2016, parts of CRR were adopted into Act No. 161/2002 on Financial Undertakings while the regulation had not been fully implemented in Iceland. As at 31 December 2016 the Bank assumes the full implementation of CRR in its capital calculations, while the figures for 31 December 2015 are based on the preceding Basel II definitions.

Figure 3.1 Development of the Bank's capital base [ISK m]

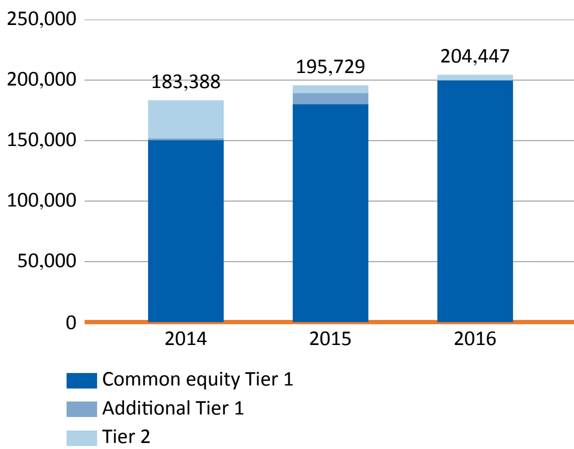


Table 3.1 Capital base

31 December [ISK m]	2016	2015
Total equity	**211,384**	**201,895**
Non-controlling interest not eligible for inclusion in CET1 capital	(172)	(9,108)
Intangible assets	(11,057)	(9,285)
Tax assets	(288)	(205)
Cash flow hedges	(22)	-
Additional value adjustments	(127)	-
Equity holdings in financial sector entities	-	(3,151)
Common equity Tier 1 capital	**199,718**	**180,146**
Additional Tier 1 capital	172	9,108
Tier 1 capital	**199,890**	**189,254**
Subordinated liabilities	-	10,365
Statutory deductions	-	(3,890)
General credit risk adjustments	4,557	
Tier 2 capital	**4,557**	**6,475**
Capital base	**204,447**	**195,729**

Common Equity Tier 1 (CET1) capital comprises of share capital, share premium, other reserves, retained earnings, and eligible non-controlling minority interests, with statutory deductions of intangible assets, tax assets and other items. The Group's Additional Tier 1 capital comprises of non-controlling minority interests of non-financial entities that do not qualify as CET1 capital. The Basel III implementation introduces allowances for the Bank's general credit provision as Tier 2 capital; these loss absorbing credit adjustments are deducted from Common Equity Tier 1 but are accounted for as Tier 2 capital, as institutions applying the standardized approach do not account for expected loss in its risk-weight calculations.

At the end of 2016, Arion Bank's capital base amounted to ISK 204,447 million, of which 98% was CET1 capital. The Bank's CET1 capital increased by ISK 19,572 million in 2016 mainly due to the Bank's net earnings. In 2016, the Bank fully prepaid its legacy 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. Non-controlling interest decreased in the third quarter due to the disbursement of share capital and dividend payment from the subsidiary BG12 slhf. following the sale of its position in Bakkavor Group Ltd. At year-end 2015, the Group's share in VISA Europe was deducted 50% from Tier 1 capital and 50% from Tier 2 capital, it being a minority holding in a financial sector entity. Under Basel III, such insignificant holdings are not subject to deduction. A large share of the position has been disbursed.

At the end of 2016, Arion Bank's capital base amounted to ISK 204,447 million, of which 98% was CET1 capital

3.1.1 CAPITAL MANAGEMENT

Arion Bank's objective is to maintain a capital adequacy ratio that is 1.5% above total FME requirements, including Pillar 1, 2 and combined capital buffers. Irrespective of the objective, the capital adequacy ratio should not be lower than 20%. Current capital adequacy ratios are in excess of the targets, and Arion Bank aims to distribute surplus capital to shareholders. However, the speed and quantum would depend on a number of factors, including (but not limited to) FX imbalance management, capital optimisation strategy and regulatory consent, and is likely to take place over a number of years.

3.1.2 DIVIDEND POLICY

Based on the Arion Bank's expected financial performance over the medium term, Arion Bank aims to pay an annual dividend before special distributions, in line with a payout ratio around 50% of net earnings attributable to shareholders.

3.2 CAPITAL REQUIREMENTS

The Bank's capital requirements calculations are determined in accordance with CRR and the Act No. 161/2002 on Financial Undertakings. The Bank's risk-weighted assets (RWA) calculations are based on standard approaches to the assessment of credit risk, market risk, credit value adjustments, and operational risk.

The total regulatory capital requirement is presented as a percentage of RWA and consists of the items shown in the following table:

Table 3.2 Capital requirements

Source	Description
Pillar 1 requirement	The 8% minimum regulatory requirement
Pillar 2R requirement	The additional capital requirement determined by the Bank's own internal assessment of capital adequacy (ICAAP) and FME's subsequent supervisory regulatory assessment process (SREP)
Combined capital buffer requirement	The aggregated capital requirement due to four capital buffers, the level of which is determined by law (capital conservation buffer) and by the FME following guidance from the Financial Stability Council (buffers for systemic risk, systemically important financial institutions, and countercyclical effects)

As part of the SREP, the results of internal or external bank-wide stress tests can result in non-binding additional capital guidance, defined as Pillar 2G.

The Pillar 1 requirement may be met with different capital instruments, restricted as follows, expressed as a percentage of RWA:

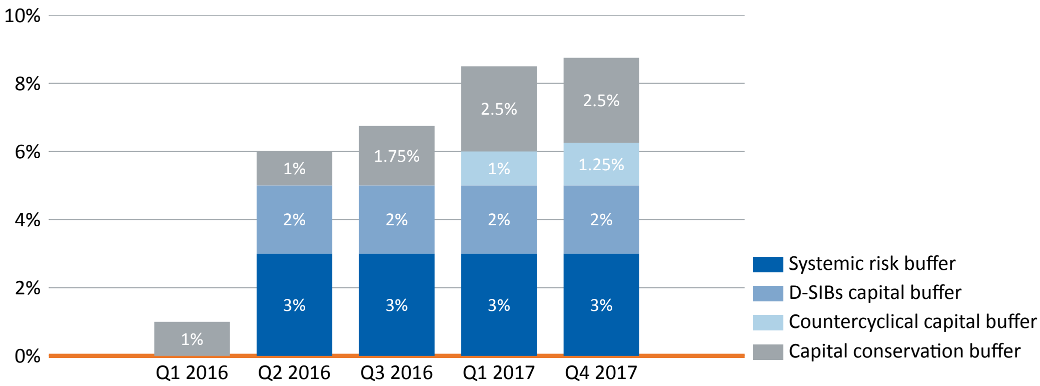
- Common Equity Tier 1 (CET1) capital shall exceed 4.5%
- Tier 1 (CET1 and Additional Tier 1) capital shall exceed 6%
- Total capital (Tier 1 and Tier 2) shall exceed 8%

The same proportion applies to the Pillar 2 capital add-on, i.e. it can be comprised of 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

One of the main purposes of Pillar 2 is to determine the Bank's capital need for risks that are either underestimated or not addressed under Pillar 1. Equity risk, interest rate risk in the banking book and single name concentration contribute to the Bank's Pillar 2 capital requirement. FME's SREP-review of the Bank's ICAAP, which concluded in October of 2016 and was based on financial figures on 31 December 2015, resulted in a 4.3% Pillar 2 requirement. See further discussion in section 3.3.

Capital buffers have been incorporated into Icelandic law with the adoption of CRD IV into the Act of Financial Undertakings and became legally valid on 1 January 2016. On 1 March 2016, FME confirmed the proposed buffer levels given by the Financial Stability Council and defined Arion Bank as a domestic systemically important financial institution (D-SIB). In November of 2016, the Council proposed an increase for the countercyclical buffer, from 1% to 1.25%, which takes effect a year later. The implementation plan is shown in Figure 3.2.

Figure 3.2 Implementation of capital buffer levels for Icelandic D-SIBs

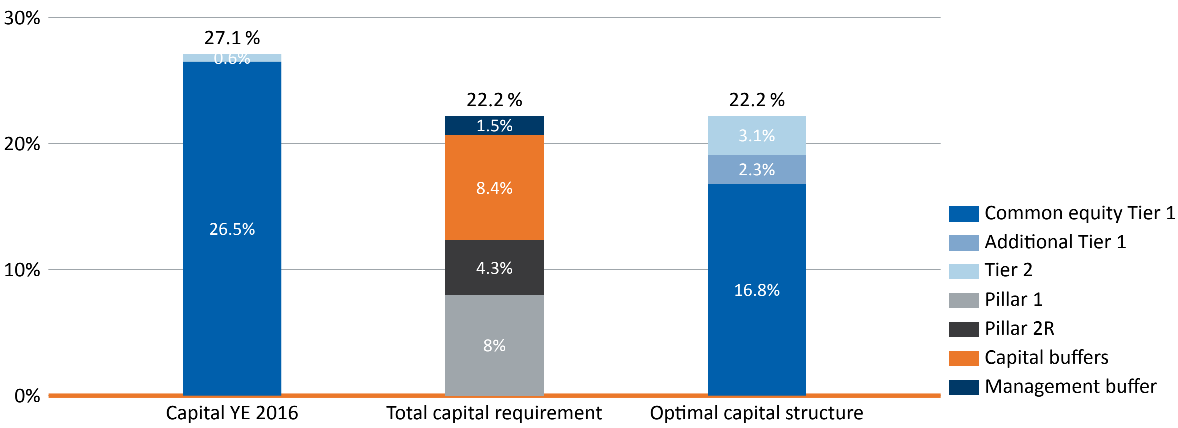


The countercyclical capital buffer and systemic risk buffer only apply to domestic exposures, and hence the systemic risk buffer and the D-SIB buffers are cumulative as opposed to the higher of the two being applied. Given the Bank's geographic distribution of exposures at year-end 2016 (91% of RWA are domestic), the fully implemented combined capital requirement is 8.4%. With the FME's possible recognition of capital buffers in foreign countries, these will apply to the portion of RWA that is calculated on exposures from the corresponding countries, resulting in higher combined capital buffer requirement.

To summarize, the Bank's total regulatory requirement at year-end 2016, assuming fully implemented capital buffers, is 20.7%. Management's policy is to voluntarily hold an additional management buffer of 1.5%, which brings the total capital requirement to 22.2%. The following figure shows the Bank's capital position and the capital requirement, along with an optimal capital structure under CRR.

The Bank's total regulatory requirement at year-end 2016, assuming fully implemented capital buffers and including the internal management buffer, is 22.2%

Figure 3.3 Arion Bank's capital position and capital requirement at year-end 2016



Ever since its establishment, the Bank's capital base has grown consistently due to strong profit generation and dividend payment restrictions. Table 3.3 outlines the development of the Bank's key capital and risk-weighted assets figures.

Table 3.3 Key capital adequacy figures

31 December [ISK m]	2016	2015	2014	2013
Tier 1 capital	199,890	189,253	151,850	138,627
Capital base	204,447	195,729	183,388	170,439
Risk-weighted assets (RWA)	753,318	807,910	696,010	720,822
Pillar 1 capital requirement	60,265	64,632	55,681	57,666
Tier 1 capital ratio	26.5%	23.4%	21.8%	19.2%
Total capital ratio	27.1%	24.2%	26.3%	23.6%
RWA divided by Total assets (on balance sheet)	72.7%	79.9%	74.5%	76.8%

Risk-weighted assets amounted to ISK 753,318 million at the end of 2016 compared to ISK 807,910 million at the end of 2015. The RWA at year-end 2015 were abnormally high due to the retroactive valuation adjustment of the Bank's position in Bakkavor Group Ltd following the sale in January of 2016, resulting in an increase in the risk assessment of both credit risk and currency risk. Further risk reductions have countered the Bank's growth in the year: sale of equity positions, lower default rates, higher market value of real estate collateral, reduction in loan commitments and lower currency imbalance all resulted in a lower average risk-weight, 72.7% at year-end 2016. The Bank's RWA are calculated using the approaches described in Table 3.4.

Figure 3.4 RWA 2016

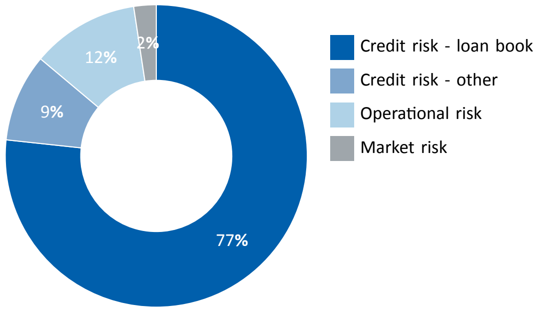


Table 3.4 Method of calculation of minimum capital requirements

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 applying standard risk weights from 0% to 150% to the Bank's assets depending on the creditworthiness of the borrower and the characteristics of the collateral and the exposure. Replacement cost and potential future exposure is used to calculate the capital requirements for counterparty credit risk in combination with the counterparty's risk weights. The Bank uses the financial collateral comprehensive method for credit risk mitigation. Credit valuation adjustment measures the market value of counterparty credit risk.
Market risk	The Bank uses the standardized approach to calculate capital requirements for market risk. To determine the own funds requirement for equity positions, general risk and specific risk are determined by applying 8% to the Bank's overall net and gross position, respectively. For traded debt instruments, risk weights ranging from 0% to 100% determine the specific risk, while general risk is calculated in accordance with the maturity based approach. The capital requirements for currency imbalance is calculated based on the total net long position or the total net short position, whichever is the higher.
Operational risk	The Bank uses the standardized approach to calculate capital requirements for operational risk. 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.

At the end of 2016 credit risk accounted for 86% of RWA, operational risk 12% and market risk 2%. The following charts show the changes to RWA and capital base in 2016.

Figure 3.5 Change in RWA in 2016 [ISK m]

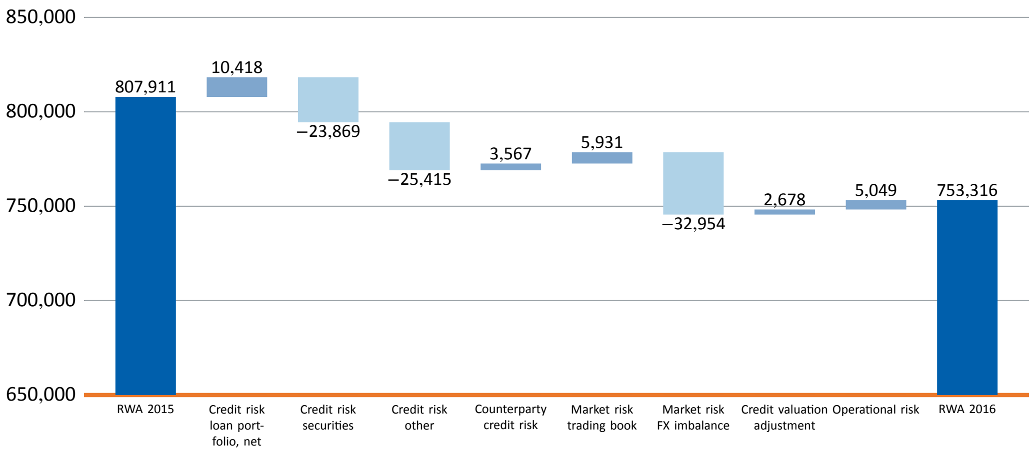
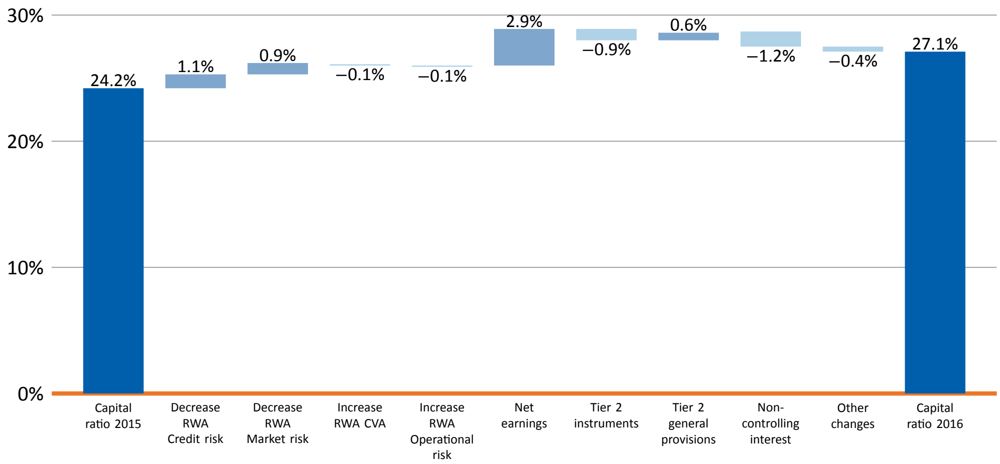


Figure 3.6 Change in capital ratio in 2016



In Table 3.5 the Bank's exposure at default, RWA and minimum capital requirements under Pillar 1 for the end of 2016 and 2015 are broken down by different risk types, and exposure classes. The breakdown for year end 2016 shows the CRR exposure class *In Default* as opposed to the Basel II based *Past Due* exposure class for 2015. Exposures that are 90 days past due is a subset of exposures in default, so the *In Default* class is therefore generally larger than the *Past Due* class. Despite this classification change, due to reduced defaults in 2016, the total exposures in default at year end 2016 is lower than past due items at year end 2015.

Table 3.5 Exposure at default before credit risk mitigation, risk-weighted assets and capital requirements split by exposure class

	Exposure at Default (EAD)				
31 December 2016 [ISK m]	On-balance sheet	Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	137,509	76	-	-	-
Regional government	4,681	2,092	1,408	20.8%	113
Administrative bodies	355	35	378	96.8%	30
Institutions	95,746	1	24,032	25.1%	1,923
Corporate	140,647	24,341	157,234	95.3%	12,579
Retail	56,587	15,376	53,554	74.4%	4,284
Real estate individuals	289,259	630	118,794	41.0%	9,504
Real estate corporate	223,681	14,613	222,422	93.3%	17,794
In default	13,486	-	15,976	118.5%	1,278
Other assets	27,051	-	26,281	97.2%	2,102
Equity, banking book	21,058	-	25,657	121.8%	2,053
Credit risk total	**1,010,060**	**57,164**	**645,735**	**60.5%**	**51,659**
Market risk					
Traded debt instruments, trading book			6,950		556
Equity, trading book			6,016		481
Foreign exchange			5,447		436
Market risk total			**18,414**		**1,473**
Credit value adjustment			**2,678**		**214**
Operational risk			**86,490**		**6,919**
Total	**1,010,060**	**57,164**	**753,317**	**70.6%**	**60,265**

	Exposure at Default (EAD)				
31 December 2015 [ISK m]	On-balance sheet	Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	99,853	3,593	-	-	-
Regional government	3,866	2,977	1,439	21.0%	115
Administrative bodies	7,803	10	279	3.6%	22
Institutions	105,815	2	37,466	35.4%	2,997
Corporate	129,375	37,960	161,452	96.5%	12,916
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
Credit risk total	**982,355**	**70,520**	**681,034**	**64.7%**	**54,483**
Market risk					
Traded debt instruments, trading book			2,598		208
Equity, trading book			4,437		355
Foreign exchange			38,401		3,072
Market risk total			**45,436**		**3,635**
Operational risk			**81,441**		**6,515**
Total	**982,355**	**70,520**	**807,911**	**76.7%**	**64,633**

Table 3.6 Exposure at Default (on-balance sheet, before collateral netting) split by exposure class and by sector

31 December 2016 [ISK m]	Exposure at Default, gross of Credit Risk Mitigation - On Balance Sheet									
	Central government	Regional government	Administrative bodies	Institutions	Corporate	Retail	Real estate	In default	Other credit risk related exposure	Total on-balance sheet
Credit risk										
Agriculture	-	-	-	-	19	526	5,572	167	-	6,285
Financial and insurance services	87,634	-	-	80,116	25,996	4,958	8,154	130	-	206,988
Fishing industry	-	-	-	-	49,819	1,610	23,769	1,412	-	76,611
Individual	-	-	-	-	-	38,516	289,293	7,880	-	335,688
Industry, energy and manufacturing	-	51	-	-	7,669	796	19,309	918	-	28,743
Information and communication technology	-	-	96	-	10,437	891	17,124	432	-	28,980
Public administration, human health and social act.	21	4,541	247	-	201	296	3,294	174	-	8,775
Real estate and construction	-	-	-	-	14,231	2,742	97,421	1,076	-	115,470
Services	-	-	-	-	3,908	3,003	10,052	520	-	17,482
Transportation	-	-	-	-	2,349	583	3,819	42	-	6,793
Wholesale and retail trades	-	-	-	-	14,382	2,665	35,133	735	-	52,915
Other assets		-	-	-	-	-	-	-	27,051	27,051
Banking book - Traded debt instruments	49,854	89	12	9,575	7,787	-	-	-	-	67,317
Banking book - Equity		-	-	-	-	-	-	-	21,058	21,058
Counterparty credit risk		-	-	6,054	3,850	-	-	-	-	9,904
Credit risk total	**137,509**	**4,681**	**355**	**95,746**	**140,647**	**56,587**	**512,939**	**13,486**	**48,109**	**1,010,060**

31 December 2015 [ISK m]	Exposure at Default, gross of Credit Risk Mitigation - On Balance Sheet									
	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	48,127	-	-	87,427	26,524	1,317	5,285	104	-	168,784
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	51,702	8	7,537	16,044	965	-	-	-	-	76,256
Banking book - Equity	-	-	-	-	-	-	-	-	33,366	33,366
Counterparty credit risk	-	-	-	-	-	-	-	-	4,063	4,063
Credit risk total	**99,854**	**3,866**	**7,803**	**103,471**	**127,655**	**57,693**	**474,511**	**14,098**	**93,405**	**982,355**

Table 3.7 shows the on-balance sheet credit risk exposure, before credit risk mitigation, broken down by exposure classes and maturity at book value. Table 3.8 shows collateral types broken down by exposure classes.

