Risk and Capital Management 2020

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Landsbankinn hf. Pillar III risk report
31.12.2020

Landsbankinn hf. in brief

Landsbankinn hf. was founded on 7 October 2008 by the Ministry of Finance on behalf of the Icelandic State Treasury. The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank is licensed as a commercial bank and operates in accordance with Act No. 161/2002, on Financial Undertakings. The Bank is subject to supervision by the Financial Supervisory Authority of the Central Bank of Iceland (FSA) in accordance with Act No. 87/1998, on Official Supervision of Financial Activities.

Landsbankinn hf. is the largest financial services company in Iceland and provides reliable universal services based on long-standing business relationships to individuals, corporates and investors throughout Iceland.

The National Treasury of Iceland holds 98.2% of shares in the Bank. The Bank itself owns 1.6% of shares and other shareholders own 0.2% of shares in the Bank.

Contents

The disclosures have solely been comprised to explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks. They do not constitute any form of audited financial statement. They should not be relied upon in making judgements about the Bank. The disclosures will only be subject to external verification to the extent that they are equivalent to those made under accounting requirements.

In the interest of simplifying text, Landsbankinn Group, which consists of the parent entity, Landsbankinn, and its subsidiaries, is referred to as the 'Bank' in the disclosures. Where necessary, a distinction is made in the report between the group and the parent entity. For further information, see Note No. 89.1 – Consolidation in the Bank's Consolidated Financial Statements for 2020.

This publication, Risk and Capital Management 2020, has not been audited by external auditors. However, it includes information from the audited Consolidated Financial Statements 2020 and has been verified internally and approved by the Board of Directors. There may be some discrepancies between this report and financial information in the Consolidated Financial Statements 2020, as the report has been prepared for the purpose of Article 18 of Act No. 161/2002, on Financial Undertakings, cf. Article 11 of Act No. 96/2016, and the provisions of Directive 36/2013/EU of the European Parliament and of the Council of 26 June 2013 (CRD IV) and Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 (CRR) incorporating the Basel Pillar III disclosure requirements, rather than in accordance with IFRS.

Additional Pillar III disclosures required under CRR can be downloaded from https://corporate.landsbankinn.com/en/the-bank/investor-relations/reports-and-financials

1 2020 Highlights and Outlook

In 2020, the Bank experienced an increase in all significant risk areas. In March 2020, when the first wave of Covid-19 hit, both credit risk and market risk increased within a very short time due to the uncertainty and fluctuations that followed. At the same time, the Bank had to relocate the workstations of the majority of employees due to health concerns relating to the pandemic, thus raising operational risk. Those events, along with the Covid-19 related relief measures for the Bank's borrowers, put the Bank's crisis management to a significant test for the first half of the year. The Bank managed to function at near-normal levels despite a closing of branches and a dispersed workforce.

The Central Bank of Iceland (CBI) embarked on a rapid rate cut during the year in response to the pandemic and banks followed suite, reducing their deposit and lending rates. This in turn sparked increased demand for non-indexed mortgages with variable interest rates and a search for yield amongst individuals and investors.

The Bank's overall risk position increased in 2020 mainly due to increased credit risk. General moratoria and subsequent further measures have, although necessary, increased uncertainty in the Bank's loan portfolio. This was met with increased provisioning and manual credit rating changes for corporate customers, mainly in the travel industry and with borrowers in payment difficulties.

Market conditions lead to fluctuations in market risk in 2020. Market risk decreased towards the end of 2020 and was well within risk appetite at the end of year. Liquidity ratios remained strong and above the Bank's risk appetite over the course of the year.

1.1 Capital position

The Bank's total capital ratio remained strong in 2020, ending in 25.1%, decreasing slightly from 2019. The uncertainty resulting from the pandemic caused the minimum requirement set by the CBI through the Supervisory Review and Evaluation Process (SREP) to remain unchanged between 2019 and 2020 at 11.4%. The Bank's minimum capital requirement, as determined by the FSA, is the sum of Pillar I and Pillar II-R requirements. Due to a reduction in the countercyclical capital buffer, from 1.7% to 0%, the combined buffer requirement decreased from 9.07% to 7.38%, resulting in a total capital requirement of 18.8%. The Bank did not pay dividends in 2020 following guidance from the CBI.

Risk exposure amount (REA) increased by ISK 101 billion, or 9.8%, in 2020. Two notable changes were made to calculation of REA to accommodate regulatory changes and changes in the use of credit mitigation. The Bank's equity increased by ISK 10.5 billion between 2019 and 2020.

The Bank measures internal capital requirements by economic capital (EC) for all material risks with regard to risk-weighted assets. The internal assessment of EC increased in 2020, driven mostly by rising credit risk, to ISK 110 billion at year end. The ratio to REA increased by 0.2 percentage points to 9.8%.

1.2 Credit risk

The carrying amount of the Bank's loan portfolio to customers grew by 12% in 2020. As in 2019, the increase was primarily driven by increased residential mortgage lending to individuals. Demand for non-indexed mortgages increased in 2020 from the previous year, mainly due to decreasing interest rates and favourable refinancing costs. The credit quality of the mortgage portfolio remained high with an average PD of 1.3% and a slight increase in average loan-to-value to 57.7%. The share of non-indexed mortgages in the portfolio continued to increase from 42.0% in 2019 to 61.0% in 2020.

The Bank's corporate portfolio grew by 1.3% in 2020, with low growth largely attributable to uncertainty in the economy and granting of moratoria measures. Credit risk increased as measured by probability of default (PD), rising from 2.9% to 4.1% between 2019 and 2020, primarily due to a downgrade in the rating grades of corporates in the travel industry experiencing financial difficulties during the pandemic. A total of 4 exposures are classified as large exposures at year-end 2020 as opposed to 5 at year-end 2019.

Credit risk of the total loan portfolio increased in 2020, with general moratoria granted to customers and higher PD in the corporate portfolio for certain sectors, most notably the travel industry. Credit risk slightly exceeded the Bank's risk appetite and uncertainties remain while current economic conditions persist and parts of the portfolio remain in moratoria.

EC for credit risk for other assets increased, driven by increased exposure and a higher risk weight for equities in the banking book.

1.3 Market risk

The Bank's market risk increased in 2020 due to severe fluctuations in equity markets. Despite this, market risk was well within the Bank's risk appetite for 2020 and remains modest. Market risk to REA decreased by 0.2 percentage points from year-end 2019 to year-end 2020 and the Bank's exposure in the trading portfolio remained largely unchanged. However, the Bank's net FX balance increased by ISK 1 billion in 2020, remaining well within the Bank's risk appetite. The Bank's CPI imbalance decreased even further in 2020 with increased borrowing compounded by decreased lending in CPI-linked mortgages and refinancing. The imbalance was 26% of equity at year-end 2020, compared to 52% at year-end 2019, a record low for the Bank.

1.4 Liquidity risk and funding

Liquidity risk is a current risk factor which remained relatively stable over the year despite the pandemic and market fluctuations. The Central Bank of Iceland took action in response to the pandemic, further strengthening the Bank's access to liquidity if needed. The Bank's total LCR at year-end was 154%, LCR ISK was 105% and 424% in foreign currencies, well above regulatory limits and the Bank's risk appetite. The Bank's net stable funding ratio in foreign currencies is strong at 132% and total NSFR was 116% at year end.

The largest part of the Bank's funding continues to be in the form of deposits from customers, which increased by 86 billion in 2020 and amounted to ISK 793 billion at year end. The Bank was an active issuer on the domestic bond market in 2020 with issuance of covered bonds in the domestic market and issuance of bonds in foreign currencies under its EMTN programme. At year-end 2020, bond issuance in foreign currencies amounted to ISK 227 billion, increasing by ISK 4 billion during the year. The size of the programme for covered bond issuance at year-end was ISK 250 billion and was increased from ISK 200 billion in 2020. Regular auctions of covered bonds were held in 2020, tapping previously issued bonds and issuing two new bond series. At year end, outstanding covered bonds issuance amounted to ISK 189 billion, increasing by ISK 49 billion during the year 2020.

In April 2020, the Bank's credit rating was lowered by one notch, to BBB/A-2 with stable outlook. The downgrade was triggered by S&P's assessment of industry risk with regard to a reduction in economic activity due to the Covid-19 pandemic. The stable outlook of the Bank's credit rating was based on S&P's expectation that the Bank will withstand the consequences of the economic recession by maintaining solid capital positions and comfortable funding and liquidity profiles.

1.5 Operational risk

The Bank's operational risk increased significantly in 2020. Two of the Bank's most important pandemic crisis plans were put to the test and operations and services showed resilience and remained stable. The Bank's response to the pandemic was successful in part due to the focus on straight-through processing and customer self-service, as well as data storing and processing, which has been at the forefront in the

Bank's strategy since 2017.

It was expected that such large-scale relocation of staff and segregation of employees in those units required to work on-site would lead to a significant increase in operational and loss incidents. This risk did not materialise, with only a few recorded incidents linked to the pandemic response.

ICT risk and third-party risk management remains a significant focus point for the Bank because of its reliance on third-party providers of software solutions.

For the Bank's customers, fraud and cybercrime remain a growing risk. The Bank continues to place strong emphasis on reducing the likelihood of customers falling prey to such criminal activity, employing customer outreach and other measures.

The Bank suffered no major operational incidents in 2020 and most incidents that did occur were caused by weaknesses in processes or systems.

The Bank has increased its prudence regarding fraud and money-laundering because of the Covid-19 pandemic. Customer behaviour has changed, altering the use of cash and digital solutions. Necessary changes to the Bank's operation during the pandemic have lead to heightened awareness of conduct risk. No loss events or signs of increased customer misconduct in the Bank's systems can be attributed to the pandemic to date.

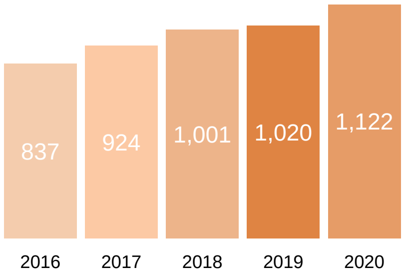
1.6 Economic outlook

Landsbankinn Economic Research forecasts an 8.5% contraction in domestic product in 2020 as a result of Covid-19. There is still a great deal of uncertainty about the economic outlook, but it now appears that the pandemic will hamper economic growth well into 2021. At this point, Economic Research does not expect the economy to begin its recovery until fall 2021 yet growth is nevertheless expected to be positive by 3.4% in 2021. Robust growth is expected in 2022 and 2023, or 5% each year, alongside a speedy recovery of the travel industry. Unemployment levels have risen considerably, averaging 5.5% in 2020. Unemployment is expected to rise to 8.4% in 2021 before coming down to 5.8% in 2022.

Inflation averaged 2.8% in 2020. It rose to 4.3% in January 2021, well above the inflation target of 2.5%. Inflation is expected to recede in coming months as the effects of last year's ISK depreciation dwindle and to trend towards target levels in the second half of the year.

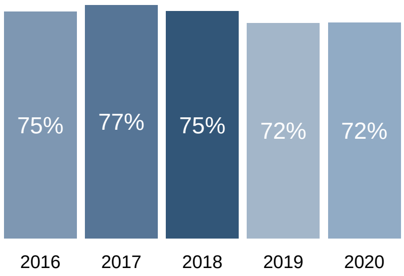
Risk metrics overview

Risk exposure amount



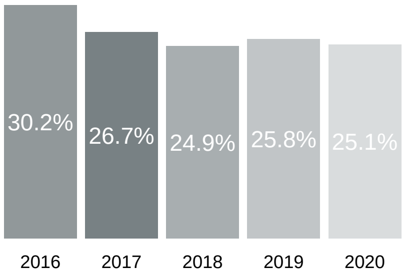
1,122 ISK bn

REA to total assets



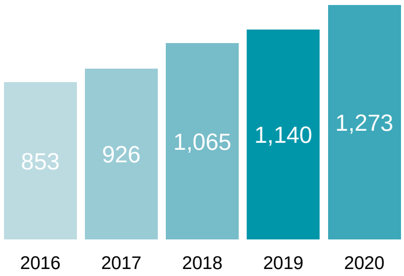
72%

Total capital ratio



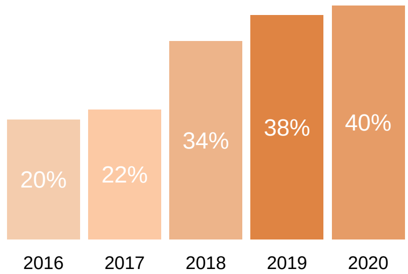
25.1%

Loans and advances to customers



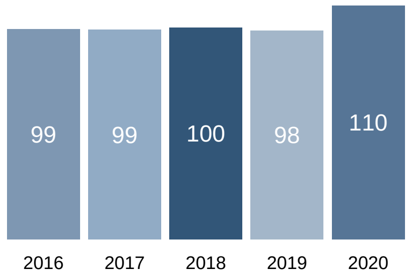
1,273 ISK bn

Large exposures to eligible capital



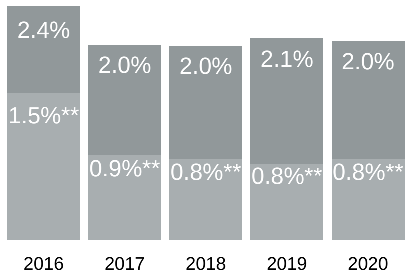
40%

Economic capital



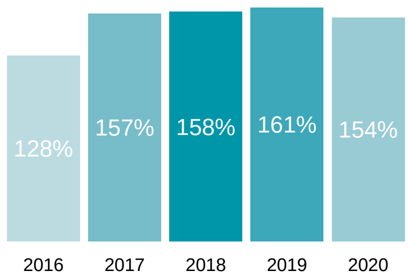
110 ISK bn

Stage 3 loans*



2.0%

Liquidity coverage ratio total



154%

* Staging of loans was implemented in 2018. For 2016-2017, defaulted and impaired loans are used as a proxy for stage 3.
** Of which 90 days past due.

2 Risk management

Risk Management

The Board of Directors has reviewed the adequacy of the Bank's risk management arrangements, providing assurance that the risk management systems put in place are adequate with regard to the Bank's profile and strategy, in accordance with Article 435 of CRR.

Risk is inherent in the Bank's activities. It is managed through a process of on-going identification, measurement, management and monitoring, subject to risk limits and other controls. Risk identification involves finding the origins and structures of possible risk factors in the Bank's operations and undertakings. Risk measurement entails measuring identified risk for management and monitoring purposes. Finally, risk controls and limits promote compliance with rules and procedures, as well as adherence with the Bank's risk appetite.

The objective of the Bank's risk policies and procedures is to ensure that the risks in its operations are detected, measured, monitored and effectively managed. Exposure to risk is managed to ensure that it remains within limits and that the risk appetite adopted by the Bank complies with regulatory requirements. To limit and manage fluctuations that might affect the Bank's equity, liquidity and performance, the Bank has adopted policies regarding the risk structure of its asset portfolio, which are covered in more detail under each risk type.

Risk policy is implemented through risk appetite, goal setting, business strategy, internal policies and limits that comply with the regulatory framework of the financial markets.

2.1 Risk appetite

The Bank's risk appetite for 2021 has been reviewed, revised and implemented. Section 2.4 lists the risk appetite metrics, targets for the present year and year-end values for the past three years. The Bank's risk policy is as follows:

The Bank's operations, risk diversification and decisions shall always be in accordance with its risk appetite, sound business practices, financing, liquidity and equity position. The Bank seeks to ensure diversified and sound financing and a sustainable risk profile in its balance sheet. The Bank has set internal limits with the aim of maintaining a strong capital and liquidity position which, along with active risk management, are important to achieve long-term profitability and strong standing. In this manner, the Bank aims to minimise fluctuation in its operations and is well positioned to withstand stress scenarios.

Risk appetite defines the type and extent of risk that management is willing to take to meet the Bank's business objectives. The Bank has set itself objectives regarding financial position, asset quality, exposures and sustainable long-term profitability. In pursuit of its goals, the Bank only takes on risks that it understands, and can measure, evaluate and manage.

The Bank seeks to maintain solid business relationships, having regard for its own position as well as that of its customers at all times, and with due regard to any internal connections between customers. The Bank pursues long-term business relationships and aims to minimise and contain reputational risk.

The Bank has set a policy on corporate social responsibility that integrates economic, social and environmental factors in its operations. The policy aims to promote sustainability in Iceland, to ensure that the Bank is a dynamic force in the community and that it operates in accordance with the principles of good corporate governance.

The Bank is obligated to comply with relevant laws and regulations in all its operations. The main focus areas within the Bank's risk culture are adherence to rules, integrity, ethical behaviour, professionalism and the promotion of good risk culture by all senior management.

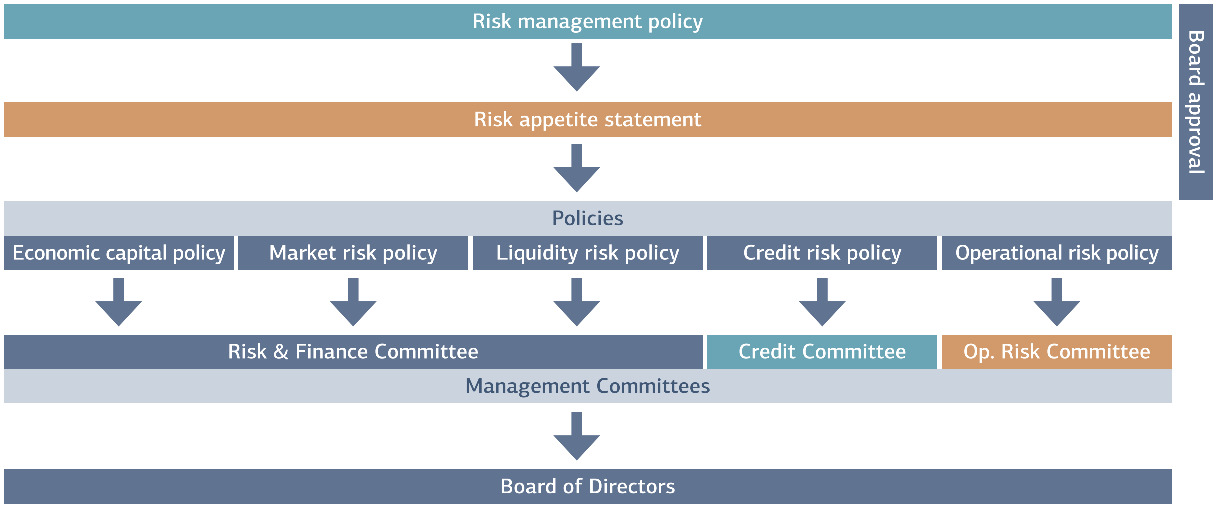


Figure 2.1: Risk policy structure

2.2 Risk identification

The Bank is exposed to the following material risks that arise from financial instruments:

- Credit risk
- Market risk
  - Currency risk
  - Interest rate risk
  - Other market risk
- Liquidity risk
- Operational risk

Table 2.1 provides a link between the Bank's business units and the material risks that they are exposed to. The risk significance is assessed within the context of the Bank as a whole and is measured based on allocation of economic capital (EC) within the Bank.

The Bank also manages other relevant risks, including, but not limited to, concentration risk, business risk, legal risk, reputational risk, conduct risk, compliance risk, data risk and modelling risk.

2.3 Risk management structure

The Bank aims to operate in line with international best practice and guidelines on risk management. The Bank devotes substantial resources to developing and maintaining its risk management systems and operations.

The Bank's risk management is based on guidelines, policies and instructions determined by the Board of Directors. The Bank has prepared specific instructions on risk management for individual business units based on the general policies set by the Board of Directors. At the unit level, these instructions are used, among other things, as the basis for business and control procedures.

2.3.1 Risk committees

The Bank's risk management governance structure at year-end 2020 is shown in Tables 2.2 and 2.3.

Effective sub-committees provide important preparation for Board meetings. The establishment of

Table 2.1: Material risks exposed by the Bank's business units

Material risk	Personal Banking	Corporate Banking	Markets	Treasury
Credit risk	High	High	Low	Low
Operational risk	Medium	Medium	High	Medium
Market risk	Low	Low	Medium	High
Liquidity risk	n/a	n/a	n/a	High

Table 2.2: Key risk management bodies and committees

Committee	Chair	Other members
Executive Board	CEO	Managing Directors
Risk & Finance Committee	CEO	CFO, CRO, Head of Legal Department
Credit Committee	CEO	CRO, MD of Corporate Banking
Operational Risk Committee	CRO	MD of Personal Banking, MD of IT, Chief Compliance Officer, Senior Director of Operation, Director of Operational Risk
Project Committee	CEO	Managing Directors

sub-committees is designed to facilitate discussion and deeper analysis of issues for the Board's attention and its efficacy.

The Board assesses its need for sub-committees at the Board level, according to legal requirements and the size and scope of the Bank at each time, as well as the composition of the Board. The Bank's corporate governance statement is required to provide information on the establishment and appointment of sub-committees. There are currently four sub-committees of the Board of Directors.

The Audit Committee's role is to ensure the quality of the Bank's financial statements and other financial information, as well as the independence of its auditors. The Committee's function is, among other things, to supervise accounting procedures. The Committee also monitors the organisation and function of internal auditing. Moreover, the Committee supervises auditing of the Bank's financial and consolidated statements and assesses the independence of the Bank's external auditors. It also supervises other tasks performed by external auditors and submits proposals to the Board of Directors for the selection of external auditors.

The Risk Committee serves as a consulting entity to the Board of Directors in the development of the Bank's risk strategy and risk appetite. The Committee also advises the Board on the Bank's risk culture and on the organisation and effectuation of the Bank's risk policy, as well as reviewing the Bank's policy as set forth in risk rules. The Committee assesses the Bank's risk management framework on an annual basis, concerning all significant risk factors and reviews reports from internal control functions on internal control factors that relate to risk management. The Committee also reviews policies on capital management and funding, ICAAP/ILAAP reports, the results of stress tests, credit decision issues, the status of the Bank's loan portfolio, procedures for impairment calculations, the activities of Compliance and other types of risks as and where applicable.

Table 2.3: Sub-committees of the Board of Directors

Supervision by the Board of Directors and its sub-committees
Audit Committee
Remuneration Committee
Risk Committee
Strategic Development Committee

The Remuneration Committee reports annually to the Board of Directors. The Committee guides the Board of Directors and the CEO on remuneration policy and monitors the implementation of that policy after it has been approved. For further details on the Bank's remuneration policy, see Chapter 9.

The Strategic Development Committee prepares the Board of Directors for discussion and decisions on the future vision and strategy of the Bank. The Strategic Development Committee monitors changes in the Bank's operating environment and deliberates on the Bank's position and business plan with regard to strategic development.

The Board of Directors has overall responsibility for the establishment and oversight of the risk management framework, risk appetite, and setting risk limits. The CEO is responsible for the effective implementation of the framework and risk appetite through the corporate governance structure and committees.

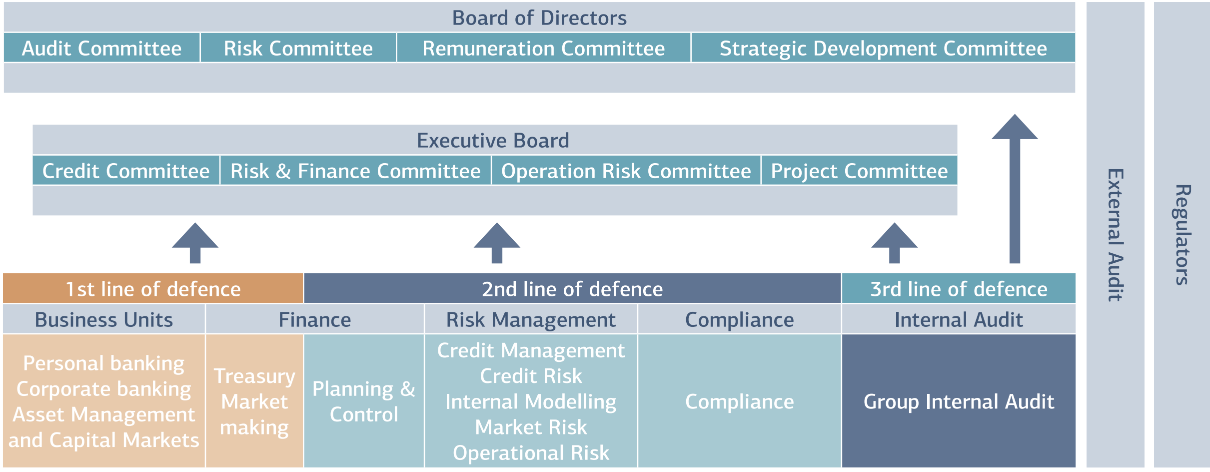


Figure 2.2: Risk management governance structure

The CEO is the chairman of the Executive Board, the Risk & Finance Committee, the Credit Committee and the Project Committee.

The Credit Committee covers credit risk, including individual credit decisions, credit limits for customers and credit risk policy.

The Risk & Finance Committee primarily covers market risk, liquidity risk and legal risk. The Risk & Finance Committee monitors the Bank's overall risk position, is responsible for enforcing the Bank's risk appetite and risk limits, and reviews and approves changes to risk models before presentation to the Board of Directors.

The Executive Board serves as a forum for discussion about business opportunities and challenges, approves funding for larger projects, and serves as a decision-making platform on matters that do not fall under the remit of other committees.

The Operational Risk Committee is a forum for discussion and decisions on operational risk issues and review of the effective implementation of the operational risk framework.

The Project Committee selects, prioritises, oversees and supports the Bank's bigger projects and digital transformation projects.

Governance pertaining to specific risks is discussed in the relevant sections.

2.3.2 Risk Management Division

The Risk Management Division is responsible for the Bank's risk management framework. Subsidiaries of the Bank have their own risk management functions and the Risk Management Division receives information on exposures from the subsidiaries and collates them into Group exposure. The Risk Management Division is also responsible for comprehensive risk reporting on risk positions to various internal departments and committees and supervisory authorities.

The Risk Management Division comprised seven departments at year-end 2020:

- The Credit Management Department reviews and confirms or vetos credit decisions made by the Bank's business units when credit applications exceed the business unit's limits. Confirmation by Credit Management implies that Credit Management has reviewed the credit application and does not exercise its veto rights. Credit applications exceeding the confirmation limits of the Risk Management Division are referred to the Bank's Credit Committee. The Department also oversees regular updates of the Bank's credit policies and other rules related to the credit process.

- The Credit Risk Department is responsible for measuring and monitoring credit risk as well as for providing the Bank with systems and processes to measure, monitor and control credit risk in credit and policy decisions. Credit Risk is responsible for analysis and reporting on credit risk, economic capital and impairment. Credit Risk is also responsible for rules and procedures regarding credit risk, such as procedures for impairment measurement, credit mitigation and forbearance.

- The Market Risk Department is responsible for measuring, monitoring and reporting on market risk, liquidity risk and interest rate risk in the banking book along with limit monitoring and reporting. The Department develops and maintains the Bank's market risk models and maintains the Bank's Market Risk Policy and Liquidity Risk Policy, as well as implementing processes to measure and monitor market risk and liquidity risk within the Bank. Market Risk is also responsible for monitoring all derivatives trading the Bank enters into, both for hedging and trading purposes, as well as FX balance monitoring for the Bank.

- The Operational Risk Department is responsible for ensuring centralised management of operational risk on a Group level. The department assists in mapping the Bank's operational risk in a comprehensive risk assessment and in executive assessment and analysis of operational and loss events. The Operational Risk department is involved in the design and testing of the Group's continuity plans. The Department is responsible for the organisational structure and operation of the IT and for ensuring compliance with the ISO 27001 standard for information security.

- The Risk Manager for Pension Funds is an independent entity, responsible for development and implementation of risk policy and risk governance, execution of risk assessment and correspondence with regulators such as the Central Bank and its financial supervisory function. The Risk Manager also ensures that monitoring of regulatory compliance is carried out, reviews calculations and results, and performs tolerance interval monitoring. The Risk Manager has direct access to the boards of the pension funds and also reports to their managing directors.

- The Internal Modelling Department is responsible for providing the Bank with IRB and EC models and related processes to estimate credit risk and link the risk to equity, as well as for providing support during the implementation of those models and processes within the Bank. The Department is also responsible for the development of models for pre-approved limits.

- The Risk Solutions Department develops and operates external solutions used by the Risk Management Division, and maintains the IT reporting and development environment for the Risk Management Division. The Department is also responsible for monitoring and maintaining periodic executions of code by the Division and reporting to supervisory parties. The Department is responsible for effective risk data aggregation and risk reporting, in accordance with BCBS 239.

2.3.3 Compliance

Compliance is an independent management unit which reports directly to the CEO and operates in accordance with a letter of appointment from the Board of Directors. The operations of the Compliance unit are shaped by its independence from other units.

Compliance is part of the Bank's second level control and is responsible for monitoring compliance with laws and actions against money laundering and financing of terrorist activities, laws on securities trading and data protection laws. Compliance also monitors the efficiency of the Bank's policy on compliance with laws, regulations and internal rules.

Compliance consults and instructs management on the effects of changes to the legal environment on the Bank's operations, measures to prevent conflict of interest and action necessary to ensure that the Bank operates in accordance with proper and sound business practices with the aim of strengthening the credibility of and confidence in financial markets.

The Data Protection Officer works independently out of Compliance, in accordance with a letter of appointment from the Board of Directors.

