Risk and Capital Management 2022

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Landsbankinn hf. Pillar III risk report
31.12.2022

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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1 Introduction

Introduction

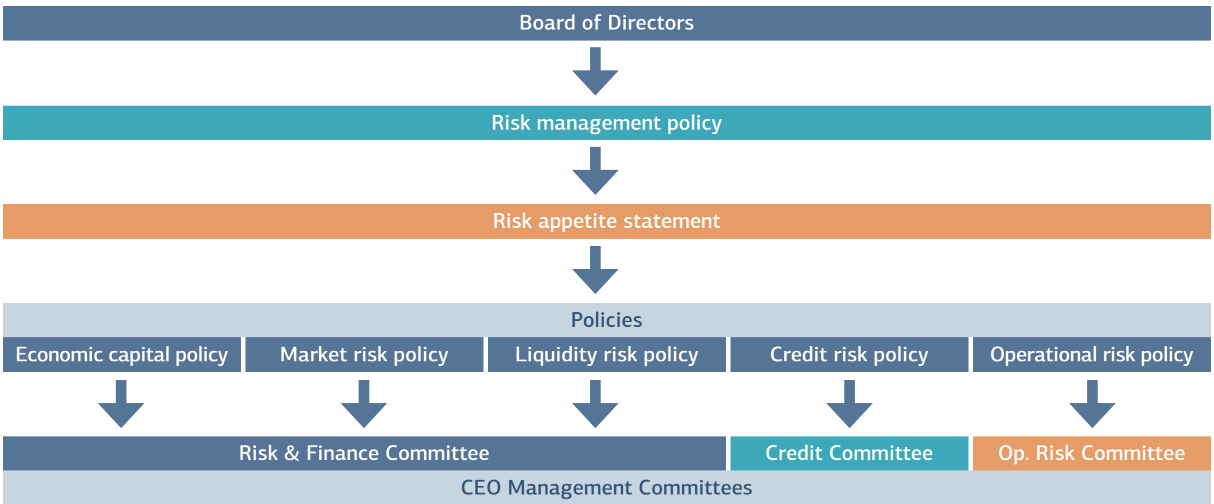
1.1 Declaration of the Board

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. 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 operation 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 market.

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.

Figure 1.1: Risk policy structure



1.2 Risk statement

The following statement has been approved by the Board of Directors and describes the Bank's overall risk profile. For key ratios and figures refer to section 1.7 in this chapter, and for the interaction of the Bank's risk profile with risk tolerances set by the Board via the Bank's risk appetite, refer to section 2.4.

1.2.1 Capital position

The Bank's capital position remains strong. The total capital ratio (TCR) decreased by 1.9 percentage points in 2022 and was 24.7% 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 3.4% is based on the FSA's 2021 Supervisory Review and Evaluation Process (SREP). In September 2022, the Central

Bank of Iceland (CBI) raised the countercyclical capital buffer from 0% to 2%, and thus the total capital buffer requirement was 9.3% at year-end 2022. Taking capital buffers into account, the total capital requirement for the Bank was 20.7%. As the Bank's management has set a capital target of $\geq$22%, there is an implied management buffer of 1.3% and, as a result, excess capital of 2.7%, or ISK 32 billion.

The Bank's risk-weighted exposure amount (RWEA) was ISK 1,188 billion at year-end 2022 and increased by ISK 44 billion, or 3.9%, for the year. The increase was primarily due to lending growth. Credit risk remains the single largest risk factor, amounting to 90% of total RWEA.

The Bank measures internal capital requirements by economic capital (EC) for all material risks with regard to RWEA. The internal assessment of EC decreased slightly in 2022, to ISK 103 billion at year end. The ratio to RWEA decreased by 0.5 percentage points to 8.6% at year end.

1.2.2 Credit risk

Key risk metrics for credit risk were all within with the Bank's risk appetite at year-end 2022. Most measures developed positively in 2022 as average PD values decreased and average LGD values remained low and stable. The ratio of carrying amount of loans in default was only 1.0% at year-end 2022 as the default rate remains historically low. The ratio of loans in stage 2 and loans with active forbearance measures also decreased in 2022.

This had a positive effect on impairment in 2022 and led to a slight decrease in economic capital, despite an 11% growth in the loan portfolio. Negative changes in the fair value of equities in the banking book affected the Bank's income statement in 2022, as well as lowering the economic capital for credit risk.

Mortgage lending to individuals grew by 9% in 2022, with most of the growth occurring in the first half of the year. Customers have increasingly chosen fixed-rate mortgages as interest rates rose sharply in 2022 in line with rising policy rates. At year-end 2022, 75% of mortgages were non-indexed, 56% thereof carried fixed rates. Most of these loans will be subject to repricing of interest rates in the latter half of 2024 and first half of 2025. Rising interest rates can cause financial difficulties for some customers, especially if interest rates continue to increase or remain high for the next 2-3 years. Credit quality in the mortgage portfolio remains strong as shown by a low ratio of loans past due and a low default rate. Average PD and LGD values are stable and show strong credit quality in line with the Bank's risk appetite.

Loans to corporates grew by 13% in 2022 after limited growth in the past years. New lending is in line with the Bank's risk appetite and is fairly distributed across sectors. Credit risk decreased in the corporate portfolio in 2022 as indicated by a decrease in weighted average PD. Lower PD is largely due to positive rating migration as many customers have resumed regular payments and expiration of moratoria measures applied in 2020 and 2021 due to the pandemic. As most loans to corporates have variable interest rates, increasing interest rates in 2022 have had an effect. As lending growth has been low in the past couple of years, the indebtedness of corporates has generally not increased significantly in a lower interest rate environment. Because of this, rising interest rates are not a significant concern for credit risk in the corporate loan portfolio in the short term. Decreasing inflation, stabilising and lowering interest rates and continued economic growth will be important factors in the development of credit risk going forward.

Concentration risk decreased in 2022 as economic capital decreased alongside risk metrics for concentration risk. The ratio of large exposures to Tier 1 capital was 32.3% at year-end 2022 (2021: 33.1%), well within the limits of the Bank's risk appetite and the ratio of the 20 largest exposures to total exposure also decreased.

1.2.3 Market risk

The Bank's total market risk increased in 2022 due to challenging market conditions. Net FX balance increased over the year and remained long from second quarter. Exposure in the equity trading book was lower at year-end 2022 than year-end 2021 but interest rate risk in the trading book increased due to higher exposure. Despite increased market risk and a turnaround in market conditions from last year, the Bank's market risk remains well within its risk appetite, and was 1.7% of total RWEA at year-end 2022. The Bank's total CPI indexation balance amounted to ISK 8 billion at year-end 2022, or 3% of total equity, as compared to ISK 5 billion at year-end 2021.

1.2.4 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 liquidity coverage ratio (LCR) at year-end 2022 was 134%, LCR ISK was 99% and 351% in foreign currencies, well above regulatory requirements and the Bank's internal limits. The Bank's total net stable funding ratio was 117% (132% in foreign currencies), above regulatory limits and the Bank's risk appetite.

The Bank's funding rests on three main pillars; equity, deposits from customers and funding 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. Deposits are the Bank's largest source of funding. Deposits increased by 68 billion in 2022 and amounted to ISK 968 billion at year end. Inflation-linked deposits amounted to ISK 160 billion at year-end 2022, increasing by ISK 25 billion from previous year.

In January 2022, the Bank issued bonds under the Bank's EMTN programme. The issuance was comprised of 3-year bonds amounting to SEK 850 million, 2-year bonds amounting to SEK 850 million and 3-year bonds amounting to NOK 500 million. In addition, the Bank issued 2-year bonds amounting to NOK 300 million and 3-year bonds amounting to NOK 350 million in August. At year-end 2022, total bond issuance in foreign currency amounted to ISK 236 billion, decreasing by ISK 13 billion during the year. The size of the programme for covered bond issuance was EUR 2.5 billion (ISK 380 billion) at year-end 2022 and increased from ISK 250 billion in 2022. The programme has been updated to allow for issuance in other currencies than Icelandic króna. At year-end 2022, outstanding covered bonds issuance amounted to ISK 223 billion, increasing by ISK 5 billion during the year. Subordinated bond issuance under the Bank's debt issuance programme remained unchanged between years, amounted to ISK 5.5 billion at year-end 2022 and subordinated issuance under the Bank's EMTN programme amounted to EUR 100 million at the same time.

The Bank's credit rating has remained unchanged since April 2020, at BBB/A-2 and with continuing stable outlook, confirmed in the latest rating report by S&P Global Ratings in July 2022. The Bank's covered bond program has been rated by S&P Global Ratings since January 2021. In May 2022, the covered bond rating was raised to A.

1.2.5 Operational risk

In 2022, there was a slight uptick in the number of operational incidents. There were no major operational incidents and the operational risk profile remains stable. The war in Ukraine has not impacted the Bank directly but has led to a review of the Bank's crisis response plans and has prompted a review of Iceland's dependency on the undersea cables connecting the country to the internet. The trend over the last few years of increased attempts of fraud and cybercrime targeting the Bank's customers continues. International cooperation, such as Nordic Financial CERT, continues to be an integral part of fighting cybercrime along with the support of the Icelandic CERT-IS. Part of the Bank's response to cybercrime has been the implementation of strong customer authentication in line with legal requirements and customer protection, as well as continued training and education. One of the main pillars of the Bank's control of operational risk and security of information assets is continued ISO 27001 certification. In 2022, the Bank was recertified in accordance with the standard for the 15th time.

1.2.6 Economic outlook

Preliminary figures from Statistics Iceland show that gross domestic product grew by 7.3% in the third quarter as compared to the same quarter last year. This is the sixth quarter in a row of economic growth post-COVID. As before, economic growth was driven by a strong growth in tourism. Landsbankinn Economic Research expects final figures for economic growth in 2022 to be around 6.5% and forecasts continued growth in 2023, or 2.1%.

Inflation has been above the Central Bank's inflation target since May 2020. The consumer price index (CPI) increased by 0.66% between months in December and inflation was 9.6% at year end. Inflation was 5.1% a year ago and has increased by 4.5 percentage points in the span of one year. The annual average inflation rate in 2022 was 8.3%, compared to 4.5% in 2021. The outlook is for above-target inflation for all of 2023, 2024 and 2025.

The Monetary Policy Committee of the Central Bank began a rate hike cycle in May 2021 and has since raised its key interest rate from 0.75% to 6.0%. Landsbankinn Economic Research expects that the Central Bank will maintain high policy rates and that rate cuts will not begin until possibly in the second half of 2023.

Unemployment has trended downwards since it reached its pandemic heights in January 2021. The rate had fallen to 3.4% at year-end 2022, 8.2 percentage points below its January 2021 level of 11.6%. Wages grew by 8.3% in 2022 but purchasing power remained unchanged. Private consumption increased a great deal in 2022, driven among other factors by Icelanders travelling abroad. Consumption growth is expected to slow down in 2023.

1.3 Regulatory background

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 2022, 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.

1.4 Disclaimer

This report is presented solely to explain the basis for preparation and disclosure of certain capital requirements and provide information about the management of certain risks. The report does not constitute any form of audited financial statement. The information it contains should not form the basis for any judgements about the Bank. The disclosures herein 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. For further information, see Note No. 82.1 – Consolidation in the Bank's Consolidated Financial Statements for 2022 and Template EU LI3 in the Pillar III additional disclosures.

This publication, Risk and Capital Management 2022, has not been audited by external auditors. It does include information from the audited Consolidated Financial Statements 2022 and has been verified internally and approved by the Board of Directors. This publication has also been presented to and reviewed by the Board's Risk Committee. There may be some discrepancies between this report and financial information in the Consolidated Financial Statements 2022, 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.

All amounts are in ISK million unless otherwise stated.

1.5 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.

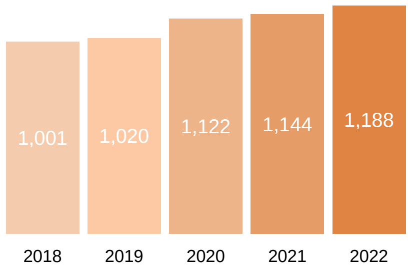
The disclosures are published annually on the Bank's website.

1.6 Additional disclosures

Additional Pillar III disclosures required under CRR are included as an appendix to this report in the form of a spreadsheet. Table 10.1 in the appendix to this report lists the relevant templates included in the additional disclosures. The additional disclosures can be downloaded here: https://corporate.landsbankinn.com/en/the-bank/investor-relations/reports-and-financials.

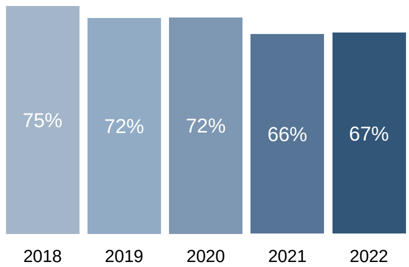
1.7 Risk metrics overview

Risk-weighted exposure amount (RWEA)



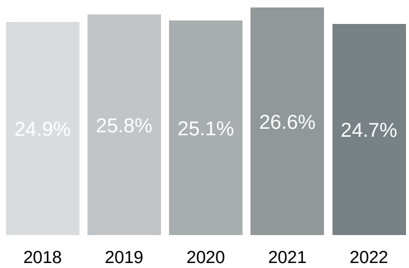
1,188 ISK bn

RWEA to total assets



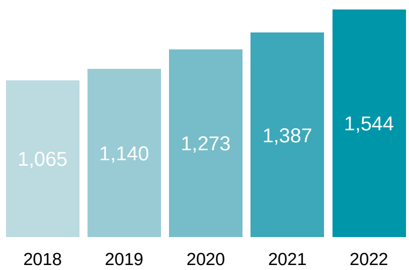
67%

Total capital ratio



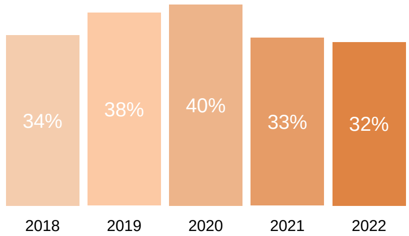
24.7%

Loans and advances to customers



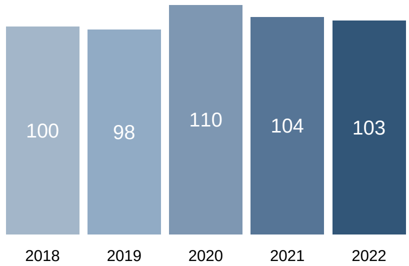
1,544 ISK bn

Large exposures to tier 1 capital*



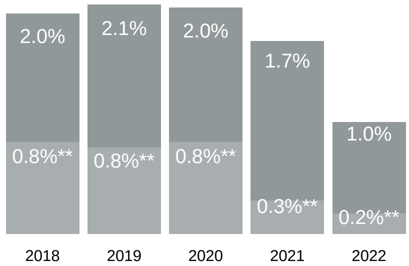
32%

Economic capital



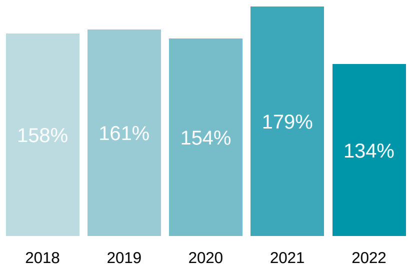
103 ISK bn

Stage 3 loans



1.0%

Liquidity coverage ratio total



134%

* Up to and including 2020, large exposures were measured as a % of eligible capital.
** Of which 90 days past due.

2 Risk management

Risk management

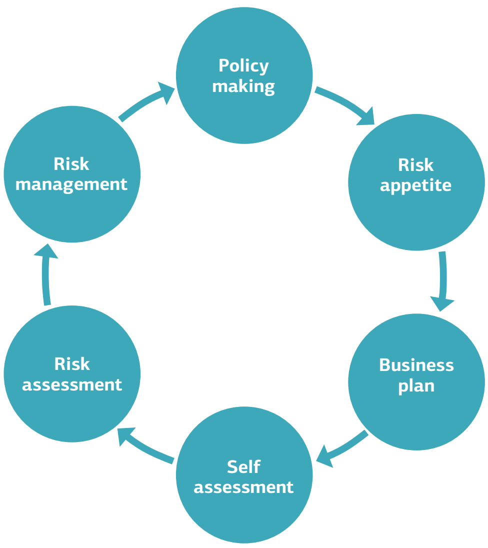
Risk management involves the identification, assessment and control of risk in the Bank's operation. The Bank adopts detailed risk rules and develops an effective internal governance structure to ensure a clear division of responsibility, management of risks and compliance to internal and external rules and regulations.

All pertinent risks in the operation are considered, both financial and non-financial. The Bank's management structure defines authorisations regarding decision making, risk taking, follow-up and monitoring.

The Board of Directors approves the Bank's risk appetite, which defines target levels for risk in the Bank's operation and is utilised for the management of risk taking within the Bank. Risk appetite shall be reviewed at least annually, or as needed, so that it reflects the Bank's targets regarding risk taking at any given time.

Risk management entails a process in which the Bank's risk appetite and business plan are intertwined. That process includes self assessment and risk assessment which are followed by further analysis and management of risk. The Bank's strategic planning takes risk appetite and risk management into account, making risk policy an integral part of its operation. Risk management is an ongoing process, the implementation of which is an integral part of a sound risk culture.

Figure 2.1: Risk management process



2.1 Risk policy

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, high asset quality, 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 minimise and contain reputational risk.

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 organisation.

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

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.

For each of these risk factors, several material risk subfactors are defined. There are also several risk factors, such as ESG risk and conduct risk, that can act as amplifiers on one or more of the Bank's material risk factors. These are covered in detail in the subsequent chapters.

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 Directors. 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 2022 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.

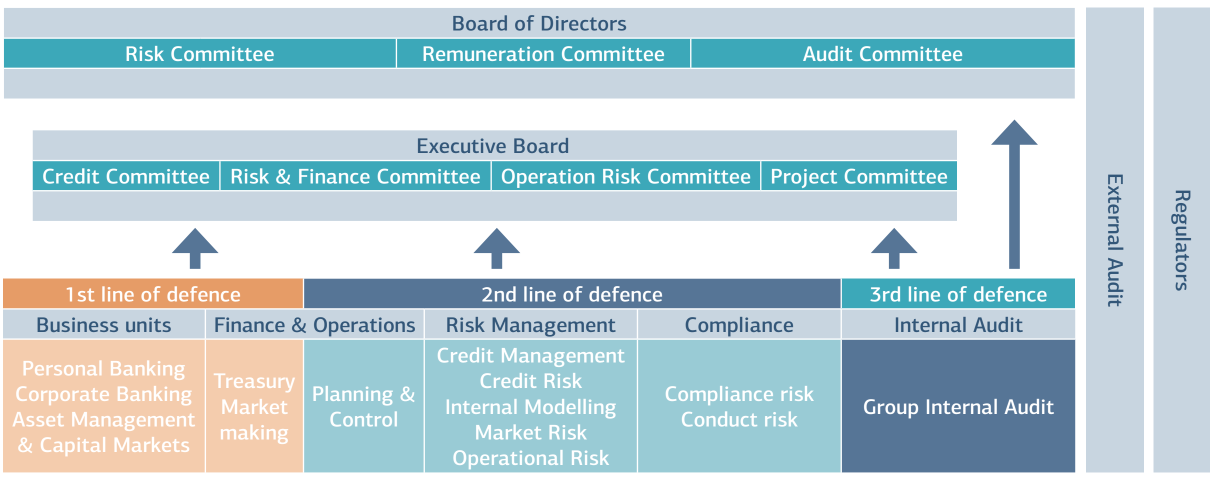
The Board assesses its need for sub-committees at the Board level, according to legal requirements and the size and scope of the Bank at each time, as well as the composition of the Board. The Bank's corporate governance statement is required to provide information on the establishment and appointment 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, supervise the audit of the Bank's financial statements as well as any additional tasks performed by the external auditors.

Figure 2.2: Risk management governance structure



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's main role is to prepare an ongoing 3-year business plan in line with the Bank's strategic objectives and ensure that targets are met, 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 approve lending and ensure that the Bank's loan portfolio and credit risk remain in compliance with its credit risk policy and risk appetite. The Committee makes individual credit decisions, credit limits for customers, credit quality and large exposures, among other things.

The Risk & Finance Committee primarily reviews market and liquidity risk and is responsible for formulating risk limits for these factors for the Bank. 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 makes decisions on operational risk issues and reviews 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 Managing directors

Managing directors are responsible for the implementation of risk appetite and risk culture in their units based on the Bank's risk policy and business plan. Managers are responsible for risk-taking and risk management and for ensuring that risk within their units is assessed and measured, and information escalated to the relevant parties. Managers shall contribute to the development and maintenance of a healthy risk culture in their units, present the risk policy and ensure that employees are familiar with the rules that apply to their duties.

2.3.3 Risk Management

Risk Management is responsible for measuring, monitoring and reporting on all 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 2022:

- Credit Management reviews and approves 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 assessment, 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.

2.3.4 Compliance

Compliance is an independent control function which reports directly to the CEO and operates in accordance with a letter of appointment from the Board of Directors.

Compliance is part of the Bank's second level control and is responsible for monitoring compliance and coordinating measures against money laundering and terrorist financing and personal data processing.

Compliance informs management on the impact of regulatory changes on the Bank's operations, and advises on actions necessary to ensure that the Bank operates in accordance with regulatory requirements and proper and sound business practices.

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

2.3.5 Internal Audit

Internal Audit is an independent, objective assurance and consulting activity that is a part of the Bank's organisational chart and an element of its 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).

2.3.6 General staff

All employees are responsible for carrying out their duties in accordance with external laws and rules, risk appetite, risk policy, rules and the Bank's procedures and ensure compliance with them at all times. Employees shall report any suspected breaches to their superior. Employees need to be familiar with the purpose and nature of the control measures they carry out. They must be mindful of the proper functionality of control measures and inform management should they consider control measures insufficient or control inadequate to support the Bank's objectives.

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.

