Risk and Capital Management 2021

LANDSBANKINN HF. | Reg. No. 471008-0280 | LANDSBANKINN.IS

Landsbankinn hf. Pillar III risk report
31.12.2021

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.

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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. 83.1 – Consolidation in the Bank's Consolidated Financial Statements for 2021.

This publication, Risk and Capital Management 2021, has not been audited by external auditors. However, it includes information from the audited Consolidated Financial Statements 2021 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 2021, 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 (CRD IV) and Regulation (EU) No. 575/2013 (CRR) as amended by Regulation (EU) 2019/876 (CRR II), 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 2021 Highlights and outlook

Uncertainty caused by the COVID-19 pandemic continued to affect the economy and the Bank in 2021. Nonetheless, the Bank's key risk indicators show that Landsbankinn remains resilient, both in terms of strong earnings and a sound risk profile. Despite challenges caused by the pandemic, the impact on the Bank's operations and service to customers has been minimal.

The Bank's risk measurements and assessment of key risk factors indicate a positive and stable outlook; defaults are at an all-time low, the Bank is highly capitalized, liquidity is strong, and all risk measures are within the Bank's risk appetite.

1.1 Capital position

The Bank's capital position remains strong. The total capital ratio increased by 1.5 percentage points in 2021 and is 26.6% at year end. The Bank's minimum capital requirement, as determined by the FSA, is the sum of Pillar I and Pillar II-R requirements. The Pillar II-R requirement of 3.5% is based on the FSA's 2020 Supervisory Review and Evaluation Process (SREP). Taking capital buffers into account, the total capital requirement for the Bank is 18.9%. The Bank's management has set a capital target of $\geq$22%. and thus, there is an implied management buffer of 3.1%. The Bank's excess capital is therefore 4.6%, or ISK 53 billion.

The Bank's risk-weighted exposure amount (RWEA) was ISK 1,144 billion at year-end 2021 and increased by ISK 22 billion, or 2.0%, for the year. Credit risk is the single largest risk type or 90.3% of total RWEA. The increase in RWEA is in line with increased lending, particularly in mortgages.

The Bank measures internal capital requirements by economic capital (EC) for all material risks with regard to RWEA. The internal assessment of EC decreased in 2021, to ISK 104 billion at year end. The ratio to RWEA decreased by 0.7 percentage points to 9.1%.

1.2 Credit risk

The carrying amount of the Bank's loan portfolio to customers grew by 9% in 2021, primarily due to a continued growth in residential mortgage lending to individuals. High demand for non-indexed mortgages continued in 2021 due to favourable interest rates, and the share of non-indexed mortgages in the portfolio continued to increase, from 61% in 2020 to 73% at year-end 2021. The credit quality of the mortgage portfolio remained high with an average probability of default (PD) of 1.2%.

Credit risk, as measured by PD decreased from 2.8% at year-end 2020 to 2.1% at year-end 2021. Substantial government aid to individuals and corporates during the pandemic, along with a relatively robust economic recovery have caused the effects of the pandemic on the loan portfolio to be less severe than initially thought, and more targeted towards certain sectors, such as the travel industry. At year-end 2021, the carrying amount of loans with active pandemic related moratoria is ISK 74 billion, of which ISK 59 billion is to customers in the travel industry sector.

A total of 5 exposures are classified as large exposures at year-end 2021, as opposed to 4 exposures at year-end 2020. The total ratio of large exposures to tier 1 capital is 33% at year end, well within risk appetite.

EC for the loan portfolio decreased in 2021 by ISK 5.8 billion while the EC for other assets under credit risk increased by ISK 2.1 billion. The main reason for a lower EC for the loan portfolio is a higher proportion of loans to retail customers with lower PD while the exposure to corporate customers decreased in 2021. The increased EC for other assets under credit risk is mainly due to higher EC for equity in the banking book.

1.3 Market risk

The Bank's market risk decreased in 2021 due to far less market volatility than during the year 2020, lower exposure in the Bank's trading portfolios and lower net FX Balance. Market risk is well within the Bank's risk appetite and remains modest. Market risk to RWEA decreased by 0.2 percentage points from year-end 2020 to year-end 2021. The Bank's FX balance decreased by ISK 5 billion in 2021 and remains well within the Bank's risk appetite. The Bank's CPI imbalance continued to decrease in 2021, amounting to ISK 5 billion at year-end 2021 or 2% of equity, compared to 26% of equity at year-end 2020. Lower balance mainly stems from decrease in indexed loans and increase in CPI-linked borrowing and deposits.

1.4 Liquidity risk and funding

Liquidity risk is one of the Bank's key risk factors and the Bank's policy is to sustain strong liquidity position in the near- and long term. The Bank's total LCR at year-end 2021 was 179%, LCR ISK was 120% and 556% in foreign currencies, all well above regulatory limits and the Bank's risk appetite. The Bank's net stable funding ratio was total 121% (142% in foreign currencies) and above the regulatory limits which changed in June 2021. Rules no. 1032/2014 were replaced with rules no. 750/2021 where limits, 100%, for NSFR total was implemented instead of limits for net stable funding in foreign currencies.

The largest part of the Bank's funding remains in the form of deposits from customers, which increased by 107 billion in 2021 and amounted to ISK 900 billion at year end. Indexed-linked deposits amounted to ISK 136 billion at year-end 2021, increasing by ISK 10 billion from previous year. In February the Bank issued its inaugural green bond issuance under the Bank's EMTN programme with reference to the sustainable finance framework, amounting to EUR 300 million. In November the Bank issued a subsequent green EUR 300 million bond. In addition, the Bank issued 18-month bonds amounting to SEK 900 million in February. Bond issuance in foreign currency increased by ISK 36 billion during 2021, amounting to ISK 248 billion in year-end 2021. Outstanding covered bonds issuance amounted to ISK 218 billion in year-end 2021, increasing by ISK 29 billion during the year. Subordinated bond issuance under the bank's debt issuance programme amounted to ISK 5.5 billion at year-end 2021 and subordinated issuance under the bank's EMTN programme amounted to EUR 100 million at the same time.

The Bank's credit rating, BBB/A-2 has not changed since last rating action in April 2020. The outlook still remains stable.

1.5 Operational risk

The Bank's operational risk profile was stable in 2021. The Bank's response to the COVID-19 pandemic has meant that the impact on its operations and service to customers has been minimal. Early in the pandemic the Bank started using a suite of tools for remote work and that has enabled the Bank to be flexible and follow the public health official guidelines throughout the pandemic.

In 2021 there was a reduction in the number of operational incidents continuing the trends of the last few years.

There has been a marked increase in attempted fraud and cybercrime that customers are subjected to. In response to this increase the Bank has made changes to online anti-fraud systems and internal processes to be better able to respond and protect customers. ICT risk continues to be a focus area for the Bank with an important part of the framework for ICT risk being adherence to Guidelines on ICT and security management by EBA as well as the Bank's ISO 27001 certification.

1.6 Economic outlook

Preliminary figures from Statistics Iceland show that GDP grew by 6% in the third quarter as compared to the same quarter last year. This is the second quarter in a row of economic growth post-COVID and further confirmation that the economy is on the road to recovery. Economic growth in the first three quarters of the year was 4.1%, carried by the second and third quarter as growth was slightly negative in the first quarter. Landsbankinn Economic Research expects final figures for economic growth in 2021 to be around 5% and forecasts continued robust growth in 2022, or 5.5%.

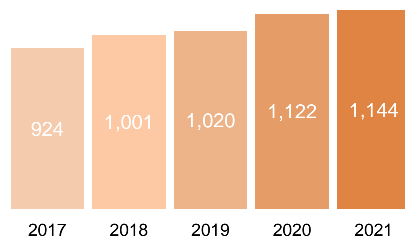
Unemployment, according to measurements by Statistics Iceland, was 3.4% in November, 3.8 percentage points lower than the same time last year. General unemployment as registered by the Directorate of Labour was 4.9%, down by 5.7 percentage points between years.

Inflation has been over the Central Bank's inflation target since May 2020. The consumer price index (CPI) increased by 0.45% between months in December and inflation was 5.1% at year-end. Inflation was 3.6% a year ago and has increased by 1.5 percentage points in the span of a year. The annual average inflation rate in 2021 was 4.4%, compared with 2.8% in 2020. The outlook is for above-target inflation until around mid-2022.

The Monetary Policy Committee of the Central Bank began a rate hike cycle in May 2021 with a 0.25 percentage point increase. Interest rates were again raised by the same increment in August and October followed by a 0.5 percentage point increase in November. During this period, rates have risen from 0.75%, a historic low for Icelandic policy rates, to 2.0%. Economic Research's forecast assumes that the Central Bank's key rates will be raised continuously going forward to the third quarter of 2023, at which point they will be 4.25%. The inflation target will be attained at that point, with interest rates decreasing again to stand at 3.5% at year-end 2024.

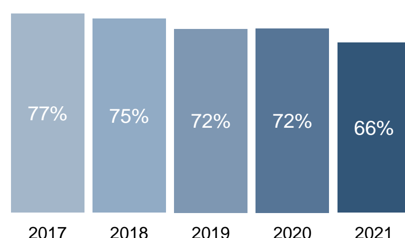
Risk metrics overview

Risk-weighted exposure amount



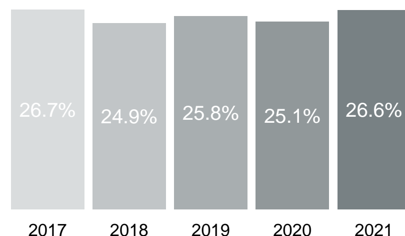
1,144 ISK bn

RWEA to total assets



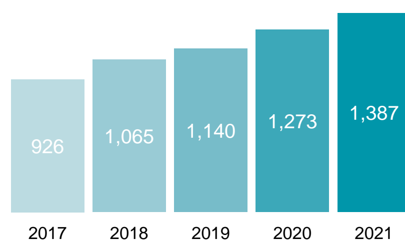
66%

Total capital ratio



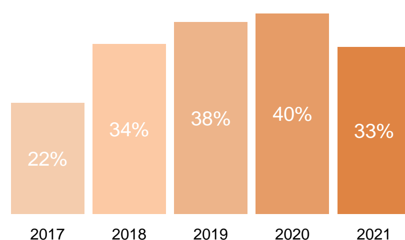
26.6%

Loans and advances to customers



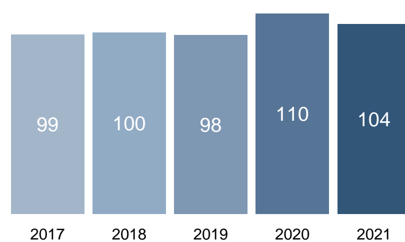
1,387 ISK bn

Large exposures to tier 1 capital*



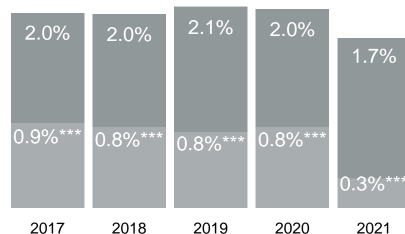
33%

Economic capital



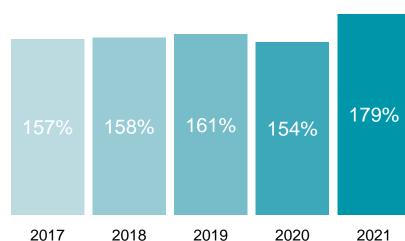
104 ISK bn

Stage 3 loans**



1.7%

Liquidity coverage ratio total



179%

* Up to and including 2020, large exposures were measured as a % of eligible capital.
** Staging of loans was implemented in 2018. For 2017, defaulted and impaired loans are used as a proxy for stage 3.
*** Of which 90 days past due.

2 Risk management

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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 internal limits and 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, 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, and that exposure to risk is managed to ensure that it remains within limits. Risk management policy is implemented through risk appetite, business strategy, and 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 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. 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 promote resilience.

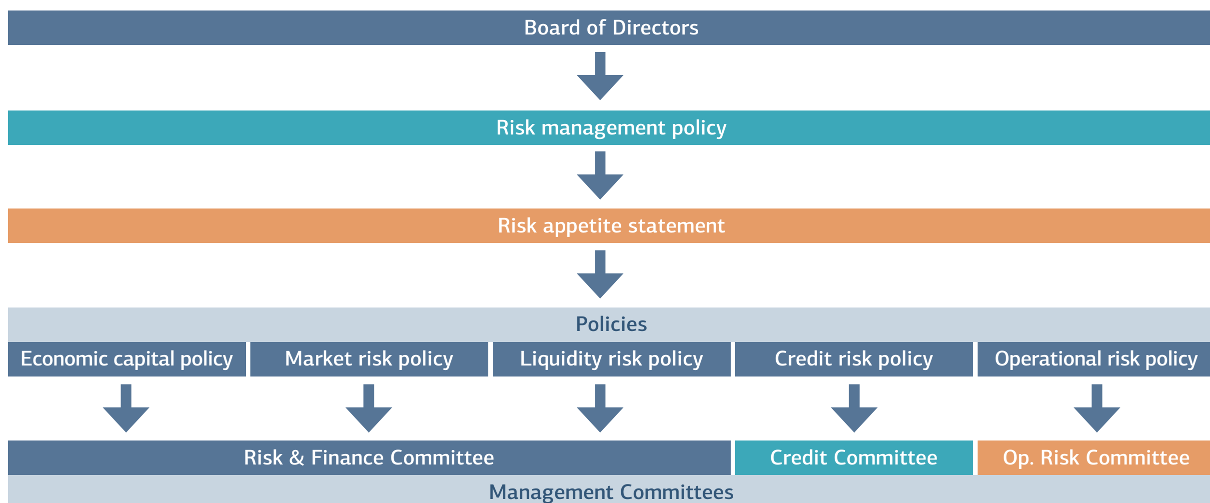
Risk appetite defines the type and extent of risk that management is willing to take to meet the Bank's business objectives. In pursuit of its goals, the Bank only takes on risks that it understands, and can measure, evaluate and manage.

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 minimize and contain reputational risk.

The Bank has adopted a Sustainability Policy 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 risk awareness throughout the organization.

Figure 2.1: Risk policy structure



2.2 Risk identification

The Bank defines material risk as any risk large enough to substantially impact the success of the enterprise, risk described in its risk appetite and/or amounting to more than 2.5% of its capital base.

The Bank is exposed to the following material risks:

- Credit risk
- Market risk
- Liquidity risk
- Operational risk

For each of these risk factors, several material risk subfactors are defined. These are covered in detail in the subsequent chapters.

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.

Table 2.1: Relative allocation of economic capital due to material risks to the Bank's business units

Material risk	Personal Banking	Corporate Banking	Asset Management & Capital Markets	Treasury & Market Making
Credit risk	High	High	Low	Low
Market risk	Low	Low	Medium	High
Liquidity risk	n/a	n/a	n/a	High
Operational risk	Medium	Medium	High	Medium

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 policies and governance determined by the Board of Direc-

tors. These policies are implemented by the Bank's CEO through key risk management bodies and committees.

2.3.1 Risk committees

The Bank's risk management governance structure at year-end 2021 is shown in Tables 2.2 and 2.3.

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 Services
Credit Committee	CEO	CRO, MD of Corporate Banking
Operational Risk Committee	CRO	MD of Personal Banking, MD of IT, Chief Compliance Officer, Head of Operations, Head of Operational Risk
Project Committee	CEO	Managing Directors

Effective sub-committees provide important preparation for Board meetings. The establishment of sub-committees is designed to promote discussion and deeper analysis of issues for the Board's attention and its efficacy.

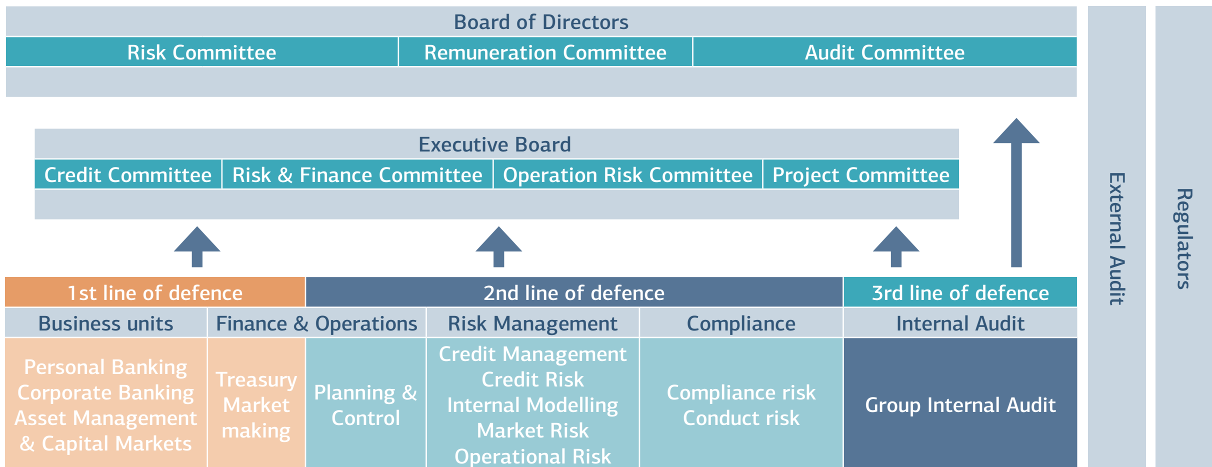
The Board assesses its need for sub-committees at the Board level, according to legal requirements and the size and scope of the Bank at each time, as well as the composition of the Board. The Bank's corporate governance statement is required to provide information on the establishment and appointment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

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

The Audit Committee's main role is to review the Bank's financial statements and other financial information, supervise accounting procedures, monitor the organisation and function of Internal Audit and to submit a proposal to the Board on the selection of external auditors, assess their independence, super-

Figure 2.2: Risk management governance structure



vise the audit of the Bank's financial statements as well as any additional tasks performed by the 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 reviews issues that exceed the authorisation of the CEO and/or the Credit Committee concerning individual credit facilities and write-offs, and submits proposals on these issues to the Board. The Committee also reviews policies on capital management and funding, ICAAP/ILAAP reports, the results of stress tests, the status of the Bank's loan portfolio, procedures for impairment calculations, the activities of Compliance and other types of risk as and where applicable.

The Remuneration Committee shall submit to the Board a draft remuneration policy for the salaries and terms of employment of the CEO, other senior executives and Directors of the Board, and monitor the implementation of an approved remuneration policy. The Committee shall review that salaries and other terms of employment comply with current laws, rules and best practices. The Committee shall discuss developments in collective bargaining agreements, salary expenses, breakdown of salaries, other remuneration and the number of employees. For further details on the Bank's remuneration policy, see Chapter 9.

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

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 main role of the Executive Board is to ensure compliance of the Bank's operations with laws, regulations, business plans and policies at any given time.

The Credit Committee's main role is to ensure that the Bank's loan portfolio and credit risk remain in compliance with its credit risk policy and risk appetite. The Committee covers individual credit decisions, credit limits for customers, credit quality and large exposures, among other things.

The Risk & Finance Committee primarily covers market and liquidity risk and is responsible for formulating risk limits for these factors for the Board of Directors. The committee also covers counterparty risk, reviews various rules and policies regarding risk, review the ICAAP methodology and scenarios and reviews the Bank's market risk, liquidity risk and economic capital policies.

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 policy.

The Project Committee selects, prioritises and oversees key projects that support the Bank's strategy.

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

2.3.2 Risk Management

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

The Risk Management division comprised six departments at year-end 2021:

- Credit Management 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 Risk Management 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.

- Credit Risk 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.

- Market Risk 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, securities financing transactions as well as FX balance monitoring for the Bank.

- Operational Risk is responsible for ensuring centralised management of operational risk other than compliance and conduct risk. 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. Operational Risk is involved in the design and testing of the Group's continuity plans. The department is responsible for ensuring compliance with the ISO 27001 standard for information security.

- Internal Risk Models provides the Bank with IRB and EC models and related processes to estimate credit risk and link the risk to equity and provides support during the implementation of those models and processes within the Bank. The department develops models for pre-approved limits in order to facilitate the automation of lending processes.

- Risk Solutions develops and operates external solutions used by Risk Management and maintains the IT reporting and development environment for Risk Management. 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 Compliance 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 organizational chart and an element of its internal control 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-based 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. The risk appetite framework considers key risks relevant to the Bank's business activities by setting limits and target levels for risk. In addition, the Bank measures and monitors other risk indicators to support the management of key risk factors.

Monitoring and reporting on the Bank's risk appetite has been aligned with monitoring and reporting of recovery plan indicators according to the Bank Recovery and Resolution Directive (BRRD).