Table 3.7 On-balance sheet credit risk exposure broken down by exposure classes and maturity, book value

31 December 2016 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	87,644	11	-	-	87,655
Regional government	1,970	386	2,237	-	4,592
Administrative bodies	36	305	3	-	343
Institutions	80,116	-	-	-	80,116
Corporate	48,421	62,529	18,060	-	129,011
Retail	21,883	21,300	13,404	-	56,587
Real estate	47,297	124,008	341,634	-	512,939
In default	4,546	931	8,009	-	13,486
Other assets	-	-	-	27,051	27,051
Equity, banking book	-	-	-	21,058	21,058
Traded debt instruments, banking book	6,963	48,757	11,598	-	67,317
Counterparty credit risk	3,115	6,398	391	-	9,904
Total on-balance sheet credit risk exposure	**298,876**	**258,227**	**394,944**	**58,013**	**1,010,059**

31 December 2015 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	48,136	16	-	-	48,152
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	1,685	2,067	311	-	4,063
Total on-balance sheet credit risk exposure	**256,314**	**250,402**	**382,234**	**93,405**	**982,355**

Table 3.8 Collateral types broken down by exposure classes

31 December 2016 [ISK m]	Cash and securities	Real estates	Fishing	Other	Total
Central government	-	-	-	-	-
Regional government	4	486	-	-	490
Administrative bodies	0	0	-	0	0
Corporate	26,076	16,561	42,326	35,609	120,572
Retail	557	2,257	1,150	9,966	13,930
Real estate	484	453,511	15,208	26,663	495,866
In default	151	13,071	53	852	14,128
Total collateral	**27,272**	**485,887**	**58,737**	**73,090**	**644,986**

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	24,726	1,480	44,671	31,274	102,151
Retail	1,446	3,677	1,118	10,301	16,542
Real estate	554	421,424	12,657	25,994	460,629
Past due	19	16,841	376	305	17,541
Total collateral	**26,748**	**443,987**	**58,822**	**67,874**	**597,431**

3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

The ICAAP is the Bank’s internal, group-wide assessment of its capital needs. The ICAAP is carried out in accordance with the Act on Financial Undertakings 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 .

Managing Directors with their key personnel and key personnel from

The ICAAP is the Bank’s internal, group-wide assessment of its capital needs

the Bank's subsidiaries participate in the process of identifying and evaluating high risk areas, and discuss their management of risk, in cooperation with Risk Management. The result from the identification phase serves as the basis for the risk assessment within the Bank's ICAAP. Risk categories identified for the business units are shown in Table 3.9.

Table 3.9 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 minimum 8% regulatory capital requirements. This additional capital requirement is referred to as the Pillar 2R requirement. The main risk elements for which additional capital is required are:

- Interest rate risk in the banking book (IRRBB) and indexation risk
- Single name concentration of credit risk
- Equity risk

The Pillar 2 capital assessment does not address risks that are covered by the capital buffers.

The ICAAP and SREP of 2016, which was based on financial figures from 31 December 2015, resulted in a 4.3% Pillar 2R capital requirement.

The ICAAP and SREP of 2016, which was based on financial figures from 31 December 2015, resulted in a 4.3% Pillar 2R capital requirement

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 to 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 program 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 material 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 carried out.

Scenario analyses are carried out on the Bank's business plan. One of the 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.

In addition to the internal bank-wide stress test and the Central Bank stress test the Bank performs both targeted ad-hoc stress tests and regularly scheduled stress tests. Examples of targeted stress tests in the past include analysis of the effect of the stability conditions in relation to the lifting of capital controls and the claimed illegality of indexed loans.

Stress tests provide an important management tool for the Bank

Figure 3.7 The stress test procedure at the Bank.

Scenario description – the story	Macro economic impact - time series	Credit / Market Liquidity / Operational Risk parameters	Micro economic impact-translation	Assumptions in model altered-effect reported
Internal bank-wide: Cross department workshops, meetings and collaboration with the Economic Research team. **Targeted:** Risk Management / BRIC **Regulators:** Central Bank of Iceland / FME	**Internal bank-wide:** Economic Research, Risk Management Planning & Analysis **Targeted:** Risk Management. Planning & Analysis	**Internal bank-wide / Targeted / Regulators:** Risk Management	**Internal bank-wide / Regulators:** Planning & Analysis, Economic Research, Risk Management	**Internal bank-wide / Regulators:** Planning & Analysis, Risk Management

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 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 3.9 Allocated capital at end of December 2016

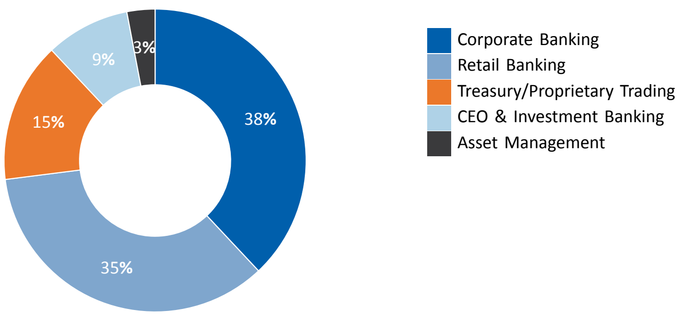
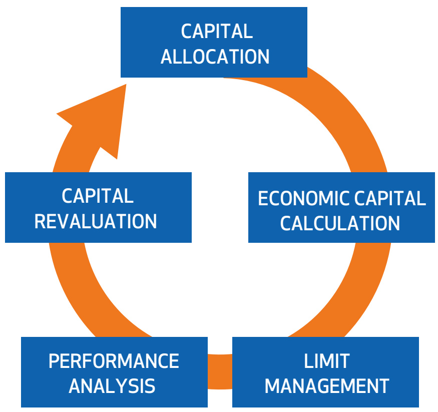


Figure 3.8 Capital planning and monitoring process



The focus of capital management at the Bank is to optimize the capital structure in the medium term and consequently maintain the Bank's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The focus of capital management at the Bank is to optimize the capital structure in the medium term and consequently maintain the Bank's capitalization comfortably above the regulatory minimum

3.6 CAPITAL CONTINGENCY PLAN

The Bank monitors its capital position and capital adequacy as 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 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 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

The 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 2016, the Bank had a strong leverage ratio of 18.0%, significantly higher than the 3% minimum prescribed by the Act on Financial Undertakings.

Table 3.10 The Bank's leverage ratio

31 December [ISK m]	2016	2015	2014	2013
On balance-sheet exposures	1,011,735	982,348	912,303	921,079
Derivative exposures	8,226	3,789	1,348	1,929
Securities financing transaction exposures	9,330	16,287	10,044	10,381
Off balance-sheet exposures	83,156	127,675	59,922	25,199
Total exposure	**1,112,447**	**1,130,099**	**983,617**	**958,588**
Tier 1 capital	**199,890**	**189,253**	**151,850**	**138,627**
Leverage ratio	**18.0%**	**16.7%**	**15.4%**	**14.5%**

4 **CREDIT** RISK

4.1 CREDIT POLICY
4.2 CREDIT GRANTING
4.3 CREDIT RISK MANAGEMENT
4.4 CREDIT RISK EXPOSURE
4.5 COLLATERAL MANAGEMENT AND VALUATION
4.6 CREDIT MONITORING AND VALUATION
4.7 CREDIT RATING
4.8 PORTFOLIO CREDIT QUALITY
4.9 THE IFRS 9 ACCOUNTING STANDARD
4.10 COUNTERPARTY CREDIT RISK
4.11 INFORMATIVE: CPI-LINKED LOANS EXPLAINED

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 six categories; loans to customers, commitments and guarantees, bond and debt instruments, balances with the Central Bank and loans to credit institutions, counterparty credit risk, and equity risk in the banking book, see Table 4.1.

Table 4.1 Sources of credit risk

Source	Description
Loans to customers	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.
Bonds and Debt instruments	The Bank trades and invests in bonds and debt instruments. Bonds and debt instruments are important to the Bank's liquidity management, see section 4.4.5.
Balances with the Central Bank and loans to credit institutions	The Bank maintains cash and balances with the Central Bank, in the form of certificates of deposits, mandatory reserve deposits and other balances. Furthermore the Bank holds money-market deposits and deposits in nostro accounts with credit institutions. These assets form a key part of the Bank's liquidity buffer, see section 4.4.6.
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 4.10.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made in short term trading purpose and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 5.6.

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 an universal bank offering companies and individuals tailored banking solutions. Credit is granted by a hierarchy of credit committees with different credit granting limits or, by employees with restricted credit granting limits. The emphasis is on maintaining a high quality credit portfolio by adhering to 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.

Granting, where the underlying collateral is securities issued by Arion Bank, is prohibited.

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.

To ensure 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. 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. Monthly credit risk reports are sent to the ACC, the BRIC and the Board of Directors.

4.4 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, guarantees and letters of credit.

At the end of 2016, the Bank's total credit risk exposure was ISK 1,124,007 million (2015: ISK 1,094,623 million). Loans to customers increased by 4.7% between 2015 and 2016 and represent the largest part of the Bank's total credit exposure or 63%. 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 97%. Table 4.2 shows the Bank's credit risk exposure. The average exposure during 2016 is calculated from four quarterly interim financial statements.

Loans to customers represent the largest part of the Bank's total credit exposure or 63%

Table 4.2 Breakdown of credit risk exposure

	2016		2015	
[ISK m]	31 December	Average	31 December	Average
On-balance sheet items:				
Cash and balances with Central Bank	87,634	80,151	48,102	54,539
Loans to credit institutions	80,116	81,413	87,491	102,569
Loans to customers	712,422	708,867	680,350	668,844
Bonds and debt instruments	69,565	74,533	78,794	70,746
Derivatives	14,418	10,438	6,457	3,150
Bond and debt instruments, hedging	7,318	4,536	1,519	2,440
Other assets with credit risk	8,617	9,003	4,581	8,339
Credit risk exposure on-balance sheet	**980,090**	**968,941**	**907,294**	**910,626**
Off-balance sheet items:				
Financial guarantees	15,270	18,007	19,162	15,080
Unused overdraft	46,379	44,189	42,100	40,105
Loan commitments	82,268	76,679	126,068	91,801
Credit risk exposure off-balance sheet	**143,917**	**138,876**	**187,330**	**146,985**
Total credit risk exposure	**1,124,007**	**1,107,817**	**1,094,624**	**1,057,611**

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

Table 4.3 Development of the loan portfolio

31 December [ISK m]	2016	2015	2014	2013	2012
Cash and cash balances with Central Bank	87,634	48,102	21,063	37,999	29,746
Thereof cash with Central Bank	80,186	43,181	6,873	24,913	17,514
Loans to credit Institutions	80,116	87,491	108,792	102,307	101,011
Thereof bank accounts, and	45,642	74,531	79,592	70,671	84,164
money market loans	32,267	7,976	23,007	26,197	13,763
Loans to customers	712,422	680,350	647,508	635,774	566,610
Total loans	**880,172**	**815,943**	**777,363**	**776,080**	**697,367**

The growth in loans to customers between year end 2016 and 2015 is due to organic growth, both for individuals and corporate. The breakdown of the Bank's loans to customers is shown in Table 4.4.

Table 4.4 Loans to customers specified by types of loans

31 December 2016 [ISK m]	Individuals		Corporates		Total	
	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,805	13,381	19,314	17,630	34,119	31,011
Credit cards	11,363	11,099	1,180	1,151	12,543	12,250
Mortgage loans	285,784	282,996	16,298	15,975	302,082	298,971
Other loans	34,777	29,940	351,739	340,250	386,516	370,190
Loans to customers	**346,729**	**337,416**	**388,531**	**375,006**	**735,260**	**712,422**
31 December 2015 [ISK m]	**Individuals**		**Corporates**		**Total**	
	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	16,840	14,833	24,248	22,387	41,088	37,220
Credit cards	10,842	10,560	1,054	997	11,896	11,557
Mortgage loans	271,895	268,048	12,889	12,601	284,784	280,649
Other loans	38,058	31,178	334,849	319,746	372,907	350,924
Loans to customers	**337,635**	**324,619**	**373,040**	**355,731**	**710,675**	**680,350**

Loans to individuals represent 47% of total loans to customers and have increased by 3.9% year on year. The majority of loans to individuals, or 84%, are mortgage loans which present 40% of total loans to customers.

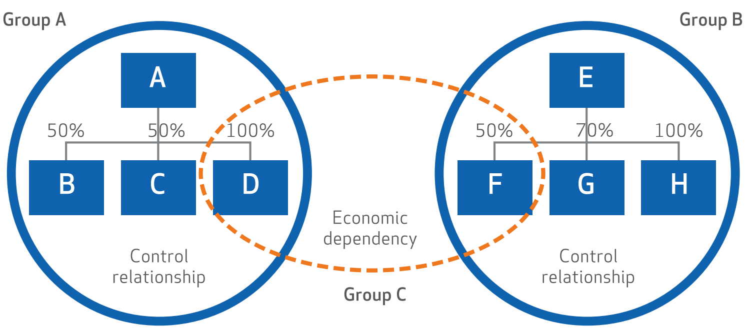
4.4.1 RELATED PARTIES AND LARGE EXPOSURE

A large exposure is defined as an exposure to a Bank 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 Banks of related parties. No single large exposure or sum of large exposures shall exceed limits expressed in the Bank's risk appetite, 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 Banks of related parties. The internal rules define the Bank's interpretation of 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 Bank evaluates the relationship of customers both with respect to control and economic dependencies. Economic dependencies between two companies within different Banks do not necessarily combine these Banks into one. This relationship is illustrated in Figure 4.1.

Figure 4.1 Related parties



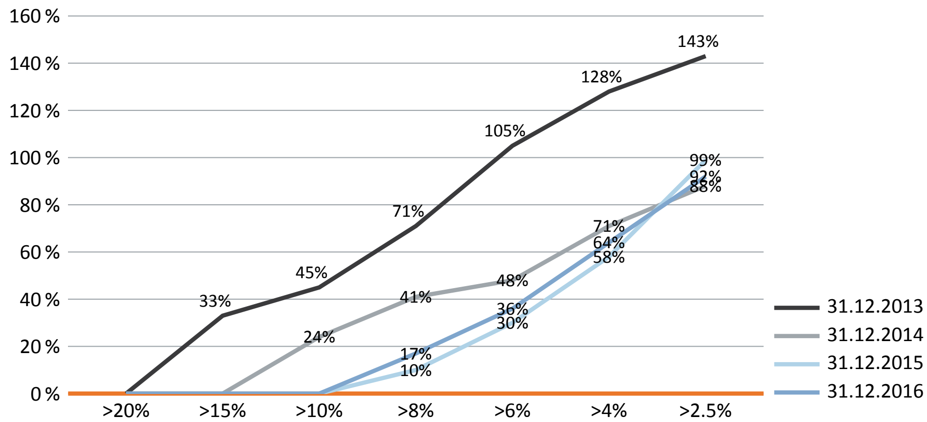
Risk Management monitors party relations both prior to the granting of a loan and during the lifetime of the loan. Connections are stored in the Bank's customer relationship management (CRM) system and the relationship database.

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

At year end 2016 the Bank had no large exposures, compared to one at the end of 2015. The largest exposure to a group of related parties at the end of 2016 was ISK 17.8 billion or 8.6% of the capital base, before accounting for eligible collateral.

The Bank's single-name concentration continues to decrease, see Figure 4.2. For comparison, large exposure among loans to customers was 24% at the end of 2014. The sum of large exposures exceeding 2.5%, net of eligible collateral, has also decreased from 99% to 92% year-on-year.

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



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

The Bank's single-name concentration decreased during 2016 and no exposure to a group of related parties was classified as a *large exposure* at end 2016

4.4.2 CREDIT RISK EXPOSURE BY SECTOR

The Bank's loan book is diversified with regard to individuals and industry sectors. Of loans to customers, 47% are loans to individuals, of which 84% are mortgage loans. Credit exposure towards individuals represents 33% of the total credit risk exposure. Real estate activities and construction is the largest industry sector comprising 16% of loans to customers or 12% 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 applied to some subclasses, mainly holding companies, the Bank applies this see-through principle to better locate the underlying sector risk.

Arion Bank monitors the risk associated with the rapid growth of the tourism industry. The Bank has not modified its standard industry classification to incorporate a separate tourism sector, opting instead to monitor the exposure internally alongside the standard sectors. To define the tourism industry, the Bank has adopted a classification from the Central Bank of Iceland which identifies, primarily, 19 activities from ISAT08 as core tourism activities. According to this definition, the Bank has determined that its exposure to the tourism industry is 5% of loans to customers at the end of year 2016, up from 4% in 2015. The tourism exposure draws mostly from four standard industry sector: Wholesale and retail trades (39%), Real estate and construction (23%), Services (20%) and Transportation (10%).

5% of loans to customers are related to the rapidly growing tourism industry

Figure 4.3 Sector distribution of total credit risk exposure

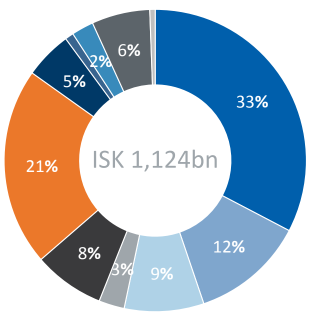


Figure 4.4 Sector distribution of loans to customers

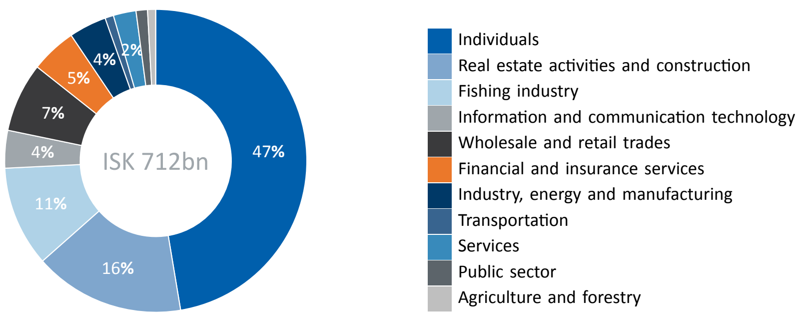


Table 4.5 Credit risk exposure broken down by industry

31 December 2016 [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	-	-	-	-	-	87,634	-	-	-	-	-	87,634
Loans to credit institutions	-	-	-	-	-	80,116	-	-	-	-	-	80,116
Loans to customers	337,417	114,895	76,475	28,647	52,719	34,939	28,633	6,519	17,308	8,711	6,159	712,422
Financial instruments	307	1,106	261	-	7	18,865	10,942	3	557	59,253	-	91,301
Other assets with credit risk	443	779	14	19	22	6,708	10	7	540	72	3	8,617
Credit risk exposure on-balance sheet	**338,167**	**116,780**	**76,750**	**28,666**	**52,748**	**228,262**	**39,585**	**6,529**	**18,405**	**68,036**	**6,162**	**980,090**
% of Credit risk exposure on-balance sheet	34.5%	11.9%	7.8%	2.9%	5.4%	23.3%	4.0%	0.7%	1.9%	6.9%	0.6%	100.0%
Off-balance sheet items:												
Financial guarantees	1,394	1,967	1,573	1,039	2,416	1,333	1,880	978	2,643	35	12	15,270
Unused overdrafts	27,609	2,226	640	574	5,951	1,546	2,363	381	2,845	1,895	349	46,379
Loan commitments	33	15,276	16,756	540	24,249	7,154	13,155	2,399	2,659	38	9	82,268
Credit risk exposure off-balance sheet	**29,036**	**19,469**	**18,969**	**2,153**	**32,616**	**10,033**	**17,398**	**3,758**	**8,147**	**1,968**	**370**	**143,917**
% of Credit risk exposure off-balance sheet	20.2%	13.5%	13.2%	1.5%	22.7%	7%	12.1%	2.6%	5.7%	1.4%	0.3%	100%
Total credit risk exposure	**367,203**	**136,249**	**95,719**	**30,819**	**85,364**	**238,295**	**56,983**	**10,287**	**26,552**	**70,004**	**6,532**	**1,124,007**
% of Total credit risk exposure	32.7%	12.1%	8.5%	2.7%	7.6%	21.2%	5.1%	0.9%	2.4%	6.2%	0.6%	100%

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%

4.4.3 CREDIT RISK EXPOSURE BY MATURITY

Table 4.6 Credit risk exposure broken down by maturity

31 December 2016 [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	87,634	78,302		9,332	-	
Loans to credit institutions	80,116	54,104	26,012	-	-	
Loans to customers	712,422	9,051	54,204	79,205	253,938	316,025
Bonds and debt instruments	69,565	5,397	1,362	2,418	48,790	11,598
Derivatives	14,418	-	2,285	2,182	9,329	621
Bond and debt instruments, hedging	7,318	7,318	-	-	-	-
Other assets with credit risk	8,617	2,687	3,882	1,303	745	-
Credit risk exposure on-balance sheet	**980,091**	**156,859**	**87,746**	**94,440**	**312,802**	**328,244**
% of Credit risk exposure on-balance sheet	100%	16%	9%	9.6%	31.9%	33.5%
Off-balance sheet items:						
Financial guarantees	15,270	2,893	4,032	4,136	2,538	1,671
Unused overdraft	46,379	1,460	9,098	18,305	17,516	-
Loan commitments	82,268	1,348	38,757	17,075	21,088	4,000
Credit risk exposure off-balance sheet	**143,917**	**5,701**	**51,887**	**39,516**	**41,142**	**5,671**
% of Credit risk exposure off-balance sheet	100%	4.0%	36.1%	27.5%	28.6%	3.9%
Total credit risk exposure	**1,124,009**	**162,560**	**139,633**	**133,956**	**353,944**	**333,915**
% of Total credit risk exposure	100%	14.5%	12.4%	11.9%	31.5%	29.7%

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 to credit institutions	87,491	50,151	37,340	-	-	-
Loans 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%	31.0%	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%

4.4.4 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 term money market loans. Loans to customers outside Iceland amounted to ISK 30,970 million or 4% of the total loans to customers of which ISK 8,009 million are loans to individuals currently domiciled outside Iceland.

