Pillar 3 Risk Disclosures

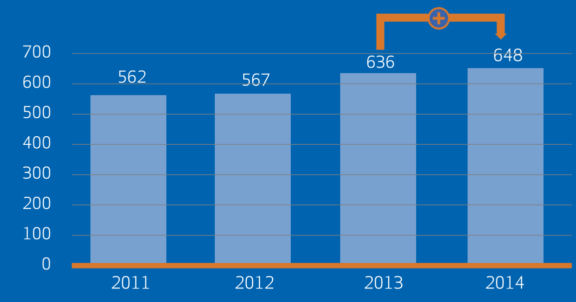
2014

Arion Bank

DISCLAIMER

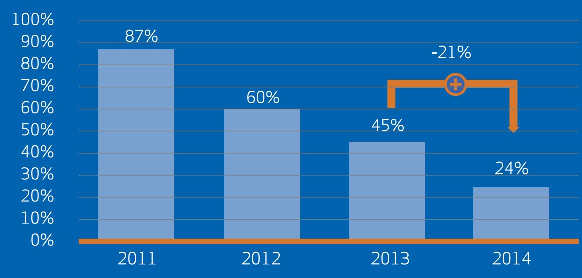
RISK METRICS OVERVIEW

Loans to customers



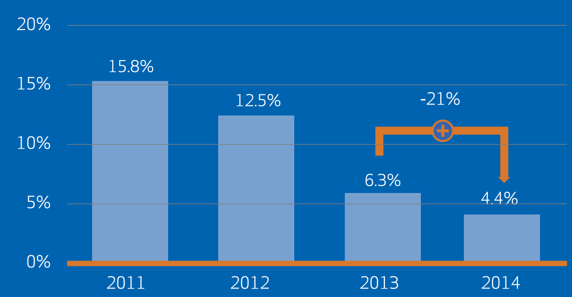
See section 4.5

Sum of large exposures net of eligible collateral



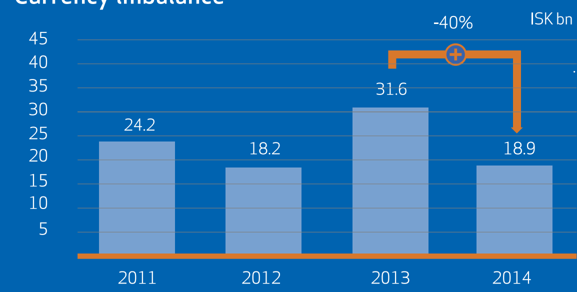
See section 4.5.1

Problem loans



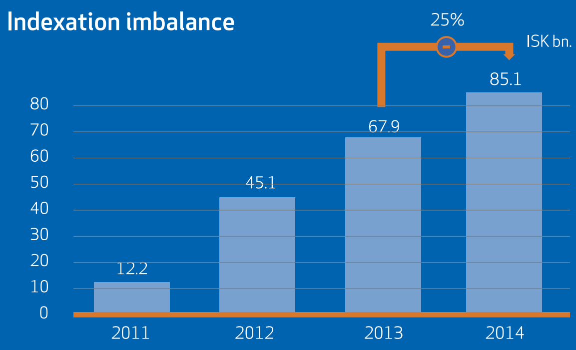
See section 4.8.4

Currency imbalance



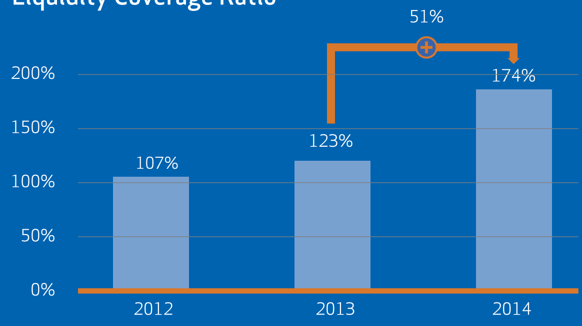
See section 5.5

Indexation imbalance



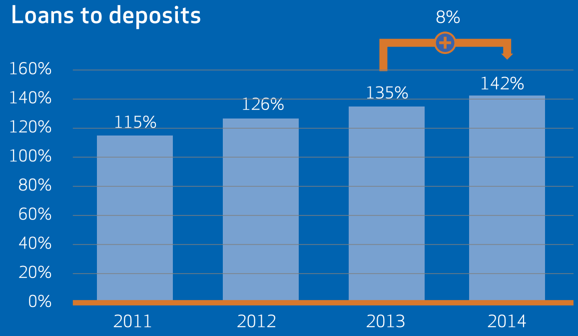
See section 5.6

Liquidity Coverage Ratio



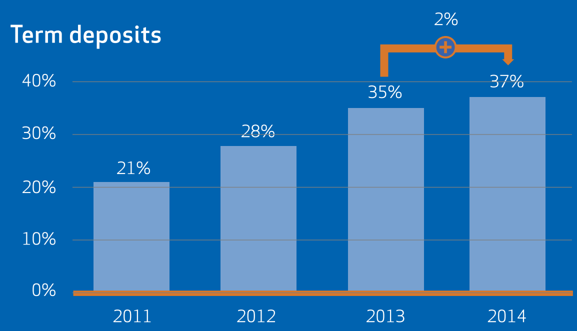
See section 6.3

Loans to deposits



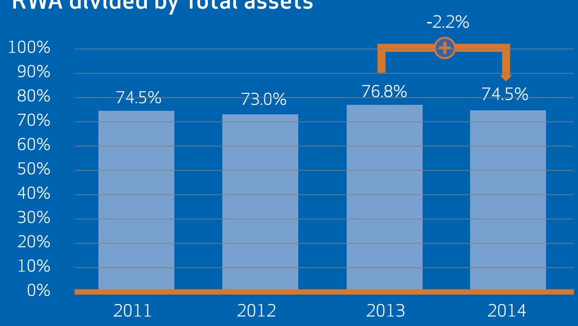
See section 6.4

Term deposits



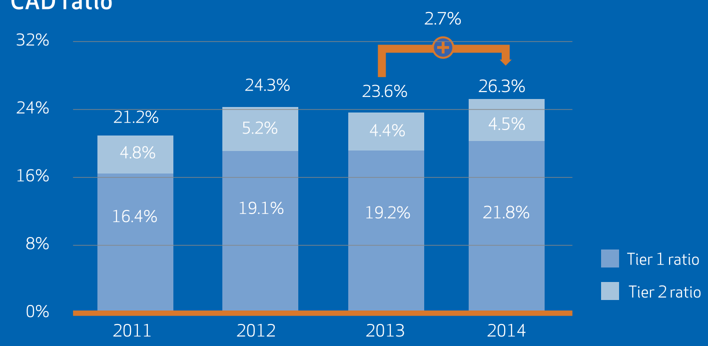
See section 6.3

RWA divided by Total assets



See section 3.2

CAD ratio



See section 3.2

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1 INTRODUCTION

1 INTRODUCTION

The Pillar 3 Risk Disclosures comprise information on capital and risk management at Arion Bank. The purpose of the disclosures is to meet regulatory requirements and to inform readers about Arion Bank's risk profile and risk management. The disclosures contain