The Bank's risk appetite for 2022 has been reviewed, revised and implemented. Table 2.4 lists the risk appetite metrics, year-end values for the past three years and the status of the metrics in relation to tolerance levels set by the Board. A green status indicates that the value is in line with tolerance levels, yellow status indicates that the value is outside tolerance levels but within external limits and red

Table 2.4: Overview of risk appetite metrics

Risk category	Risk type	Metric	31.12.2022	31.12.2021	31.12.2020
Credit risk	Credit quality	Expected loss (% of total loans)	0.3%	0.4%	0.5%
		Probability of default	1.8%	2.2%	2.9%
	Single name concentration	Large exposures (% of Tier 1 capital)*	32.3%	33.1%	39.6%
Market risk	Market risk	Total market risk (% of RWEA)	1.7%	0.9%	1.0%
Liquidity risk	Liquidity risk	Liquidity coverage ratio - Total	133.6%	178.8%	154.2%
		Liquidity coverage ratio - FX	351.0%	555.8%	424.0%
		Liquidity coverage ratio - ISK	99.2%	120.1%	104.8%
Funding risk	Funding	Net stable funding ratio - Total	116.6%	121.0%	116.5%
Capital risk	Capital adequacy ratio	Capital adequacy ratio	24.7%	26.6%	25.1%
Profitability	Profitability	Return on equity after taxes	6.3%	10.8%	4.3%
Operational risk	Change in RWEA	12-month change in RWEA	-5.3%	-2.8%	6.4%

*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 31.12.2022, the largest exposure is well below that goal. External regulation mandates a ratio of <25%.

status indicates that the value is outside of external limits. 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 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.

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.

Figure 2.3: Overview of risk reporting within the Bank

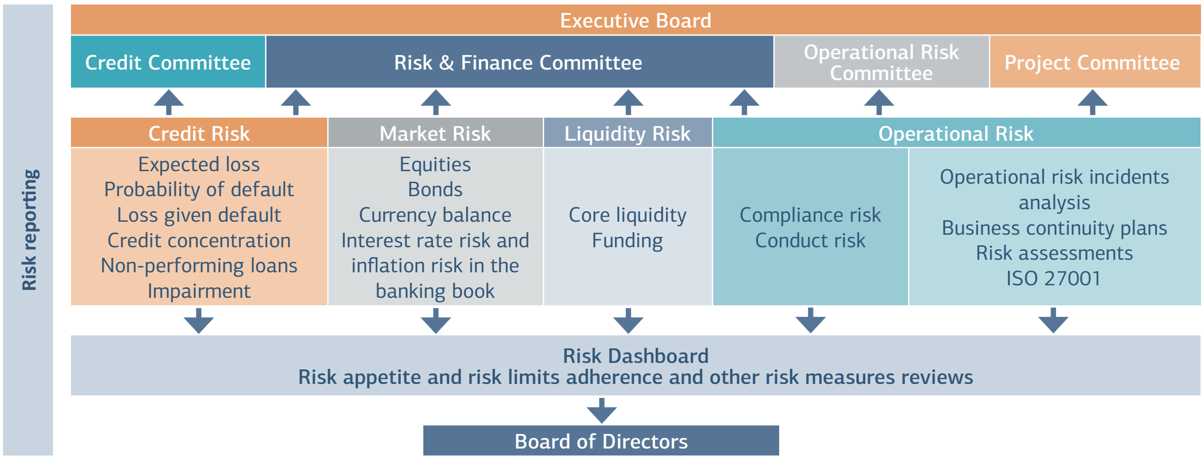


Table 2.5: Principal reporting to the Board of Directors

Annual	
Risk and capital management report	Pillar III disclosures.
ICAAP/ILAAP report	Evaluation of the risk profile and solvency need. The report contains conclusions drawn from stress testing, including the effect of various scenarios on expected losses and capital needs. The ICAAP/ILAAP report is subject to the FSA's Supervisory Review and Evaluation Process (SREP).
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.
Semi-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

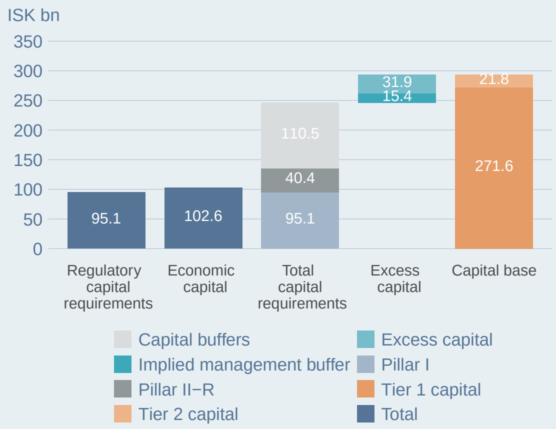
3 Capital management

Capital management

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

- The Bank's total capital ratio decreased by 1.9 percentage points in 2022 to 24.7%.
- A regular and special dividend payment of ISK 0.87 per share in the total amount of ISK 20.6 billion were made in 2022.
- The overall economic capital decreased and the risk-weighted exposure amount increased in 2022, resulting in an EC/RWEA ratio of 8.6% at year end.
- Compared to the most recent SREP requirement of 20.7%, and an implied management buffer of 1.3%, the Bank's excess capital was 2.7 percentage points or ISK 32 billion.

Capital position as at 31.12.2022



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 2022 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. 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. The Division is also responsible for the Bank's recovery plan which is to ensure that banks are prepared to restore their viability in a timely manner even in periods of severe financial stress.

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, the Pillar III risk report and the ICAAP and ILAAP report.

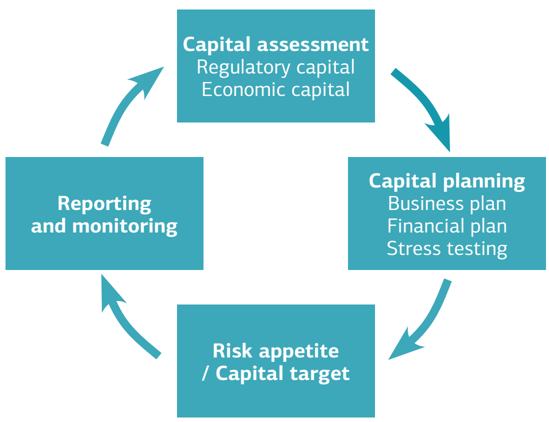
Managing directors of income-generating divisions

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 by 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 exceed 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, MREL requirements, regulatory capital buffers, the management capital buffer, risk appetite, and strategic objectives are considered. The Bank's aim is to maintain a capital ratio above the CBI'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 of ISK 14.4 billion and a special dividend of ISK 6.1 billion in 2022.

When determining the amount of dividend payments, the Board needs to maintain the Bank's strong financial position. The Board needs to consider internal and external risk, growth prospects and the maintenance of a long-term, robust equity and liquidity position, as well as compliance with regulatory requirements.

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 CBI. 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 CBI, are shown in Table 3.1 (%/RWEA).

Table 3.1: Capital requirement

31.12.2022	**CET1**	**Tier 1**	**Total**
Pillar I	4.5%	6.0%	8.0%
Pillar II-R	1.9%	2.6%	3.4%
Minimum requirement under Pillar I and Pillar II-R	**6.4%**	**8.6%**	**11.4%**
Systemic risk buffer	2.9%	2.9%	2.9%
Capital buffer for systematically important financial institutions	2.0%	2.0%	2.0%
Countercyclical capital buffer	1.9%	1.9%	1.9%
Capital conservation buffer	2.5%	2.5%	2.5%
Combined buffer requirement	**9.3%**	**9.3%**	**9.3%**
Total capital requirement	**15.7%**	**17.9%**	**20.7%**

Table 3.2: SREP results

		2022 % RWEA	2021 % RWEA
Pillar I	Credit risk	7.2%	7.0%
	Market risk	0.1%	0.3%
	Operational risk	0.7%	0.7%
	Minimum capital requirement	**8.0%**	**8.0%**
Pillar II	Credit, counterparty and concentration risk	1.8%	1.6%
	Market risk and IRRBB	1.4%	1.7%
	Other risk	0.2%	0.2%
	Additional P-II R	**3.4%**	**3.5%**
	Additional P-II G	**0.0%**	**0.0%**
	Minimum requirement under Pillar I and Pillar II-R	**11.4%**	**11.5%**

The capital requirement of 20.7% is based on the outcome of the CBI's 2022 SREP, and includes the latest decisions on capital buffer requirements. The Pillar II-R requirement decreased from 3.5% to 3.4% between the 2021 and 2022 SREP and the Pillar II-G remained at 0%. Table 3.2 shows the results of the 2022 SREP compared to 2021.

The Bank's capital target is based on the current regulatory capital requirement of 15.7% CET1 and 20.7% 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 20.7% TCR requirement, the Bank's current implied management buffer is 1.3%. The total capital ratio at year-end 2022 was 24.7%, hence the implied Bank's excess capital was 2.7% of RWEA, or ISK 32 billion.

Table 3.3: Capital ratio

	Target	2022	2021	2020	Comment
Total capital ratio	$\geq$22.0%	24.7%	26.6%	25.1%	Long-term goal
Common equity Tier 1	$\geq$18.0%	22.9%	24.8%	23.2%	Long-term goal
Dividend pay-out ratio	Around 50%	71%	43%	0%	The target dividend pay-out ratio is around 50% of the previous year's profit.

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 (FSC) for SIFIs was 9.5% of RWEA at year-end 2022.

In September 2021, the FSC announced its intention to raise the countercyclical buffer from 0% to 2.0% at the end of September 2022. The FSC confirmed this on 29 September 2022, grounding its decision on increased external uncertainty and the importance of maintaining the resilience of the Icelandic financial system. In a statement released in December 2022, the FSC announced its decision to hold the O-SII buffer at 2%, stating that the systemically important banks in Iceland are highly resilient with strong capital and liquidity ratios and well prepared to respond to external economic shocks and support households and business.

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 2.9% 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. The buffer is currently 2% in Iceland; taking into account the countercyclical buffers for foreign exposures, the effective buffer was 1.9% at year-end 2022. 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

	2022	2021
Domestic RWEA	96%	96%
Foreign RWEA	4%	4%
Total	100%	100%

The effective total regulatory capital buffer for the Bank at year-end 2022 was 9.3% of consolidated RWEA. In addition, and as previously mentioned, the Bank has set an implied minimum management buffer of 1.3%, bringing total capital buffers at year-end up to 10.6%.

Table 3.5: Regulatory capital buffers

	1.2.2020	19.3.2020	29.9.2022	Effective capital buffers at year-end 2022
Systemic risk buffer	3.00%	3.00%	3.00%	2.90%
O-SII buffer	2.00%	2.00%	2.00%	2.00%
Countercyclical buffer	2.00%	0.00%	2.00%	1.90%
Capital conservation buffer	2.50%	2.50%	2.50%	2.50%
Combined capital buffer requirement	**9.50%**	**7.50%**	**9.50%**	**9.30%**

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

	31.12.2022	31.12.2021
Share capital	23,621	23,621
Share premium	120,593	120,594
Reserve	11,986	23,591
Retained earnings	122,891	114,839
Total equity attributable to owners of the Bank	**279,091**	**282,645**
Intangible assets	-10	-14
Deferred tax assets	0	-15
Foreseeable dividends*	-8,498	-
Fair value hedges	320	-758
Adjustment under IFRS 9 transitional arrangements	727	1,674
CET1	**271,630**	**283,532**
Non-controlling interests	0	0
Tier 1 capital	**271,630**	**283,532**
Subordinated liabilities	21,753	20,785
Tier 2 capital	**21,753**	**20,785**
Capital base	**293,383**	**304,317**
Risk exposure amount (RWEA)		
Credit risk	1,071,091	1,032,889
Market risk	19,618	9,909
Operational risk	97,716	101,194
Total RWEA	**1,188,425**	**1,143,992**
CET1 ratio	**22.9%**	**24.8%**
Total capital ratio	**24.7%**	**26.6%**

*The Board of Directors intends to propose to the Annual General Meeting (AGM), scheduled to be held in March 2023, that a dividend amounting to around 50% of the consolidated profit in 2022 will be paid to shareholders. The intended dividend proposal is account for in the calculation of the Bank's capital base as at 31.12.2022, under the line item Foreseeable dividends.

3.3 Capital position

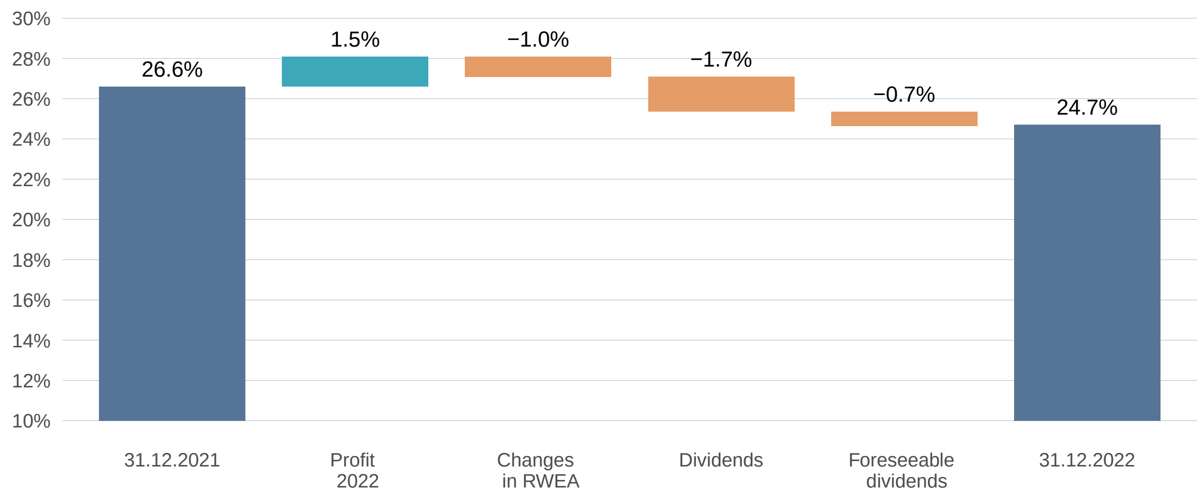
The Bank's equity decreased by ISK 3.6 billion in 2022 and amounted to ISK 279.1 billion (2021: ISK 282.6 billion) at 31 December 2022. The capital adequacy ratio is calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings. The Bank's total capital ratio decreased by 1.9 percentage points in 2022, remaining strong at 24.7% as at 31 December 2022 (2021: 26.6%).

The capital base consists of 22.9% CET1 based on core equity only and 1.8% of Tier 2 capital, with two instruments in the form of subordinated liabilities: first, an EUR 100 million (ISK 15.2 billion) instrument with final maturity in September 2028 but callable in September 2023 and, second, an ISK 5.5 billion fixed-rate inflation-linked instrument (carrying amount ISK 6.5 billion) 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 0.7 billion in 2022 as compared to ISK 1.7 billion in 2021.

Changes in the Bank's total capital ratio for the year 2022 are demonstrated in Figure 3.2.

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



The Board of Directors intends to propose that the Annual General Meeting (AGM) approve a dividend of ISK 8.5 billion, or ISK 0.36 per share, to be paid to shareholders in 2023. The Bank's capital and capital ratio has been reduced by an amount equivalent to the dividend payment as foreseeable dividends in the consolidated financial statements for the year 2022.

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 Chapter 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 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 the original exposure method and for operational risk, it uses the basic indicator approach.

[1] See https://www.althingi.is/lagas/152c/2002161.html

The Bank's risk-weighted exposure amount (RWEA) was ISK 1,188 billion at year-end 2022 and increased by ISK 44 billion, or 3.9%, for the year. Accordingly, the minimum capital requirement for the Bank was ISK 95.1 billion as compared to ISK 91.5 billion at year-end 2021. Credit risk is the single largest risk type or 90.0% of total RWEA and minimum capital requirement.

In 2022, the Bank assessed the potential impact of the implementation of the final Basel III framework on the Bank's RWEA and concluded that the impact will likely lead to a decrease in the Bank's RWEA.

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

	31.12.2022		31.12.2021	
	Pillar I	**RWEA**	**Pillar I**	**RWEA**
Credit risk	85,687	1,071,091	82,631	1,032,889
Market risk	1,569	19,618	793	9,909
Operational risk	7,817	97,716	8,096	101,194
Total capital requirement and RWEA	**95,074**	**1,188,425**	**91,519**	**1,143,993**

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. 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 102.6 billion on 31 December 2022 and decreased by 1.7 billion, or 1.6%, during the year (2021: ISK 104.3 billion). The ratio of EC to RWEA decreased from 9.1% to 8.6% during the year.

Almost 70% of EC is due to credit risk, amounting to ISK 71.7 billion at the end of 2022 (2021: ISK 76.0 billion). EC for the loan portfolio amounted to ISK 65.9 billion and EC for other assets under credit risk was ISK 5.8 billion. Further information on EC for credit risk is in section 4.2.2.

EC for other risk categories than credit risk amounted to ISK 30.9 billion at year-end 2022 (2021: ISK 28.3 billion). EC for market risk and currency risk increased by ISK 3.3 billion, due to market conditions in 2022, exposure in the Bank's trading debt instruments portfolio has increased and net FX balance position has been long for past several months. EC for interest rate risk and inflation risk in the banking book decreased by ISK 0.4 billion. EC for legal and regulatory risk increased from almost negligible in 2021 to 1.8 billion at year-end 2022.

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 the 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 risk 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 concentration 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 in the banking book is calculated according to regulation EBA/RTS/2022/10 and is the largest loss in Economic Value of Equity due to predefined shifts of the interest rate curve in each currency. EC for inflation risk in the banking book is calculated according to the 2020 SREP guidelines from the CBI and is a percentage of net CPI exposure.
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.

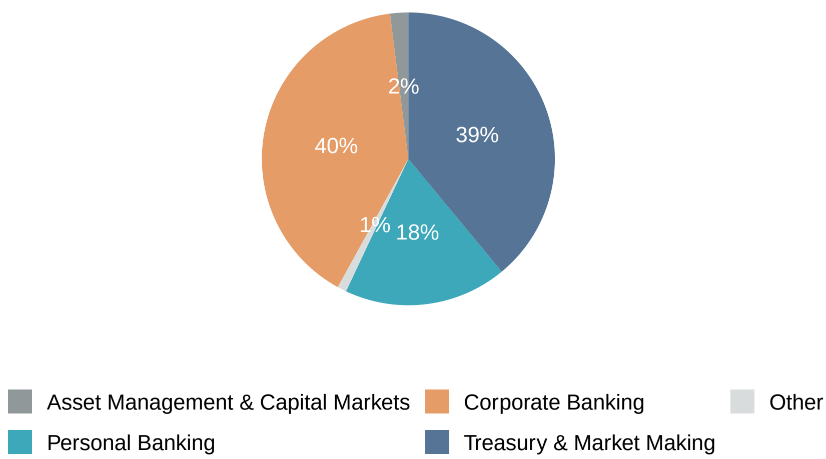
Table 3.9: Economic capital

	2022	2021
Credit risk - Loans to customers and credit institutions	65,881	66,341
Credit risk - Other assets	5,831	9,691
Market risk	2,820	1,670
Currency risk	2,656	540
Operational risk	7,817	8,096
Single name concentration risk	5,739	6,460
Industry concentration risk	0	1,003
Interest rate and inflation risk	10,063	10,489
Business risk	0	0
Legal and political risk	1,773	2
Total	**102,580**	**104,291**
RWEA	1,188,425	1,143,993
EC/RWEA	**8.6%**	**9.1%**

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 2022 is shown in Figure 3.3.

Figure 3.3: Capital allocation per business line 31.12.2022



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 31.12.2022, the Bank's leverage ratio was 14.4%. 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 times the minimum 3% requirement.

Table 3.10: Leverage ratio

	2022	**2021**
Tier 1 capital	271,628	283,533
Leverage exposure		
- On balance sheet exposure (excluding derivatives)	1,772,743	1,711,930
- Derivatives instrument exposure	9,482	8,799
- Securities financing transaction exposures	12,325	21,958
- Off balance sheet exposure	97,338	160,994
- Regulatory adjustments to Tier 1 capital	-7,463	887
Total leverage exposure	**1,884,426**	**1,904,568**
Leverage ratio	**14.4%**	**14.9%**

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 derivative instrument exposures are not significant factors of the Bank's leverage ratio. The risk of excessive leverage is thus not considered a significant risk factor for the Bank. Leverage ratio is nevertheless 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

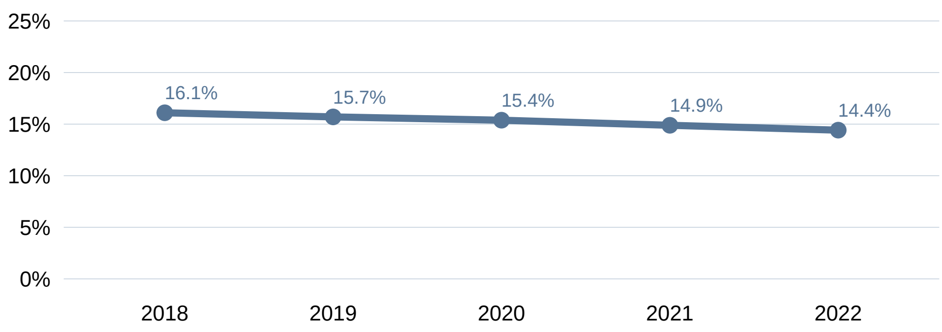
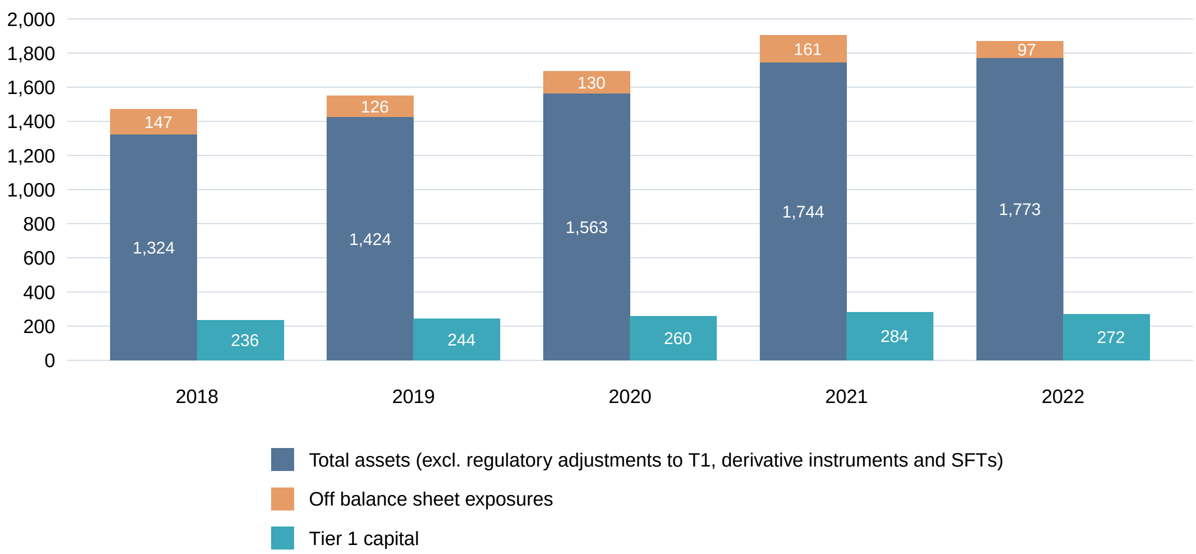


Figure 3.5: Leverage ratio breakdown (ISK bn)



3.6 Minimum requirement for own funds and eligible liabilities (MREL)

Under the Act on Recovery and Resolution of Credit Institutions and Investment Firms, No. 70/2020, companies that fall under the scope of the Act shall at all times satisfy minimum requirements for own funds and eligible liabilities (MREL). On 29 September 2022, the CBI's Resolution Authority announced its latest MREL decision for the Bank. The MREL decision entails that the Bank must satisfy a 22.8% MREL requirement, as a percentage of total risk-weighted exposure amount, which was equivalent to 14.9% of the Bank's total liabilities and own funds (TLOF) at year-end 2021. The Bank must meet the MREL requirement, as a percentage of TLOF, MREL must be met independently of the combined buffer requirement (CBR), which must be fulfilled separately alongside MREL. No specific subordination requirement has yet been implemented into Icelandic law.