Figure 4.5 Geographic distribution of total credit risk exposure

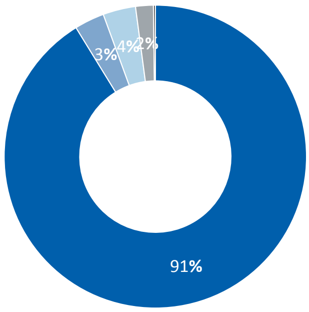


Figure 4.6 Geographic distribution of loans to customers

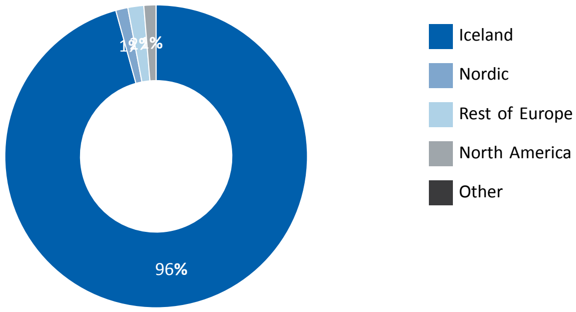


Table 4.7 Geographic distribution of credit risk exposure

31 December 2016 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	87,634	-	-	-	-	87,634
Loans to credit institutions	34,623	20,667	16,514	8,179	133	80,116
Loans to customers	681,452	9,561	11,843	9,268	299	712,422
Bonds and debt instruments	59,261	3,448	3,675	1,695	1,485	69,565
Derivatives	7,726	306	6,018	368	-	14,418
Bonds and debt instruments, hedging	7,318	-	-	-	-	7,318
Other assets with credit risk	7,673	41	768	134	2	8,617
Credit risk exposure on-balance sheet	**885,687**	**34,023**	**38,818**	**19,644**	**1,919**	**980,091**
% of Credit risk exposure on-balance sheet	90.4%	3.5%	4.0%	2.0%	0.2%	100%
Off-balance sheet items:						
Financial guarantees	15,216	3	51	-	-	15,270
Unused overdraft	45,559	412	253	107	48	46,379
Loan commitments	79,557	1,582	-	1,129	-	82,268
Credit risk exposure off-balance sheet	**140,332**	**1,997**	**304**	**1,236**	**48**	**143,917**
% of Credit risk exposure off-balance sheet	97.5%	1.4%	0.2%	0.9%	0%	100%
Total credit risk exposure	**1,026,019**	**36,021**	**39,121**	**20,880**	**1,968**	**1,124,008**
% of Total credit risk exposure	91.3%	3.2%	3.5%	1.9%	0.2%	100%

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	-	-	-	-	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	-	78,794
Derivatives	3,470	463	2,523	-	-	6,456
Bonds and debt instruments, hedging	1,519	-	-	-	-	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	-	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%

4.4.5 BONDS AND DEBT INSTRUMENTS

Table 4.8 shows the position in bonds and debt instruments. The Bank trades and invests in bonds and debt instruments. Investment is primarily for the purpose of liquidity management. Credit ratings are due to Standard and Poor's.

Table 4.8 Credit risk due to bonds and debt instruments

31 December [ISK m]	2016	2015
Icelandic government and government guaranteed bonds	47,534	42,147
Domestic corporates	7,148	8,020
Icelandic regional governments	328	340
Foreign government bills and bonds	6,604	18,541
thereof rated AAA	3,674	9,756
thereof rated AA+	2,930	8,785
Credit institutions	7,951	9,747
Total	**69,565**	**78,794**

4.4.6 BALANCES AT THE CENTRAL BANK AND LOANS TO CREDIT INSTITUTIONS

Cash, certificates of deposits, mandatory reserve deposits and other balances with the Central Bank and money-market and nostro deposits to Icelandic and foreign credit institutions are an additional form of liquidity management for the Bank. Table 4.9 shows a breakdown of these exposures at year-end 2016 and 2015.

Exposure limits are granted by ALCO based on credit ratings from accepted rating agencies and monitored daily by Risk Management.

Table 4.9 Balances at the Central Bank and loans to credit institutions

31 December [ISKm]	2016	2015
Central Bank	87,634	48,102
Credit institutions	80,116	87,491
thereof rated AA- and above	1,721	792
thereof rated A- to A+	34,586	38,389
thereof rated BBB+ and lower	43,809	48,310
Total	**167,750**	**135,593**

4.5 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.

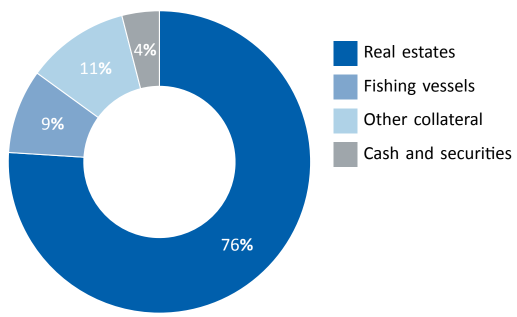
To ensure coordinated collateral value assessment, the Bank operates five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The five committees' areas of expertise are:

- 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 4.10 shows the collateral held by the Bank for loans to customers, broken down by business sector. Collateral held at year end is to the largest extent real estate collateral making up 76% of total collateral. At the end of 2016 loans to customers are secured by collateral, conservatively valued at ISK 630,500 million, for a collateral coverage ratio of 89% compared with 86% at the end of 2015.

The credit exposure towards the Central Bank and financial institutions is unsecured as it is due to the Bank's own deposit accounts and money market loans.

Figure 4.7 Collateral by type



The collateral coverage ratio of loans to customers at the end of 2016 is 89% compared with 86% at the end of 2015

Table 4.10 Collateral for loans to customers

31 December 2016 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2016	Unsecured ratio % 2015
Individuals	481	297,974	5	7,419	305,878	9.3%	9.3%
Real estate activities and construction	581	106,770	34	1,444	108,829	5.3%	11.2%
Fishing industry	564	8,100	57,092	8,041	73,797	3.5%	3.8%
Information and communication technology	27	2,598	-	18,363	20,987	26.7%	31.6%
Wholesale and retail trade	410	26,570	8	19,988	46,976	10.9%	15.9%
Financial and insurance services	14,826	7,620	-	807	23,253	33.4%	34.6%
Industry, energy and manufacturing	3,287	15,332	-	6,875	25,493	11.0%	17.4%
Transportation	73	892	278	3,622	4,864	25.4%	16.2%
Services	20	7,221	71	3,650	10,963	36.7%	62.1%
Public sector	7	3,811	-	179	3,997	54.1%	52.3%
Agriculture and forestry	5	5,128	-	327	5,461	11.3%	37.3%
Total	**20,280**	**482,017**	**57,487**	**70,715**	**630,500**	**11.5%**	**14.3%**

Figure 4.9 shows the mortgage portfolio broken down to LTV bands based on the face value of the mortgages. At the end of 2016, 76% of the mortgages, by value, had loan-to-value below 80% compared with 69% at the end of 2015. As shown in figure 4.8 the mortgage property is primarily located in the Greater Reykjavik area or 72% of the portfolio, by value.

Figure 4.8 Mortgage portfolio by location

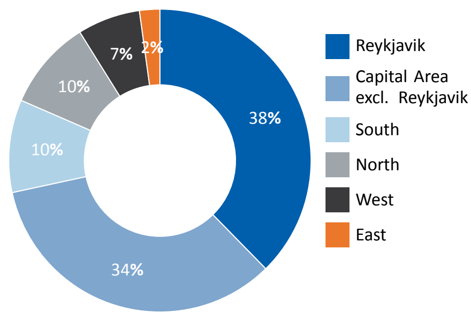
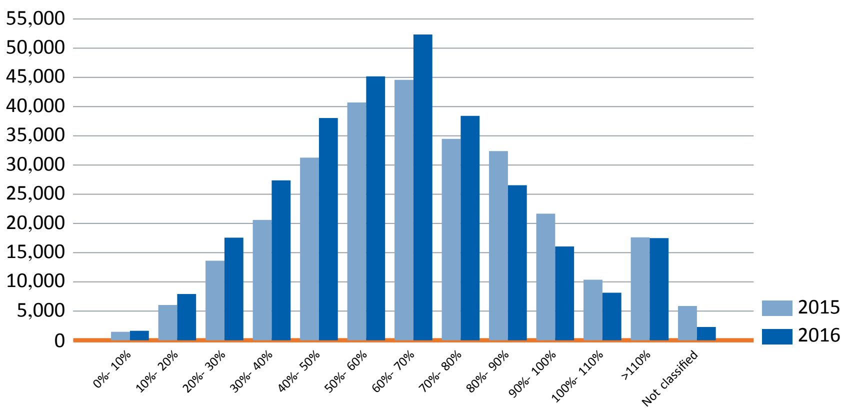


Figure 4.9 Loan to value of mortgage loans [ISK m]



4.6 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.

4.6.1 EARLY WARNING SYSTEM

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

The EWS attempts to anticipate deterioration of the customer credit quality

The classification is based on borrowers' contractual arrangements with the Bank, i.e. timeliness of payments and loan terms, financial ratios and credit rating with different criteria applied to different industrial sectors. Table 4.11 shows an aggregation of the EWS to illustrate the different categories and underlying criteria.

Table 4.11 The Early Warning System - an aggregate view

Category	Provision	Days Past Due	(Debt/EBITDA) /LTV	Equity ratio	Credit Rating
Green	No	< 30	< 4.0 - 5.0 / < 75 % -80 %	> 15 % - 25%	≥B -
Yellow	No	30 - 90	4.0 - 6.0 / < 75 % -90 %	10 % - 25%	CCC+
Orange	No	> 90	> 5.0 - 6.0 / 90% - 100%	< 10% - 20%	< CCC+
Red	Yes	> 90	> 5.0 - 6.0 / > 100%	< 10% - 20%	< CCC+
< ISK 100 million	x	x			x

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

The classification is intentionally strict since its main purpose is to draw attention to credits showing evidence of impairment so that they me be subjected to a detailed inspection and possible provisioning.

4.6.2 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 under 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 the 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 4.12. In addition to the analysis statistics, the table shows whether the monitoring involves interviewing the responsible account manager and whether a detailed valuation report for the credit is required.

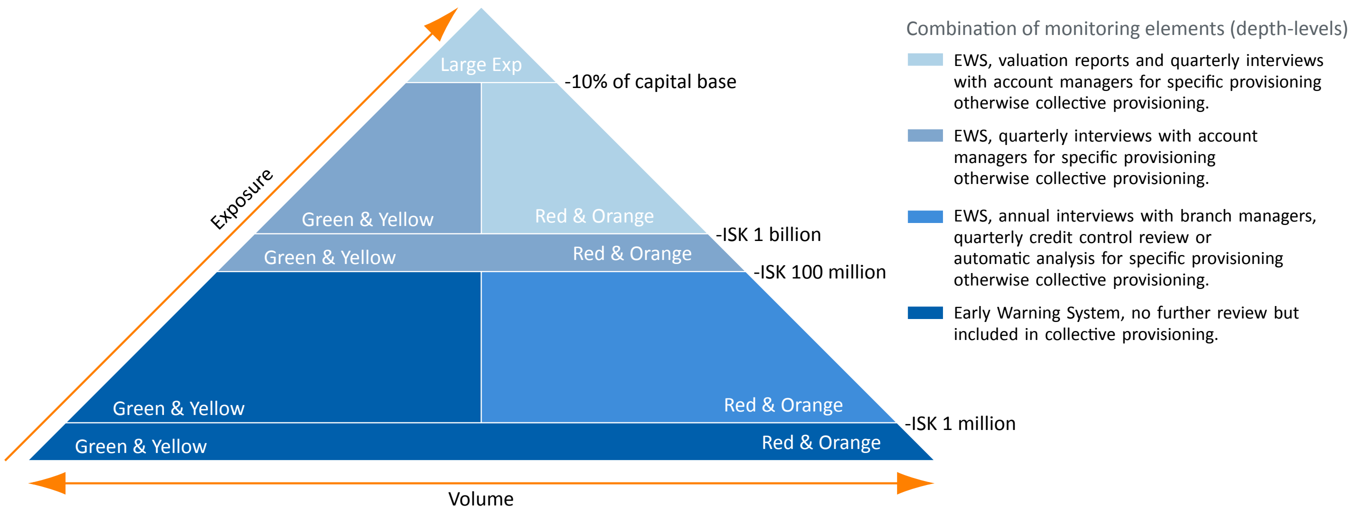
52% of total loans, by value, are individually analyzed

Table 4.12 Credit monitoring

Credit size	Total exposure	Total analyzed	Interview	Valuation report	Total customers	Customers analyzed
≥10% of capital base	0%	0%	All quarterly	All	0	0
≥1,000 million	37%	37%	All quarterly	Red+Orange	288	288
≥100 million	12%	12%	Quarterly	none	957	957
≥1 million	50%	3%	Red+Orange annually	none	26,590	1,366
< 1 million	2%	0%	none	none	45,130	0
Total	**100%**	**52%**			**72,965**	**2,611**

Figure 4.10 describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.

Figure 4.10 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 and the realizable value of collateral in accordance with the valuation committees' guidance (see section 4.5).

Collective provisioning is applied to credits other than those that have been specifically impaired. Also exempt from collective provisions are loans over 90 days in default but have been determined not to require specific impairment. Collective provisions are based on estimates of expected loss (see section 4.8.4), 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 4.7) and the LGD is based on the Bank's own model for loss given default (see section 4.8.4).

4.7 CREDIT RATING

As outlined in Chapter 3, the Bank uses the standardized approach 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. These estimates are used extensively within the Bank as they play a role in the manual and automatic evaluations of loan applications, portfolio monitoring, collective provisioning and internal economic capital calculations.

The Bank uses four credit rating models for application to different types of borrowers and exposures. Prior to 2016, a single model was used to rate all individuals, but in 2016 this model was replaced with two models – a model for individuals with prime mortgages (IS: Íbúðalán) and a model for other exposures to individuals. The purpose of this change is to better capture the observed differences in behavioral characteristics for the two categories. In preparation of IFRS 9, the Bank has also created separate application-versions of each model in order to rate new exposures and loan commitments. Furthermore, the Bank has enhanced its definition of default, for stricter conformance to the Basel III definition.

Table 4.13 Probability of Default models

Model	Description
Large 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 updated and recalibrated in 2015-2016 using historical data from 2009 to 2014.
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 updated in 2016, calibrated on historical data from 2012 to 2015.
Individuals, prime mortgages	Applied to prime mortgages, for which there are standard loan collateral agreements. The model is statistical, run automatically, based on historical behavior of customers and characteristics of the customer and the exposure. The model was created in 2016, calibrated on historical data from 2012 to 2015.
Individuals, other exposures	Applied to other loans than prime mortgages. The model is statistical, run automatically, based on historical behavior of customers and characteristics of the customer and the exposure. The model was created in 2016, calibrated on historical data from 2012 to 2015.

The Bank's PD models are developed within the Balance Sheet Risk department, while the validation of the models is performed independently by the Credit Control unit of Risk Management.

4.7.1 CREDIT EXPOSURE BY RATING

Table 4.14 shows the rating status of the portfolio, by book value, for each type of rating model. In some cases, companies are temporarily unrated. At the end of 2016 only 1.5% of the parent company's loan portfolio was unrated. This is primarily due to newly formed entities where no financial or historical information is available and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and holding companies.

Customers are assigned a DD rating (default) when they have been in arrears for over 90 days or are deemed unlikely to pay, which, among other things, can be a result of provisions being made for losses against the customer's exposure. Note that the DD rating is an indication of a default event as opposed to an assigned credit rating from the Bank's rating models.

Overall the number of active ratings is increasing and the number of exposures in default is decreasing. Around 3.0% of the portfolio, by book value, was assigned a default rating at the end of the year 2016 compared with 3.9% at the end of year 2015. Active PD values are translated into an internal rating scale of letters from CCC- to A+, seen in table 4.15. For use in Retail Banking, the Bank has standardized five risk classes that group the internal rating scale, shown in the same table.

Table 4.14 Breakdown of rating status by book value

	2016			2015		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	94.9%	1.9%	3.2%	96.4%	0.6%	3.0%
Retail corporates	93.3%	5.8%	0.9%	93.0%	5.5%	1.5%
Individuals, prime mortgages	97.4%	2.6%	0.0%	94.6%	5.4%	0.0%
Individuals, other exposure	93.0%	7.0%	0.0%	90.2%	9.8%	0.0%
Total	**95.4%**	**3.0%**	**1.5%**	**94.7%**	**3.9%**	**1.5%**

Table 4.15 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%

The rating distributions of each model are discussed below. Note that the comparison is between different model versions as all of the models were updated in 2016 and the definition of default has been changed.

LARGE CORPORATES

Figure 4.12 shows the corporate portfolio broken down by ratings. As seen in table 4.14 the number of unrated corporates at year end was around 3% which is similar to the year before. The exposure-weighted average PD for corporate customers was 2.3% in year end 2016 compared to 2.6% in 2015.

In terms of book value about 18% have been upgraded towards a better risk class, in contrast to 20% that have been downgraded. Migration analysis does not cover defaulting customers or customers that were previously unrated (e.g. new costumers), or rated by the model for retail corporates.

Figure 4.11 Risk class rating migration by book value between 2015 and 2016 – Corporate

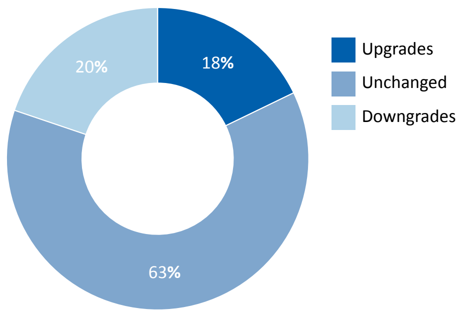
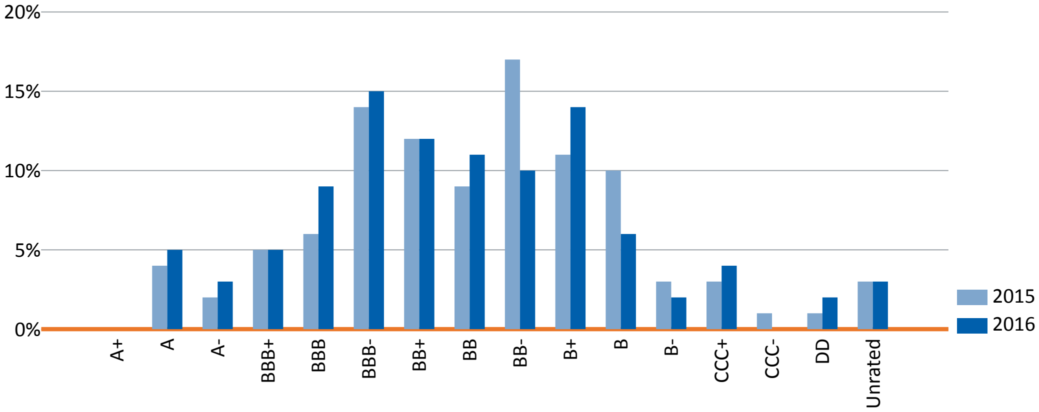


Figure 4.12 Distribution of book value, large corporates



RETAIL CORPORATES

Figure 4.14 shows the retail corporates portfolio broken down by ratings. The exposure-weighted average PD was 10.3% at the end of 2015 compared with 6.7% at the end of 2016.

In terms of book value 31% have been upgraded towards a better risk class whereas 15% have been downgraded. 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 partly be attributed to pure migration, while the enhanced definition of default and new model for retail corporates also play a role.

Figure 4.13 Risk class rating migration by book value between 2015 and 2016 – Retail Corporates

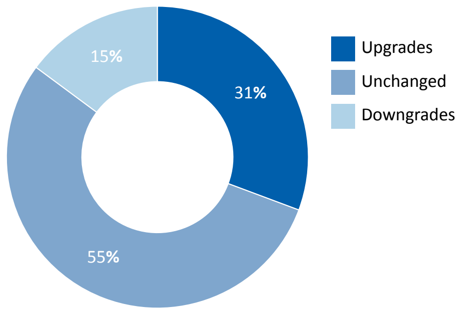
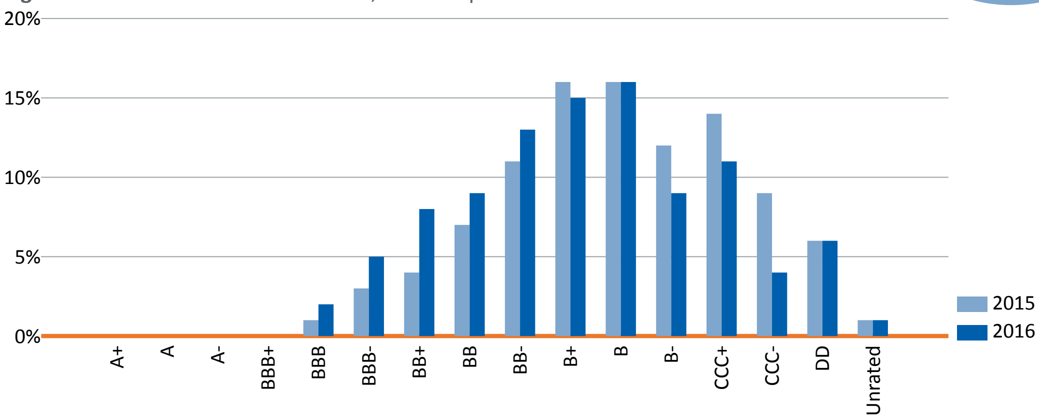


Figure 4.14 Distribution of book value, retail corporates

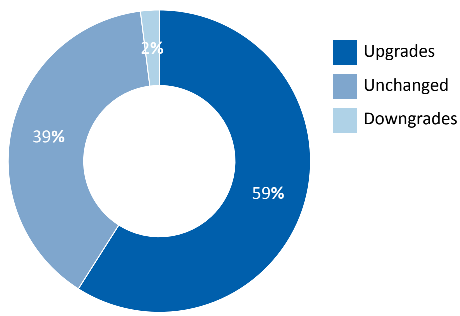


PRIME MORTGAGES TO INDIVIDUALS

Figure 4.16 shows the prime mortgage portfolio broken down by ratings. The distribution of PD values has shifted considerably towards better values between 2015 and 2016. The change in rating distribution can partly be attributed to pure migration, but the leading cause is the creation of a separate model for prime mortgages to individuals. This result highlights the need for the separation of models which has resulted in improved prediction accuracy and allowed capturing the lower historical default rate for prime mortgages than the default rate for other exposures to individuals.