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

Table 2.4: Overview of risk appetite metrics

Risk category	Risk type	Metric	31.12.2021	31.12.2020	31.12.2019
Credit risk	Credit quality	Expected loss (% of total loans)	0.4%	0.5%	0.4%
		Probability of default	2.2%	2.9%	2.4%
	Single name concentration	Large exposures (% of Tier 1 capital)*	33.1%	39.6%	38.0%
Market risk	Market risk	Total market risk (% of RWEA)	0.9%	1.0%	1.2%
Liquidity risk	Liquidity risk	Liquidity coverage ratio - Total	178.8%	154.2%	160.5%
		Liquidity coverage ratio - FX	555.8%	424.0%	768.8%
		Liquidity coverage ratio - ISK	120.1%	104.8%	60.6%
Funding risk	Funding	Net stable funding ratio - FX	142.0%	132.1%	143.0%
		Net stable funding ratio - Total	121.0%	116.5%	117.0%
Capital risk	Capital adequacy ratio	Capital adequacy ratio	26.6%	25.1%	25.8%
Profitability	Profitability	Return on equity after taxes	10.7%	4.3%	7.5%
Operational risk	Change in RWEA	12-month change in RWEA	-2.8%	6.4%	-0.7%

*In addition to monitoring large exposures as a % of Tier 1 capital, the Bank also monitors the largest single exposure as a % of Tier 1 capital. The goal is <18% and as at 31.12.2021, the largest exposure is well below that goal. External regulation mandates a ratio of <25%.

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 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.

2.4.1.2 Credit risk

Stress testing is an important part of the Bank's capital planning process. Stress testing for credit risk is mainly applied as part of capital planning and focuses on measuring potential credit losses and effects on EC.

2.4.1.3 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.

2.4.1.4 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 also performs other internal stress tests that may vary from time to time.

Figure 2.3: Overview of risk reporting within the Bank

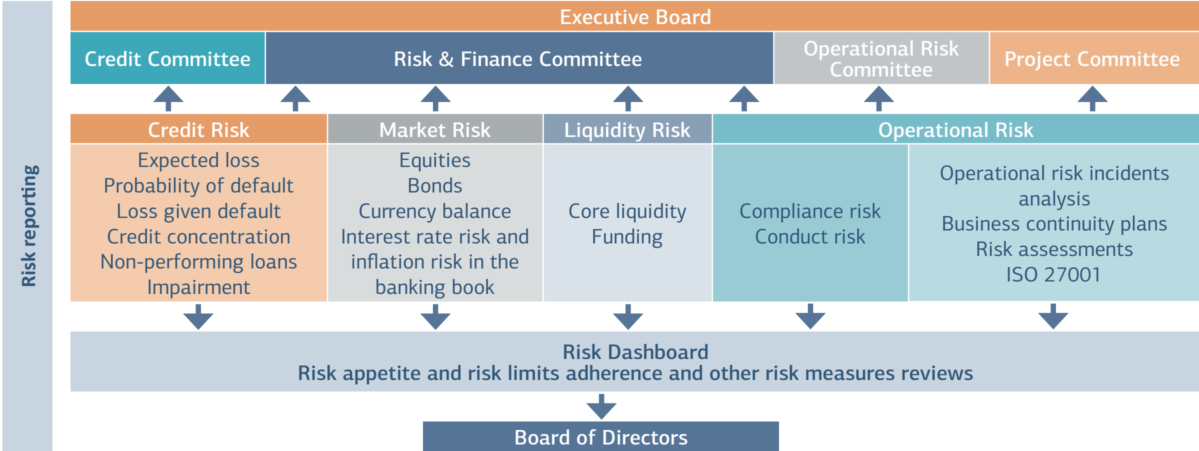


Table 2.5: Principal reporting to the Board of Directors

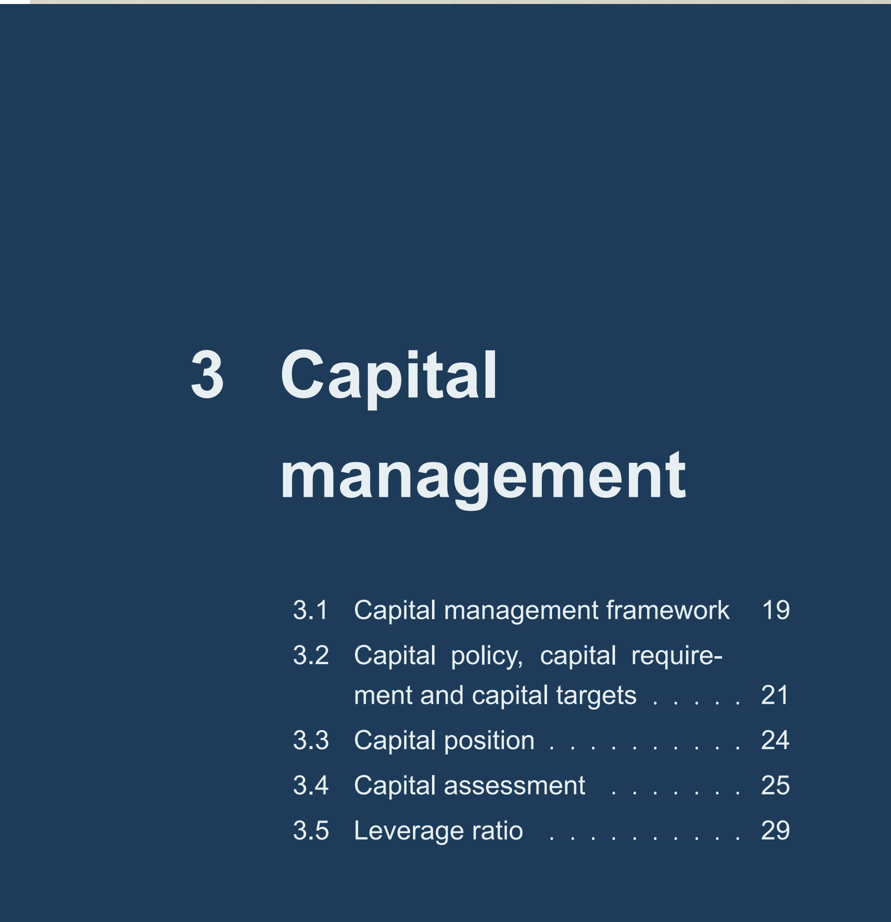
Report	Description
Annual	
Risk and capital management report	Pillar III disclosures.
ICAAP/ILAAP report	Evaluation of the risk profile and solvency need. The report contains conclusions drawn from stress testing, including the effect of various scenarios on expected losses and capital needs. The ICAAP/ILAAP report is subject to the FSA's Supervisory Review and Evaluation Process (SREP).
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. The report contains an assessment of compliance risk and conduct risk as well as an AML report and a data protection report.
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.
Executive management report	An aggregated report containing risk related material such as risk appetite, EC and RAROC.
Bi-weekly or more frequently	
Market & liquidity risk report*	Market and liquidity risk report highlighting the Bank’s market risk exposures, risk appetite, market risk limit utilisation and liquidity risk and any concerns regarding liquidity and/or market risk.

*Daily during adverse conditions

2.5 Risk monitoring

The Bank allocates considerable resources to ensure on-going adherence with approved risk limits and for risk monitoring. The risk monitoring process combines active monitoring of risks, exposures and adherence to the Bank’s risk framework and extensive risk reporting. The Bank has set guidelines for reporting to relevant management bodies, including the Board of Directors, Executive Board and all relevant committees on developments in risk measures and risk appetite.

The Bank has implemented a policy on risk data in compliance with BCBS 239 (Basel Committee on Banking Supervision’s guideline 239). The policy defines which reports should be submitted where, the frequency of those submissions, and who is responsible for them.



3 Capital management

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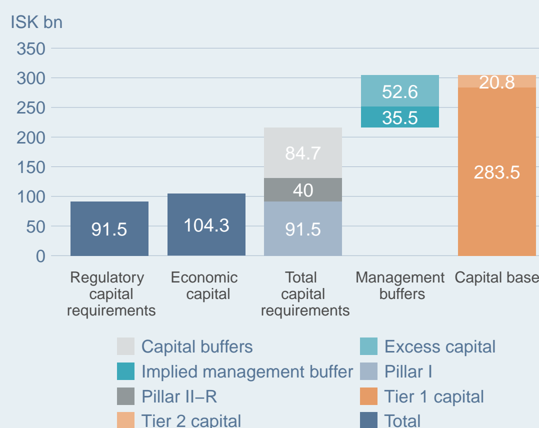
Capital Management

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 increased by 1.5 percentage points in 2021 to 26.6%.
- A dividend payment of ISK 0.19 per share in the total amount of ISK 4.5 billion was made in 2021.
- The overall economic capital decreased and the risk-weighted exposure amount increased in 2021, resulting in an EC/RWEA ratio of 9.1% at year-end.
- Compared to the most recent SREP requirement of 18.9%, and an implied management buffer of 3.1%, the Bank's excess capital is 4.6 percentage points or ISK 53 billion.

Capital position
as at 31.12.2021



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 four 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 2021 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.

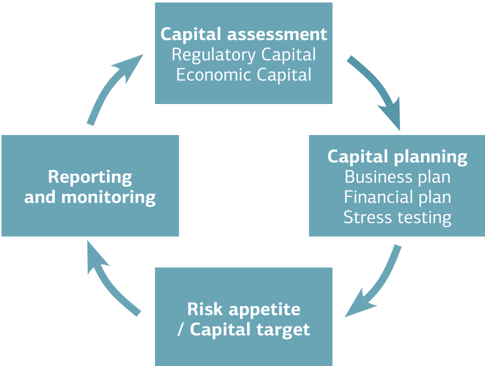
Managing directors of income-generating divisions

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 Bank's capital structure. The Bank paid a regular dividend payment of ISK 4,489 million in 2021.

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 (%/RWEA).

Table 3.1: Capital requirement

31.12.2021	**CET1**	**Tier 1**	**Total**
Pillar I	4.5%	6.0%	8.0%
Pillar II-R	2.0%	2.6%	3.5%
Minimum requirement under Pillar I and Pillar II-R	**6.5%**	**8.6%**	**11.5%**
Systemic risk buffer	2.90%	2.90%	2.90%
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	**7.40%**	**7.40%**	**7.40%**
Total capital requirement	**13.9%**	**16.0%**	**18.9%**

The capital requirement of 18.9% is based on the outcome of the FSA's 2020 SREP, having regard for the latest decisions on capital buffer requirements. The Pillar II-R requirement increases slightly, from 3.4% to 3.5% between the 2019 and 2020 SREP but the Pillar II-G remains at 0%. Table 3.2 shows the results of the 2020 SREP. The domestic countercyclical capital buffer was eased from 1.75% as of 15.5.2019 to 0.0% from 19.03.2020 to date but will be increased to 2.00% at 29.9.2022.

Table 3.2: SREP results

		2021 % RWEA	2020 % RWEA
Pillar I	Credit risk	7.0%	7.1%
	Market risk	0.3%	0.1%
	Operational risk	0.7%	0.8%
	Minimum capital requirement	**8.0%**	**8.0%**
Pillar II	Credit, counterparty and concentration risk	1.6%	1.9%
	Market risk and IRRBB	1.7%	1.3%
	Other risk	0.2%	0.2%
	Additional P-II R	**3.5%**	**3.4%**
	Additional P-II G	**0.0%**	**0.0%**
	Minimum requirement under Pillar I and Pillar II-R	**11.5%**	**11.4%**

The Bank's capital target is based on the current regulatory capital requirement of 13.9% CET1 and 18.9% 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 3.3, the Bank's total target capital ratio is $\geq$ 22% and $\geq$ 18% for the CET1 ratio. Given the 18.9% TCR requirement, the Bank's current implied minimum management buffer is 3.1%. The total capital ratio at year-end 2021 was 26.6%, meaning that the Bank's excess capital is 4.6% of RWEA, or ISK 53 billion.

Table 3.3: Capital ratio

	Target	2021	2020	2019	Comment
Total capital ratio	≥22.0%	26.6%	25.1%	25.8%	Long-term goal
Common equity Tier 1	≥18.0%	24.8%	23.2%	23.9%	Long-term goal
Dividend pay-out ratio	Around 50%	43%	0%	52%	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 special dividend from 2020 profits in 2021.

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 Committee for SIFIs is 7.50% of RWEA at year-end 2021. Easing the countercyclical capital buffer requirement in March 2020 aimed to allow the banking system to better support households and businesses through the pandemic.

The Financial Stability Committee has announced an increase for the countercyclical buffer to 2.00% at the end of September 2022. The rationale for the increase is based on the strong economic recovery that has taken place in the past few months supporting households and businesses with raising share prices and property prices in the recent term. Systemic risk continues to grow, owing in particular to growth in household debt alongside rising house prices.

The capital buffers are expressed as a proportion of consolidated RWEA. However, the systemic risk buffer only applies to domestic RWEA, meaning that the effective requirement for the buffer is somewhat lower than defined by the financial authorities, or 2.90% instead of 3.0%, as foreign exposures account for 4% of total RWEA. 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 0.003%. Further quantitative information regarding the countercyclical capital buffer can be found in templates CCyB1 and CCyB2 in the additional disclosures accompanying this report.

Table 3.4: Domestic and foreign RWEA

	2021	**2020**
Domestic RWEA	96%	96%
Foreign RWEA	4%	4%
Total	100%	100%

The effective total regulatory capital buffer for the Bank at year-end 2021 is 7.40% of consolidated RWEA. In addition, and as previously mentioned, the Bank has set an implied minimum management buffer of 3.1%, bringing total capital buffers at year-end up to 10.5%.

Table 3.5: Capital buffers

	15.5.2019	**1.2.2020**	**19.3.2020**	**Effective capital buffers at year-end 2021**
Systemic risk buffer	3.00%	3.00%	3.00%	2.90%
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%**	**7.40%**

Table 3.6: Breakdown of the capital base (ISK m)

	31.12.2021	31.12.2020
Share capital	23,621	23,625
Share premium	120,594	120,630
Reserve	23,591	19,250
Retained earnings	114,839	94,750
Total equity attributable to owners of the Bank	**282,645**	**258,255**
Intangible assets	-14	-1,696
Deferred tax assets	-15	-23
Fair value hedges	-758	-1,643
Adjustment under IFRS 9 transitional arrangements	1,674	5,353
CET1	**283,533**	**260,246**
Non-controlling interests	0	0
Tier 1 capital	**283,533**	**260,246**
Subordinated liabilities	20,785	21,366
Tier 2 capital	**20,785**	**21,366**
Capital base	**304,317**	**281,612**
Risk exposure amount (RWEA)		
Credit risk	1,032,889	1,010,588
Market risk	9,909	11,526
Operational risk	101,194	99,485
Total RWEA	**1,143,992**	**1,121,599**
CET1 ratio	**24.8%**	**23.2%**
Total capital ratio	**26.6%**	**25.1%**

3.3 Capital position

The Bank's equity increased by ISK 24.4 billion in 2021 and amounted to ISK 282.6 billion (2020: ISK 258.2 billion) at year-end 2021. 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 increased by 1.5 percentage points in 2021, remained strong at 26.6% at year-end 2021 (2020: 25.1%).

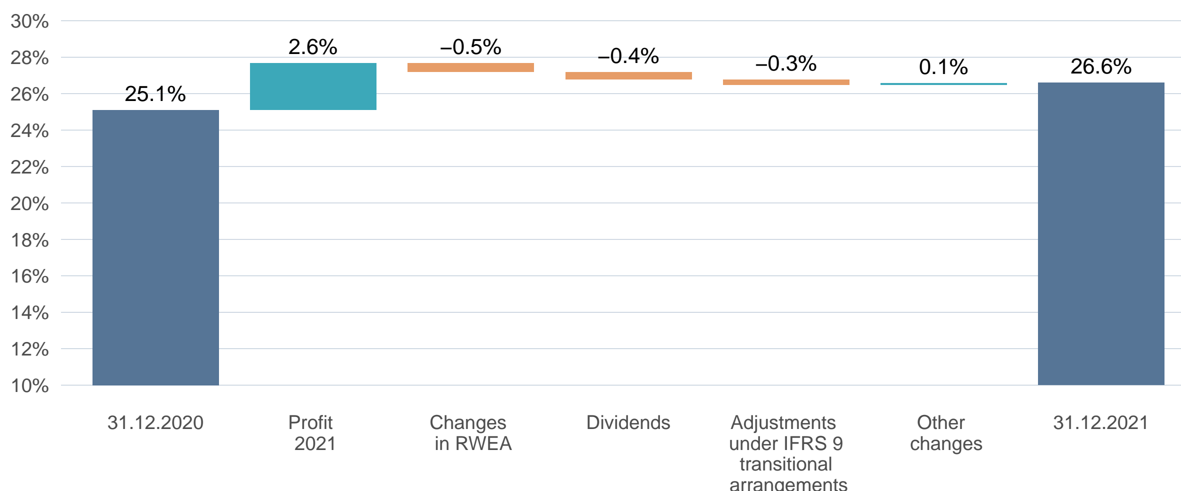
The capital base consists of 24.8% CET1 based on core equity only and 1.8% of Tier 2 capital, with two instruments in the form of subordinated liabilities: firstly, an EUR 100 million (ISK 14.8 billion) instrument with final maturity in September 2028 but callable in September 2023 and, secondly, an ISK 6.0 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 billion and RWEA increases by the same amount in 2020 and ISK 1.7 billion in 2021.

Changes in the Bank's total capital ratio for the year 2021 are demonstrated in Figure 3.2.

The Board of Directors intends to propose that the annual general meeting (AGM) approve a dividend of ISK 14.4 bn, or 0.61 per share, to be paid to shareholders in 2022. Should the AGM approve this

Figure 3.2: Change in the Bank's total capital ratio



dividend proposal, the Bank's capital will be reduced by an amount equivalent to the dividend payment and the Bank's capital ratio, in accordance with the Act on Financial Undertakings, will decrease by 1.3 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

Further 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.

Further quantitative information regarding the Bank's capital position can be found in templates CC1, CC2 and CCA in the additional disclosures accompanying this report.

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 exposure amount (RWEA) for credit risk, market risk and operational risk. The Bank uses the standardised approach in measuring Pillar I capital requirements for credit risk and market risk. For counterparty credit risk, the Bank uses original exposure method and for operational risk, it uses the basic indicator approach.

[1] Article 55, see http://www.althingi.is/lagas/145b/2002161.html

Table 3.7: Pillar I capital requirement and RWEA (ISK m)

	31.12.2021		31.12.2020	
	Pillar I	**RWEA**	**Pillar I**	**RWEA**
Credit risk	82,631	1,032,889	80,847	1,010,588
Market risk	793	9,909	922	11,526
Operational risk	8,096	101,194	7,959	99,485
Total capital requirement and RWEA	**91,519**	**1,143,993**	**89,728**	**1,121,599**

The Bank's RWEA was ISK 1,144 billion at year-end 2021 and increased by ISK 22 billion, or 2.0%, for the year. Accordingly, the minimum capital requirement for the Bank is ISK 91.5 billion as compared to ISK 89.7 billion at year-end 2020. Credit risk is the single largest risk type or 90.3% of total RWEA and minimum capital requirement.

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 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 also 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 3.8 summarises how the Bank calculates its EC for the risks included in the framework.

EC amounted to ISK 104.3 billion at year-end 2021 and decreased by almost 5.8 billion or 5.2% during the year (2020: ISK 110.1 billion). The ratio of EC to RWEA decreased from 9.8% to 9.1% during the year.

Almost 73% of EC is due to credit risk, amounting to ISK 76 billion at year-end 2021 (2020: ISK 79.8 billion). EC for the loan portfolio amounted to ISK 66.3 billion and EC for other assets under credit risk was ISK 9.7 billion. Further information on EC for credit risk is in Section 4.2.2.

EC for other risk categories than loans to customers and credit institutions amounted to ISK 28.3 billion at year-end 2021 (2020: ISK 37.9 billion). EC for market risk and currency risk decreased by ISK 1.1 billion, primarily due to far less market volatility than during the year 2020, lower exposure in the Bank's trading portfolios and lower net FX Balance. EC for interest rate risk and inflation risk in the banking book increased by ISK 2.6 billion. EC for legal and regulatory risk is negligible at year-end 2021.

Table 3.8: 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 regulation (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.

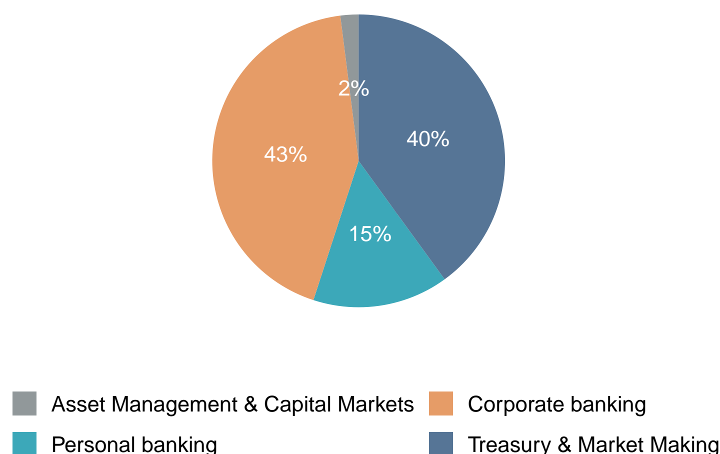
Table 3.9: Economic capital

	2021	2020
Credit risk - Loans to customers and credit institutions	66,341	72,194
Credit risk - Other assets	9,691	7,583
Market risk	1,670	2,300
Currency risk	540	964
Operational risk	8,096	7,959
Single name concentration risk	6,460	7,226
Industry concentration risk	1,003	1,618
Interest rate and inflation risk	10,489	7,878
Business risk	0	0
Legal and political risk	2	2,329
Total	**104,291**	**110,051**
RWEA	1,143,993	1,121,599
EC/RWEA	**9.1%**	**9.8%**

3.4.3 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 2021 is shown in Figure 3.3.