2.3.4 Internal Audit

Internal Audit is an independent, objective assurance and consulting activity that is a part of the Bank's organisational chart and an element of its monitoring system. The Board of Directors has oversight of Internal Audit and appoints the Chief Audit Executive. The role of Internal Audit is to improve and protect the Bank's value with risk-focused and objective verification, consultation and insight. Internal Audit evaluates and improves the risk management framework, control and governance processes through systematic and disciplined practices, thus supporting the Bank in accomplishing its objectives. The Chief Audit Executive is responsible for ensuring that Internal Audit works in accordance with laws, recommendations from the FSA no. 3/2008, and standards and guidelines cited therein, including the benchmarks of the Institute of Internal Auditors (IIA).

2.4 Risk measurement

The Bank regularly monitors and assesses its current risk profile in important business areas and for the most significant, measurable risk types. It also constantly seeks to improve the process for setting risk appetite in order to supplement the risk management framework and to support the business model.

The risk appetite framework considers key risks relevant to the Bank's business activities by setting risk appetite targets and limits. On an aggregate level, risk appetite is represented in terms of credit risk, market risk, liquidity risk, operational risk and funding risk. Each target or limit varies in detail, as well as which metrics are used. In addition, the Bank measures and monitors other key risk indicators to capture process risk, as well as additional credit, market, operational and funding risk.

Economic capital (EC) is a key element in the management of the Bank's risk and capital structure, as well as in day-to-day financial management. One of the benefits of EC is that it presents an aggregate figure for all measurable risk types, products and business units. It thus produces a unified risk measurement expressed as a single unit of value. Further details on EC are provided in Section 3.4.2.

2.4.1 Stress testing and sensitivity analysis

Stress testing and sensitivity analysis are important tools used to quantify risk in severe, unlikely but plausible scenarios. This section provides an overview of stress testing and sensitivity analysis for different risk types within the Bank.

2.4.1.1 Capital and liquidity

Stress testing is an important part of the Bank's capital and liquidity planning process. Internal stress tests are used as an important risk management tool to determine how severe, unlikely but plausible changes in the business and macro environment affect the Bank's capital need and liquidity position. Stress tests reveal how the capital need and liquidity ratios vary during a stressed scenario, where impact on financial statements, regulatory capital requirements and capital ratios are tested. The stress testing process is divided into the following steps:

- Scenario development and approval
- Scenario translation
    - Translation model to determine loan loss
    - Translation method to determine the effect on financial statements
    - Translation model to determine EC
- Calculation
- Analysis and reporting
- Management actions

The Bank aims to develop dynamic, forward-focused scenarios that simultaneously cover key aspects of the Bank's operations, including system-wide interaction and feedback effects.

These scenarios, which include a baseline scenario, assume developments of key macro indicators over a three-year period. The scenarios demonstrate an alternative development of key economic variables induced by various shocks compared to the baseline

Table 2.4: Overview of risk appetite metrics

Risk category	Risk type	Metric	31.12. 2020	2020 year-end target	31.12. 2019	31.12. 2018
Credit risk	Credit quality	Expected loss (% of total loans)	0.5%	<0.5%	0.4%	0.4%
		Probability of default	2.9%	<2.7%	2.4%	2.5%
		Loss given default	14.3%	<18.0%	14.5%	14.7%
	Industry concentration	Largest industry (% of total loans)	16.6%	<25.0%	20.6%	21.1%
	Single name concentration	Large exposures (% of eligible capital)*	39.6%	<50.0%	38.0%	33.6%
Market risk	Market risk	Total market risk (% of REA)	1.0%	<5.5%	1.2%	1.8%
	Equity	Risk-weighted position in the trading book (% of REA)	0.3%	<2.0%	0.4%	0.9%
	Bonds	Risk-weighted position in the trading book (% of REA)	0.2%	<0.5%	0.4%	0.2%
	Currency	Risk-weighted currency position (% of REA)	0.4%	<3.0%	0.4%	0.6%
	Interest rate risk	Interest rate & inflation risk in the banking book (% of equity)	3.0%	<10.0%	3.4%	3.0%
	Inflation risk	Net position (% of equity)	26.4%	<80.0%	52.2%	71.5%
Liquidity risk	Liquidity risk	Liquidity coverage ratio - Total	154.2%	>140.0%	160.5%	158.0%
		Liquidity coverage ratio - FX	424.0%	>200.0%	768.8%	531.9%
		Liquidity coverage ratio - ISK	104.8%	>70.0%	60.6%	-
Operational risk	Change in REA	12-month change in REA	6.4%	+/-4.0%	-0.7%	5.1%
	IT risk	Number of open issues in vulnerability scans of the Bank's websites	0	0	-	-
	Compliance risk	Expired serious issues flagged by Internal Audit and regulators	0	0	-	-
Funding risk	Funding	Net stable funding ratio - FX	132.1%	>120.0%	143.0%	165.7%
		Net stable funding ratio - Total	116.5%	>120.0%	117.0%	120%
	Economic capital	EC/REA	9.8%	<10.5%	9.6%	10.0%
	Capital ratio	Total capital ratio	25.1%	>23.0%	25.8%	24.9%
	Risk-weighted capital	S&P's risk adjusted capital (RAC) ratio	17.9%	>15.0%	17.9%	17.9%

*In addition to monitoring large exposures as a % of eligible capital, the Bank also monitors the largest single exposure as a % of eligible capital. The goal is <20% and as at 31.12.2020, the largest exposure is well below that goal. External regulation mandates a ratio of <25%.

macroeconomic forecast of the Bank's Economic Research Department. Idiosyncratic events are also defined within the scenarios to stress specific asset classes or operations of the Bank.

The Bank uses a loan loss model which incorporates macroeconomic variables and produces probability of default (PD), default rates, as well as loss given default (LGD), which can be translated into loan losses for a given scenario. In addition to the loan loss model results, expert judgement is applied for loan loss on selected large exposures by industries affected within each scenario.

Scenario results are compared with the Bank's current business plan, risk appetite, and the Bank's solvency.

The effect on financial statements is translated and calculated with a resulting impact on the capital base and liquidity position. EC for the Bank is calculated for each scenario, as well as various risk metrics within the Bank's risk appetite. If the risk appetite constraints are violated, management actions are required within the scenario.

Act No. 54/2018, amending Act No. 161/2002, on Financial Undertakings, transposed into Icelandic law the provisions of the Bank Recovery and Resolution Directive No. 2014/59/EU (BRRD) on recovery plans, early intervention and intra-group financial support. According to Article 82(a) of the Act on Financial Undertakings, the Bank has prepared a recovery plan on a group level, based on consolidated financial information as at 30 September 2020. In accordance with Article 82(f) of the Act, the Bank has identified several recovery indicators with the aim to assess the overall financial strength of the Bank, as well as relevant threshold levels indicating the need for pre-emptive measures to be taken.

2.4.1.2 Market risk

The Bank conducts stress tests and sensitivity analysis pertaining to market risk on a regular and ad-hoc basis. Comprehensive market risk stress testing is conducted as part of the Bank's ICAAP/ILAAP once a year with a time horizon of three years. Other stress tests and sensitivity analyses of the Bank's trading and non-trading portfolios with regard to equity and interest rate risk and currency risk are made on a case-by-case basis. These stress tests are subjective in nature and may pertain to specific portfolios, instruments or issuers, and usually stem from concerns regarding the Bank's operating environment, economic conditions, portfolio composition, or other reasons relevant to the Bank at the time.

The Bank uses value-at-risk (VaR) and expected shortfall (ES) as a common ground for measuring market risk in different products. An internal VaR model is in place for the quantification of market risk and estimation of EC, and the Bank calculates daily VaR at the 99% confidence interval using at least one year of historical data. Both parametric and historical VaR for the Bank's trading books in equity, fixed income and FX are calculated and reported to relevant business units.

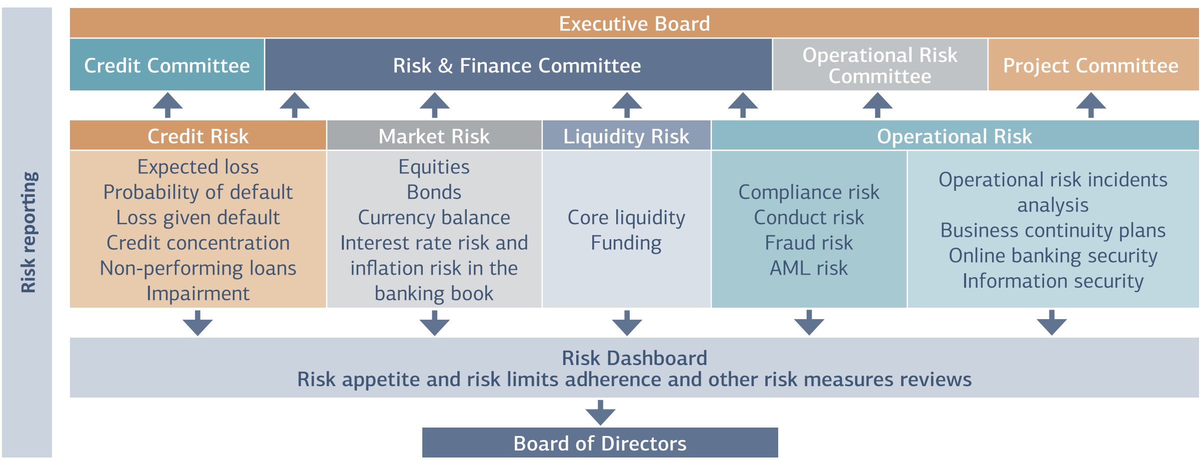


Figure 2.3: Overview of risk reporting witin the Bank

The Bank is aware that all VaR models have limitations that can have a major effect on model outcomes and hence, may not hold in real adverse market conditions. The Bank therefore compliments VaR calculations with other methods such as stress testing and sensitivity analysis and does not employ VaR to control market risk or set trading book limits, but rather views it as one of several indicators to better enable market risk management.

2.4.1.3 Liquidity risk

Various stress tests have been constructed to try to efficiently model how different scenarios affect the Bank's liquidity position and liquidity risk. The stress tests are based on the Bank's balance sheet mixture and take the Bank's current operating environment into account. Key liquidity metrics are also mapped onto annual internal stress tests that are used as an important risk management tool in order to determine how severe, unlikely but plausible changes in the business and macro environment affect the capital need and liquidity position of the Bank. The Bank's own subjective views, historical trends and expert opinion are key factors in constructing the stress tests. All stress tests are regularly reviewed by the Risk & Finance Committee and the stress test results are a part of the Bank's early warning indicators for liquidity risk. The Bank also tracks the volatility and VaR numbers of the liquidity ratios and performs other internal stress tests that may vary from time to time.

2.5 Risk monitoring

The Bank allocates considerable resources to ensure on-going adherence with approved risk limits and for risk monitoring. It has set guidelines for reporting to relevant management bodies, including the Board of Directors, the Risk Committee, the Risk & Finance Committee, the Operational Risk Committee, the Project Committee and the Executive Board on developments in risk measures and risk appetite.

Table 2.5: Principal reporting to the Board of Directors

	Annual
Risk and capital management report	Pillar III disclosures
ICAAP/ILAAP report	Evaluation of the risk profile and solvency need. The report contains conclusions drawn from stress testing, including the effect of various scenarios on expected losses and capital needs. The ICAAP/ILAAP report is subject to the FSA's Supervisory Review and Evaluation Process (SREP)
Economic capital report	Thorough analysis of EC developments and EC breakdown by risk types and business units as well as REA and other related aspects
Recovery plan	The recovery plan focuses on measures to protect and restore the Bank's financial position, following a significant deterioration. It includes governance and decision-making processes, continuity of critical economic functions and core business lines, specification of trigger points to activate recovery options and internal and external communications
Compliance report	Annual assessment of the role, independence, authorisations and work of Compliance, and whether Compliance has sufficient funding to perform its duties.
	Bi-annual
Credit risk report	Thorough risk report providing analysis of such issues as development in risk appetite, past due loans, average exposure-weighted probability of default (PD), default rate vs. PD, distribution of loan portfolio in rating categories and migration analysis and other analysis of credit risk aspects
Market & liquidity risk report	Thorough risk report summarising the Bank's liquidity risk and market risk exposures and any concerns regarding liquidity and/or market risk
Operational risk report	Thorough risk report providing analysis of operational risk aspects
	Monthly
Risk report	An aggregate report containing information on the Group's risk appetite and material from the credit, market, liquidity and operational risk reports. The report is interactive and available electronically
Executive management report	An aggregated report containing risk related material such as risk appetite, EC and RAROC
	Bi-weekly or more often
Market & liquidity risk report*	Market and liquidity risk report highlighting the Bank's market risk exposures, risk appetite, market risk limit utilization and liquidity risk and any concerns regarding liquidity and/or market risk

*Daily during adverse conditions

3 Capital management

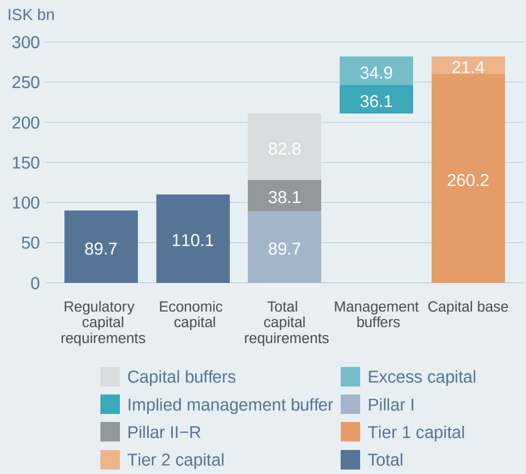
Capital Management

The purpose of the Bank's capital management is to support the Bank's strategy and ensure that it has sufficient capital to cover its risk at all times.

- The Bank's total capital ratio decreased by 0.7 percentage points in 2020 to 25.1%.
- Due to prevailing economic uncertainty and precautionary guidance from the FSA, the Bank did not pay dividends in 2020.
- The overall economic capital and the risk exposure amount both increased in 2020, resulting in an EC/REA ratio of 9.8% at year-end.
- Compared to the most recent SREP requirement of 18.8% and an implied management buffer of 3.2%, the Bank's excess capital is 3.1 percentage points or ISK 35 billion.

Capital position

as at 31.12.2020



3.1 Capital management framework

The purpose of the Bank's capital management framework is to support the Bank's strategy and ensure that it has sufficient capital to cover its risks. The capital management framework of the Bank is comprised of 4 interdependent activities: capital assessment, risk appetite/capital target, capital planning, and reporting/monitoring.

The Bank uses standardised approaches in measuring the regulatory capital requirement for Pillar I risks and economic capital (EC) for capital management purposes.

The Bank's capital management governance structure at year-end 2020 is as follows:

Board of Directors

The Board of Directors of Landsbankinn is responsible for reviewing and approving the Bank's business strategy and policy on aggregate exposure and determines the Bank's risk appetite. The Board of Directors approves the Bank's current funding programme and subordinated borrowings. The Board of Directors shall be actively involved in the design and implementation of stress tests and ensure that they are based on robust and efficient governance and methodology.

CEO, Risk & Finance Committee

The CEO is responsible for implementation of the capital structure policy. The CEO has formed the Risk & Finance Committee to manage and oversee the implementation. The Committee is responsible for ensuring compliance with the policy in the development of the Bank's business and financial plans. The Risk & Finance Committee is responsible for the design and presentation of stress tests and scenarios.

Finance & Operations

The CFO is responsible for the day-to-day capital management and funding of the Bank and reports to the Risk & Finance Committee. The Finance & Operations Division is tasked with monitoring the risk-weighted asset base, the capital base and capital position at any given time, and reporting on these matters. Reporting incorporates regular reports on developments in the capital base and equity requirements and plans, as well as the ICAAP/ILAAP report and the recovery plan. Finance & Operations is responsible to the Risk & Finance Committee for the design and presentation of scenarios and implementation of stress testing of the Bank's capital structure. Treasury, a department within Finance & Operations, is responsible to the Risk & Finance Committee for the management of the Bank's funding, both in ISK and foreign currency.

Risk Management

The CRO is responsible for risk assessment and monitoring of risk factors and reports to the Risk & Finance Committee. Risk Management is also responsible for the EC framework and measurement and the Pillar III risk report.

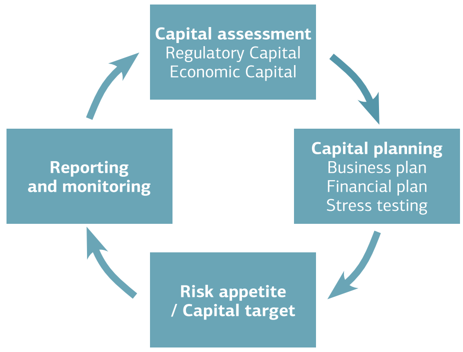
Managing directors of income-generating divisions

The managing directors of income-generating divisions shall comply with the capital structure policy in their activities. This means, *inter alia*, that business decisions taken within these divisions shall comply with the business plan and budget, risk appetite and the Bank's current profitability target.

Internal Audit

Internal Audit shall regularly review and comment on the framework and work procedures related to the capital structure policy and, thereby, help ensure that the policy extends to and is proportional to the nature, scope and risk inherent in the Bank's operation.

Figure 3.1: Capital management framework



3.2 Capital policy, capital requirement and capital targets

3.2.1 Capital policy

The Bank has a policy on capital structure, the objective of which is to ensure appropriate management, efficiency and economic utilisation of the Bank's equity, while additionally ensuring that the Bank fulfils regulatory capital requirements. With active capital management, the Bank ensures that dividend payments are based on its dividend policy and do not violate equity and liquidity positions in excess of set limits, and that the Bank can at all times meet increased risk in its operating environment.

The total capital ratio target is reviewed annually. When setting the target, EC, Pillar I and II capital requirements, regulatory capital buffers, management capital buffer, risk appetite, and strategic objectives are considered. The Bank's aim is to maintain a capital ratio above the FSA's total capital requirement at any given time, plus a management buffer specified in the Bank's risk appetite. The Bank also aims to be in the highest category for risk-adjusted capital ratio, as determined and measured by the relevant credit rating agencies.

The Bank aims to pay regular dividends to shareholders, amounting to around 50% of the previous year's profit. In addition, and in line with the Bank's target capital and liquidity ratios, the aim is also to make special dividend payments to optimise the

Table 3.1: Capital Requirement

31.12.2020	CET1	Tier 1	Total
Pillar I	4.5%	6.0%	8.0%
Pillar II-R	1.9%	2.6%	3.4%
Minimum requirement under Pillar I and Pillar II-R	**6.4%**	**8.6%**	**11.4%**
Systemic risk buffer	2.88%	2.88%	2.88%
Capital buffer for systematically important financial institutions	2.00%	2.00%	2.00%
Countercyclical capital buffer	0.00%	0.00%	0.00%
Capital conservation buffer	2.50%	2.50%	2.50%
Combined buffer requirement	**7.38%**	**7.38%**	**7.38%**
Total capital requirement	**13.8%**	**16.0%**	**18.8%**

Bank's capital structure. No dividend was paid in 2020 because of the prevailing economic uncertanity and precautionary guidance from the FSA.

In determining the amount of dividend payments, the Bank's continued strong financial position should be considered. Risk in the Bank's internal and external environment, growth prospects and the maintenance of a long-term, robust equity and liquidity position shall be taken into account, as well as compliance with regulatory requirements of financial standing at any given time.

3.2.2 Capital requirement and capital target

The Internal Capital/Liquidity Adequacy Assessment Process (ICAAP/ILAAP) under Pillar II is the Bank's own assessment of its capital need. It is based on EC calculations, stress testing and current results from the Supervisory Review and Evaluation Process (SREP) by the FSA. ICAAP/ILAAP and SREP form the foundation for the Bank's capital planning, including the business and financial plan for the next 3 years. The Bank's most recent capital requirements, as determined by the FSA, are shown in Table 3.1 (%/REA).

The capital requirement of 18.8% is based on the outcome of the FSA's 2019 SREP, having regard for the latest decisions on capital buffer requirements (the domestic countercyclical capital buffer was eased from 1.75% as of 15.5.2019 to 0.0% from 19.03.2020 to date).

The Covid-19 pandemic hit in the early stages of the 2020 SREP. This has led to great economic and operational uncertainty for financial institutions. Responding to these unprecented circumstances, the Financial Stability Committee of the Central Bank of Iceland in September 2020 decided to maintain the 2019 SREP capital requirements for Pillar II-R of 3.4%. The FSA closely monitors the most significant risk factors for systematically important financial institutions (SIFIs) and will review the Pillar II-R and Pillar II-G (current Pillar II-G requirement is 0%) requirement in the 2021 SREP at the latest.

The Bank's capital target is based on the current regulatory capital requirement of 13.8% CET1 and 18.8% total capital ratio. In addition, the Bank defines a management buffer for the purpose of targeting and managing its capital position comfortably above the overall regulatory capital requirement. Determination of the management buffer is based on various current and forward-looking factors such as the economic and funding outlook, competitive issues, risk profile and business plan.

As shown in Table 3.2 the Bank's total targeted capital ratio is $\geq$ 22% and $\geq$ 18% for the CET1 ratio. Given the 18.8% TCR requirement, the Bank's current implied minimum management buffer is 3.2%. The total capital ratio at year-end 2020 was 25.1% meaning the Bank's excess capital is 3.1% of REA, or ISK 35 billion.

Table 3.2: Capital Ratio

	Goal	2020	2019	2018	Comment
Total capital ratio	≥22.0%	25.1%	25.8%	24.9%	Long-term goal
Common equity Tier 1	≥18.0%	23.2%	23.9%	23.6%	Long-term goal
Dividend pay-out ratio	Around 50%	0%	52%	78%	The target dividend pay-out ratio is around 50% of the previous year's profit. In addition, the Bank aims to make special dividend payments to optimise capital structure. Taking precautionary measures related to economic uncertainty, the Bank did not pay a dividend from 2019 profits in 2020.

Table 3.3: Capital buffers

	15.5.2019	1.2.2020	19.3.2020	Effective capital buffers at year-end 2020
Systemic risk buffer	3.00%	3.00%	3.00%	2.88%
Capital buffer for systematically important financial institutions	2.00%	2.00%	2.00%	2.00%
Countercyclical buffer	1.75%	2.00%	0.00%	0.00%
Capital conservation buffer	2.50%	2.50%	2.50%	2.50%
Combined capital buffer requirement	**9.25%**	**9.50%**	**7.50%**	**7.38%**

3.2.3 Capital buffers

CRD IV introduced a combined buffer requirement that applies in addition to the solvency need ratio. The combined buffer consists of a countercyclical buffer, a capital conservation buffer, O-SII buffer and a systemic risk buffer. Capital buffers must be funded with CET 1 capital.

The combined capital buffer requirement as determined by the Icelandic Financial Stability Council (FSC) for SIFIs is 7.50% of REA at year-end 2020 as compared to 9.50% at year-end 2019. The change is driven by a Covid-19 related decrease in the domestic countercyclical capital buffer in March 2020. Easing the countercyclical capital buffer requirement aims to allow the banking system to better support households and businesses through the pandemic.

The capital buffers are expressed as a proportion of consolidated REA. However, the systemic risk buffer only applies to domestic REA, meaning that the effective requirement for the buffer is somewhat lower than defined by the financial authorities, or 2.88% instead of 3.0%, as foreign exposures account for 4% of total REA. The systemic risk buffer is high in Iceland compared to other countries. The Bank maintains the viewpoint that this buffer overestimates the systemic risk present in Iceland. The effective countercyclical capital buffer is determined using the weighted average of the prevailing capital buffer level in the countries where the Bank has exposure. As the buffer is currently 0% in Iceland, like in most other European countries, the Bank's effective requirement for the countercyclical capital buffer is close to 0%, or 0.004%.

The effective total regulatory capital buffer for the Bank at year-end 2020 is 7.38% of consolidated REA. In addition, and as previously mentioned, the Bank has set an implied minimum management buffer of 3.2%, bringing total capital buffers at year-end up to 10.6%.

Table 3.4: Domestic and foreign REA

	2020	2019
Domestic REA	96%	95%
Foreign REA	4%	5%
Total	100%	100%

3.3 Capital position

The Bank's equity increased by ISK 10.7 billion in 2020 and amounted to ISK 258.3 billion (2019: ISK 247.7 billion) at 31 December 2020. The capital adequacy ratio is calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings. The Bank's total capital ratio decreased by 0.7 percentage points in 2020, remained strong at 25.1% as at 31 December 2020 (2019: 25.8%).

The capital base consists of 23.2% CET1 based on core equity only and 1.9% of Tier 2 capital, with two instruments in the form of subordinated liabilities: firstly, an EUR 100 million (ISK 15.7 billion) instrument with final maturity in September 2028 but callable in September 2023 and, secondly, an ISK 5.7 billion fixed-rate inflation-linked instrument with final maturity in December 2029 but callable in December 2024.

On 4 May 2020, regulation No. 452/2020 transposed into Icelandic law Regulation (EU) 2017/2395 of the European Parliament and of the Council amending Regulation (EU) No. 575/2013, as regards, *inter alia*, transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds. The Financial Supervisory Authority (FSA) has granted permission for the Bank to apply IFRS 9 transitional arrangements in accordance with the aforementioned regulations. The effect of the arrangements on the Bank's CET1 capital was positive by ISK 5.4 bn and REA increased by the same amount.

Changes in the Bank's TCR for the year 2020 are demonstrated in Figure 3.2.

The Board of Directors intends to propose that the annual general meeting (AGM) approve a dividend of ISK 0.19 per share, to be paid to shareholders in 2021. Should the AGM approve this dividend proposal, the Bank's capital will be reduced by an amount equivalent to the dividend payment and the Bank's capital ratios, in accordance with the Act on Financial Undertakings, will decrease by 0.4 percentage points.

3.3.1 CET1 capital - statutory deductions and transitional arrangements

CET1 capital consists of core equity less statutory deductions according to requirements of the FSA based on Article 10 of Act No. 161/2002.[1] The Bank makes deductions in order to determine its CET1 capital where applicable.

- Carrying amounts of intangible assets
- Deferred tax assets
- Capital holdings in other credit and financial institutions amounting to more than 10% of their capital
- Foreseeable dividends in next year's operations

Furher to CET1 statutory deductions, the Bank makes transitional arrangements by mitigating the impact of the introduction of IFRS 9 on own funds based on regulation 452/2020.

3.4 Capital assessment

3.4.1 Minimum capital requirement

The regulatory minimum capital requirement (CR) under Pillar I of the Directive is 8% of risk-weighted assets for credit risk, market risk and operational risk. The Bank uses the standardised approach[2] in measuring Pillar I capital requirements for credit risk and market risk. For operational risk, it uses the basic indicator approach.

The Bank's risk exposure amount (REA) was ISK 1,122 billion at year-end 2020 and increased by ISK 101 billion, or 9.8%, for the year. Accordingly, the minimum capital requirement for the Bank was ISK

[1] Article 55, see http://www.althingi.is/lagas/145b/2002161.html
[2] See Staðalaðferð http://www.stjornartidindi.is/Advert.aspx?ID=f051707c-8c23-4e99-a305-68dcb6f97a29

Table 3.5: Breakdown of the capital base

	31.12.2020	**31.12.2019**
Share capital	23,625	23,625
Share premium	120,630	120,630
Reserve	19,250	14,334
Retained earnings	94,750	89,145
Total equity attributable to owners of the Bank	**258,255**	**247,734**
Intangible assets	-1,696	-2,296
Deferred tax assets	-23	-20
Fair value hedges	-1,696	-1,327
Adjustment under IFRS 9 transitional arrangements	5,353	-
CET1	**260,246**	**244,091**
Non-controlling interests	0	0
Tier 1 capital	**260,246**	**244,091**
Subordinated liabilities	21,366	19,081
Tier 2 capital	**21,366**	**19,081**
Capital base	**281,612**	**263,172**
Risk exposure amount (REA)		
Credit risk	1,010,588	908,249
Market risk	11,526	11,754
Operational risk	99,485	100,394
Total REA	**1,121,599**	**1,020,396**
CET1 ratio	**23.2%**	**23.9%**
Total capital ratio	**25.1%**	**25.8%**

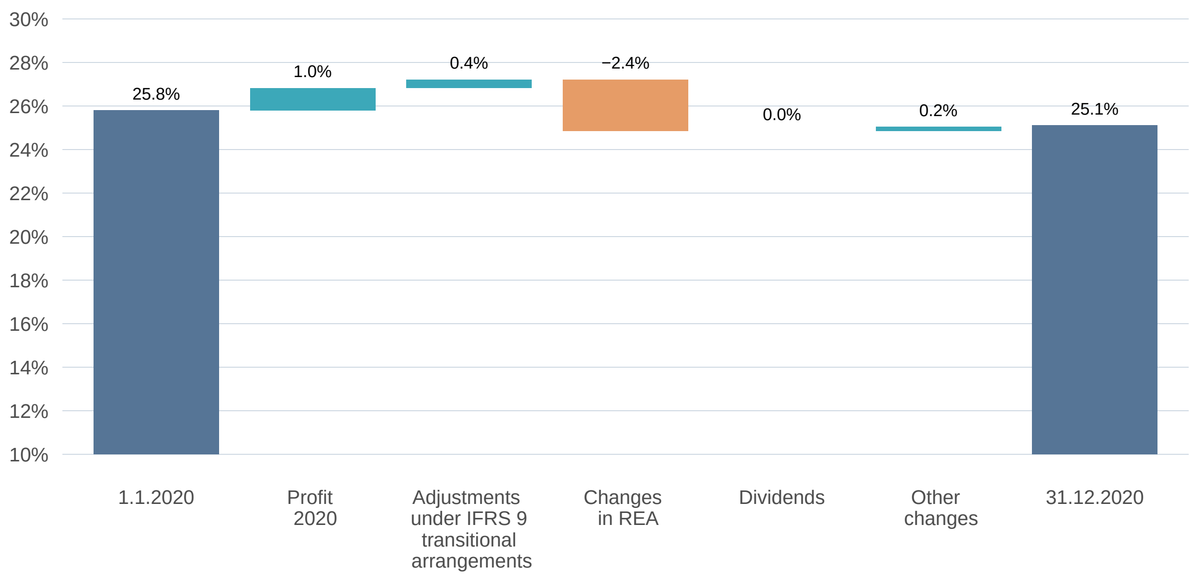


Figure 3.2: Change in capital ratio

89.7 billion as compared to ISK 81.6 billion at year-end 2019. Credit risk is the single largest risk type or 90.1% of total REA and minimum capital requirement.