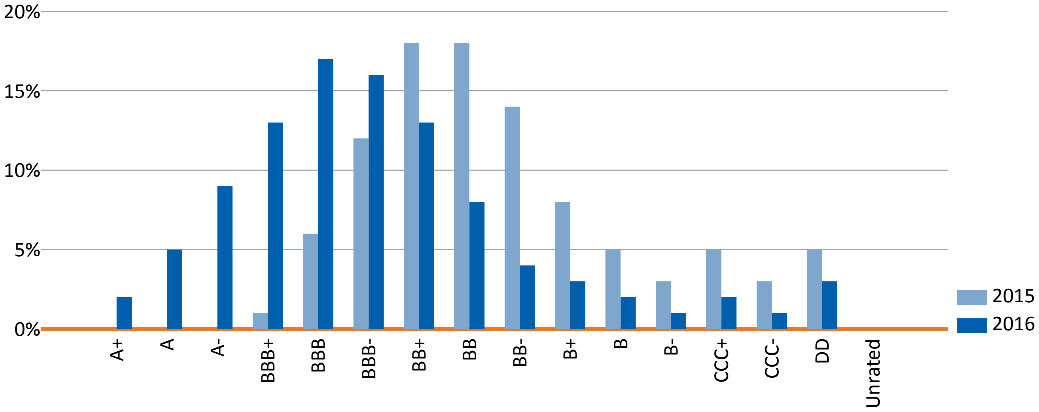
In terms of book value approximately 59% of prime mortgages have migrated towards an improved credit grade whereas only 2% have been downgraded. The exposure-weighted average PD for the prime mortgage portfolio was 1.8% in year end 2016 compared with 4.0% in 2015.

Figure 4.15 Risk class rating migration by book value between 2015 and 2016 - prime mortgages to Individuals



Approximately two thirds of this improvement is due to the model separation and other modeling changes. Migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.16 Distribution of book value, prime mortgages to individuals



OTHER EXPOSURES TO INDIVIDUALS

Figure 4.18 shows the portfolio for other exposure to individuals broken down by ratings. The exposure-weighted distribution of PD values has slightly shifted towards better values between 2015 and 2016. The change in rating distribution can partly be attributed to pure migration. However, due to the aforementioned model segregation for exposures to individuals, which resulted in improved ratings for prime mortgages, the average PD (measured on number of customers) for other exposures has increased from 2015 to 2016.

In terms of book value about 28% have been upgraded towards a better risk class whereas 19% have been downgraded. The exposure-weighted average PD for the portfolio was 3.8% in year end 2016 compared to 5.9% in 2015. Migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.17 Risk class rating migration by book value between 2015 and 2016 - other exposures to Individuals

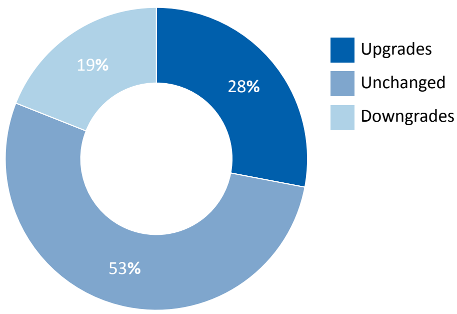
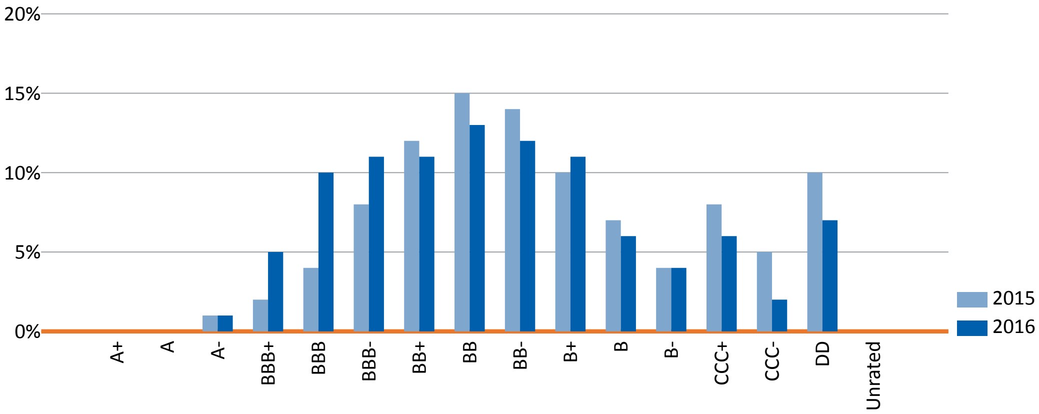


Figure 4.18 Distribution of book value, other exposures to individuals



MODEL PERFORMANCE

All four rating models in use have passed internal validation tests following their development process in 2016. The discriminatory power is in line with or exceeds the Bank's internal requirements and the prediction accuracy is satisfactory. The comparison values for the average PD estimates at the end of 2015 and observed default rates in 2016 are shown in the following table.

Table 4.16 Model performance. Observed default rates in 2016 compared to probability of default predicted at end 2015

Model portfolio	Average PD	Observed avg default rate
Large corporate	3.1%	5.3%
Retail corporate	4.1%	4.6%
Individuals, prime mortgages	1.9%	1.3%
Individuals, other exposures	2.7%	2.3%

Note that here the default rate and predicted probability is measured by number of customers, not exposure-weighted as for the rating distributions above. Figures 4.19 and 4.20. No defaults were observed for grades A- or better compare actual default rate in 2016 with predicted default probability at the end of 2015 for individuals and corporates, respectively. The discrepancy in the actual vs. predicted default rate for individuals with A+ rating is attributable to a single default event for one individual. For corporates no defaults were observed for grades A- or better.

Figure 4.19 Comparison of actual default rate in 2016 and predicted default probability - Individuals

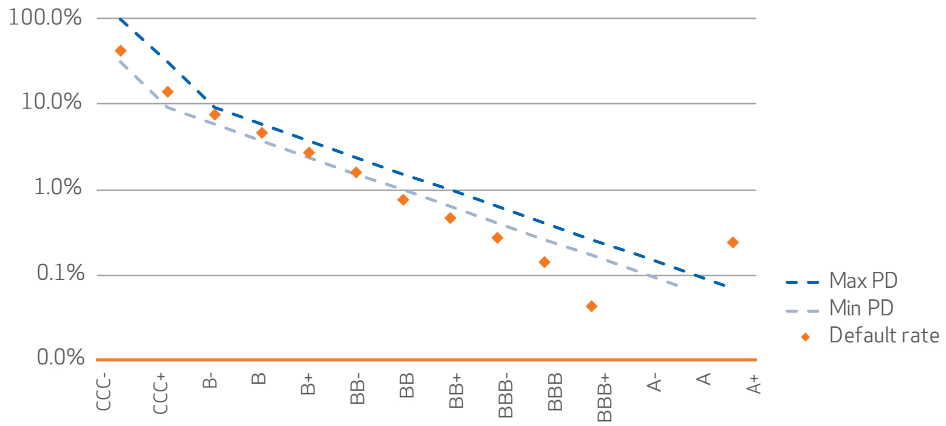
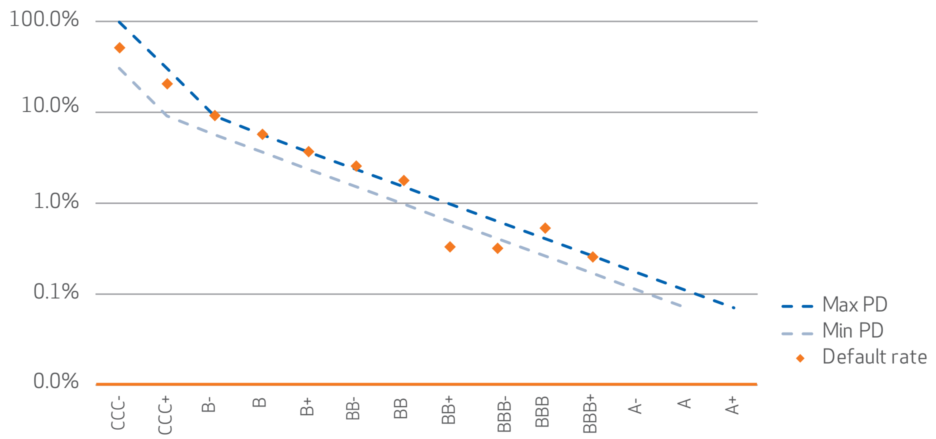


Figure 4.20 Comparison of actual default rate in 2016 and predicted default probability - Corporates



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 PAST DUE EXPOSURES

Figures 4.21 and 4.22 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, the resolution of the legal uncertainty surrounding the FX loans, progress in legal collection as well as better economic environment.

Figure 4.21 Development of past due exposures to individuals, parent company

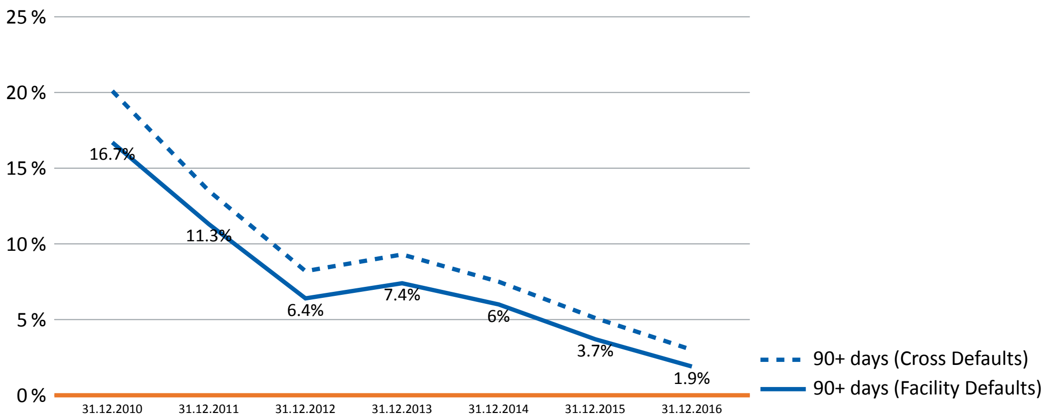
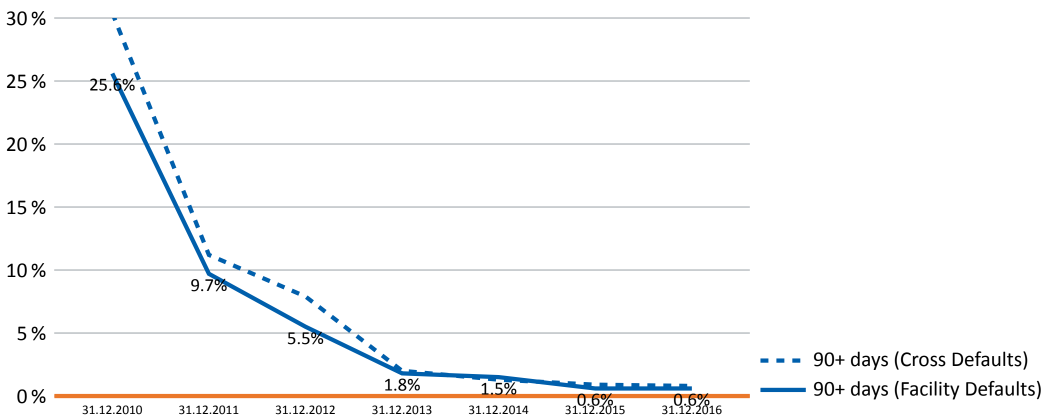


Figure 4.22 Development of past due exposures to companies, parent company



Customer loans that are past due more than 90 days are 1.2% of the total loan book at year end if measured at facility level. The cross default ratio more than 90 days is 1.9%, 3.0% for individuals and 0.8% for corporates. Table 4.17 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 1.2% of the total loan book at year end if measured at facility level

Table 4.17 Defaults by sector, parent company

31 December 2016 [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	1.9%	74.0%	3.0%	76.6%
Wholesale and retail trade	0.7%	4.2%	0.9%	3.6%
Real estate activities and construction	0.7%	8.8%	0.7%	6.5%
Fishing industry	0.2%	2.0%	0.8%	4.8%
Public sector	1.4%	1.3%	2.0%	1.3%
Agriculture and forestry	1.3%	0.9%	1.9%	0.9%
Services	0.9%	1.7%	1.1%	1.4%
Financial and insurance activities	0.3%	1.1%	0.3%	0.7%
Industry, energy and manufacturing	0.3%	0.8%	0.3%	0.7%
Transportation	0.3%	0.3%	0.6%	0.3%
Information and communication technology	1.5%	4.9%	1.5%	3.3%
Total past due > 90 days as a % of loans to customers	**1.2%**	**100%**	**1.9%**	**100%**

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%**

4.8.2 FORBEARANCE

The Bank has adopted the European Banking Authority's (EBA) definition of forbearance. According to the definition, an exposure is considered forborne if concessions, such as modification of terms or debt refinancing, have been granted due to financial difficulties of the client and those concessions would not have been granted in the absence of those financial difficulties.

The Bank is willing to consider forbearance measures in situations when a client is unable to comply with terms and conditions, due to financial difficulties, but there is a realistic possibility the terms and conditions can be met again. This is especially considered in cases when the Bank and the client enjoy a long-standing business relationship.

The decision to apply a forbearance measure is subject to the credit granting mechanism of the Bank, as described in section 4.2 and for potential forbearance cases there is, as a part of the relevant credit committee's decision, a determination of whether the concession constitutes forbearance.

Table 4.18 shows the amount of forborne loans at the Bank by forbearance type and whether the loan is currently classified as performing or a problem loan.

Table 4.18 Forborne loans to customers

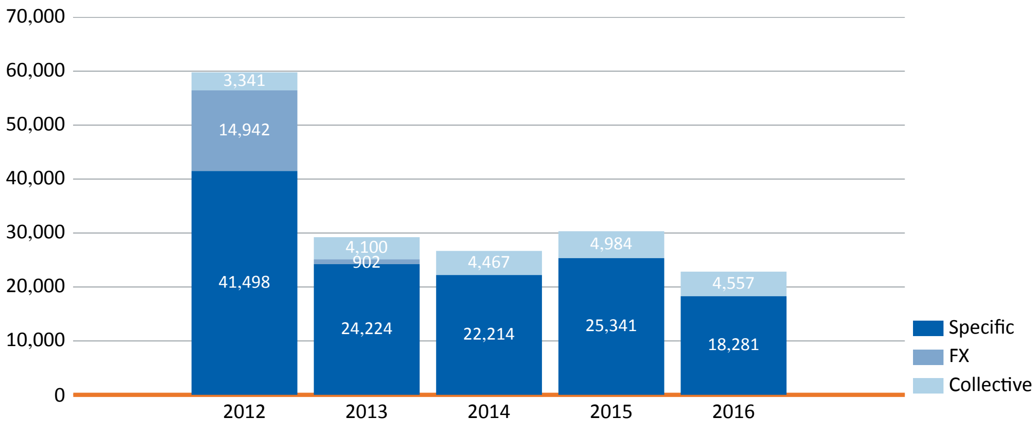
	2016		2015	
31 December [ISK m]	Performing	Problem Loans	Performing	Problem Loans
Modification	19,589	3,113	19,209	1,573
Refinancing	1,389	119	1,599	25
Total	**20,978**	**3,232**	**20,809**	**1,598**

4.8.3 IMPAIRMENT AND PROVISIONS

Loan impairment is recognized when credit monitoring has shown that there is objective evidence of credit losses and appropriate provision has been made (see section 4.6.2). Note that loans which were acquired at a discount are not considered to be impaired unless the specific allowance exceeds the discount received.

At the end of 2016 the Bank's total provision for impairment on loans to customers amounted to ISK 22,838 million including collective provision. Figure 4.23 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 4.23 Changes in the provision for losses on loans to customers [ISK m]



At the end of 2016 the Bank has no provision for losses due to court rulings on illegal FX loans. Specific provisions due to borrower credit quality have been similarly reduced by 56% from 2012, largely due to progress in 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 2016 was ISK 18,281 million, compared with ISK 25,341 million at year end 2015. Table 4.19 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 4.19 Impaired loans to customers by sector

	2016		2015	
31 December [ISK m]	Impairment amount	Gross carrying amount	Impairment amount	Gross carrying amount
Individuals	7,069	10,372	10,593	17,403
Real estate activities and construction	770	1,056	1,515	1,867
Fishing industry	966	1,648	257	373
Information and communication technology	179	182	308	332
Wholesale and retail trade	540	868	681	893
Financial and insurance services	261	298	5,953	6,011
Industry, energy and manufacturing	786	878	828	1,025
Transportation	4,301	4,307	4,433	4,440
Services	3,145	3,624	504	682
Public sector	89	113	143	215
Agriculture and forestry	175	284	126	186
Total	**18,281**	**23,630**	**25,341**	**33,427**

Table 4.20 shows the geographical distribution of impaired loans.

Table 4.20 Impaired loans to customers by geographic area

	2016		2015	
31 December [ISK m]	Impairment amount	Gross carrying amount	Impairment amount	Gross carrying amount
Iceland	12,704	17,955	18,947	26,417
Europe	5,421	5,517	5,983	6,344
North America	144	144	159	252
Other	12	14	251	414
Total	**18,281**	**23,630**	**25,341**	**33,427**

4.8.4 EXPECTED LOSS

Expected Loss is defined as the amount of credit loss that the Bank expects, on average, in the following business year. The Bank accounts for general provisions in its accounts, which are based on expected loss calculations. On the other hand, the Bank holds capital in order to be able to meet unexpected loss (see chapter 3.2).

The Bank has refined its Expected Loss (ECL) 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 4.8.3), 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 default (PD), as per the Basel III definition, 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 4.7 and 4.7.1.

Expected Loss is calculated using the formula $EL = PD \cdot LGD \cdot EAD$

The main components of LGD are:

- the *cure-rate* of the exposure, which describes the probability that the customer returns to a non-defaulting status, without a write-off, within one year from default event
- the *collateral gap* of the defaulted exposure, with haircuts based on historical evidence and expert judgement
- assessment of recoveries of defaulted non-collateralized exposures conditional on non-cure

Table 4.21 shows the Expected Loss rate for different customer and exposure classes. PD and LGD values are weighted by the corresponding balances. As discussed in section 4.7, new models were developed in 2016 based on an enhanced definition of default, where separate models were created for prime mortgages and other exposures to individuals. With other things equal, the updated definition of default contributes to lower PDs between years but this is countered by lower cure rates, resulting in higher LGD values. Theoretically, the updated definition of default does not affect the assessment of the expected loss rate.

Table 4.21 Expected loss by exposure type

31 December 2016	PD	LGD	EL
Corporate	2.4%	20.9%	0.54%
SME	6.3%	18.3%	1.24%
Individuals, Prime Mortgages	1.8%	5.0%	0.12%
Individuals, Other	4.0%	35.2%	1.47%
Weighted average	**2.6%**	**17.0%**	**0.56%**

31 December 2015	PD	LGD	EL
Corporate	2.7%	15.7%	0.49%
SME	10.2%	16.9%	1.83%
Individuals, Prime Mortgages	4.0%	5.2%	0.22%
Individuals, Other	5.8%	31.4%	1.86%
Weighted average	**4.1%**	**14.4%**	**0.68%**

4.8.5 PROBLEM LOANS

The basic elements of loan quality are whether the loan is past due or individually impaired. Table 4.22 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. Credit equivalent of derivatives is excluded.

Table 4.22 Credit quality by class of financial asset

31 December 2016 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers				
Loans to corporates	358,708	14,251	2,046	375,005
Loans to individuals	312,260	21,854	3,303	337,417
Financial instruments	82,042	-	-	82,042
Other assets with credit risk	8,617	-	-	8,617
Total credit quality	**929,377**	**36,105**	**5,349**	**970,831**

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
Other assets with credit risk	4,581	-	-	4,581
Total credit quality	**851,318**	**43,834**	**8,086**	**903,238**

Table 4.23 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 31% from the previous year.