Figure 3.3: Capital allocation per business line



3.4.4 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 3.10) 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 31.12.2021, the Bank's leverage ratio was 14.9%.

Table 3.10: Leverage ratio

	2021	**2020**
Tier 1 capital	283,533	260,246
Leverage exposure		
- On balance sheet exposure (excluding derivatives)	1,711,930	1,556,541
- Derivatives instrument exposure	8,799	5,944
- Potential future exposure on derivatives	21,958	4,366
- Off balance sheet exposure	160,994	130,089
- Regulatory adjustments to Tier 1 capital	887	-3,362
Total leverage exposure	**1,904,568**	**1,693,578**
Leverage ratio	**14.9%**	**15.4%**

Figures 3.4 and 3.5 show the Bank's leverage ratio for the past five years. Despite trending downwards in this period, the ratio is still around five-fold the minimum 3% requirement.

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. Further quantitative information regarding the Bank's leverage ratio can be found in templates LR1, LR2 and LR3 in the additional disclosures accompanying this report.

Figure 3.4: Leverage ratio

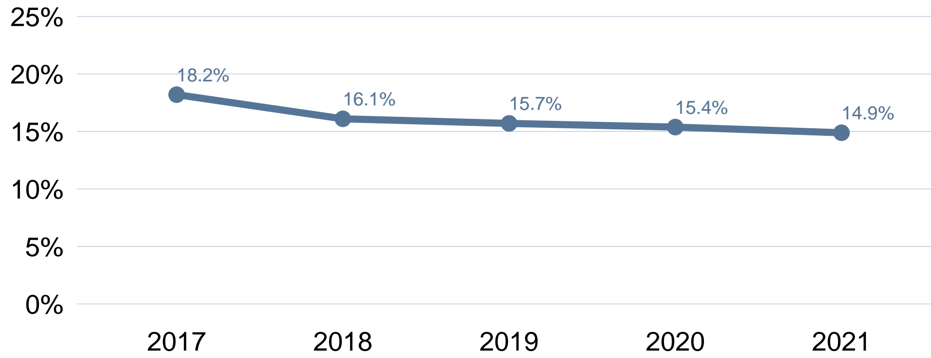
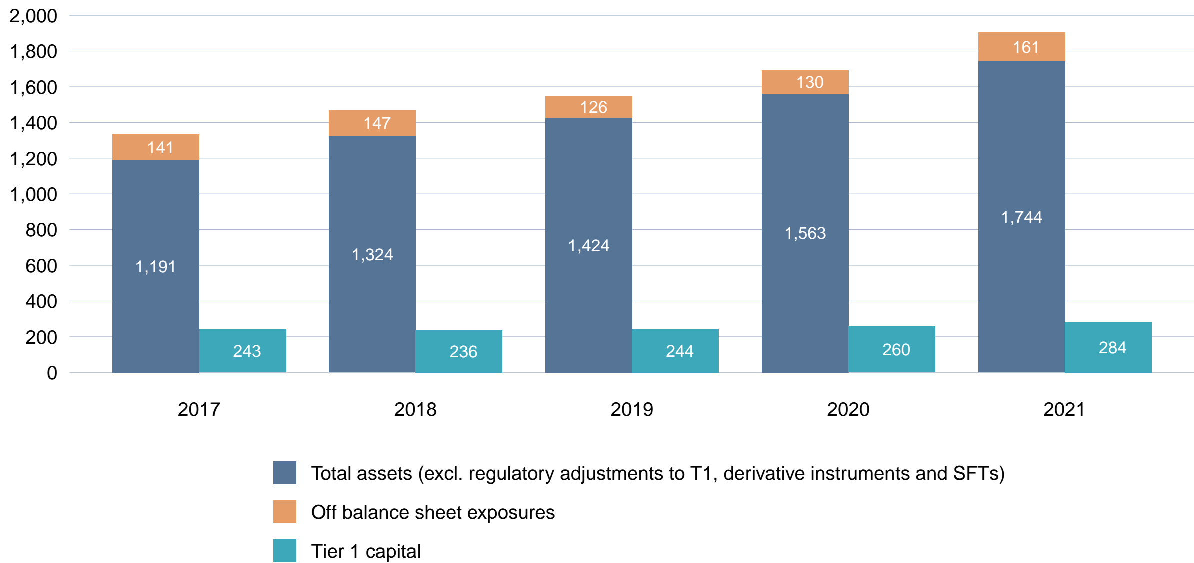


Figure 3.5: Leverage ratio breakdown (ISK bn)



4 Credit risk

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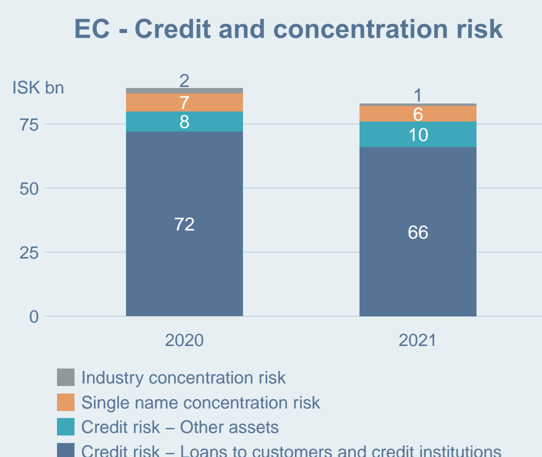
Credit Risk

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.

- At year-end 2021, a total of ISK 74 billion of outstanding loans had active COVID-19 related moratoria measures.
- Probability of default, weighted by gross carrying amount, decreased to 2.2% at year-end 2021 (2020: 2.9%).
- Economic capital due to credit risk from loans to customers and credit institutions decreased in 2021, due to a decrease in PD values, a decrease in EAD for the corporate portfolio and a change in the SME factor.
- Total expected credit loss was ISK 14 billion at year-end 2021 (2020: ISK 25 billion).
- Total credit exposure from lending activities increased by 9%, driven by growth in the mortgage portfolio.



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.

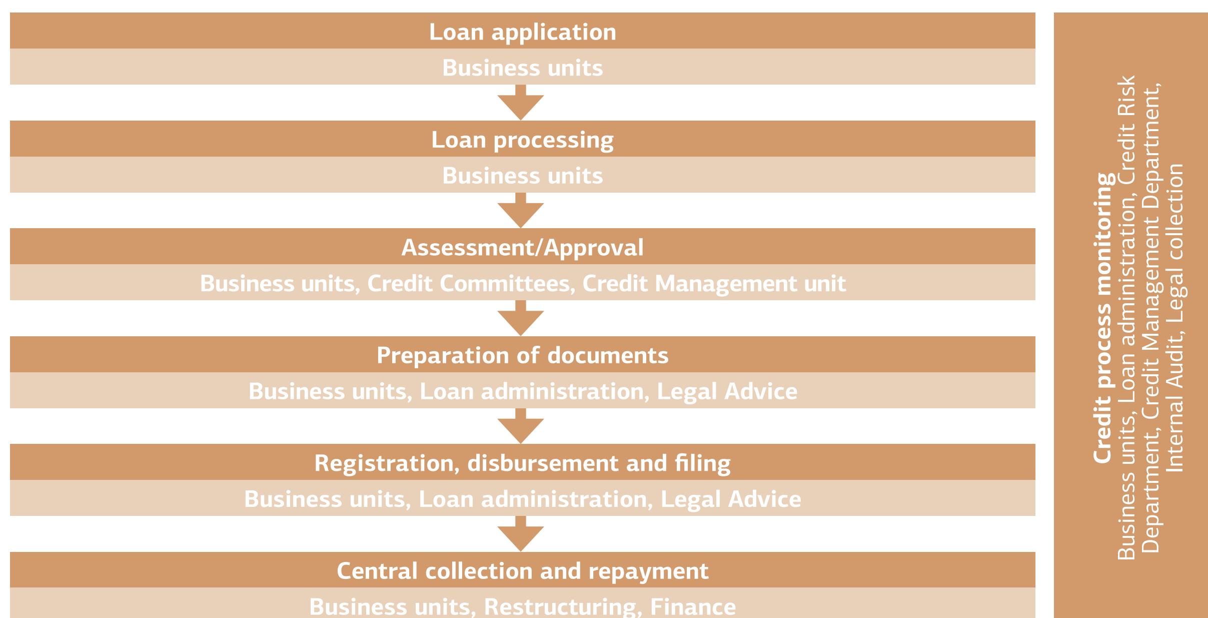
The credit risk appetite is converted by the business units to their specific key performance indicators (KPIs) in collaboration with Risk Management. Monitoring functions determine whether credit facilities are granted in accordance with the risk appetite. Risk Management monitors and challenges the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

Figure 4.1: The credit process



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, but also from loans and advances to financial institutions, investments in bonds and debt instruments, investments in equity and equity instruments, commitments, guarantees and documentary credits, counterparty credit risk in derivatives contracts, and the aforementioned settlement risk along with other assets.

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 several 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 considered.

In 2021 the Bank revised its definition of default in accordance with the EBA Guidelines on the application of the definition of default and EBA Regulatory Technical Standards on materiality threshold of credit obligation past due.

The internal rating system is used to assign ratings and calculate risk-weighted exposure amounts for the

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%

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.

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.

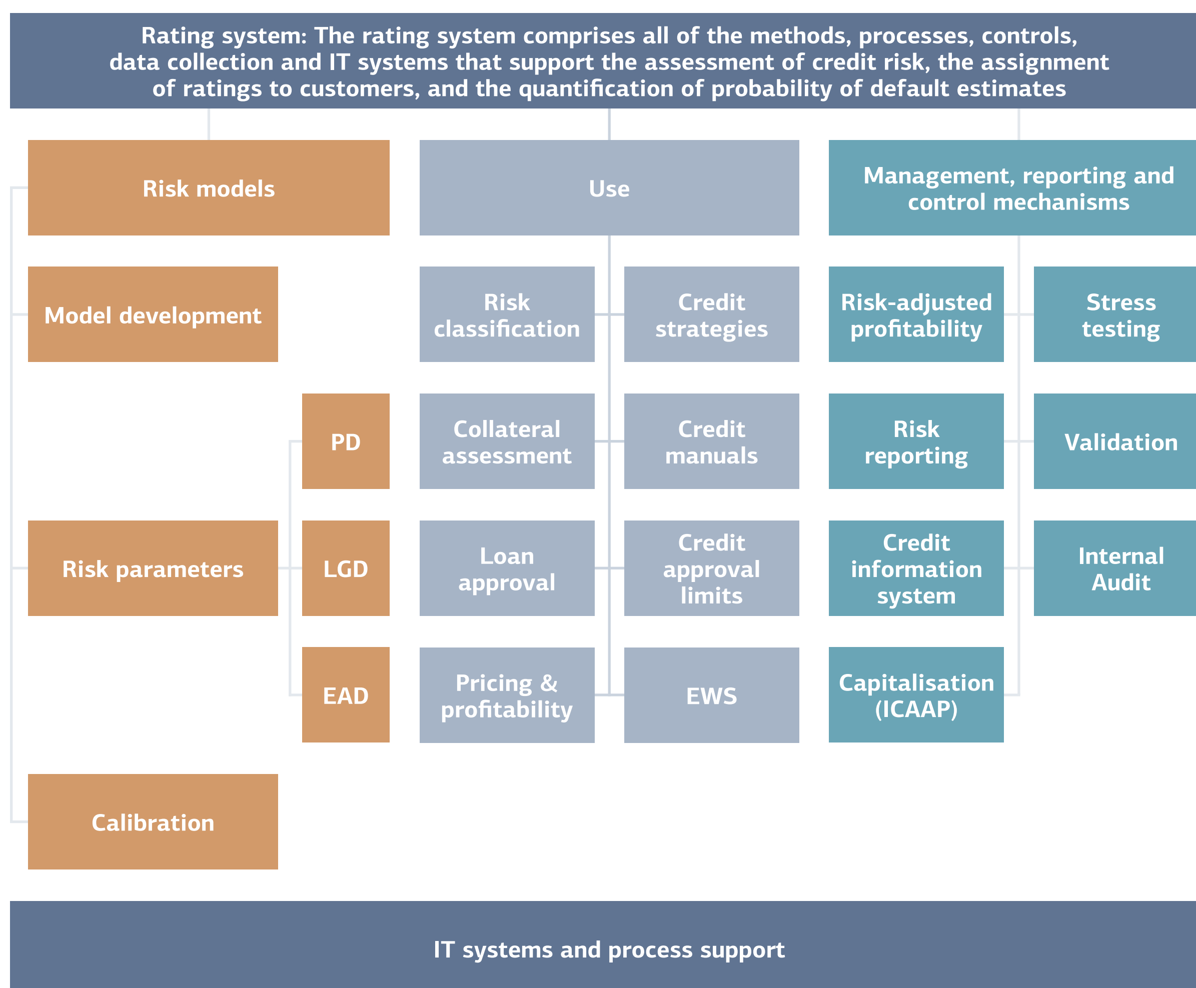
The rating models are validated annually, both quantitatively and qualitatively. The quantitative validation includes statistical tests of the models' discriminatory power, i.e. the models' ability to distinguish default risk, and absolute accuracy, i.e. the ability to predict default levels.

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 RWEA and EC but uses internal models for provisioning.

Figure 4.2: Rating system overview



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.

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

Figure 4.3: Credit risk management framework

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 parts 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 financial difficulties

- 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.

For further information on the Bank's impairment process, see Note 83.11(g) in the Bank's Annual Financial Statement 2021.

In 2021, new models for LGD and allocation to stages were developed and implemented. 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 Risk-weighted exposure amount (RWEA)

The greatest impact that the implementation of CRR II had on the capital assessment is the extension of the threshold for SME exposures. The threshold was extended from EUR 1.5 million to EUR 2.5 million.

Table 4.2: RWEA and Pillar I capital requirement for credit risk by exposure classes

	31.12.2021		31.12.2020	
	Pillar I	**RWEA**	**Pillar I**	**RWEA**
Central governments or central banks	61	768	129	1,616
Regional governments or local authorities	84	1,053	151	1,884
Public sector entities	82	1,024	12	152
Institutions	851	10,639	804	10,050
Corporates	38,016	475,200	41,895	523,691
Retail	7,611	95,135	7,149	89,368
Secured by mortgages on immovable property	19,850	248,123	16,460	205,750
Exposures in default	1,531	19,140	2,446	30,576
Items associated with particular high risk	11,555	144,435	9,811	122,639
CIU's	602	7,519	0	0
Equities and equity instruments	177	2,217	76	947
Other items	2,211	27,637	1,913	23,914
Credit risk	**82,631**	**1,032,889**	**80,847**	**1,010,588**

SME exposures up to EUR 2.5 million get an SME multiplication factor of 0.7619 and the part of an SME exposure exceeding EUR 2.5 million gets an SME multiplication factor of 0.85. The application of these changes decreased the RWEA by a total of ISK 16.8 billion for SME exposures classified as 'corporate', 'retail', and 'secured by immovable property'.

Due to the implementation of CRR II the Bank started to classify exposures in the form of units or shares in a collective investment undertaking (CIU's) separately instead of classifying these exposures as equity exposures.

Other material changes in RWEA are in line with increased lending, mostly in mortgages. Table 4.2 shows the RWEA for credit risk at year-end 2020 and 2021, broken down by exposure classes. Further quantitative information regarding RWEAs for credit risk can be found in templates CR4 and CR5 in the additional disclosures accompanying this report.

4.2.2 Economic capital

EC for credit risk amounted to ISK 76 billion at year-end 2021 and has decreased by roughly ISK 3.7 billion or 4.7% (2020: ISK 79.8 billion). EC for the loan portfolio decreased in 2021 by ISK 5.8 billion while the EC for other assets under credit risk increased by ISK 2.1 billion. The corporate loan portfolio decreased by 3% or ISK 2.7 billion and the overall PD of the portfolio decreased from 4.1% to 3.0% leading to a lower EC for the corporate portfolio. The retail loan portfolio increased by 21% or ISK 138.8 billion and the PD of the portfolio decreased from 1.8% to 1.5%. Therefore, the main reason for a lower EC for the loan portfolio is a higher proportion of loans to retail customers with lower PD while the exposure to corporate customers decreased in 2021. The increased EC for other assets under credit risk is mainly due to higher EC for equity in the banking book.

Table 4.3 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.

Table 4.3: Credit risk - loans to customers and credit institutions

Credit risk as at 31 December 2021	PD	LGD	EAD	EC
Financial institutions	0.0%	45.0%	45,553	729
Public entities	1.4%	45.0%	5,682	140
Retail	1.5%	24.1%	810,677	17,423
Corporates	3.0%	34.3%	680,847	48,049
Total	**2.1%**	**29.3%**	**1,542,760**	**66,341**
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**

4.2.3 Credit exposure

At year-end 2021, 90% of the Bank's risk-weighted exposure amount (RWEA) was due to credit risk, most of which comes from lending activities. On the same date, total loans and advances amounted to ISK 1,435 billion (2020: ISK 1,321 billion), with ISK 1,387 billion coming from lending activities (2020: ISK 1,273 billion) and ISK 47 billion from loans and advances to financial institutions (2020: ISK 48 billion).

Overall credit quality in the portfolio improved in 2021. In 2021, a net release of credit impairment of ISK 7 billion was recognised in the Bank's income statement, as opposed to an ISK 12 billion charge in 2020. The effects of the COVID-19 pandemic on the loan portfolio have not yet fully materialised, as a number of customers still have active moratoria measures, but the effects have so far turned out to be less severe, and more targeted on certain sectors, i.e. the travel industry, than initially thought. 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 2021, Section 4.2.3.1 in this report and templates COV1, COV2 and COV3 in the additional disclosures accompanying this report.

The Bank's credit exposure 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 2021, the total on-balance carrying amount is ISK 1,668 billion. ISK 1,387 billion is derived from lending activities, ISK 82 billion from cash and balances with the Central Bank, and ISK 101 billion from bonds and debt instruments. The total off-balance exposure at year-end 2021 is ISK 221 billion. ISK 127 billion is derived from undrawn loan commitments, ISK 67 billion from undrawn overdraft/credit card facilities and ISK 27 billion from financial guarantees and underwriting commitments. Further quantitative information regarding the Bank's credit portfolio can be found in templates CR1, CR1-A, CR2, CQ1, CQ3, CQ5, CQ7 and CR3 in the additional disclosures accompanying this report.

4.2.3.1 Effects of the COVID-19 pandemic on the credit portfolio

From the beginning of the COVID-19 pandemic, the Bank has responded to its effects in various ways. At the start, general moratoria measures were granted to customers that needed them. In 2021, all of these general moratoria measures had expired, but a number of customers, particularly in the travel industry sector have received further moratoria measures, either on principal payments only or principal and interest payments. At year-end 2021, the carrying amount of loans with active moratoria measures was ISK 74 billion, of which ISK 58.9 billion was to customers in the travel industry sector, ISK 14.4 billion was to other corporate customers and ISK 0.5 billion was to individuals.

The effects of the COVID-19 pandemic on the default ratio in the Bank's portfolio were less severe in 2021 than originally expected. There are two main reasons for this. Firstly, massive government aid packages helped reduce the economic effect of the pandemic on both individuals and corporates and secondly, the full effect of the pandemic on the Bank's default rate may not yet have fully materialised due to outstanding loans with active moratoria.

During 2021, the need for general allowance to meet the uncertainty caused by the pandemic was regularly assessed in the Bank's impairment calculations. At year-end 2021, the travel industry portfolio has a general allowance of ISK 2,057 million and other corporate customers with COVID-19 related moratoria have a general allowance of ISK 119 million. Further information on the Bank's impairment calculations can be found in Section 4.2.7 on loan impairment.

4.2.3.2 Credit exposure from lending activities

At year-end 2021, the Bank's total credit exposure from lending activities amounted to ISK 1,387 billion, increasing by 9% from ISK 1,273 billion at year-end 2020. The increase was almost exclusively driven by a 22% growth in the mortgage portfolio. The increase in the mortgage portfolio was based on the continued demand for non-indexed mortgages, that became more favourable to indexed mortgages due to a period of declining interest rates from 2019 to mid-2021. 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 4.2.5.5. The size of the corporate portfolio decreased from the previous year by 4.1%. The largest sectors in the corporate portfolio are fisheries, construction companies, real estate companies and the travel industry. Further information on each sector is in Section 4.2.5

At year-end 2021, the total average PD weighted by gross carrying amount was 2.2% (2020: 2.9%). The average PD for individuals was 1.3% (2020: 1.5%) and the average PD for corporates was 3.1% (2020: 4.3%). Credit quality in the corporate portfolio increased in 2021, after having decreased in 2020. 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 November 2021, a new model for the calculation of LGD was implemented. The model is more sophisticated and developed on a larger amount of loss data than previous models. At year-end 2021, the total average LGD weighted by gross carrying amount was 13.2% (2020: 14.3%). The average LGD for individuals was 4.7% (2020: 9.1%) and the average LGD for corporates was 15.8% (2020: 18.7%).