information on the governance of risk, capital structure and capital adequacy, and risk management with respect to each type of risk. Information on new and upcoming legislation as well as information on remuneration policy is included in the disclosures.

1.1 ARION BANK AT A GLANCE

Arion Bank, whose roots date back to 1930, is built on a strong heritage and infrastructure. Arion Bank is a strong, well capitalized bank which offers a full range of universal banking services to its customers through various distribution channels. The Bank operates a number of branches across Iceland with a focus on the capital area. In addition, the Bank operates a customer service centre, and offers online and mobile banking, which provides a wide range of self-service options.

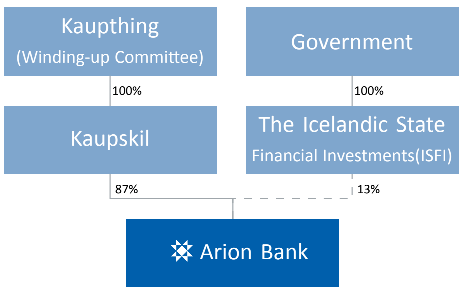
Figure 1.1 Arion Bank's branch network

Arion Bank is a relationship bank with its prime emphasis on corporations and individuals seeking a variety of financial solutions. The Bank focuses on building and strengthening long-term customer relationships by delivering excellent service and tailored solutions. Arion Bank is at the forefront of the domestic financial market in regards to return on equity, operational efficiency and service offering.