Table 4.23 Number of days in default for loans which are not impaired

31 December 2016 [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	5,388	4,282	1,589	1,211	1,781	14,251
Loans to individuals	3,196	8,708	4,989	391	4,570	21,854
Total past due but not impaired loans	**8,584**	**12,990**	**6,578**	**1,602**	**6,351**	**36,105**

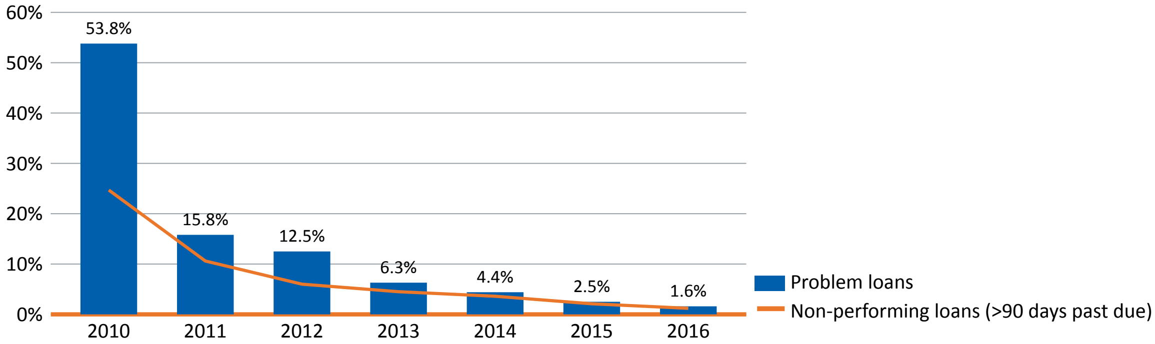
31 December 2015 [ISK m]	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Total past due but not impaired loans	**13,344**	**13,216**	**6,918**	**1,216**	**9,140**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

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, the resolution of the legal uncertainty surrounding FX loans, progress in legal collection and better economic environment.

At year end 2016 problem loans constitute 1.6% of loans to customers and have decreased from 53.8% in 2010 or by 97%, see Figure 4.24. 68% of problem loans, by value, at year end 2016 are loans to individuals and 32% are loans to corporates. 1.2% of loans to customers are more than 90 days default.

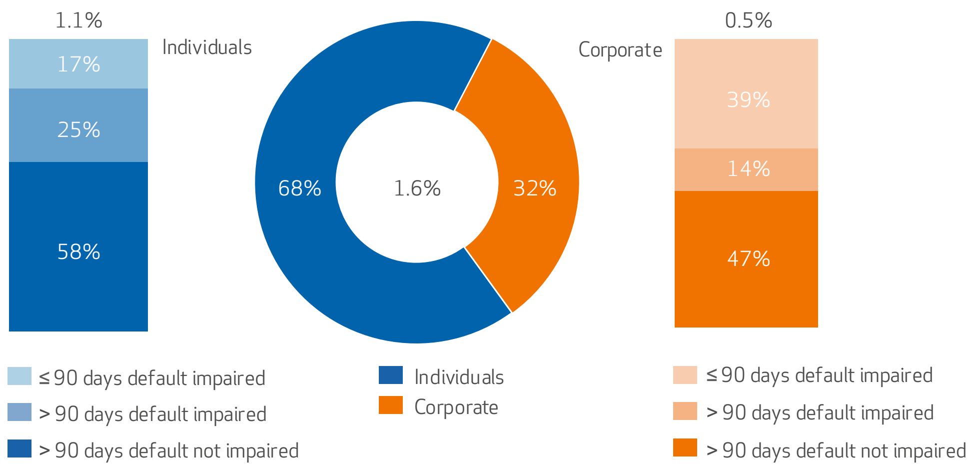
Problem loans, as a percentage of loans to customers, have decreased from 53.8% at the end of 2010 down to 1.6% or by 97%

Figure 4.24 Development of problem loans



The breakdown of problem loans by status is shown in Figure 4.25. Approximately 24% of the problem loans are impaired without being over 90 days past due.

Figure 4.25 Breakdown of problem loans by status



4.9 THE IFRS 9 ACCOUNTING STANDARD

In July 2014, the IASB issued IFRS 9 Financial Instruments, the standard that will replace IAS 39 for annual periods on or after 1 January 2018, with early adoption permitted. The Bank has set up a multidisciplinary implementation team ('the Team') with members from Risk Management, Finance and other relevant divisions to prepare for IFRS 9 implementation ('the Project'). IFRS 9 steering committee consists of Chief Risk and Finance officers as well as senior managers from Corporate banking and Retail banking, who regularly report to the BAC. The Project has six key phases: the initial assessment and analysis, design, build and test the system, parallel running in the second half of 2017, and go live in 2018. At year-end 2016 the Project is on time and the Bank will be able to meet the set timeline in this project. The Bank is currently evaluating the impacts of IFRS 9 on the Financial Statements.

IFRS 9 will also fundamentally change the loan loss impairment methodology. The standard will replace IAS 39's incurred loss approach with a forward-looking expected loss (ECL) approach. The Bank will be required to record an allowance for expected losses for all loans and other debt financial assets not held at fair value through profit or loss (FVPL), together with loan commitments and financial guarantee contracts. The allowance is based on the expected credit losses associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination, in which case, the allowance is based on the expected loss over the life of the asset - lifetime expected credit loss (LECL).

The IFRS 9 standard will replace IAS 39's incurred loss approach with a forward-looking expected loss approach

The Bank has established a policy to perform an assessment at the end of each reporting period of whether credit risk has increased significantly since initial recognition by considering the change in the risk of default occurring over the remaining life of the financial instrument. To calculate ECL, the Bank will estimate the risk of a default occurring on the financial instrument during its expected life. ECLs are estimated based on the present value of all cash shortfalls over the remaining expected life of the financial asset, i.e., the difference between: the contractual cash flows that are due to the Bank under the contract, and the cash flows that the Bank expects to receive, discounted at the effective interest rate of the loan. In comparison to IAS 39, the Bank expects the impairment charge under IFRS 9 to be more volatile than under IAS 39 and to result in an increase in the total level of current impairment allowances. The Bank will group its loans into Stage 1, Stage 2 and Stage 3, based on the applied impairment methodology, as described below:

- Stage 1 – Performing loans: when loans are first recognised, the Bank recognises an allowance based on 12-month expected credit losses.
- Stage 2 – Underperforming loans: when a loan shows a significant increase in credit risk, the Bank records an allowance for the lifetime expected credit loss.
- Stage 3 – Impaired loans: the Bank recognises the lifetime expected credit losses for these loans. In addition, in Stage 3 the Bank accrues interest income on the amortised cost of the loan net of allowances.

The Bank expects the impairment charge under IFRS 9 to be more volatile than under IAS 39 and to result in an increase in the total level of current impairment allowances

The Bank will record impairment for fair value through other comprehensive income (FVOCI) debt securities, depending on whether they are classified as Stage 1, 2, or 3, as explained above. However, the expected credit losses will not reduce the carrying amount of these financial assets in the statement of financial position, which will remain at fair value. Instead, an amount equal to the allowance that would arise if the asset were measured at amortised cost will be recognised in other comprehensive income (OCI) as an accumulated impairment amount, with a corresponding charge to profit or loss. For 'low risk' FVOCI debt securities, the Bank intends to apply a policy which assumes that the credit risk on the instrument has not increased significantly since initial recognition and will calculate ECL as explained in Stage 1. Such instruments will generally include traded, investment grade securities where the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Bank will not consider instruments to have low credit risk simply because of the value of collateral. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the Bank's other financial instruments. The Bank will incorporate forward-looking information in both the assessment of significant increase in credit risk and the measurement of ECLs. The Bank considers forward-looking information such as macroeconomic factors and economic forecasts. To evaluate a range of possible outcomes, the Bank intends to formulate three scenarios: a base case, a worse case and a better case. The base case scenario represents the more likely outcome resulting from the Bank's normal financial planning and budgeting process, while the better and worse case scenarios represent more optimistic or pessimistic outcomes. For each scenario, the Bank will derive an ECL and apply a probability weighted approach to determine the impairment allowance. The Bank will use internal information coming from internal economic experts, combined with published external information from government and private economic forecasting services. Both the Risk and Finance management teams will need to approve the forward-looking assumptions before they are applied for different scenarios.

To evaluate a range of possible outcomes, the Bank intends to formulate three scenarios: a base case, a worse case and a better case

4.10 COUNTERPARTY CREDIT RISK

Counterparty credit risk is the risk of the Bank's counterparty in derivative transactions, 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 4.24 shows derivative trading activities currently permitted. The derivative instruments are classified according to primary risk factor and the type of derivative instrument.

Table 4.24 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 customers' total exposure 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.

The margin-call process is monitored by Risk Management

Table 4.25 shows the Bank's exposure towards counterparty credit risk gross and net of collateral.

Table 4.25 Counterparty credit risk exposure gross and net of collateral

31 December 2016 [ISK m]	Net MtM	EAD	Collateral	EAD net of collateral
Corporate	1,748	3,146	3,019	2,523
Financial institution	1,775	6,054	-	6,054
Funds	(335)	522	2,422	-
Individuals	129	182	512	-
Total	**3,317**	**9,904**	**5,953**	**8,577**

31 December 2015 [ISK m]	Net MtM	EAD	Collateral	EAD net of collateral
Corporate	(97)	1,465	3,901	1,128
Financial institution	452	1,898	-	1,898
Funds	(913)	596	2,959	-
Individuals	(34)	105	608	-
Total	**(591)**	**4,063**	**7,468**	**3,025**

4.11 INFORMATIVE: CPI-LINKED LOANS EXPLAINED

Loans indexed to the official consumer price index (CPI) have been a common credit product in Iceland since 1979. An Icelandic government agency, Statistics Iceland, maintains the CPI by measuring changes in the prices paid by consumers for a reference-basket of goods and services, the composition of which is based on an expenditure survey conducted regularly. The expenditure survey has been carried out continuously since 2000, and the results are used in the annual revision of the CPI base. The CPI is published monthly.

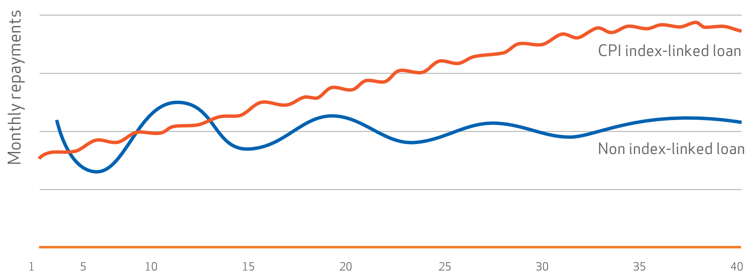
CPI-linked mortgages is the most common form of mortgage lending in Iceland. They are typically annuities, where the monthly payment and the remaining principal are linked to the CPI. As the real interest rates on the loans are generally lower than nominal rates, the initial payments for CPI-linked loans are lower than those for corresponding non-CPI-linked loans. This increases the purchasing power of the borrower, which contributes to the popularity of the product.

CPI-linked mortgages are typically annuities, where the monthly payment and the remaining principal are linked to the CPI

In an inflation environment there will be a gradual increase in the monthly payment. To understand the risk trade-off for the borrower it is interesting to contrast a CPI-linked mortgage and a non-CPI-linked mortgage with a variable interest rate. In a high inflation environment with e.g. 20% annual inflation a monthly payment of 100 would rise to 120 year-on-year. In this environment, a non-CPI borrower might see a doubling of his interest rate which could lead, approximately, to a doubling of the monthly payment. The greater risk of default for the non-CPI loan is evident in this scenario. For CPI-linked loans, the inflation effect accumulates on top of the principal, effectively being borrowed throughout the lifetime of the exposure.

For CPI-linked loans, the inflation effect accumulates on top of the principal, effectively being borrowed throughout the lifetime of the exposure

Figure 4.26 Monthly payments of a 40 year CPI-linked annuity, for illustrative purposes

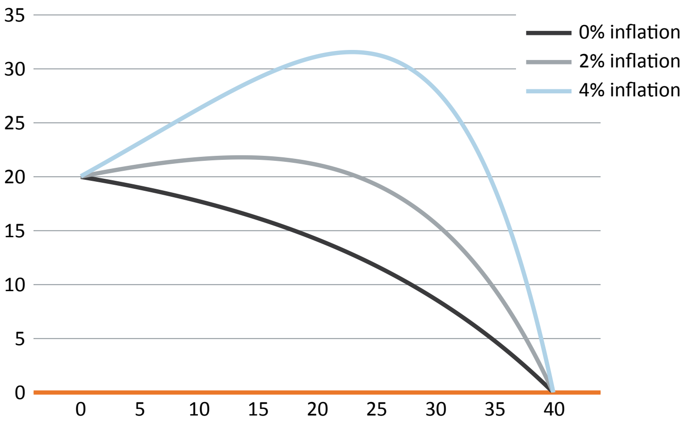


Default-risk in CPI-linked loans is further mitigated by a legislated mechanism called *payment adjustment* (IS: greiðslujöfnun). The purpose of the mechanism is to reduce the risk of borrower distress in periods when inflation outpaces increases in wages. The mechanism is triggered when the CPI exceeds the official wage index and has the effect that the monthly payment is temporarily indexed to the wage index instead of the CPI and a portion of the monthly payment is deferred. The deferred portion is drawn down once the wage index has surpassed the CPI or by extending the term of the loan.

The downside for CPI-linked loans is the borrower's equity position. Because the remaining principal is CPI-linked, in an inflation environment a negative amortisation may occur, particularly during the first part of the term, see Figure 4.27. During the period of 20% inflation in the aforementioned scenario, the remaining principal would increase by approximately 20%, which could deplete the borrower's equity (LTV could increase from 80% to 100%).

In an inflation environment a negative amortization of a CPI-linked loan may occur, particularly during the first part of the term

Figure 4.27 The effect of inflation on the development of the remaining principal of a 40 year CPI-linked annuity [ISK m]

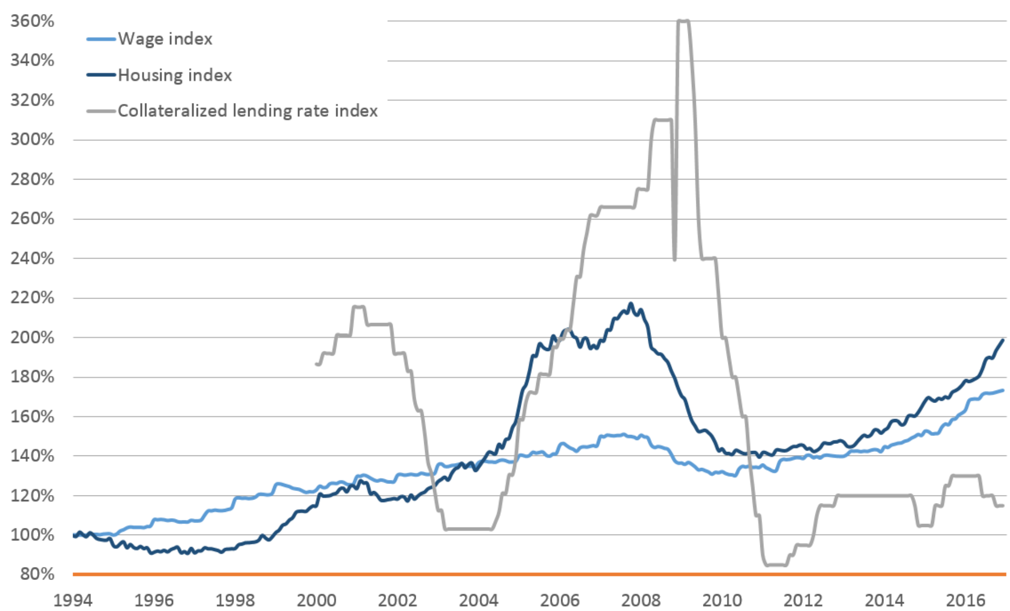


Typically wages and housing prices are correlated to the CPI in the medium and long term. Therefore, payment difficulties and LTV-deficiencies for a CPI-linked mortgage are often demonstrated to be temporary. This relationship was stressed following the financial crisis which began in October 2008. Figure 4.28 shows the development of the official wage and housing indices, in real terms. The figure demonstrates the approx. 35% average drop in housing prices and approx. 15% average drop in salaries – in real terms – during the recession of 2009-2010. The loss of home equity and purchasing power explains the loss in mortgage portfolio quality during the period.

Figure 4.28 also shows the development of the Central Bank's key interest rate (not CPI-linked) for collateralized lending (indexed to the 5% believed to be prevailing in 1994). Periods with sharp increases in the key rate are evident.

The loss of home equity and purchasing power during the recession of 2009-2010 explains the loss in mortgage portfolio quality during the period

Figure 4.28 Development of wages, housing prices and interest rates



A significant portion of the Bank's CPI-linked mortgages has a fixed interest rate for up to 40 years and is match funded with covered bonds which have a pre-payment option.

5 MARKET RISK

5.1 MARKET RISK POLICY
5.2 MARKET RISK MANAGEMENT
5.3 MARKET RISK MEASUREMENT
5.4 FOREIGN EXCHANGE RISK
5.5 INDEXATION RISK
5.6 EQUITY RISK IN THE BANKING BOOK
5.7 INTEREST RATE RISK IN THE BANKING BOOK
5.8 TRADING BOOK

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. The Bank aims to limit market exposure and imbalances between assets and liabilities in accordance with its strategic goals for net profit.

5.2 MARKET RISK MANAGEMENT

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, that are actively managed on a daily basis. The limit framework for the trading book is explicit and is monitored daily, while 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.

Table 5.1 Sources of market risk

Origin	Source	Risk Management
Trading Book	Positions held for Market Watch and Proprietary Trading purposes. Trading derivatives and respective hedge positions managed within Treasury and Capital Markets.	Explicit limits and rules for positions and hedging requirements. Daily monitoring.
Banking Book	Balance sheet imbalances and direct positions managed by Treasury. Equity positions held at the office of the CEO.	Board of Directors' risk appetite and strategic management of ALCO and UIC. Monthly monitoring.

Risk Management's Balance Sheet Risk department is responsible for measuring and monitoring market risk exposure and compliance with the limits framework. The department takes proactive steps towards market risk management, which involves reviewing exposures and potential shortfalls and analyzing scenarios and stress tests with the relevant business units. 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.

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 5.2.

Table 5.2 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.
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 movements.

5.4 FOREIGN EXCHANGE RISK

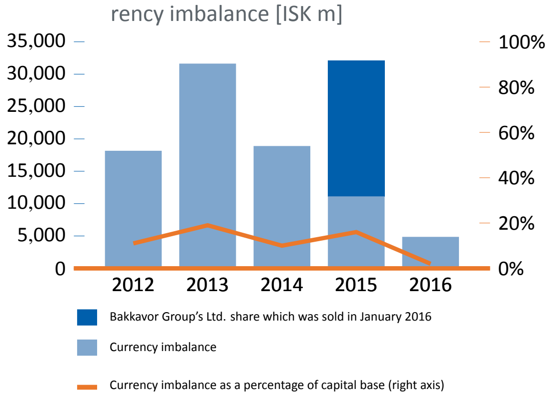
Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to the currency imbalance between assets and liabilities where foreign exchange denominated assets are a greater part of the Bank's balance sheet than that of liabilities. As of the end of 2016 the Bank has an effective net position in foreign currency of ISK 4,863 million so that a 10% depreciation of the Icelandic krona, for example, would result in a profit of ISK 486 million for the Bank. The opposite would be true for a 10% appreciation of the Icelandic krona.

The parent company's currency imbalance of ISK -3,971 million has been relatively stable and is within the limit set by the Central Bank of Iceland. The consolidated currency imbalance has been significantly reduced over the last years, looking past the retroactive valuation adjustment of the Bank's position in Bakkavor Group Ltd. which resulted in an imbalance of ISK 32,119 at year-end 2015.

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 shows the net position of assets and liabilities by foreign currency at the end of 2016. Table 5.4 shows the Value-at-Risk for the net currency positions.

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 Net position of assets and liabilities by currency

Foreign currency [ISK m]	Net Exposure
EUR	791
USD	619
GBP	520
DKK	3,478
NOK	(295)
Other	(250)
Total net position	**4,863**

Table 5.4 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	16
USD	25
GBP	21
DKK	70
NOK	12
Other	15
Diversification	(66)
Total Value-at-Risk	**93**

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 unforeseen developments in connection to the removal of capital controls. The Bank uses stressed VaR to assess future currency risk.

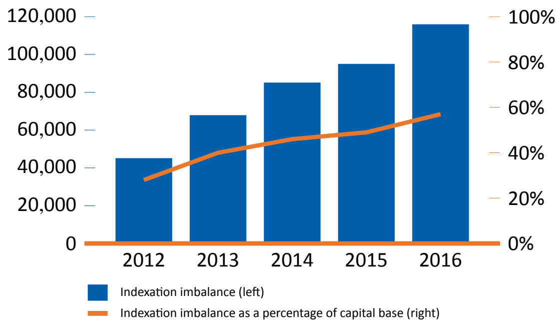
5.5 INDEXATION RISK

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 2016, the total amount of CPI-linked assets amounted to ISK 343,687 million and the total amount of CPI-linked liabilities amounted to ISK 227,727 million. Therefore, the net CPI-linked imbalance was ISK 115,960 million, which means that deflation would result in a loss for the Bank. The indexation imbalance has increased in 2016 by ISK 20,943 million primarily due to an increase in the Bank's inflation-linked loans to customers.

The Bank strives to keep its indexation imbalance stable. The Bank views the imbalance as an important hedge against loss to 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 55% of equity, a stable economic environment with low inflation is ideal for the Bank.

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



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 5.3 Twelve month inflation in Iceland.

5.6 EQUITY RISK IN THE BANKING BOOK

Exposure limits for the banking book are set in the Bank's risk appetite statement. The Bank has had a disposal schedule for non-core assets which the Bank acquired during the process of restructuring companies following the financial crisis of 2008. As a result the Bank's equity exposures has been reduced significantly in the past years, following successful disposals and IPOs. The total equity position was reduced significantly in 2016, mainly due to the sale of Bakkavor Group Ltd. in January 2016 and other disposals such as the sale of shares in Valitor Europe Ltd. and Skeljungur hf.