The carrying amount of loans in stage 3 net of accumulated ECL as a percentage of the total portfolio decreased slightly in 2021 and was 1.7% at year-end 2021. The ratio remained stable in the corporate portfolio and decreased in the individual portfolio, standing at 3.3% for corporates and 0.3% for individuals

Figure 4.4: Probability of default (PD)

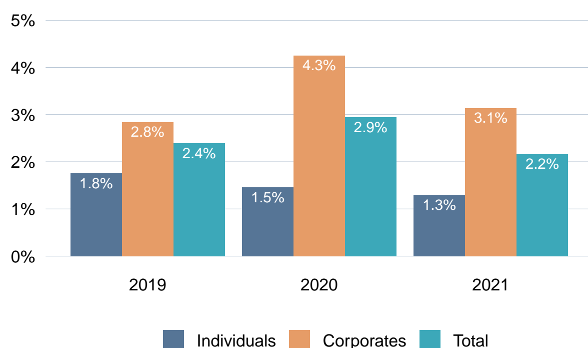


Figure 4.5: Loss given default (LGD)

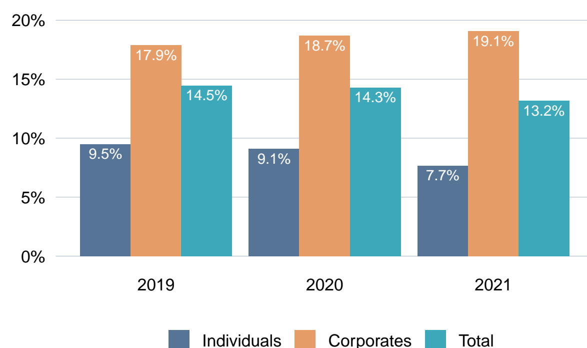


Figure 4.6: Stage 3 loans (% of total portfolio)

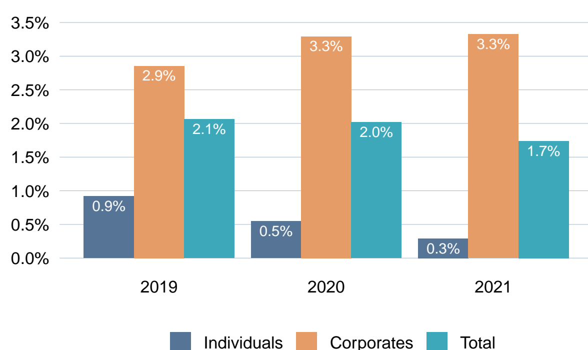
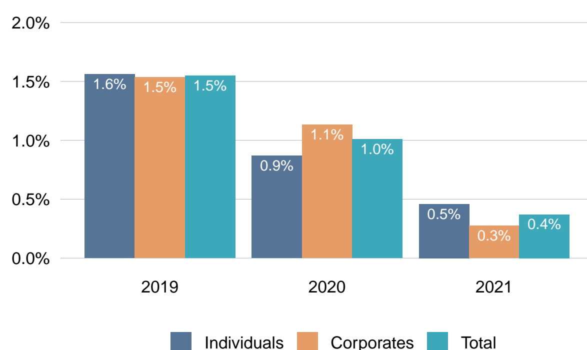


Figure 4.7: Ratio of loans past due 6-90 days



at year-end 2021. For individuals, the decrease is explained by an increase in the mortgage portfolio coupled with a very low default ratio for individuals in 2021. In the corporate portfolio, the ratio decreased or remained unchanged for most sectors, apart from construction companies, where the ratio increased.

The carrying amount of loans and advances to customers past due by 6-90 days decreased in 2021. The ratio of loans past due by 6-90 days is 0.4% at year-end 2021 (2020: 1.0%). For individuals, the ratio is 0.5% at year-end 2021 (2020: 0.9%) and for corporates the ratio is 0.3% at year-end 2021 (2020: 1.1%). In the corporate portfolio, moratoria on loans, granted as a response to the COVID-19 pandemic skews the overall outlook a bit. A considerable amount of loans in the travel sector, as well as in a few other sectors still have active moratoria measures.

4.2.4 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.

Table 4.4: Exposures subject to forbearance (ISK million)

	31.12.2021		31.12.2020	
	Performing	**Non-performing**	**Performing**	**Non-performing**
Modification	89,869	28,787	85,570	29,996
Refinancing	1,605	2,466	3,437	3,529
- of which: Under probation	2,716	0	2,716	0
Total	**91,474**	**31,253**	**89,007**	**33,525**

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 4.4 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 122 billion at year-end 2020 to ISK 123 billion at year-end 2021, which is a decrease from 9.4% to 8.7% of the total portfolio.

Further quantitative information regarding forborne exposures can be found in template CQ1 in the additional disclosures accompanying this report.

4.2.5 Credit risk by industry sectors

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 2021.

Table 4.5 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.

Table 4.5: Overview of credit risk measures by industries

As at 31 December 2021	Carrying amount	PD	LGD	Past due 6-90 days	Stage 2 loans	Stage 3 loans	Total ECL
Public entities	3,895	1.9%	5.0%	0.0%	0.8%	0.0%	-3
Individuals	**725,542**	**1.3%**	**7.7%**	**0.5%**	**3.6%**	**0.3%**	**-1,359**
Individuals Mortgage	646,514	1.2%	4.9%	0.4%	2.9%	0.3%	-466
Individuals Other	79,029	1.8%	30.1%	0.9%	9.5%	0.6%	-893
Corporates	**658,025**	**3.2%**	**19.2%**	**0.3%**	**11.6%**	**3.3%**	**-12,460**
Fisheries	177,438	1.6%	7.0%	0.0%	1.9%	0.0%	-203
Real estate companies	120,326	3.3%	12.6%	0.6%	5.7%	2.2%	-1,322
Construction companies	89,867	3.4%	38.6%	0.2%	3.9%	8.8%	-1,572
Travel industry	97,635	7.2%	22.9%	0.5%	50.0%	9.0%	-6,949
Services and ITC*	56,872	2.1%	31.8%	0.4%	11.9%	1.1%	-643
Retail	49,535	1.5%	17.6%	0.3%	1.9%	0.3%	-1,181
Manufacturing and energy	30,117	1.5%	29.9%	0.1%	7.5%	5.7%	-499
Holding companies	30,077	4.7%	14.2%	0.0%	11.5%	0.0%	-77
Agriculture	6,157	2.2%	10.6%	0.2%	1.6%	2.4%	-14
Other	0	19.0%	50.1%	0.0%	0.5%	0.0%	0
Total loans to customers	**1,387,463**	**2.2%**	**13.2%**	**0.4%**	**7.4%**	**1.7%**	**-13,822**
Financial institutions	47,231	0.0%	30.0%	0.0%	0.0%	0.0%	0
Total loans including financial institutions	**1,434,694**	**2.1%**	**13.7%**	**0.4%**	**7.1%**	**1.7%**	**-13,823**
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**

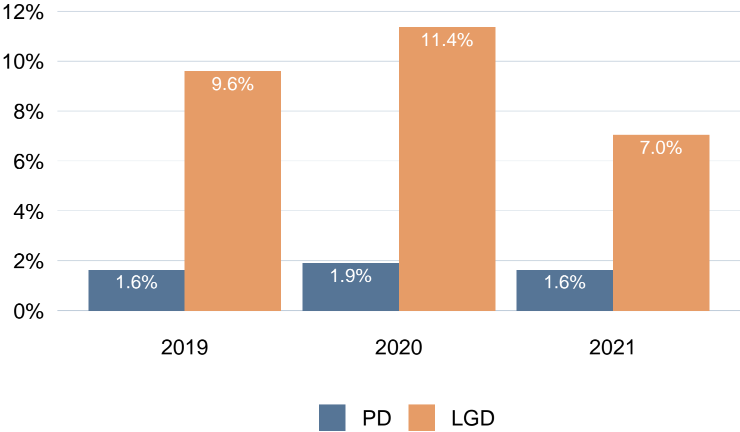
*ITC consists of corporations in the information, technology and communication sectors

4.2.5.1 Fisheries

Loans and advances to customers in the fisheries industry amounted to ISK 177 billion as at 31 December 2021 (2020: ISK 180 billion). Credit exposure to the sector represented 13% of the Bank's loan portfolio.

The average PD value for the sector decreased in 2021 and was 1.6% at year end. The average LGD value for the sector decreased in 2021 and was 7.0% at year-end 2021. Less than 50 million ISK of outstanding loans in the fisheries sector are in default at year-end 2021 and the ratio of loans in stage 2 was 1.9%, decreasing from 2.5% at year-end 2020.

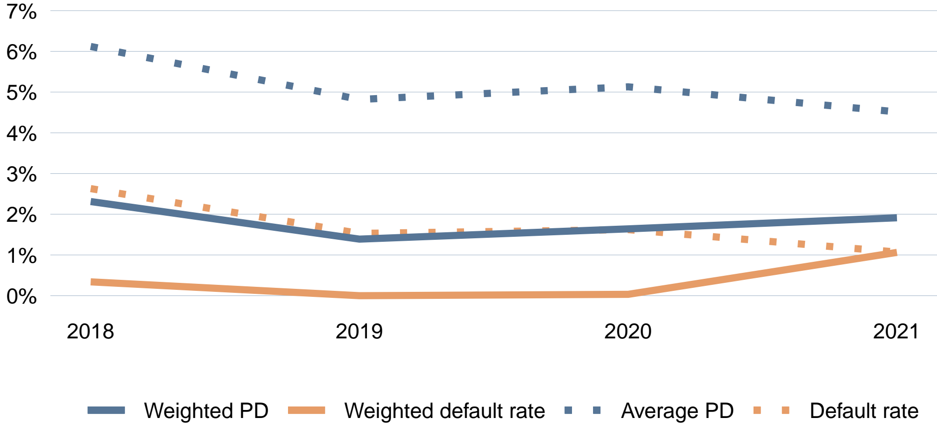
Figure 4.8: PD & LGD - Fisheries



Credit extended by the Bank to the fisheries industry is primarily secured by fishing vessels together with their non-transferable fishing quotas, or 75% 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.

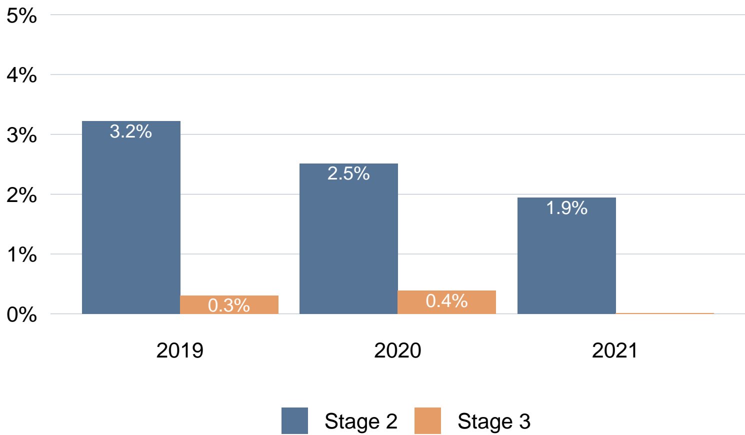
Figure 4.9: Default rate vs. PD - Fisheries



Total ECL for the fisheries sector decreased by ISK 1,033 million in 2021 to a total of ISK 203 million at year-end 2021, primarily due to a decrease in PD values based on improved credit quality and more favourable economic scenarios use in impairment calculations, but also due to a decrease in ECL in

stage 3. The decrease in stage 3 ECL is both due to obligors returning to performing status and due to write-offs.

Figure 4.10: Staging - Fisheries

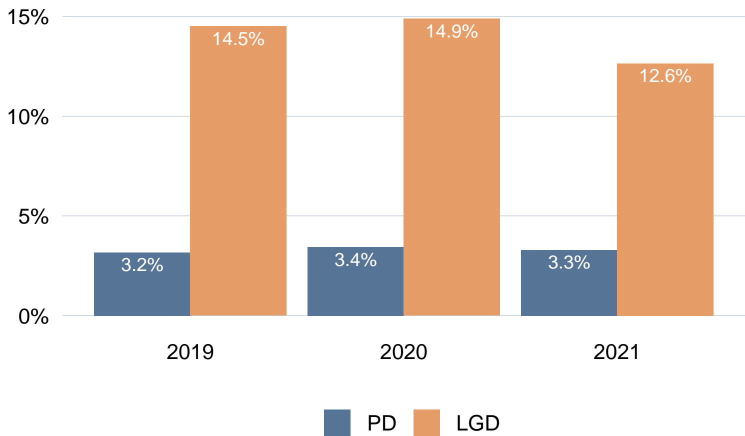


4.2.5.2 Real estate companies

Loans and advances to customers in the real estate industry amounted to ISK 120 billion at year-end 2021 (2020: ISK 129 billion). Credit exposure to the sector represented 9% of the Bank's loan portfolio. Excluding the travel industry sector, most of the remaining COVID-19 related moratoria was granted to companies in the real estate sector. The total gross carrying amount of loans in the sector, with active moratoria at year-end 2021 was ISK 5.0 billion or 4.2% of all loans in the sector.

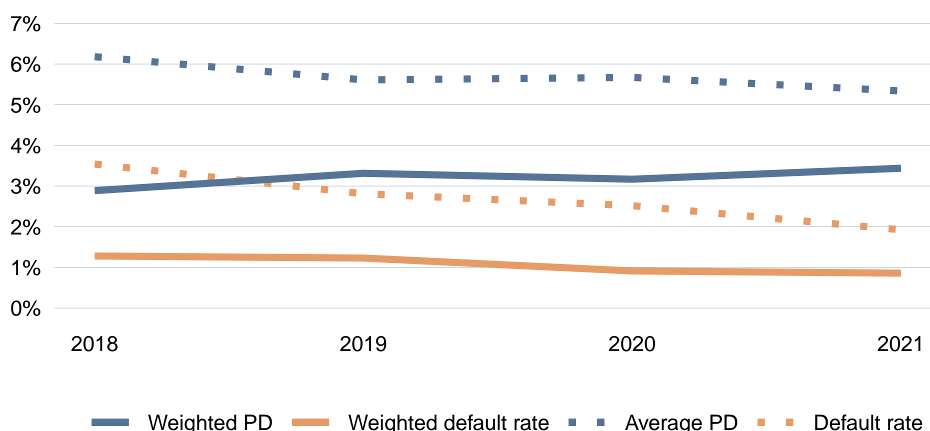
The average PD value for the sector remained stable in 2021 and was 3.3% at year end (2020: 3.4%). The average LGD value for the sector decreased in 2021 and was 12.6% at year-end 2021 (2020: 14.9%).

Figure 4.11: PD & LGD - Real estate companies



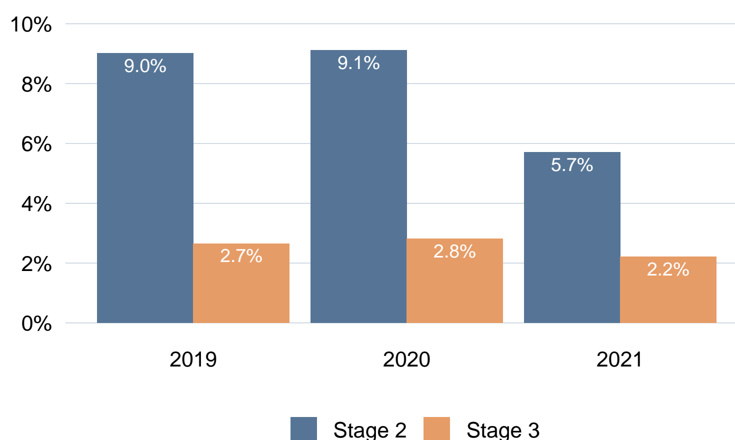
The realised weighted default rate for real estate companies remained stable in 2021 and was 0.9% at year end. The realised default rate for the sector has been consistently below the average PD values for the past few years.

Figure 4.12: Default rate vs. PD - Real estate companies



The ratio of stage 2 loans decreased considerably in 2021 and was 5.7% at year end. The ratio of stage 3 loans decreased slightly in 2021 and was 2.2% at year end.

Figure 4.13: Staging - Real estate companies



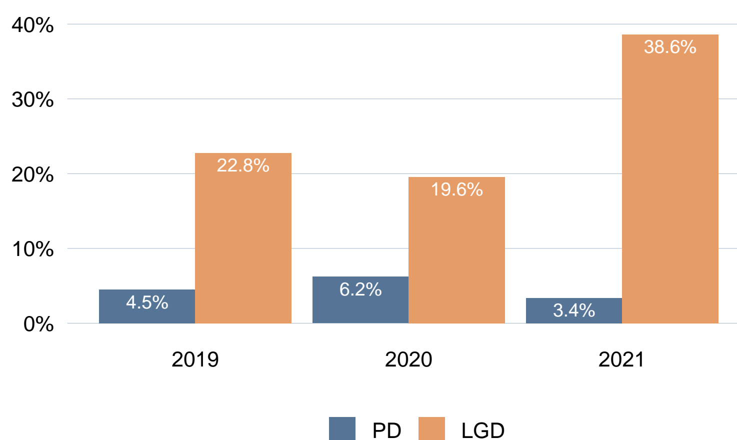
Total ECL for the real estate sector decreased by ISK 2,013 million in 2021 to a total of ISK 1,322 million at year end. ECL decreased across all stages, but mostly in stage 3 where ECL decreased by ISK 1,129 million in 2021.

4.2.5.3 Construction companies

Loans and advances to construction companies amounted to ISK 90 billion at year-end 2021 (2020: ISK 82 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. The carrying amount of outstanding loans in the sector increased in 2021 after having decreased in 2020.

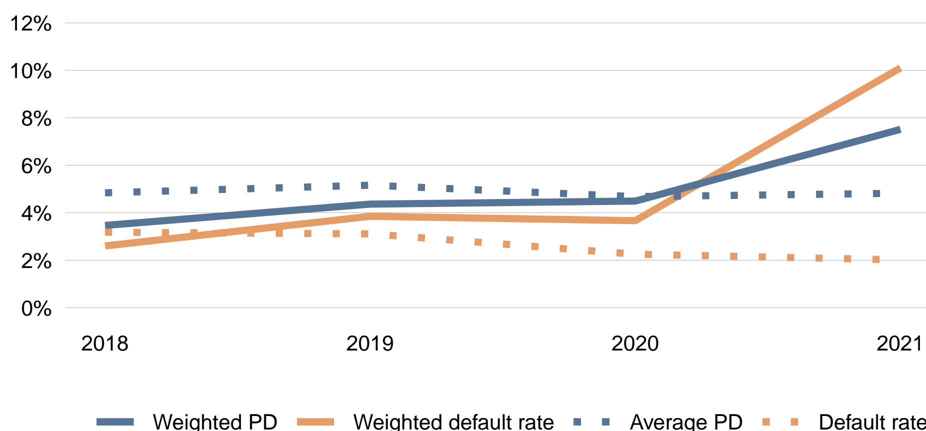
The average PD value for the sector decreased in 2021 and was 3.4% at year end (2020: 6.2%). This decrease is due to an increase in credit quality as well as due to defaults in the sector. The average LGD value for the sector increased in 2021 and was 38.6% at year end (2020: 19.6%).

Figure 4.14: PD & LGD - Construction companies



After having been consistently below the average PD value for the past few years, the realised default rate increased considerably in 2021 and was 10.1%. This is not due to any trend however, but rather due to the default of a single relatively large entity in the sector during the year.

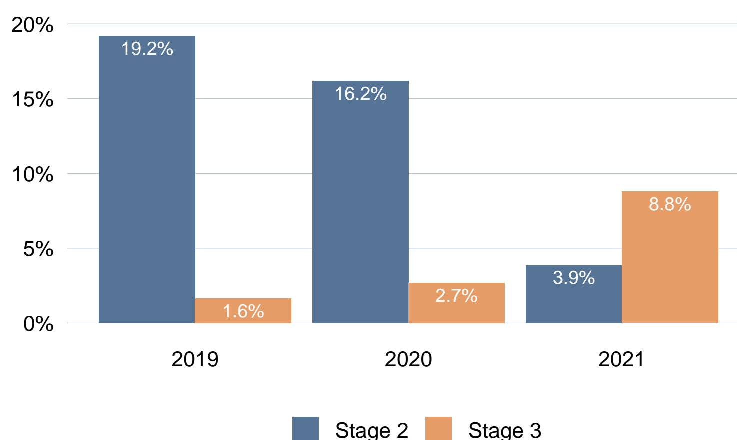
Figure 4.15: Default rate vs. PD - Construction companies



The ratio of stage 2 loans decreased in 2021, from 16.2% to 3.9%. The ratio of stage 3 loans increased in 2021 and was 8.8% at year end. The default of a single relatively large entity in the sector is the main driver of these changes.

Total ECL for the construction sector decreased by ISK 910 million in 2021 to a total of ISK 1,572 million at year end.

