

Conclusions of the Supervisory Review and Evaluation Process at Arion Bank hf.

The Financial Supervisory Authority (FME) evaluates risk factors in the operations of financial institutions in the Supervisory Review and Evaluation Process (SREP) and assesses how financial institutions handle these risk factors in their operations, cf. the Financial Undertakings Act No. 161/2002. Such an assessment is performed annually at institutions considered systemically important.

The process evaluates factors such as business model, corporate governance, credit and concentration risk, market risk, operational risk, liquidity and funding risk and stress testing. When evaluating these risk factors, the FME uses the *Common Criteria and Methodologies for SREP* which are based on the European Banking Association's (EBA) guidelines on the same subject.

SREP reveals to what extent the measures taken by a financial institution in respect of risk factors are adequate, whether management is reliable and whether the capital base is sufficient with respect to the risks inherent in the activities. On the basis of SREP, the FME is authorized, amongst other things, to prescribe a higher capital ratio than the statutory minimum of 8%, improvements to internal processes, the impairment of assets when calculating the capital base, restrictions or limits to the activities of the financial institution or the reduction of the risks factors associated with activities. The FME can also make various critical comments and recommendations during the process.

Arion Bank submitted its capital adequacy assessment as of 31 December 2018, in the form of an ICAAP/ILAAP report, to the FME in March 2019. The FME sent the Bank its draft conclusions of the SREP in July 2019, where the Bank was given the opportunity to express its views, cf. Section IV of the Administrative Procedures Act No. 37/1993. The response of the Bank was received in August 2019. The FME has now completed SREP and sent Arion Bank a letter containing its conclusions in September 2019.

FME's additional capital requirement for Arion Bank hf. (Pillar II-R)

The main conclusion of SREP was that from 30 September 2019 Arion Bank should maintain an additional capital requirement of 3.1% of risk-weighted assets. The additional requirement is in respect of credit-, counterparty- and concentration risk, and the risk associated with subsidiaries and legal risk, which is not adequately taken into consideration when calculating the minimum capital requirement (Pillar I). The additional requirement is divided so that CET1 capital shall be a minimum of 1.7% of risk-weighted assets and tier 1 capital shall be a minimum of 2.3% of risk-weighted assets¹.

The FME's additional capital requirement is in addition to the minimum capital requirement and capital buffers:

- Minimum capital requirement (pillar I) is 8% of risk-weighted assets. The requirement is divided so that CET1 capital shall be a minimum of 4.5% of risk-weighted assets and tier 1 capital shall be a minimum of 6% of risk-weighted assets².
- The combined capital buffer requirement is 8.9% of risk-weighted assets and it shall be met entirely with CET1 capital. The combined capital buffer requirement takes into account the

¹ Cf. Article 86 g (4.a) and 86 g (7) of the Financial Undertakings Act No. 161/2002

² Cf. Article 84 (1) of the Financial Undertakings Act No. 161/2002

domestic/foreign composition of risk-weighted assets, which differs between banks. Based on the 0.25 percentage point increase in the countercyclical capital buffer on 1 February 2020, the combined buffer requirement will be 9.2%, all other things being equal. The FME recommends that Arion Bank maintain capital in accordance with the proposed increase in the countercyclical capital buffer³.

The FME's overall capital requirement for Arion Bank hf, on a parent and group level, is therefore 20% of risk-weighted assets and comprises the minimum capital requirement, the FME's additional capital requirement and capital buffers. The FME's overall capital requirement for Arion Bank hf., on a parent level, is 19.9% net of capital requirements for subsidiaries.

The FME has informed Arion Bank hf. that when assessing capital requirement, it is necessary to examine events which could potentially occur at a later date. The board of directors of Arion Bank therefore needs to ensure that the Bank is able to continue normal lending activities, including during economic downturns, and that the Bank's funding is structured in such a way that it facilitates the Bank's access to the financial markets in challenging conditions.

Critical comments and demands for corrective action

The FME made the following critical comments to Arion Bank hf. and requested that appropriate corrective action be taken.

- The FME made critical comments concerning the Bank's *conflict of interest policy*, inter alia concerning the recording of ongoing and occasional conflicts of interest in the Bank's general operations, and concerning the board of directors and employees, and the documentation of the response on each occasion. The FME requests that the Bank review and update its policy and procedure for conflicts of interest.
- The FME made a critical comment of the fact that the Bank's IT Policy was neither regularly updated on a formal basis, nor submitted to the board for approval. The FME requests that this be addressed.

³ See also decisions on capital buffers on the FME's website:
<https://www.fme.is/eftirlitsstarfsemi/fjarmalastodugleiki/eiginfjaraukar/>