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 23 in the Consolidated Financial Statements of Arion Bank for 2016.

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

Table 5.5 Equity exposure in the banking book

31 December 2016 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core	-	339	339
Equity instruments with variable income	8,931	7,899	16,830
Fund shares - Bonds	194	4,028	4,222
Fund shares - Other	-	3,034	3,034
Total equity exposure in the banking book	**9,125**	**15,301**	**24,426**
Realized gain/loss in 2016			1,666
Unrealized gain/loss in 2016			3,089
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	354	4,080	4,434
Fund shares - Other	-	1,312	1,312
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 operations are subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods

The Bank's strategy for managing interest rate risk is to strive for an interest rate balance between assets and liabilities. Table 5.6 shows the Bank's interest-bearing assets and liabilities by interest-fixing period at the end of 2016. Assets and liabilities with zero duration, such as overdrafts and general deposit accounts, are included in the 0-1M time bucket. The interest-fixing period is not to be confused with the maturity of assets and liabilities.

Table 5.6 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	80,186	-	-	-	-	-	-	-	80,186	80,186
Loans to credit institutions	80,116	-	-	-	-	-	-	-	80,116	80,116
Loans to customers	302,282	112,466	33,741	139,732	4,469	24,341	100,515	-	717,546	712,422
Bonds	38,910	6,208	632	11,364	9,779	749	1,923	-	69,565	69,565
Derivatives and hedging securities*	-	-	-	-	-	-	-	20,856	20,856	20,856
Total interest bearing-assets	**501,494**	**118,674**	**34,373**	**151,096**	**14,248**	**25,090**	**102,438**	**20,856**	**968,269**	**963,145**
Non-interest-bearing assets	-	-	-	-	-	-	-	72,879	72,879	72,879
Total	**501,494**	**118,674**	**34,373**	**151,096**	**14,248**	**25,090**	**102,438**	**93,736**	**1,041,149**	**1,036,024**

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	7,961	-	25	-	-	-	-	-	7,987	7,987
Deposits from customers	290,199	62,225	4,064	12,450	42,310	816	-	-	412,064	412,064
Covered bonds	-	-	-	14,701	20,726	42,855	86,921	-	165,203	161,277
Other borrowings	52,311	14,840	3,093	112,952	-	-	-	-	183,196	178,199
Derivatives and hedging securities*	-	-	-	-	-	-	-	3,769	3,769	3,769
Total interest bearing-liabilities	**350,471**	**77,065**	**7,182**	**140,103**	**63,036**	**43,671**	**86,921**	**3,769**	**772,219**	**763,296**
Non-interest-bearing liabilities	-	-	-	-	-	-	-	61,345	61,345	61,345
Equity	-	-	-	-	-	-	-	211,383	211,383	211,383
Total	**350,471**	**77,065**	**7,182**	**140,103**	**63,036**	**43,671**	**86,921**	**276,497**	**1,044,947**	**1,036,024**

Derivatives and hedging securities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(34,664)	1	49,354	(280)	-	-	2,676	17,087

Total [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	116,359	41,610	76,545	10,713	(48,788)	(18,581)	18,193	196,051

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

Interest rate risk on the banking book has decreased in 2016 due to strategic risk mitigation which includes hedging derivatives and issuance of fixed rate covered bonds. The Icelandic government mortgage relief program mainly affected fixed rate mortgages and thus resulted in lower interest rate risk for the Bank. The Bank has also shifted its focus in lending on shorter term fixing periods.

Table 5.7 shows the fair value sensitivity 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. The calculations are based on contractual interest fixing periods, not taking into account the expected behavior of non-maturing deposits. Note that the Bank's book value is not affected in the same way as the fair value.

Table 5.7 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book

31 December 2016 [ISK m]	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	Total
ISK, non-indexed	(77)	(858)	900	(3)	(469)	(508)
ISK, CPI-indexed	31	(1,725)	(67)	2,224	(525)	(63)
EUR	(68)	(42)	(29)	(10)	-	(147)
GBP	(0)	-	-	-	-	(0)
CHF	6	-	-	-	-	6
USD	121	-	(271)	-	-	(150)
JPY	(3)	-	-	-	-	(3)
Other	9	(9)	-	-	-	(0)
31 December 2015 [ISK m]	**0-1Y**	**1-5Y**	**5-10Y**	**10-20Y**	**>20Y**	**Total**
ISK, non-indexed	(132)	(887)	327	(3)	(20)	(715)
ISK, CPI-indexed	105	(2,236)	218	1,773	(1,096)	(1,235)
EUR	34	(179)	(33)	0	0	(178)
GBP	(21)	-	-	-	-	(21)
CHF	(5)	-	-	-	-	(5)
USD	(46)	(16)	(355)	-	-	(417)
JPY	(1)	-	-	-	-	(1)
Other	(48)	-	-	-	-	(48)

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 5.8 shows the loss in fair value in the banking book due to the aforementioned shock at the end of 2016. The shock movements for the krona rates reflect their respective historical volatilities.

Table 5.8 Loss in fair value in banking book due to interest rate shock movements

31 December 2016 [ISK m]	Shift (bps)	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	All periods
ISK, non-indexed	400	(300)	(3,226)	3,266	(8)	(854)	(1,122)
ISK, CPI-indexed	200	61	(3,390)	(132)	4,118	(1,019)	(363)
EUR	200	(157)	(83)	(56)	(17)	-	(312)
GBP	200	(1)	-	-	-	-	(1)
CHF	200	12	-	-	-	-	12
USD	200	237	-	(526)	-	-	(289)
JPY	200	(5)	-	-	-	-	(5)
Other	200	18	(18)	-	-	-	(0)
All currencies total		**(136)**	**(6,716)**	**2,552**	**4,093**	**(1,874)**	**(2,081)**

[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 ISK interest rate risk and indexation risk are calculated through simulations of ISK and NEY yield curve movements 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. For foreign currencies, the Bank applies a 200bps shock interest rate hike.

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]	2016	2015
Bonds	5,277	1,196
Equity	2,948	2,138
Total	**8,225**	**3,335**

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 2016 average and maximum exposure in both equity and bonds.

Table 5.10 The Bank's proprietary trading exposure

	Bonds		
31 December 2016 [ISK m]	Long	Short	Net
Year-end	5,277	-	5,277
Average	4,623	(706)	3,917
Maximum	7,429	(2,823)	7,060

	Equity		
31 December 2016 [ISK m]	Long	Short	Net
Year-end	2,948	-	2,948
Average	3,282	(25)	3,258
Maximum	5,390	(170)	5,390

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 on the trading book

31 December 2016 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	106	67	236	(169)	13,341	Market risk
Interest rate and exchange rate agreements	54	1,113	677	436	32,907	Market risk
Bond swap agreements	18	1	8	(7)	2,995	Credit risk
Share swap agreements	183	597	457	140	8,138	Credit risk
Options	9	7	26	(19)	1,218	Market risk
Total	**370**	**1,785**	**1,404**	**381**		

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	3,811	Credit risk
Share swap agreements	312	178	1,934	(1,756)	13,099	Credit risk
Options	21	1	34	(33)	1,247	Market risk
Total	**472**	**707**	**2,337**	**(1,630)**		

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 4.10.

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 2016. 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	8,084	2.2	(1.8)
ISK, non-indexed	10,992	1.0	(1.1)
FX	37,399	(0.5)	2.0
Total	**56,474**	**0.2**	**(0.9)**

Short positions [ISK m]	MV	Duration	BPV
ISK, CPI-indexed	518	4.7	(0.2)
ISK, non-indexed	15,680	0.3	(0.4)
FX	29,847	(0.8)	2.4
Total	**46,046**	**(0.4)**	**1.8**

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 2016, 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 addressed in the Bank's VaR calculations for currency risk which covers both the banking book and the trading book.

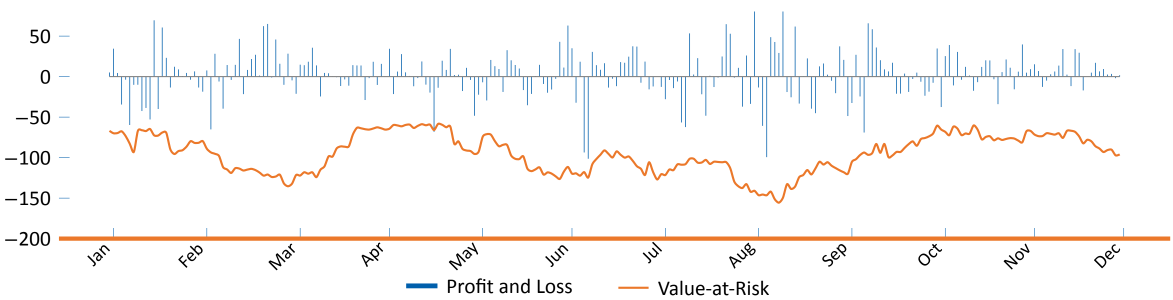
Table 5.13 Value-at-Risk for the trading book with a 99 percent confidence level over a 1 day and 1 year horizon

31 December 2016 [ISK m]	10 day 99%VaR
Equities	306
Equity Options	129
Bonds	257
Interest Rate Swaps	87
Diversification effects	(475)
Trading Book Total	**304**

The result shows that there is 1% likelihood of a loss in the trading book exceeding ISK 304 million over a 10 day period.

Figure 5.4 further shows the daily profit and loss of the Bank's trading book for 2016 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss exceeds the VaR once during the 250 business days, less than the 2.5 times expected by the risk measure.

Figure 5.4 Backtesting of the Bank's one-day 99 percent Value-at-Risk for 2016 [ISK m]



6 **LIQUIDITY** RISK

6.1 LIQUIDITY RISK AND FUNDING POLICY
6.2 LIQUIDITY RISK MANAGEMENT
6.3 LIQUIDITY AND FUNDING RISK MEASUREMENT
6.4 LIQUIDITY POSITION
6.5 FUNDING
6.6 INTERNAL LIQUIDITY ADEQUACY ASSESSMENT PROCESS
6.7 CONTINGENCY PLAN FOR LIQUIDITY SHORTAGE

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. Treasury provides all divisions with funds for their activities against a charge of internal interest.

The Bank's Asset and Liability Committee (ALCO) is responsible for liquidity management conforming to the risk appetite set by the Board. The committee meets monthly to review liquidity reports and make strategic decisions on liquidity and funding matters.

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 at each ALCO meeting liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, stress tests and any relevant information or risk management concern regarding liquidity and funding risk. ALCO maintains and reviews the Bank's liquidity contingency level on a regular basis.

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.

The Bank's liquidity buffer amounts to ISK 182,712 million, or 18% of total assets and 44% of total deposits

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

6.4 LIQUIDITY POSITION

The Bank's liquidity buffer amounts to ISK 182,712 million, or 18% of total assets and 44% of total deposits. The Bank's ISK 30 billion liquidity facility with the Icelandic government expired at the end of 2016 and is not included in the figure. Composition of the Bank's liquid assets is shown in table 6.1.

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

31. December 2016	ISK	USD	EUR	Other	Total
Cash and Central Bank deposits	85,053	627	775	1,179	87,634
Short term deposits with other banks	1,688	16,018	14,090	21,671	53,467
Domestic bonds eligible as collateral at the Central Bank	27,718	-	-	-	27,718
Foreign government bonds	-	5,536	4,908	-	10,444
Covered bonds with a minimum rating of AA-	-	-	1,202	2,247	3,449
Total liquidity reserve	**114,459**	**22,181**	**20,975**	**25,097**	**182,712**

At year-end 2016, the Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 171% and 263% for total and foreign currency balances respectively. Under the liquidity rules issued by the Central Bank of Iceland, financial institutions are required to maintain a LCR above 100% from 1 January 2017, for both total LCR and LCR in foreign currencies.

At year end 2016, Arion Bank's strong liquidity position was reflected in high LCR values, namely 171% and 263% for total and foreign currency balances respectively

Table 6.2 Liquidity Coverage Ratio

31 December 2016	FX	Total
Liquidity Coverage Ratio	263%	171%
LCR Central Bank requirements (2016)	100%	90%
LCR Central Bank requirements (2017)	100%	100%

It is evident, since the Central Bank of Iceland (CBI) 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. In early 2016, a number of entities in winding-up were given an exemption from capital control constraints after meeting the necessary stability conditions issued by the Icelandic authorities in 2015. As a result, a number of volatile depositors withdrew their funds and Kaupthing replaced all of its foreign exchange denominated deposits with a 7-year maturity USD bond. This significantly reduced FX deposits at the Bank and as a result the liquidity risk in relation to the release of capital controls is deemed minimal.

The Bank actively monitors its liquidity reserve and its 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 outflows, inflows and assets.

Under the LCR stressed scenario the Bank's weighted assets and inflows amount to ISK 186,367 million, substantially exceeding the stressed outflow of ISK 133,472 million. Of the total stressed outflow, ISK 110,470 million are due to deposits which are further analyzed in the section on deposit categories on page 84 .

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

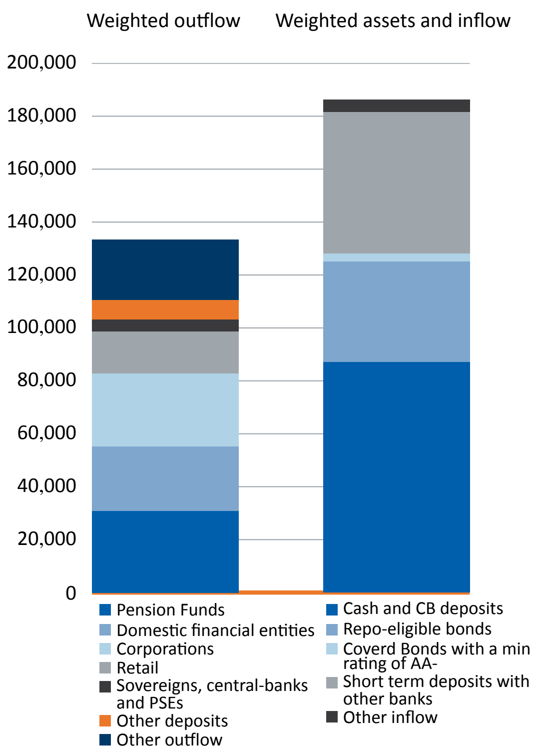


Table 6.3 Breakdown of LCR

31 December 2016 [ISK m]	FX	Total
Inflow from deposits at credit institutions	51,779	53,467
Other inflow	1,011	4,854
Total inflow *	**52,790**	**58,321**
Deposit outflow	16,885	110,469
Other outflow	7,384	23,003
Total outflow	**24,269**	**133,471**
Net outflow	**6,067***	**75,150***
Cash on hand and Central Bank deposits	2,581	85,052
Government bonds and other repo-eligible bonds	10,445	40,744
Total level 1 assets**	**13,026**	**125,796**
Total level 2 assets**	**2,932**	**2,932**
Total high quality liquid assets	**15,958**	**128,728**
Liquidity Coverage Ratio	263%	171%

*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 6.3 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 with the base being visualized in figure 6.2 .

Figure 6.2 Distribution of deposits by LCR categories at year end 2016

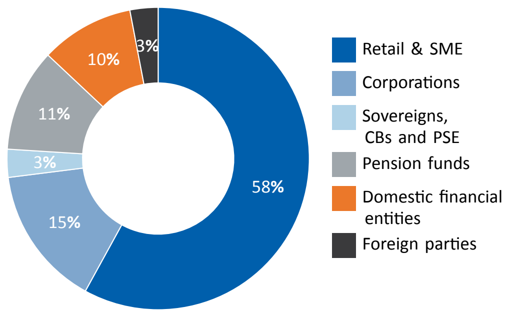


Table 6.4 Distribution of deposits by LCR categories. The expected stressed outflow weight is shown for each category

31 December 2016 [ISK m]	Deposits maturing within 30 days					
Category	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total
Retail	97,232	10%	40,376	5%	59,344	196,952
SME	39,823	10%	3,955	5%	3,762	47,540
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central-banks and PSE	11,653	40%	-	-	1,379	13,032
Pension funds	31,157	100%	-	-	15,959	47,116
Domestic financial entities	24,310	100%	-	-	16,730	41,040
Foreign financial entities	2,150	100%	-	-	-	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	**265,885**		**48,528**		**105,312**	**419,725**

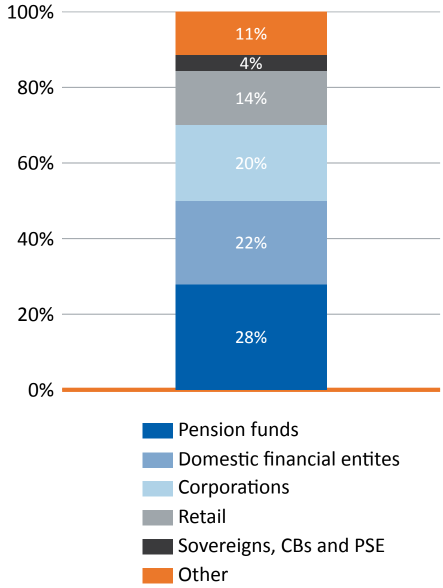
* As per the LCR methodology, no outflow is assumed from deposits with maturity longer than 30 days.

Table 6.5 Distribution of deposits by LCR categories

Category	2016	2015
Retail	46.9%	37.4%
SME	11.3%	9.6%
Operational relationship	0.0%	0.0%
Corporations	14.7%	8.8%
Sovereigns, central-banks and PSE	3.1%	2.8%
Financial entities being wound up	0.0%	13.4%
Pension funds	11.2%	16.0%
Domestic financial entities	9.8%	9.1%
Foreign financial entities	0.5%	1.1%
Other foreign parties	2.4%	1.9%
Total	**100%**	**100%**

At year-end 2016, there are no deposits from entities in winding-up process, mainly due to their withdrawal of funds, but also due to a re-classification of these entities following their composition agreements. The proportion of deposits from individuals and small and medium enterprises has increased from 47.0% to 58.2%. The Bank has placed emphasis on increasing its retail deposit base.

Figure 6.3 Source of impact on LCR outflow from deposits categories



6.4.3 CONCENTRATION OF DEPOSITS

As seen in figure 6.4, 75% of the Bank's deposits mature within 30 days. The concentration within the deposit base has steadily decreased since 2013. At the end of 2016, 16% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors, same as in 2015, whereas the proportion of the next ninety largest depositors is considerably lower at 15% compared to 23% at year end 2015.

Figure 6.4 Deposit term distribution

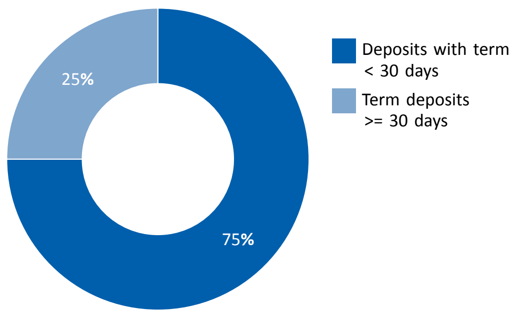
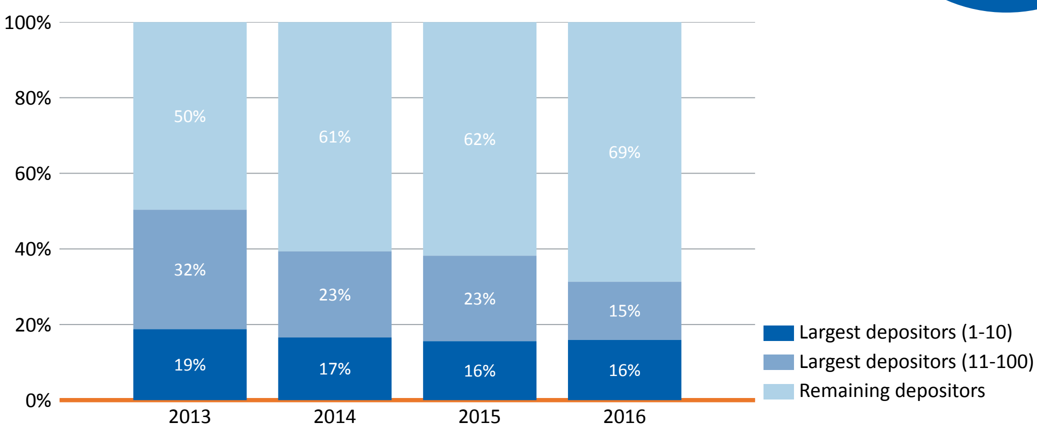


Figure 6.5 Concentration of deposits on demand within 30 days



6.5 FUNDING

The Bank has continued to diversify its funding profile. In January 2016 the Bank reached an agreement with Kaupþing ehf. which involved the Bank issuing a USD 747 million bond under the EMTN programme, which matures in 2023, with a pre-payment option during the first 2 years. The bond is held by Kaupþing and replaced Kaupthing's FX denominated deposits and the FX denominated secured loan from the

At the end of 2015, 39% of the Bank's deposits maturing within 30 days belonged to the 100 largest depositors. At the end of 2016 this ratio had gone down to 31%

Central Bank of Iceland. This bond issuance was an important part of the stability agreement between Kaupthing and the Icelandic authorities in relation to the lifting the capital controls.

In January 2016 S&P changed the Bank's outlook from stable to positive citing positive developments in the Icelandic economy and the recent steps being taken in preparation to the lifting of the capital controls.