In 2020, the SME factor was implemented in Iceland and the Bank was authorised to apply the factor to decrease risk exposure amounts to customers who fulfil the SME factor requirements. Application of the SME factor decreased the risk exposure amount at year-end 2020 by a total of ISK 11.5 billion for exposures classified as 'corporate', 'retail' and 'secured by immovable property'.

During the year 2020, the Bank implemented the European Banking Authority's (EBA) guidelines for exposures with high risk (EBA/GL/2019/01). In line with these guidelines, certain exposures were re-classified as high risk resulting in an increase in REA by ISK 51.7 billion. These exposures are mainly either equities in the banking book or speculative immovable property financing (corporates and retail). This increase in REA, and therefore in Pillar I capital requirement, will likely be offset in the upcoming SREP as these exposures have a higher Pillar II capital requirement, which means that the Pillar II requirement will most likely decrease as a result.

Other material changes in REA were in line with increased lending, mostly in mortgages.

3.4.2 Economic capital

Economic capital (EC) is a risk measure that is applied to all material risks. It captures unexpected losses and reduction in value or income for which the Bank needs to hold capital to avoid insolvency. It arises from the unexpected nature of losses as distinct from expected losses. EC is calculated as the difference between unexpected losses and expected losses, where unexpected loss is defined as the 99.9% Value-at-Risk (VaR), with a one-year time horizon.

The purpose of the EC framework is to enable the

Table 3.6: Capital requirement and REA

	31.12.2020		31.12.2019	
	CR	**REA**	**CR**	**REA**
Credit risk breakdown				
Central governments or central banks	129	1,616	69	867
Regional governments or local authorities	151	1,884	159	1,984
Public sector entities	12	152	0	0
Institutions	804	10,050	802	10,024
Corporates	41,895	523,691	45,185	564,810
Retail	7,149	89,368	9,217	115,214
Secured by mortgages on immovable property	16,460	205,750	12,220	152,747
Exposures in default	2,446	30,576	2,118	26,481
Items associated with particular high risk	9,811	122,639	0	0
Equity	76	947	0	0
Other items	1,913	23,914	2,890	36,122
Credit risk	**80,847**	**1,010,588**	**72,660**	**908,249**
Market risk breakdown				
Traded debt instruments	209	2,613	293	3,658
Equities	313	3,913	305	3,807
CVA	14	172	8	106
Currency risk	536	6,698	606	7,571
Market risk	**386**	**4,828**	**335**	**4,183**
Operational risk	**7,959**	**99,485**	**8,032**	**100,394**
Total capital requirement and REA	**89,728**	**1,121,599**	**81,632**	**1,020,397**

Bank to assess the amount of capital it requires to cover the economic effects of risk-taking activities, as well as to compare different risk types using a common "risk currency". The EC framework further measures unexpected losses, decomposes EC on various levels to enable capital allocation, limit-setting, pricing of products, risk-adjusted performance measurement and value-based management.

The framework covers the following risk types: credit risk, market risk, currency risk, operational risk, concentration risk, interest rate risk in the non-trading book, inflation risk, legal risk and business risk.

Table 3.7 summarises how the Bank calculates its EC for the risks included in the framework.

EC amounted to ISK 110.1 billion at 31 December 2020 and increased by ISK 11.8 billion or 15.9% during the year (2019: ISK 98.2 billion). The ratio of EC to REA increased from 9.6% to 9.8% during the year.

Credit risk is the driving factor for increase in EC in 2020 with increase of ISK 10.4 billion for the year. EC for the retail loan portfolio increased by ISK 1.8 billion, or 13%, for the year due to increased mortgage lending. However, the credit quality of the retail portfolio improved with 2.3% EC/EAD (2019: 2.5% EC/EAD), mainly due to higher ratio of mortgages in the portfolio. EC for the corporate loan portfolio increased by ISK 8.1 billion, or 17%, and EC/EAD increased from 7.0% to 8.0% in 2020, where PD increased from 2.5% to 4.1% for the year. The increase in EC was mainly due to the increase in PD for the portfolio, largely caused by downgrade in rating grade for corporates within the travel industry that are in financial difficulties due to Covid-19.

EC for other risk categories than loans to customers and credit institutions amounted to ISK 37.9 billion at year-end 2020 (2019: ISK 35.9 billion). EC for market risk and currency risk increased collectively by ISK 1 billion, primarily due to extreme market volatility following the Covid-19 pandemic.

Table 3.9 shows a breakdown for credit risk, probability of default by asset class, as well as LGD, EAD and EC for loans to customers and credit institutions.

3.4.3 Pillar II

Pillar II sets forth the framework for the supervisory review process (SREP) and the framework for the Bank's internal capital/liquidity adequacy assessment process (ICAAP/ILAAP). The Bank is exposed to many risks, and they are not limited to those that are quantified under Pillar I (credit, market and operational risks). Pillar II concerns the Bank's risks in a wider sense, yet is still specific to its operation, i.e. risk profile and business environment.

Table 3.10 shows the results of the 2020 SREP as published by the FSA on 1 February 2021. The Pillar II requirements are 3.4% of REA and as a result, the Bank's minimum capital requirement under Pillar I and Pillar II-R is 11.4% plus capital buffers of 7.38%. The Pillar II requirement is unchanged from the previous year as the Central Bank of Iceland financial stability committee decided in September 2020 to withhold the 2019 SREP capital requirements for Pillar II-R until the 2021 SREP process at the latest.

3.4.4 Capital allocation to business lines

The Bank makes an internal capital allocation across business divisions on the basis of each unit's contribution to the Bank's total risk as estimated by the Bank's EC model. Capital exceeding the Bank's minimum capital target and the management buffer is allocated to Treasury. Allocated capital plus retained earnings per business unit at year-end 2020 is shown in Figure 3.3.

Figure 3.3: Capital allocation per business line

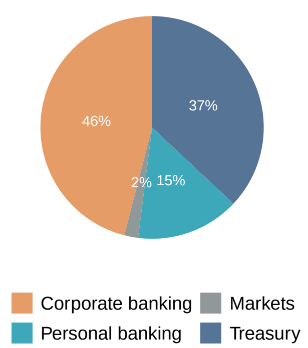


Table 3.7: Calculation method of economic capital

Risk	Calculation method
Credit risk	The main credit risk EC model is the asymptotic single risk factor (ASRF) model from the Basel framework internal rating based (IRB) approach's risk weight formula, i.e., EC equals the capital requirements of the IRB approach in the capital requirements directive. The main inputs to the model are the risk parameters probability of default (PD), loss given default (LGD) and exposure at default (EAD). EC for counterparty credit risk is calculated according to the Mark-to-Market Method in the CRR and for equities in teh banking book the simple risk weight approach in the CRR is applied. EC for credit risk for all other exposure classes is measured by the standardised approach.
Market risk	Market risk EC includes EC for interest rate risk in the trading book and EC for equity price risk in the trading book. Each EC is calculated according to a stressed VaR model as specified in the internal model's approach in the capital requirements directive (CRR). The model inputs are calibrated to historical data from the previous 5 years. EC for credit valuation adjustment (CVA) equals the capital requirements for CVA.
Currency risk	EC for foreign exchange risk is calculated according to a modified stressed VaR model, where the model inputs are calibrated to historical data from a period of significant stress relevant to the Bank's net FX position. The time horizon is one year.
Concentration risk	EC for single name concentration is calculated by adjusting for the granularity and non-homogeneity in the loan portfolio. This is necessary as the credit risk EC model assumes that the portfolio is infinitely large and homogeneous; hence, the single name concentration EC is given as an add-on. An internal model is used to measure the additional EC for credit risk related to industry concentrations in the loan portfolio, i.e. a concentration add-on. The model calculates the industry concentration risk for the loan portfolio and subtracts the industry concentration risk for Iceland to get the EC add-on for industry concentration.
Interest rate risk and inflation risk in the banking book	EC for interest rate risk and inflation risk in the banking book is equal to the sum of: i The loss in economic value corresponding to the 99.9th percentile for ISK and the 99th percentile for significant foreign currencies of risk factor changes estimated by a Monte Carlo simulation model. ii The loss in economic value due to a +/- 200 bps shift of risk factors in other currencies (whichever results in a larger loss).
Operational risk	EC for operational risk is calculated using the basic indicator approach, which means that it equals the Bank's capital requirement.
Business risk	EC for business risk is measured at least annually in the ICAAP and is based on the effects of the base case scenario on the Bank's balance sheet and operations and its effect on the Bank's capital base.
Legal and political risk	EC for legal and political risk is calculated by adding the potential loss of on-going disputes weighted by their status within the legal system.

Table 3.8: Economic capital

	2020	2019
Credit risk - Loans to customers and credit institutions	72,194	62,292
Credit risk - Other assets	7,583	7,098
Market risk	2,300	1,511
Currency risk	964	776
Operational risk	7,959	8,031
Single name concentration risk	7,226	6,331
Industry concentration risk	1,618	1,539
Interest rate and inflation risk	7,878	8,587
Business risk	0	0
Legal and political risk	2,329	2,067
Total	**110,051**	**98,232**
REA	1,121,599	1,020,396
EC/REA	**9.8%**	**9.6%**

Table 3.9: Credit risk - loans to customers and credit institutions

Credit risk as at 31 December 2020	PD	LGD	EAD	EC
Financial institutions	0.1%	45.0%	47,884	770
Public entities	0.7%	45.0%	9,832	163
Retail	1.8%	24.7%	671,855	15,245
Corporates	4.1%	34.0%	702,549	56,016
Total	**2.9%**	**30.1%**	**1,432,120**	**72,194**
Credit risk as at 31 December 2019	**PD**	**LGD**	**EAD**	**EC**
Financial institutions	0.1%	45.0%	47,531	765
Public entities	0.6%	45.0%	10,063	163
Retail	2.1%	25.0%	545,597	13,408
Corporates	2.5%	33.7%	686,248	47,956
Total	**2.2%**	**30.5%**	**1,289,439**	**62,292**

Table 3.10: SREP results

		2020	2019
		% REA	% REA
Pillar I	Credit risk	7.1%	7.1%
	Market risk	0.1%	0.1%
	Operational risk	0.8%	0.8%
	Minimum capital requirement	**8.0%**	**8.0%**
Pillar II	Credit, counterparty and concentration risk	1.9%	1.9%
	Market risk and IRRBB	1.3%	1.3%
	Other risk	0.2%	0.2%
	Additional P-II R	**3.4%**	**3.4%**
	Additional P-II G	**0.0%**	**0.0%**
	Minimum requirement under Pillar I and Pillar II-R	**11.4%**	**11.4%**

3.4.5 Risk-adjusted return on capital

To analyse the Bank's risk-adjusted profit and profitability, i.e. including the cost of risk, the measures risk-adjusted profit (RAP) and risk-adjusted return on capital (RAROC), are reported monthly to senior management. The objective of these metrics is to assess shareholder value creation and profitability in relation to the equity capital needed to cover the undertaken risks, i.e., the economic capital. The measures enable risk-based pricing, increase incentives to measure and manage risk appropriately, focus on long-term profit, and support the assessment of the Bank's optimal capital structure. These measures have been implemented throughout the Bank and are used in individual credit decisions for large corporate customers, as well as to determine the pricing of loan products for smaller corporate customers and individuals.

3.5 Leverage ratio

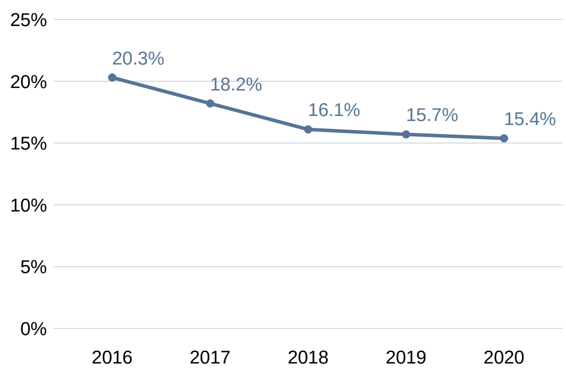
The Capital Requirements Regulation (CRR), as part of the Basel III framework, requires banks to measure, report and monitor their leverage ratios. The ratio is defined as CET1 capital as a percentage of total leverage exposure (see table 3.11) and acts as a credible supplementary measure to the risk-based capital requirements.

A credible leverage ratio is one that ensures broad and adequate capture of both the on and off-balance sheet sources of the Bank's leverage, aimed at revealing hidden leverage on the Bank's balance sheets. The ratio reinforces the risk-based requirements with a simple non-risk based "backstop" measure and is intended to restrict the build-up of leverage in the banking sector. The leverage ratio minimum requirement is 3%.

At 31.12.2020, the Bank's leverage ratio was 15.4%. Further information about the leverage ratio can be found in the additional disclosures accompanying this document.

Figures 3.4 and 3.5 show the Bank's leverage ratio for the past years. Despite trending downwards in this period, the ratio is still over five-fold the minimum 3% requirement. The main drivers of the decreasing leverage ratio are increasing total assets and decreasing Tier 1 capital, in line with the Bank's policy to better optimise its capital structure.

Figure 3.4: Leverage ratio



In theory, if the Bank would want to decrease its leverage ratio and aim for the minimum of 3%, it would not be able to do so without breaching other regulated, or internal risk appetite ratios first. Furthermore, off balance sheet exposures and derivatives instrument exposure are not significant factors of the Bank's leverage ratio. Therefore, the risk of excessive leverage is not considered a significant risk factor for the Bank. Nevertheless, leverage ratio is a part of the Bank's risk appetite and is considered a relevant risk indicator both in the Bank's ICAAP/ILAAP as well as within BRRD. The Bank has management actions in place to meet scenarios that would adversely affect the Bank's leverage ratio.

Table 3.11: Leverage ratio

	2020	2019
Tier 1 capital	260,246	244,091
Leverage exposure		
- On balance sheet exposure (excluding derivatives)	1,556,541	1,423,634
- Derivatives instrument exposure	5,944	2,695
- Potential future exposure on derivatives	4,366	1,625
- Off balance sheet exposure	130,089	125,848
- Regulatory adjustments to Tier 1 capital	-3,362	-3,643
Total leverage exposure	**1,693,578**	**1,550,158**
Leverage ratio	**15.4%**	**15.7%**

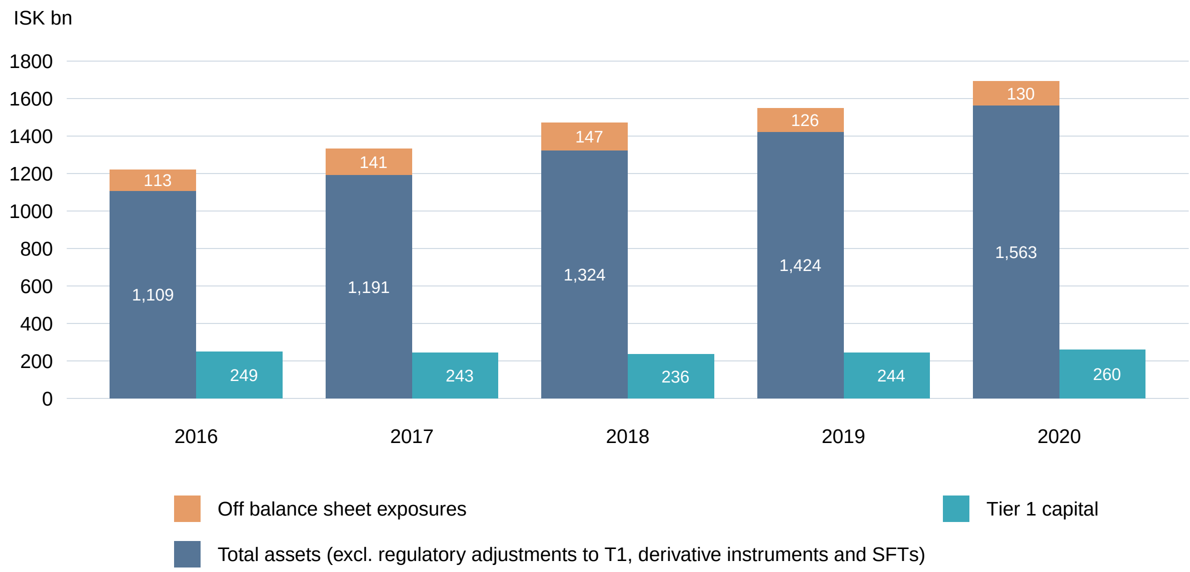


Figure 3.5: Leverage ratio breakdown

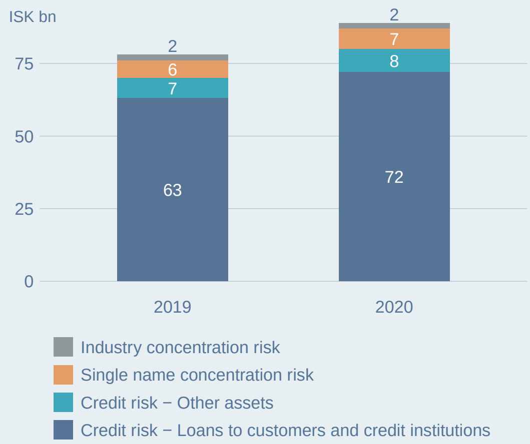
4 Credit risk

Credit Risk

Credit risk is defined as the risk of loss if customers fail to fulfil their agreed obligations and the estimated value of pledged collateral does not cover existing claims.

- The Covid-19 pandemic had an effect on the Bank's risk profile in 2020, reflected in moratoria measures for customers, increase in ECL, increase in ratio of stage 2 loans and deteriorating credit quality for customers with forborne loans.
- Probability of default, weighted by gross carrying amount, increased to 2.8% at year-end 2020 (2019: 2.3%).
- Economic capital due to credit risk from loans to customers and credit institutions increased in 2020, due to higher PD values for corporates and increased mortgage lending.
- Total expected credit loss was ISK 25 billion at year-end 2020 (2019: ISK 15 billion)
- Total credit exposure from lending activities increased by 12%, driven by growth in the mortgage portfolio.

EC - Credit and concentration risk



4.1 Credit risk management

The Bank offers loans, credits, guarantees and other credit-related products as part of its business model and thus takes on credit risk. Regular risk reporting enables the ongoing monitoring of the Bank's credit risk position relative to its risk appetite.

The credit risk appetite is converted by the business units to their specific key performance indicators (KPIs) in collaboration with Risk Management. Monitoring functions determine whether credit facilities are granted in accordance with the risk appetite. Risk Management monitors and challenges the performance and reports the progress to the Executive Board and the Board of Directors.

Credit risk is primarily managed through the credit process and the Bank's credit risk models which include PD, LGD and EAD modelling. The models are used for various purposes, such as in provisioning, calculating EC and management reporting.

4.1.1 Identification

Credit risk is defined as the risk of loss if customers fail to fulfil contractual obligations and the estimated value of pledged collateral does not cover existing claims.

The Bank's activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed. Settlement risk is deemed immaterial in the Bank's operations.

Credit risk is the greatest single risk faced by the Bank and arises principally from loans and advances to customers and from investments in debt securities, but also from commitments, guarantees and documentary credits, counterparty credit risk in derivatives contracts, and the aforementioned settlement risk.

4.1.2 Assessment

Credit risk is measured in three main dimensions: probability of default (PD), loss given default (LGD) and exposure at default (EAD). To measure PD, the Bank has developed an internal rating system, including a number of internally developed rating models. The objectives of the rating system are to provide a meaningful assessment of obligor characteristics; a meaningful differentiation of credit quality; and accurate and consistent quantitative estimates of default risk, i.e. probability of default (PD). Internal ratings and associated PD values are essential in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an obligor rating scale which exclusively reflects quantification of the risk of obligor default, or credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors from 1 to 10, with 10 indicating the highest credit quality, and the grade 0 for defaulted obligors. The rating assignment is supported by rating models, where information such as industry classification, financial accounts and payment behaviour is taken into account.

The internal rating system is used to assign ratings and calculate risk-weighted exposure amounts for the majority of the Bank's customers for economic capital. However, there are a few exceptions. External ratings, from Standard & Poor's, Moody's and Fitch, are used for foreign credit institutions and ratings from Creditinfo are used for new retail customers.

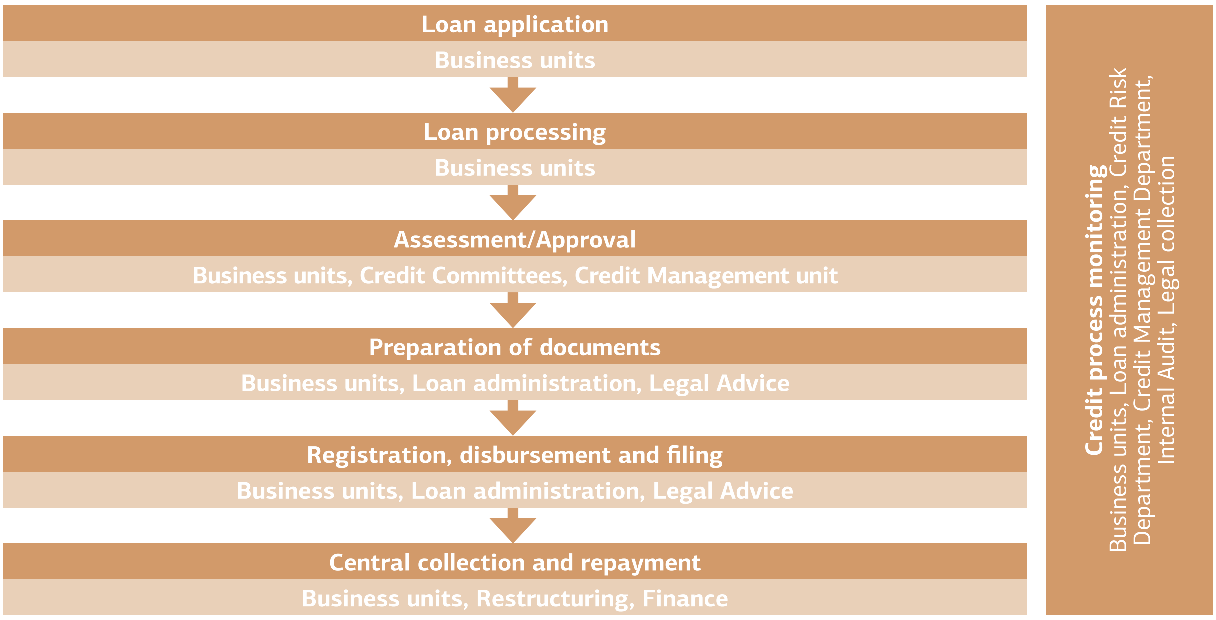


Figure 4.1: The credit process

Table 4.1: Internal mapping from internal rating grade to external rating agencies

Internal rating grade	Standard & Poor's and Fitch	Moody's	Lower PD	Upper PD
10	AAA/AA+/AA/AA-	Aaa/Aa1/Aa2/Aa3	0.00%	0.04%
9	A+/A/A-	A1/A2/A3	0.04%	0.10%
8	BBB+	Baa1	0.10%	0.21%
7	BBB/BBB-	Baa2/Baa3	0.21%	0.46%
6	BB+/BB	Ba1/Ba2	0.46%	0.99%
5	BB-	Ba3	0.99%	2.13%
4	B+	B1	2.13%	4.54%
3	B	B2	4.54%	9.39%
2	B-	B3	9.39%	18.42%
1	CCC/C	Caa1/Caa2/Caa3/Ca/C	18.43%	99.99%

The rating assignment and approval is an integrated part of the credit approval process and assignment shall be updated at least annually, or when material information on the obligor or exposure becomes available, whichever is earlier. The rating assessment of corporate obligors having financial difficulties, as a result of the Covid-19 pandemic, were updated in 2020. These more frequent updates of rating assessment usually led to a downgrade in rating grade.

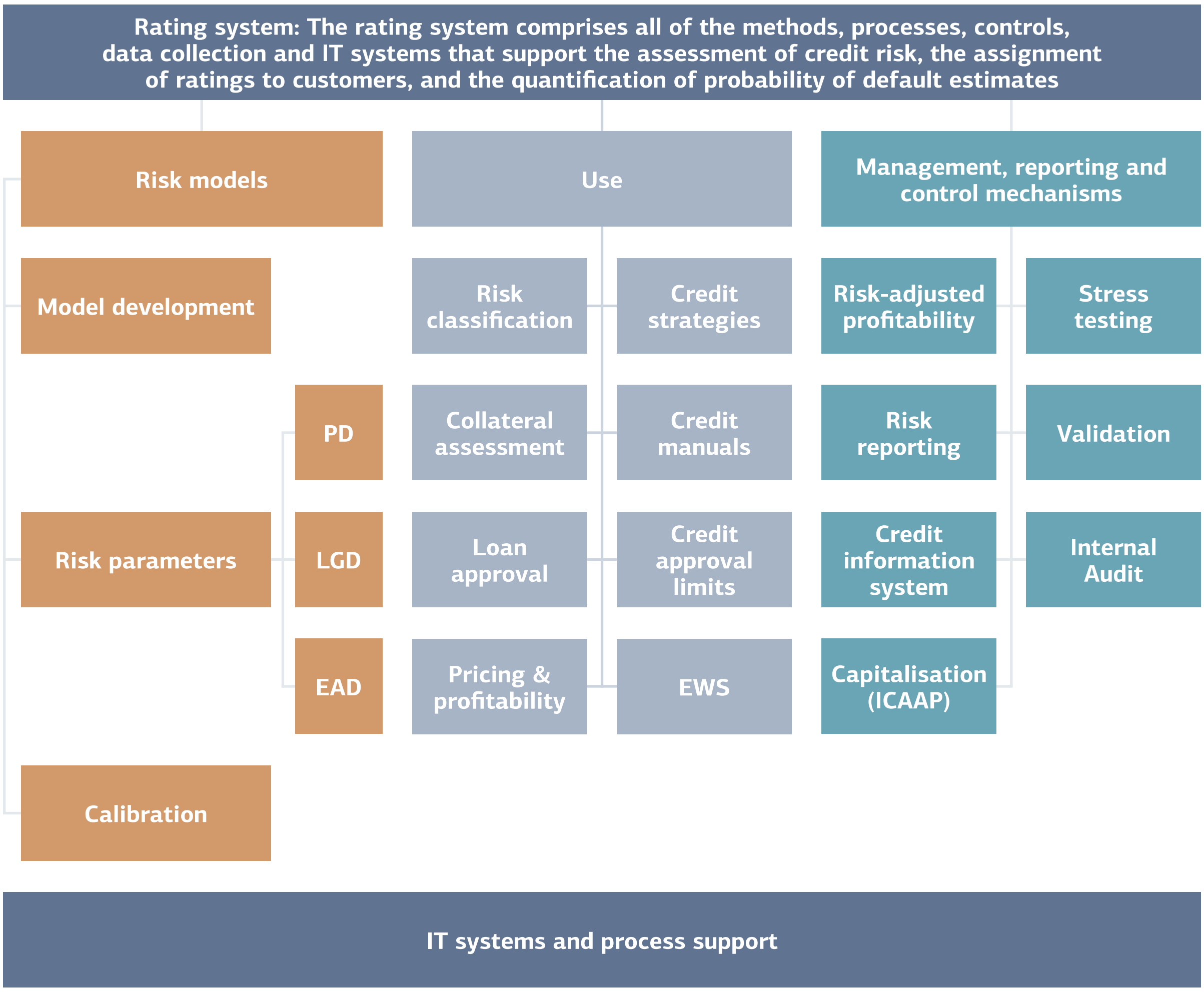


Figure 4.2: Rating system overview

The Bank's estimation and validation process includes quality controls to assess the performance of models, procedures and systems, and is designed to ensure the accuracy of the parameters through adjustments where necessary.

The rating models are validated annually, both quantitatively and qualitatively. The quantitative validation includes statistical tests of the models' discriminatory power, i.e. the models' ability to distinguish default risk, and absolute accuracy, i.e. the ability to predict default levels.

The PD parameters are re-estimated and validated annually by a quantitative and qualitative assessment. The quantitative assessment includes statistical tests to ensure that the estimates remain valid when new data is added. PD estimates are based on observed default frequency in available internal data and adjusted to long term default frequencies through an add-on. The adjustment for the length of internal data available is embedded in the margin of conservatism which also includes an add-on to compensate for statistical uncertainty in the estimation.

LGD is measured using an internal LGD model for the purpose of EC calculations and provisioning. The internal LGD model takes into account more types of collateral and is more sensitive to the collateralisation level than the model defined in the Basel framework, and is calibrated to historical loss data.