Figure 4.16: Staging - Construction companies

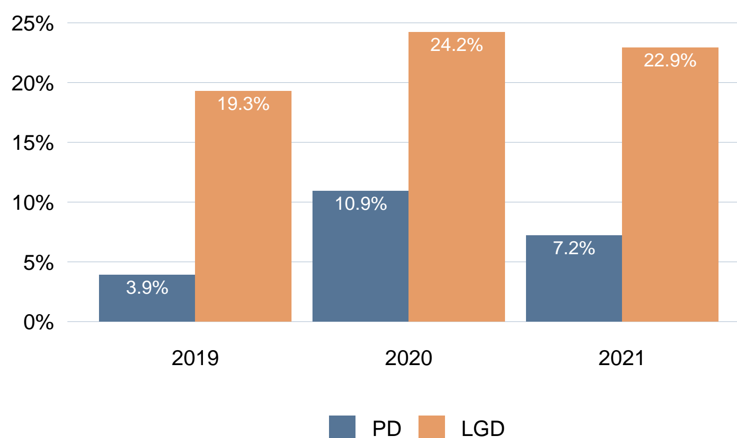


4.2.5.4 Travel industry

Loans and advances to customers in the travel industry amounted to ISK 98 billion at year-end 2021 (2020: ISK 96 billion). Credit exposure to the sector represented 7% of the Bank's loan portfolio.

The travel industry continues to be severely affected by the COVID-19 pandemic. The total carrying amount of loans with active moratoria related to the pandemic at year-end 2021 was ISK 59 billion, or 60% of the total carrying amount in the sector. The average PD value for the sector decreased in 2021, having increased considerably in 2020, and was 7.2% at year end (2020: 10.9%). The average LGD value for the sector decreased in 2021 and was 22.9% at year-end 2021 (2020: 24.2%).

Figure 4.17: PD & LGD - Travel industry



The realised default rate for the travel industry was 0.5% in 2021. In comparison, the average weighted PD value for the sector was 10.9% at year-end 2020. These results must be viewed in context with the fact that 60% of the travel industry portfolio has active moratoria at year-end 2021.

The ratio of stage 2 loans in the sector decreased in 2021, having increased significantly in 2020. The ratio was 50.0% at year-end 2021 (2020: 58.6%). The ratio of stage 3 loans in the sector decreased slightly in 2021 and was 9.0% at year end (2020: 11.0%).

Figure 4.18: Default rate vs. PD - Travel industry

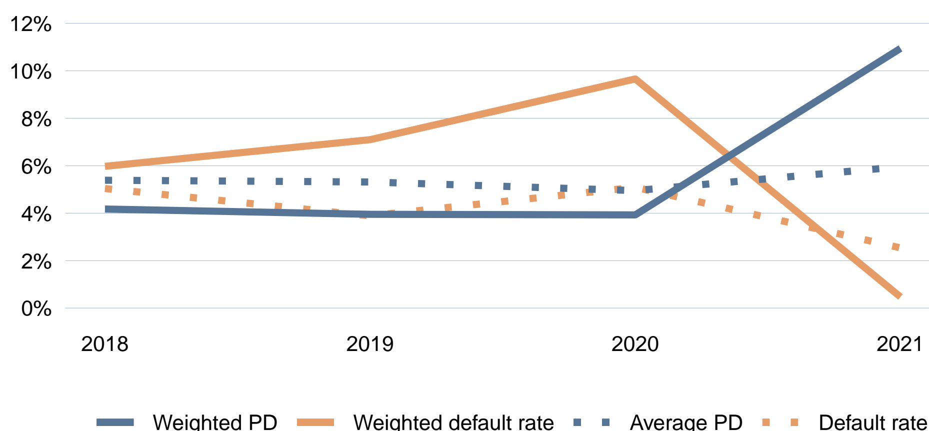
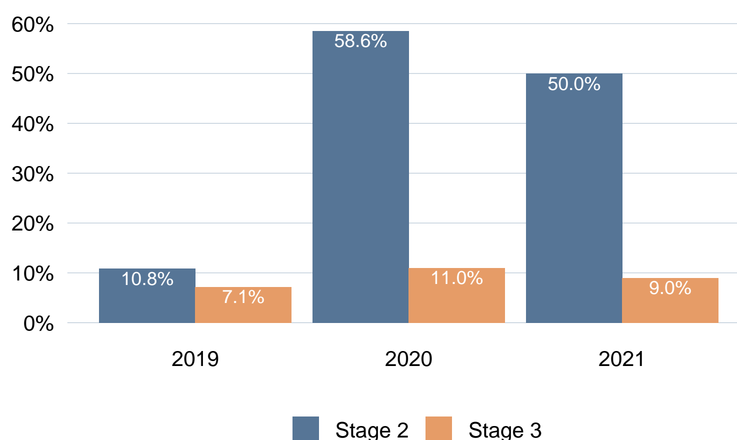


Figure 4.19: Staging - Travel industry



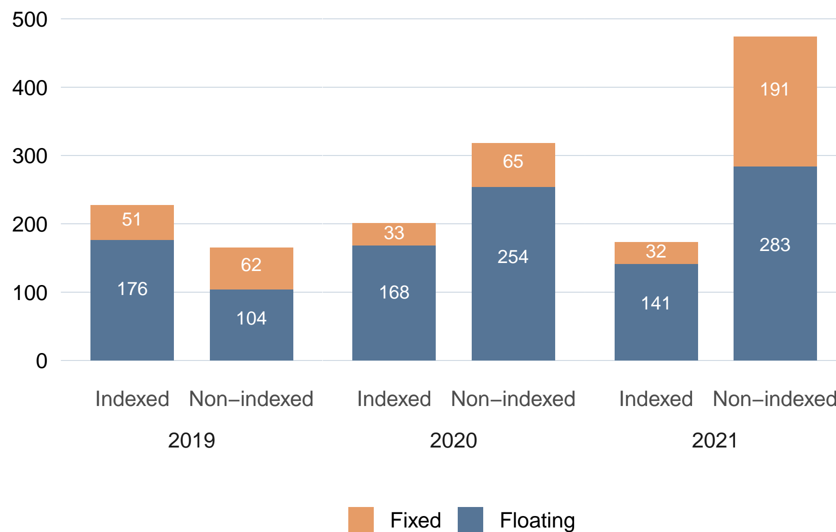
Total ECL for the travel industry decreased by ISK 1.6 billion in 2021 to a total of ISK 6.9 billion at year end. The decrease in ECL was primarily due to an increase in credit quality in the portfolio and more favourable economic scenarios used in impairment calculations. Due to the considerably uncertainty in external conditions for the travel industry, a general allowance of ISK 2,057 million was applied to the travel industry portfolio at year-end 2021.

4.2.5.5 Mortgages

The high demand for mortgages, particularly non-indexed mortgages, continued in 2021. The carrying amount of mortgages to individuals in the portfolio was ISK 647 billion at year-end 2021 (2020: ISK 518 billion). Credit exposure in mortgages represented 47% of the Bank's loan portfolio at year-end 2021 (2020: 41%). Non-indexed loans represented 73% of the gross carrying amount of the mortgage portfolio at year-end 2021 (2020: 61%).

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, set by the Central Bank, on the maximum loan-to-value (LTV) ratio of real estate loans to consumers. The Central Bank tightened

Figure 4.20: Indexed vs. non-indexed mortgages (ISK bn)



rules in July 2021 to 80%, (from 85%) but they remained unchanged for first-time buyers, at 90%. The Central Bank also introduced an additional payment capacity constraint, which took effect in December 2021, capping the monthly payment of mortgages to 35% of net monthly income (40% for first-time buyers). In 2021, the Bank's credit policy for refinancing remained unchanged, stating more stringent collateralisation limits 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 has been counterbalanced by the fact that significant and rapid interest rate cuts from the middle of 2019 until the end of May 2021 have given borrowers a greater scope, leading to increased demand. The Central Bank started to raise interest rates again at the end of May 2021, but the real estate market remained very active throughout the year with demand far exceeding supply resulting in significant price increases.

The loan-to-value (LTV) of mortgage loans, i.e., the ratio of loan value to the value of the underlying collateral has stayed fairly constant for the past few years and was 56.5% at year-end 2021, compared to 57.7% at year-end 2020.

Figure 4.21: Weighted average LTV - Mortgages

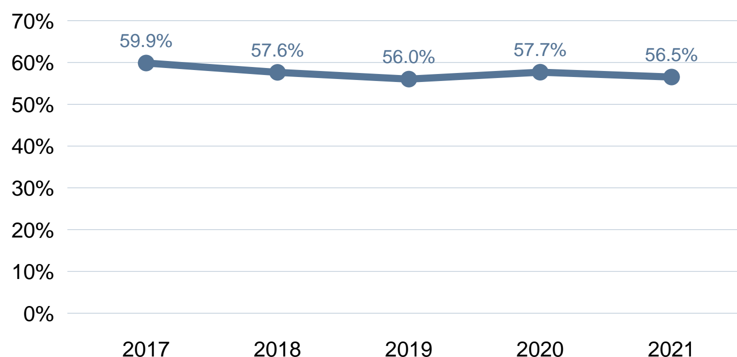
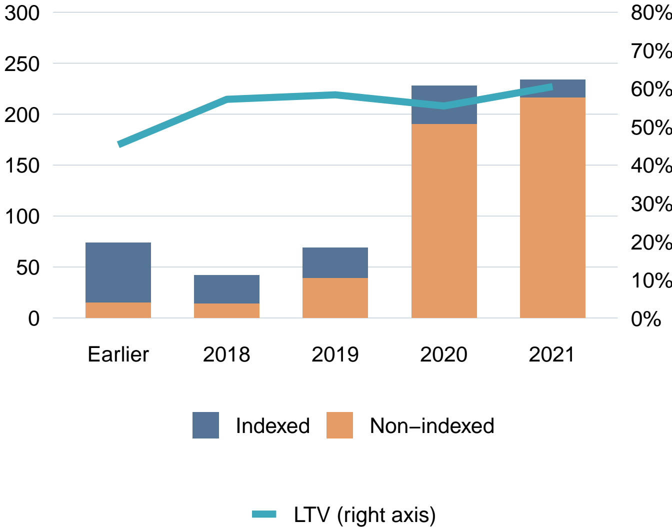


Figure 4.22 shows the gross carrying amount at year-end 2021 of indexed and non-indexed mortgages and the weighted-average LTV by year of loan origination. The figure shows how much the demand for non-indexed mortgages has grown over the last few years. This is primarily due to favourable interest

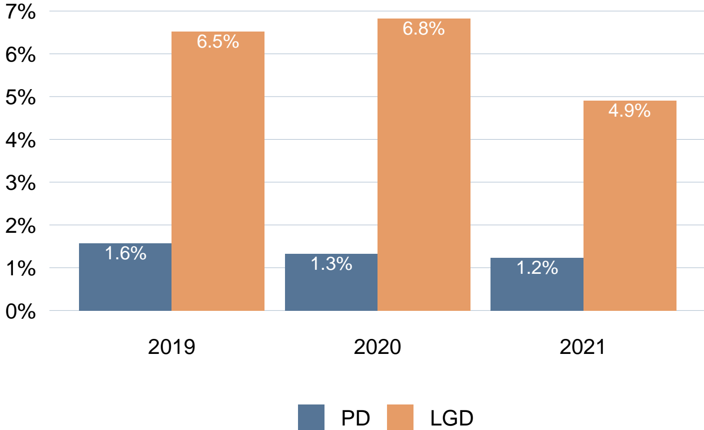
rates for non-indexed mortgages. The figure also shows a high frequency of refinancing of mortgages due the ease of refinancing costs. This leads to a high ratio of the mortgage portfolio being recently issued loans. The weighted-average LTV was consistent at around 57% for mortgages issued from 2018-2020 but was slightly higher at 60.5% for mortgages issued in 2021.

Figure 4.22: Gross carrying amount and LTV of mortgages at 31.12.2021 by year of loan origination



The average PD value for mortgages decreased slightly in 2021 and was 1.2% at year end (2020: 1.3%). Total ECL for mortgages decreased in 2021 and was ISK 466 million at year end (2020: ISK 1,221 million).

Figure 4.23: Average PD & LGD - Mortgages



4.2.6 Probability of default & migration analysis

Migration analysis in this section is based on the Bank's rating scale and PD estimates. At year-end 2021, the total average PD weighted by gross carrying amount was 2.1% (2020: 2.8%). Excluding loans to financial institutions, which as mentioned above relates to the management of the Bank's foreign liquidity reserves, average PD was 2.2% (2020: 2.9%).

The overall credit quality of the loan portfolio increased in 2021. Credit quality increased slightly in the individual portfolio and substantially in the corporate portfolio. Although uncertainty surrounding the

effects of the COVID-19 pandemic on the portfolio still exists, 2021 saw this uncertainty decrease for some sectors and become more targeted to other sectors, such as the travel industry. At year-end 2021, 60% of the carrying amount of loans in the travel industry sector still had active COVID-19 related moratoria. In other sectors, where the effects of the pandemic have turned out to be less severe than initially thought, the decrease in credit quality observed in 2020, has mostly receded to pre-2020 levels.

Figures 4.24 and 4.25 show the rating grade distribution of the loan portfolio for corporates and individuals.

Figure 4.24: Rating grade distribution - Corporates

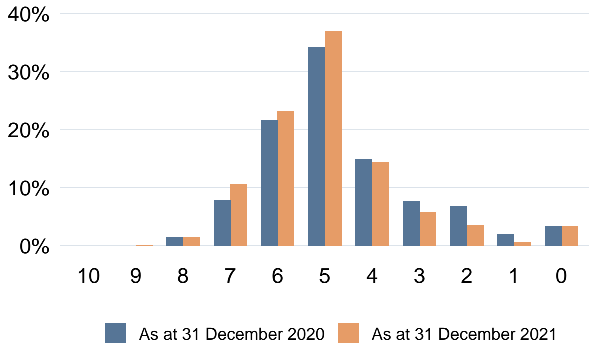
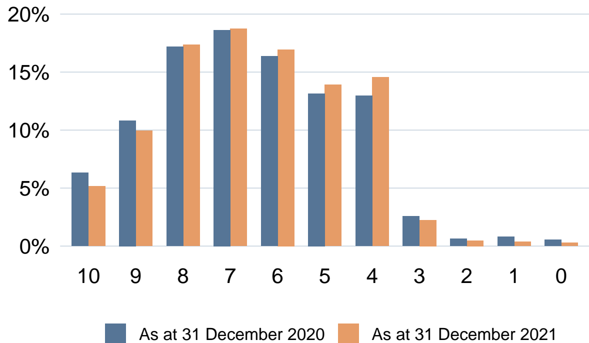


Figure 4.25: Rating grade distribution - Individuals



Figures 4.26 to 4.28 show the rating grade migration for corporates and individuals during 2021, based on existing customers at year-end 2020 and 2021.

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 4.26: Rating migration ratios in 2021

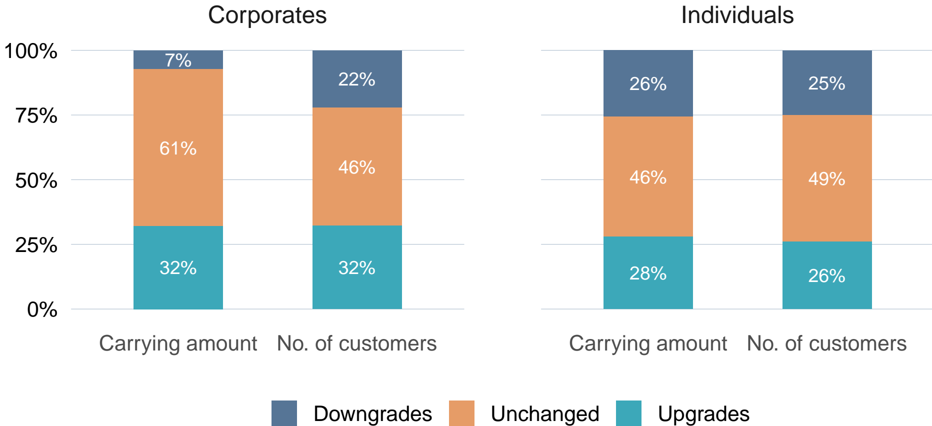


Figure 4.27: Rating migration of corporates in 2021

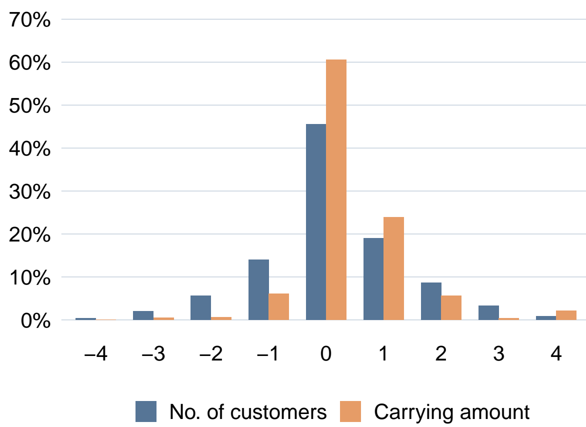
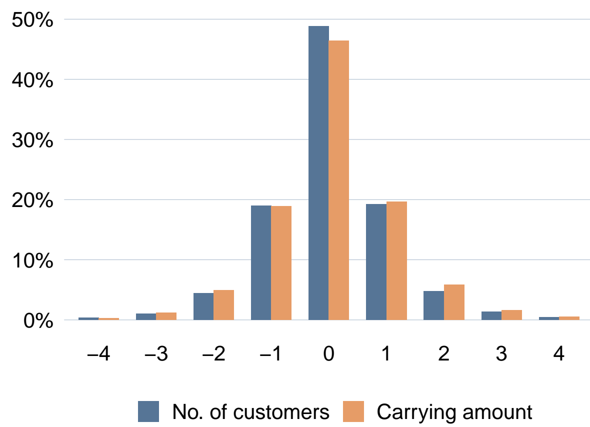


Figure 4.28: Rating migration of individuals in 2021

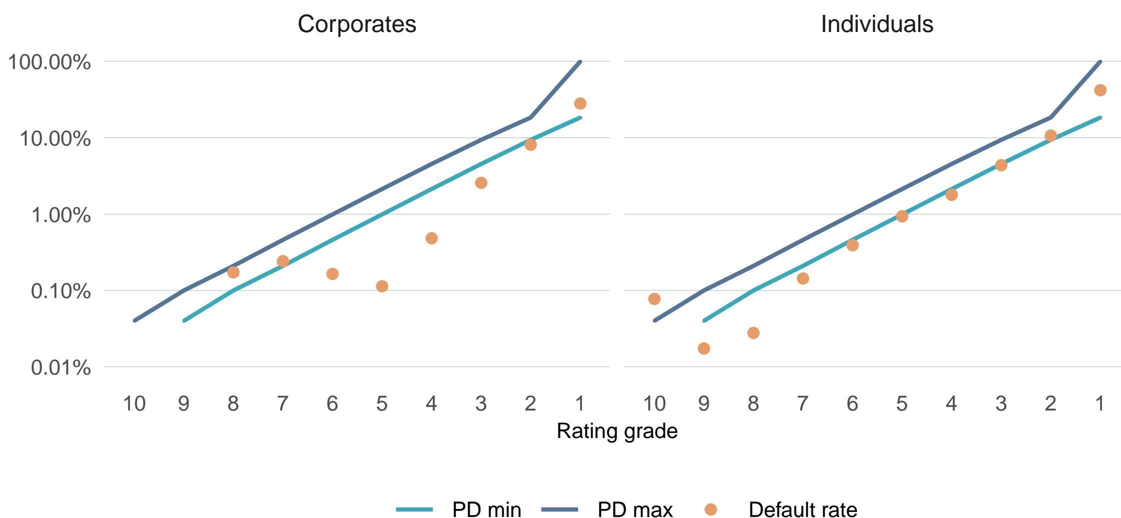


The rating and risk grade distribution changes primarily due to three factors: changes in rating grade for existing customers, or pure migration; different rating grade distribution of new customers and customers leaving the Bank compared to the rating grade distribution of existing customers during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

For individuals, the percentage of upgrades was slightly higher than the percentage of downgrades, with just under half the portfolio remaining unchanged. For corporates, the percentage of upgrades was significantly higher than the percentage of downgrades, with only 7% of the carrying amount of loans getting a downgrade during 2021. 61% of the carrying amount of loans in the corporate portfolio remained unchanged during 2021.

The default rate, measured by number of customers, was 1.9% for corporate customers in 2021, as compared to the estimated 3.9%. No corporate customers in rating grades 9 and 10 defaulted. The default rate of individuals for 2021 was 0.9% as compared to the estimated 1.2%. 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

Figure 4.29: 12-month default rate vs. probability of default band



below the PD bands. For individuals in rating grade 10, the default rate was slightly above the PD band and for the majority of rating grades for corporate customers, the default rate was below the PD band. Pandemic related moratoria measures are part of the explanation for this.