Arion Bank has taken important funding and market initiatives in recent years. In 2013 the Bank completed its first international bond offering, the first among Icelandic banks since 2007. The Bank has continued to diversify its funding profile in 2014, see section 1.2. As a relationship bank, a strong focus is placed on product development, not least on the mortgage market. The Bank became the first Icelandic bank to offer non-indexed mortgages with fixed interest for five years as well as with mixed loans.

The Bank consists of six main business segments: Asset Management, Corporate Banking, Investment Banking, Retail Banking, Treasury, and Other divisions and Subsidiaries. At year end 2014 the number of full-time equivalent positions at Arion Bank and its subsidiaries was 1,139.

Figure 1.2 Ownership structure



Arion Bank has two shareholders. Kaupthing hf., on behalf of its creditors, holds an 87% stake in the Bank through its subsidiary Kaupskil ehf. The remaining 13% share is held by the Icelandic State Financial Investments on behalf of the Icelandic Government.

The Bank's Annual Report 2014 provides further information about the Bank, such as strategy and vision, and corporate governance.

1.2 MAJOR CHANGES IN 2014

Several developments influenced Arion Bank's risk profile in 2014. Highlights include:

CHANGES IN THE GROUP STRUCTURE

In June the Bank sold its subsidiary Landfestar ehf. (commercial real estate company) to Eik fasteignafélag hf., another commercial real estate company and the Bank currently holds a 14% share in Eik fasteignafélag hf. which is recognized as financial instruments at the end of the year. The main effect on the Group of the sale of Landfestar hf. was a decrease in investment property. At the end of 2014, the Bank acquired Landsbankinn's 38% share in Valitor Holding hf. and now owns 98.8% in the company. Meanwhile, Valitor Holding hf. acquired the Danish company AltaPay A/S with the aim of supporting Valitor's growing business in the Nordic region.

SALE OF HB GRANDI

The sale and listing of HB Grandi hf. had a significant impact on the Group's results and risk profile. In April the Bank sold an 18.8% share in the company when it was listed on NASDAQ Iceland. Prior to the sale the Bank owned 31% of the company and this asset was classified as an asset held for sale. Realized gains on the sale totaled ISK 6.3 billion and this is recognized as disposal groups and unrealized gains are recognized as financial income. The Bank's holding in HB Grandi hf. at the end of the year is recognized as listed financial instruments in the balance sheet.

PREPARATION FOR THE LIFTING OF CAPITAL CONTROLS

Since the end of 2008, the Icelandic economy has been subject to capital controls on almost all monetary transactions to and from Iceland, which have entailed a low level of investment and complicated access to funding. The Icelandic Government has expressed its willingness to lift the capital controls but it is unclear when steps will be taken. During 2014 the Bank strengthened further its liquidity position and diversified its funding base in the short term and long term, with particular focus on foreign currency, to meet any potential outflow of deposits that would be expected if the capital controls were to be lifted.

FUNDING

Arion Bank established an EMTN (Euro Medium Term Note) programme to issue bonds in foreign currency during the year. The programme enables Arion Bank to issue bonds at short notice on the international market for the equivalent of up to EUR 1 billion. Arion Bank launched its inaugural transaction from the EMTN programme in March 2015 when the Bank issued its euro senior unsecured benchmark transaction, the first by an Icelandic bank post 2008. The transaction saw very strong demand from real money accounts with limited hedge fund participation. Also the transaction received good demand from Nordic investors many of which had previously invested in Arion 500mn NOK bond in 2013. At the end of 2014 structured covered bonds issued by Arion Bank were admitted to trading on NASDAQ Iceland. Arion Bank is the leading issuer of covered bonds in Iceland. The Bank's total outstanding covered bonds are ISK 129 billion.

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INTRODUCTION

GOVERNMENT PLAN FOR HOUSEHOLD DEBT RELIEF

During 2014, the Icelandic Government executed its household debt relief plan on the basis of Act No. 35/2014. The finalized plan involved writing down CPI-indexed mortgages by capping the CPI in the years 2008-2009. The maximum amount of the write-down per household was ISK 4 million and previous debt-relief remedies were deducted from the amount of the correction. 75% of the write-down will be executed during Q1 2015 and the balance at the end of 2015. The write-down is funded by the Icelandic Government via a special tax levied against Icelandic banks, including those that are in winding-up proceedings. Although this plan reduces political risk related to political pressure for household debt relief it has come at the cost of a threefold increase in the bank levy compared with the previous year.