The MREL maximum distributable amount (M-MDA) is the maximum amount that the Bank is allowed to distribute via various actions, including dividend payments to shareholders, buy-back of own shares and payments of variable remuneration. These MREL restrictions are in addition to other own funds requirements.

Table 3.11: Minimum requirements for own funds and eligible liabilities (MREL).

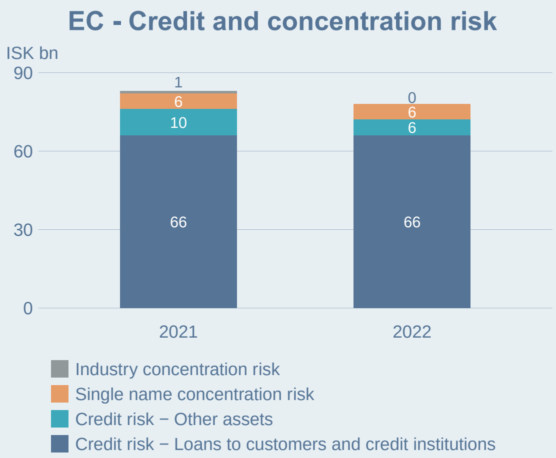
Own funds and eligible liabilities as at 31.12.2022	Amount	Percentage of TLOF	Percentage of RWEA
Common Equity Tier 1 (CET1)	271,628	15.1%	22.9%
Additional Tier 1 capital (AT1)	-	0.0%	0.0%
Tier 2 capital	21,753	1.2%	1.8%
Eligible liabilities	187,114	10.4%	15.7%
Sum of own funds and eligible liabilities	**480,495**	**26.7%**	**40.4%**
Less: Recurring MREL requirement	-268,091	-14.9%	-9.3%
Less: Combined buffer requirement (CBR)	-110,524	-6.1%	-22.6%
Sum of MREL and CBR	**-378,615**	-21.0%	-31.9%
MREL Maximum Distributable Amount (M-MDA)	**101,880**	**5.7%**	**8.6%**

4 Credit risk

Credit risk

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

- Probability of default, weighted by gross carrying amount, decreased to 1.8% at year-end 2022 (2021: 2.1%).
- Economic capital due to credit risk from loans to customers and credit institutions amounted to ISK 71.7 billion at year-end 2022, decreasing by 5.7% from the previous year.
- Total expected credit loss was ISK 10 billion at year-end 2022 (2021: ISK 14 billion).
- Total credit exposure from lending activities increased by 11% in 2022.
- Default rates in the credit portfolio remain at historically low levels.



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 on-going monitoring of the Bank's credit risk position relative to its risk appetite.

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

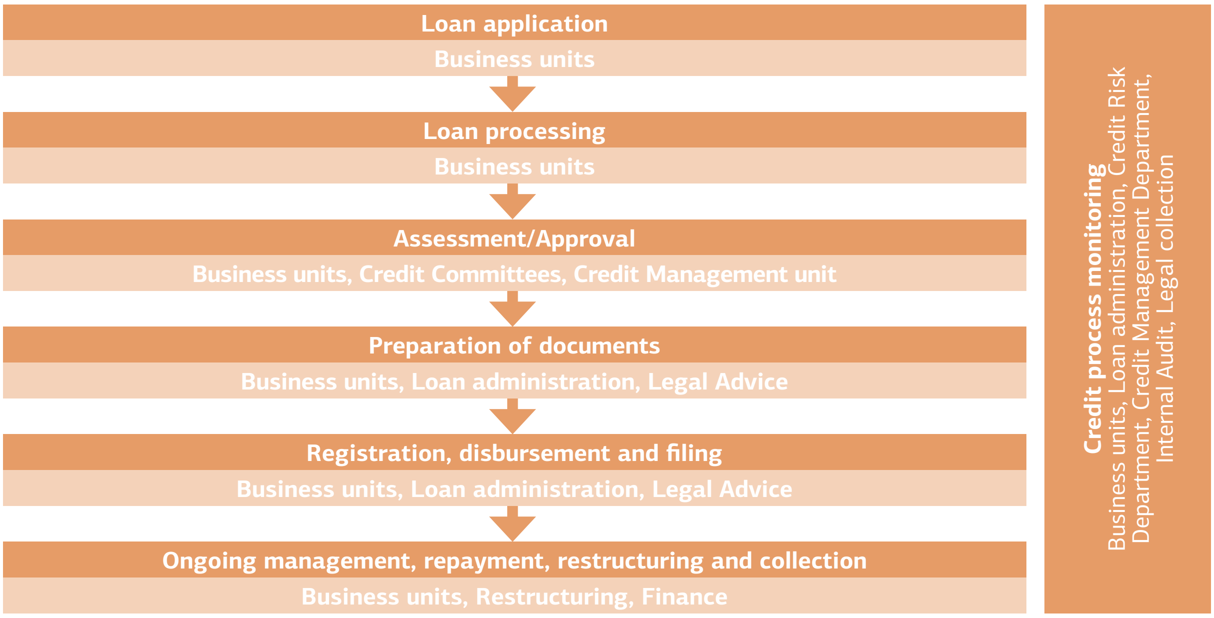
Credit risk is primarily managed through the credit process and the Bank's credit risk models which include PD, LGD and EAD modelling. The models are used for various purposes, such as in provisioning, calculating EC and management reporting.

4.1.1 Identification

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

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

Figure 4.1: The credit process



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 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.

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

The rating assignment and approval is an integrated part of the credit approval process and assignment is updated at least annually, or when material information regarding the obligor or exposure becomes available.

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

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

The 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 risk parameters through adjustments where necessary.

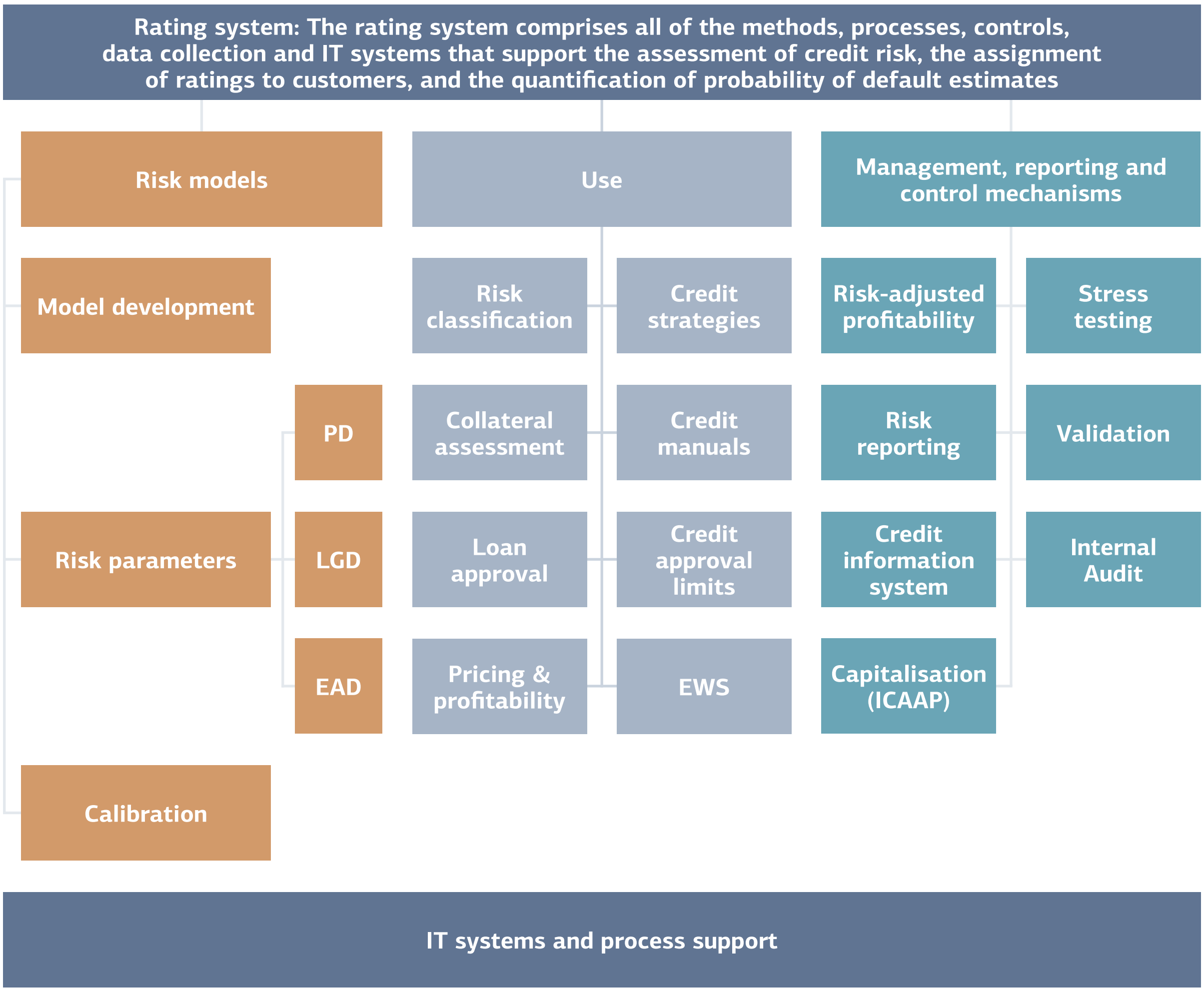
Internal rating models are validated annually, both quantitatively and qualitatively. The quantitative validation includes statistical tests of the models' discriminatory power, i.e. the models' ability to distinguish default risk, and absolute accuracy, i.e. the ability to predict default levels.

The PD parameters are validated annually by a quantitative and qualitative assessment, and re-estimated when the validation deems it necessary. PD estimates are based on long-term observed default frequency in available internal data and adjusted 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 internal 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

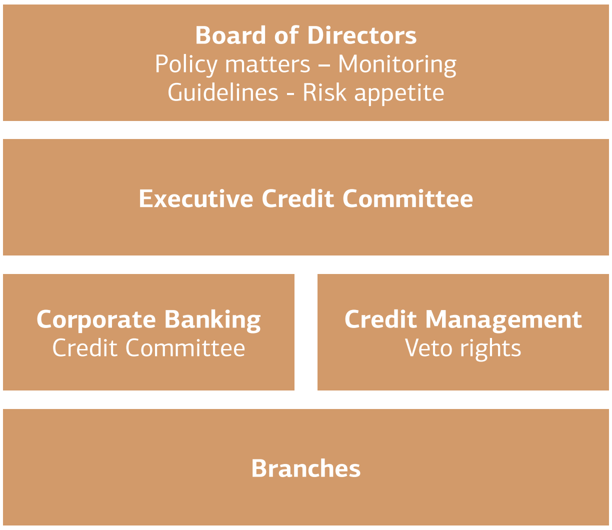
The Bank's credit risk management objective is to ensure compliance with the Bank's credit policy, which entails that the only risk taken is one that the Bank understands, can evaluate, measure and manage.

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, credit policy and industry policies, approved by the Board of Directors, as well as detailed credit policies approved by the CEO. The risk appetite, credit policy and industry policies 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 oversight of the entire process.

Incremental credit authorisation levels are defined based on size of units, types of customers and the lending experience of credit officers. Credit decisions exceeding authorisation levels of business units are subject to approval by Credit Management. The Corporate Banking Credit Committee has authorisation levels exceeding that of individual business unit managers and meets regularly to make credit decisions. Credit Management has veto powers over the decisions of the Corporate Banking Credit

Committee. Credit decisions exceeding the authorisation levels 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.

Figure 4.3: Credit risk management framework



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 Counterparty credit risk

Counterparty credit risk (CCR) is the risk arising from the possibility that the counterparty may default on amounts owned on derivative financial instruments and securities financing.

In order to mitigate this risk, 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. 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.

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.

Information on CCR can be found in templates CCRA and CCR1-CCR6 in the additional disclosures accompanying this report.

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 and the Bank's business units are 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 82.11(g) in the Bank's Annual Financial Statement 2022.

4.2 Credit portfolio

4.2.1 Risk-weighted exposure amount (RWEA)

The Bank's RWEA for credit risk was ISK 1,071 billion at year-end 2022, which is an increase of 3.7% from the previous year. The increase is mostly due to increased corporate and mortgage lending. Table 4.2 shows the RWEA for credit risk at year-end 2021 and 2022, 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.

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

	31.12.2022		**31.12.2021**	
	Pillar I	**RWEA**	**Pillar I**	**RWEA**
Central governments or central banks	3	42	61	768
Regional governments or local authorities	185	2,315	84	1,053
Public sector entities	222	2,781	82	1,024
Institutions	572	7,144	851	10,639
Corporates	46,634	582,922	38,016	475,200
Retail	8,450	105,631	7,611	95,135
Secured by mortgages on immovable property	22,357	279,464	19,850	248,123
Exposures in default	1,486	18,573	1,531	19,140
Items associated with particular high risk	3,720	46,499	11,555	144,435
CIUs	48	597	602	7,519
Equities and equity instruments	60	752	177	2,217
Other items	1,950	24,372	2,211	27,637
Credit risk	**85,687**	**1,071,091**	**82,631**	**1,032,889**

4.2.2 Economic capital

EC for credit risk amounted to ISK 71.7 billion on 31 December 2022 and decreased in 2022 by ISK 4.3 billion, or 5.7% (2021: ISK 76.0 billion). EC for the loan portfolio decreased by ISK 0.5 billion in 2022 while EC for other assets under credit risk decreased by ISK 3.9 billion. The corporate loan portfolio increased by 13%, or ISK 95 billion, and the average PD of the portfolio, weighted by EAD, decreased from 3.0% to 2.2%, leading to a lower EC for the corporate portfolio. The retail loan portfolio increased by 9%, or ISK 65 billion, and the average PD of the portfolio, weighted by EAD, increased slightly from 1.3% to 1.4%. The decrease in EC for other assets under credit risk is mainly due to lower market value of equity in the banking book.

Table 4.3 shows EC for credit risk by counterparty class, as well as total EAD of loans to customers and credit institutions and the weighted average PD and LGD.

Table 4.3: EC for credit risk - loans to customers and credit institutions

Credit risk as at 31 December 2022	**PD**	**LGD**	**EAD**	**EC**
Financial institutions	0.2%	45.0%	27,625	701
Public entities	1.3%	45.0%	10,610	178
Individuals	1.4%	23.4%	796,006	17,301
Corporates	2.2%	32.2%	858,128	47,701
Total	**1.8%**	**28.4%**	**1,692,369**	**65,881**
Credit risk as at 31 December 2021	**PD**	**LGD**	**EAD**	**EC**
Financial institutions	0.1%	45.0%	45,553	729
Public entities	1.9%	45.0%	3,992	72
Individuals	1.3%	23.3%	730,274	14,933
Corporates	3.0%	34.0%	762,941	50,606
Total	**2.1%**	**29.3%**	**1,542,760**	**66,341**

4.2.3 Credit exposure

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 amortised 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 2022, 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 1,573 billion (2021: ISK 1,435 billion), with ISK 1,544 billion coming from lending activities (2021: ISK 1,387 billion) and ISK 29 billion from loans and advances to financial institutions (2021: ISK 47 billion).

At year-end 2022, the maximum on-balance exposure to credit risk was ISK 1,745 billion. ISK 1,544 billion was derived from loans and advances to customers, ISK 42 billion from cash and balances with the Central Bank, and ISK 91 billion from bonds and debt instruments. The total off-balance exposure at year-end 2022 was ISK 240 billion. ISK 136 billion was derived from undrawn loan commitments, ISK 75 billion from undrawn overdraft/credit card facilities and ISK 29 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 Credit exposure from lending activities

At year-end 2022, the Bank's total credit exposure from lending activities amounted to ISK 1,544 billion, increasing by 11% from ISK 1,387 billion at year-end 2021. The mortgage portfolio grew by 9% in 2022, with a majority of the growth occurring in the first half of the year. More detailed information on the mortgage portfolio is in section 4.2.5.5. The corporate portfolio grew by 13% in 2022. This growth is partly due to depreciation of the ISK in 2022, but when corrected for differences in exchange rate, the real estate, construction and retail portfolios had the most growth in 2022. 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 2022, the total average PD weighted by gross carrying amount was 1.8% (2021: 2.1%). Excluding loans to financial institutions, the average PD was 1.9% (2021: 2.2%). The average PD for individuals was 1.4% (2021: 1.3%) and the average PD for corporates was 2.3% (2021: 3.2%). Credit quality in the corporate portfolio increased in 2022, as it did in 2021. Credit quality in the individual portfolio remained stable in 2022.

At year-end 2022, the total average LGD weighted by gross carrying amount, excluding loans to financial institutions, was 13.2% (2021: 13.2%). The average LGD for individuals was 7.8% (2021: 7.7%) and the average LGD for corporates was 18.7% (2021: 19.1%).

The carrying amount of loans in stage 3 net of accumulated ECL as a percentage of the total portfolio decreased in 2022 and was 1.0% at year-end 2022. The ratio decreased both in the corporate portfolio and the individual portfolio, standing at 1.8% for corporates and 0.2% for individuals at year-end 2022. The decrease in the ratio is explained by a low number of defaults observed in the portfolio in 2022.

The carrying amount of loans and advances to customers past due by 6-90 days increased slightly in 2022. The ratio of loans past due by 6-90 days was 0.7% at year-end 2022 (2021: 0.4%). For individuals, the ratio was 0.5% at year-end 2022 (2021: 0.5%) and for corporates the ratio was 0.9% at year-end 2022 (2021: 0.3%).

Figure 4.4: Probability of default (PD)

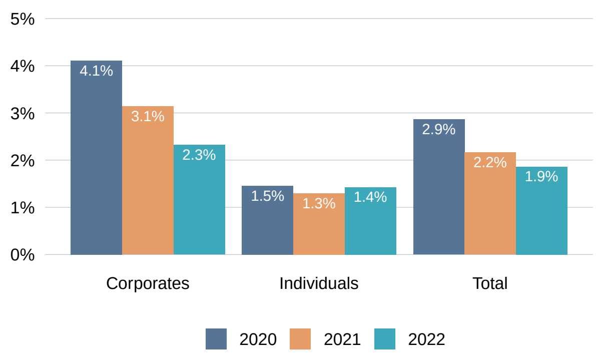


Figure 4.5: Loss given default (LGD)

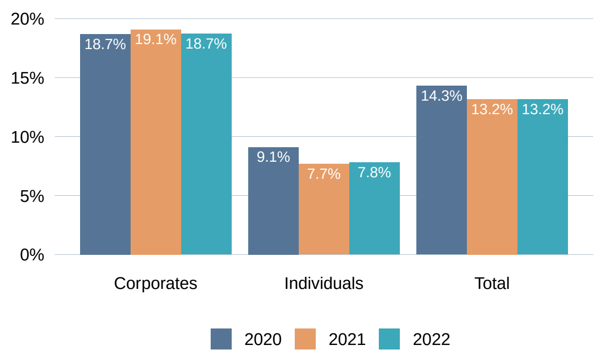


Figure 4.6: Stage 3 loans (% of total portfolio)

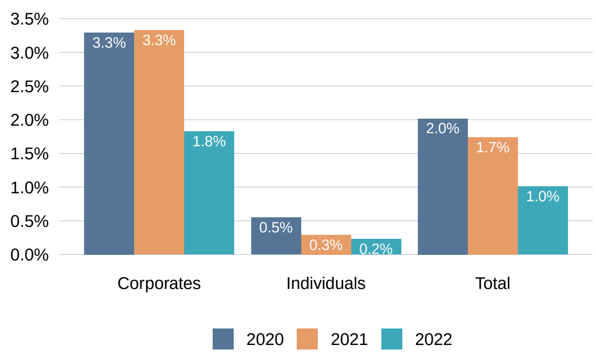
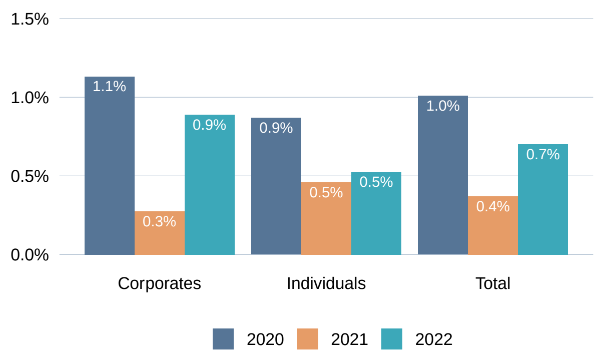


Figure 4.7: Ratio of loans past due 6-90 days



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.

Forbearance plans must comply with the Bank's credit policy. They are used as an instrument to maintain long-term customer relationships for customers with financial difficulties 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 decreased from ISK 123 billion at year-end 2021 to ISK 95 billion at year-end 2022, which is a decrease from 8.7% to 6.1% of the total portfolio. Forbearance classification was discontinued in 2022 for many exposures that were granted pandemic-related payment moratoria in 2020.