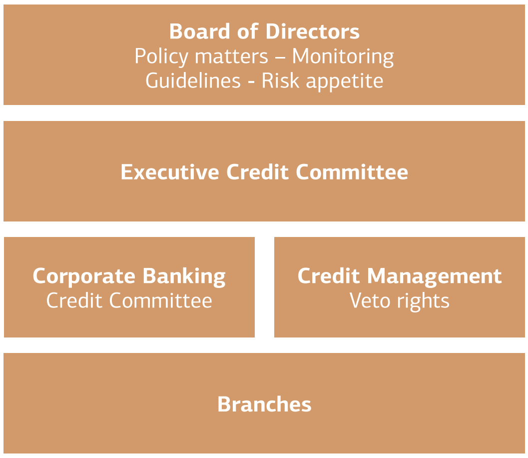
Exposure at default (EAD) is an estimate of the amount outstanding (drawn amounts plus likely future drawdowns of yet undrawn lines) in case the borrower defaults. The Bank uses the standard approach for estimating REA and EC but uses internal models for provisioning.

4.1.3 Management and policy

The Bank's credit risk management objective is to ensure compliance with the Bank's credit policy, which entails that the only risk taken is one that the Bank understands, can evaluate, measure and manage.

The Bank's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk & Finance Committee, the Credit Committee, the credit departments within the Risk Management Division and the business units. The Bank manages credit risk according to its risk appetite statement and credit policy approved by the Board of Directors, as well as detailed credit policies approved by the CEO. The risk appetite and credit policy include limits on large exposures to individual borrowers or groups of borrowers, concentration of risk and exposure to certain industries. The CEO ensures that the risk policy is reflected in the Bank's internal framework of regulations and guidelines. The Bank's Managing Directors are responsible for ensuring that the Bank's business units execute the risk policy appropriately and the CEO is responsible for the oversight of the process as a whole.

Figure 4.3: Credit risk management framework



Incremental credit authorisation levels are defined based on size of units, types of customers and the lending experience of credit officers. The Bank has also set industry policies that describe its appetite to provide credit to specific industries. Credit decisions exceeding authorisation levels of business units are subject to confirmation by Credit Management. The Corporate Banking Credit Committee has authorisation levels exceeding that of individual business unit managers and meets regularly to make credit decisions. Credit Management has veto powers over the decisions of the Corporate Banking Credit Committee. Credit decisions exceeding the signing limits of the Corporate Banking Credit Committee are subject to approval by the Bank's Credit Committee. Credit decisions exceeding the limits of the Credit Committee are subject to approval by the Board of Directors, which holds the highest credit authorisation within the Bank.

4.1.4 Mitigation

Mitigating risks in the credit portfolio is a key element of the Bank's credit policy, as well as an inherent part of the credit-decision process. Securing loans with collateral is the main method of mitigating credit risk, whereas for some loan products collateral is required by legislation, as in the mortgage finance market, or is standard market practice.

The most important types of collateral are real estate, vessels and financial assets (shares or bonds).

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the Bank's credit policy. Credit extended by the Bank may be secured on residential or commercial property, land, listed and unlisted securities, transport vessels, fishing vessels together with their non-transferable fishing quotas, etc. The Bank also secures its loans by means of receivables, inventory and operating assets, such as machinery and equipment. Residential mortgages involve the underlying residential property. Less stringent requirements are set for securing short-term personal loans, such as overdrafts and credit card borrowings.

The Bank regularly assesses the market value of received collateral. The Bank estimates the value as the market value less a haircut. A haircut in this context is a discount factor which represents a conservative estimate of the costs to sell in a forced sale. Costs to sell include maintenance costs during the period the asset is held for sale, external fees and loss in value. For listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability.

The Bank monitors the market value of mark-to-market collateral and may require additional collateral in accordance with the underlying loan agreements.

In order to further limit the credit risk arising from financial instruments, the Bank enters into netting agreements, under which the Bank is able to set off all contracts covered by the netting agreement against the debt in cases of default. The arrangements generally include all market transactions between the Bank and the customer.

Generally, collateral is not held over loans and advances to financial institutions, nor is it usually held against bonds and debt instruments.

The Bank includes all collateral to which a value is assigned in accordance with its internal procedures. Guarantees are included if they imply lower risk weights than the original exposure. In addition, collateral is volatility-adjusted (by means of a haircut) in order to take price volatility and the expected costs of repossession and sale of the pledge into account.

4.1.4.1 Derivative financial instruments and securities financing

In order to mitigate credit risk arising from derivatives and securities financing transactions, the Bank chooses the counterparties for derivatives and margin trading based on stringent requirements. The Bank also enters into standard International Swaps and Derivatives Association (ISDA) master netting agreements and similar general netting agreements with financial counterparties.

Collateral and margin requirements are in place for all derivative contracts and securities financing transactions the Bank enters into. Collateral management and monitoring is performed daily, and derivative contracts with customers are usually fully hedged.

The Bank's supervision system monitors both exposure and collateral value and calculates an intraday credit equivalent value for each derivative. It also issues margin calls and manages netting agreements.

In the case of derivatives, amounts due to and from the Bank are offset when the Bank has a legally enforceable right to set off a recognised amount and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. External ratings are used where applicable to assist in managing the credit risk exposure of bonds. Otherwise the Bank uses fair value estimates based on available information and the Bank's own estimates.

4.1.5 Control and monitoring

The Bank has set limits for large exposures as well as policies for exposure ratio for different portfolios to control the credit risk in the Bank's credit portfolio and ensure risk diversification. The credit risk decision process is controlled with limits set in the Bank's Credit rules approved by the Board of Directors. The rules set the limit for each credit decision party within the Bank where the credit approval authority is based on the underlying credit risk measured by exposure size, credit rating and colour classification code.

The credit risk monitoring process is based on regular reporting, monitoring systems and other manual monitoring. There is increased monitoring for significant exposures and for customers with indications of financial difficulties. One of the integral part of the credit risk monitoring process is the Early Warning System.

The Bank monitors exposures to identify signs of weakness in customer earnings and liquidity, or other issues that could increase the Bank's credit risk, as soon as possible. To monitor customers, the Bank uses an Early Warning System, which is supplemental to ratings and classifies credit exposures to four credit risk groups (green, yellow, orange and red). The colour classification is as follows:

- Green: the customer is considered as performing without signs of repayment problems
- Yellow: the customer shows indication of deteriorating financial strength, which could lead to financial difficulties
- Orange: the customer is or has been in financial difficulties or default
- Red: the customer is in default and in legal collection and/or restructuring

The Credit Risk Department within Risk Management is together with the business units responsible for the colour classification of customers.

4.1.6 Impairment process

The Bank uses the three-stage expected credit loss model under IFRS 9. Allowance is calculated as the 12-month expected credit loss (ECL) or the lifetime expected credit loss.

The Bank recognises loss allowances for ECL on the following financial instruments that are not measured at fair value through profit or loss:

- Cash and balances with Central Bank
- Bonds and debt instruments
- Loans and advances to financial institutions
- Loans and advances to customers
- Other assets

Off-balance sheet exposures:

- Financial guarantees and underwriting commitments
- Undrawn loan commitments
- Undrawn overdraft/credit card facilities

When measuring ECL, the Bank uses a forward-focused model in compliance with IFRS 9. This requires considerable judgement over how changes in economic factors affect ECL. ECL reflects the present value of cash shortfalls due to possible default events either over the following twelve months or over the expected life of a financial instrument, depending on credit deterioration from origination.

The Credit Risk Department is responsible for assessing impairment on loans and receivables and a Valuation Team, comprised of the CEO, the managing directors of Finance, Risk Management, Corporate Banking and Personal Banking, reviews and approves the assessment.

In general, all impairment charges are loan-specific based on the aforementioned ECL models. If needed, the Valuation Team can assess and issue additional general impairment charges.

In 2019, the lifetime PD models were validated. Based on the validation results, new and revised lifetime PD models were implemented in February 2020. In 2020, the staging allocation model and the LGD model were validated. These efforts are a clear indication of the Bank's continued focus on the quality of the impairment process.

4.2 Credit portfolio

4.2.1 Credit exposure

At year-end 2020, 90% of the Bank's risk exposure amount (REA) was due to credit risk, most of which comes from lending activities. On the same date, total loans and advances amounted to ISK 1,321 billion (2019: ISK 1,188 billion), with ISK 1,273 billion coming from lending activities (2019: ISK 1,140 billion) and ISK 48 billion from loans and advances to financial institutions (2019: ISK 48 billion).

The Covid-19 pandemic had a considerable effect on the Bank's credit risk profile in 2020. Overall credit quality deteriorated, primarily in the corporate portfolio. At year-end 2020, 73% of total credit exposure had rating grades from 5 to 10 (2019: 76%). At year-end 2020, 83% of total credit exposure to individuals had rating grades from 5 to 10 (2019: 82%) and 65% of total credit exposure to corporates had rating grades from 5 to 10 (2019: 73%). Impairment charges increased by ISK 10 billion in 2020, mostly in stage 1 and 2 in the corporate portfolio, but also in stage 3 in the travel industry. The credit risk profile is monitored and strengthened in accordance with the credit risk appetite, which encompasses credit quality (expected loss) and credit risk concentration (limits on single names and industries). For further information on the effects of the Covid-19 pandemic on the Bank's credit risk, see note 4 in the Bank's consolidated financial statement for 2020.

The Bank's credit exposure shown in Table 4.2 is defined as balance sheet items and off-balance sheet items that carry credit risk. For on-balance sheet loans and advances, the exposure is calculated net of accumulated ECL for exposures measured at amortized cost, otherwise at fair value. Off-balance sheet amounts are the maximum amounts the Bank might have to pay out in guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities.

At year-end 2020, the total on-balance carrying amount was ISK 1,520 billion. ISK 1,273 billion is derived from lending activities, ISK 68 billion from cash and balances with the Central Bank, and ISK 85 billion from bonds and debt instruments. The total off-balance exposure at year-end 2020 was ISK 188 billion. ISK 100 billion is derived from undrawn loan commitments, ISK 65 billion from undrawn overdraft/credit card facilities and ISK 24 billion from financial guarantees and underwriting commitments.

4.2.2 Effects of the Covid-19 pandemic on the credit portfolio

The Bank responded to the effects of the Covid-19 pandemic with direct measures for customers as well as internal measures to strengthen the monitoring and measurement of credit risk in light of increased uncertainty.

The Bank followed the clarifications outlined in the statement issued by EBA in March 2020 on application of the prudential framework regarding default, forbearance and IFRS9 in light of these circumstances.[1] These guidelines have also been supported by the FSA. Initially, general measures were applied under an agreement between domestic banks and other lenders. These measures consisted of delayed payments of principal and interest for up to 6 months within the year 2020. Customers experiencing prolonged financial difficulties due to the pandemic were granted further delay of payments, mostly until the second half of 2021. In addition, the Bank has granted government-backed loans amounting to gross carrying amount of ISK 3.5 billion at year-end 2020.

The gross carrying amount of loans to customers who received general moratoria measures was ISK 179 billion at year-end 2020, of which ISK 83 billion were to corporates in the travel industry, ISK 54 billion to other corporate customers and ISK 42 billion to individuals. As the general measures expired some customers had further moratoria measures while some could resume regular payments. The need for further measures was mostly to corporates in the travel industry. The gross carrying amount of loans to customers having received further moratoria measures was ISK 82 billion at year-end

[1] https://www.eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures

Table 4.2: Classification of the Bank's financial assets carrying credit risk

As at 31 December 2020	Maximum exposure to credit risk				
Financial assets	**Financial institutions**	**Public entities**	**Individuals**	**Corporations**	**Total**
Cash and balances with Central Bank	-	67,604	-	-	67,604
Bonds and debt instruments	26	79,204	-	5,994	85,224
Equities and equity instruments in the banking book	1	-	-	18,033	18,034
Derivative instruments	3,000	1	-	302	3,302
Loans and advances to financial institutions	48,073	-	-	-	48,073
Loans and advances to customers	-	4,128	592,216	677,082	1,273,426
Other financial assets	15,864	26	65	7,959	23,914
Total on-balance sheet exposure	**66,964**	**150,962**	**592,281**	**709,370**	**1,519,577**
Off-balance sheet exposure	**139**	**6,953**	**32,240**	**148,955**	**188,287**
Financial guarantees and underwriting commitments	138	44	645	23,242	24,069
Undrawn loan commitments	-	-	-	99,555	99,555
Undrawn overdraft/credit card facilities	1	6,909	31,595	26,158	64,663
Maximum exposure to credit risk	**67,103**	**157,915**	**624,521**	**858,325**	**1,707,864**

As at 31 December 2019	Maximum exposure to credit risk				
Financial assets	**Financial institutions**	**Public entities**	**Individuals**	**Corporations**	**Total**
Cash and balances with Central Bank	-	69,824	-	-	69,824
Bonds and debt instruments	11,423	102,181	-	1,658	115,262
Equities and equity instruments in the banking book	1	-	-	17,706	17,706
Derivative instruments	2,202	-	9	483	2,694
Loans and advances to financial institutions	47,929	-	-	-	47,929
Loans and advances to customers	-	4,135	467,945	668,104	1,140,184
Other financial assets	2,767	26	76	4,95	7,819
Total on-balance sheet exposure	**64,322**	**176,166**	**468,03**	**692,901**	**1,401,418**
Off-balance sheet exposure	**3,598**	**5,051**	**33,553**	**141,275**	**183,477**
Financial guarantees and underwriting commitments	306	168	775	22,718	23,967
Undrawn loan commitments	-	-	-	95,478	95,478
Undrawn overdraft/credit card facilities	3,292	4,883	32,778	23,079	64,032
Maximum exposure to credit risk	**67,920**	**181,217**	**501,583**	**834,175**	**1,584,895**

2020, of which ISK 68 billion were to corporates in the travel industry, ISK 14 billion to other corporate customers and ISK 1 billion to individuals. 70% of gross carrying amount in the travel industry have received further moratoria while the ratio was only 2.4% of gross carrying amount to corporates in other industries at year-end 2020. For further information on the effects of the Covid-19 pandemic on the Bank's credit risk, see note 4 in the Bank's consolidated financial statement for 2020.

Figure 4.4 shows the gross carrying amount of loans with active Covid-19-related measures over the course of the year 2020.

In addition to direct measures to customers, the uncertainty of the impact of the pandemic is also reflected in the Bank's monitoring and measurement of credit risk. Credit ratings were downgraded for corporate customers who received forbearance measures with further payment delays to reflect their financial difficulties and increased credit risk. Collateral value in hotels and accommodation was also lowered. Further measures were applied for impairment assessment as more loans moved to stage 2 and expected credit loss has increased considerably. The Bank also allocated a general allowance for impairment to certain portfolios to better reflect this uncertainty. Further information on the Bank's impairment calculations can be found in Section 4.2.6 on loan impairment.

4.2.2.1 Credit exposure from lending activities

At year-end 2020, the Bank's total credit exposure from lending activities amounted to ISK 1,273 billion, increasing by 12% from ISK 1,140 billion at year-end 2019. The increase was almost exclusively driven by a 25% growth in the mortgage portfolio. The increase in the mortgage portfolio was based on customers' increased demand for non-indexed mortgages that have become more favourable to indexed mortgages due to lowering interest rates. The increase in the mortgage portfolio is based on new lending to customers and comprise of first-time buyers and customers re-financing their loans from other lenders such as pension funds. More detailed information on the mortgage portfolio is in Section 4.2.4.5. The size of the corporate portfolio is largely unchanged from the previous year, growing only by 1.3%. Increased uncertainty in economic conditions due to Covid-19 has negatively affected the demand for new lending to corporates, especially in some sectors.

The total average PD weighted by gross carrying amount was 2.8% at year-end 2020 (2019: 2.3%). Excluding loans to financial institutions, the average PD was 2.9% (2019: 2.4%). The average PD for individuals was 1.5% (2019: 1.8%) and the average PD for corporates was 4.1% (2019: 2.9%). The increase in the weighted average PD in the corporate portfolio is largely due to a downward re-evaluation

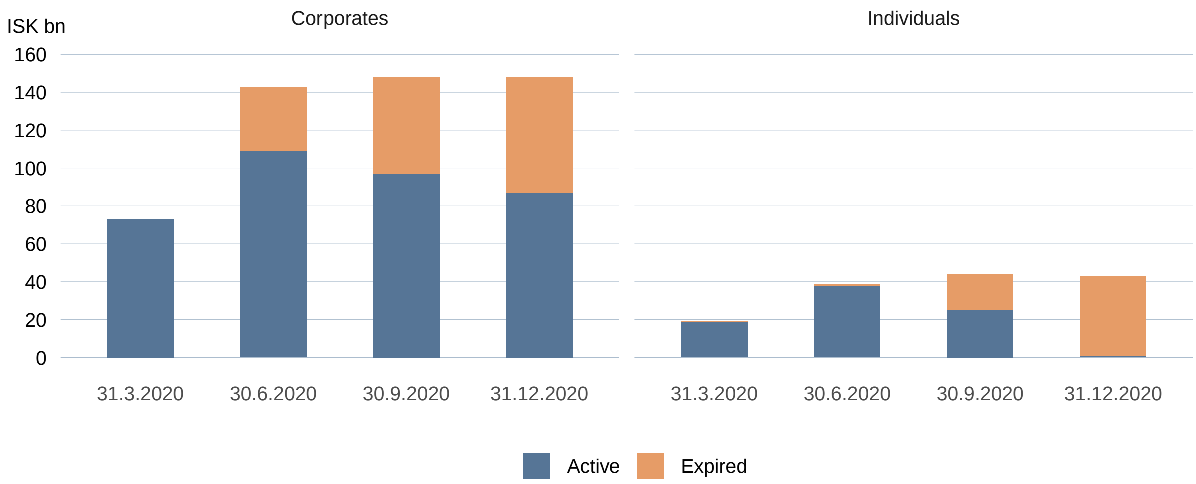


Figure 4.4: Active vs. expired Covid-19-related measures

of the credit quality of customers with financial difficulties which received Covid-19 related moratoria. Credit quality in the individual portfolio continues to increase, parallel to a significant growth in the mortgage portfolio. Increased mortgage lending to good quality customers drives down the average PD value for the individual portfolio.

In 2020, LGD decreased slightly for individuals and increased slightly for corporate customers. The decrease in LGD for individuals is largely explained by the increased ratio of mortgages to other loans in the individual portfolio, as mortgages generally have a lower LGD than other loans to individuals, and the increase in LGD in the corporate portfolio is largely explained by the fact that during the year 2020, the valuation of pledged collateral for some of the larger customers in the portfolio was re-evaluated as a response to the Covid-19 pandemic, primarily for hotels and other accommodation. At year-end 2020, the total average LGD weighted by gross carrying amount, excluding loans to financial institutions, was 14.3% (2019: 14.5%). The average LGD for individuals was 9.1% (2019: 9.5%) and the average LGD for corporates was 18.7% (2019: 17.9%).

The carrying amount of loans in stage 3 net of accumulated ECL as a percentage of the total portfolio remained stable in 2020, and is 2.0% at year-end 2020. The ratio increased in the corporate portfolio and decreased in the individual portfolio, standing at 3.3% for corporates and 0.6% for individuals at year-end 2020. For individuals, the ratio decreased both for individuals with and without morgages. In the corporate portfolio, the ratio decreased or remained unchanged for most sectors. However, a slight increase in stage 3 loans for construction and travel industry companies causes the overall ratio to increase in the corporate portfolio.

The carrying amount of loans and advances to customers past due by 6-90 days decreased in 2020. General and specific moratoria, granted as a response to the Covid-19 pandemic skews the overall outlook regarding loans past due, as many customers that might otherwise be past due on their loans have been granted such moratoria. General moratoria, which was granted in early 2020 to almost everyone that applied has expired for most customers. Some customers have been granted further, specific moratoria. These specific moratoria are classified as forbearance, and the ratio of loans with forbearance has risen considerably, from 3.6% at year-end 2019 to 9.4% at year-end 2020. For further information on Covid-19 related moratoria, refer to Note 4 in the Bank's consolidated financial statement for 2020.

Figure 4.5: Probability of default (PD)

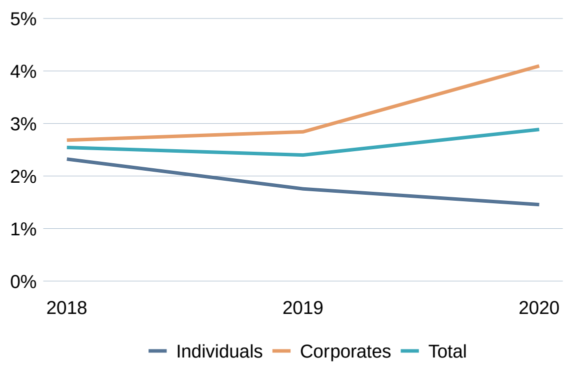


Figure 4.6: Loss given default (LGD)

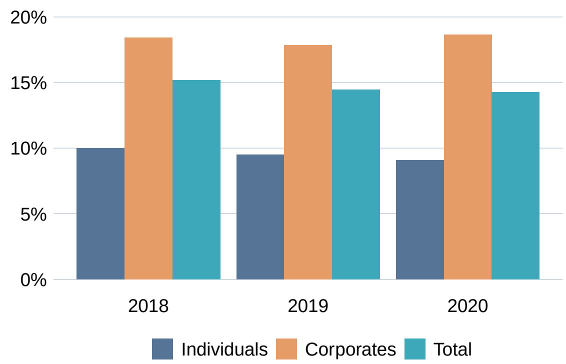


Figure 4.7: Stage 3 loans (% of total portfolio)

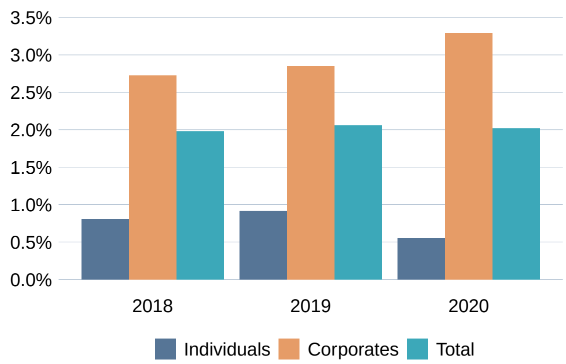
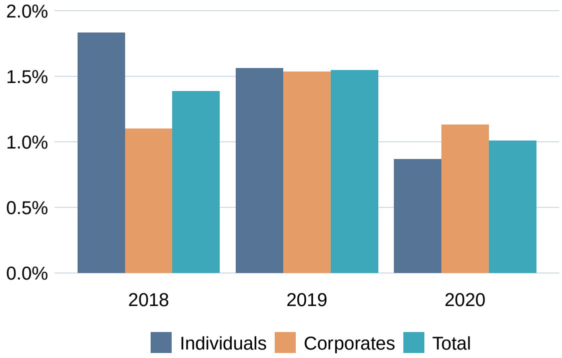


Figure 4.8: Ratio of loans past due 6-90 days



4.2.3 Forbearance

The Bank adopts forbearance plans to assist customers in financial difficulty with the goal of protecting the Bank's long-term interests. Concessions granted to customers include interest-reduction schedules, interest-only schedules, temporary payment holidays, term extensions, cancellation of outstanding fees and settlements.

Forbearance plans must comply with the Bank's Credit Policy. They are used as an instrument to maintain long-term customer relationships during economic downturns if there is a realistic possibility that the customer will be able to meet obligations again, and are used for minimising loss in the event of default.

The Bank has implemented EBA's definition of loans subject to forbearance measures. Table 4.3 is based on EBA's definition where exposures with forbearance measures are divided into performing and non-performing loans.

Total exposures subject to forbearance measures increased from ISK 41 billion at year-end 2019 to ISK 122 billion (9.4% of the total portfolio) at year-end 2020. In accordance with the EBA Guidelines on legislative and non-legislative payment moratoria, loans that were granted payment holidays under general Covid-19 moratoria were in general not classified as forborne. However, specific moratoria granted subsequently do trigger forbearance classification, which explains the substantial increase of loans with forbearance in 2020.

4.2.4 Credit risk by industry sectors

Table 4.4 shows the carrying amount of loans and advances by industry sectors along with key risk metric values. PD and LGD averages in the table are weighted by gross carrying amount, but other ratios with carrying amount. A more thorough description of the largest industry sectors follows.

This section describes developments in credit quality for the four largest corporate sectors in the Bank's lending portfolio, as well as in the mortgage portfolio for 2020.

Table 4.3: Exposures subject to forbearance (ISK millions)

	31.12.2020		**31.12.2019**	
	Performing	Non-performing	Performing	Non-performing
Modification	85,570	29,996	15,429	16,079
Refinancing	3,437	3,529	424	1,680
- of which: Under probation	2,738	0	2,281	0
Total	89,007	33,525	16,716	24,437

Table 4.4: Overview of credit risk measures by industries

As at 31 December 2020	Carrying amount	PD	LGD	Past due 6-90 days	Stage 2 loans	Stage 3 loans	Total ECL
Public entities	4,128	1.4%	51.3%	0.0%	3.4%	0.0%	-41
Individuals	**592,215**	**1.5%**	**9.1%**	**0.9%**	**6.7%**	**0.5%**	**-2,308**
Mortgages	518,249	1.3%	6.8%	0.8%	5.5%	0.5%	-1,221
Other	73,967	2.4%	24.9%	1.5%	15.1%	1.1%	-1,086
Corporates	**677,083**	**4.2%**	**18.5%**	**1.1%**	**15.7%**	**3.3%**	**-22,126**
Fisheries	179,713	1.9%	11.4%	0.1%	2.5%	0.4%	-1,236
Real estate companies	129,462	3.4%	14.9%	1.2%	9.1%	2.8%	-3,335
Construction companies	82,345	6.2%	19.6%	2.9%	16.2%	2.7%	-2,482
Travel industry	95,996	10.9%	24.2%	2.9%	58.6%	11.0%	-8,507
Services and ITC*	67,352	2.3%	30.1%	0.4%	10.1%	2.6%	-2,239
Retail	53,590	2.5%	18.9%	0.7%	8.1%	1.6%	-1,400
Manufacturing and energy	30,231	2.0%	31.0%	0.1%	9.2%	8.2%	-2,540
Holding companies	31,849	3.2%	14.4%	0.0%	18.1%	0.0%	-244
Agriculture	6,544	2.6%	14.0%	1.2%	12.7%	4.1%	-144
Other	0	17.9%	55.1%	37.4%	37.6%	0.0%	0
Total loans to customers	**1,273,426**	**2.9%**	**14.3%**	**1.0%**	**11.5%**	**2.0%**	**-24,475**
Financial institutions	48,073	0.1%	55.1%	0.0%	0.0%	0.0%	-1
Total loans including financial institutions	**1,321,498**	**2.8%**	**15.8%**	**1.0%**	**11.0%**	**1.9%**	**-24,476**
As at 31 December 2019	**Carrying amount**	**PD**	**LGD**	**Past due 6-90 days**	**Stage 2 loans**	**Stage 3 loans**	**Total ECL**
Public entities	4,135	1.4%	52.2%	0.0%	2.7%	0.0%	-35
Individuals	**467,942**	**1.8%**	**9.5%**	**1.6%**	**7.5%**	**0.9%**	**-2,151**
Mortgages	391,902	1.6%	6.5%	1.4%	6.2%	0.7%	-848
Other	76,040	2.7%	24.6%	2.6%	14.3%	1.8%	-1,303
Corporates	**668,100**	**2.9%**	**17.7%**	**1.5%**	**9.5%**	**2.9%**	**-12,697**
Fisheries	151,335	1.6%	9.6%	0.1%	3.2%	0.3%	-456
Real estate companies	135,999	3.2%	14.5%	3.3%	9.0%	2.7%	-2,174
Construction companies	98,535	4.5%	22.8%	0.7%	19.2%	1.6%	-1,677
Travel industry	96,664	3.9%	19.3%	3.5%	10.8%	7.1%	-3,306
Services and ITC*	69,604	1.7%	29.3%	1.1%	7.0%	3.1%	-1,599
Retail	60,524	2.2%	18.5%	0.9%	7.8%	2.1%	-949
Manufacturing and energy	23,836	2.2%	31.1%	0.6%	19.9%	11.7%	-2,315
Holding companies	26,154	3.6%	9.5%	0.1%	7.3%	0.3%	-129
Agriculture	5,447	2.3%	11.9%	0.4%	10.2%	5.3%	-92
Other	1	14.8%	55.1%	0.7%	70.1%	0.0%	0
Total loans to customers	**1,140,177**	**2.4%**	**14.5%**	**1.5%**	**8.6%**	**2.1%**	**-14,883**
Financial institutions	47,935	0.1%	55.1%	0.0%	0.0%	0.0%	-1
Total loans including financial institutions	**1,188,113**	**2.3%**	**16.1%**	**1.5%**	**8.3%**	**2.0%**	**-14,884**

*ITC consists of corporations in the information, technology and communication sectors

4.2.4.1 Fisheries

Loans and advances to customers in the fisheries industry amounted to ISK 180 billion as at 31 December 2020 (2019: ISK 151 billion). Credit exposure to the sector represented 14% of the Bank's loan portfolio. The growth was primarily due to increased lending and partly due to the depreciation of the ISK.