CHANGES IN LIQUIDITY RULES

On 1 December 2013 the Central Bank of Iceland issued Rules on Liquidity Ratio, No. 1055/2013. The rules are based on the Liquidity Coverage Ratio (LCR) standard developed by the Basel Committee on Banking Supervision and incorporated into EU law in 2013 via the Capital Requirements Directive (CRD IV). During 2014 the Central Bank clarified its definition of retail deposits which allowed certain deposit pension funds to be reclassified as retail deposits. At the end of 2014 the Central Bank introduced additional liquidity coverage requirements for deposits related to the winding-up of the old banks. Arion Bank satisfies the Central Bank's requirements, exceeding 100% both for the LCR and the special LCR for foreign currency.

NEW FUNDING STABILITY RULES

On 1 December 2014 the Central Bank of Iceland issued new rules on funding ratios for foreign currency funding, No. 40/2014, based on the Basel Committees Net Stable Funding Ratio (NSFR). The rules call for an 80% NSFR in foreign currency until end 2015 with a 10% increase in 2016 and 2017. Arion Bank satisfies the requirements set out in these rules.

LEVERAGE RATIO

As a complement to risk-adjusted capital requirements, the Capital Requirements Regulation (CRR) requires banks to measure and disclose its leverage ratio as a measure of its assets against its capital base. The leverage ratio is intended to reinforce the risk-based requirements with a simple, non-risk-based 'backstop' and restrict the build-up of leverage in the banking sector. As of 1 January 2015, public disclosure of the leverage ratio is required. The Bank's 15.4% leverage ratio far exceeds the 3% Tier 1 leverage ratio which will apply from 1 January 2019 onwards.

The Bank's 15.4% leverage ratio far exceeds the 3% Tier 1 leverage ratio which will apply from 1 January 2019 onwards

INTERNATIONAL CREDIT RATING

In January 2014 Standard & Poor's assigned Arion Bank a credit rating of BB+ with a stable outlook which is just one notch below the rating of the Icelandic Government. The outlook was changed to positive in the autumn in line with Standard & Poor's change in outlook on the Icelandic sovereign rating.

In the autumn of 2014 the credit ratings agency Standard & Poor's revised its BB+ rating of Arion Bank from a stable to a positive outlook

1.3 REGULATORY FRAMEWORK

Capital and risk management disclosure requirements for financial institutions are stipulated in the Basel II framework. The Basel II framework is an international accord on capital requirements and is intended to strengthen measurement and monitoring of financial institutions' capital by adopting a more risk sensitive approach to capital management.

The Basel II framework encompasses three complementary pillars:

- Pillar 1 - capital adequacy requirements
- Pillar 2 - supervisory review
- Pillar 3 - market discipline

Under Pillar 3, capital adequacy must be reported through public disclosures that are designed to provide transparent information on capital structure, risk exposures, and the risk assessment process. The Basel II framework was implemented at European Union level by Directive 2006/48 on the taking up and pursuit of the business of credit institutions and Directive 2006/49 on the capital adequacy of investment firms and credit institutions, together referred to as the Capital Requirements Directive (CRD). The Directives were incorporated into the EEA Agreement and implemented into Icelandic legislation with Act No. 170/2006 and Act No. 75/2010 amending Act No. 161/2002 on Financial Undertakings and Rules of the Icelandic Financial Supervisory Authority (FME) No. 215/2007 on the Capital Requirements and Risk Weighted Assets of Financial Undertakings with later amendments.

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

1.3.1 THE STATUS OF CRD IV IMPLEMENTATION IN ICELAND

In June 2013 the EU Council adopted the CRD IV package, which consists of the Capital Requirements Regulation (CRR, Regulation No. 575/2013) and the Capital Requirements Directive (CRD IV, Directive 2013/36/EU), the EU's implementation of the Basel III reforms. Preparation for implementation in Iceland has been underway since November 2012 when the Government established a working committee. The Committee's role is to present a proposal for a bill implementing the Directive to the Ministry of Finance and Economic Affairs. A bill of law was submitted to the Parliament in March 2015 including provisions regarding capital buffers, governance, remuneration and management of risk. A second bill completing the implementation of the Directive is expected to be put forward in the Parliament in late spring or the autumn session of the Parliament. The CRR Regulation is being translated and implementation is expected in the spring of 2015.

1.4 DISCLOSURE POLICY

The Bank has in place a formal Pillar 3 disclosure policy, approved by the Board of Directors, to address the requirements laid down by law. The Bank may omit information if it is not regarded as material. Information is regarded as material in disclosures if its omission or misstatement could change or influence the assessment or economic decisions of a user relying on the information.