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

Table 4.4: Exposures subject to forbearance (ISK million)

	31.12.2022		**31.12.2021**	
	Performing	**Non-performing**	**Performing**	**Non-performing**
Modification	70,209	20,086	89,869	28,787
Refinancing	1,899	2,554	1,605	2,466
- of which: Under probation	4,897	0	2,716	0
Total	**72,108**	**22,640**	**91,474**	**31,253**

4.2.5 Credit risk by industry sectors

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, 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 2022	Carrying amount	PD	LGD	Past due 6-90 days	Stage 2 loans	Stage 3 loans	Total ECL
Public entities	10,519	1.3%	5.0%	0.0%	0.0%	0.0%	-6
Individuals	**790,238**	**1.4%**	**7.8%**	**0.5%**	**3.6%**	**0.2%**	**-1,327**
Mortgages	705,256	1.4%	5.0%	0.5%	3.1%	0.2%	-563
Other	84,982	2.0%	30.8%	1.0%	7.8%	0.6%	-763
Corporates	**743,604**	**2.3%**	**18.9%**	**0.9%**	**4.8%**	**1.8%**	**-8,662**
Fisheries	192,036	1.6%	11.2%	0.0%	1.2%	0.0%	-403
Real estate companies	139,509	2.5%	12.7%	1.0%	4.2%	1.1%	-989
Construction companies	102,394	3.5%	26.9%	1.0%	6.0%	2.4%	-1,553
Travel industry	110,843	3.2%	22.1%	3.3%	15.1%	5.5%	-3,450
Services and ITC*	60,334	1.9%	27.6%	0.8%	3.8%	0.2%	-366
Retail	64,585	1.3%	19.2%	0.2%	2.2%	0.4%	-925
Manufacturing and energy	38,971	1.1%	36.4%	0.0%	0.9%	8.2%	-778
Holding companies	28,168	3.6%	17.9%	0.1%	1.0%	0.1%	-177
Agriculture	6,764	2.2%	8.2%	0.0%	4.0%	0.1%	-20
Other	0	0.0%	50.1%	0.0%	100.0%	0.0%	0
Total loans to customers	**1,544,360**	**1.9%**	**13.2%**	**0.7%**	**4.2%**	**1.0%**	**-9,994**
Financial institutions	28,621	0.1%	30.0%	0.0%	0.0%	0.0%	0
Total loans including financial institutions	**1,572,981**	**1.8%**	**13.5%**	**0.7%**	**4.1%**	**1.0%**	**-9,995**
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**
Mortgages	646,514	1.2%	4.9%	0.4%	2.9%	0.3%	-466
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	0.1%	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**

*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 192 billion as at 31 December 2022 (2021: ISK 177 billion). Credit exposure to the sector represented 12% of the Bank's loan portfolio.

The average PD value for the sector remained stable in 2022 and was 1.6% at year end. The average LGD value for the sector increased in 2022 and was 11.2% at year-end 2022. Only ISK 4 million of outstanding loans in the fisheries sector were in default at year-end 2022 and the ratio of loans in stage 2 was 1.2%, decreasing from 1.9% at year-end 2021.

Credit extended by the Bank to the fisheries industry is primarily secured by fishing vessels together with their non-transferable fishing quotas, or 76% 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. Total ECL for the fisheries sector increased in 2022 to a total of ISK 403 million at year-end 2022 (2021: ISK 203 million).

Figure 4.8: PD & LGD - Fisheries

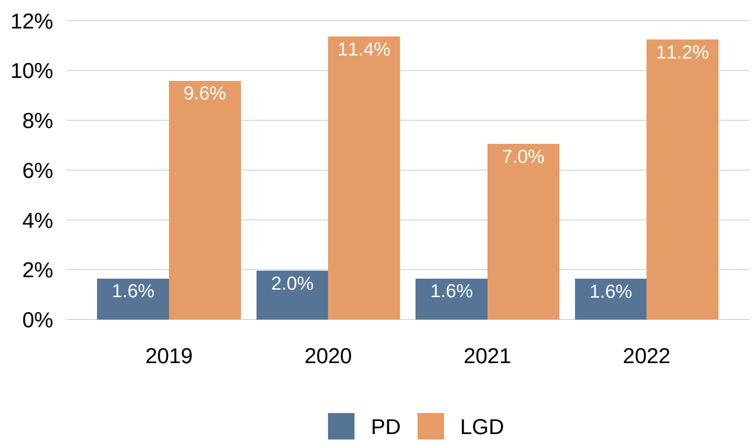


Figure 4.9: Default rate vs. PD - Fisheries

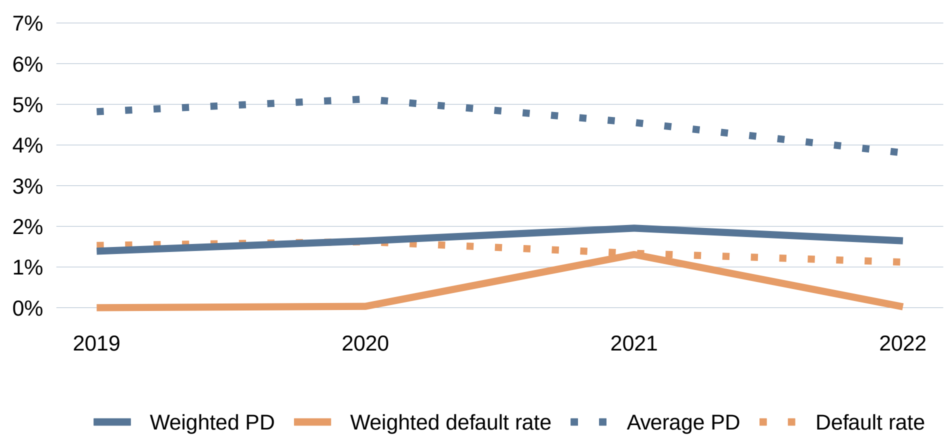
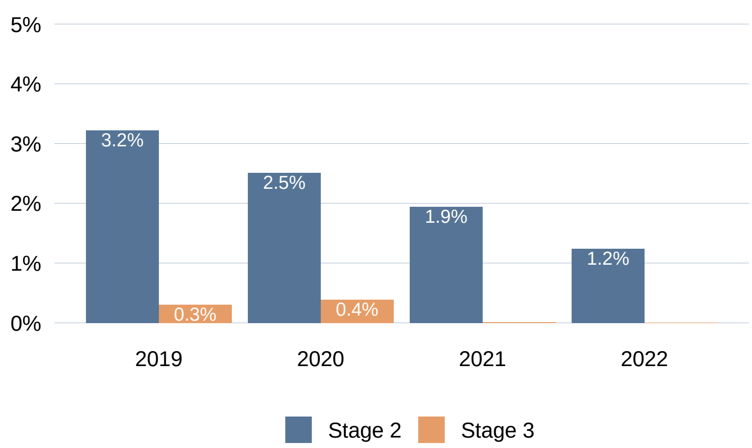


Figure 4.10: Staging - Fisheries



4.2.5.2 Real estate companies

Loans and advances to customers in the real estate industry amounted to ISK 140 billion at year-end 2022 (2021: ISK 120 billion). Credit exposure to the sector represented 9% of the Bank's loan portfolio.

The average PD value for the sector decreased in 2022 and was 2.5% at year end (2021: 3.3%). The average LGD value for the sector remained stable in 2022 and was 12.7% at year end (2021: 12.6%).

The realised weighted default rate for real estate companies in 2022 was 0.3% at year end. The realised default rate for the sector has been consistently below the average PD values for the past few years.

The ratio of stage 2 loans decreased in 2022 and was 4.2% at year end. The ratio of stage 3 loans decreased in 2022 and was 1.1% at year end.

Total ECL for the real estate sector decreased by ISK 333 million in 2022 to a total of ISK 989 million at year end.

Figure 4.11: PD & LGD - Real estate companies

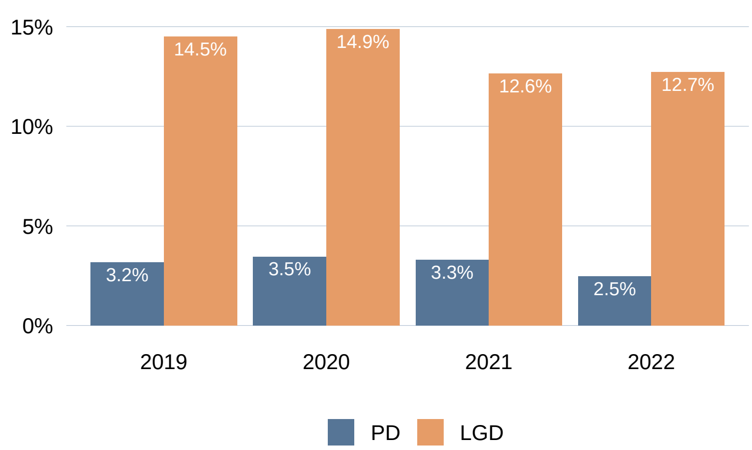


Figure 4.12: Default rate vs. PD - Real estate companies

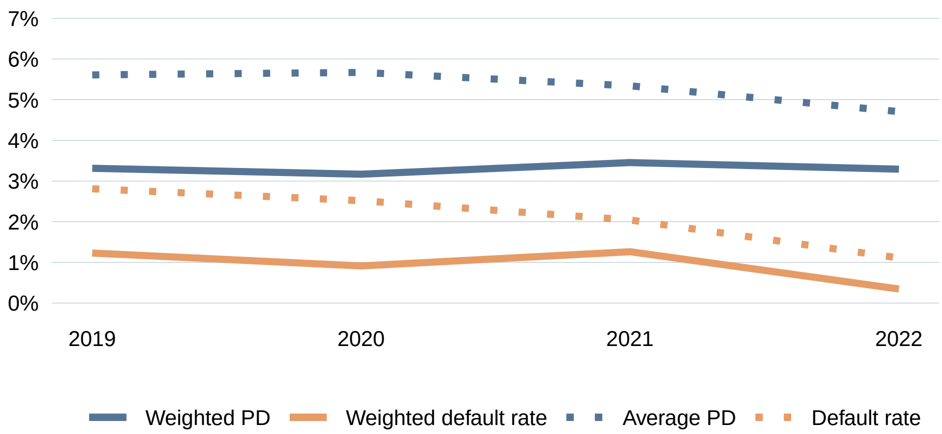
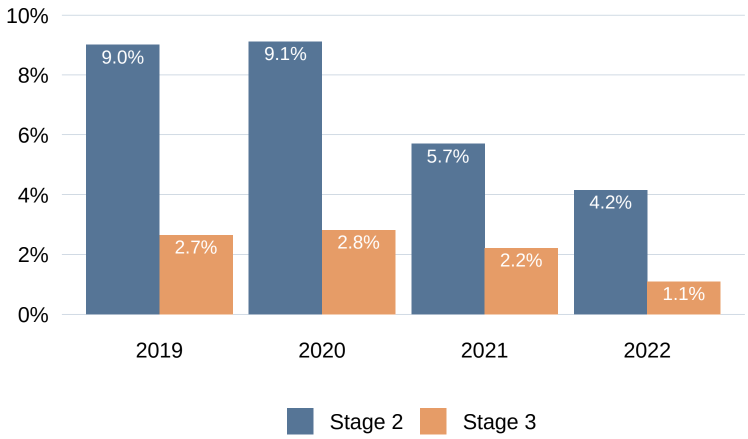


Figure 4.13: Staging - Real estate companies



4.2.5.3 Construction companies

Loans and advances to construction companies amounted to ISK 102 billion at year-end 2022 (2021: ISK 90 billion). Credit exposure to the sector represented 7% 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 because the outstanding amount increases over time during the development phase, starting to decrease as the properties begin to sell.

The average PD value for the sector increased slightly in 2022 and was 3.6% at year end (2021: 3.4%). The average LGD for the sector decreased in 2022 and was 26.8% at year end (2021: 38.6%). The decrease in LGD is partly due to change in LGD model calculation for project loans in the sector.

The realised default rate for construction companies was 1.1% in 2022, well below the average PD value, which was 3.4%. The ratio of stage 2 loans increased in 2022, from 3.9% to 6.0%. The ratio of stage 3 loans decreased in 2022 and was 2.4% at year end (2021: 8.8%). A single relatively large entity in the sector exited from default in 2022, and that is the main driver of the decrease in the ratio of stage 3 loans.

Total ECL for the construction sector remained stable in 2022 and amounted to ISK 1,553 million at year end (2021: ISK 1,572 million).

Figure 4.14: PD & LGD - Construction companies

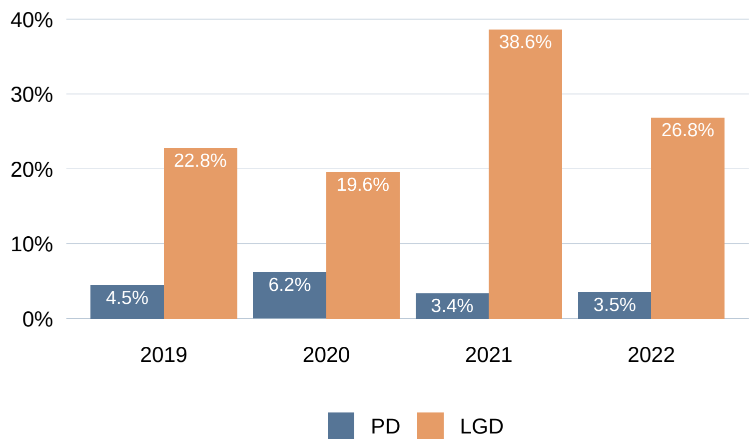


Figure 4.15: Default rate vs. PD - Construction companies

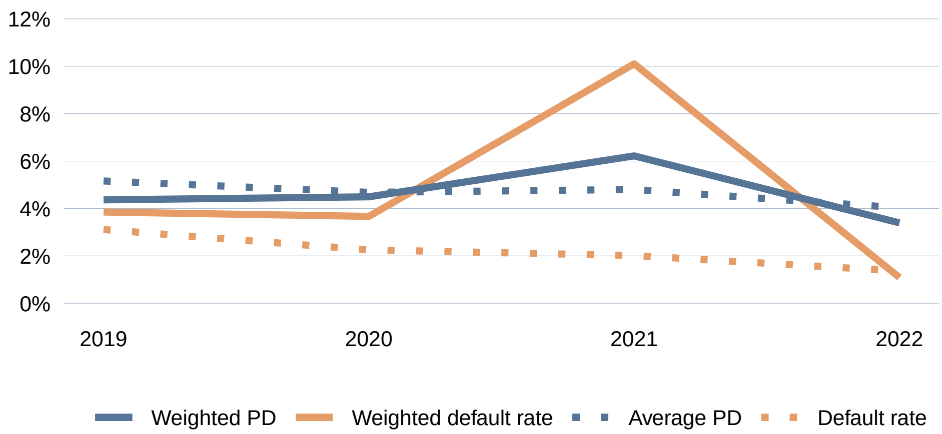
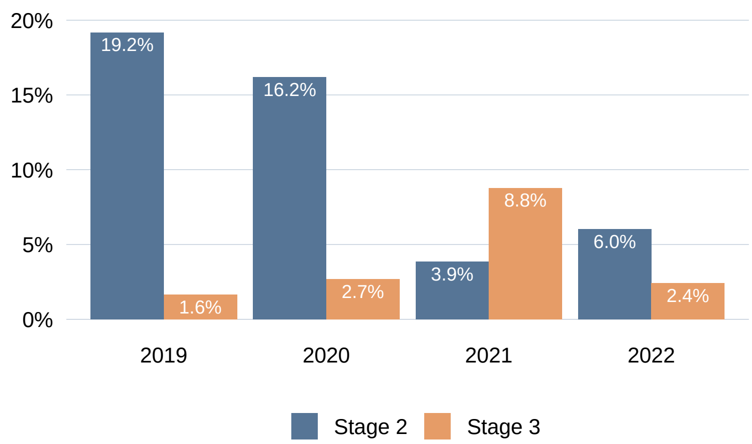


Figure 4.16: Staging - Construction companies



4.2.5.4 Travel industry

Loans and advances to customers in the travel industry amounted to ISK 111 billion at year-end 2022 (2021: ISK 98 billion). Credit exposure to the sector represented 7% of the Bank's loan portfolio.

The average PD value for the sector decreased in 2022 and was 3.2% at year end (2021: 7.2%). The main driver of this decrease is the expiration of manual overwrites to credit ratings of customers in the travel industry related to the Covid-19 pandemic. In 2022, the majority of remaining pandemic-related outstanding moratoria and manual overwrites to credit ratings expired as the sector started to function normally with the abolition of travel restrictions. The average LGD value for the sector decreased slightly in 2022 and was 22.1% at year-end 2022 (2021: 22.9%).

The realised default rate for the travel industry was 0.8% in 2022. In comparison, the average weighted PD value for the sector was 7.2% at year-end 2021.The ratio of stage 2 loans in the sector decreased considerably in 2022, for the same reasons as the already mentioned decrease in PD values in the sector. The ratio was 15.1% at year-end 2022 (2021: 50.0%). The ratio of stage 3 loans in the sector decreased in 2022 and was 5.5% at year end (2021: 9.0%).

Total ECL for the travel industry decreased by ISK 3.5 billion in 2022 to a total of ISK 3.5 billion at year end. The decrease in ECL was primarily due to a release of a general allowance charge of ISK 2.1 billion applied to the industry at year-end 2021, as well as an increase in credit quality in the portfolio.

Figure 4.17: PD & LGD - Travel industry

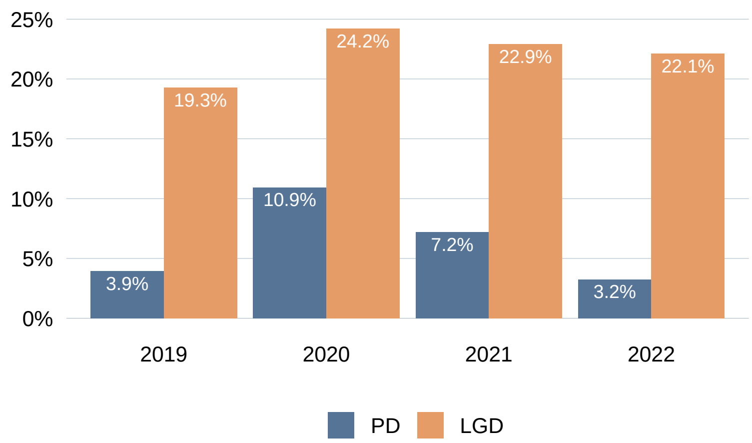


Figure 4.18: Default rate vs. PD - Travel industry

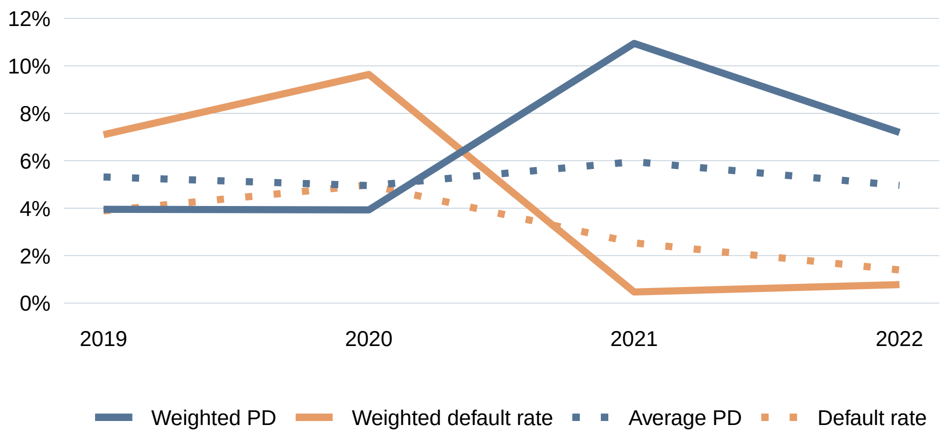
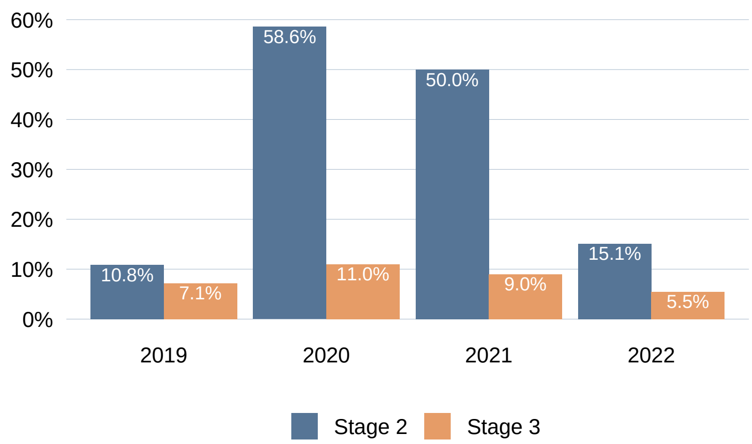


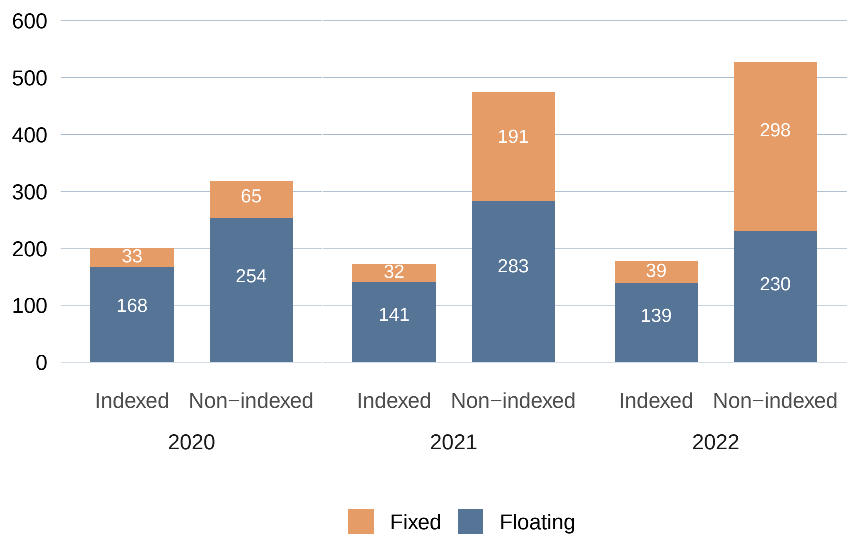
Figure 4.19: Staging - Travel industry



4.2.5.5 Mortgages

Demand for mortgages remained high for most of 2022, declining towards the end of the year with rising interest rates and more stringent payment capacity and loan-to-value limits. The carrying amount of mortgages to individuals in the portfolio was ISK 705 billion at year-end 2022 (2021: ISK 647 billion). Credit exposure in mortgages represented 46% of the Bank's loan portfolio at year-end 2022 (2021: 47%). Non-indexed loans represented 75% of the gross carrying amount of the mortgage portfolio at year-end 2022 (2021: 73%). Many customers used the opportunity while interest rates were relatively low to fix the rates on their mortgages. Fixed-rate, non-indexed mortgages amounted to ISK 298 billion at year-end 2022, as Figure 4.20 shows. This amount has more than quadrupled from year-end 2020. Customers can choose to fix rates on their mortgages for either a period of 3 or 5 years at a time. At year-end 2022, ISK 226 billion of fixed-rate, non-indexed mortgages had a repricing date in either 2024 or 2025. A majority of the remaining ISK 72 billion were due for repricing in 2026 or later.