Figure 4.9: PD & LGD - Fisheries

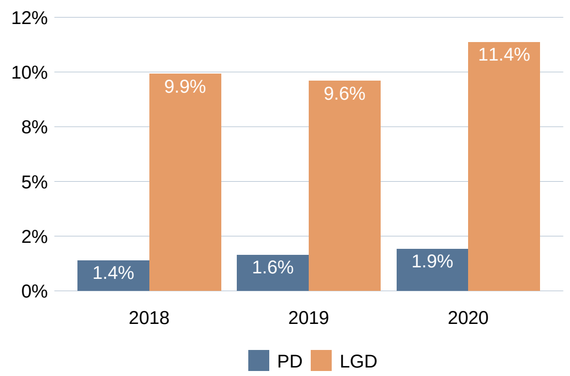


Figure 4.10: Default rate vs. PD - Fisheries

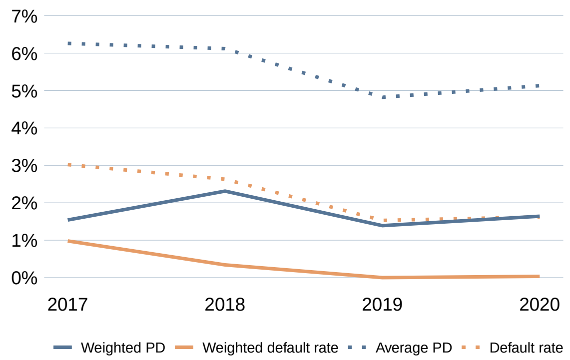
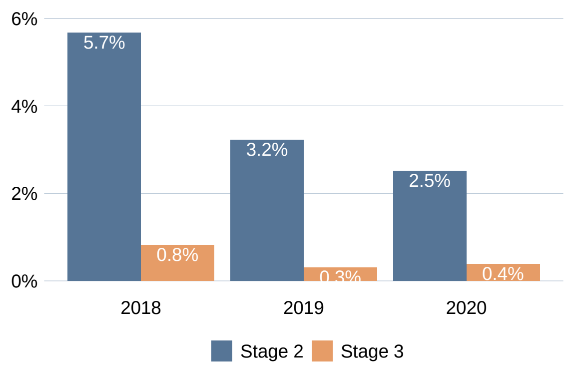


Figure 4.11: Staging - Fisheries



The average PD value for the sector increased slightly in 2020 and was 1.9% at year end. The average LGD value for the sector increased in 2020, having decreased steadily for the last few years, and was 11.4% at year-end 2020. 0.4% of loans in the sector were in default at year-end 2020, compared to 0.3% at year-end 2019.

Credit extended by the Bank to the fisheries industry is primarily secured by fishing vessels together with their non-transferable fishing quotas, or 74% of the sector's total collateral.

The realised default rate for the fisheries sector has consistently been below the average PD values for the past few years. The sector remains one of the strongest in the Bank's portfolio with relatively low underlying risk.

The ratio of stage 2 loans in the fisheries sector decreased in 2020, standing at 2.5% at year-end 2020.

Total ECL for the fisheries sector increased by ISK 780 million in 2020 to a total of ISK 1,236 million at year end, primarily due to an increase in ECL in stage 1 due to an increase in point-in-time PD based on more adverse economic scenarios used in impairment calculations.

4.2.4.2 Real estate companies

Loans and advances to customers in the real estate industry amounted to ISK 129 billion at year-end 2020 (2019: ISK 136 billion). Credit exposure to the sector represented 10% of the Bank's loan portfolio. Excluding the travel industry sector, most specific, Covid-19 related moratoria have been granted to companies in the real estate sector. The total gross carrying amount of loans in the sector, with granted specific moratoria is ISK 7.3 billion or 5.5% of all loans in the sector.

The average PD value for the sector increased slightly in 2020 and was 3.4% at year end (2019: 3.2%). The average LGD value for the sector increased slightly in 2020, having decreased considerably in 2019, and was 14.9% at year-end 2020 (2019: 14.5%).

The realised weighted default rate for real estate companies decreased from the previous year in 2020, as it did in 2019 and was 0.9%. The realised default rate for the sector has been consistently below the average PD values for the past few years.

The ratio of stage 2 loans remained largely unchanged in 2020, after having increased considerably in 2019. The ratio of stage 3 loans increased slightly in 2020 and was 2.8% at year end.

Figure 4.12: PD & LGD - Real estate companies

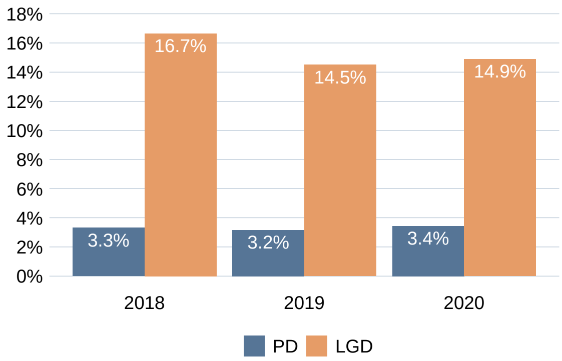


Figure 4.13: Default rate vs. PD - Real estate companies

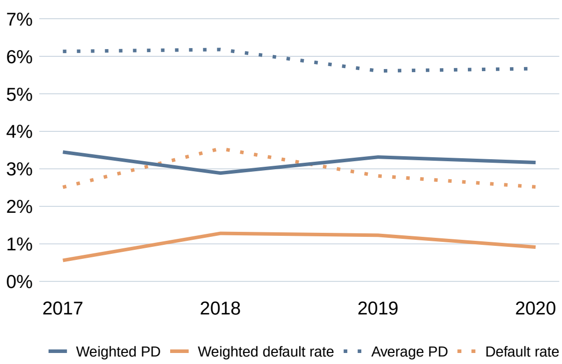
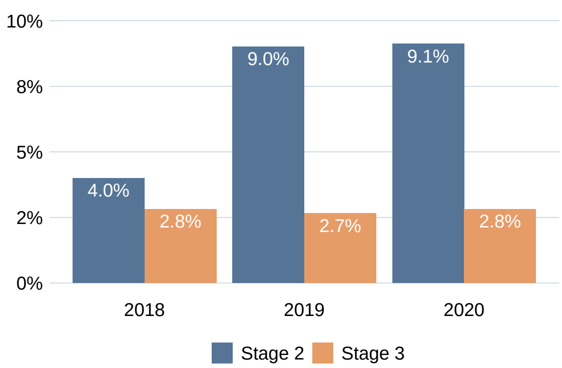


Figure 4.14: Staging - Real estate companies



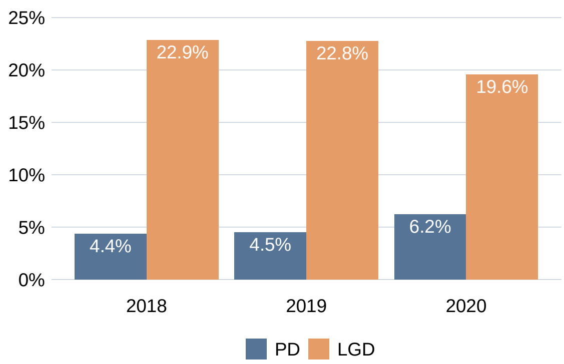
Total ECL for the real estate sector increased by ISK 1,161 million in 2020 to a total of ISK 3,335 million at year end, primarily due to an increase in ECL in stage 1 and 2 due to an increase in point-in-time PD based on more adverse economic scenarios used in impairment calculations, and increased impairment for stage 3 loans.

4.2.4.3 Construction companies

Loans and advances to construction companies amounted to ISK 82 billion at year-end 2020 (2019: ISK 99 billion). Credit exposure to the sector represented 6% of the Bank's loan portfolio. As the credit portfolio for construction companies is largely project based the outstanding carrying amount of loans can fluctuate between periods. This is due to the fact that as projects are in development the outstanding amount increases over time while as the properties begin to sell the outstanding amount decreases. In 2020 the demand for newly built apartments has been high leading to a decrease in the outstanding amount.

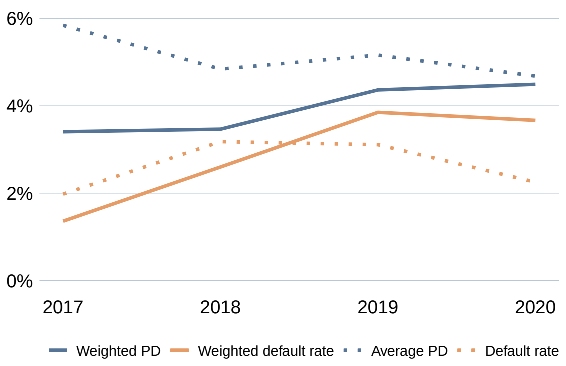
The average PD value for the sector increased in 2020 and was 6.2% at year-end (2019: 4.5%). This increase was primarily due to the deterioration of credit quality for a few large customers in the sector. The average LGD value for the sector decreased in 2020 and was 19.6% at year end (2019: 22.8%).

Figure 4.15: PD & LGD - Construction companies



The realised default rate for construction companies decreased from the previous year in 2020 and was 3.7%. The realised default rate for the sector has been consistently below the average PD values for the past few years.

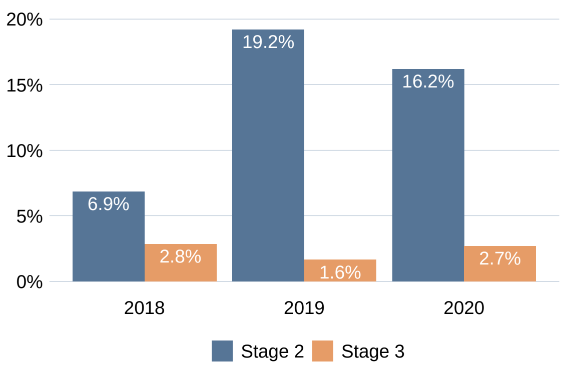
Figure 4.16: Default rate vs. PD - Construction companies



The ratio of stage 2 loans decreased in 2020, from 19.2% to 16.2%, after having increased considerably in 2019. The ratio of stage 3 loans increased slightly in 2020 and was 2.7% at year-end.

Total ECL for the construction sector increased by ISK 805 million in 2020 to a total of ISK 2,482 million at year-end.

Figure 4.17: Staging - Construction companies

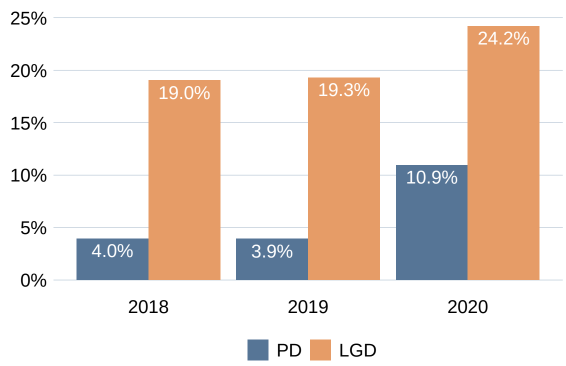


4.2.4.4 Travel industry

Loans and advances to customers in the travel industry amounted to ISK 96 billion at year-end 2020 (2019: ISK 97 billion). Credit exposure to the sector represented 8% of the Bank's loan portfolio.

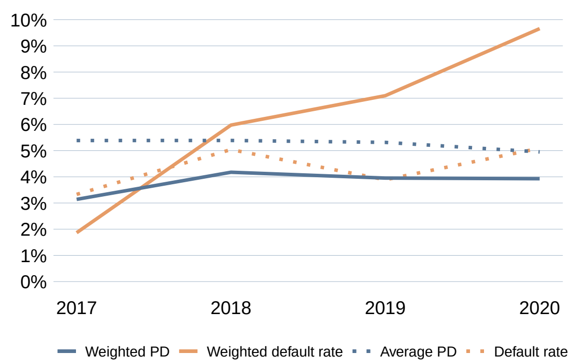
The travel industry has been severely affected by the Covid-19 pandemic, and the average PD value for the sector increased considerably in 2020 to 10.9% at year-end (2019: 3.9%). A large portion of customers in this sector have received specific Covid-19 related moratoria (see note 4 in the Bank's consolidated financial statement for 2020), and their exposures are therefore classified as forborne, and their credit rating decreased as a result of financial difficulties. At year-end 2020, 85% of the total gross carrying amount in the sector had a lower credit rating than at year-end 2019. The average LGD value for the sector increased in 2020 and was 24.2% at year-end (2019: 18.7%). This increase is primarily due to a decrease in value of pledged collateral, mainly hotels and accommodation.

Figure 4.18: PD & LGD - Travel industry



The realised default rate for the travel industry was 9.7% in 2020. In comparison, the average weighted PD value for the sector was 3.9% at year-end 2019.

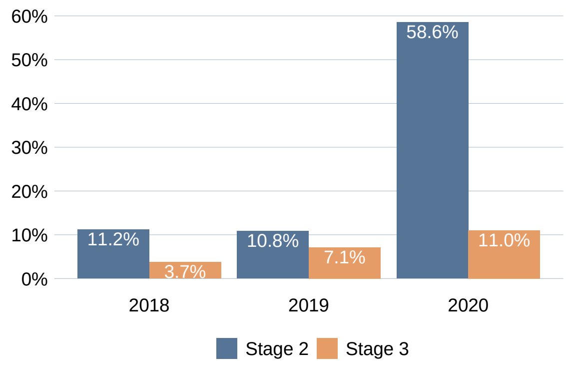
Figure 4.19: Default rate vs. PD - Travel industry



The ratio of stage 2 loans in the sector increased significantly in 2020. This is partly due to an increase in point-in-time PD, but also due to manual transfers of loans to stage 2 as a response to the adverse conditions in the sector. The ratio of stage 2 loans in the travel industry was 58.6% at year-end 2020 (2019: 10.8%) and the ratio of stage 3 loans was 11.0% (2019: 7.1%).

Total ECL for the travel industry increased by ISK 5.2 billion in 2020 to a total of ISK 8.5 billion at year end. The increase in ECL was primarily due to an increase in point-in-time PD for loans in stage 1 and 2, and a general allowance applied to the sector. There was an increase in stage 3 ECL by ISK 2 billion in 2020. The general allowance in the sector was ISK 841 million at year-end 2020.

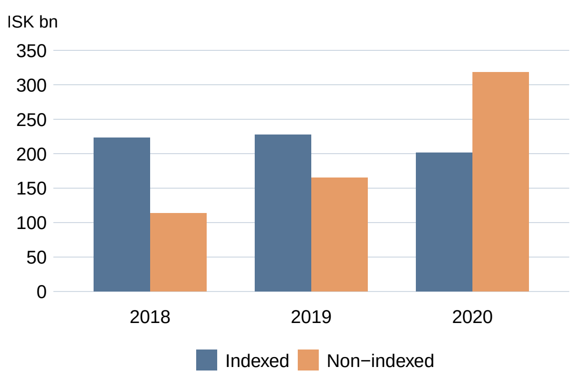
Figure 4.20: Staging - Travel industry



4.2.4.5 Mortgages

The carrying amount of mortgages to individuals in the portfolio was ISK 518 billion at year-end 2020 (2019: ISK 392 billion). Credit exposure in mortgages represented 41% of the Bank's loan portfolio at year-end 2020 (2019: 33%). Demand for non-indexed mortgages continued to grow in 2020, both for new customers and existing customers refinancing due to favourable interest rates in the current market, and at year-end 2020, non-indexed loans represented 61% of the gross carrying amount of the mortgage portfolio (2019: 42%), having represented only 25% of the mortgage portfolio as recently as 2017.

Figure 4.21: Indexed vs. non-indexed mortgages



All mortgages must meet requirements for credit rating, payment capacity and collateralisation limits. For loans exceeding a certain amount, the Bank's requirements for credit ratings, payment capacity and capital become more stringent, growing in line with the loan amount. Mortgages to individuals fall under the scope of the Act on Housing Loans to Consumers, as well as external rules on the maximum loan-to-value (LTV) ratio of real estate loans to consumers (85%, or up to 90% for first-time buyers). In 2020, the Bank tightened its requirements for refinancing, setting a lower collateralisation limit for refinancing customers than for buyers. In addition, the maximum loan term for inflation-indexed loans has been shortened to align the debt service on such loans to the current interest level of comparable debt service on non-indexed loans. This is counterbalanced by the fact that significant and rapid interest rate cuts have given borrowers a greater scope, leading to increased demand. It is also relevant that competition from the pension funds has until now been in inflation-indexed loans and, with falling interest rates on non-indexed loans, demand for non-indexed loans has increased with a corresponding drop in demand for inflation-indexed loans. Borrowers have increasingly refinanced pension fund loans with non-indexed credit from banks.

The loan-to-value (LTV) of mortgage loans, i.e., the ratio of loan value to the value of the underlying collateral had been decreasing in the past few years as housing prices in Iceland have risen consistently, but this ratio increased slightly in 2020, from 56.0% to 57.7%.

Figure 4.22: Weighted average LTV - Mortgages

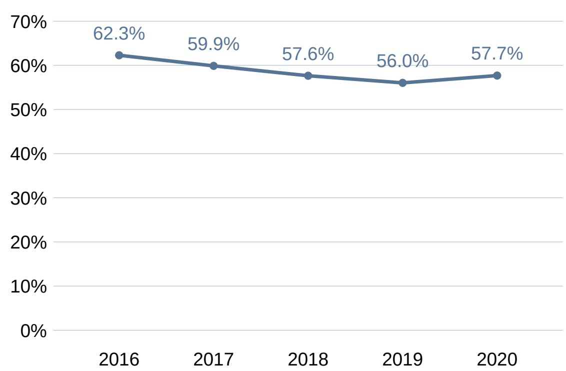
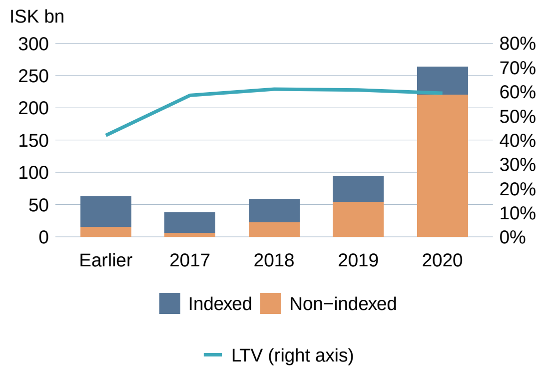


Figure 4.23 shows the gross carrying amount at year-end 2020 of indexed and non-indexed mortgages and the weighted-average LTV by year of loan origination.

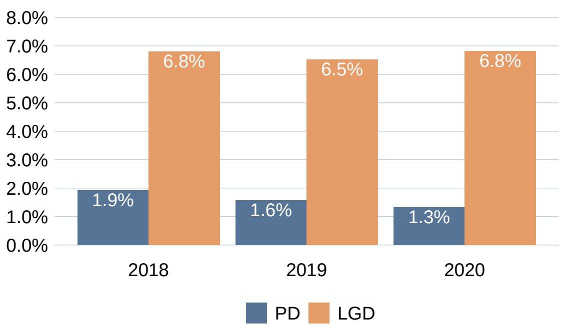
The figure shows how much the demand for non-indexed mortgages has grown over the last few years. This is primarily due to favourable interest rates for non-indexed mortgages. The figure also shows a high frequency of refinancing of mortgages due the ease of refinancing costs. This leads to a high ratio of the mortgage portfolio being recently issued loans. The weighted-average LTV is consistent around 60% for mortgages issued from 2017-2020.

Figure 4.23: Gross carrying amount and LTV of mortgages at 31.12.2020 by year of loan origination



The average PD value for mortgages, continued to decrease in 2020 and was 1.3% at year-end (2019: 1.6%). Total ECL for mortgages increased in 2020 and was ISK 1,221 million at year end (2019: ISK 848 million).

Figure 4.24: Average PD & LGD - Mortgages



4.2.5 Probability of default & migration analysis

Migration analysis in this section is based on the Bank's rating scale and PD estimates. At year-end 2020, the total average PD weighted by gross carrying amount was 2.8% (2019: 2.3%). Excluding loans to financial institutions, which as mentioned above relates to the management of the Bank's foreign liquidity reserves, average PD was 2.9% (2019: 2.4%).

The overall credit quality of the loan portfolio decreased in 2020. Credit quality in the individual portfolio increased slightly during 2020 while the corporate portfolio declined in credit quality during the year. Response measures due to effects of the Covid-19 pandemic are the biggest factor behind this high ratio of rating downgrades for corporates. A large part of these downgrades was in the travel industry portfolio, which makes up 14% of the corporate portfolio. In total, 85% of the gross carrying amount of loans in the sector received general Covid-19 related moratoria in 2020, and 70% of the total gross carrying amount received further, specific moratoria. In turn, a large part of the travel industry portfolio was manually downgraded in credit rating due to financial difficulties and forbearance measures, and at year-end 2020, 85% of the total gross carrying amount in the sector had a lower credit rating than at year-end 2019.

Figures 4.25 and 4.26 show the rating grade distribution of the loan portfolio for corporates and individuals.

Figure 4.25: Rating grade distribution - Corporates

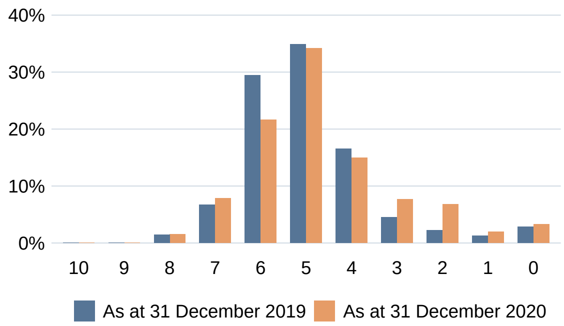
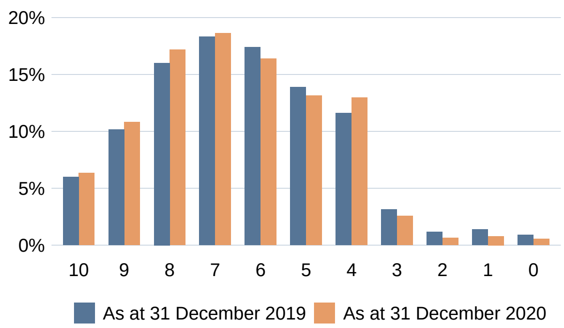


Figure 4.26: Rating grade distribution - Individuals



Figures 4.27 to 4.29 show the rating grade migration for corporates and individuals during 2020, based on existing customers at year-end 2019 and 2020.

Migration is shown both in terms of number of customers and exposure. Migration analysis does not include customers in default, i.e. customers with a credit rating of 0.

Figure 4.27: Rating migration of corporates in 2020

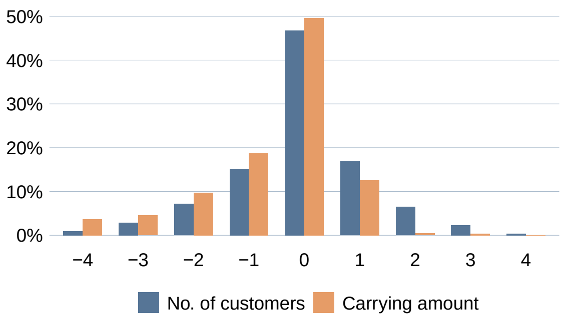
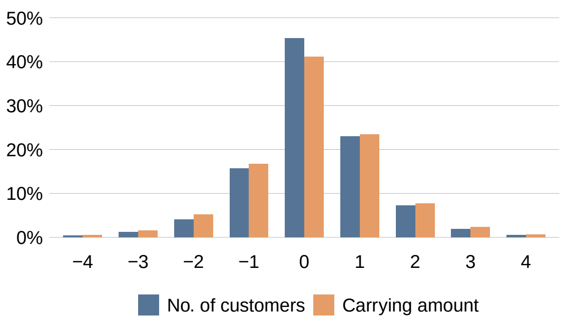


Figure 4.28: Rating migration of individuals in 2020



The rating and risk grade distribution changes primarily due to three factors: changes in rating grade for existing customers, or pure migration; different rating grade distribution of new customers and customers leaving the Bank compared to the rating grade distribution of existing customers during the comparison period; and, increased or decreased exposure per rating grade to existing customers.

For individuals, the percentage of upgrades was significantly higher than the percentage of downgrades, both in terms of carrying amount and number of customers. Half of the corporate portfolio remained unchanged in terms of rating during 2020, with migrations split almost evenly between upgrades and downgrades, in terms of the number of customers. In terms of carrying amount however, 37% of the portfolio was downgraded while only 13% was upgraded.

The default rate, measured by number of customers, was 2.4% for corporate customers in 2020, as compared to the estimated 4.0%. No corporate customers in rating grades 8, 9 and 10 defaulted. The default rate of individuals for 2020 was 1.2% as compared to the estimated 1.4%. Estimated default rates are based on the average through-the-cycle (TTC) PD values for each rating category at the start of the year. For most rating grades, both for individuals and corporates, the default rate was within or below the PD bands, the only exceptions being rating grade 10 for individuals and rating grade 7 for corporates.

Figures 4.31 and 4.32 show a comparison between realised default rates and estimated PD values at the start of each year, weighted by gross carrying amount and number of customers, for both corporates and individuals.

Figure 4.31: Default rate vs. PD - Corporates

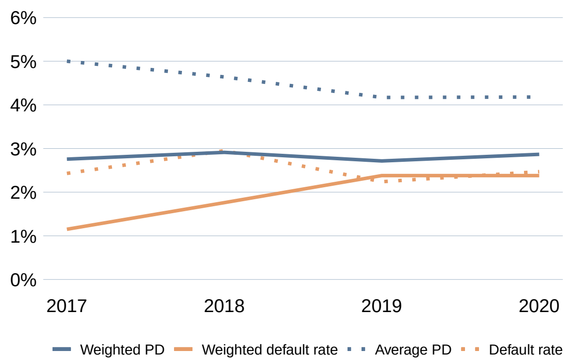
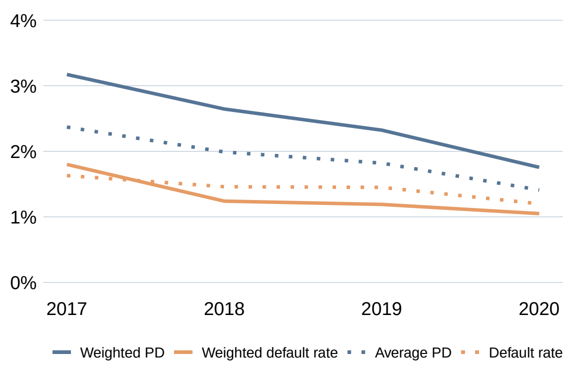


Figure 4.32: Default rate vs. PD - Individuals



Realised default rates have been consistently below the estimated PD values both for corporates and individuals for the past four years. The significant change in the external economic climate during 2020 has not yet led to increased default rates for the

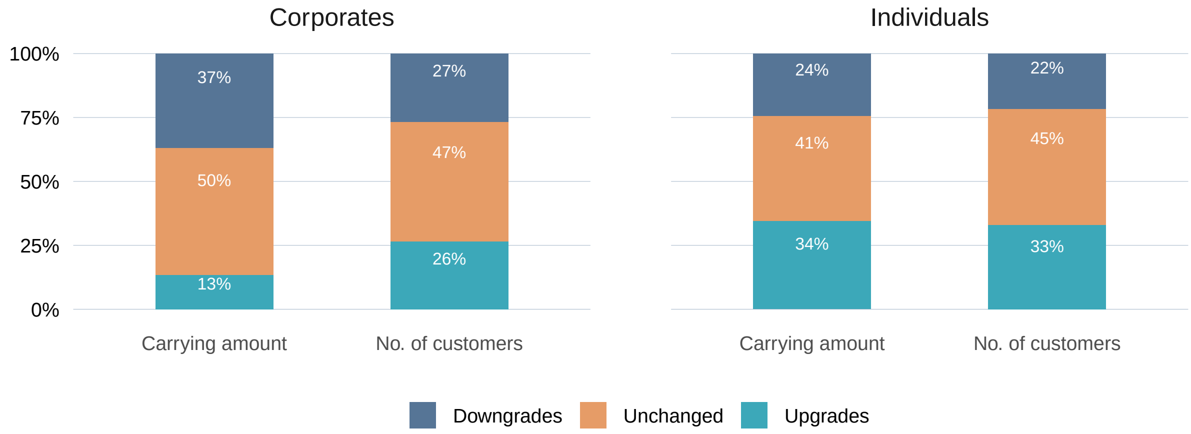


Figure 4.29: Rating migration ratios in 2020

portfolio as a whole. This is partly due to Covid-19 related moratoria that many customers took advantage of during 2020. The default rates will have to be monitored going forward, as these moratoria expire, and customers try to recover from the effects of the pandemic.

4.2.6 Loan impairment

Total ECL amounted to ISK 25.3 billion at year-end 2020 (thereof classified as deduction from gross carrying amounts: ISK 24.5 billion), as compared to ISK 15.2 billion at year-end 2019 (thereof classified as deduction from gross carrying amounts: ISK 14.9 billion). The increase in ECL is primarily due to increases in PD values, both point-in-time and lifetime PD, due to deteriorating credit quality of a part of the corporates loan portfolio and less favourable economic scenarios. These changes lead to increased ECL as well as increased transfers from stage 1 to stage 2. Finally, there is also an increase in ECL in stage 3, primarily in the travel industry, both due to new defaults and an increase in ECL for previously defaulted customers. Details on the development of ECL during the year can be found in note 67 in the Bank's annual financial statement for 2020.