Figures 4.30 and 4.31 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 4.30: Default rate vs. PD - Corporates

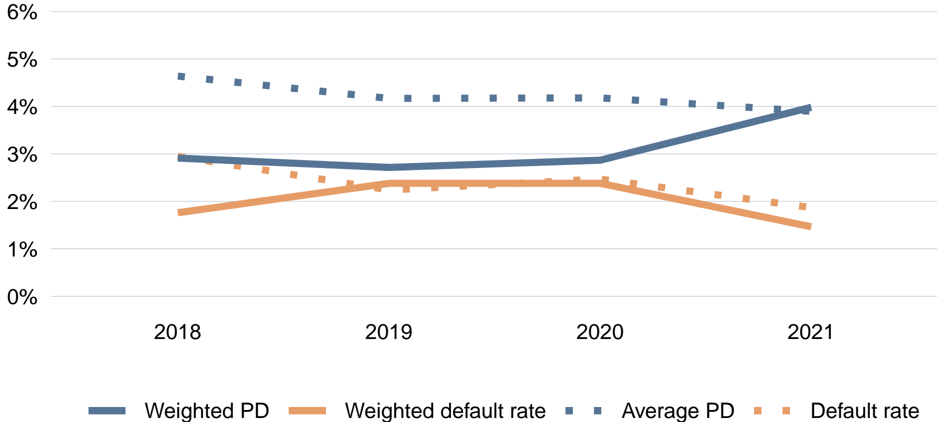
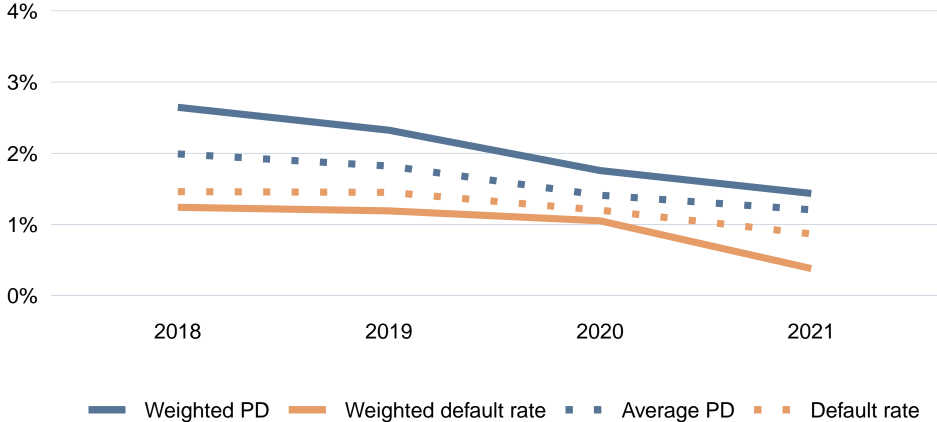


Figure 4.31: Default rate vs. PD - Individuals



Realised default rates have been consistently below the estimated PD values both for corporates and individuals for the past four years. The full effects of the COVID-19 pandemic on default rates in the portfolio have yet to fully materialise, although these effects seem to be less severe than initially thought. At year-end 2021, the carrying amount of loans with active COVID-19 related moratoria was ISK 74 billion. As these moratoria expire, and the customers try to recover from the effects of the pandemic, the full effect on the default rate in the portfolio will become clear.

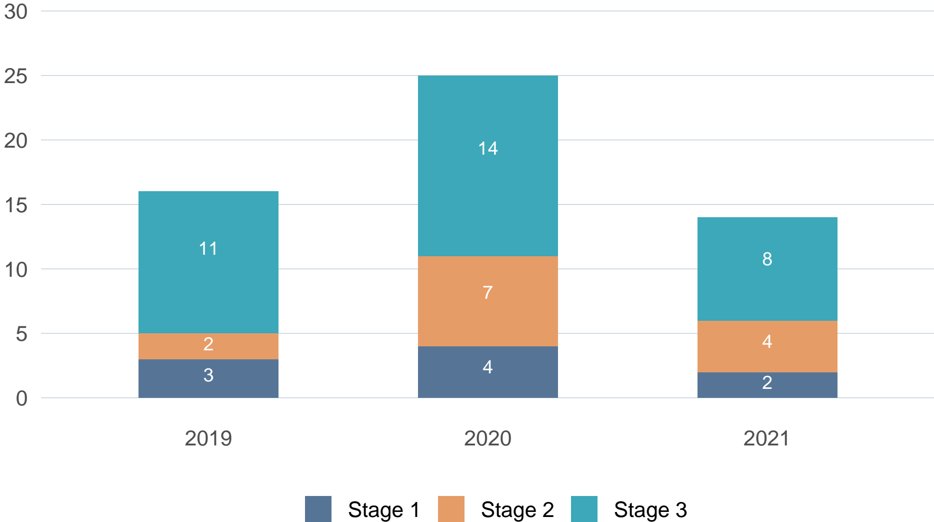
4.2.7 Loan impairment

Total ECL amounted to ISK 14.4 billion at year-end 2021 (thereof classified as deduction from gross carrying amounts: ISK 13.8 billion), as compared to ISK 25.3 billion at year-end 2020 (thereof classified as deduction from gross carrying amounts: ISK 24.5 billion). The decrease in ECL is primarily due to write-offs and a decrease in PD values, both because of increasing credit quality in the portfolio, and

more favourable economic scenarios in impairment calculations. This led to decreased ECL, as well as decreased transfers from stage 1 to stage 2. In 2021, a new model for calculating LGD was implemented. The implementation of the model had a net-decreasing impact on ECL. The significant decrease in ECL in stage 3 is explained in part by write-offs during the year, and in part by a more favourable outlook regarding recoveries from certain defaulted individually assessed significant customers. Details on the development of ECL during the year can be found in note 61 in the Bank's annual financial statement for 2021.

During 2021, the need for general allowance for customers with COVID-19 related moratoria and sectors heavily affected by the pandemic was regularly assessed. General allowance, and transfers to stage 2 were applied where the ECL models were deemed to not reflect the risk accurately. During the 4th quarter of 2021, an assessment was carried out to evaluate the outlook for large corporate customers with active COVID-19 related moratoria. While the general outlook for this subset of customers was positive, the increased uncertainty in the pandemic with the emergence of the Omicron variant provided a foundation for a continued need for general allowance. At year-end 2021, the travel industry portfolio has a general allowance of ISK 2,057 million and other corporate customers with COVID-19 related moratoria have a general allowance of ISK 119 million. 12-month ECL for loans and advances to customers was ISK 3.2 billion at year-end 2021, compared to ISK 8 billion at year-end 2020.

Figure 4.32: Expected credit loss by stage



ECL decreased across all stages in 2021. For individuals, the total ECL decreased by ISK 949 million while ECL in the corporate portfolio decreased by ISK 9.7 billion. The ratio of ECL to gross carrying amount in stage 1 decreased for both individuals and corporates in 2021. 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 decreased both for individuals and corporates in 2021. The ratio of ECL to gross carrying amount in stage 3 decreased for corporates but increased slightly for individuals. The gross carrying amount of loans in stage 3 decreased significantly in 2021 for the total portfolio, both due to write-offs and defaulted customers returning to performing status. The gross carrying amount of loans in stage 2 decreased in 2021, both for corporates and individuals, as Figure 4.36 shows.

Figure 4.33: ECL to gross carrying amount - Stage 1

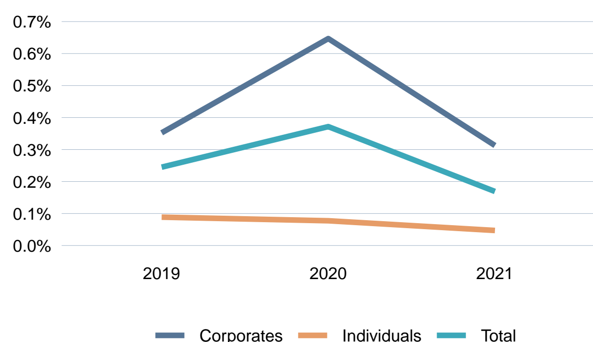


Figure 4.34: ECL to gross carrying amount - Stage 2

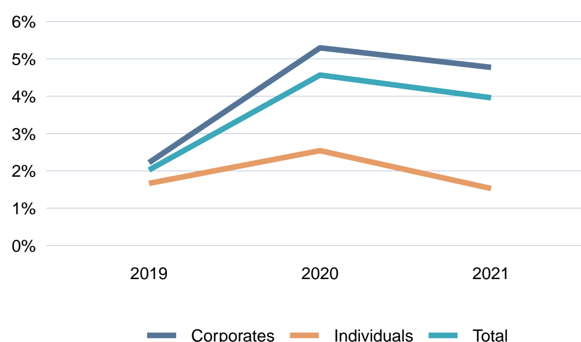


Figure 4.35: ECL to gross carrying amount - Stage 3

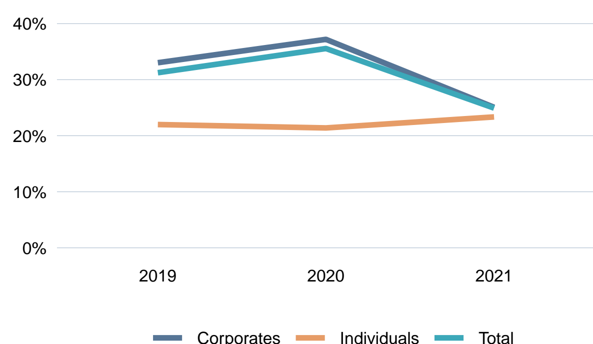
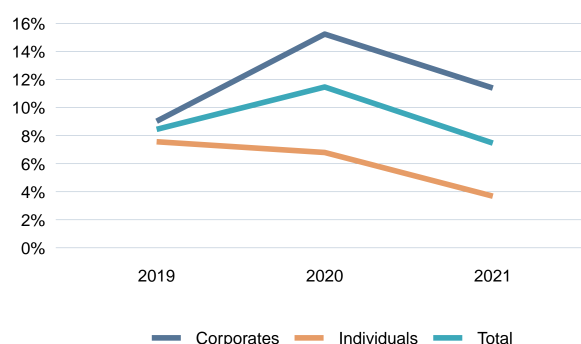


Figure 4.36: Gross carrying amount in stage 2



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 Tier 1 capital. No exposure to a single customer or a group of related customers exceeded 25% in the year 2021, 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.

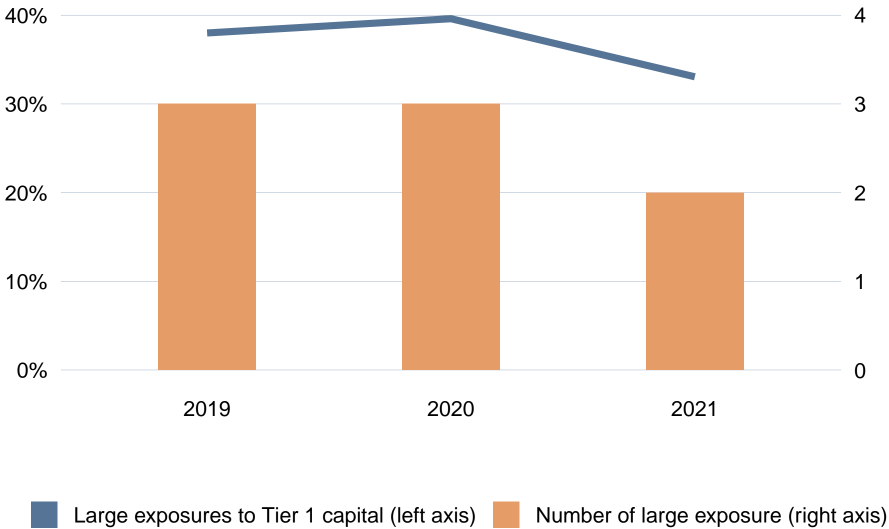
At year-end 2021, lending to individuals represented 52% of the Bank's total credit exposure (2020: 47%). Most of the demand from individuals is for mortgages, and the Bank's lending to individuals is therefore mostly secured by real estate.

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 98% of the Bank's total credit exposure, excluding exposures to financial institutions, in 2021 (2020: 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 4.39 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 4.37: Exposures between 10% and 20% of Tier 1 capital*



* For 2019 and 2020, the ratio was measured as a % of Tier 1 capital.

Figure 4.38: Loans and advances by geographical area

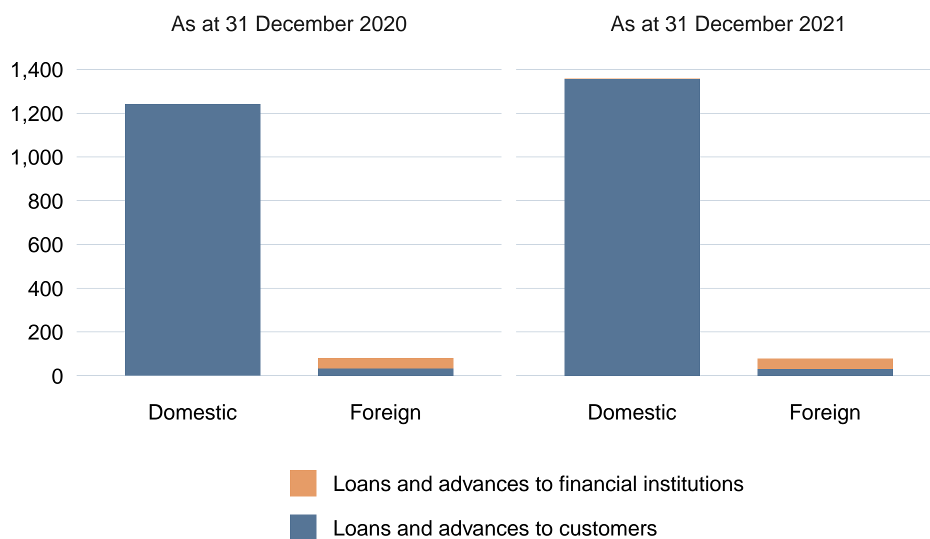


Figure 4.39: Industry concentration

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

5 Market risk

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Market risk

Market risk is the risk that changes in market prices will adversely impact the fair value of 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 decreased in 2021 due to lower exposure in the Bank's trading portfolios most of the year and lower net FX Balance, the equity market was also far less volatile than the year before.
- Total market risk in the Bank's trading book together with foreign exchange risk and CVA risk, as measured by economic capital, was ISK 2.2 billion at year-end 2021 compared to ISK 3.3 billion at the end of 2020.
- The Bank's market risk is 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 2021.

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).

Table 5.1: Total net exposure subject to market risk

	Net position at year-end	
	2021	**2020**
Equities and equity instruments in the trading book	2,145	1,951
Bonds and debt instruments in the trading book	5,839	4,272
FX balance	-1,108	3,939

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

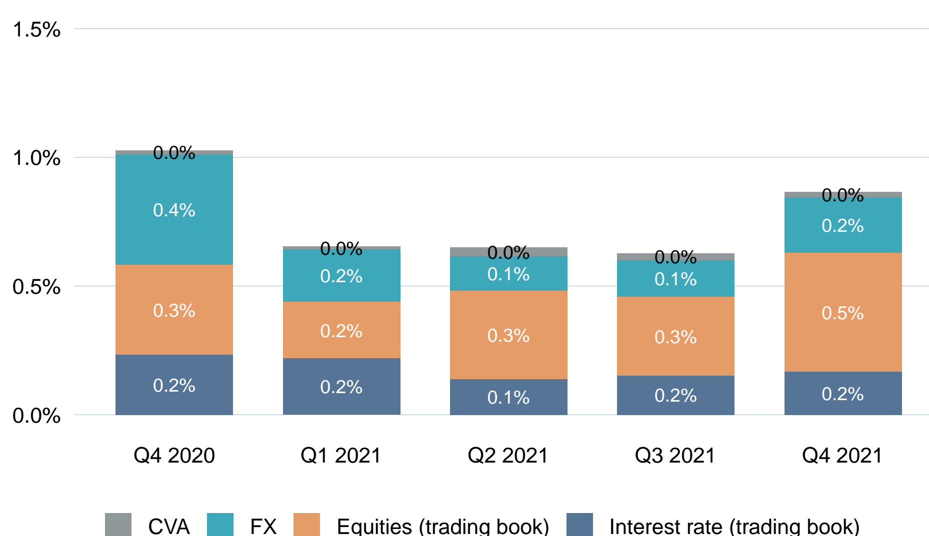
The Bank uses risk-weighted exposure amounts (RWEA) and economic capital (EC) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. RWEAs are determined by applying specific risk weights to the Bank's assets, according to capital requirement regulations. Several other indicators are used as measures of market risk as well, including Value-at-Risk (VaR), profit and loss analysis, 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 RWEA, remains low, amounting to 0.9% at year-end 2021 (compared to 1% at year-end 2020), well within the Bank's risk appetite.

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

	2021		2020	
	RWEA	Ratio to RWEA	RWEA	Ratio to RWEA
Equity price risk in the trading book	5,289	0.5%	3,913	0.3%
Interest rate risk in the trading book	1,911	0.2%	2,613	0.2%
Foreign exchange risk	2,458	0.2%	4,828	0.4%
CVA risk	251	0.0%	172	0.0%
Total	**9,909**	**0.9%**	**11,526**	**1.0%**

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



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 2021 and 2020, are shown in Table 5.3.

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

	Net position at year-end 2021				
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	1,228,486	138,186	283,956	26,957	1,677,585
Total liabilities	997,874	36,078	337,603	59,553	1,431,106
Net on-balance sheet position	230,613	102,108	-53,647	-32,595	246,479
Effect of derivatives held for risk management	-44,280	0	44,280	0	0
Net off-balance sheet position	2,000	0	-2,000	0	0
Total interest repricing gap	**188,333**	**102,108**	**-11,367**	**-32,595**	**246,479**
	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	**194,875**	**97,718**	**-30,749**	**-36,326**	**225,518**

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 5.4 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 2021 and 2020 can be seen in Table 5.5.

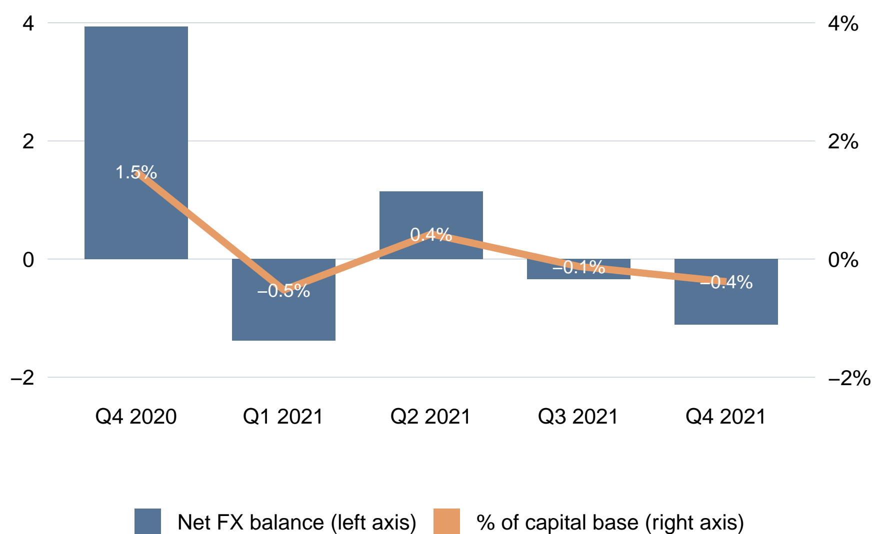
Table 5.4: Interest rate risk (fair value sensitivity) in the banking book at year-end

	2021		2020	
	+100 bps	-100 bps	+100 bps	-100 bps
ISK non-indexed	-3,551	3,717	-102	94
ISK indexed	4,460	-4,808	4,366	-4,293
EUR	4,747	-4,948	2,074	-2,184
SEK	24	-24	14	-14
USD	-41	41	-74	74
Other	8	-8	14	-14
Total	**5,647**	**-6,029**	**6,293**	**-6,337**

Table 5.5: Net FX balance

	Net position at year-end	
	2021	2020
CHF	-28	174
EUR	-1,804	933
GBP	375	233
JPY	122	88
USD	-485	2,422
Other	712	89
Total	**-1,108**	**3,939**

Figure 5.2: Net FX balance (ISK bn)



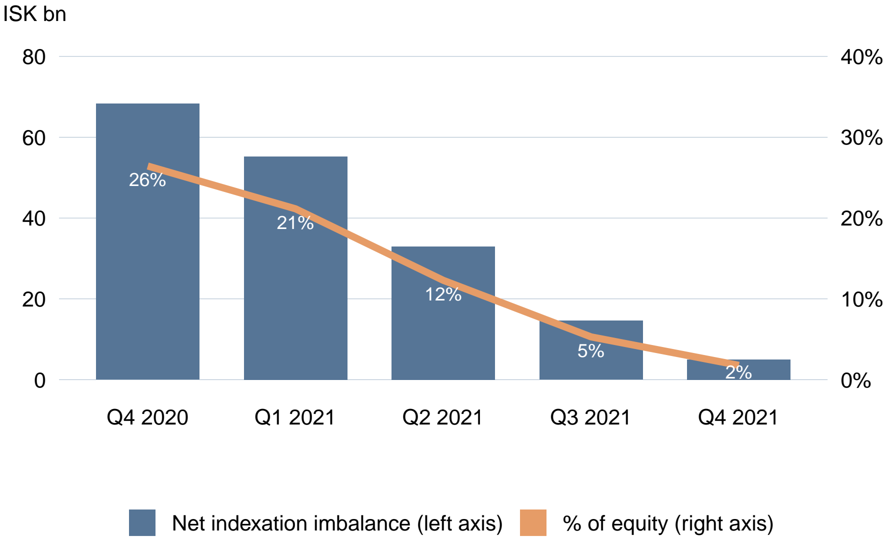
5.4.5 Other market risk

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 2021, amounting to ISK 5 billion at year-end 2021 as compared to ISK 68 billion at year-end 2020. Lower balance mainly stems from decrease in indexed loan portfolio and increase in CPI-linked borrowing and deposits. Further information regarding the Bank's market risk can be found in template MR1 in the additional disclosures accompanying this report.