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



All new mortgages must meet requirements for credit rating, payment capacity and collateralisation limits. These limits become more stringent as the loan amount increases. The Central Bank of Iceland has set rules on the maximum loan-to-value (LTV) ratio, i.e. the ratio of loan value to the value of the underlying collateral, of real estate loans to consumers. The current rules state that the maximum LTV for new mortgages is 80%, except for first-time buyers, where the maximum is 85%. The rules also include a payment capacity constraint, capping the monthly payment of mortgages to 35% of net monthly income (40% for first-time buyers). Finally, the Bank itself has imposed a limit on the length of indexed mortgages at 25 years. These limits were imposed to prevent unsustainable indebtedness for mortgage customers in the portfolio, in a market environment with rising interest rates and rising housing prices. The lowest rates on floating, non-indexed mortgages with the Bank were raised from 4.2% at year-end 2021 to 7.5% at year-end 2022 due to rising policy rates, and the housing price index rose by 22.2% in 2022 in nominal terms.

The weighted average LTV of mortgage loans has stayed fairly constant for the past few years and was 56.5% at year-end 2022, unchanged from year-end 2021. If the LTV per customer is considered for the mortgage portfolio, two thirds of the customers in the portfolio have an LTV of 70% and lower, and 96% have an LTV of 85% and lower. Figure 4.22 shows the gross carrying amount at year-end 2022 of indexed and non-indexed mortgages and the weighted-average LTV, as at year-end 2022, by year of loan origination. The figure shows the great demand for non-indexed mortgages for the past few years due to favourable interest rates for non-indexed mortgages. Demand for indexed mortgages increased slightly in 2022 as variable interest rates on non-indexed mortgages have increased significantly. The figure also shows a high frequency of mortgage refinancing due to favourable refinancing costs. This leads to a high ratio of the mortgage portfolio being recently issued loans. The weighted-average LTV was just over 61% for loans issued in 2022, around 58.5% for loans issued in 2021 and slightly lower for older loans.

The average PD value for mortgages increased slightly in 2022 and was 1.4% at year end (2021: 1.2%). Total ECL for mortgages increased slightly in 2022 and was ISK 563 million at year end (2021: ISK 466 million). The default rate for mortgages, weighted by gross carrying amount, was 0.2% in 2022 (2021: 0.3%). Default rates and past due ratios have been very low in the mortgage portfolio for the past few years.

Figure 4.21: Weighted average LTV - Mortgages

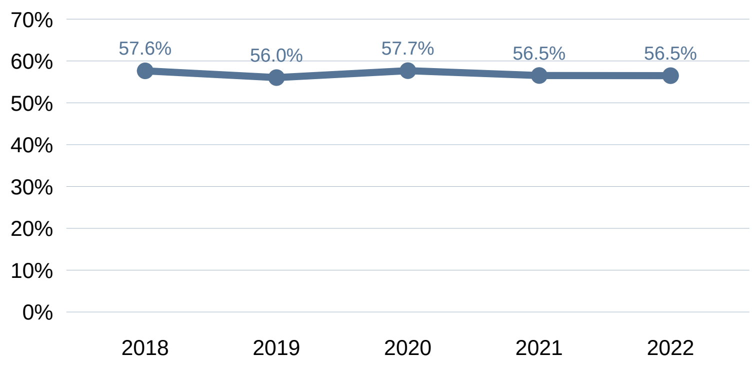


Figure 4.22: Gross carrying amount (ISK bn) and LTV of mortgages at 31.12.2022 by year of loan origination

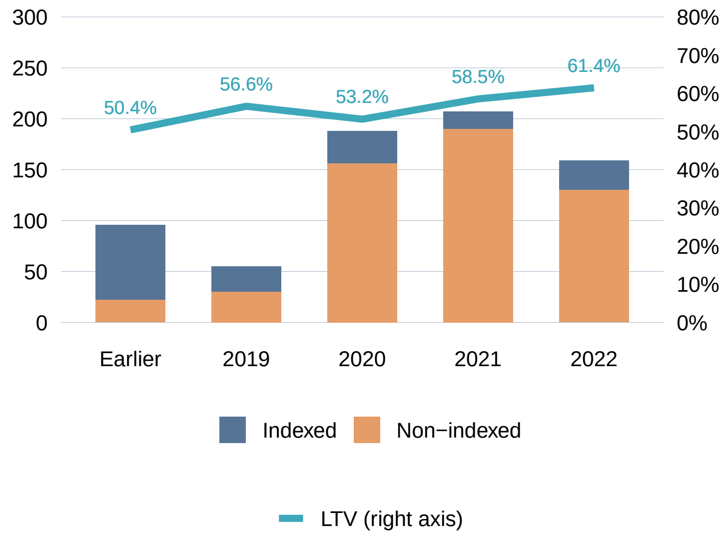
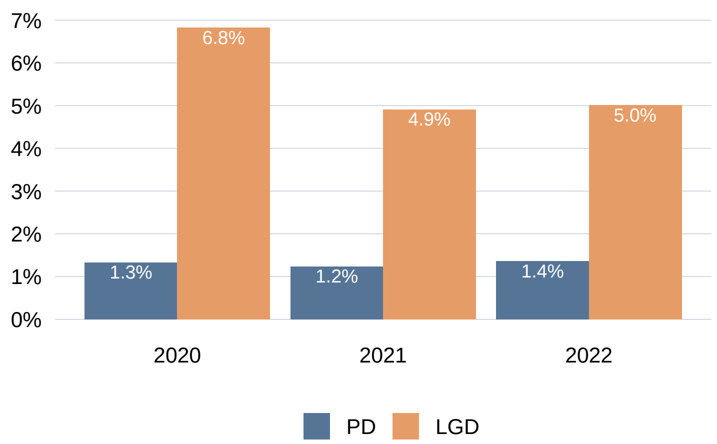


Figure 4.23: Average PD & LGD - Mortgages



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 2022, the total average PD weighted by gross carrying amount was 1.8% (2021: 2.1%). Excluding loans to financial institutions, which as mentioned above relates to the management of the Bank's foreign liquidity reserves, the average PD was 1.9% (2021: 2.2%).

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

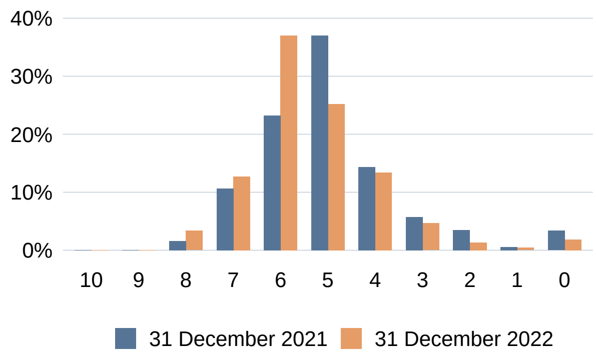
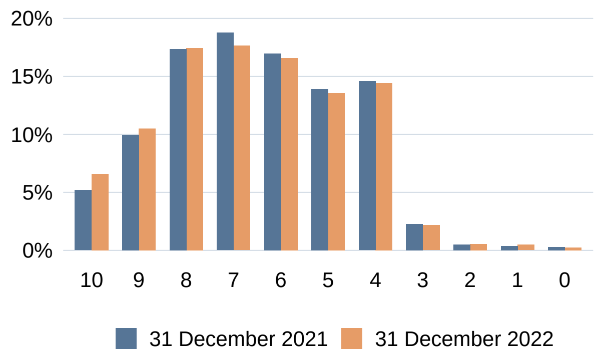


Figure 4.25: Rating grade distribution - Individuals



Figures 4.26 to 4.28 show the rating grade migration for corporates and individuals during 2022, based on existing customers at year-end 2021 and 2022.

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 2022

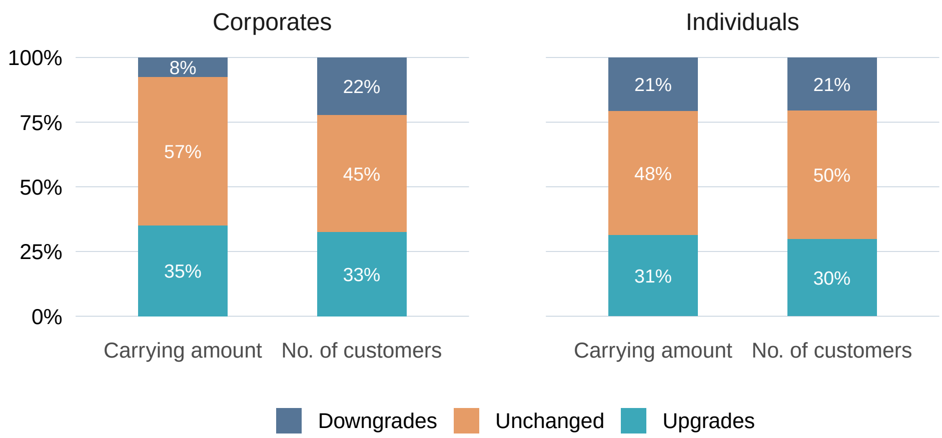


Figure 4.27: Rating migration of corporates in 2022

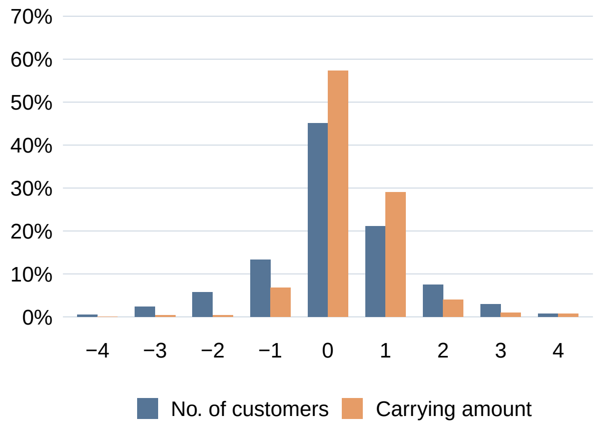
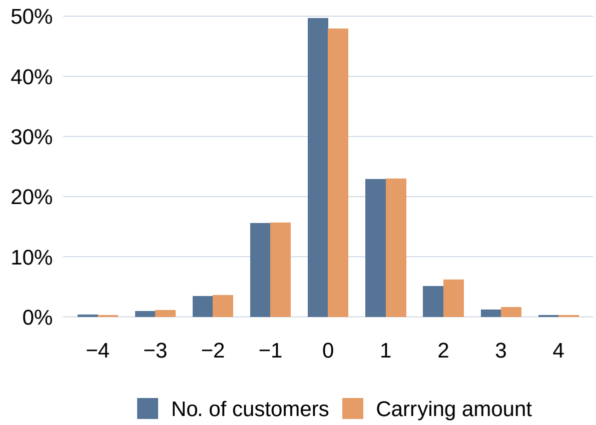


Figure 4.28: Rating migration of individuals in 2022

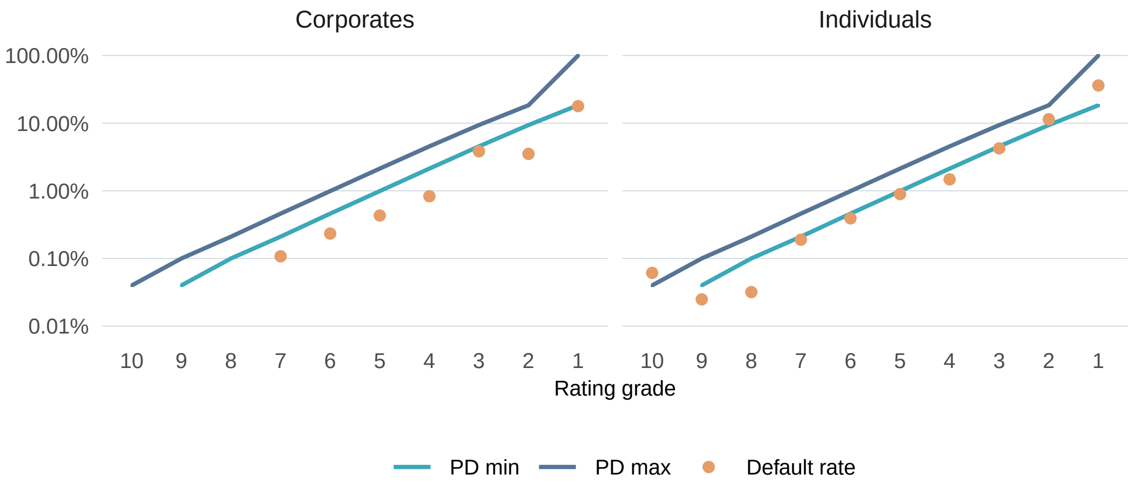


The rating and risk grade distribution changes primarily due to three factors: changes in rating grade for existing customers, or pure migration; different rating grade distribution of new customers and customers leaving the Bank compared to the rating grade distribution of existing customers during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

For individuals, the percentage of upgrades was higher than the percentage of downgrades, with just under half the portfolio remaining unchanged. For corporates, the percentage of upgrades was higher than the percentage of downgrades, with only 8% of the carrying amount of loans getting a downgrade during 2022. 57% of the carrying amount of loans in the corporate portfolio remained unchanged in 2022.

The default rate, measured by number of customers, was 1.0% for corporate customers in 2022, as compared to the estimated 3.4%. No corporate customers in rating grades 8, 9 and 10 defaulted. The default rate of individuals for 2022 was 0.7% as compared to the estimated 1.1%. 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 below the PD bands. For individuals in rating grade 10, the default rate was slightly above the PD band. For all rating grades for corporate customers the default rate was below the PD band.

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



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. Realised default rates have been consistently below the estimated PD values both for corporates and individuals for the past four years.

Figure 4.30: Default rate vs. PD - Corporates

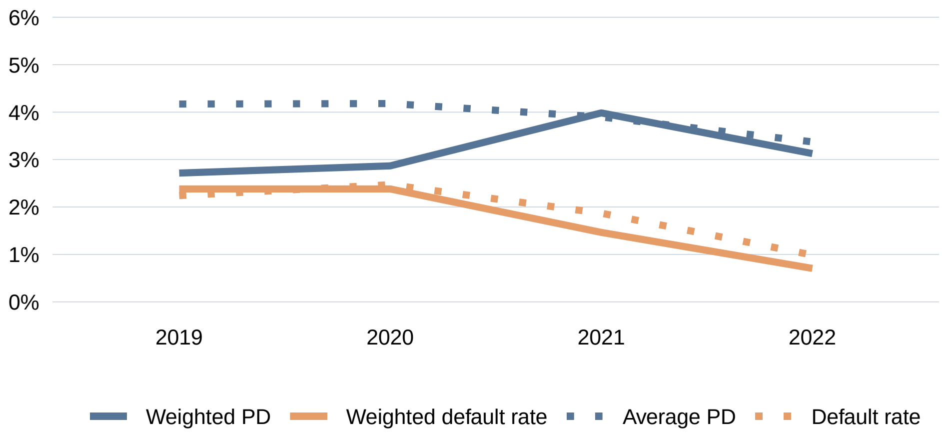
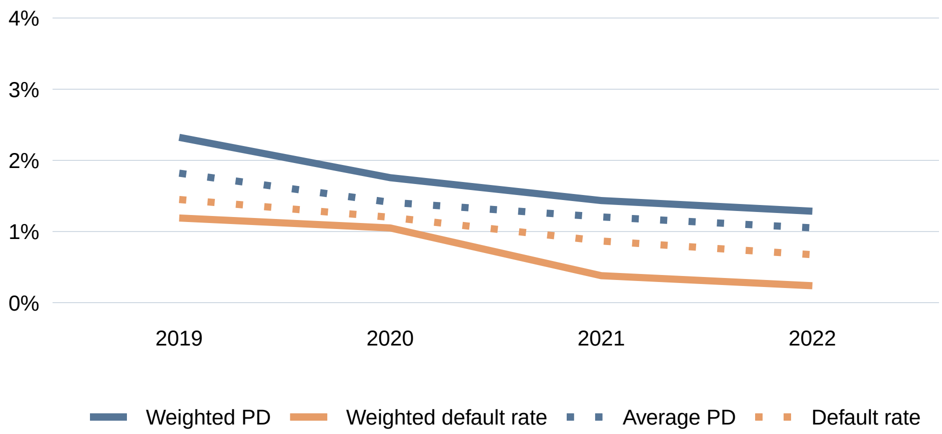


Figure 4.31: Default rate vs. PD - Individuals



4.2.7 Loan impairment

Total expected credit loss (ECL) amounted to ISK 10.6 billion at year-end 2022 (thereof classified as deduction from gross carrying amounts: ISK 10.0 billion), as compared to ISK 14.4 billion at year-end 2021 (thereof classified as deduction from gross carrying amounts: ISK 13.8 billion). In 2022, a net impairment release of ISK 2.4 billion was recognised in the Bank's income statement, as opposed to an ISK 7 billion released in 2021. The decrease in ECL is primarily due to the release of an ISK 2.2 billion general allowance for customers in the travel industry and other corporates with pandemic-related moratoria. In 2022, the rest of these moratoria expired and corporate customers that had received them resumed normal payments of their loans, without any significant increase in defaults in the portfolio. Another big reason for the decrease in ECL is that default rates in 2022 were historically low. The decrease in ECL is also partly due to a decrease in PD values for corporate customers because of increased credit quality in the portfolio and due to 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 60 in the Bank's annual financial statement for 2022.

ECL decreased in stage 2 and 3 in 2022 but increased in stage 1, due to new lending and a higher portion of the portfolio being in stage 1. For individuals, the total ECL decreased by ISK 38 million while ECL in the corporate portfolio decreased by ISK 3.7 billion. The ratio of ECL to gross carrying amount (GCA) in stage 1 decreased slightly for individuals but increased slightly for corporates in 2022. A decrease in this ratio signifies increased credit quality for performing loans without significantly increased credit risk. The ratio of ECL to GCA in stage 2 decreased both for individuals and corporates in 2022. The ratio of ECL to GCA in stage 3 decreased for corporates but increased for individuals in 2022. The GCA of loans in stage 2 decreased in 2022, as Figure 4.36 shows.

Figure 4.32: Expected credit loss by stage (ISK bn)

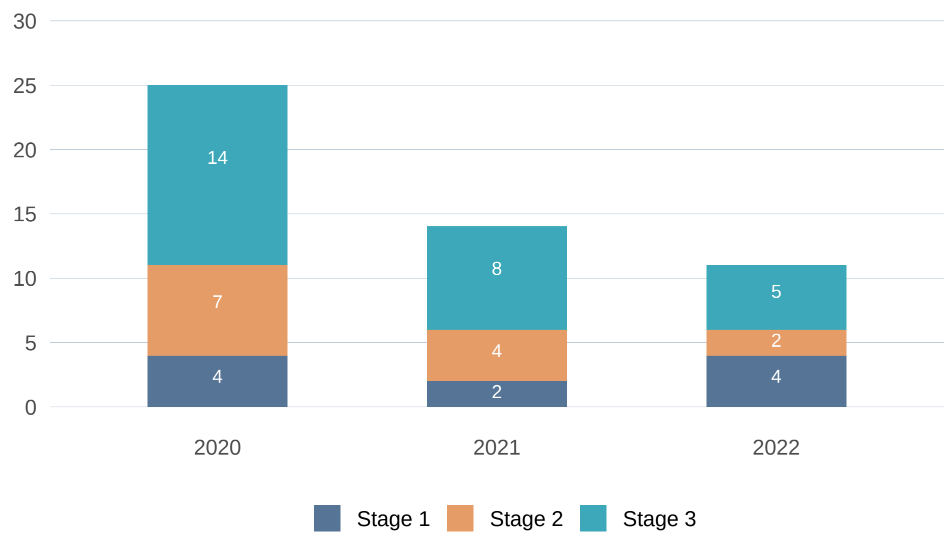


Figure 4.33: ECL to gross carrying amount - Stage 1

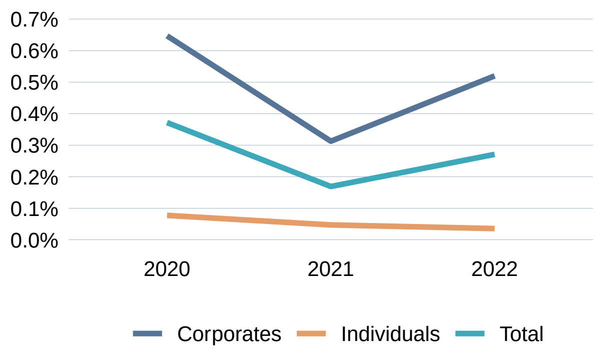


Figure 4.34: ECL to gross carrying amount - Stage 2

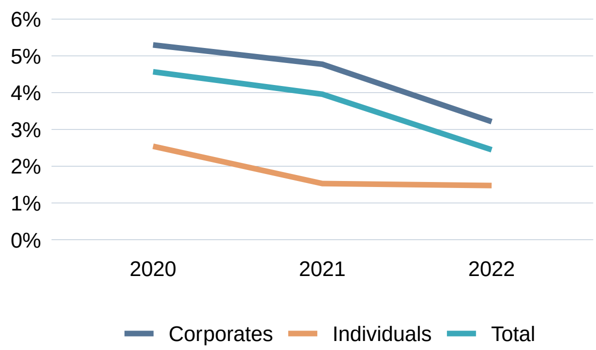


Figure 4.35: ECL to gross carrying amount - Stage 3

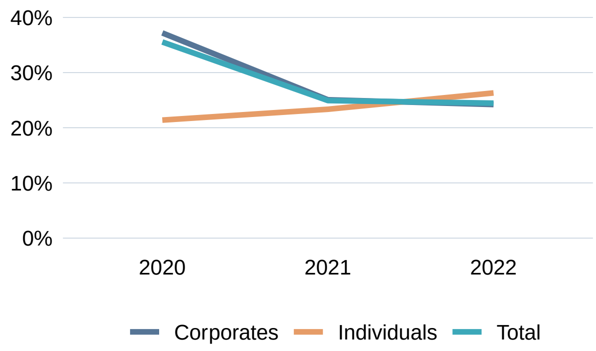
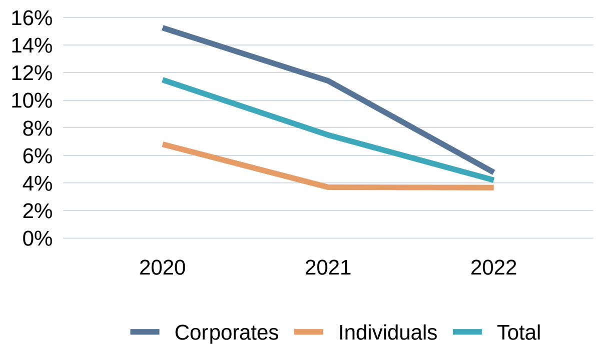


Figure 4.36: Gross carrying amount in stage 2



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 risk 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 concentration arises 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 CRR, exposures to a single customer or a group of related customers – after the deduction of particularly secure claims – may not exceed 25% of common equity tier 1 (CET1) capital. No exposure to a single customer or a group of related customers exceeded 25% in the year 2022 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.