During 2020, economic scenarios used as input in the Bank's ECL models were frequently updated to reflect the rapidly changing external economic environment. Manual transfers to stage 2 were performed for certain subsets of the loan portfolio, to

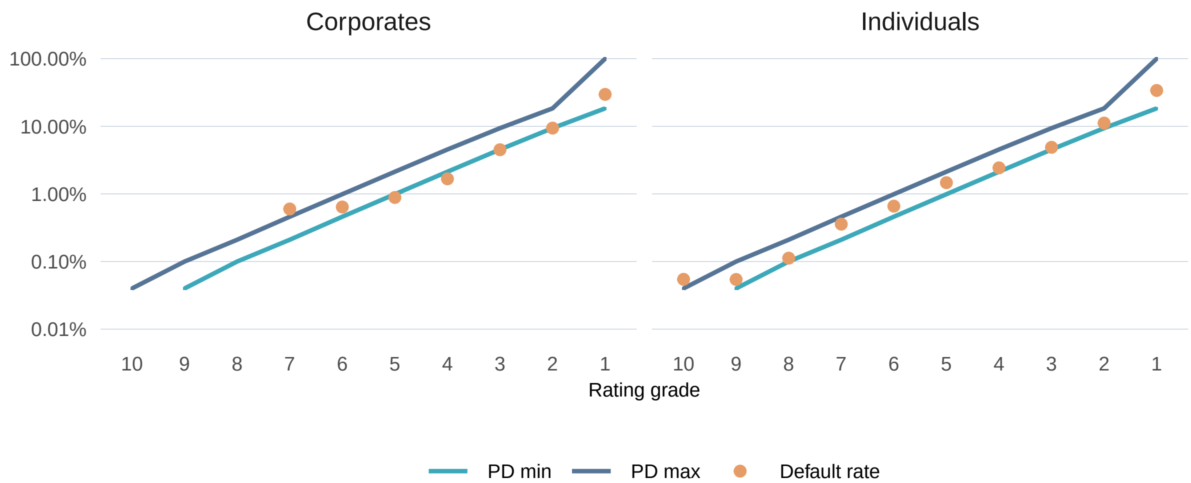
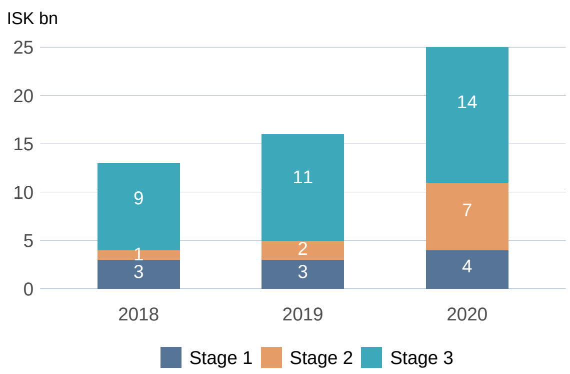


Figure 4.30: 12-month default rate vs. probability of default band

better reflect the increased credit risk in the travel industry and for customers with active Covid-19 related moratoria. These same portfolios were also evaluated for a potential need for the application of general allowance. At year-end 2020, individuals with active Covid-19 related moratoria have a general allowance of ISK 309 million, and the travel industry portfolio has a general allowance of ISK 841 million. The total increase in ECL in stages 1 and 2 in 2020 was ISK 6.1 billion. 12-month ECL for loans and advances to customers was ISK 8 billion at year-end 2020, compared to ISK 4 billion at year-end 2019.

Figure 4.33: Expected credit loss by stage



ECL increased across all stages in 2020. For individuals, the total ECL increased by ISK 151 million while ECL in the corporate portfolio increased by ISK 9.9 billion, most notably in the travel industry. The ratio of ECL to gross carrying amount in stage 1 decreased for individuals in 2020 but increased significantly for corporates. A decrease in this ratio signifies increased credit quality for performing loans without significantly increased credit risk. The ratio of ECL to gross carrying amount in stage 2 increased both for individuals and corporates in 2020. The ratio of ECL to gross carrying amount in stage 3 decreased for individuals but increased for corporates. The gross carrying amount of loans in stage 3 changed only slightly in 2020 for the total portfolio, decreasing for individuals but increasing for corporates. The gross carrying amount of loans in stage 2 increased for corporates in 2020, but decreased slightly for individuals, as Figure 4.37 shows.

Figure 4.34: ECL to gross carrying amount - Stage 1

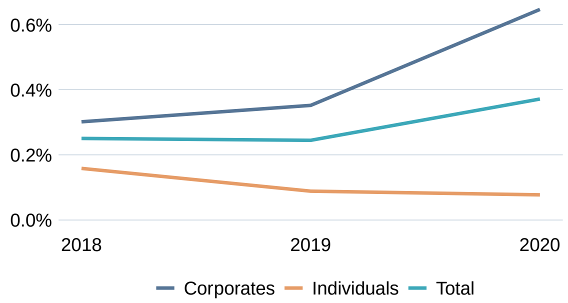


Figure 4.35: ECL to gross carrying amount - Stage 2

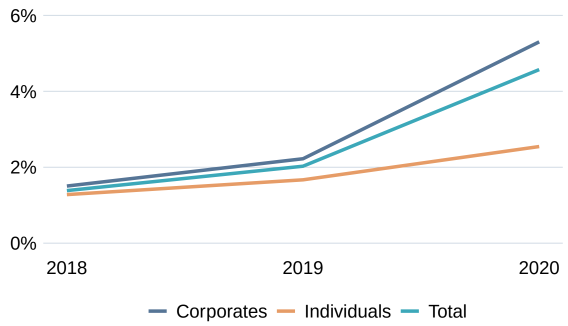


Figure 4.36: ECL to gross carrying amount - Stage 3

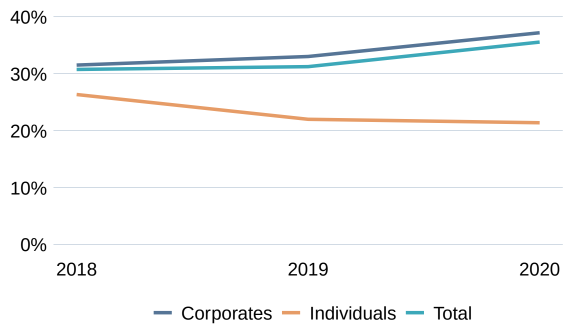
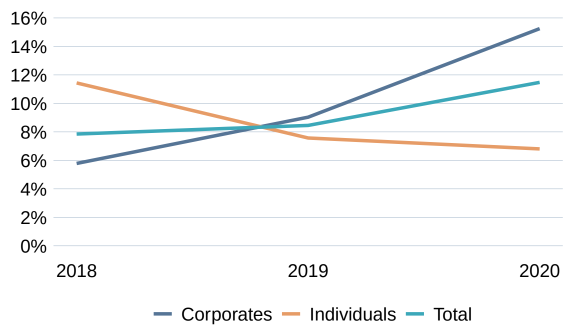


Figure 4.37: Gross carrying amount in stage 2



4.3 Risk concentration

Concentration risk includes (i) single name concentrations of large (connected) individual counterparties and (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location, instrument type, or other.

Limit management for single name and segment concentrations is set, monitored and managed through the Bank's risk appetite and its limit management structure. The Bank's risk profile for concentration risks is reported monthly to the Risk & Finance Committee and the Board of Directors according to internal guidelines.

The Bank uses the identification of risk concentration in the credit portfolio as a credit risk management parameter. Risk concentrations arise in the credit portfolio as an inevitable consequence of the Bank's business strategy. Concentration risk is credit risk related to the degree of diversification in the credit portfolio and includes both single name concentration risk and segment concentration risk.

According to FSA Regulation No. 233/2017, on prudential requirements for credit institutions and investments firms, exposures to a single customer or a group of related customers - after the deduction of particularly secure claims - may not exceed 25% of eligible capital. No exposure to a single customer or a group of related customers exceeded 25% in the year 2020, and at year end, the largest single-customer exposure was well below 25%.

The Bank's risk profile for large exposures is monitored daily by Risk management and is reported monthly to Managing Directors and the Board of Directors.

As for single name concentration, the Bank's Board of Directors sets portfolio limits for segment concentration in the Bank's risk appetite.

At year-end 2020, lending to individuals represented 47% of the Bank's total credit exposure (2019: 41%). Most of the demand from individuals is for mortgages, and the Bank's lending to individuals is therefore mostly secured by real estate.

The Bank's credit exposures are primarily to Icelandic corporate customers. Companies in the fisheries, real estate, travel industry and construction sectors represent the largest exposure to single industry sectors.

Customers domiciled in Iceland accounted for 97% of the Bank's total credit exposure, excluding exposures to financial institutions, in 2020 (2019: 97%). The majority of exposures to foreign counterparties relate to the management of the Bank's foreign liquidity reserves, and are classified as loans and advances to financial institutions.

The Bank estimates sector concentration risk as the difference between sector concentration for Iceland and the sector concentration in the Bank's portfolio.

Figure 4.40 shows a comparison of industry concentration between the Bank's portfolio and the portfolios of all Icelandic banks as a whole. Data for Iceland is from the Central Bank of Iceland. Note that this sector classification includes the travel industry as part of the services sector.

Figure 4.38: Large exposure between 10% and 20% of the Group's eligible capital

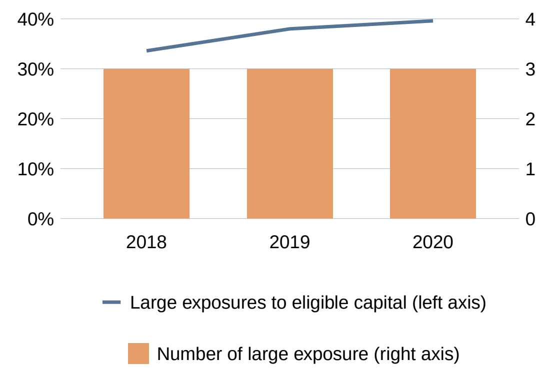
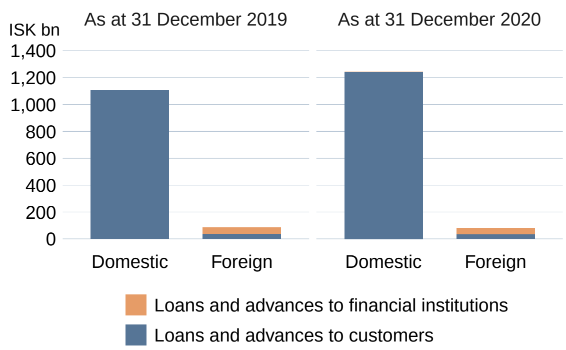
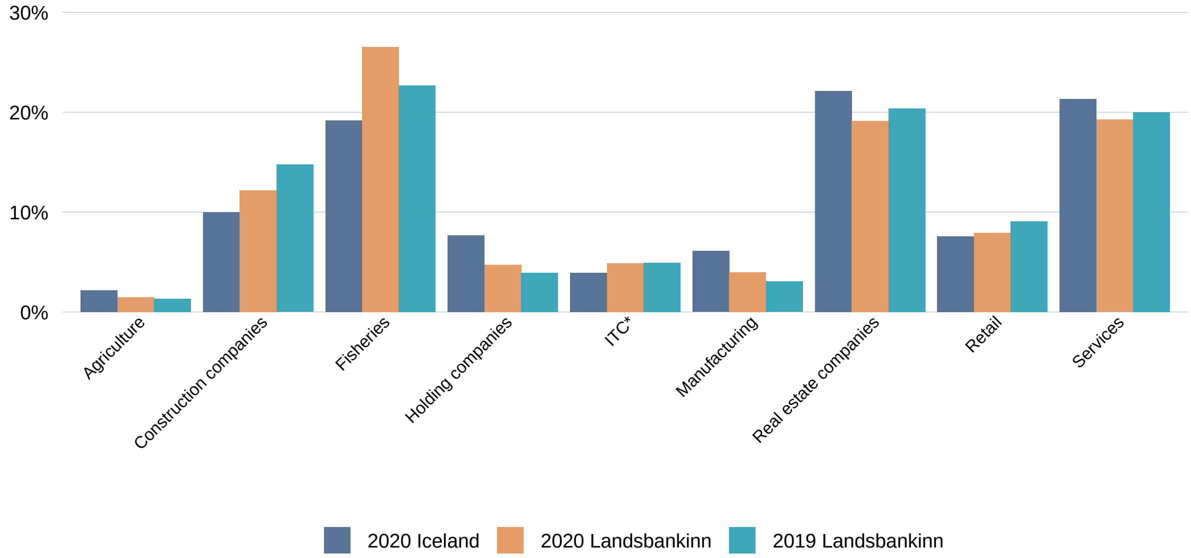


Figure 4.39: Loans and advances by geographical area





*ITC consists of corporations in the information, technology and communication sectors

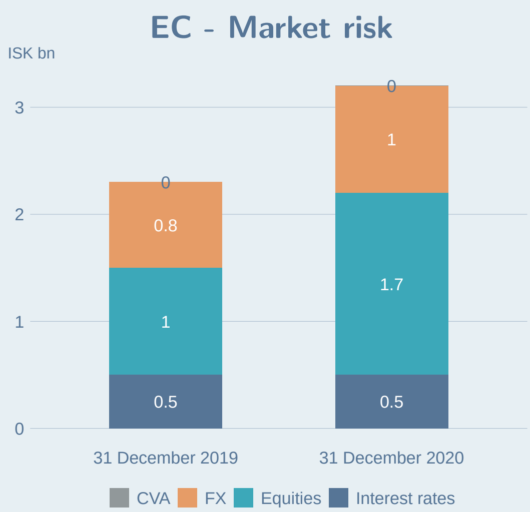
Figure 4.40: Industry concentration

5 Market risk

Market risk

Market risk is the risk that changes in market prices will adversely impact the fair value or future cash flows of financial instruments. Market risk arises from open positions in currency, equities and interest rate products, all of which are exposed to general and specific market movements and changing volatility levels in market rates and prices, for instance in interest rates, inflation, foreign exchange rates and equity prices.

- The Bank's market risk increased in 2020, first and foremost due to extreme volatility in equity markets following the Covid-19 pandemic, whereas exposure in the Bank's trading portfolios increased only temporarily due to market making activities.
- Total market risk in the Bank's trading book together with foreign exchange risk and CVA risk, as measured by economic capital, was ISK 3.3 billion at year-end 2020, compared to ISK 2.3 billion at the end of 2019.
- The Bank's market risk remains modest and well within the Bank's risk appetite.



5.1 Market risk management and policy

The Board of Directors is responsible for determining the Bank's market risk appetite, and the CEO and the Risk & Finance Committee are responsible for developing market risk management policies and procedures and setting market risk limits. Market risk is managed centrally by Treasury as well as within trading units, in accordance with the Bank's policies, limits and risk appetite. Together, the risk appetite of the Bank and the market risk policies set the overall limits for market risk management within the Bank in accordance with the Bank's three lines of defence principle.

The Bank separates its exposure to market risk into trading and non-trading portfolios, managing each separately. Trading portfolios include positions arising from market-making, derivative sales and proprietary position-taking. Non-trading portfolios include positions arising from the Bank's retail and commercial banking operations, proprietary position-taking as part of asset and liability management, and funding transactions, managed by Treasury. Treasury is also responsible for daily liquidity management, which entails exposure to market risk.

Market risk mitigation reflects the Bank's overall risk appetite by identifying the target level for market risk factors and to limit exposure in line with the Bank's risk appetite. Other market risk mitigation plans are made on a case-by-case basis involving hedging strategies and risk reduction through diversification.

5.2 Control and monitoring

The aim of the market risk management process is to ensure that market risk levels are within the Bank's risk appetite and mitigate the risk of losses while maintaining acceptable profitability. This entails quickly detecting and correcting deficiencies in compliance to policies, processes and procedures along with limit monitoring, handling limit breaches, risk modelling and reporting. The Bank monitors various indicators that can provide warning of an increased risk of future losses. Market risk indicators need to be concise, reported in a timely manner, give clear signals, and highlight portfolio risk concentrations and reflect current risk positions. Risk reports show the Bank's total risk in addition to summarising risk concentration in different business units and asset classes, as well as across other attributes, as appropriate, pursuant to the Bank's activities.

Market risk arising from trading and non-trading activities is measured, monitored and reported on a daily, weekly and monthly basis. The market risk limits set by the Risk & Finance Committee are monitored by Market Risk, and exceptions and breaches of limits are reported on a regular basis to the Risk & Finance Committee and other relevant parties as necessary. Furthermore, summarised reports highlighting market risk, risk appetite measurements and any concerns regarding market risk are sent to the Board of Directors on a regular basis.

5.3 Market risk exposure

Table 5.1 summarises the Bank's exposure to market risk at year-end 2020.

The Bank also faces counterparty credit risk arising from derivative contracts and securities financing transactions with customers and financial institutions. Counterparty credit risk is, however, very low compared to other credit risk and is mitigated through strict collateral requirements and limits. Further information about the Bank's exposure to counterparty credit risk can be found in the additional disclosures accompanying this document (see also 4.1.4.1).

5.3.1 Banking book exposures

The banking book exposures of the Bank pertaining to market risk are exposures in equities and bonds. The vast majority of the equities are unlisted and are, for the most part, legacy positions obtained through corporate restructuring, or acquired when the Bank was established in 2008. The bond holdings in the banking book are comprised of strategic investments and liquidity management instruments. Capital reserved against these exposures is classified as credit risk.

5.4 Measuring market risk

The Bank uses risk exposure amounts (REA) and economic capital (EC) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. Risk exposure amounts are determined by applying specific risk weights to the Bank's assets, according to capital requirement regulations. Several other indicators are used as measures of market risk as well, including Value-at-Risk (VaR), profit and loss analy-

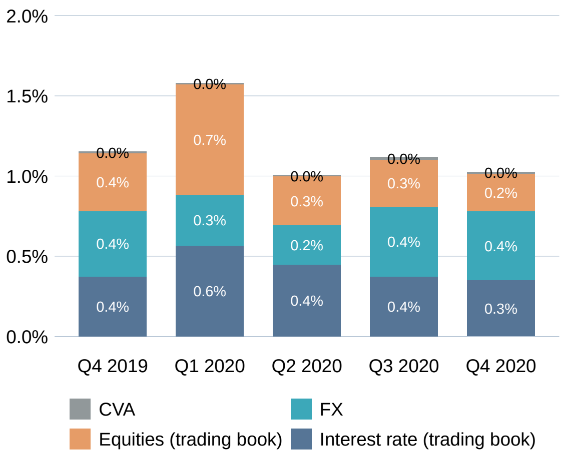
Table 5.1: Total net exposure subject to market risk

	Net position at year-end	
	2020	**2019**
Equities and equity instruments in the trading book	1,951	1,759
Bonds and debt instruments in the trading book	4,272	5,924
FX balance	3,939	2,989

sis, delta positions and net positions across different attributes such as the currency and issuer. These risk measurements are supplemented by specific stress tests and scenario analyses as appropriate, taking the Bank's balance sheet composition and operating environment into account.

Total market risk, measured as the ratio of risk exposure amounts to total REA, remains low, amounting to 1% at year-end 2020 (compared to 1.2% at year-end 2019), well within the Bank's risk appetite.

Figure 5.1: Total market risk (ratio to total REA)



5.4.1 Equity price risk in the trading book

Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments. The Bank's equity trading portfolio is comprised of proprietary trading positions and exposures due to market making, including equity derivatives and hedging positions. All equity-based derivative contracts are usually fully hedged with regards to market risk and are subject to various, strict limit requirements.

5.4.2 Interest rate risk in the trading book

Interest rate risk is the risk of loss arising from the impact of adverse changes in market interest rates. The Bank's trading portfolios contain exposures due to market making and proprietary trading, highly concentrated on government-guaranteed bills/bonds, as well as covered bonds and fixed income derivatives. As with equity-based derivatives, all fixed income derivative contracts are usually fully hedged with regards to market risk and are subject to strict limit requirements.

5.4.3 Interest rate risk in the banking book

Interest rate risk in the banking book is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. Changes in interest rates on the Bank's assets and liabilities impact its interest rate margin and/or the value of its equity. This risk is primarily the result of duration mismatch of assets and liabilities. Net positions of assets and liabilities in the banking book by the interest rate fixing period, at year-end 2020 and 2019, are shown in Table 5.3.

The Bank employs a monthly stress test of the interest rate risk in the banking book by measuring the impact of shifting the relevant interest rates for every currency on the fair value of all interest-rate sensitive assets and liabilities in the banking book.

Table 5.2: Total market risk (REA measure) at year end

	2020		2019	
	REA	**Ratio to REA**	**REA**	**Ratio to REA**
Equity price risk in the trading book	3,913	0.3%	3,807	0.4%
Interest rate risk in the trading book	2,613	0.2%	3,658	0.4%
Foreign exchange risk	4,828	0.4%	1,183	0.4%
CVA risk	172	0.0%	106	0.0%
Total	11,526	1.0%	11,754	1.2%

Table 5.3: Assets and liabilities in the banking book by interest rate fixing period

	Net position at year-end 2020				
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	1,189,237	140,748	160,009	31,595	1,521,589
Total liabilities	927,203	18,529	282,418	67,921	1,296,071
Net on-balance sheet position	262,034	122,219	-122,409	-36,326	225,518
Effect of derivatives held for risk management	-93,660	0	93,660	0	0
Net off-balance sheet position	26,501	-24,501	-2,000	0	0
Total interest repricing gap	**194,876**	**97,718**	**-30,749**	**-36,327**	**225,517**
	Net position at year-end 2019				
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	1,037,797	152,484	148,684	44,747	1,383,712
Total liabilities	814,888	29,736	253,301	62,708	1,160,632
Net on-balance sheet position	222,909	122,748	-104,618	-17,961	223,079
Effect of derivatives held for risk management	-85,357	3,877	81,480	0	0
Net off-balance sheet position	16,143	10,192	-24,335	-2,000	0
Total interest repricing gap	**153,696**	**136,817**	**-47,473**	**-19,961**	**223,079**

Table 5.4 summarises the sensitivity of the Bank's banking book fair value resulting from a flat 100 bps upward and downward shift of all yield curves at year-end.

5.4.4 Foreign exchange risk

Foreign exchange risk (FX risk) is the risk of loss due to exchange rate fluctuations. Foreign exchange risk within the Bank may arise from holding assets in one currency and liabilities in another, or from a spot or forward foreign exchange trade, currency swaps or other currency contracts that are not matched with an offsetting contract. The net FX balance at year-end 2020 and 2019 can be seen in Table 5.5.

Figure 5.2: Net FX balance

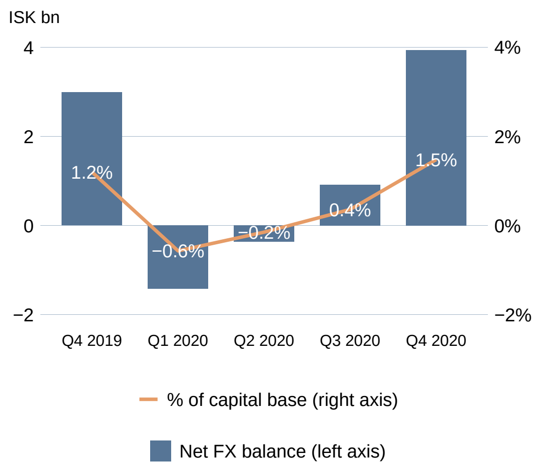


Table 5.4: Interest rate risk (fair value sensitivity) in the banking book at year-end

	2020		**2019**	
	+100 bps	**-100 bps**	**+100 bps**	**-100 bps**
ISK non-indexed	-102	94	205	-248
ISK indexed	4,366	-4,293	4,437	-4,510
EUR	2,074	-2,184	1,405	-1,478
SEK	14	-14	141	-142
USD	-74	74	28	-28
Other	14	-14	31	-31
Total	**6,293**	**-6,337**	**6,247**	**-6,437**

Table 5.5: Net FX balance

	Net position at year-end	
	2020	**2019**
CHF	174	-142
EUR	933	2,540
GBP	233	489
JPY	88	-21
USD	2,422	335
Other	89	-212
Total	**3,939**	**2,989**

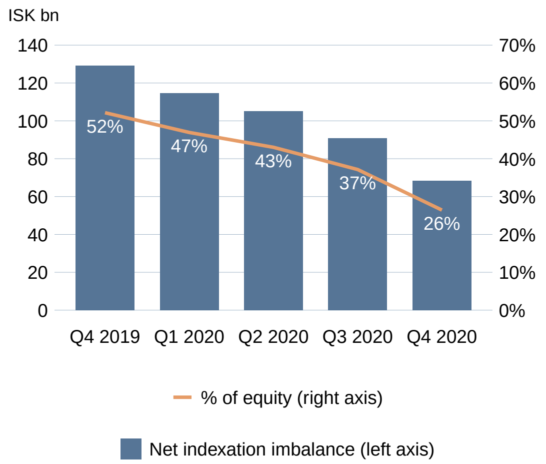
5.4.5 Other market risk

Other market risk within the Bank is comprised of indexation risk and risk due to credit valuation adjustment (CVA).

CVA is an adjustment to the fair value (or price) of derivative instruments to account for counterparty credit risk. The derivative contracts the Bank enters into that entail CVA risk are well collateralised, reducing CVA risk. Hence, the Bank's CVA risk is low and considered immaterial.

Indexation risk is the risk that the fair value or future cash flows of CPI-indexed financial instruments may fluctuate due to changes in the Icelandic CPI index. Mismatched CPI-linked assets and liabilities expose the Bank to indexation risk. The Bank's total CPI indexation balance continued to decrease in 2020, amounting to ISK 68 billion at year-end 2020 as compared to ISK 129 billion at year-end 2019. This decrease mainly stems from indexed borrowing, decreased lending in CPI-linked loans and customers refinancing indexed mortgages.

Figure 5.3: Indexation imbalance

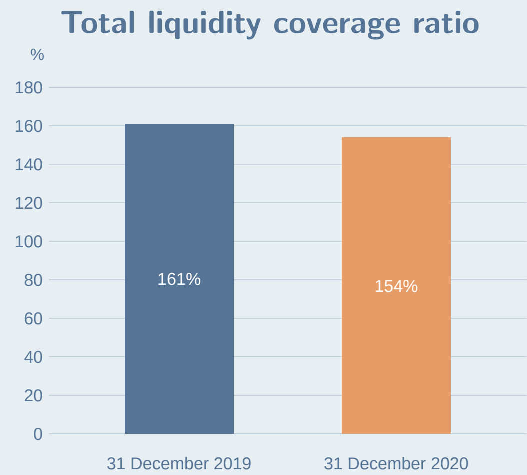


6 Liquidity risk

Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting its financial liability obligations with cash or other financial assets, or having to do so at excessive cost. This risk arises from earlier maturities of financial liabilities than financial assets.

- Liquidity risk is identified as one of the Bank's key risk factors and great emphasis is placed on liquidity risk management within the Bank, which is reflected in both its risk appetite as well as in internal liquidity management policies and rules. The Bank's policy remains to sustain a strong liquidity position in the near- and longer-term as is reflected in the Bank's business plan.
- The Bank's liquidity position is sound and well above regulatory requirements and the Bank's risk appetite. The total liquidity coverage ratio was 154% at year-end 2020 (year-end 2019: 161%) and the Bank's LCR in foreign currencies was 424% (year-end 2019: 769%) and 105% in ISK (year-end 2019: 61%).
- Uncertainties introduced by Covid-19 and increased market volatility have not had a material impact on the Bank's liquidity position and the Bank did not experience increased drawdown of credit facilities nor an increase in deposit outflows.



6.1 Identification

The Board sets a liquidity management policy for the Bank. Liquidity risk management refers to the internal policies and procedures containing quantitative and qualitative objectives, limits and reporting put in place. The policy describes how the Bank identifies, evaluates, measures, monitors, manages and reports its liquidity. The policy clearly outlines the structure, responsibilities and controls for managing liquidity risk within the Bank and includes a liquidity contingency plan. The contingency plan provides a framework for detecting an upcoming liquidity event with predefined early warnings and actions for preventing temporary or longer-term liquidity disruptions.

6.2 Assessment

The Bank measures two key indicators, LCR and NSFR, to monitor and manage short-term liquidity risk and medium to long-term liquidity risk, respectively.

6.2.1 Liquidity coverage ratio (LCR)

The Bank measures the liquidity coverage ratio (LCR) as a key indicator for short-term liquidity. The objective of the ratio is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to withstand a significant stress scenario lasting 30 calendar days. Quantitative information on the Bank's LCR at year-end 2020 is shown in the EU LIQ1 template on the following page. Further information can be found in the additional disclosures accompanying this document.

Table 6.1 shows the Bank's deposit base at year-end 2020. Runoff rates are used to estimate deposit outflows under stressed conditions for the next 30 calendar days and are set according to liquidity rules No. 266/2017. Figure 6.1 and Figure 6.2 show further breakdown of the Bank's deposit base.