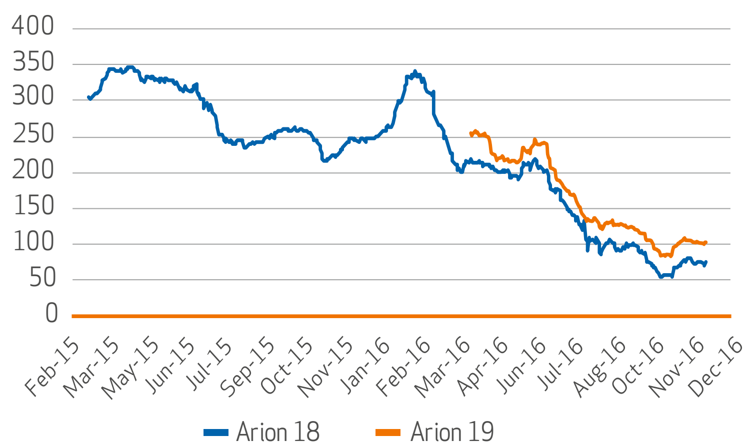
In March 2016 the Bank issued a SEK 275 million bond and in the following month a EUR 300 million bond, both under the EMTN programme. Three-quarters of the amount of the EUR issue were then used to prepay the USD bond issued to Kaupthing in January, as obliged under the terms of that issuance.

In September the Bank paid up the remainder of a Tier 2 subordinated loan from the Icelandic Government, having already prepaid two-thirds in 2015. Prepayment of this loan was a part of the Bank's strategy to lower its funding cost.

In October the capital controls were eased substantially. Shortly thereafter, S&P upgraded the Bank's credit rating to BBB from BBB-, with positive outlook, citing reduced uncertainty and improving conditions for Iceland's Banking sector. At year-end, the ratings of the Icelandic sovereign were A3, BBB+, BBB+ according to Moody's, S&P and Fitch, respectively, with stable outlook for all ratings. In January 2017, S&P and Fitch updated their ratings to A- with stable outlook and BBB+ with positive outlook, respectively.

In October 2016, the international credit ratings agency Standard & Poor's (S&P) upgraded Arion Bank's rating to BBB, with positive outlook

Figure 6.6 Development of the market spread for the Bank's EUR bond issue [Basis points]



In November the Bank issued another EUR 300 million bond under the EMTN programme. As with the previous issue, three-quarters of the amount were used to prepay the USD bond held by Kaupthing. As a result, two-thirds of the USD bond had been prepaid at year-end 2016. The bank tapped the bond issue for additional EUR 200 million in January 2017, taking the total outstanding size to EUR 500 million.

The Bank also issued some privately placed bonds under the EMTN programme in 2016: In January it issued a RON 35 million bond, in April it issued a USD 30 million bond and in October it issued both a SEK 250 million bond and a NOK 220 million bond.

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 24.8 billion of covered bonds in 2016 in the domestic market, of which ISK 11.7 billion were inflation-linked bonds and ISK 13.1

billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis in the domestic market in 2017.

The development of the Bank's total funding by type is shown in Table 6.6. Table 6.7 shows the Bank's borrowings as at 31 December 2016.

Table 6.6 Breakdown of funding by type

31 December	2016	2015	2014	2013	2012
Due to credit institutions and Central Bank	0.8%	1.1%	2.4%	3.0%	3.7%
Customer deposits	39.8%	46.4%	48.7%	50.3%	49.8%
Borrowings	32.8%	25.3%	21.5%	21.8%	21.7%
Subordinated loans	0%	1.0%	3.4%	3.4%	3.8%
Financial liabilities	0.4%	0.8%	1.0%	1.0%	1.5%
Tax liabilities	0.7%	0.5%	0.5%	0.5%	0.4%
Other liabilities	5.2%	4.9%	5.1%	4.7%	4.7%
Equity	20.4%	20.0%	17.4%	15.4%	14.5%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

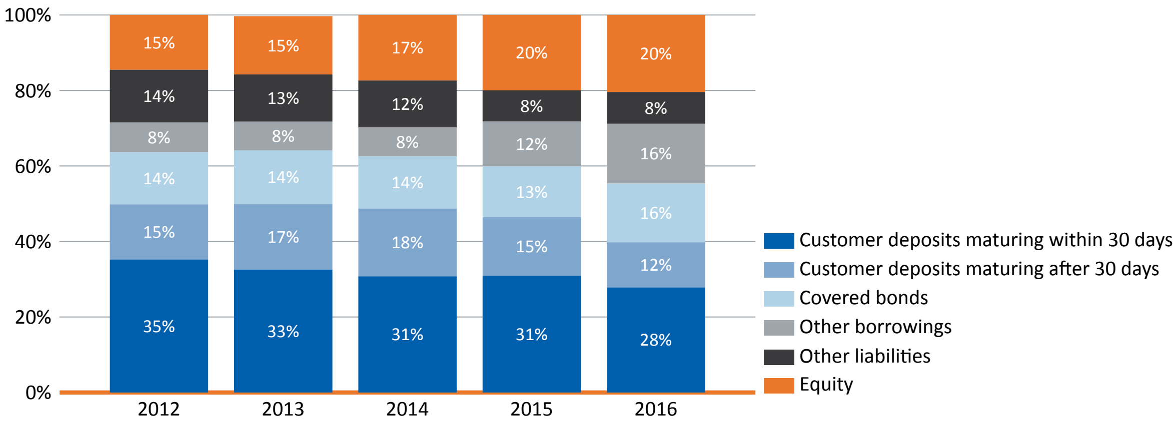
Table 6.7 List of borrowings

31 December 2016	Issued	Maturity	Maturity type	Currency	Terms of interest	Amount
Covered bonds	2013	2019	At maturity	ISK	Fixed CPI linked, 2.5%	4,502
Covered bonds	2016	2019	At maturity	ISK	Fixed, 5.5%	580
Covered bonds	2014	2021	At maturity	ISK	Fixed CPI linked, 3.5%	9,696
Covered bonds	2015	2022	At maturity	ISK	Fixed, 6.5%	19,596
Covered bonds	2014	2029	At maturity	ISK	Fixed CPI linked, 3.5%	23,524
Covered bonds	2006	2033	Amortizing	ISK	Fixed CPI linked, 3.75%	16,734
Covered bonds	2012	2034	Amortizing	ISK	Fixed CPI linked, 3.6%	2,207
Covered bonds	2008	2045	Amortizing	ISK	Fixed CPI linked, 4.0%	6,199
Covered bonds	2006	2048	Amortizing	ISK	Fixed CPI linked, 3.75%	78,239
Senior unsecured bond	2016	2017	At maturity	USD	Floating, 3 month LIBOR +1.93%	3,406
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1%	662
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1%	1,063
Senior unsecured bond	2015	2018	At maturity	EUR	Fixed, 3.125%	36,610
Senior unsecured bond	2016	2019	At maturity	SEK	Floating, 3 month STIBOR + 1.09%	3,113
Senior unsecured bond	2016	2019	At maturity	EUR	Fixed, 2.5%	36,307
Senior unsecured bond	2016	2019	At maturity	RON	Fixed, 3.8%	951
Senior unsecured bond	2016	2019	At maturity	SEK	Floating, 3 month STIBOR + 2.65%	3,422
Senior unsecured bond	2015	2020	At maturity	NOK	Floating, NIBOR + 2.95%	10,617
Senior unsecured bond	2016	2020	At maturity	NOK	Floating, NIBOR +1.95%	2,902
Senior unsecured bond	2016	2021	At maturity	EUR	Fixed, 1.625%	35,639
Senior unsecured bond*	2016	2023	At maturity	USD	Floating, USD 3 month LIBOR + 2.6%	29,317
Bills issued						13,854
Other						336
Total borrowings						**339,476**

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

Figure 6.7 shows the development of the Bank's funding profile. The replacement of Kaupthing's FX deposits has altered the funding distribution, with the share of the deposit base of the Bank's total funding decreasing from 50% to 40%.

Figure 6.7 Development of funding by type



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

At the end of 2012 deposits maturing within 30 days accounted for 35% of the Bank's funding compared to 28% at the end of 2016

Table 6.8 Breakdown of assets by contractual maturity

Assets 31 December	2016	2015	2014	2013	2012
On demand	15.1%	9.4%	9.0%	9.0%	13.0%
Up to 3 months	8.3%	8.3%	11.8%	12.5%	7.5%
3 - 12 months	9.0%	11.2%	10.7%	11.6%	11.4%
1 - 5 years	29.6%	28.6%	30.5%	27.9%	30.9%
Over 5 years	31.6%	31.7%	29.3%	29.2%	28.6%
With no maturity	6.3%	10.6%	8.7%	9.8%	8.6%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Table 6.9 Breakdown of liabilities by contractual maturity

Liabilities 31 December	2016	2015	2014	2013	2012
On demand	38.5%	36.5%	36.1%	33.3%	36.6%
Up to 3 months	11.4%	15.2%	18.2%	21.5%	22.3%
3 - 12 months	7.5%	12.9%	10.7%	11.5%	6.8%
1 - 5 years	20.5%	11.5%	9.5%	6.7%	8.0%
Over 5 years	19.9%	22.6%	24.5%	26.1%	25.4%
With no maturity	2.2%	1.1%	1.1%	0.9%	0.9%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base continues to be an important funding source and the focal point of liquidity risk management. The ratio of loans to deposits was 173% as at 31 December 2016. The development of the loans to deposits ratio is shown in Table 6.10. The increase in 2016 is primarily the result of deposit withdrawals from entities in winding-up, including the aforementioned agreement with Kaupthing, and, to a lesser extent, a growth and valuation adjustment in the loan portfolio.

The covered bonds are also an important funding source and its payment profile is largely matched by the corresponding pledged mortgages, see Figure 6.8. Other liabilities are mostly foreign currency denominated with the next significant redemption in 2018 as seen in Figure 6.9. As the Bank's foreign currency deposits are 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 23% to 21% in the year 2016, mainly due to the prepayment of the secured loan from the Central Bank of Iceland.

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

31 December	2016	2015	2014	2013
Loans to deposits ratio	173%	145%	142%	135%
Asset encumbrance ratio	21%	23%	27%	30%

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 90% until the end of year 2016 and 100% from 1 January 2017. The Bank's NSFR in foreign currencies is at 191% at year-end 2016 while the total NSFR is 124%.

The Bank's NSFR in foreign currencies is at 191% at year-end 2016 while the total NSFR is 124%

Table 6.11 Net Stable Funding Ratio

31 December 2016	FX	Total
Net Stable Funding Ratio	191%	124%
NSFR Central Bank requirements	90%	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 2016 [ISK m]	FX	Total
Equity and Tier II	-	197,752
Secured Financing	-	159,917
Unsecured Financing	152,054	154,637
Retail / SME deposits	7,712	224,973
Other deposits	10,054	45,489
Other liabilities	1	18
Available stable funding	**169,821**	**782,784**
Liquid assets	859	10,355
Loans to customers, performing	76,125	528,869
Securities	9,000	39,511
Other assets	445	50,658
Off-balance sheet	580	2,471
Required stable funding	**87,010**	**631,864**
Balance	**(2,526)**	-
Net stable funding ratio	191%	124%

Figure 6.8 Maturity profile of covered bonds and corresponding pledged mortgages [ISK m]

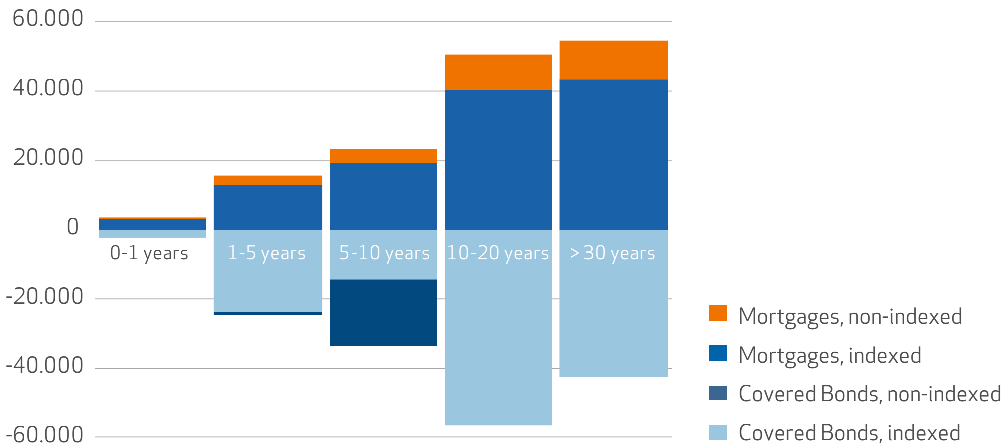
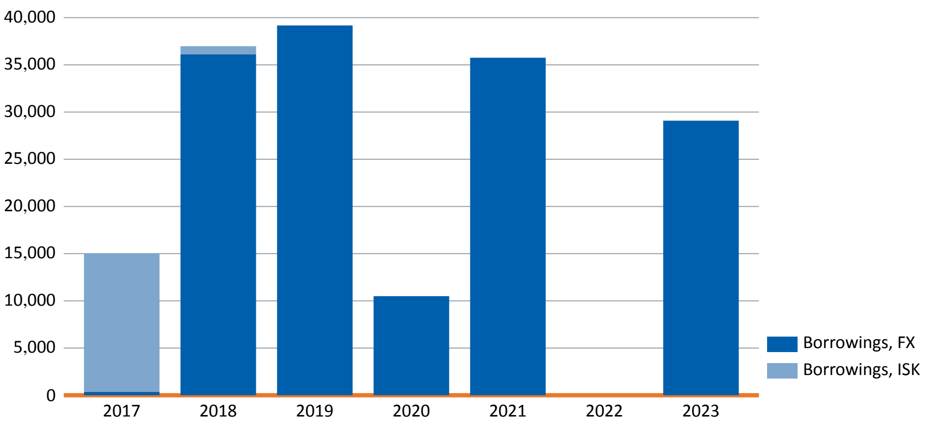


Figure 6.9 Maturity profile of borrowings, other than covered bonds [ISK m]



6.6 INTERNAL LIQUIDITY ADEQUACY ASSESSMENT PROCESS

In conjunction with the ICAAP, see Section 3.3, the Bank runs the Internal Liquidity Adequacy Assessment Process (ILAAP) with the purpose of assessing the Bank's liquidity position. The ILAAP is carried out in accordance with the Act on Financial Undertakings 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 liquidity risk.

The Bank's ILAAP 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 ILAAP report in the following its supervisory and review process (SREP).

6.7 CONTINGENCY PLAN FOR LIQUIDITY SHORTAGE

The Bank monitors its liquidity position and funding strategies on an ongoing 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. Although it is unlikely that a funding crisis of any significant degree could materialize, it is important to evaluate this risk and formulate contingency plans should one occur.

LIQUIDITY RISK

The Bank's Contingency Plan for Liquidity Shortage is constantly active and the contingency level is reviewed at each of the monthly ALCO meetings, based on various analysis and stress tests. ALCO reviews a report on liquidity risk from Risk Management and receives projections on sources of funding and the use of funds from Finance.

7 **OPERATIONAL** RISK

7.1 OPERATIONAL RISK POLICY
7.2 OPERATIONAL RISK MANAGEMENT
7.3 OPERATIONAL RISK MEASUREMENT

7 OPERATIONAL RISK

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

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

- IT risk is defined as the risk arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity.
- Legal risk is defined as the risk to the Bank's interests resulting from instability in the legal and regulatory environment, as well as risk arising from ambiguous contracts, laws or regulations (see also section 8.1).
- 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 III standard 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.

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

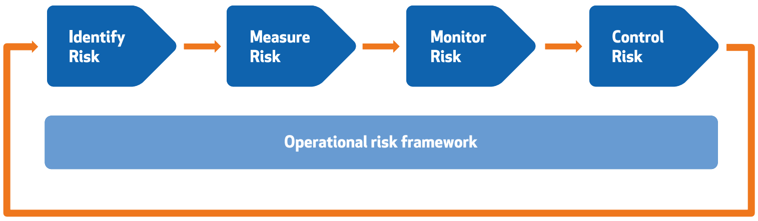
The Bank reduces its exposure to operational risk with a selection of internal controls and quality management, and well-educated and qualified staff

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.

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.

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.

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

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

7.3 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 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 so 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.

Figure 7.3 Distribution of loss events by number, parent company

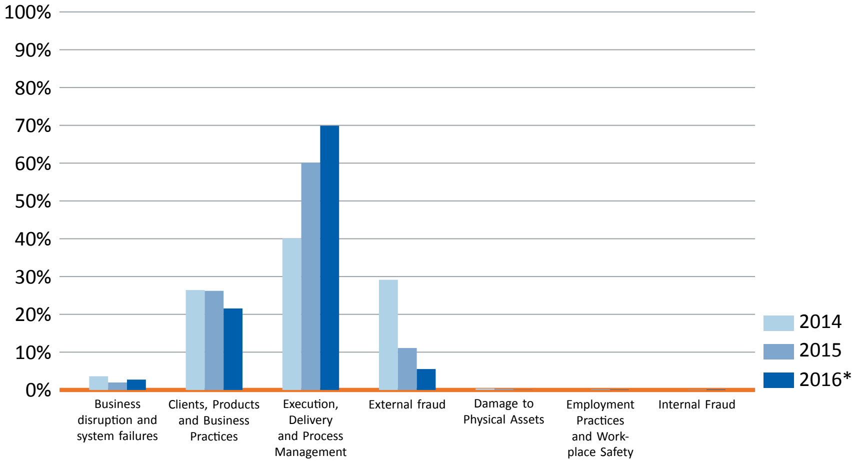
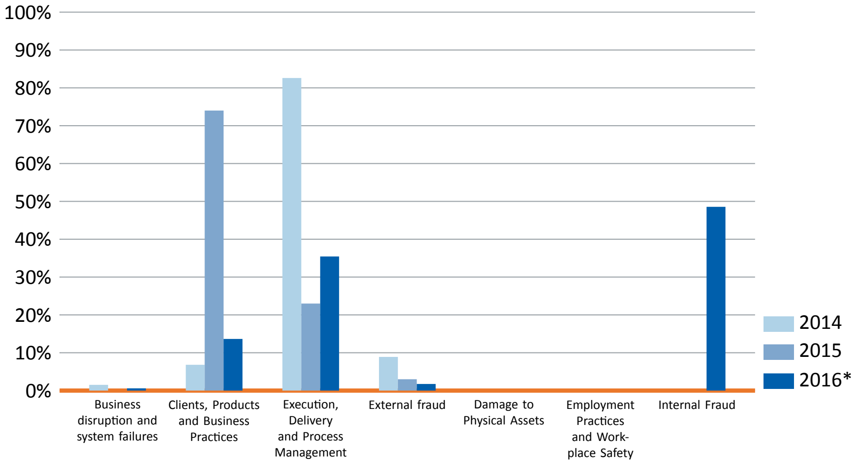


Figure 7.4 shows the distribution of reported events by amount.

Figure 7.4 Distribution of loss events by amount, parent company



* For 2016 the parent company has adopted the approach of estimating the loss of reported events when the final results are not known. Among the incidents that are subject to this change are three incidents of alleged internal fraud that were investigated in 2016. One of these incidents is alleged to have occurred in an entity that merged with the parent company in the year of 2015.

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

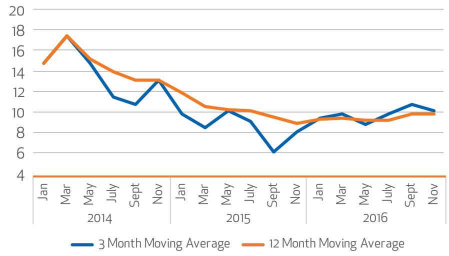
Major Incident is a significant event causing serious operational interruption in IT or an operational failure in a system classified as important. The purpose of the MI Process is to ensure firm, coordinated and controlled action in the occurrence of MI, in order to restore service as soon as possible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



8 **OTHER MATERIAL** RISK

9 **REMUNERATION**

10 **UPCOMING AND NEW** LEGISLATION

11 **ABBREVIATIONS**

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 legal risk, business risk and political risk as material risk. Other risk types are not considered material, and will not be discussed further.

8.1 LEGAL AND COMPLIANCE RISK

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. The Bank holds additional capital for legal risk under Pillar 2.

Compliance risk is defined as the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices or ethical standards. Compliance risk is present in all areas of the Bank. Compliance risk can lead to fines, damages and/or the voiding of contracts and can diminish the Bank's reputation.

In 2016, the Bank was not subject to any fines or other sanctions arising from violations or non-compliance.

Frequent changes to applicable requirements, and any ambiguous requirements, increase compliance risk. The Bank monitors upcoming changes, and has in place procedures for regulatory change management. Foreseeable changes in legislation that might affect the Bank are discussed in chapter 10. These risk factors are considered in the Bank's ICAAP.

In 2016 there were several legal matters or unresolved legal claims that were considered contingent liabilities, such as legal proceedings regarding damages. The former chairman of the board of the company BM Vallá hf. together with Lindarflöt ehf. have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf. damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes, however, that it is more likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed suit against Valitor hf. for compensatory damages relating to Valitor hf.'s cessation of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have a premise to rescind the agreement. The plaintiffs had court-appointed appraisers evaluate their alleged losses. The appraisers returned their report in March 2016. Valitor disagreed with the assessment stated in the report and filed a motion for appointing three court appraisers to re-evaluate plaintiffs' alleged losses. The district court approved the motion and they have been appointed. Conclusion is pending.

Courts cases are being prosecuted against the Bank regarding mortgage documents in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. Recently the district court, in respect of a case which did not involve the Bank, invalidated a mortgage under similar circumstances to these. The Bank is assessing the possible impact of a negative outcome on the Bank's loan portfolio.

Then there is some uncertainty regarding the book value of foreign currency loans. Some uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. Although there is much more clarity regarding FX loans, there remains some uncertainty regarding foreign currency-linked loans in certain respects, such as regarding the recalculation of particular loans and compensations on account of enforcement actions that have been made on the basis of currency-linked loans. Nevertheless, the Group considers its portfolio of foreign currency-linked loans to be fully provisioned for the most likely outcome.