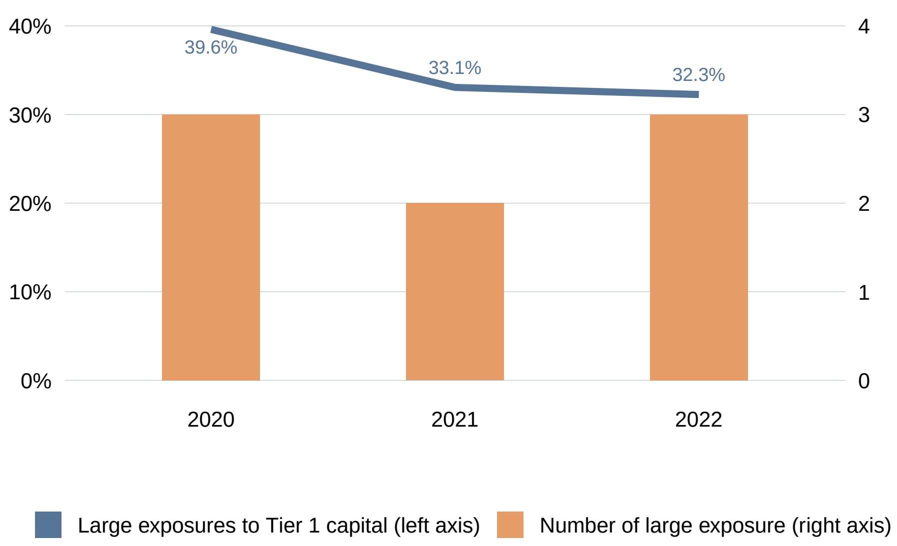
At year-end 2022, lending to individuals represented 51% of the Bank's total credit exposure (2021: 52%). Most of the demand from individuals is for mortgages, and the Bank's lending to individuals is therefore mostly secured by real estate.

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

Customers domiciled in Iceland accounted for 96% of the Bank's total credit exposure in 2022 (2021: 98%), excluding exposures to financial institutions. The majority of exposures to foreign counterparties relate to 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 CBI. 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 2020, the ratio was measured as a % of Tier 1 capital.

Figure 4.38: Loans and advances by geographical area (ISK bn)

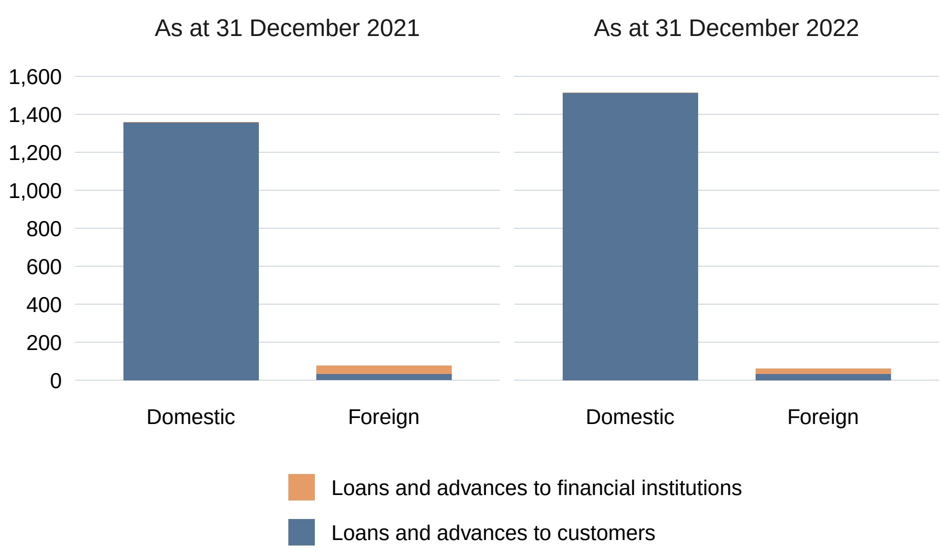
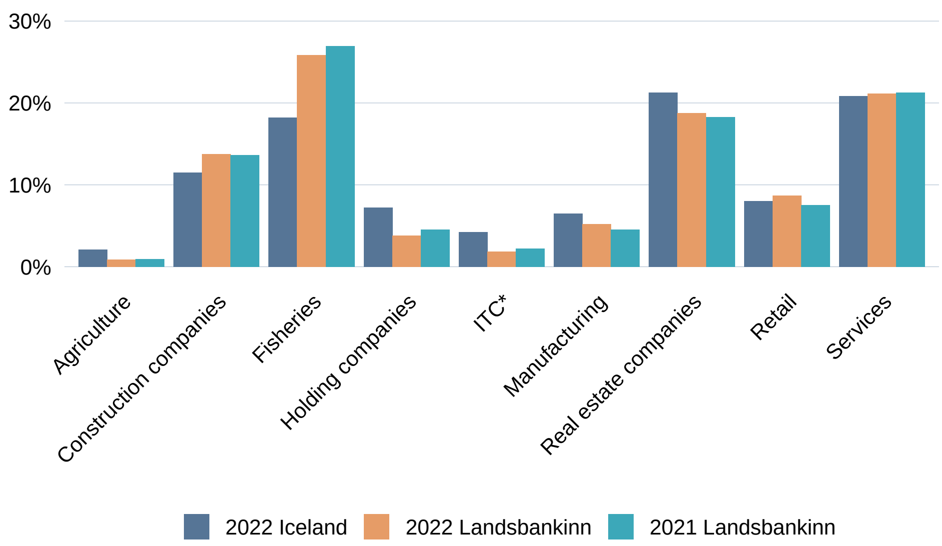


Figure 4.39: Industry concentration



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

5 Market risk

Market risk

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

- The Bank's market risk increased in 2022 due to market conditions. Net FX Balance increased over the year and remained long from second quarter. Exposure in equity trading book was lower at year-end 2022 than year-end 2021 but interest rate risk in trading book increased due to higher exposure.
- Total market risk in the Bank's trading book together with foreign exchange risk and CVA risk, as measured by economic capital, was ISK 5.5 billion at year-end 2022 compared to ISK 2.2 billion at the end of 2021.
- Despite increased market risk and a turnaround in market conditions from last year the Bank's market risk is well within its risk appetite.

5.1 Market risk management and policy

The Board of Directors is responsible for determining the Bank's market risk appetite. 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 loss 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 loss. Market risk indicators need to be concise, reported in a timely manner, give clear signals, 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. Additional 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 2022.

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	
	2022	**2021**
Equities and equity instruments in the trading book	2,146	2,145
Bonds and debt instruments in the trading book	15,715	5,839
FX balance	7,041	-1,108

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

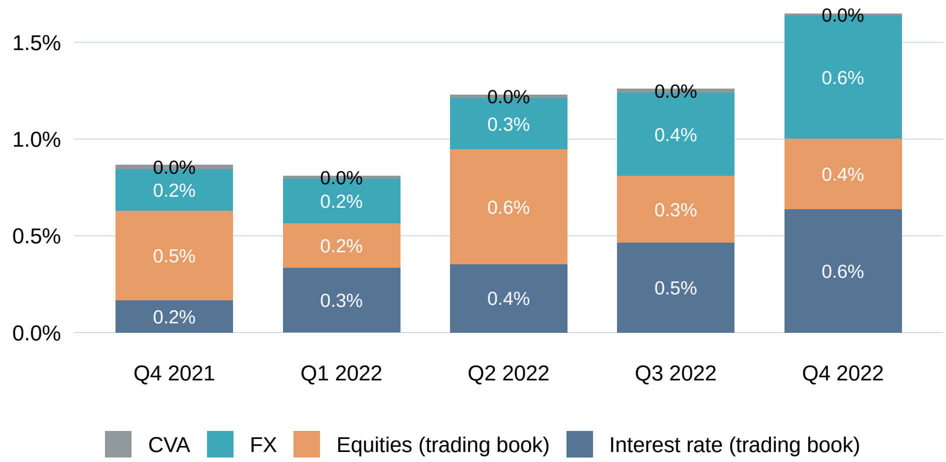
The Bank uses risk-weighted exposure amounts (RWEA) and economic capital (EC) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. RWEAs are determined by applying specific risk weights to the Bank's assets, according to capital requirement 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, was moderate, amounting to 1.7% at year-end 2022 (compared to 0.9% at year-end 2021), and well within the Bank's risk appetite.

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

	2022		2021	
	RWEA	Ratio to RWEA	RWEA	Ratio to RWEA
Equity price risk in the trading book	4,322	0.4%	5,289	0.5%
Interest rate risk in the trading book	7,587	0.6%	1,911	0.2%
Foreign exchange risk	7,562	0.6%	2,458	0.2%
CVA risk	147	0.0%	251	0.0%
Total	**19,618**	**1.7%**	**9,909**	**0.9%**

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 regard 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 2022 and 2021, 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 2022		
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	1,187,494	153,272	381,841	26,823	1,749,430
Total liabilities	1,041,946	118,767	259,455	64,137	1,484,306
Net on-balance sheet position	145,548	34,505	122,386	-37,314	265,124
Effect of derivatives held for risk management	-45,450	45,450	0	0	0
Net off-balance sheet position	2,000	0	-2,000	0	0
Total interest repricing gap	**102,098**	**79,955**	**120,386**	**-37,314**	**265,124**
			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**

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 bp 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, 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 2022 and 2021 can be seen in Table 5.5.

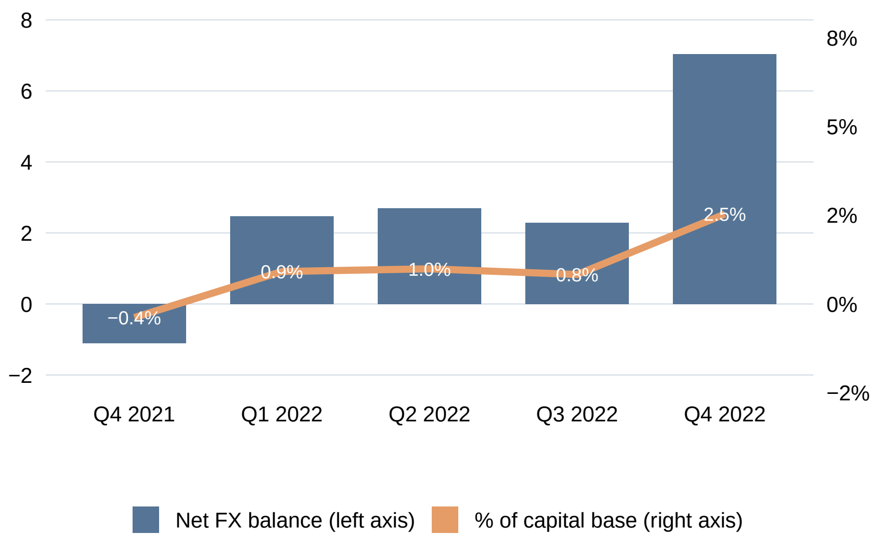
Table 5.4: Interest rate risk (fair value sensitivity) in the banking book at year-end

	2022		2021	
	+100 bps	-100 bps	+100 bps	-100 bps
ISK non-indexed	-5,256	5,574	-3,551	3,717
ISK indexed	2,328	-2,458	4,460	-4,808
EUR	3,242	-3,355	4,747	-4,948
SEK	14	-14	24	-24
USD	-63	64	-41	41
Other	8	-8	8	-8
Total	**273**	**-197**	**5,647**	**-6,029**

Table 5.5: Net FX balance

	Net position at year-end	
	2022	2021
CHF	56	-28
EUR	4,396	-1,804
GBP	746	375
JPY	158	122
USD	915	-485
Other	769	712
Total	**7,041**	**-1,108**

Figure 5.2: Net FX balance (ISK bn)



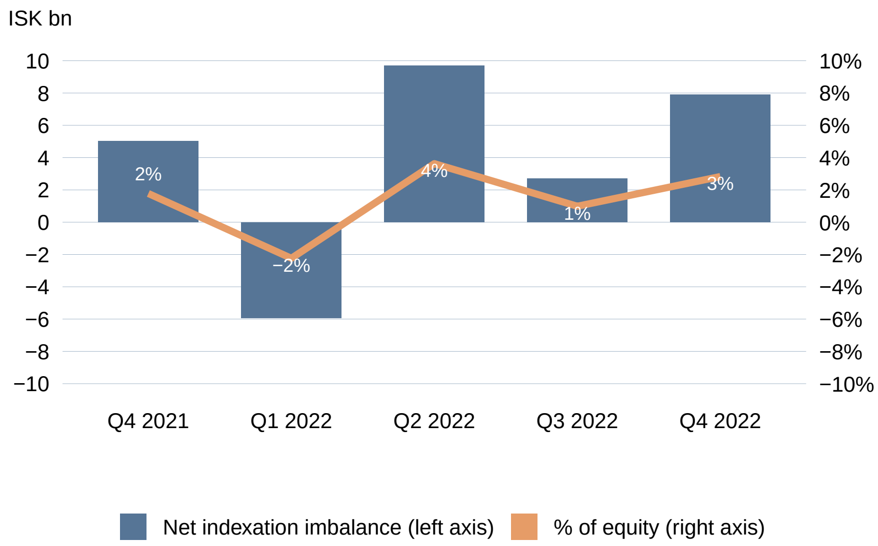
5.4.5 Other market risk

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. As a result, 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-linked financial instruments may fluctuate due to changes in the Icelandic CPI. Mismatched CPI-linked assets and liabilities expose the Bank to indexation risk. The Bank's total CPI indexation balance amounted to ISK 8 billion at year-end 2022 as compared to ISK 5 billion at year-end 2021. The balance had some fluctuations over the the past year, loans and advances to customers decreased, CPI-linked borrowing matured, bonds and debt instrument increased as did deposits to customers, but the total balance steadily increased in the fourth quarter of 2022. 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

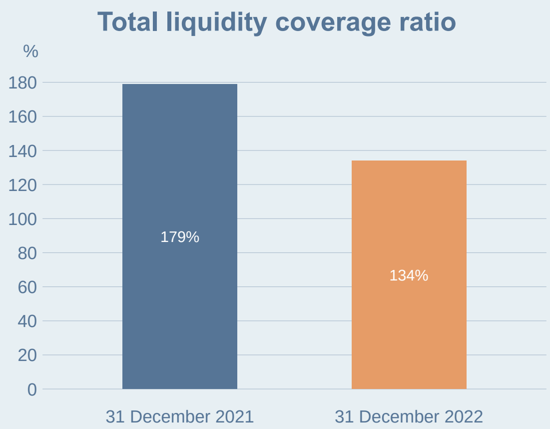


6 Liquidity risk

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 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 at year-end 2022 was well above regulatory requirements and the Bank's internal limits. The total liquidity coverage ratio was 134% at year-end 2022 (year-end 2021: 179%) and the Bank's LCR in foreign currencies was 351% (year-end 2021: 556%) and 99% in ISK (year-end 2021: 120%).



6.1 Identification

The Board sets a liquidity management policy and the liquidity contingency plan 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. 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 2022 is shown in the EU LIQ1 template below. Further information can be found in the additional disclosures accompanying this document.

Table 6.1 shows the Bank's deposit base at year-end 2022. Run-off 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 2022	Runoff rate	0-30 days	Over 30 days	Total
Retail deposits				
Individuals	5-100%	368,227	136,105	504,332
Small and medium-sized corporates	5-100%	94,086	8,877	102,963
Operational deposits	5-25%	0	0	0
Non-operational deposits				
Large corporates	20-40%	182,734	54,171	236,905
Government	20-40%	42,089	4,659	46,748
Financial customers	100%	33,335	37,990	71,324
Other*		11,604	621	12,225
Total deposits		**732,074**	**242,423**	**974,496**

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

Figure 6.1: Total deposits by maturity

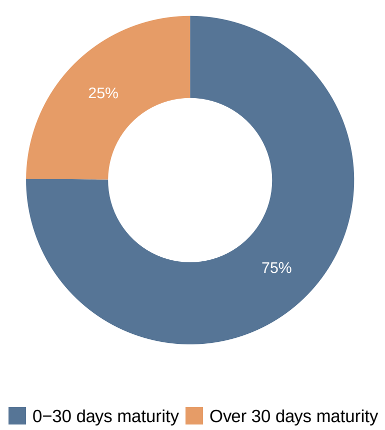
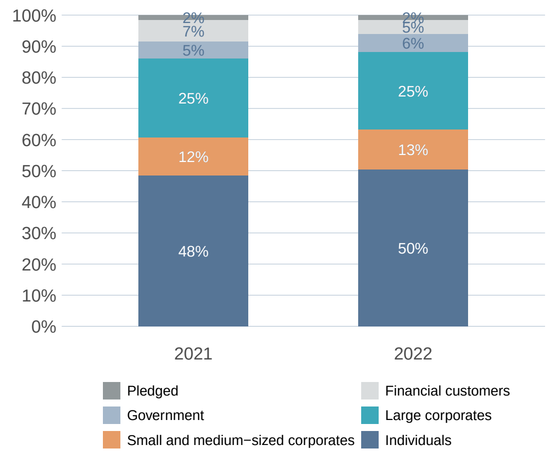


Figure 6.2: 0-30 days maturity deposits by groups*



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

Table 6.2: EU LIQ1 template

		Total unweighted value* 31.12.2022	Total weighted value* 31.12.2022
Number of data points used in the calculation of averages		12	12
High-quality liquid assets			
1	Total high-quality liquid assets (HQLA)		175,393
Cash-outflows			
2	Retail deposits and deposits from small business customers, of which:	447,565	32,053
3	Stable deposits	323,757	16,188
4	Less stable deposits	122,822	14,879
5	Unsecured wholesale funding	283,003	138,932
6	Operational deposits (all counterparties) and deposits in networks of cooperative banks	0	0
7	Non-operational deposits (all counterparties)	278,487	134,415
8	Unsecured debt	4,517	4,517
9	Secured wholesale funding		0
10	Additional requirements	135,288	19,145
11	Outflows related to derivative exposures and other collateral requirements	5,504	5,504
12	Outflows related to loss of funding on debt products	2,543	2,543
13	Credit and liquidity facilities	127,241	11,098
14	Other contractual funding obligations	8,676	1,099
15	Other contingent funding obligations	29,153	5,975
16	**Total cash outflows**		197,203
Cash-inflows			
17	Secured lending (e.g. reverse repos)	0	0
18	Inflows from fully performing exposures	98,277	72,130
19	Other cash inflows	7,942	2,513
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**	106,220	74,643
EU-20a	***Fully exempt inflows***	0	0
EU-20b	***Inflows subject to 90% cap***	0	0
EU-20c	***Inflows subject to 75% cap***	106,220	74,643
			Total adjusted value
21	**Liquidity buffer**		**175,393**
22	**Total net cash outflows**		**122,560**
23	**Liquidity coverage ratio (%)**		**143%**

*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). According to the schedule set forth by the Central Bank the minimum LCR in ISK will increase from 40% to 50% as of 1 January 2023 and sets an end to the adaption period. Figure 6.5 shows the development of the Bank's LCR in ISK.

Figure 6.3: Liquidity coverage ratio (total)

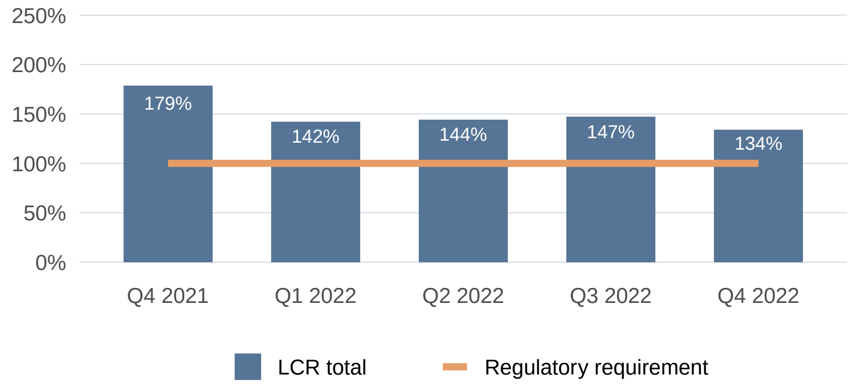


Figure 6.4: Liquidity coverage ratio (FX)

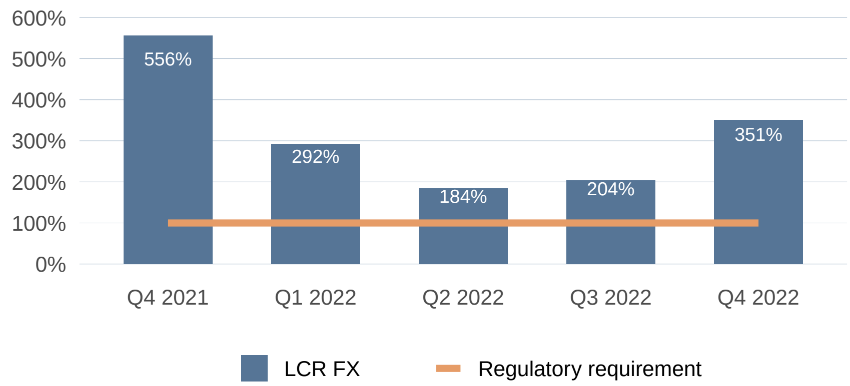
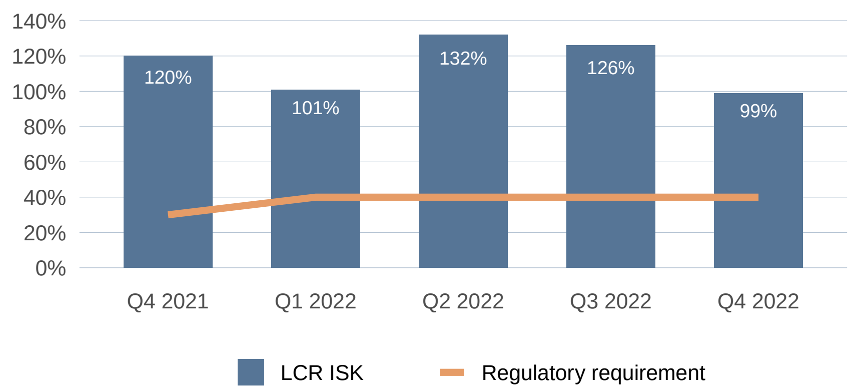


Figure 6.5: Liquidity coverage ratio (ISK)



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 117% at year end (year-end 2021: 121%), and the NSFR in foreign currencies was 132% (year-end 2021: 142%).