Figure 5.3: Indexation imbalance



6 Liquidity risk

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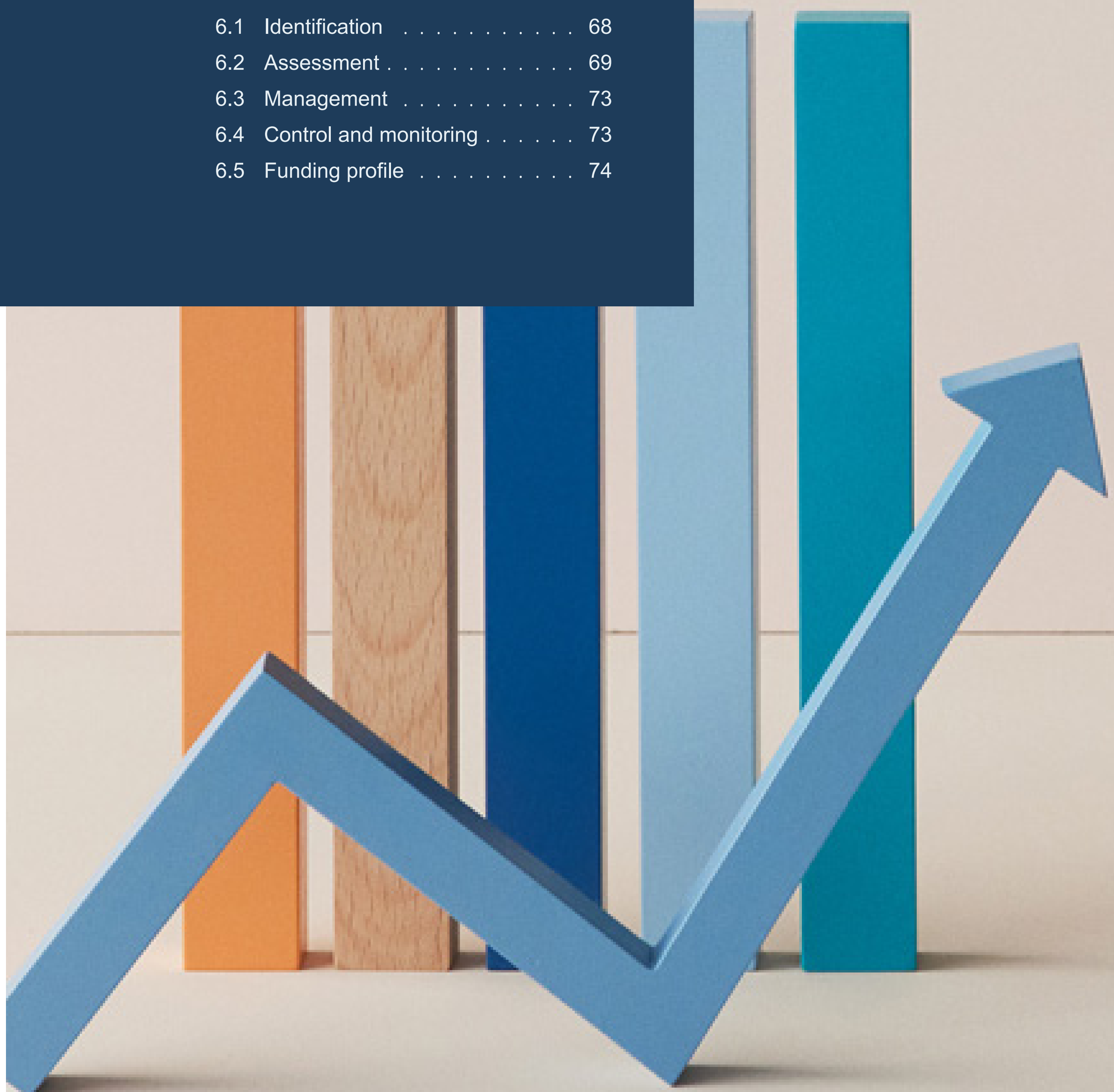


Liquidity risk

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 strong at year-end 2021 and well above regulatory requirements and the Bank's risk appetite. The total liquidity coverage ratio was 179% at year-end 2021 (year-end 2020: 154%) and the Bank's LCR in foreign currencies was 556% (year-end 2020: 424%) and 120% in ISK (year-end 2020: 105%).
- High demand for mortgages could have put a strain on the liquidity position of the bank in early 2021 but deposit growth and borrowing fully offset the increase in the mortgage loan portfolio (ISK 128bn) during the course of the year.

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 2021 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 2021. 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.

Table 6.1: Total deposits by groups

As at 31 December 2021	Runoff rate	0-30 days	Over 30 days	Total
Retail deposits				
Individuals	5-100%	353,612	114,234	467,846
Small and medium-sized corporates	5-100%	88,358	6,121	94,480
Operational deposits	5-25%	0	0	0
Non-operational deposits				
Large corporates	20-40%	185,594	33,970	219,565
Government	20-40%	38,926	2,231	41,157
Financial customers	100%	50,739	24,080	74,818
Other*		12,154	503	12,657
Total deposits		**729,383**	**181,140**	**910,523**

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

Figure 6.1: Total deposits by maturity

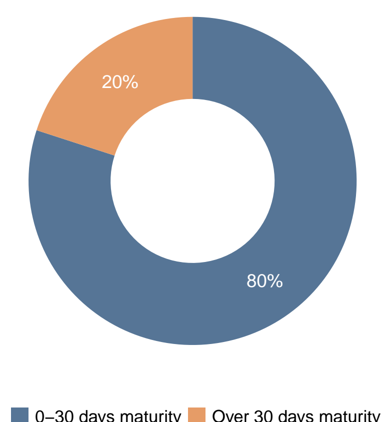
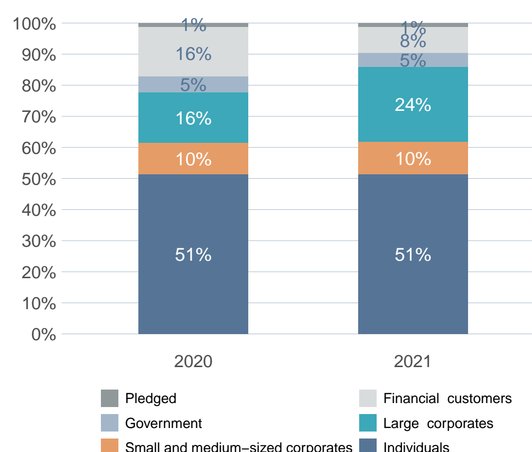


Figure 6.2: 0-30 days maturity deposits by groups*



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

Table 6.2: EU LIQ1 template

		Total unweighted value*	Total weighted value*
		31.12.2021	31.12.2021
Number of data points used in the calculation of averages		12	12
High-quality liquid assets			
1	Total high-quality liquid assets (HQLA)	-	191,711
Cash-outflows			
2	Retail deposits and deposits from small business customers, of which:	424,634	29,927
3	Stable deposits	313,148	15,657
4	Less stable deposits	110,591	13,374
5	Unsecured wholesale funding	257,623	142,831
6	Operational deposits (all counterparties) and deposits in networks of cooperative banks	0	0
7	Non-operational deposits (all counterparties)	255,380	140,587
8	Unsecured debt	2,243	2,243
9	Secured wholesale funding	-	0
10	Additional requirements	113,858	13,917
11	Outflows related to derivative exposures and other collateral requirements	3,677	3,677
12	Outflows related to loss of funding on debt products	577	577
13	Credit and liquidity facilities	109,604	9,663
14	Other contractual funding obligations	4,558	0
15	Other contingent funding obligations	29,510	6,925
16	**Total cash outflows**	-	193,599
Cash-inflows			
17	Secured lending (e.g. reverse repos)	0	0
18	Inflows from fully performing exposures	113,968	81,963
19	Other cash inflows	7,559	1,720
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**	121,527	83,704
EU-20a	***Fully exempt inflows***	0	0
EU-20b	***Inflows subject to 90% cap***	0	0
EU-20c	***Inflows subject to 75% cap***	121,527	83,704
			Total adjusted value
21	**Liquidity buffer**	**-**	**191,711**
22	**Total net cash outflows**	**-**	**109,896**
23	**Liquidity coverage ratio (%)**	**-**	**174%**

*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. Figure 6.5 shows the development of the Bank's LCR in ISK.

Figure 6.3: Liquidity coverage ratio (total)

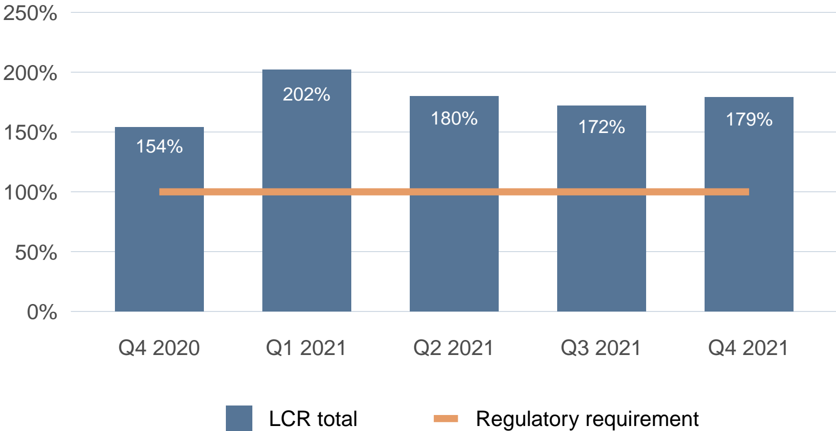


Figure 6.4: Liquidity coverage ratio (FX)

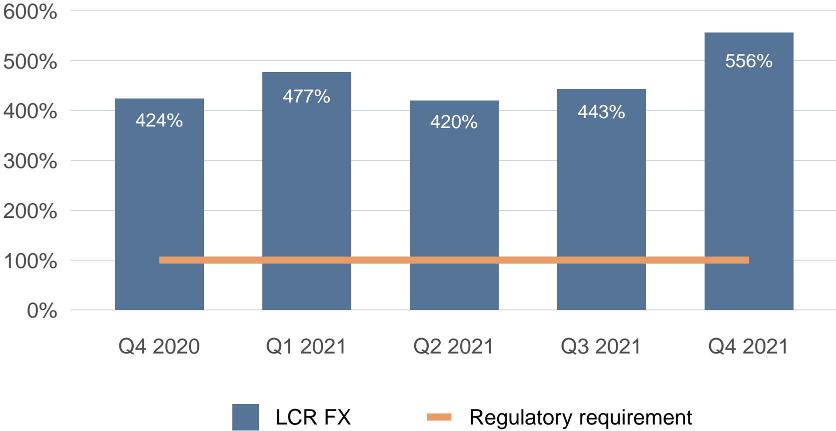
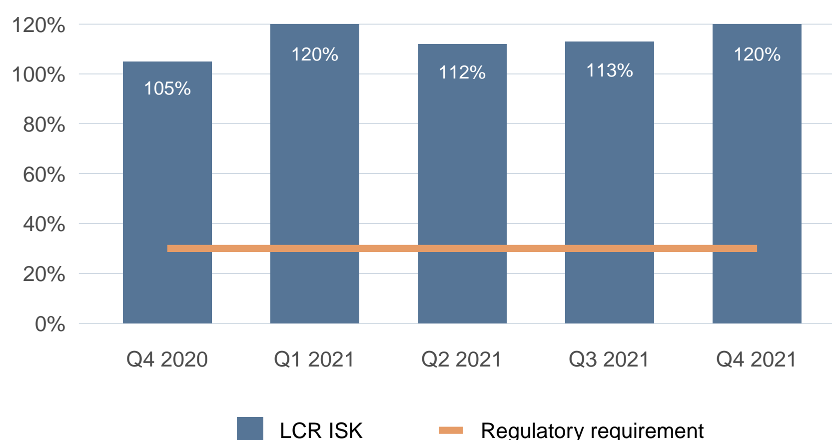


Figure 6.5: Liquidity coverage ratio (ISK)



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 121% at year end (year-end 2020: 116%), and the NSFR in foreign currencies was 142% (year-end 2020: 132%).

On 30 June 2021, Central Bank rules No. 1032/2014, on Funding Ratios in Foreign Currencies, were repealed and Rules No. 750/2021, on Minimum Net Stable Funding, took effect. The Rules introduce an 100% total net stable funding ratio.

Figure 6.6: Net stable funding ratio (total)

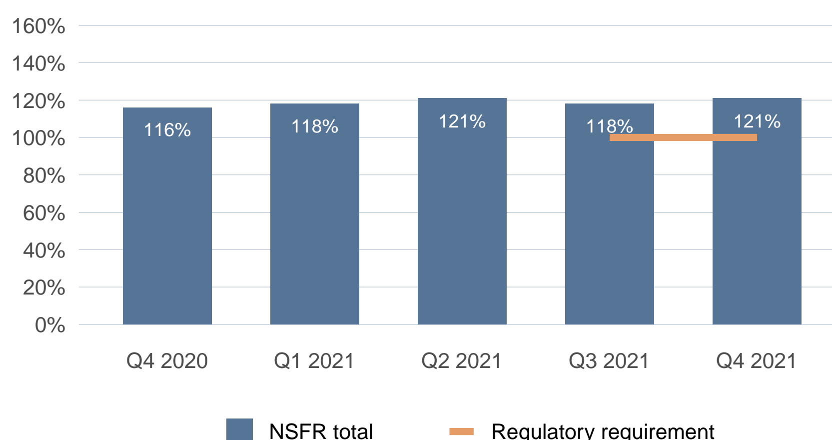
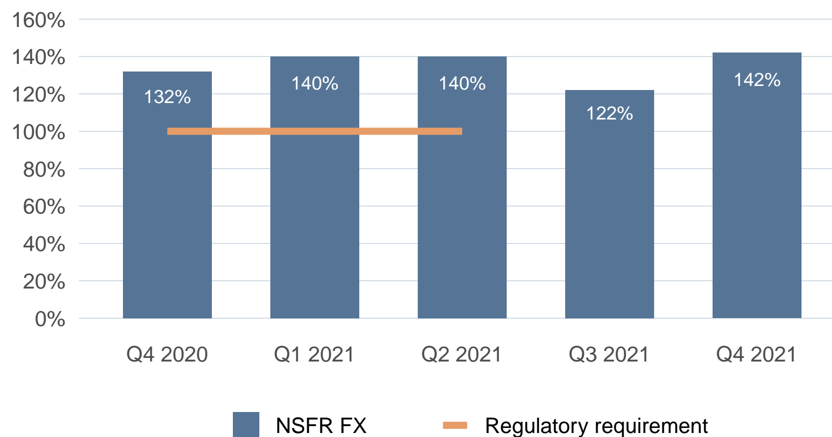


Figure 6.7: Net stable funding ratio (FX)



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.

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.

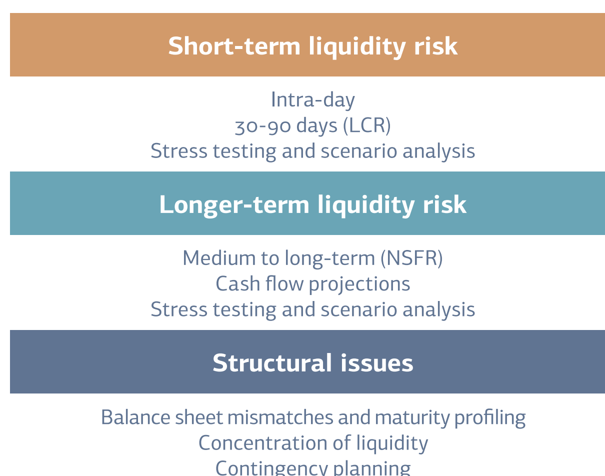
6.4 Control and monitoring

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.

Figure 6.8: Liquidity management process



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 & 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. Furthermore, the Bank issued bonds in foreign currencies under its EMTN programme.

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 of year-end 2021 and 2020.

Figure 6.9: Borrowings and subordinated liabilities (ISK bn)

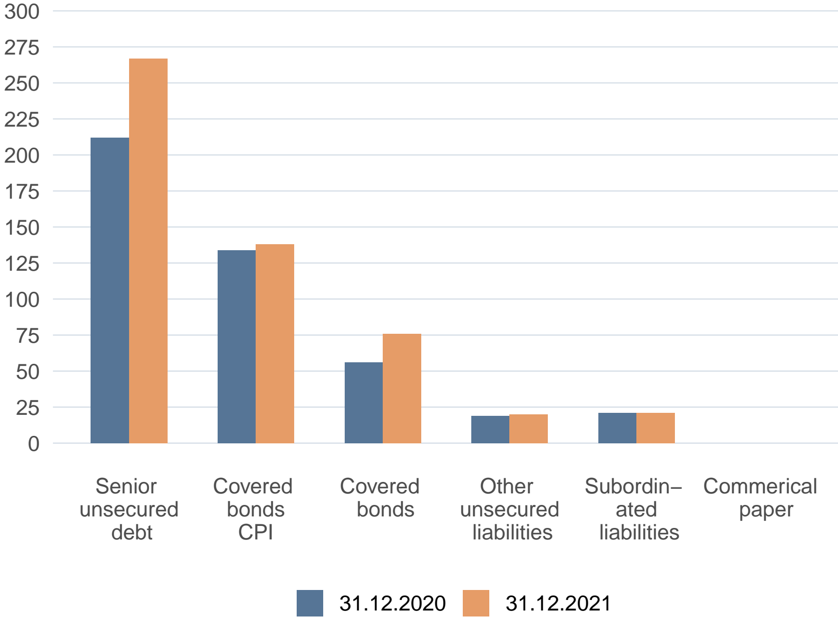
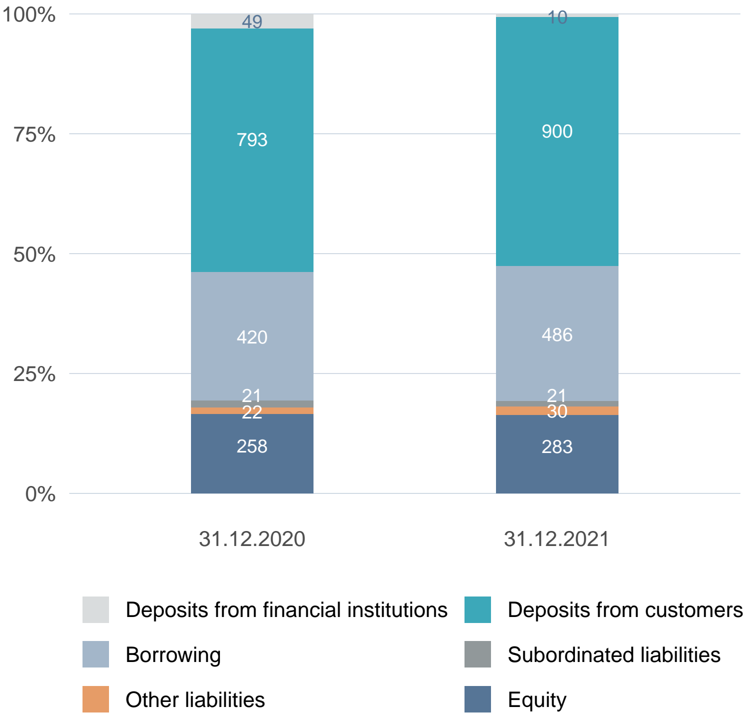


Figure 6.10: Funding profile (ISK bn)



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 107 billion in 2021 and amounted to ISK 900 billion at year end. Inflation-linked deposits amounted to ISK 136 billion at year-end 2021, increasing by ISK 10 billion from previous year, whereas non-indexed on demand deposits amounted to 764 billion at year end, increasing by ISK 97 billion.

6.5.3 Borrowings

6.5.3.1 EMTN Programme and other unsecured loans

In February, the Bank issued its inaugural green bond issuance under the Bank´s EMTN programme with reference to the sustainable finance framework. The bond issuance was a 4.25-year bond amounting to EUR 300 million concurrent with a tender offer of bonds maturing in March 2021. In November, the Bank issued a subsequent green 4.25-year EUR 300 million bond concurrent with a tender offer of bonds maturing in March 2022. In addition, the Bank issued 18-month bonds amounting to SEK 900 million in February.