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 endeavors 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 rejection of Kortaþjónustan's claims Kortaþjónustan's court-appointed evaluator has given a report on Kortaþjónustan's alleged loss. The Bank and other defendants in the case have demanded that a reassessment be carried out.

The Icelandic 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 ICA has sent the Bank a letter proposing concluding the matter with an agreement. The Bank is looking into the conditions of the proposed agreement.

In April 2013 the ICA imposed an 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 ICA. The Supreme Court ruled in April 2016 on upholding the ICA´s decision from April 2013. Valitor paid the fine in 2013.

8.2 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.

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 credit funds that are able to offer better terms for quality loans. The pension funds' expanded participation in the mortgages market for individuals is further affecting the Bank. The Bank responds by offering more versatile and tailored services, and competes on price where possible. Another threat is competition from foreign banks that mainly target strong Icelandic companies with revenues in foreign currency. The capital controls increase companies' incentives to move part or all of their business abroad although the recent easing of the controls should reduce that risk.

Another competitive factor facing the bank is the large footprint of the Icelandic State in financial services through its ownership in Landsbankinn hf., Íslandsbanki hf., The Icelandic Housing Financing Fund and the Icelandic Student Loan Fund, who together are representing the largest pool of all loans to individuals.

Arion Bank faces a business risk in the form of excessive or unbalanced taxation. Several new taxes on financial institutions were introduced to help fund the recovery of the Icelandic financial system following the crisis of 2008 and were understood to be temporary. The taxes paid by the main Icelandic banks are much higher than those paid by other companies. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion. Although the recovery of the Icelandic financial system and the Icelandic economy has, by most accounts, been successfully completed the tax environment has not changed.

Special taxes on Icelandic banks include the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion

8.3 POLITICAL RISK

Political risk is defined as the risk to the Bank's interests resulting from political changes or instability, and therefore instability in the legal and regulatory environment. In light of the economic crisis of 2008 and the political 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. The Single Rulebook of the European Union aims to provide a single set of harmonised prudential rules which institutions throughout the EU must respect. Nevertheless, 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. As the Icelandic Sate is now the majority owner of the Bank's principal domestic competitors, Landsbankinn hf. and Íslandsbanki hf., the likelihood of this event may have increased.

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. 388/2016 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 2016, see Note 11. 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 performance 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 BRIC have a role as regards the scheme. BRC reviews and monitors the scheme, before submitting it to the Board, and BRIC´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-income ratio)
- Performance of individual divisions
- Performance of individuals
- Compliance with internal and external rules

In the year 2016 the Bank made provision for variable remuneration, including salary related expense of ISK 395 million and at year end 2016 the total obligation amounted to ISK 1,453 million to be paid out over the next three years.

Boards of directors of individual subsidiaries decide on an incentive scheme for the subsidiaries. The Asset Management Company Stefnir hf. and the card and payment solution company Valitor have incentive schemes in place.

10 UPCOMING AND NEW LEGISLATION

As a financial undertaking, Arion 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 legal requirements at any given time. The following section covers recent legislative activities by Parliament, Althingi, as well as upcoming legislation signalled by the Icelandic authorities, which the Bank deems necessary to mention.

10.1 NEW LEGISLATION

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

The Act furthers the transposition of two the CRD IV Directive and the CRR-regulation. The Act brought more detailed definitions of concepts, in line with those of the CRD IV and the CRR; codified leverage ratio requirements on financial undertakings; brought further provisions on the Supervisory Review and Evaluation Process (SREP) and the Internal Capital Adequacy Assessment Process (ICAAP); made changes concerning capital requirements, in line with the CRR-regulation and the Basel III Global Regulatory Framework; introduced a legal basis for the CRR-regulation as secondary legislation in Iceland; and provided greater regulatory competences for the FME, both rule-setting competences and imposition of sanctions.

The Act came into force 21 September 2016.

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

The Act clarifies the legal status of financial assets received by the CBI from financial undertakings previously operating as commercial banks or savings banks, i.e. so called stability contributions, by authorising the Minister of Finance and Economic Affairs to put in place a Private Limited Company for the administration and satisfaction of claims and liabilities and appropriation of assets.

The Act came into force 5 April 2016.

ACT NO. 37/2016 ON THE TREATMENT OF KRÓNA-DENOMINATED ASSETS SUBJECT TO SPECIAL RESTRICTIONS

The Government has taken the next step towards liberalisation of capital controls in Iceland, addressing offshore ISK holders through auction format, as previously signalled in June 2015. In accordance with the Government´s action plan, the Act sought to address the problem created by offshore ISK. Offshore ISK assets have in recent years traded at much lower exchange rates than seen in the domestic FX market. These assets are considered a flight risk, i.e. a potential non-incremental departure via the domestic FX markets is a risk to balance of payments conditions and financial stability. Examples of these assets are deposits, funds held in custodial accounts, bonds and bills. The offshore ISK assets will continue to be subject to special restrictions and the main objective of the Act is to segregate them more clearly. In conjunction, The Central Bank of Iceland (CBI) announced, and held, a currency auction on 16 June 2016. Owners of offshore ISK were given the option of exchanging their offshore ISK assets for EUR, the remainder of which are subjected to restrictions outlined in the Act until maturity or further liberalisation of capital controls.

The Act came into force 23 May 2016.

ACT NO. 42/2016, AMENDING THE ACT ON THE TREATMENT OF KRÓNA-DENOMINATED ASSETS SUBJECT TO SPECIAL RESTRICTIONS (NO. 37/2016), ACT ON FOREIGN EXCHANGE (NO. 87/1992) AND THE ACT ON THE SPECIAL TAX ON FINANCIAL INSTITUTIONS (NO. 155/2010)

The Act was introduced before Parliament on 2 June 2016 and successfully passed the same day. Directly linked to the Government's plan to liberalise capital controls, its objective was to introduce prudential macroeconomic tools vis-à-vis so-called carry trades, allowing the CBI to regulate the inflow of capital and impact its composition, thereby reducing the risk of capital flight accompanying excessive short-term capital inflows. This is also aimed at supporting domestic economic policy and contribute to macroeconomic and financial stability.

The CBI now has rule-setting competences to stipulate reserve requirements for certain currency inflows, directly affecting incentives for carry trade and supporting effective monetary policy transmission.

Lastly, amendments to the Act on Special Tax on Financial Institutions exempt ISK denominated assets subject to special restrictions from the special financial activity tax levied on financial institutions.

The Act came into force 3 June 2016.

AMENDMENTS TO THE ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST ACT (NO. 64/2006)

Taking note from recommendations by the Financial Action Task Force (FATF) and following a mutual evaluation of the implementation of anti-money laundering and counter-terrorist financing standards in Iceland, the Act brings improvements to the regulatory framework by strengthening standards of evaluation by regulated undertakings, including increased obligations by financial undertakings to identify real holders of financial assets.

The Act came into force 5 February 2016.

AMENDMENTS TO THE ACT ON MANDATORY PENSION INSURANCE AND ON THE ACTIVITIES OF PENSION FUNDS (NO. 127/1997)

The Act gives pension funds extended leeway to formulate investment policy and invest in listed and unlisted securities, covered bonds and credit market securities. This entails a so-called prudent person-standard for investment of pension fund assets. Also of importance, the Act obliges pension funds to maintain a risk management function, with documented internal processes, and which must partake in all significant investment decisions.

The Act enters into force 1 July 2017.

UPCOMING AND NEW LEGISLATION

AMENDMENTS TO TAX CODE (NO. 90/2003) AND MORE

The aim of the Act is to limit the use of offshore low-taxed entities. The changes prohibit parent company deductions of operational costs of such entities and limits cross-border mergers and acquisitions.

The so-called CFC-provision of the Tax Code, dealing with taxation of those residing in low-tax countries, is also clarified with greater obligations of disclosure. The Act lastly codifies both the concept of "permanent establishment", addressing strategies used to avoid a taxable presence in a country under tax treaties, and a so-called country-by-country-annual reporting for each tax jurisdiction where multinational groups operate. Supplementary amendments are made to other relevant legal acts.

The Act came partly into force on 25 October 2016. However, certain provisions apply to conduct prior to the Act's entry, should the relevant limitation period not have commenced. Furthermore, specific provisions either entered into force 1 January 2017 or become applicable for public levying purposes in 2018 for the operating year 2017.

THE CONSUMER MORTGAGE ACT NO. 118/2016

Mainly through Iceland's obligations via the EEA-Agreement, the Act transposes into Icelandic law the so-called Mortgage Credit Directive 2014/17/EU, promoting responsible mortgage lending practices with enhanced consumer protection when mortgage lenders promote, counsel and grant residential mortgages to consumers.

The Act stipulates general requirements for appropriate and up-to-date levels of staff knowledge and competence, principles for remuneration policies and prohibits "tying practices", i.e. credit granting preconditioned on other distinct financial products or services. The FME is given rule-setting competences on the basis of Financial Stability Council recommendations vis-à-vis maximum mortgage leverage-ratios. Lastly, the Act stipulates maximum pre-payment penalties in an effort to increase share of fixed-rate mortgages.

The Act enters into force 1 April 2017.

THE FIRST TIME HOME OWNERS ACT NO. 111/2016

Aimed at providing assistance to first time home owners, the Act allows future or present individual pension account funds to be allocated for said purpose for up to ten years, without tax implications. The Act brings changes to the Tax Code Act and the Act on Mandatory Pension Insurance and on the Activities of Pension Funds.

The Act enters into force 1 July 2017.

ACT NO. 100/2016 ON INSURANCE ACTIVITY

A new comprehensive act on Insurance Activity which implements the EEA relevant Directive 2009/138/EU on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II Directive) and the amending Directive 2014/51/ESB (Omnibus II).

The Act strengthens legal protection for policy holders, increases solvency and governance requirements, and stipulates clearer winding-up proceedings for insurance undertakings.

The Act came into force on 1 October 2016, whereas insurance undertakings in winding up proceedings are still under the scope of the repealed Insurance Activity Act (No. 56/2010).

10.2 UPCOMING LEGISLATION

10.2.1 BILLS SUBMITTED TO PARLIAMENT

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

The bill is one of the final part of the CRD IV implementation process, the amending bill concerns branch activities of financial undertakings and other financial services operating within the EEA, namely, branch operations by EEA institutions as well as activities of branches by non-EEA financial institutions in Iceland.

The bill is expected to be submitted to Parliament in spring 2017.

Another bill on Amendments to the Financial Undertakings Act are expected to be implemented early in 2017, the amending bill corresponds to provisions of Directive 2001/24/EC on the reorganisation and winding up of credit institutions and seeks to respond to a reasoned opinion by the EFTA Surveillance Authority, which found Iceland to have improperly transposed certain provisions of the Directive.

A draft bill has been published on the Ministry of Finance and Economic Affairs' website with calls for stakeholder reviews and is expected to be submitted to Parliament in spring 2017.

The third bill is to be expected to amend one of the final part of the CRD IV/CRR framework, intended to make it easier for employees of financial undertakings to report misconduct. According to the bill, employees of financial sector businesses must be able to report financial regulation violations under whistle-blower schemes in financial sector businesses. This bill is expected to make some amendments to the Act on Official Supervision of Financial Activities as well.

The bill is expected to be introduced to parliament in 2017.

BILL ON OFFICIAL SUPERVISION OF FINANCIAL ACTIVITIES ACCORDING TO THE AGREEMENT ON A EUROPEAN ECONOMIC AREA (EUROPEAN SUPERVISORY AUTHORITIES)

The bill implements a European System of Financial Supervision into the Icelandic legal framework. When, passed, substantive provisions of EU Regulation 1093/2010 establishing a European Banking Authority (EBA), Regulation 1094/2010 establishing a European Insurance and Occupational Pensions Authority (EIOPA) and Regulation 1095/2010 establishing a European Securities and Markets Authority (ESMA) will be adopted. The aim is to ensure uniform surveillance and application throughout the entire EEA.

In accordance with the two-pillar structure of the EEA Agreement, the EFTA Surveillance Authority (ESA) will have the formal power to take decisions addressed to national supervisory authorities or market operators in Norway, Iceland and Liechtenstein. Furthermore, ESA will formally be the designated supervisory authority for credit rating agencies and trade repositories established in the three countries.

The bill is expected to be introduced to parliament in 2017.

BILL ON NEW ACT ON SHORT SELLING

The bill, transposing EU Regulation No. 236/2012 on Short Selling, introduces new requirements to notify competent authorities when a short position exceeds certain limits, places restrictions on unprotected short selling and provides regulatory bodies the authority under certain conditions to temporarily ban short selling or to publicly disclose the short position of a party.

The bill represents a novelty in the Icelandic legal framework, as there are currently no general provisions on the short selling of financial instruments in Icelandic law. The aim is increased transparency of short positions held by investors and a reduction in settlement risks. Also, competent authorities will have powers to intervene in exceptional situations to reduce systemic risks and risks to financial stability and market confidence arising from short selling and credit default swaps.

The bill is expected to be submitted to Parliament in early 2017.

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 proposed bill seeks to address comments made in an EFTA Surveillance Authority reasoned opinion, whose conclusion was that an all-out ban on granting exchange rate indexed loans in ISK is inconsistent with Iceland's obligations via the EEA Agreement. The Authority did, however, acknowledge the risks associated with such lending practices and accordingly the bill is expected to include regulatory competences for the Central Bank of Iceland in line with an overall macro-prudential framework for financial stability.

The bill is expected to be submitted to Parliament in 2017.

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 via more effective procedures. The bill implements Regulation No. 648/2012/EB (EMIR) on OTC derivatives, central counterparties and trade repositories into Icelandic law.

The acronym EMIR stands for European Market Infrastructure Regulation, whereas the legislative act is grounded on an agreement made in Pittsburgh, US, in September 2009 by the leaders of the G20 countries. Amongst the changes introduces include all standardised OTC derivatives contracts to be cleared via central counterparties, the objective of which is to minimise systemic risks, as well as reporting duties to a trade repository, which is to include at least the counterparty and the underlying of the derivatives contract as well as the face value of the contract.

The impact of this will be a substantial change to current market practices. Challenges include setting-up of internal processes in relation to the compliance with the reporting and clearing obligations.

The bill is scheduled to be submitted to Parliament spring 2017.

BILL ON SECURITIES SETTLEMENT AND ON CENTRAL SECURITIES DEPOSITORIES

Regulation No. 909/2014 on improving securities settlement and on central securities depositories (CSDR) is intended to harmonise the relevant rules in this sector and to better ensure safe and efficient settlements of security transactions. Examples of further demands concern increased prudential requirements for central securities depositories and an increase in regulatory oversight.

A bill is likely to be submitted to Parliament in 2017.

UNDERTAKINGS FOR THE COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES BILL

Directive 2014/91/EU brings amendments to the regulatory framework outlined by Directive 2009/65/EB Undertakings for collective investment in transferable securities, in conjunction with higher standards vis-à-vis alternative investment funds which the AIFM Directive will introduce. The amendments focus on further clarifying the UCITS depositary's functions and improvements to provisions governing their liability, should assets be lost in custody; the introduction of rules on remuneration policies; and harmonisation of the minimum administrative sanctions that are to be available to supervisors.

A bill is likely to be submitted to Parliament in 2017.

BILL ON CREDIT RATING AGENCIES

The bill is in line with EU Regulation 1060/2009 on credit rating agencies, amended with Regulations 513/2011 and 462/2013, respectively. Substantively, these acts are to ensure a consistent quality of all issued credit ratings by Credit Rating Agencies (CRA) in the EEA, based on harmonised procedures, on order to facilitate investor protection and financial stability. Responsibility for CRA supervision will first and foremost be in the hands of the EFTA Supervisory Authority, via the aforementioned changes to the supervisory framework of financial markets in the EEA.

The bill is expected to be submitted to Parliament in 2017.

BILL ON SUPPLEMENTARY SUPERVISION OF FINANCIAL CONGLOMERATE

The bill is based on Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and Directive 2011/89/EU as regards the supplementary supervision of financial entities in a financial conglomerate. The bill will also codify FME's regulation No. 165/2014.

A draft bill has been published on the Ministry of Finance and Economic Affairs' website with calls for stakeholder reviews and is expected to be submitted to Parliament in spring 2017. At the best knowledge there is no Financial Conglomerate in Iceland today.

10.2.2 EU DIRECTIVES AND REGULATIONS – EXAMPLES OF FORESEEABLE IMPLEMENTATION

Considerable changes have taken place recently in the legal environment of financial institutions on account of changes brought by the introduction into Icelandic law of the directives of the EEA agreement. In the medium term there is also a great deal of work to be carried out concerning proposed changes to legislation applying to banking and in response the Bank is now in carrying out implementation process. Legislation to be implemented soon include e.g. MiFID II, EMIR, Short selling, MAR, BRRD, PSD II, AML IV and GDPR.

BILL ON MIFID II/MIFIR

The MiFID II Directive 2014/65/EU and the accompanying MiFIR Regulation 600/2014 represent a review and update to the Markets in Financial Instrument Directive 2004/39/EC (MiFID), passed into law in Iceland in 2007. The review seeks to increase market stability and confidence and bolster consumer protections.

The MiFID II Directive applies to all financial entities providing investment services, introducing a new trading venue for bonds, structured finance products, emissions allowances and derivatives. These organised trading facilities (OTF) aim to increase transparency and efficiency of the financial market. Financial undertakings licensed to engage in securities trading will be made to fulfil more extensive organisational and trade transparency requirements.

A bill is likely to be submitted to Parliament in 2018.

BILL ON MARKET ABUSE

A bill is expected concerning the implementation of Regulation No. 596/2014 on market abuse (MAR). The regulation entails new provisions on insiders, lists of insiders, handling of insider information, duties of notification, market abuse, etc. The MAR regulation contains more extensive provisions than the present legal framework, a broader scope and includes more financial instruments than previously.

A bill is likely to be submitted to Parliament in 2018.

BILL ON PAYMENT SERVICES

Directive 2015/2366/EU, which the bill introduces to Icelandic law, broadened the scope of the Directive on Payment Services 2007/64/EC considerably, which previously only applied to intra-EEA payments. The legal framework the Directive introduces further strengthens intra-EEA cross boarder payment activities, including payments to and from third countries, where one of the payment service providers is located in the European Economic Area, and enhances consumer protection.

A bill is likely to be submitted to Parliament in 2017 or 2018.

BILL ON THE PROTECTION OF PRIVACY

In April 2016, an agreement was reached between the relevant EU institutions on a new European legal framework for data protection, the General Data Protection Regulation 2016/679, which is scheduled to come into force on May 25 2018 in the EU. Protection of personal data falls within the confines of the EEA Agreement and hence Icelandic legislation mirrors that of the EU's. Therefore, the Regulation will be introduced in Iceland and it is expected that the date of adoption in Iceland will mirror that of the EU's date of entry into force.

The reform in question signifies the biggest reform of data protection by the EU since the adoption of Directive 95/46/EC, which Iceland's current Act on the Protection of Privacy as regards the Processing of Personal Data, No. 77/2000, is based on. The framework seeks to strengthen and unify data protection for individuals in the EEA and entails a strict data protection compliance regime with somewhat severe penalties in case of breaches. The regulation also applies to organizations based outside the EEA should they process personal data of EEA residents.

A bill is likely to be submitted to Parliament in spring of 2018.

BILL ON EU BANK RECOVERY AND RESOLUTION (BRRD)

A committee within the Ministry of Finance and Economic Affairs has been established, with the task of implement Directive 2014/59/EU (BRRD) into Icelandic law. The BRRD lays out a comprehensive set of measures which ensures that banks and authorities make adequate preparation for crises. The BRRD will equip national authorities with the necessary tools to intervene in a troubled institution at a sufficiently early stage to address developing problem and have harmonized resolution tools and powers to take rapid and effective action when bank failure cannot be avoided. With the BRRD it will be mandatory for banks to build recovery plan which meet the BRRD standards and requirements.

A bill is likely to be submitted to Parliament in 2017-2018.

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 bill is expected to be submitted to Parliament in 2017-2018.

BILL ON AML IV

The AML IV Directive 2015/849/EU seeks to reinforce the efficacy of the fight against money laundering and terrorist financing, and to align Union legal acts with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation adopted by the FATF in February 2012.

The Directive applies i.a. to credit and financial institutions, and emphasizes the use of a risk-based approach to identify, understand and mitigate the risks of money laundering and terrorist financing.

Member States shall bring the Directive into force by 26 June 2017, and a bill to that effect is likely to be submitted to Parliament in 2017.

11 ABBREVIATIONS

ACC	Arion Credit Committee
ALCO	Asset and Liability Committee
BAC	Board Audit Committee
BCC	Board Credit Committee
BPV	Basis Point Value
BRC	Board Remuneration Committee
BRIC	Board Risk Committee
CCC	Corporate Credit Committee
CEO	Chief Executive Officer
COREP	Common Reporting
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Customer Relationship Management
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
D-SIB	Domestic Systemically Important Bank
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
ECL	Expected Loss
EMIR	European Market Infrastructure Regulation
EMTN	Euro Medium Term Note
EU	European Union
EWS	Early Warning System
FME	Financial Supervisory Authority Iceland
FSC	Financial Stability Council Iceland
FVOCI	Fair Value through Other Comprehensive Income
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	Icelandic Competition Authority
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IPO	Initial Public Offering
KRI	Key Risk Indicator
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
MD	Managing Director
MI	Major Incident
MV	Market Value
NSFR	Net Stable Funding Ratio
PD	Probability of Default
PSE	Public Sector Entities
RCSA	Risk Control Self-Assessment
RBC	Retail Branch Credit Committees
RWA	Risk-Weighted Assets
SME	Small and Medium Enterprises
SREP	Supervisory Review and Evaluation Process
UIC	Underwriting and Investment Committee
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value at Risk

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