Figure 6.6: Net stable funding ratio (total)

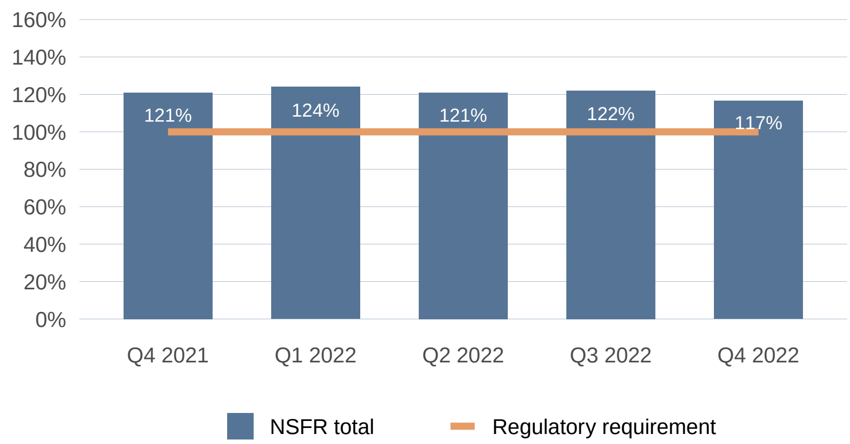
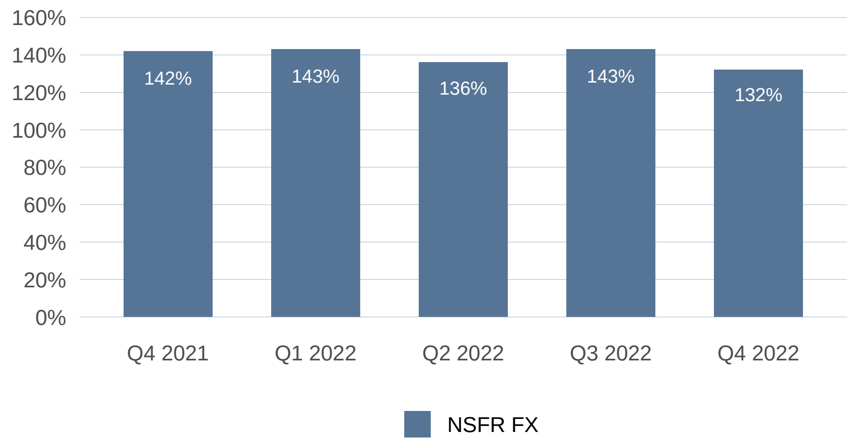


Figure 6.7: Net stable funding ratio (FX)



6.3 Management

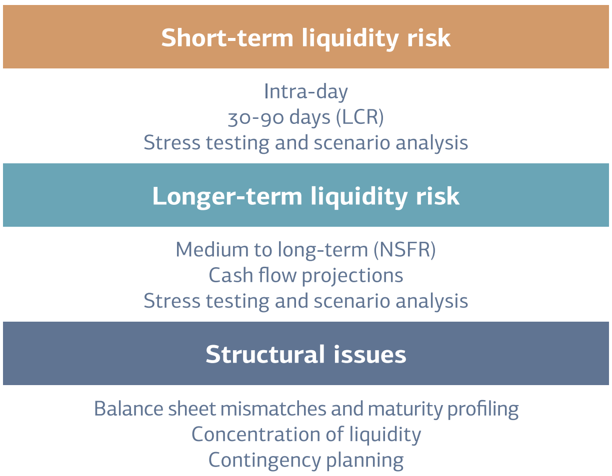
The objective of the liquidity management policy is to ensure that sufficient liquid assets and funding are available to meet financial obligations and sustain withdrawals of deposits in a timely manner and at a reasonable cost, even under stressed conditions.

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.

Figure 6.8: Liquidity management process



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 Market Risk department regularly evaluates the Bank's liquidity position and monitors internal and external events and factors that may affect the liquidity position.

6.4.1 Liquidity Contingency Plan

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

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

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

The contingency plan is supplemented by the monitoring of early warning indicators along with their defined warning and trigger levels to detect potential liquidity problems. These early warning indicators are either internal, such as changes in the Bank's balance sheet composition, decreasing liquidity ratios, deposit outflows or a downward trend in financial ratios, or external, such as rating downgrades, third party evaluations or market price fluctuations. The Bank determines up to 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 is an active issuer on the domestic bond market with issuance of covered bonds each month in the year 2022 and was also active in the international market with a number of issuances of bonds in foreign currencies under its EMTN programme throughout the year.

The Bank´s credit rating has remained unchanged since April 2020, at BBB/A-2 and with continuing stable outlook in the last rating report by S&P Global Ratings in July 2022.

The Bank's covered bond program has been rated by S&P Global Ratings since January 2021. In May 2022 the covered bond rating was raised to A.

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 2022 and 2021.

Figure 6.9: Borrowings and subordinated liabilities (ISK bn)

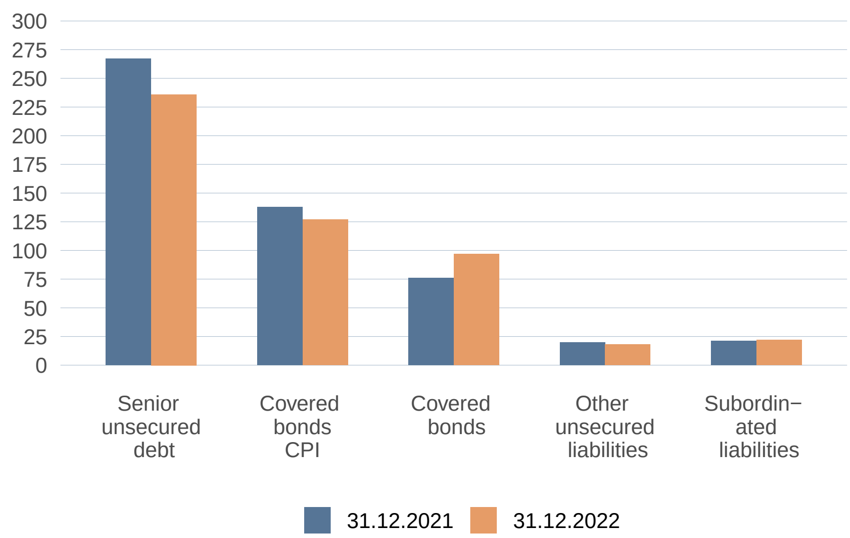
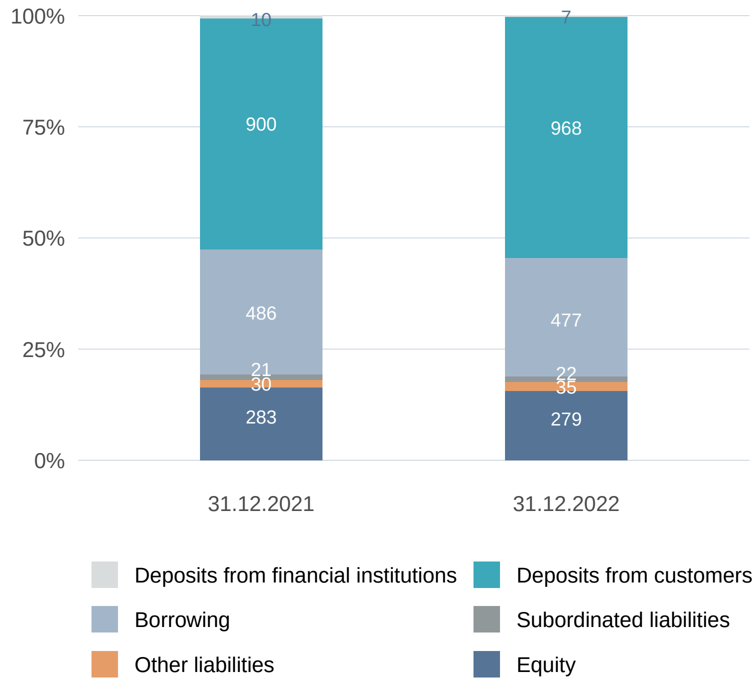


Figure 6.10: Funding profile (ISK bn)



6.5.2 Deposits from customers

The majority of the Bank's funding is in the form of deposits from customers, which increased by 68 billion in 2022 and amounted to ISK 968 billion at year end. On demand deposits (up to 30 days) amounted to ISK 657 billion and term deposits amounted to ISK 311 billion. Inflation-linked deposits amounted to ISK 160 billion at year-end 2022, increasing by ISK 25 billion from previous year.

6.5.3 Borrowings

6.5.3.1 EMTN Programme and other unsecured loans

In January, the Bank issued bonds under the Bank´s EMTN programme. The issuance was comprised of 3-year bonds amounting to SEK 850 million, 2-year bonds amounting to SEK 850 million and 3-year bonds amounting to NOK 500 million. In addition, the Bank issued 2-year bonds amounting to NOK 300 million and 3-year bonds amounting to NOK 350 million in August. At year-end 2022, bond issuance in foreign currency amounted to ISK 236 billion, decreasing by ISK 13 billion during the year.

Table 6.3: EMTN Programme

As at 31 December 2022	Currency	Final maturity	Outstanding principal	Contractual interest rate
Senior unsecured				
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 FLOAT 01/24	SEK	19.01.2024	850	STIBOR + 0.65%
LBANK 0.5 5/24	EUR	20.05.2024	300	FIXED 0.5%
LBANK FLOAT 08/24	NOK	12.08.2024	300	NIBOR + 2.0%
LBANK FLOAT 01/25	NOK	20.01.2025	500	NIBOR +0.79%
LBANK FLOAT 01/25	SEK	20.01.2025	850	STIBOR + 0.80%
LBANK 0.375 5/25	EUR	23.05.2025	300	FIXED 0.375%
LBANK FLOAT 08/25	NOK	18.08.2025	350	NIBOR + 2.35%
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%

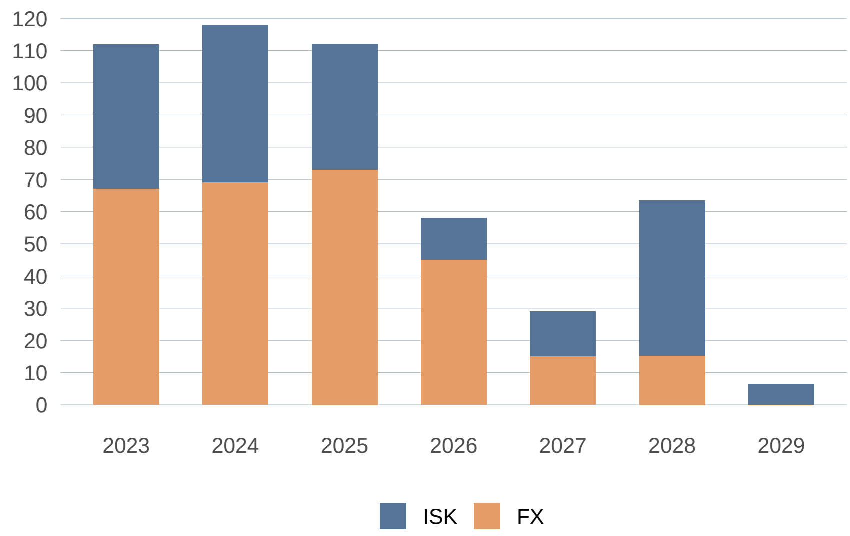
6.5.3.2 Covered bonds

The size of the programme for covered bond issuance was EUR 2.5 billion (ISK 380 billion) at year-end 2022 and increased from ISK 250 billion in 2022. Furthermore, the programme now allows for issuance in other currencies than Icelandic króna and the listing was moved to the Irish stock exchange, Euronext Dublin. Regular auctions of covered bonds were held in 2022 where previously issued bonds were tapped and a new non-indexed series, LBANK CB27 was introduced. During the year the indexed series LBANK CBI22 matured. Agreements with market makers in the secondary market for covered bonds were renewed. At year-end 2022, outstanding covered bonds issuance amounted to ISK 223 billion.

Table 6.4: Covered bonds

As at 31 December 2022	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	38,560	3.40%
LBANK CB 27	ISK	20.09.2027	13,960	4.60%
Indexed				
LBANK CBI 24	ISK	15.11.2024	38,080	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)



6.5.3.3 Commerical paper

No commercial paper auctions were held in 2022 under the ISK 50 billion debt issuance programme. There was no outstanding issuance of commercial paper at year-end 2022.

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 2022 and subordinated issuance under the bank's EMTN programme amounted to EUR 100 million at the same time.

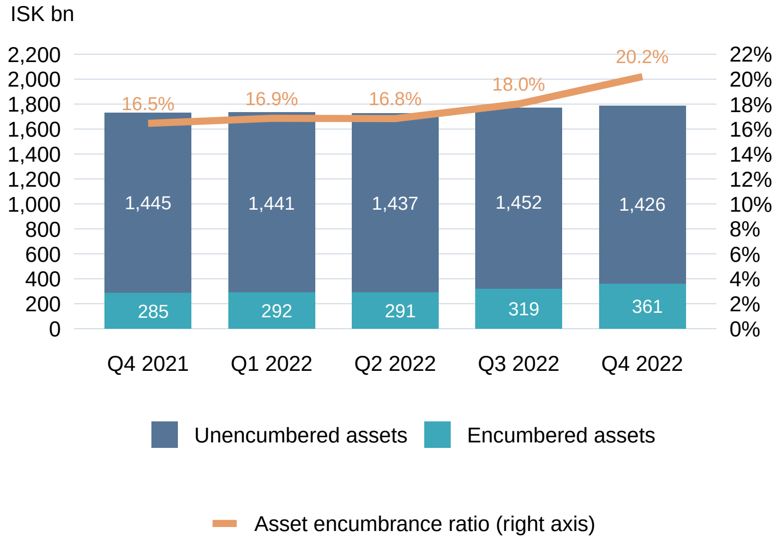
6.5.3.5 Equity

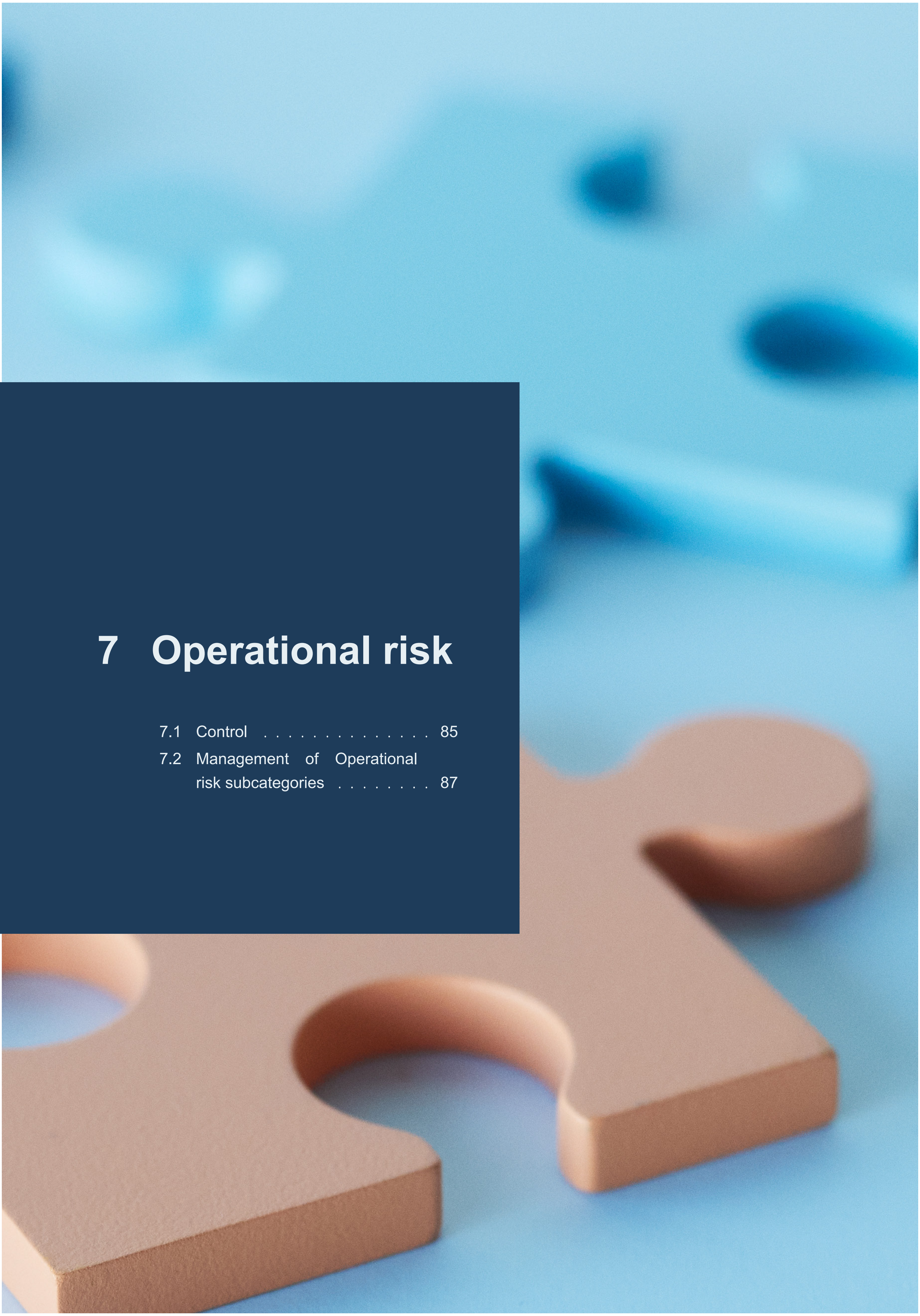
The Bank's equity was ISK 279 billion at year-end 2022, decreasing by ISK 3.6 billion over the course of the year, and the Bank's total capital ratio was 24.7%.

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

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 was an increase of 7% in operational incidents in 2022 compared to 2021.
- There was an increase of 1% in incidents in 2022 compared to 2021.
- Continued emphasis on ICT risk 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 into 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

<table>
<tr><th>Operational Risk Department</th><th>Compliance Department</th></tr>
<tr><td>ICT risk</td><td rowspan="3">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.</td></tr>
<tr><td>Model risk</td></tr>
<tr><td>Change management risk</td></tr>
<tr><td>Physical security</td><td rowspan="2">Conduct risk
involves the risk of financial loss due to human error, neglect or fraud in relation to the Bank’s customers.</td></tr>
<tr><td>Outsourcing risk</td></tr>
</table>

7.1.1 General methods to measure 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 in any particular business unit.
- 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 48 loss events in 2022. The category of execution, delivery and process management has the largest number of loss events; 42 in 2022, the next category ’Business Disruption & System failures’ has 4 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 2022 was 192, 106 were due to transaction processing and 74 related to technology.

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 an annual 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 overseeing 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. Based on the Policy, the Bank has set in place a variety of organisational and managerial actions, e.g.:

- Adopted suitable internal policies and procedures, e.g. Code of Conduct, Fraud Policy, Conflict of Interest Policy and Product Governance Rules.
- Adopted suitable work processes to minimize conduct risk, including robust complaints management procedures and procedures for managing conflicts of interest.
- 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, procedures and processes relevant to their work and responsibilities and take appropriate action in response to conduct infringements.
- Training of management and employees.
- Reporting incidents and internal alerts procedures (‘Whistleblowing’).

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 categorize 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 Operational Risk Policy. Based on the policy, the Bank has set in place a variety of organisational and managerial actions, e.g.:

- A process to monitor and implement regulatory changes.
- 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 compliance 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.

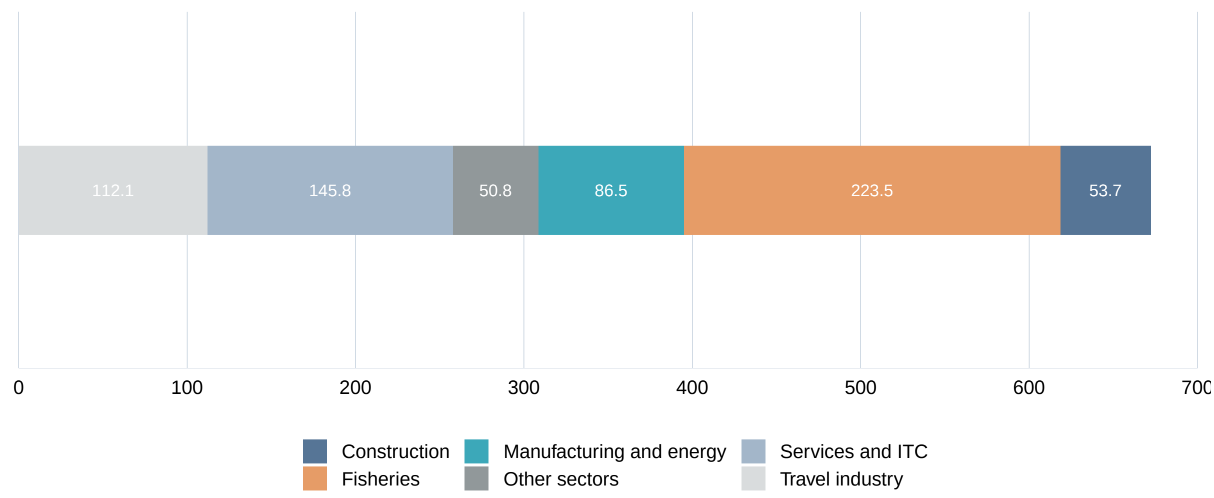
8 ESG risk

ESG risk

Environmental, social and governance (ESG) risk is defined as risk that stems from the current or prospective impact of ESG factors on an institution's counterparties or invested assets, i.e., the risk arising from the core activities of institutions. ESG risk materialises through the traditional categories of financial risks (credit risk, market risk, operational and reputational risks, liquidity and funding risks).

In 2022, the Bank continued to develop its ESG risk framework. The Bank assessed greenhouse gas (GHG) emissions from its credit portfolio for the second time, using the methodology of the Partnership for Carbon Accounting Financials (PCAF). Total GHG emissions from the Bank's credit portfolio amounted to 672 kilotons of CO_2 equivalent ($ktCO_2e$) in 2021 (2020: 627 $ktCO_2e$). Figure 8.1 shows a breakdown of emissions by sector.

Figure 8.1: GHG emissions from the loan portfolio in $ktCO_2e$



The Bank publicly declared support for the Task Force on Climate-related Financial Disclosures (TCFD) in 2022 and continued its work on science-based targets for reducing carbon emissions from its operation. The Bank has assessed ESG risk in relation to other material risks for the Bank. The largest impact of ESG risk is on credit risk, funding risk and operational risk. In 2023, the Bank will continue to develop and implement ESG risk management within its overall risk framework based on this assessment.