At year-end 2021, bond issuance in foreign currency amounted to ISK 248 billion, increasing by ISK 36 billion during the year.

Table 6.3: EMTN Programme

As at 31 December 2021	Currency	Final maturity	Outstanding principal	Contractual interest rate
Senior unsecured				
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	144	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%
LBANK 0.375 5/25	EUR	23.05.2025	300	FIXED 0.375%
LBANK 0.75 5/26	EUR	25.05.2026	300	FIXED 0.75%
Subordinated				
LBANK 3.125 28NC23 T2	EUR	06.09.2028	100	FIXED 3.125%

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 2021 where previously issued bonds were tapped. During the year the non-indexed series LBANK CB21 matured. Agreements with market makers in the secondary market for covered bonds were renewed. At year end, outstanding covered bonds issuance amounted to ISK 218 billion, increasing by ISK 29 billion during the year 2021.

6.5.3.3 Commerical paper

No commercial paper auctions were held in 2021 under the ISK 50 billion debt issuance programme. There was no outstanding issuance of commercial paper at year-end 2021.

Table 6.4: Covered bonds

As at 31 December 2021	Currency	Final maturity	Outstanding principal	Contractual interest rate
Non-indexed				
LBANK CB 23	ISK	23.11.2023	44,080	5.00%
LBANK CB 25	ISK	17.09.2025	31,580	3.40%
Indexed				
LBANK CBI 22	ISK	28.04.2022	19,520	3.00%
LBANK CBI 24	ISK	15.11.2024	38,100	3.00%
LBANK CBI 26	ISK	20.11.2026	11,120	1.50%
LBANK CBI 28	ISK	04.10.2028	48,280	3.00%

Figure 6.11: Maturity profile (ISK bn)

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 2021 and subordinated issuance under the bank's EMTN programme amounted to EUR 100 million at the same time.

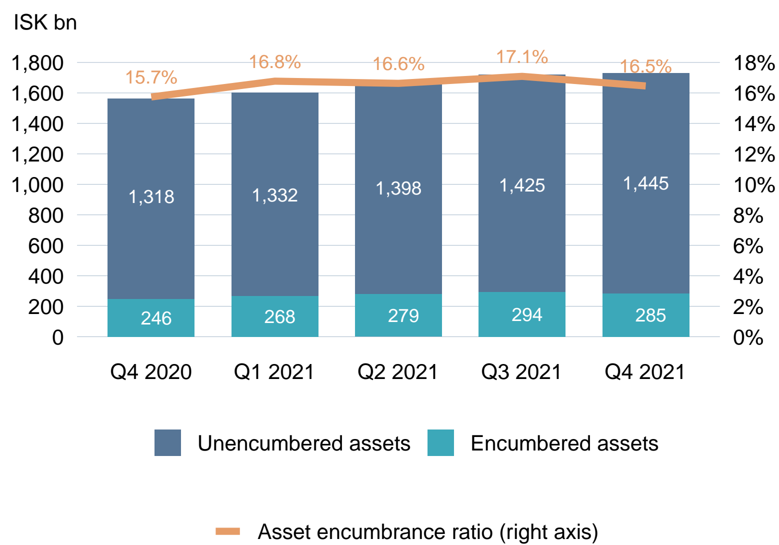
6.5.3.5 Equity

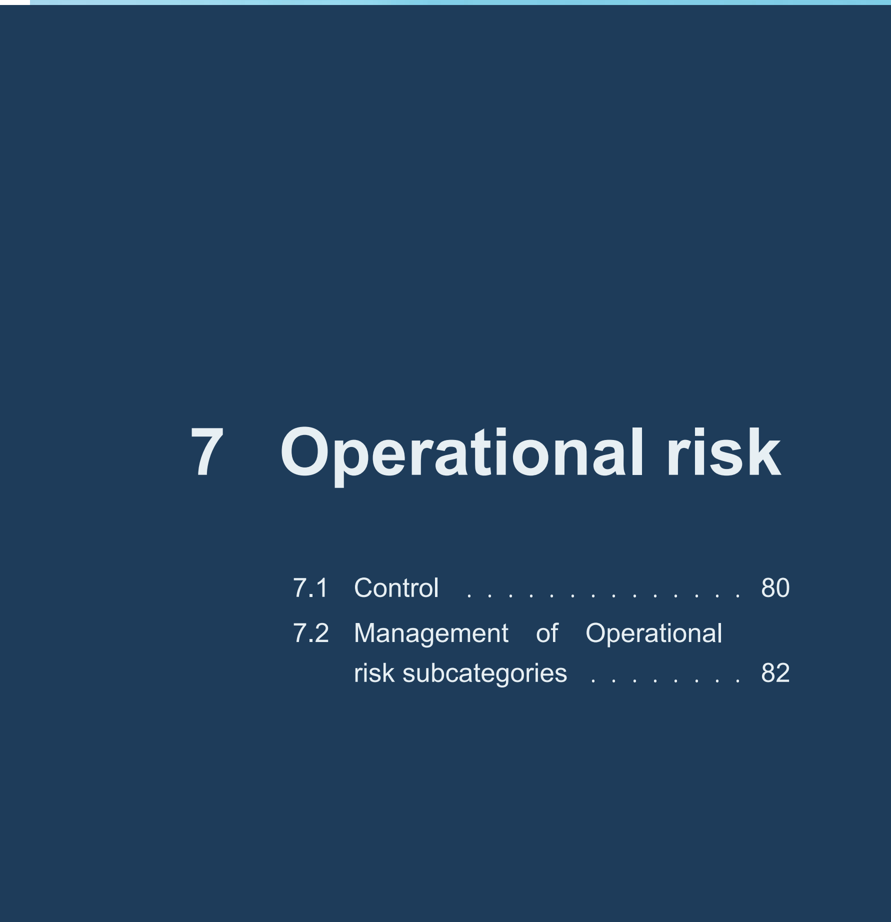
The Bank's equity was ISK 283 billion at year-end 2021, increasing by ISK 24 billion over the course of the year, and Landsbankinn's total capital ratio was 26.6%.

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





7 Operational risk

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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 10% fewer operational incidents in 2021 compared to 2020.
- There were 5% fewer loss incidents in 2021 compared to 2020.
- There has been increased emphasis on ICT risk in 2021 by the Bank and regulators.

7.1 Control

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.

The Board of Directors sets the Bank's policy regarding operational risk and risk appetite. The policy outlines the roles and responsibilities of stakeholders within the Bank, and the operational risk tolerance in terms of limits. The Operational Risk Committee is responsible for overseeing all operational risk except for model risk which is managed by the Risk & Finance Committee and for approving rules that fall within the remit of the Operational Risk Committee.

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.

Operational risk has been categorised by Landsbankinn in to seven separate subcategories and responsibilities for managing the risks posed by them are divided between the Operational Risk Department and the Compliance Department.

Figure 7.1: Operational risk categories

Operational Risk Department	Compliance Department
ICT risk Model risk Change management risk	**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.
Physical security Outsourcing risk	**Conduct risk** involves the risk of financial loss due to human error, neglect or fraud in relation to the Bank's customers.

7.1.1 General methods to measure and mitigate operational risk

In order to understand the effects of the exposures to operational risks in general, the Bank continually assesses its operational risk. 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.

In total there were 47 loss events in 2021. The category of execution, delivery and process management has the largest number of loss events; 35 in 2021, the next category 'Business Disruption & System failures' has 6 events.

The Bank categorises operational incidents into deviation from rules or processes, weakness in processes or systems, external circumstances, or security violations. The total number of incidents in 2021 was 180, 94 were due to weakness in processes or systems and 74 due to deviation from rules or processes.

7.1.2 Mitigation

The Bank buys insurance to mitigate its operational risk. The insurance comprises of banker's comprehensive crime policy and 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.

7.1.3 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.

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.

Operational risk measurements are reported to the Board in a comprehensive manner as part of regular reporting.

7.2 Management of Operational risk subcategories

7.2.1 ICT risk

The Bank manages ICT risk by minimising the risk of loss through breach of confidentiality, loss of integrity and/or unavailability of data and systems. The Bank's framework is based on an ISO 27001 certification, since 2007, and on adherence to Guidelines on ICT and security management by EBA. ICT risk includes the risk of breach of data confidentiality through attacking and exploiting vulnerabilities. Cyber defences

are based on layered security. Every layer is monitored by more than one security system. A continuous vulnerability scan is performed by an external party. An internal scan is also performed on internal and external systems, associated ports, services and applications. Cultural awareness of cyber threats within the Bank is an important aspect and Workplace from Meta is used to share relevant material with employees. Finally, the Bank utilises knowledge from external parties, e.g. NF CERT, to gain insight into current threats with the aim to prevent them before they happen.

7.2.2 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 place a variety of organizational 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 minimise conduct risk.
- Mandated management to promote a corporate 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.

7.2.3 Model risk management

The Bank has a model risk management framework in place. A model inventory is used, where models that fulfil the Banks model definition are registered.

A risk assessment scorecard is used to categorise models into risk groups that controls the level of monitoring and controls applied to the models. The Risk & Finance Committee approves the Bank's model rules and manages the Banks model risk.

7.2.4 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.

7.2.5 Change management

The Bank has robust procedures in place to govern change management. Bank has a product approval process that is aligned with updated EBA guidelines on product governance. The updated version further strengthens the governance of new product approvals and has been fully implemented. The process includes provisions for life cycle management.

7.2.6 Physical security

The Bank's security manager is responsible for physical security in the Bank's operations. That includes integrating safety and security policies with the business operations. He is charged with evaluating safety and security plans for effectiveness and managing the emergency response team.

7.2.7 Outsourcing

The Bank has outsourcing rules that are in line with the EBA guidelines on outsourcing. This sets the standard for how the Bank manages outsourcing agreements and risks by identifying, assessing and controlling risks in relation to outsourcing.

7.2.8 Other operational risk

7.2.8.1 COVID-19

The Bank's response to the COVID-19 pandemic has ensured that there has been minimal impact on its operations and service to customers. The Bank has put emphasis on following public health official guidelines throughout the pandemic. The Executive Board and the Operational Risk Committee have regularly had joint meetings to coordinate the Bank's response to the pandemic.

7.2.8.2 ESG risk

The Bank is in the process of increasing awareness of the climate-related risks it is exposed to. Both qualitative and quantitative processes either have or are being implemented to gain insights into those risks on various levels within the bank. Transition climate risk has been a focus in 2021, partly because of recent methodological advances made by PCAF (Partnership for carbon accounting financials). In 2021 the Bank published information regarding financed scope 3 emissions in line with the PCAF standard, an important step to gain fundamental insights into financed emissions (Scope 3 category 15) and transition risk exposure. Calculations of indirect emissions continue to be streamlined and automated. An internal dashboard has been structured to visualise and view the development of indirect emissions along with other sustainability related metrics. Article 449a of CRR II states that from June 28, 2022, the Bank will be required to disclose information on ESG risks, including physical and transition risks. This information shall be disclosed on an annual basis for the first year, and biannually thereafter.

Climate risk as a risk factor has recently been emerging within the Bank's risk management and important groundwork has been put in place. The Director of Community, a part of the Banks senior management, has the responsibility of maintaining and promoting the Bank's sustainability policy.

The Bank has automated the calculations for its indirect emissions through our loan portfolio (Scope 3 category 15). Such automation streamlines the process for identifying high emitting sectors and the option to assess potential climate-related transition risk.

In general, companies are assessed based on various ESG metrics before a loan is issued. Internal guidelines have been issued to assist managers to evaluate ESG metrics and performance. The guidelines are both available for individual sectors as well as general outline of ESG metrics.

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.

Information regarding operational risk own funds requirements and risk-weighted exposure amounts can be found in template OR1 in the additional disclosures accompanying this report.

8 Regulatory developments

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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 2021 and secondly, regulatory requirements expected in 2022.

8.1 New regulatory requirements in 2021

Act amending the Act on Financial Undertakings (line of defence on investment banking activity)

Act No. 11/2021, amending the Act on Financial Undertakings, No. 161/2002 (line of defence on investment banking activity), enacts a proposal set forth in the White Paper on a Future Vision for the Financial System to put in place a line of defence between commercial and investment banking activity. The Act provides that the investments of banks on own account are limited to a certain percentage of equity. Direct and indirect exposure by systemically important commercial banks is limited in terms of capital to 15% of their equity base. The Act minimises 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.

Act amending the Act on Financial Undertakings (transposing European protocols and recovery plans)

Act No. 44/2021, amending the Act on Financial Undertakings, No. 161/2002 (transposition, recovery plans), empowered the Minister of Finance and Economic Affairs and the Central Bank of Iceland to transpose Regulation (EU) 2019/630, the so-called Non-Performing Exposures Regulation, and Regulation (EU) 2019/876, often referred to as CRR II, and a few sub-protocols of CRR. The NPE requires financial undertakings to deduct a part of non-performing loans against equity if reserves are not available to balance expected credit losses. Loans are broadly considered in arrears if the lender fails to fulfil payment obligations for a period of 90 days or if there are other reasons to expect non-fulfilment. The size of the deduction is determined by the extent to which an exposure is secured and the period of non-performance. The deduction only applies to loans granted after enactment of the protocol and does not require recalculation of equity for previously granted loans. CRR II provides for a 3.0% minimum leverage ratio to limit gearing by banks and limit minimum stable funding to prevent banks from relying too heavily on short-term funding. Requirements on large exposures are tightened by including the calculation of large exposures under Tier 1 capital only, rather than under eligible funds that to some degree fall under Tier 2 capital. It eases conditions for lower capital requirements on lending to SMEs and lending to infrastructure projects.

Legislation on Payment Services

Act No. 114/2021, on Payment Services, transposed into Icelandic law Directive (EU) 2015/2366, on payment service in the internal market (PSD2), amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU, and Regulation (EU) 1093/2010 and repealing Directive 2007/64/EC. The Act provides

for new payment service providers, payment initiation service providers and account information service providers, who are also payment institutions. Banks will be required 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 to the payment initiation service provider or the account information service provider. The Act also provides for enhanced security requirements for payment service providers.

Act on Financial Benchmarks

Act No. 7/2021 transposes into Icelandic law the main substance of Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016, on financial benchmarks (the Benchmark Regulation). The Act is a comprehensive new legislation on financial benchmarks, containing provisions on the publication and use of indices used as financial benchmarks such as LIBOR and EURIBOR. The Act provides for the operating licences and practices of index providers and the methodologies used by index providers. There are also provisions for supervision and administrative sanctions by the Financial Supervisory Authority of the Central Bank of Iceland (FSA) and administrative provisions. The Act applies both to the benchmark provision process, including the quality of input data, and use thereof. "Benchmarks" broadly refers to all indices that are publicly available, published regularly on the bases of specified values and used to calculate payments, the value of financial instruments or asset composition of investment funds. Specified entities are exempt from the Benchmark Regulation, including central banks and authorities who compile benchmarks for public policy.

Act on Disclosure Obligations for Issuers of Securities and Flagging Obligations

Act No. 20/2021, on Disclosure Obligations for Issuers of Securities and Flagging Obligations, transposes into Icelandic law Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 (the Transparency Directive), as subsequently amended. The Transparency Directive was previously partially transposed into Icelandic law with Act No. 108/2007, on Securities Transactions, and Act No. 3/2006, on Financial Statements. There was not deemed reason to amend the provisions of the Transparency Directive transposed with the Act on Financial Statements, No. 3/2006.

Act amending the Act on Recovery and Resolution of Credit Institutions and Investment Firms (priority of claim under resolution and winding-up proceedings)

Act No. 38/2021, amending Act No. 70/2020, on the Resolution of Credit Institutions and Investment Firms, transposes Directive (EU) 2017/2399 on the ranking of unsecured debt instruments in insolvency proceedings into Icelandic law. Directive (EU) 2017/2399 is set for clarification of the provisions of Directive (EU) 2014/59 (BRRD) and provides for the priority ranking of specific claims in insolvency proceedings. The Act provides for 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 Act provides for 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.

Act on Key Information Documents for Specified Investment Products for General Investors

Act No. 55/2021, on Key Information Documents for Specified Investment Products for General Investor, transposes into Icelandic law Regulation (EU) No. 1286/2014 (PRIIPs). 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 prior to the conclusion of agreements. 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.

Act on Action to Prevent Market Abuse

Act No. 60/2021, on Action to Prevent Market Abuse, transposed Regulation (EC) No. 596/2014, on market abuse (Market Abuse Regulation, MAR), into Icelandic law. MAR is more comprehensive and detailed and extends to more financial instruments than previous legislation. It contains new provisions on insiders, insider lists, treatment of insider information, the obligation to report insiders, etc. The Act has a wider scope, providing for extended disclosure requirements, changes to the classification of insiders and changed rules on the trading of primary insiders and financially connected parties. In addition, the Act expands the competency of authorities to carry out reviews and new authorisations for financial undertakings to delay information disclosure to safeguard economic stability.

Act amending the Act on Derivative Trading, Central Counterparties and Trade Repositories (easing of rules)

Act No. 56/2021, amending Act No. 15/2018, on Derivative Trading, Central Counterparties and Trade Repositories (easing of rules), transposed Regulation (EU) 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 Act eases 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.

Act on UCITS

Act No. 116/2021, on UCITS, transposed into Icelandic law Directive 2014/91/EU, on UCITS, 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 were also made to Act No. 45/2020, on Alternative Investment Fund Managers (AIFs), first and foremost as regards the remuneration policies of AIF managers and use of the concept investment fund. The Act repeals Act No. 128/2011, on UCITS.

Act on Foreign Exchange

Act No. 70/2021, on Foreign Exchange, repealed Act No. 81/1992, on Foreign Exchange, and Act No. 37/2016, on Treatment of ISK-denominated Assets Subject to Special Restrictions. While the Act is based on the same considerations as the previous Act, presentation has been thoroughly overhauled. Cross-border foreign currency trading, capital movement and payments, are made free and unrestricted, unless they threaten stability in the FX market and monetary stability. The Act contains 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 are allowed to intermediate in FX transactions, no others. Parties who carry out FX transactions, cross-border capital movement and international payments remain under an obligation to report such transactions and movements to the Central Bank. By repealing Act No. 37/2016, on Treatment of ISK-denominated Assets Subject to Special Restrictions, no restrictions apply to off-shore ISK or their distribution. With entry into force of the Act, the off-shore and on-shore markets merged into one.

8.2 Expected regulatory requirements

Planned Bill of Legislation to amend the Act on Financial Undertakings (CRD IV and CRR)

The Althingi spring session aims to finalise the transposition into Icelandic law 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 to codify Regulation (EU) No. 575/2013, on prudential requirements for credit institutions and investment firms (CRR). CRD IV will be transposed as amended under Directive 2019/878/EU. CRR in its entirety will be transposed into Icelandic law with reference to its publication in the EEA Appendix of the Official Journal of the European Union and concomitantly repealing current provisions of the Act on Financial Undertakings that set forth CRR content and the Regulation on Prudential Requirements for the Operation of Financial Undertakings.

Amendment of the Act on Recovery and Resolution of Credit Institutions and Investment Firms

The spring session of Althingi proposes to transpose the remaining provisions of Directive (EU) 2014/59 (BRRD) and determine the funding of a Resolution Fund with an Act amending the Act on Recovery and Resolution of Credit Institutions and Investment Firms No. 70/2020. With provisions for a Resolution Fund and its funding, fee collection for the deposit division of the Depositors' and Investors' Guarantee Fund (TIF) will cease, as TIF's role changed under Act No. 70/2020 and other improvements to the financial market.

Regulation on money-market funds that provide short-term finance to financial institutions, corporations and governments (Money Market Funds)

The intention is to transpose Regulation (EU) 2017/1131, which provides for short-term finance to financial institutions, corporations and governments, in the last quarter of 2022. Expected rules include licensing of money market funds (MMFs), their investment strategies, MMF types, valuation of MMF assets and risk management.

Act on Payment Accounts

A new Bill of Legislation for payment accounts is expected to be presented to the current session of Althingi. The law would transpose Directive 2014/92/EU, on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features (Payment Accounts Directive, PAD), into Icelandic law. Codification of the Bill would ensure access by all legal long-term residents of Iceland to payment accounts with basic features. It will be made easier for consumers to switch payment accounts and public access to information about fees related to payment accounts will be improved, through such measures as a web portal to compare fees related to payment accounts. The new law would increase the obligations of credit institutions to ensure these consumer rights.

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Remuneration Report

9.1 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.

9.2 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 comprised 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.

The Remuneration Committee members are Chairman of the board, which is also the Chairman of the Remuneration Committee, Vice-Chairman of the board and one other board member. During 2021 the Remuneration Committee held 6 meetings. The Committee reviewed the remuneration policy prior to the 2021 annual meeting and made no significant changes.

9.3 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 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 3 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.

Table 9.1: Remuneration by business area in ISK million

	Personal banking	Corporate banking	Asset management & Capital Markets	Treasury & Market Making	Support functions	Total
Total remuneration	3,867	1,726	1,326	250	7,590	14,759
- of which variable remuneration	0	0	0	0	0	0

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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 2021, 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 2021, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2021. There may be some discrepancy between financial information in the Consolidated Financial Statement 2021 and information in the Risk and Capital Management 2021, 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.