Figure 6.1: Total deposits by maturity

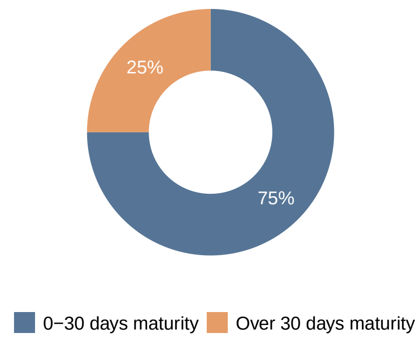
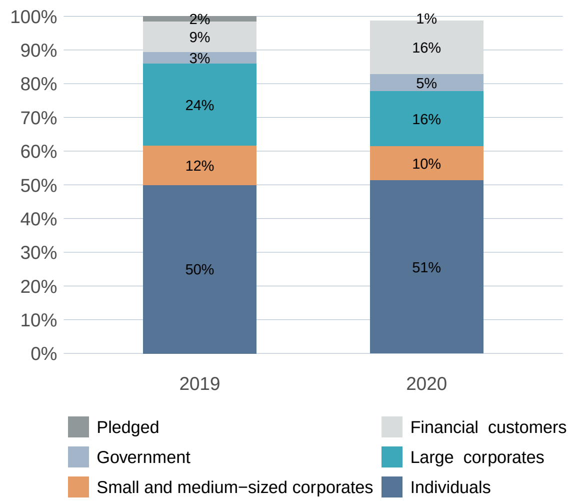


Figure 6.2: 0-30 days maturity deposits by groups*



*According to the Central Bank's Rules on Liquidity Coverage Requirements.

Table 6.1: Total deposits by groups

As at 31 December 2020	Runoff rate	0-30 days	Over 30 days	Total
Retail deposits				
Individuals	5-100%	320,408	111,226	431,634
Small and medium-sized corporates	5-100%	78,887	7,092	85,979
Operational deposits	5-25%	0	0	0
Non-operational deposits				
Large corporates	20-40%	116,435	20,269	136,704
Government	20-40%	35,071	8,041	43,112
Financial customers	100%	68,961	64,280	133,241
Other*		11,082	399	11,481
Total deposits		**630,844**	**211,307**	**842,151**

*Include pledged deposits not included in the Group's consolidated financial statement.

Table 6.2: EU LIQ1 template

		Total unweighted value*	Total weighted value*
		31.12.2020	**31.12.2020**
Number of data points used in the calculation of averages		12	12
High-quality liquid assets			
1	Total high-quality liquid assets (HQLA)	-	169,286
Cash-outflows			
2	Retail deposits and deposits from small business customers, of which:	371,883	28,879
3	Stable deposits	203,383	10,169
4	Less stable deposits	168,501	18,710
5	Unsecured wholesale funding	222,295	131,840
6	Operational deposits (all counterparties) and deposits in networks of cooperative banks	0	0
7	Non-operational deposits (all counterparties)	218,194	127,738
8	Unsecured debt	4,102	4,102
9	Secured wholesale funding	-	0
10	Additional requirements	91,695	10,939
11	Outflows related to derivative exposures and other collateral requirements	2,560	2,560
12	Outflows related to loss of funding on debt products	457	457
13	Credit and liquidity facilities	88,678	7,921
14	Other contractual funding obligations	1,881	0
15	Other contingent funding obligations	32,014	6,915
16	**Total cash outflows**	-	153,609
Cash-inflows			
17	Secured lending (e.g. reverse repos)	0	0
18	Inflows from fully performing exposures	110,938	84,110
19	Other cash inflows	7,919	1,869
EU-19a	(Difference between total weighted inflows and total weighted outflows arising from transactions in third countries where there are transfer restrictions or which are denominated in non-convertible currencies)	-	0
EU-19b	(Excess inflows from a related specialised credit institution)	-	0
20	**Total cash inflows**	118,857	85,979
EU-20a	**Fully exempt inflows**	0	0
EU-20b	**Inflows subject to 90% cap**	0	0
EU-20c	**Inflows subject to 75% cap**	118,857	85,979
			Total adjusted value
21	**Liquidity buffer**	-	**169,286**
22	**Total net cash outflows**	-	**92,593**
23	**Liquidity coverage ratio (%)**	-	**183%**

*EU LIQ1 template; values are a simple arithmetic average of end of month data for each month in the previous year.

The Central Bank of Iceland changed the Rules on Liquidity Coverage Requirements for Credit Institutions in December 2019, effective as of 1 January 2020. The changes include a new minimum requirement for the liquidity coverage ratio in ISK (LCR-ISK). The implementation of the new minimum requirement is according to a schedule set forth by the Central Bank which requires the Bank to have a minimum LCR-ISK of 30% as of 1 January 2020, 40% as of 1 January 2021 and 50% as of 1 January 2022. The Central Bank lengthened the adaption period by one year in December 2020 to further ease access to liquidity in ISK due to prevailing economic uncertainty as a result of the pandemic. Hence, the minimum LCR in ISK will be 40% as of 1 January 2022 and 50% as of 1 January 2023.

Liquidity coverage ratio in ISK is a part of the Bank's liquidity management policy and the Bank's risk appetite, which together define target levels and constraints for liquidity management in ISK. During 2020, the Bank has strengthened its liquidity ratio in ISK, in line with the Bank's risk appetite and the implementation schedule set forth by the Central Bank. Figure 6.5 shows the development of the Bank's LCR in ISK.

Figure 6.3: Liquidity coverage ratio (total)

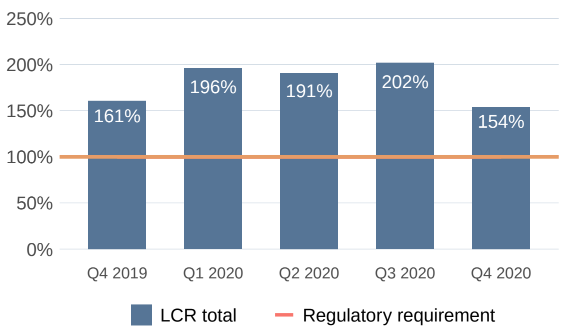


Figure 6.4: Liquidity coverage ratio (FX)

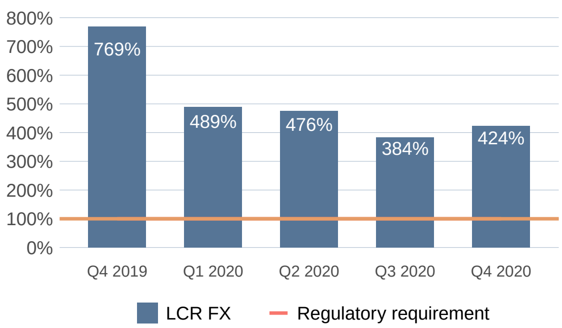
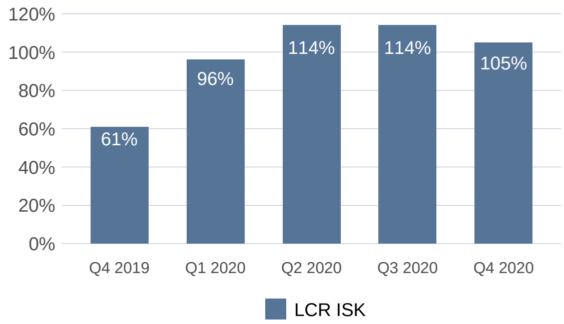


Figure 6.5: Liquidity coverage ratio (ISK)



6.2.2 Net stable funding ratio (NSFR)

The net stable funding ratio has a longer time horizon. Its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities. The aim of NSFR is to promote more medium and long-term funding. It establishes a minimum acceptable amount of stable funding based on the Bank's liquidity risk profile and limits over-reliance on short-term wholesale funding.

NSFR is defined as the ratio between the amount of available stable funding to the amount of required stable funding. Available stable funding is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR. The amount of such stable funding required of the Bank is a function of the liquidity characteristics and residual maturities of the various assets held by the institution, as well as those of its off-balance sheet (OBS) exposures. The Bank's total NSFR was 116% at year-end 2020 (year-end 2019: 117%), and the NSFR in foreign currencies was 132% (year-end 2019: 143%).

Figure 6.6: Net stable funding ratio (total)

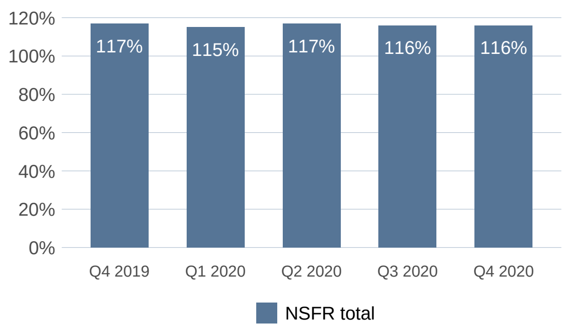
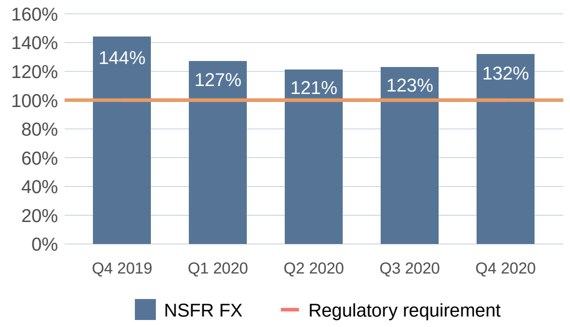


Figure 6.7: Net stable funding ratio (FX)

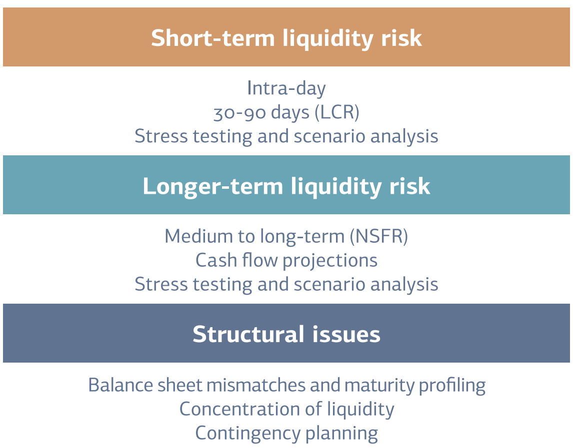


6.3 Management

The objective of the liquidity management policy is to ensure that sufficient liquid assets and funding are available to meet financial obligations and sustain withdrawals of deposits in a timely manner and at a reasonable cost, even under stressed conditions.

The policy aims to ensure that the Bank does this by maintaining an adequate level of unencumbered, high-quality liquid assets that can readily be converted into cash. The Bank has also implemented stringent stress tests that have a realistic basis in the Bank's operating environment to further measure the Bank's ability to withstand different and adverse scenarios of stressed operating environments.

Figure 6.8: Liquidity management process



The Bank's liquidity risk is managed centrally by Treasury and is monitored and reported by Market Risk, allowing management to monitor and manage liquidity risk throughout the Bank. The Risk & Finance Committee monitors the Bank's liquidity risk, while the Bank's Internal Audit function assesses whether the liquidity management process is designed properly and is operating effectively.

The Bank's liquidity management process entails procedures, measurements, monitoring and reporting of both short-term and longer-term liquidity risk as well as structural issues in the balance sheet. An integral part of the management process is conducting forward-looking analysis to estimate future liquidity position, taking the Bank's commitments into account.

6.4 Control and monitoring

The Bank's Treasury Department is responsible for day-to-day liquidity management, which entails closely monitoring current trends and potential market developments that may present significant and complex challenges for the Bank's liquidity strategy.

Liquidity risk is primarily controlled through limits set in the Bank's risk appetite and the Bank's liquidity management policy. Limit management is supplemented by regular monitoring and reporting of liquidity position under normal and stressed business conditions.

The Risk Management Division regularly evaluates the Bank's liquidity position and monitors internal and external events and factors that may affect the liquidity position.

6.4.1 Liquidity Contingency Plan

The Bank has a contingency plan in place, which is set to provide a framework for detecting an upcoming liquidity event with predefined early warning indicators and actions for preventing temporary or longer-term liquidity disruptions.

The Liquidity Contingency Plan stipulates the actions that shall be taken to monitor the likelihood or imminence of the occurrence of a liquidity event or a confidence crisis. It also includes a detailed action plan and procedures for managing a liquidity event. The Contingency Plan includes the following items:

- A list of potential confidence crisis scenarios and their likely effects on the Bank's liquidity position.

- A list of potential liquidity events and their effects on the Bank's liquidity management.
- Various management actions aimed at resolving liquidity disruptions.

The contingency plan is supplemented by the monitoring of early warning indicators along with their defined warning and trigger levels to detect potential liquidity problems. These early warning indicators are either internal, such as changes in the Bank's balance sheet composition, decreasing liquidity ratios, deposit outflows or a downward trend in financial ratios, or external, such as rating downgrades, third party evaluations or market price fluctuations. The Bank determines four levels of stress for each early warning indicator. These four levels of stress are risk alert levels and each level further indicates the increasing likelihood of funds leaving and increased likelihood of a liquidity event. The indicators are monitored weekly by the Risk and Finance Committee and reviewed at least annually by the Board of Directors.

6.5 Funding profile

The Bank continued to be an active issuer on the domestic bond market with issuance of covered bonds and commercial paper. Furthermore, the Bank issued bonds in foreign currencies under its EMTN programme.

In April 2020, the Bank's credit rating was lowered to BBB/A-2 with stable outlook.

6.5.1 Funding

The Bank's funding rests on three main pillars. Deposits from customers are the Bank's primary funding source but the Bank is also funded through borrowing in the form of bond issuance, both in the international markets in foreign currencies as well as in the domestic market in ISK. Furthermore, the Bank is funded with contributions from owners in the form of equity. Figure 6.9 shows the breakdown of the Bank's borrowings while Figure 6.10 shows the Bank's funding structure as at year-end 2020 and 2019.

Figure 6.9: Borrowings and subordinated liabilities

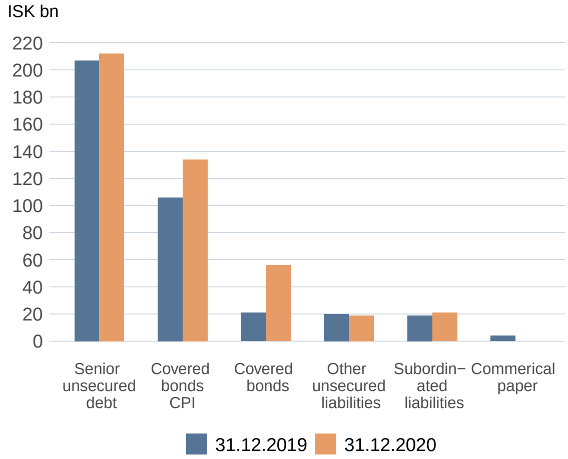
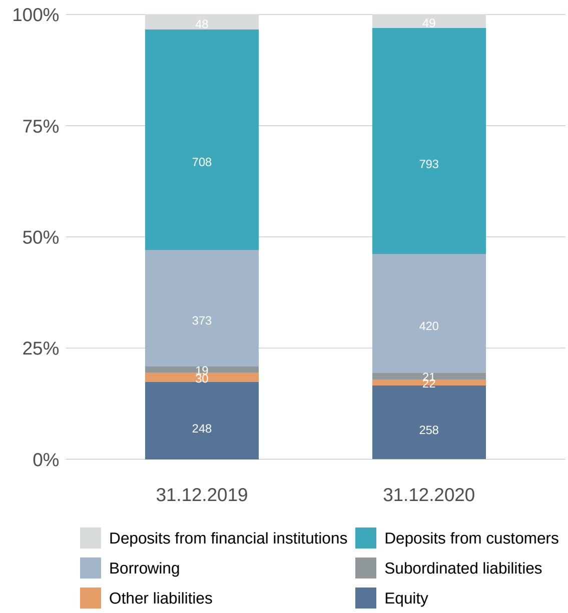


Figure 6.10: Funding profile - ISK billions



6.5.2 Deposits from customers

The largest part of the Bank's funding is in the form of deposits from customers, which increased by 86 billion in 2020 and amounted to ISK 793 billion at year end. Inflation-linked deposits amounted to ISK 126 billion at year-end 2020, increasing by ISK 6 billion from previous year, whereas non-indexed on demand (up to 30 days) deposits amounted to 551 billion at year end, increasing by ISK 83 billion.

6.5.3 Borrowings

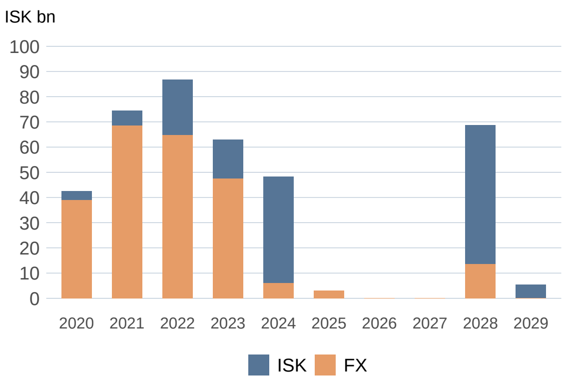
6.5.3.1 EMTN Programme and other unsecured loans

In February, the Bank issued a 4.25-year bond for EUR 300 million against a buy-back of bonds maturing in March 2021 for EUR 300 million. In October, the Bank issued 3-year bonds for SEK 500 million and NOK 500 million. In November, bonds in the amount of SEK 2,600 million and NOK 300 million matured and the remaining outstanding principal was paid in full on the maturity date. At year-end 2020, bond issuance in foreign currency amounted to ISK 227 billion, increasing by ISK 4 billion during the year. Other unsecured loans in foreign currency amounted to ISK 19 billion at the same time.

6.5.3.2 Covered bonds

The size of the programme for covered bond issuance is ISK 250 billion and was increased from ISK 200 billion in 2020. The covered bond issuance is primarily intended to fund the Bank's mortgage portfolio and to mitigate interest rate risk. Regular auctions of covered bonds were held in 2020 where previously issued bonds were tapped and two new bond series issued, one non-indexed series, LBANK CB 25, and one inflation-linked, LBANK CBI 26. No covered bond series matured in 2020. Agreements with market makers in the secondary market for covered bonds were renewed in the year. At year-end 2020, outstanding covered bonds issuance amounted to ISK 189 billion, increasing by ISK 49 billion during the year.

Figure 6.11: Maturity profile



6.5.3.3 Commerical paper

No commercial paper auctions were held in 2020 under the ISK 50 billion debt issuance programme. Two series of commercial paper matured in 2020, in a total amount of ISK 3,640 million. There was no outstanding issuance of commercial paper at year-end 2020.

6.5.3.4 Subordinated bond issuance

Subordinated bond issuance under the Bank's debt issuance programme amounted to ISK 5.5 billion at year end and subordinated issuance under the Bank's EMTN programme amounted to EUR 100 million at the same time.

6.5.3.5 Equity

The Bank's equity was ISK 258 billion at year-end 2020, increasing by ISK 10.5 billion over the course of the year, and the Bank's total capital ratio was 25.1%.

6.5.4 Asset encumbrance ratio

The Bank's liquidity and funding risk framework includes measures of encumbered assets as a ratio to total assets. Encumbered assets are primarily comprised of loans and advances which are pledged against covered bonds and secured bonds issued by the Bank. Other encumbered assets are pledged as collateral to the Central Bank, pledged as collateral to secure trading lines, and credit support for GMRA/ISDA master agreements and other pledges of similar nature. The Bank's asset encumbrance ratio remains low.

Figure 6.12: Asset encumbrance ratio

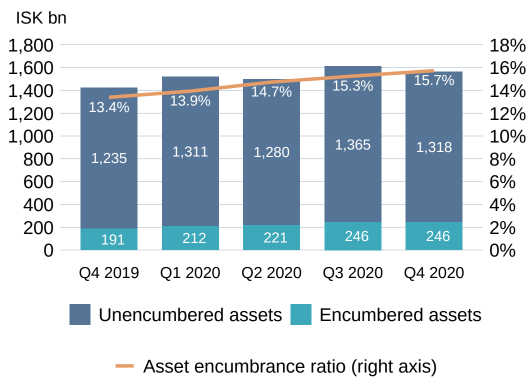


Table 6.3: EMTN Programme

As at 31 December 2020	Currency	Final maturity	Outstanding principal	Contractual interest rate
Senior unsecured				
LBANK 1.625 03/21	EUR	15.03.2021	200	FIXED 1.625%
LBANK FLOAT 02/22	NOK	21.02.2022	1,000	NIBOR + 1.75%
LBANK FLOAT 02/22	SEK	21.02.2022	500	STIBOR + 1.75%
LBANK 1.375 03/22	EUR	14.03.2022	300	FIXED 1.375%
LBANK 1.00 5/23	EUR	30.05.2023	300	FIXED 1.0%
LBANKFL1023	NOK	19.10.2023	500	NIBOR + 1.55%
LBANKFL1023	SEK	19.10.2023	500	STIBOR + 1.55%
LBANK 0.5 5/24	EUR	20.05.2024	300	FIXED 0.5%
Subordinated				
LBANK 3.125 28NC23 T2	EUR	06.09.2028	100	FIXED 3.125%

Table 6.4: Covered bonds

As at 31 December 2020	Currency	Final maturity	Outstanding principal	Contractual interest rate
Non-indexed				
LBANK CB 21	ISK	30.11.2021	5,860	5.50%
LBANK CB 23	ISK	23.11.2023	37,800	5.00%
LBANK CB 25	ISK	17.09.2025	10,240	3.40%
Indexed				
LBANK CBI 22	ISK	28.04.2022	19,540	3.00%
LBANK CBI 24	ISK	15.11.2024	38,120	3.00%
LBANK CBI 26	ISK	20.11.2026	10,140	1.50%
LBANK CBI 28	ISK	04.10.2028	48,280	3.00%

7 Operational risk

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

- There were 23% fewer operational incidents in 2020 compared to 2019.
- There was an 8% increase in loss incidents in 2020 compared to 2019.
- The Covid-19 pandemic led to the majority of the Bank's employees working from home for a large part of 2020.

The Bank is exposed to operational risk through its activities. Loss may result from inadequate or failed internal processes, people and systems, or from external events. This includes factors such as information and communication technology risk (ICT), conduct risk, model risk, compliance risk and risk involved with outsourcing.

ICT risk is the risk of loss due to a breach of confidentiality, failure of integrity of systems and data, and unavailability of systems and data within a reasonable time frame. This includes cyber risk. Conduct risk involves the risk of financial loss due to human error, neglect or fraud in relation to the Bank's customers. Effective model risk management involves reducing the risk of flaws in the development, implementation and use of models. Compliance risk is the exposure of the Bank to legal penalties and reputational damage if it fails to act in accordance with laws and regulations, internal policies and prescribed best practices. Outsourcing risk is the risk involved in outsourcing important functions and loss of control over those functions. These factors are all relevant in the Bank's current environment.

The Bank identifies the types of operational risk to which it is exposed in order to better understand its operational risk profile and assess its vulnerability to these risks. The aim is to identify and assess the operational risk inherent in all existing or new material products, activities, processes and systems.

Effective operational risk identification and assessment processes are crucial in establishing a framework for operational risk monitoring and control.

In identifying operational risk, the Bank examines both internal and external factors that could adversely affect its performance and prevent the achievement of its objectives, such as:

- Risk culture, human resource management practices, organisational changes and employee turnover
- The nature of the Bank's customers, products, contractors and activities, including sources of business, distribution mechanisms and volume of transactions
- The design, implementation, review and operation of the processes and systems involved in the operating cycle of the Bank's products and activities
- The external operating environment and industry trends, including political, legal, technological and economic factors, as well as the competitive environment and market structure.

7.1 Control

The Board of Directors sets the Bank's policy regarding operational risk and risk appetite. The operational risk rules set out the policy regarding operational risk, the roles and responsibilities of stakeholders in the Bank and the operational risk tolerance in terms of limits.

The Operational Risk Committee is responsible for all risk relating to operational risk, including ICT risk and physical security. All rules connected to the remit of the Operational Risk Committee are approved by it.

The Operational Risk Department, which is responsible for developing and maintaining the framework for managing operational risk and supporting the organisation in the implementation of the framework, is a part of the Risk Management Division. This framework includes the Bank's business continuity plans and the security system for online banking. The Department is also responsible for the Bank's certification under ISO 27001.

Internal Audit is responsible for auditing the effectiveness of the operational risk framework and the work of the Operational Risk Department.

Operational risk measurements are reported to the Board in a comprehensive manner as part of regular reporting by Risk Management. Managing directors receive semi-annual reports on the key risk indicators relevant to operations under their control.

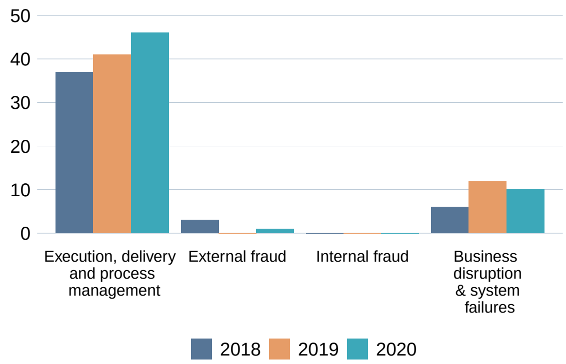
7.2 Measurement and mitigation

In order to understand the effects of the exposures to operational risks, the Bank continually assesses its operational risks. A number of tools are used to identify and assess operational risk:

- Self-assessment. The Bank assesses its operations and activities against a menu of potential risk vulnerabilities. This is done annually, and more often if there are material changes in the operational risk environment of departments.
- Risk mapping. This process involves mapping all reported incidents by risk type and to business units.
- Risk assessments on important IT systems and as a part of project management.
- Key risk indicators (KRIs) are statistics and/or metrics, which can provide insight into the Bank's risk position.
- The Bank is certified in accordance with ISO 27001, the international standard on information security.

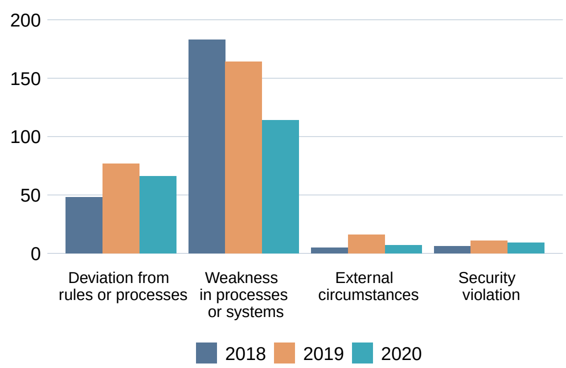
'Execution, delivery and process management' has the largest number of loss events; 37 in 2018, 41 in 2019 and 46 in 2020.

Figure 7.1: Number of loss incidents based on Basel II classification



The Bank categorises operational incidents into deviation from rules or processes, weakness in processes or systems, external circumstances, or security violations.

Figure 7.2: Operational incidents



7.2.1 Mitigation

The Bank utilises insurance as part of its mitigation technique when it comes to operational risk. This is done through a bankers' comprehensive crime policy, as well as a cyber liability insurance policy.

Clear procedures are in place regarding the mitigating actions that result from self-assessment. There are separate procedures in place for how the Bank handles operational incidents and corrective and mitigating actions resulting from these incidents.

The architecture of the Bank's information systems is based on two mirrored data centres, primary and secondary, located in two different buildings linked with high speed communication. This setup allows the Bank to run its core systems with access to mission critical data, even if one data centre (for instance the primary data centre) becomes unusable. In the event of a failure, core systems will automatically switch from one site (the failed one) to the other.

There are business continuity plans in place for all operations considered to be mission critical to the Bank. These plans are all tested on a yearly basis, apart from the IT Department's plan, which is tested more frequently.

7.2.2 Control and monitoring

The Board and the CEO set detailed rules on operational risk governance and responsibilities. Day-to-day management of operational risk is a part of every manager's responsibility, and they are further responsible for monitoring and controlling the operational risk in their departments. Managers evaluate operational risk through risk self-assessment, focusing on key risks identified with top-down management involvement.

Information security, physical security, education and training activities are important components of the management of operational risk, and close cooperation is maintained with the relevant departments involved in these processes. Internal Audit and Compliance are key functions in the framework that the Bank has established to monitor and control operational risk. The Bank has put strong emphasis on ensuring full compliance with GDPR. This has been led by a designated Data Protection Officer (DPO) within the Bank.

Incident reporting, auditing and follow-up is an important part of operational risk management, as the identification and remedial action helps to limit losses resulting from inadequate and failed processes. The Operational Risk Department is responsible for business continuity management and for maintaining the Bank's disaster recovery plans.

A number of documents, policies, rules and work procedures cover key aspects of the responsibilities of the Operational Risk Department. These include the Bank's policy on information security, rules on operational risk, rules on information security, rules on operational risk assessment, and rules on documents and document handling.

7.3 Compliance risk

The Bank manages compliance risk in accordance with its Compliance Policy. The Policy reduces the Bank's compliance risk by taking suitable measures to mitigate it, having regard for the nature, scope and complexity of its operation. Based on the policy, the Bank has set in place a variety of organisational and managerial actions, e.g.:

- A specific process to implement legal changes by adapting the Bank's operation to include any amendments to laws, regulations, rules, contracts, accepted work procedures or ethical guidelines.
- Adopted suitable internal rules and work processes to promote compliance.
- Mandated management to promote compliance e.g. by leading by example, ensuring that employees are familiar with policies, rules and procedures relevant to their work and responsibilities, and take appropriate action in response to compliance violations.
- Training of management and employees.
- Reporting incidents.

The Compliance Department monitors the efficacy of the Compliance Policy and submits a semi-annual report to the Risk Committee and an annual report to the Board of Directors.