No economic capital was allocated nor expected credit loss or other allowance charged in the Bank's financial statement for 2022 due to ESG risk. ESG risk had no direct financial impact on the Bank's 2022 financial results.

8.1 Governance

The Bank's Sustainability Policy sets out aims for sustainability and describes the Bank's methods of implementing these in its operation. The Board of Directors approves the Policy and the CEO is responsible for its implementation and realisation. The CEO is also responsible for monitoring implementation of the Policy and reports to the Board of Directors annually. Authority to approve and amend key points and principles lies with the Executive Board. The Managing Director of Community is responsible for shaping, maintaining and presenting the Sustainability Policy.

Climate risk has been defined as a relevant risk factor in the Bank's Risk Policy. The Risk Management division is responsible for assessing, measuring and developing risk measures for relevant risk factors in the Policy.

The Bank's Risk & Finance Committee has formed a Sustainability Group under its auspices. The Group's role is to oversee the Bank's sustainability framework and compliance of the Bank's green financing schemes to the framework. The Bank produces annual public reports on various ESG-related factors, such as carbon emissions (PCAF and Pillar III additional disclosures) and the Bank's progress on sustainability in a report to the Global Reporting Initiative (GRI).

Information about the governance structure for remuneration is presented in the Bank's Remuneration Report in Chapter 9. For further information on the Bank's governance as regards sustainability, refer to the Bank's Sustainability Policy and the Bank's corporate governance statement.

8.2 Strategy

The Bank has set itself eight sustainability goals based on its Sustainability Policy. These goals directly impact the Bank's business and financial plans, as well as its risk framework, as appropriate. The sustainability goals are:

- Be informed and inform about the Bank's impact on sustainability
- Emphasise responsible lending
- Achieve a reduction in direct GHG emissions
- Achieve a reduction in indirect GHG emissions
- Attain a gender ratio at management levels that accords with set limits
- Share information about EKKO, the Bank's prevention and response plan regarding bullying, gender-based and sexual harassment
- Review sustainability information
- Direct business to responsible suppliers

The Bank has also reassessed which of the United Nations' Sustainable Development Goals (SDGs) its operation impacts most. The Bank focuses on the following four SDGs in its operation.

Figure 8.2: Sustainable Development Goals

The Bank has established a green financing framework and set a target providing that a minimum of 50% of all financing in the next 2 years shall meet the standards of the framework.

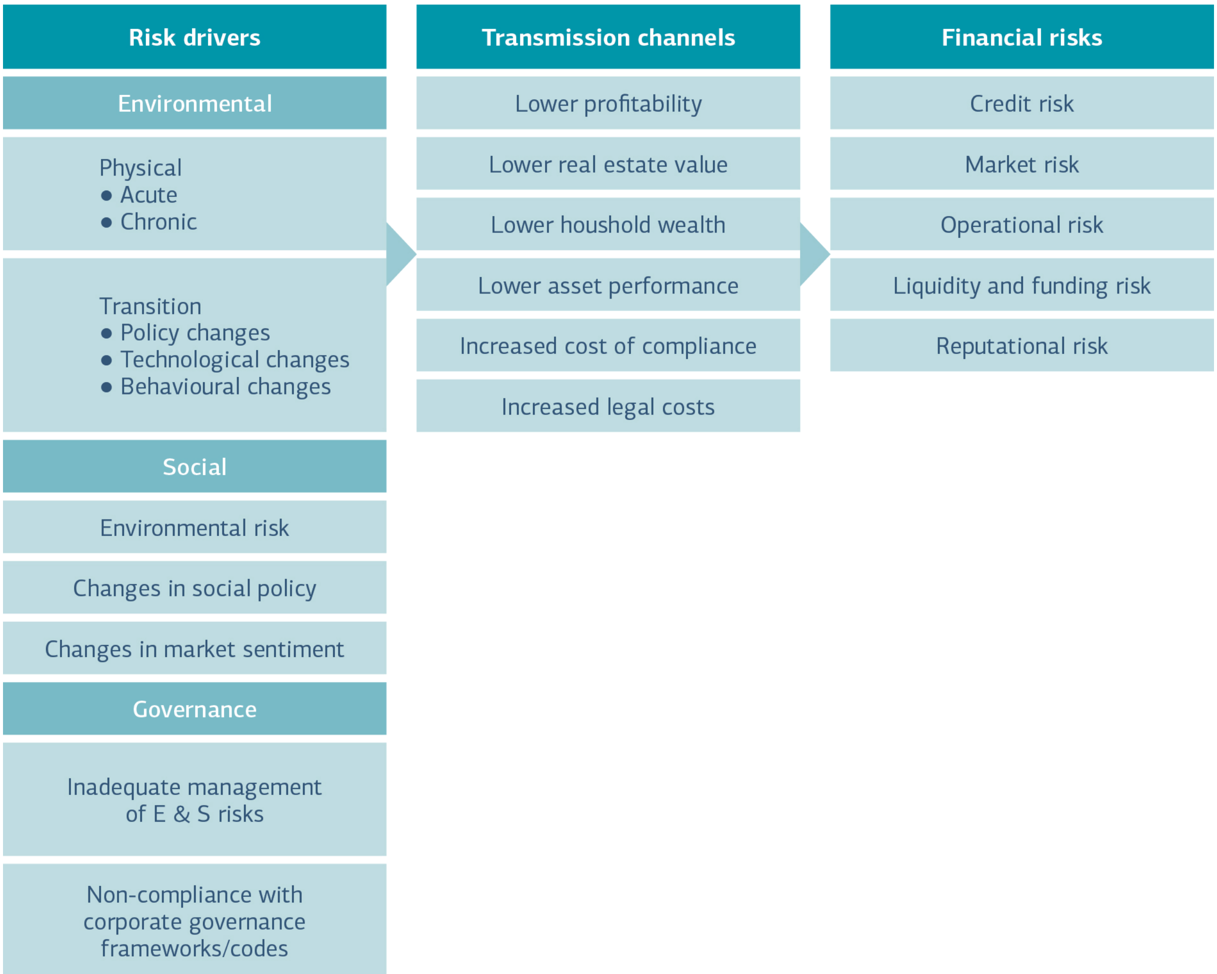
The Bank is in the process of setting science-based targets for carbon emissions and has committed to reaching carbon neutrality by 2040, in tandem with targets set by the Icelandic government. The Bank aims to reach this target in cooperation with its customers, assisting them in their sustainability journey, rather than directing business away from larger emitters. The Bank has published a PCAF report for the year 2021, disclosing information on total GHG emissions from the Bank's operation.

For corporate lending, the Bank has set itself sustainability guidelines. These guidelines influence the assessment of risk and compliance with the Bank's sustainability goals in credit decisions, applying both generally to corporate customers and specifically to certain sectors. These guidelines cover issues such as sound business practises, choice of suppliers, effect of climate change, waste management and more.

8.3 Risk management

ESG risk drivers, e.g. physical climate risk, can affect and amplify traditional financial risk factors such as credit and market risk via various transmission channels as shown in Figure 8.3.

Figure 8.3: ESG risk drivers



The Bank has assessed the impact and materiality of different ESG risk factors on other material financial risk factors in its operations. The assessment underpins further implementation of ESG-related assessments, measures and mitigants in the Bank's risk framework.

Development and integration of ESG risk assessment within the Bank's risk framework will continue in 2023. The main challenges the Bank faces in that regard are the definition of relevant measures, identification of necessary data to apply those measures as well as the collection of identified data.

8.3.1 Environmental risk

Environmental risk is the risk of any negative financial impact on the Bank stemming from the current or prospective impact of environmental factors, such as climate change and other forms of environmental degradation, on its counterparties or invested assets. Climate risk is the most relevant environmental risk factor for the Bank's operation and is the focal point of this section. Climate risk comprises physical risk, which can be further divided into acute and chronic physical risks, and transition risk.

8.3.1.1 Acute physical risk

Acute physical risk arises from particular events, especially weather-related events such as storms, floods, fires or heatwaves or other environmental hazards that may damage production facilities and disrupt value chains, potentially having a negative financial impact on the Bank, its counterparties or invested assets.

An increase in acute physical events due to climate change would potentially impact credit risk for the Bank through the effect on collateral. Real estate is the single largest category of collateral in the Bank's portfolio, all of which is located in Iceland. Another plausible impact on credit risk is that physical risk events could lead to negative economic effects and/or direct negative effects on distinct counterparties or groups of counterparties of the Bank, leading to an increase in default rates. Acute physical risk events are not uncommon in Iceland. Earthquakes, volcanic eruptions, avalanches and landslides are all common acute physical events. As a result, real estate in Iceland is generally well insured against damages, both through regular insurance and via the National Catastrophe Insurance of Iceland (NTI).

Should the effects of acute physical events increase in commonality and seriousness, they might negatively impact asset prices and put increased pressure on the Bank's liquidity profile if individuals and corporates need to access cash as a response to physical catastrophes.

Acute physical events can impact the Bank's operational risk via potential damages to property and equipment, injuries to staff and system disruptions. The Bank utilises data centres in various locations to mitigate this risk. Acute physical events also impact the Bank's suppliers, increasing the importance of supplier monitoring.

The negative impact on the Bank's collateral of acute physical events increasing in commonality and seriousness is already partly mitigated through strong insurance coverage. The impact and materiality of acute physical risk on the Bank's credit risk is therefore considered low. While the potential effect of increased frequency of acute physical events on asset prices and liquidity is not currently mitigated, market risk is a small part of the Bank's overall risk profile and the impact and materiality of acute physical risk on the Bank's market and liquidity risk is as result considered low. The impact and materiality of acute physical risk on the Bank's operational risk is considered low.

8.3.1.2 Chronic physical risk

Chronic physical risk arises from longer-term trends such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity. Such trends can potentially have a negative financial impact on the Bank, its counterparties or invested assets.

Through its exposure to the fisheries industry, the largest sector in the Bank's credit portfolio, the Bank is potentially exposed to chronic physical risk from the negative effect of rising temperatures and acidification on the marine ecosystem around Iceland. Rising sea levels can also potentially impact economic activity and/or real estate close to sea level.

The impact and materiality of chronic physical risk on the Bank's credit, market and liquidity risk is considered medium.

8.3.1.3 Transition risk

Transition risk is the risk of any negative financial impact on the Bank stemming from the current or prospective impact of the transition to an environmentally sustainable economy on its counterparties or invested assets.

Operational conditions in certain sectors of the economy can be sensitive to change in laws and regulations, market conditions and market sentiment. Carbon-heavy industry is an example of this (manufacturing and transportation industries), where potentially increased costs due to the rising price of carbon emission certificates can impact the operation of companies significantly. As Iceland is committed to reaching carbon neutrality by 2040, regulatory changes, increased taxes for carbon-heavy industries or other measures that contribute to this national target can be expected.

This could potentially affect the Bank's credit and liquidity risk, as well as operational risk via conduct risk. As a result, the impact and materiality of transition risk on the Bank's credit, liquidity and operational risk is considered medium. The impact and materiality of transition risk on the Bank's market risk is considered low.

8.3.2 Social risk

Social risk is the risk of any negative financial impact on the Bank stemming from the current or prospective impact of social factors on its counterparties or invested assets.

These social risk factors include but are not limited to activities towards the community and society, employee relationships and labour standards, customer protection and product responsibility and human rights. The Bank's risk policy states that 'the Bank seeks to maintain sound business relationships, having regard for its own position as well as that of customers at each time, and with due regard for any internal connections between customers. The Bank pursues long-term business relationships and aims to avoid being linked to transactions that might damage its reputation.'

As previously mentioned, the Bank has set itself sustainability benchmarks for corporate lending, some of which pertain to social risk factors, such as:

- Considering potential risk factors in the counterparties' operational environment regarding inappropriate business practices, such as tax evasion, market dumping, competition infringements or other deviations from sound business practises.
- Human resource issues, such as equality, turnover of staff and number of staff in relation to the scope of operations.
- The collection of personal data, and security of such data.

The Bank can also be exposed to social risk in its own operation via reputational and conduct risk if it were to fail to adhere to laws, regulations and best practises regarding gender equality, inclusiveness, and health and safety in the workplace. Social conditions in Iceland rank among top conditions in the world in most areas and the Bank is well positioned as regards social issues. The Bank has implemented rules on gender ratios among managers, it has equal pay certification, and contributes to society through partnerships and charitable donations. The impact and materiality of social risk on the Bank's material risk factors in considered low.

8.3.3 Governance risk

Governance risk is the risk of any negative financial impact on the Bank stemming from the current or prospective impact of governance factors on its counterparties or invested assets.

These governance factors include but are not limited to ethical considerations, strategy and risk management, inclusiveness, transparency, management of conflict of interest and internal communication of critical concerns. The credit assessment of corporate customers includes a qualitative assessment of various governance factors for the customer, such as the experience, competence and integrity of executives, finances and planning, and disclosure of information to the Bank. The Bank can also be exposed to governance risk in its own operation via reputational and conduct risk. The Bank has a sound governance structure, with an established three lines of defence setup of risk governance, strong internal audit and compliance departments, a clear remuneration policy and sustainability policy. The greatest potential impact governance risk could have on the Bank is via reputational risk and conduct risk.

The impact and materiality of governance risk on the Bank's material risk factors in considered low.

9 Remuneration report

Remuneration report

The Bank emphasises hiring and employing exceptional personnel. The aim of its 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 Bank's Executive Board, and all employees of the Bank. The subsidiary of Landsbréf has its own remuneration policy and Remuneration Committee.

9.1 Governance

The remuneration policy of the Bank is approved by its Board of Directors and submitted to the Bank's Annual General Meeting for approval or rejection. The remuneration policy is reviewed annually, 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 note any deviations from the remuneration policy and substantiation thereof in the Board 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 Procedure for the Committee, setting out its role and duties.

The Remuneration Committee members are the Chairman of the Board, which also chairs the Remuneration Committee, the Vice-Chairman of the Board and one other Director of the Board. In 2022, the Remuneration Committee held 6 meetings. The Committee reviewed the remuneration policy in preparation for the 2022 AGM and made no significant changes.

9.2 Remuneration policy 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 had for hours spent on the job, the responsibilities borne by Directors of the Board and the Company's performance. The Remuneration Committee presents the Board of Directors with a substantiated proposal for remuneration to Directors 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 remuneration in accordance with the remuneration policy.

The CEO hires the Bank's key executives in accordance with the remuneration policy. The Bank publicises the terms of employment of Directors and key executives in its Annual & Sustainability Report. The Bank intends to achieve and maintain a gender balance of at least 60/40 at all levels of management. There are currently five male and two female Managing Directors, and the CEO is female. Members of the Bank's management body hold a total of 3 directorships in other entities.

Most employees in the Bank receive a fixed salary, according to position and function. The salary is evaluated on an annual basis. Employee benefits are offered to all employees. Mandatory pension contributions are made for all employees who also receive paid vacation as provided for by law, collective agreements and general market terms.

The Bank does not offer variable remuneration or bonuses and has no plan to implement any such remuneration system. Any decision to implement a variable remuneration scheme must be presented to a shareholders' meeting for approval.

In 2013, 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 by financial undertakings. As a result, employees appear on the list of shareholders in the Bank.

The Remuneration Committee performs an annual comparison with market data on the Bank's remuneration to ensure remuneration is in accordance with the remuneration policy. Further quantitative information regarding the Bank's remuneration can be found in templates REM1, REM2 and REM5 in the additional disclosures accompanying this report.

10 Appendix

Table 10.1: List of additional disclosures

Template name	Template code	Type	Disclosure frequency	Reference chapter
Risk management				
Institution risk management approach	OVA	Qualitative	Annual	Chapter 2
Disclosure on governance arrangements	OVB	Qualitative	Annual	Chapter 2
Key metrics and risk-weighted exposure amounts				
Overview of RWEAs	OV1	Quantitative	Quarterly	Chapter 3
Key metrics template	KM1	Quantitative	Quarterly	Chapter 1
ICAAP information	OVC	Qualitative	Annual	Chapter 3
Own funds				
Composition of regulatory own funds	CC1	Quantitative	Semi-annual	Chapter 3
Reconciliation of regulatory own funds to balance sheet in the audited financial statements	CC2	Quantitative	Semi-annual	Chapter 3
Main features of regulatory own funds instruments and eligible liabilities instruments	CCA	Quantitative	Annual	Chapter 3
Comparison of institutions' own funds and capital and leverage ratios with and without the application of transitional arrangements for IFRS 9 or analogous ECLs	IFRS 9-FL	Quantitative	Quarterly	Chapter 3
Countercyclical capital buffers				
Geographical distribution of credit exposures used in the countercyclical capital buffer	CCyB1	Quantitative	Semi-annual	Chapter 3
Amount of institution-specific countercyclical buffer	CCyB2	Quantitative	Semi-annual	Chapter 3
Scope of application				
Differences between the accounting scope and the scope of prudential consolidation and mapping of financial statement categories with regulatory risk categories	LI1	Quantitative	Annual	Chapter 3
Main sources of differences between regulatory exposure amounts and carrying values in financial statements	LI2	Quantitative	Annual	Chapter 3
Outline of the differences in the scopes of consolidation (entity by entity)	LI3	Quantitative	Annual	Chapter 3
Explanations of differences between accounting and regulatory exposure amounts	LIA	Qualitative	Annual	Chapter 3

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Table 10.1 - Continued from previous page

Template name	Template code	Type	Disclosure frequency	Reference chapter
Other qualitative information on the scope of application	LIB	Qualitative	Annual	Chapter 3
Leverage ratio				
LRSum - Summary reconciliation of accounting assets and leverage ratio exposures	LR1	Quantitative	Semi-annual	Chapter 3
LRCom - Leverage ratio common disclosure	LR2	Quantitative	Semi-annual	Chapter 3
LRSpl - Split-up of on balance sheet exposures (excluding derivatives, SFTs and exempted exposures)	LR3	Quantitative	Semi-annual	Chapter 3
Disclosure of LR qualitative information	LRA	Qualitative	Annual	Chapter 3
Liquidity requirements				
Liquidity risk management	LIQA	Qualitative	Annual	Chapter 6
Quantitative information of LCR	LIQ1	Quantitative	Quarterly	Chapter 6
Qualitative information on LCR, which complements template EU LIQ1	LIQB	Qualitative	Quarterly	Chapter 6
Net Stable Funding Ratio (NSFR)	LIQ2	Quantitative	Semi-annual	Chapter 6
Credit risk quality				
General qualitative information about credit risk	CRA	Qualitative	Annual	Chapter 4
Additional disclosure related to the credit quality of assets	CRB	Qualitative	Annual	Chapter 4
Performing and non-performing exposures and related provisions	CR1	Quantitative	Semi-annual	Chapter 4
Maturity of exposures	CR1-A	Quantitative	Semi-annual	Chapter 4
Changes in the stock of non-performing loans and advances	CR2	Quantitative	Semi-annual	Chapter 4
Credit quality of forborne exposures	CQ1	Quantitative	Semi-annual	Chapter 4
Credit quality of performing and non-performing exposures by past due days	CQ3	Quantitative	Semi-annual	Chapter 4
Credit quality of loans and advances to non-financial corporations by industry	CQ5	Quantitative	Semi-annual	Chapter 4
Collateral obtained by taking possession and execution processes	CQ7	Quantitative	Semi-annual	Chapter 4
Credit risk mitigation techniques				
Qualitative disclosure requirements related to CRM techniques	CRC	Qualitative	Annual	Chapter 4
CRM techniques overview - Disclosure of the use of credit risk mitigation techniques	CR3	Quantitative	Semi-annual	Chapter 4
Use of the standardised approach				

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Table 10.1 - Continued from previous page

Template name	Template code	Type	Disclosure frequency	Reference chapter
Qualitative disclosure requirements related to standardised approach	CRD	Qualitative	Annual	Chapter 4
Standardised approach - credit risk exposure and Credit Risk Mitigation (CRM) effects	CR4	Quantitative	Semi-annual	Chapter 4
Standardised approach	CR5	Quantitative	Semi-annual	Chapter 4
Counterparty credit risk				
Qualitative disclosure related to CCR	CCRA	Qualitative	Annual	Chapter 5
Analysis of CCR exposure by approach	CCR1	Quantitative	Semi-annual	Chapter 5
Transactions subject to own funds requirements for CVA risk	CCR2	Quantitative	Semi-annual	Chapter 5
Standardised approach - CCR exposures by regulatory exposure class and risk weights	CCR3	Quantitative	Semi-annual	Chapter 5
Composition of collateral for exposures to CCR	CCR5	Quantitative	Semi-annual	Chapter 5
Credit derivatives exposures	CCR6	Quantitative	Semi-annual	Chapter 5
Market risk				
Qualitative disclosure requirements related to market risk	MRA	Qualitative	Annual	Chapter 5
Market risk under the standardised approach	MR1	Quantitative	Semi-annual	Chapter 5
Operational risk				
Qualitative information on operational risk	ORA	Qualitative	Annual	Chapter 7
Operational risk own funds requirements and risk-weighted exposure amounts	OR1	Quantitative	Annual	Chapter 7
Encumbered assets				
Encumbered and unencumbered assets	AE1	Quantitative	Annual	Chapter 6
Collateral received and own debt securities issued	AE2	Quantitative	Annual	Chapter 6
Sources of encumbrance	AE3	Quantitative	Annual	Chapter 6
Accompanying narrative information	AE4	Quantitative	Annual	Chapter 6
Remuneration				
Remuneration policy	REMA	Qualitative	Annual	Chapter 9
Remuneration awarded for the financial year	REM1	Quantitative	Annual	Chapter 9
Special payments to staff whose professional activities have a material impact on the instituions' risk profile	REM2	Quantitative	Annual	Chapter 9
Information on remuneration of identified staff	REM5	Quantitative	Annual	Chapter 9
Interest rate risk of non-trading book activities				

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Table 10.1 - Continued from previous page

Template name	Template code	Type	Disclosure frequency	Reference chapter
Qualitative information on interest rate risks of non-trading book activities	IRRBBA	Qualitative	Annual	Chapter 5
Interest rate risk of non-trading book activities	IRRBB1	Quantitative	Semi-annual	Chapter 5
Environmental, social and governance risk				
Environmental risk	ESGA	Qualitative	Annual	Chapter 8
Social risk	ESGB	Qualitative	Annual	Chapter 8
Governance risk	ESGC	Qualitative	Annual	Chapter 8
Climate change transition risk: Credit quality of exposures by sector, emissions and residual maturity	ESG1	Quantitative	Annual	Chapter 8