7.4 Conduct risk

The Bank manages conduct risk in accordance with its Operational Risk Policy. The policy states that all employees shall work in a disciplined manner and follow internal rules and procedures to reduce the risk of losses due to human error, negligence or fraud (conduct risk). Based on the Policy, the Bank has set in a place variety of organisational and managerial actions, e.g.:

- Adopted suitable internal policies and rules, e.g. Code of Conduct, Fraud Policy, Conflict of Interest Policy and Product Governance Rules.
- Adopted suitable work processes to minimize conduct risk.
- Mandated management to promote a coroporate culture that supports good conduct, e.g. to have an overview over possible conduct risk within each department and implement suitable measures to reduce the risk of human error, negligence or fraud, ensuring that employees are familiar with policies, rules and procedures relevant to their work and responsibilities and take appropriate action in response to conduct infringements.
- Training of management and employees.
- Reporting incidents.

The Compliance Department has many responsibilities related to employee conduct and is responsible for monitoring the status of conduct risk within the Bank. However, due to its nature, monitoring conduct risk is not a simple matter and Compliance is continuously working towards improving this task and reviewing decisions on which parameters to watch in relation to conduct risk.

7.5 Covid-19

The Bank had a robust set of continuity plans in place when Covid-19 hit. In February of 2020, the relevant plans were updated by the Operational Risk Committee in preparation for the possible pandemic, which is based on the Civil Protection Agency's pandemic plans. During the onset of the pandemic, a Crisis Management Team was asembled and its first actions were to ensure a safe and secure work environment for the Bank's employees. With the increased seriousness of the pandemic in March 2020, the CMT merged with the MD team to form a stronger, unified front to respond to the growing crisis and its effect on the Bank's daily operations and ensure adherence with the public health official guidelines. The frequency of meetings was increased and subgroups created. The Executive Board and the Operational Risk Committee have had joint weekly meetings from the start of the pandemic to coordinate the Bank's response. The Bank's response to the pandemic has ensured that there have been no major disruptions to its operations.

7.6 Environmental, social and governance risk

The Bank has assessed its credit portfolio for ESG risk and the exposure of borrowers to such risk. The assessment was based on analysis of ESG risk factors sector-by-sector in the Bank's credit portfolio and considered diversification of the portfolio with regard to ESG risk.

As this work progresses, the Bank will have regard for guidelines issued by international regulators and ESG risk reviewers, such as EBA and the Task Force for Climate Related Disclosures (TCFD), and sharpen its focus on climate-related risk.

7.7 Outsourcing and product governance

In 2020, the Bank updated its product approval process to align with updated EBA guidelines on product governance. The updated version further strengthens the governance of new product approvals and has been fully implemented. The new process includes provisons for life cycle management.

A new outsourcing policy was approved by the Bank in 2020. This sets the standard for how the Bank manages outsourcing agreements and risks. The new policy is in line with the EBA guidelines on outsourcing.

7.8 Model risk management

In 2020, the Bank started developing its model risk management framework. Interviews were conducted with different teams in the Bank to gather information on its models. A model inventory was created, where models that fulfilled an interim model definition were registered.

A risk assessment scorecard was developed and will be used to categorise the models into risk groups that will control the level of monitoring and controls applied to the models. The Bank's model risk management framework is being written.

The Bank bases its work on the instructions stated in the ECB guide to internal models. Additionally, the Federal Reserve's supervisory guidance on model risk management (SR 11-7) and the Polish Financial Supervision Authority's Recommendation W on model risk management in banks have been used for reference.

7.9 Cybersecurity risk

Cybersecurity risk is IT security risk that affects the confidentiality, availability or integrity of information or information systems.

The Bank uses the National Institute of Standards and Technology - Cyber Security framework as a template for the Bank to build its cyber resilience around the following five bullet points:

- Identify – Gaining the institutional understanding to identify what systems need to be protected, assess priority in light of organisational mission, and manage processes to achieve cost-effective risk management goals, and to aim to know vulnerability.
- Prevent – Categories of management, technical, and operational activities that enable the organisation to decide on the appropriate outcome-based actions to ensure adequate protection against threats to business systems that support critical infrastructure components.
- Detect – Activities that identify (through ongoing monitoring or other means of observation) the presence of undesirable cyber risk events, and the processes to assess the potential impact of those events.
- Respond – Specific risk management decisions and activities enacted based upon previously implemented planning (from the Prevent function) relative to estimated impact.
- Recover – Categories of management, technical, and operational activities that restore services that have previously been impaired through an undesirable cybersecurity risk event.

Based on the Bank's knowledge of cyber incidents, the current focus is threefold. Firstly, to educate and increase awareness among both customers (the public) and the Bank's staff. Secondly, intelligence sharing is an important part of collaboration with other FIs that helps all parties to prevent future incidents. Thirdly, building a layered security approach on the knowledge obtained from partners and colleagues (FIs). This is a reliable approach that is reviewed on a regular basis to ensure the implementation of the right procedures and policies to cope with major cybersecurity related threats. This also allows the Bank to provide better support for customers who experience cyber incidents.

8 Regulatory developments

Regulatory Developments

Landsbankinn monitors regulatory developments to ensure that its operation complies with the applicable laws, regulations and rules (hereafter "regulatory requirements"). This section provides an overview of new and expected regulatory requirements of which the Bank has knowledge and are considered by the Bank to be of significance to its operation. The section firstly summarises new regulatory requirements that came into effect in 2020 and secondly, regulatory requirements expected in 2021.

8.1 New regulatory requirements in 2020

Act on Recovery and Resolution of Credit Institutions and Investment Firms

Act No. 70/2020 transposes into Icelandic law the main substance of the Bank Recovery and Resolution Directive 2014/59/EU (BRRD) on resolution procedures. This is a new, comprehensive Act on the resolution of credit institutions and investment firms, containing provision about preventative measures, preparation for the resolution process, its implementation and finalisation. The Act entrusts the Central Bank of Iceland with new administrative powers, so-called powers of resolution. The Act also establishes a special funding resource, the Resolution Fund, to finance resolution proceedings. A new requirement provides that a credit institution satisfy minimum requirements for own funds and eligible liabilities (MREL); i.e., demands that an institution's capital and other funding be sufficient to recapitalise should it be subjected to resolution proceedings, through write-downs of subordinated debt. The Act also provides for certain amendments to Act No. 161/2002, on Financial Undertakings, based in part on the BRRD and in part on the Act's requirement for new, comprehensive legislation to replace certain older rules on the same subject. The Act further provides for specific amendments to Act No. 98/1999, on Deposit Guarantees and an Investor-Compensation Scheme, due to interconnections with the provisions of the Act. These amendments provide, *inter alia*, for a new maximum insurance coverage in the equivalent amount of EUR 100,000 in ISK.

Act on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments

Act No. 7/2020, on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments, transposes into Icelandic law Regulation (EU) No. 909/2014, on Improving Securities Settlement in the European Union and on Central Securities Depositories (CSDR). CSDR alters the framework for the operation of securities depositories to a considerable degree and involves various increased requirements of securities depositories, the settlement of financial instruments and securities settlement systems. Some of the provisions of Act No. 131/1997, on Electronic Registration of Title to Securities, not provided for by CSDR, have been incorporated in Act No. 7/2020, and the aforementioned Act otherwise repealed.

Act on Prospectus for Public Offering or Admission to Trading on a Regulated Market

A new, comprehensive law, Act No. 14/2020, on Prospectus for Public Offering or Admission to Trading on a Regulated Market, transposes the Prospectus Regulation (Regulation (EU) No. 2017/1129) into Icelandic law. The main substance of the Act is to transpose the Regulation and necessary related provisions, such as scope, supervision, authorisation for information gathering granted to regulators, enforceability of decisions by the EFTA Surveillance Authority and the EFTA Court, and penalty provisions. The Act also repeals certain provisions of Act No. 108/2007, on Securities Transactions, providing for prospectuses in Icelandic law.

Act on Managers of Alternative Investment Funds (AIFs)

Act No. 45/2020, on Alternative Investment Fund Managers, is a new, comprehensive law transposing Directive 2011/61/EU, on Alternative Investment Fund Managers (AIFMD), into Icelandic law. Alternative funds refer to all funds for collective investment other than UCITS. This refers to funds other than UCITS, including fund divisions, that receive funds from investors for collective investment based on a pre-determined investment strategy with the aim of achieving returns for the investors. This includes, *inter alia*, investment funds and institutional investor funds. The Act provides for changes which will impact managers of AIFs in Iceland, to a varying degree depending on size. The Act also contains provisions for organisational and operating permit conditions, transparency, custodians and marketing.

Amendments to the Act on a Special Tax on Financial Undertakings

Act No. 131/2019 amended the provisions of Act No. 155/2010, on a Special Tax on Financial Undertakings, to provide for an incremental lowering of the special tax on financial undertakings in four steps, from 0.376% to 0.145% in the period 2021-2024. Act No. 25/2020, which changes various other acts in response to the economic impact of the Covid-19 pandemic, amended Act No. 155/2010 to accelerate the previously enacted incremental lowering of the tax already in the tax assessment year 2021 by lowering the rate to 0.145%.

Amendments to the Act on Measures against Money Laundering and Terrorist Financing and the Act on the Registration of Beneficial Owners

Act No. 96/2020 amends Act No. 140/2018, on Measures against Money Laundering and Terrorist Financing, as subsequently amended, and Act No. 82/2019, on the Registration of Beneficial Owners. This concludes the transposition of the 5th Anti-Money Laundering Directive 2018/843/EU (AML V), as well as some amendments based on experience of application of the law. Select provisions of the Directive were introduced with Act No. 140/2018; this new Act transposes the remaining provisions into Icelandic law. Parties with legal recording obligations to record beneficial owners are now obligated to take suitable action to ensure the accuracy of information about beneficial owners and beneficial owners are now obligated to provide information at the behest of a party with recording obligations.

8.2 Regulatory requirements expected in 2021

Limitation on the extent of investment banking activity

A Bill of legislation to amend Act No. 161/2002, on Financial Undertakings, was submitted to the parliament Althingi in October 2020, proposing that the investments of banks on own account be limited to a certain percentage of equity. The aim is to limit direct and indirect exposure by systemically important commercial banks to 15% of their equity base. The legislation is intended to minimise risk to deposit owners and the National Treasury from the investment banking activities of commercial banks while simultaneously ensuring that commercial banks can receive and process appropriated assets and provide services such as market making and underwriting. The new legislation is expected to enter into force on 1 January 2022.

Regular and on-going disclosure obligations for issuers of securities and flagging obligations

A Bill of legislation on regular and on-going disclosure obligations for issuers of securities was submitted to Althingi in November 2020. The Bill proposes a new, comprehensive legislation on transparency in information disclosure to the issuers of securities listed on a regulated market by repealing the relevant provisions of Act No. 108/2007, on Securities Transactions. The Bill also implements Directive 2013/50/EU, which amends the Transparency Directive 2004/109/EC, as subsequently amended.

Restrictions on the use of inflation-indexation in consumer loan agreements

A Bill of legislation amending Act No. 38/2001, on Interest and Price Indexation, was submitted to Althingi in January 2021. The Bill proposes changes to the Act on interest and price indexation, based on the government's stated intent to systematically remove price indexation. The statement from 3 April 2019 includes seven measure the government will take to abolish indexation. This Bill provides for the first two measures, i.e. the maximum and minimum lifetime of inflation-indexed annuity loans.

Priority of claim under resolution and winding-up proceedings

A Bill of legislation is expected to be submitted to the spring session of Althingi, on the amendment of Act No. 70/2020, on the Resolution of Credit Institutions and Investment Firms, which will transpose the content of Directive (EU) 2017/2399 on the ranking of unsecured debt instruments in insolvency hierarchy into Icelandic law. Directive (EU) 2017/2399 is set for clarification of the provisions of Directive (EU) 2014/59 (BRRD), and provides for the ranking of specific claims in insolvency proceedings. The Bill is connected to minimum requirements for own funds and eligible liabilities (MREL) which the Resolution Authority of the Central Bank of Iceland is responsible for determining for each company under the scope of the Act on the Resolution of Credit Institutions and Investment Firms. The Bill sets out comprehensive rules on the priority ranking of claims, including deposits, in resolution and winding-up proceedings. The claim hierarchy will clarify which claims fulfil the MREL requirement of the Resolution Authority.

Cross-border operation and group-oriented surveillance

Another Bill is in the pipeline for spring 2021 to amend the Act on Financial Undertakings to mostly finalise the transposition of Directive 2013/36/EU, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), and Regulation (EU) No. 575/2013, on prudential requirements for credit institutions and investment firms (CRR). Expected changes are connected to capital buffers, branches and cross-border service, control and prudential requirements on a consolidated basis, and collaboration and exchange of information between regulators.

Markets for financial instruments

A Bill on a new, comprehensive legislation on markets for financial instruments, which entails the transposition of the MiFID II Directive 2014/65/EU and the accompanying MiFIR Regulation 600/2014 into Icelandic law, is expected to be submitted to the spring session of Althingi. This represents considerable modification of the current legislation, calling for amendments to Act No. 161/2002, on Financial Undertakings, Act No. 108/2007, on Securities Transactions, and Act No. 110/2007, on Stock Exchanges. The Bill involves significant changes to requirements applying to regulated markets, multilateral trading facilities and investment firms. Enhanced requirements will apply to transparency, investor protection and business practices, to the management, governance and general organisation of investment firms and regulated markets. The Bill further proposes various changes in response to market developments and technological changes since Directive 2004/39/EU (MiFID I) was transposed into Icelandic law.

Market abuse

The Althingi spring session is also expected to process a Bill on new, comprehensive legislation on market abuse, intended to transpose into Icelandic law the provisions of Regulation (EU) No. 596/2014 on market abuse (MAR). The provisions of Act No. 108/2007, on the same subject, will be repealed. MAR is more detailed than the provisions of current laws and regulations and has a wider scope, applying to more financial instruments than before. It contains new provisions on, *inter alia*, insiders, insider lists, treatment of insider information, and the obligation to report insiders. Main changes from current legislation are a wider scope, more stringent disclosure rules, changes to the classification of insiders and changed rules on the trading of primary insiders and financially connected parties. In addition, the Bill will expand the competency of authorities to carry out reviews and new authorisations for financial undertakings to delay information disclosure to safeguard economic stability.

Derivative trading, central counterparties and trade repositories

Changes are planned to Act No. 15/2018, on Derivatives, Central Counterparties, and Trade Repositories, in the current session of Althingi. The Bill to amend the Act proposes transposing Regulation (EU) No. 2019/834 (EMIR Refit) into Icelandic law. The Regulation amends Regulation (EC) No. 648/2012, on OTC derivatives, central counterparties and trade repositories (EMIR), transposed into Icelandic law with the aforementioned Act on the same subject, No. 15/2018. The Bill reduces various requirements made of non-financial counterparties and smaller financial counterparties in derivatives trading. In addition, managers of alternative investment funds, as defined in Act No. 45/2020, on Alternative Investment Fund Managers, are annexed into the definition of financial counterparties by the Act. The changes are intended to uphold the goal to ensure transparency in derivative trading and about authorisations of regulators while clarifying requirements and, in some cases, ease requirements to simplify derivative transactions, reporting on derivative transactions, and reduce cost.

UCITS

The Minister of Finance and Economic Affairs plans to submit to the current session of Althingi a Bill to a new comprehensive Act on UCITS, transposing into Icelandic law Directive 2014/91/EU, on the coordination of laws, regulations and administrative provisions relating to UCITS (UCITS V) and Directive 2010/78/EU, as regards UCITS and occupational pension funds (Omnibus I). This is a complete review of the current Act No. 128/2011, on UCITS, first and foremost intended to transpose the aforementioned Directives as they include new provision on custodians of UCITS, the remuneration policies of operating companies, and minimum authorisations of regulators. Changes are also planned to Act No. 45/2020, on Alternative Investment Fund Managers (AIFs), first and foremost as regards the remuneration policies of AIFs and use of the concept investment fund.

Key information documents for packaged retail and insurance-based investment products

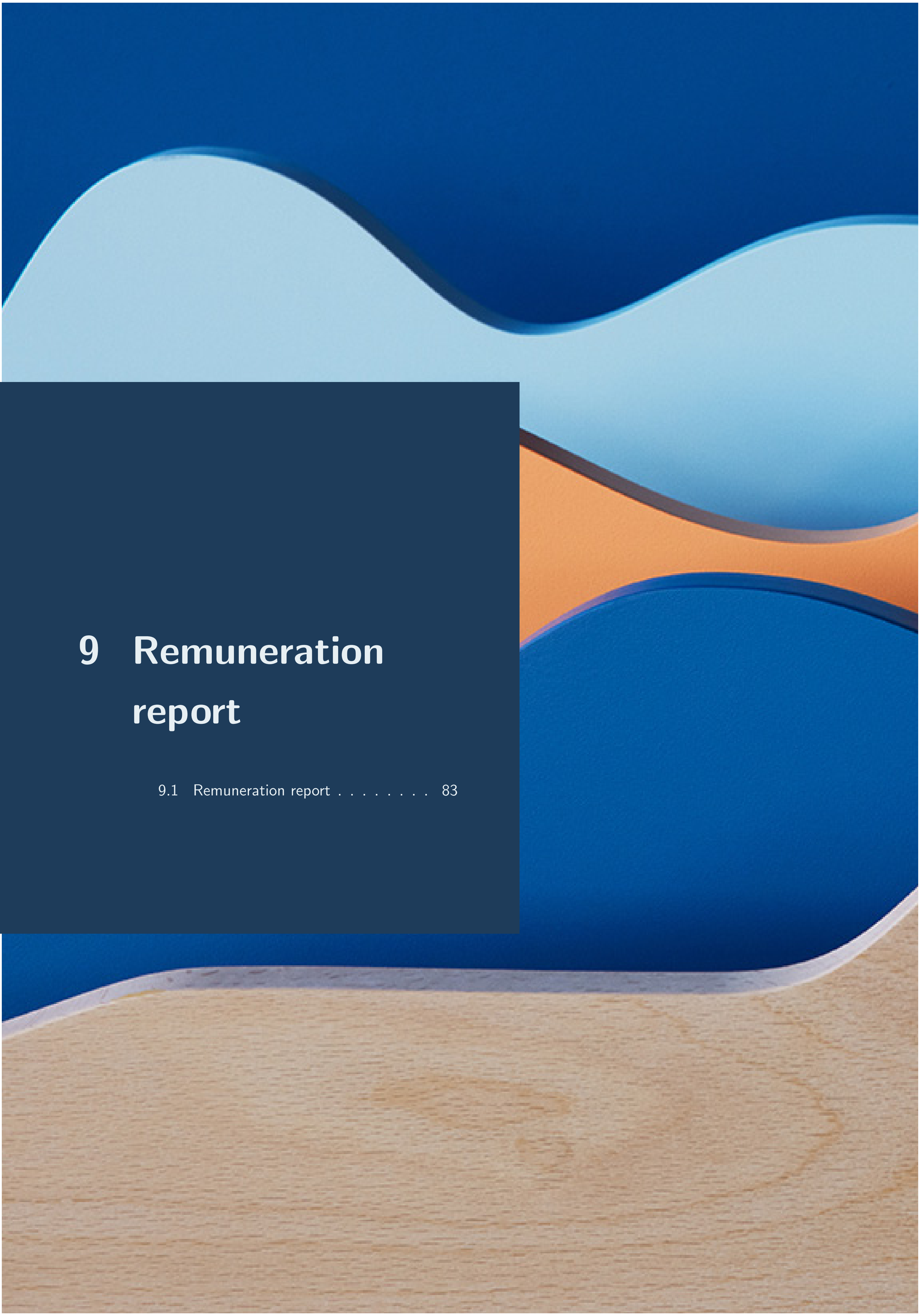
The spring session is also set to see the submission of a Bill on key information documents for packaged retail and insurance-based investment products for general investors, which will transpose into Icelandic law Regulation (EU) No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIPPs). The Regulation requires parties who advise on or sell packaged retail and insurance-based investment products for general investors to compile and make available to general investors key information documents. The aim is to make it easier for general investors to compare key information on different products and understand their characteristics, accompanying risks and costs.

Foreign exchange

A Bill proposing a new, comprehensive legislation on foreign exchange is expected to be submitted to the current session of Althingi, following a complete review of Act No. 87/1992, on Foreign Exchange, and Act No. 37/2016, on Treatment of ISK-denominated Assets Subject to Special Restrictions. While the Bill will generally be based on the same considerations as the current Act, presentation has been thoroughly overhauled. The Bill will propose free and unrestricted cross-border foreign currency trading, capital movement and payments, unless they threaten stability in the FX market and monetary stability. The Bill contains proposals for two types of restrictions on foreign currency trading, on the one hand macroprudential restrictions and, on the other, capital controls to be applied under unusual circumstances. Only parties authorised under the law will be allowed to intermediate in FX transactions. Parties who carry out FX transactions, cross-border capital movement and international payments will continue to be obligated to report such transactions and movements to the Central Bank. Act No. 37/2016, on Treatment of ISK-denominated Assets Subject to Special Restrictions, will be repealed and no restrictions will apply to off-shore ISK or their distribution. The off-shore and on-shore markets will merge into one.

Payment services

Finally, a Bill on a new, comprehensive payment services legislation, transposing Directive (EU) 2015/2366 (PSD2) into Icelandic law and simultaneously repealing Act No. 120/2011, on Payment Service, will be submitted to the spring session. This Bill aims to align Icelandic rules with current EEA rules, encouraging the activities of foreign companies in Iceland as well as domestic operation abroad. The main purpose of the proposed Bill is to promote competition in payment service, strengthen surveillance of new parties on the payment service market and increase data security and consumer protection. The main changes proposed in the Bill are, firstly, the addition of new payment service providers, payment initiation service providers and account information service providers, who are both payment institutions. Secondly, banks will be obligated to provide new payment service providers with access to customers' payment accounts from their systems without previously concluded contracts, provided the owner of the payment account has given express consent. Thirdly, increased security requirements are made of payment service providers, involving consumer protection and safer payment transfers. Following the entry into force of the new payment service law, the Central Bank of Iceland will set rules by virtue of the law to implement the versions of the Payment Service Directive.



9 Remuneration report

Remuneration Report

9.1 Remuneration report

Introduction

The Bank emphasises hiring and employing exceptional personnel. The aim of the remuneration policy is to make the Bank a desirable workplace for qualified employees to ensure the Bank's competitiveness, continued development and acceptable profitability. The remuneration policy shall support sound operations in the long-term and not encourage unreasonable risk-taking. It is the Bank's aim that the terms of employment of executives and other employees are competitive but modest and not market leading. In determining terms of employment, responsibility and performance shall be taken into account, as well as equal rights perspectives. The remuneration policy applies to the Board of Directors, the Executive Board of Landsbankinn, and all Landsbankinn employees. The subsidiary of Landsbréf has its own remuneration policy and Remuneration Committee.

Governance

The remuneration policy of the Bank is approved by its Board of Directors. Furthermore, the remuneration policy is submitted to the Bank's Annual General Meeting for approval or rejection. The remuneration policy may be reviewed more than once yearly, and any amendments shall be submitted to a shareholders' meeting for approval. The remuneration policy serves as an indicative guideline for the Bank and the Board of Directors. The Board of Directors shall enter any deviations from the remuneration policy and substantiation thereof in the minutes. Deviations shall be presented to the Bank's next AGM.

The Remuneration Committee of the Bank is composed of three Directors. The role of the Remuneration Committee is to provide guidance to the Board of Directors and CEO on salary and benefits for key executives and to advise the board on the remuneration policy. The Committee reviews that the terms of employment of the Bank's executives are within the framework provided by the remuneration policy and report on its implementation yearly in connection with the Bank's AGM. The Committee shall monitor the developments of collective bargaining agreements, trends in salary expenses and number of employees. The Board of Directors has issued Rules of procedures for the Committee, within which its role and duties are defined.

At the start of 2020, the Remuneration Committee was composed of the Chairman of the board, which is also the Chairman of the Remuneration Committee, Vice-Chairman of the board and one other board member. Following the resignation of the board member on the 19th of November 2020, an alternate Director joined the Committee. In addition, the CEO of the Bank, Head of HR and Head of Legal regularly attend certain parts of Remuneration Committee meetings.

During 2020, the Remuneration Committee held 6 meetings. The Committee reviewed the remuneration policy prior to the 2021 annual meeting and made no significant changes.

Remuneration policies for the Bank's Board of Directors and CEO

Board members shall receive set monthly remuneration in accordance with the decision of the AGM each year, as provided for in Article 79 of Act No. 2/1995, on Public Limited Companies. In determining the remuneration amount, consideration shall be taken to the hours spent on the job, the responsibilities borne by the board members and the Company's performance. The Remuneration Committee presents the Board of Directors with a substantiated proposal for remuneration to Board members in the coming operating year. The Board of Directors deliberates on the Committee's proposal and submits a final proposal on remuneration to the AGM. The Bank reimburses Directors domiciled outside the capital

Table 9.1: Remuneration by business area in ISK million

	Personal banking	Corporate banking	Markets	Treasury	Support functions	Total
Total remuneration	3,941	1,427	1,686	176	7,537	14,767
- of which variable remuneration	0	0	0	0	0	0

region for travel expenses. Board members may not conclude severance agreements with the Bank.

The Board of Directors appoints the Bank's CEO and determines the remuneration of the Bank's CEO in accordance with the remuneration policy.

The CEO hires the Bank's key executives, and their terms of employment shall be competitive, but modest and not market leading. The Bank publicly publishes the terms of employment of each of the Directors and key executives in its annual report. For Managing Directors, the Bank strives to maintain a gender balance of at least 60/40. Currently there are four male and three female Managing Directors. Members of the management body hold a total of 5 directorships.

Most employees in the Bank receive a fixed salary, according to position and function. The salary level is evaluated on an annual basis. Employee benefits are offered to all employees. All employees have mandatory pension contributions and paid holidays in line with general market terms and as negotiated by the employee's union.

The Bank does not offer variable remuneration and has no plan to implement variable remuneration. Any decision to implement variable remuneration has to be presented to a shareholders' meeting for approval. Table 9.1 discloses information on remuneration for all employees broken down by business area.

As further detailed in the 2014 and 2013 Remuneration reports, the Bank offered a one-off employee incentive scheme in an agreement made by the Minister of Finance on behalf of the State, Landsbankinn hf. and Landsbanki Íslands hf. dated 15 December 2009. The scheme was compliant with FSA rules on performance linked remuneration with financial undertakings. As a result, employees appear on the list of shareholders.

The Remuneration Committee performs an annual comparison with market data on the Bank's remuneration to ensure remuneration is competitive, modest and not market-leading.

10 Disclosure policy

Disclosure Policy

10.1 Introduction

The Basel III Accord, implemented in the European Union through the Capital Requirements Directive (CRD 2013/36/EU (the 'Directive')) establishes a revised regulatory capital framework across Europe, governing the amount and nature of capital that must be maintained by credit institutions. Parts of the Directive have been implemented into Icelandic law by amendments to the Act on Financial Undertakings (Act. No. 57/2015 and Act No. 69/2016, amending Act No. 161/2002 on Financial Undertakings). The amendments to Icelandic law incorporate, among other things, the CRD IV capital buffer requirements, disclosure requirements, minimum leverage ratio, supervisory review and evaluation process and capital definitions.

The Basel framework consists of three 'Pillars':

- Pillar I defines the minimum capital amount that meets the firm's credit, market and operational risk;
- Pillar II requires the firm to assess whether its Pillar I capital is adequate to meet its risks (Internal Capital / Liquidity Adequacy Assessment Process, ICAAP/ILAAP) and is subject to annual review by the FSA in the Supervisory Review and Evaluation Process (SREP);
- Pillar III requires disclosure of specified information about the underlying risk management controls and capital position.

This publication, Risk and Capital Management 2020, reviews the Bank's organisation and processes relating the identification and management of the risk type characteristic of a financial group with its type of business concept. It also describes the Bank's risk position based on the requirements under Pillar III.

10.2 Disclosure policy

In accordance with the Directive, the Bank has adopted a formal disclosure policy in that it will comply with the requirement to publicly disclose relevant information.

The rules state that one or more of the required disclosures may be omitted if it is believed that the information is immaterial. Materiality is based on the criteria that the omission or misstatement of material information would be likely to change or influence the assessment or decision of a user relying on that information for the purposes of making economic decisions. If a disclosure is considered immaterial, it will be stated in the relevant section.

One or more of the required disclosures may be omitted if the information is regarded as proprietary or confidential. Proprietary information is that which, if it were shared, would undermine a competitive position. Information is considered confidential if there are obligations binding the Bank to confidentiality with customers and counterparties. If information is omitted for either of these reasons, it will be stated in the relevant section along with the rationale. Further general information on required disclosures will be published where appropriate.

10.3 Frequency of publication

The disclosures are reviewed on an annual basis and, if appropriate, more frequently. Disclosures are published as soon as is practicable following any revisions.

10.4 Verification

The disclosures have been put together solely to explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks. They do not constitute any form of audited financial statement and have been produced solely for the purpose of Pillar III. They should not be relied upon in making judgements about the Bank. The disclosures will only be subject to external verification to the extent that they are equivalent to those made under accounting requirements.

The disclosures are reviewed by and presented to the Bank's Board of Directors and Risk & Finance Committee. The first two chapters, which contain a declaration on the adequacy of risk management arrangements within the Bank and a concise risk statement, succinctly describing the Bank's overall risk profile are approved by the Board of Directors, in accordance with Article 435 in CRR.

This publication, Risk and Capital Management 2020, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2020. There may be some discrepancy between financial information in the Consolidated Financial Statement 2020 and information in the Risk and Capital Management 2020, as the report has been prepared in accordance with the Capital Requirements Directive and the Basel III capital framework, rather than in accordance with IFRS.

10.5 Media and location of publication

The disclosures are published on the Bank's website.