In addition, if required information is deemed to be proprietary or confidential, the Bank may decide to exclude it from the Pillar 3 Risk Disclosures. The Bank defines information as proprietary which, if shared, would undermine the Bank's competitive position. Information is regarded as confidential if there are obligations binding the Bank to confidentiality.

1.5 PILLAR 3 RISK DISCLOSURES

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfil the aforementioned legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures have been reviewed, verified and approved internally in line with the Bank's Pillar 3 disclosure policy. The disclosures have not been subject to external audit but contain information from the Bank's audited Consolidated Financial Statements for 2014. Summarized information on risk management and capital adequacy is presented in the Bank's Annual Report and regulatory capital information is provided quarterly in the Bank's interim reports. The Bank's annual Financial Statements are audited by the Bank's external auditors, the half-year Financial Statements are reviewed by the Bank's external auditors but the Q1 and Q3 Financial Statements are unaudited.

The Pillar 3 Risk Disclosures have been prepared in accordance with regulatory capital adequacy rules and may differ from similar information in the Bank's Consolidated Financial Statements for 2014, which are prepared in accordance with International Financial Reporting Standards (IFRS). Therefore some information in these disclosures may not be directly comparable with the information in the Financial Statements.

All financial figures, calculations and information in the disclosures are based on 31 December 2014 and presented in ISK millions, unless otherwise stated. Due to rounding, numbers in the disclosures may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures. The disclosures are published on an annual basis in the Pillar 3 Risk Disclosures and are available on the Bank's website following the Annual General Meeting.

1.6 SCOPE OF APPLICATION

Information in the Pillar 3 Risk Disclosures refers to the Arion Bank Group, which consists of the parent entity, Arion Bank, and its subsidiaries; together referred to as the 'Bank'. The Bank is subject to consolidated supervision by the FME. The basis of consolidation for financial accounting purposes is the same as for regulatory capital reporting purposes. All subsidiaries are fully consolidated. The main subsidiaries, in which Arion Bank held a direct interest at the end of 2014, are shown in Table 1.1. Where necessary, a distinction is made in the report between the group and parent entity. Parent entity information includes the Arion Bank Mortgages Institutional Investor Fund (ABMIIF).

Table 1.1 Main subsidiaries in which Arion Bank held a direct interest at the end of 2014, fully consolidated

Company	Operating activity	Ownership %	Currency	Country	Operation
AFL - sparisjodur	Retail banking	99.3	ISK	Iceland	Core
ABMIIF	Retail banking	100.0	ISK	Iceland	Core
BG12 slhf.	Holding company	62.0	ISK	Iceland	Non-core
EAB 1 ehf.	Holding company	100.0	ISK	Iceland	Non-core
Eignabjarg ehf.	Holding company	100.0	ISK	Iceland	Non-core
Eignarhaldsfelagid Landey ehf.	Real estate	100.0	ISK	Iceland	Non-core
Okkar liftryggingar hf.	Life insurance	100.0	ISK	Iceland	Core
Stefnir hf.	Asset management	100.0	ISK	Iceland	Core
Valitor Holding hf.	Payment solutions	98.8	ISK	Iceland	Core

2 **RISK** MANAGEMENT

2 RISK MANAGEMENT

The Bank is in the business of taking risk. Risk is primarily incurred from extending credit to customers through trading and lending operations. Beyond credit risk, the Bank is also exposed to a range of other risk types such as market, liquidity, operational, reputational and other risks that are inherent in the Bank's strategy, product range and operating environment.

Risk transparency for senior managers helps them make better decisions. The Bank's risk management policy is to maintain a risk culture at the Bank whereby risk is everyone's business.

The Bank's strategy is to have effective risk control which includes the identification of significant risks, the quantification of the risk exposure, actions to limit risk and monitoring risk. The Executive Management Committee devotes a significant portion of its time to the management of these risks. The Bank's risk is most often categorized in four types; credit, market, liquidity and operational risk. Each type will be discussed in detail in this report.

2.1 INTERNAL CONTROLS AND LINES OF REPORTING

The Bank is committed to the highest standards of corporate governance in its business, including risk management. The Bank's corporate governance framework is based on legislation, regulations and recognized guidelines in force at each time. The ultimate responsibility for setting the Bank's risk and governance policies and for ensuring effective internal control and management of risk rests with the Board of Directors. The enforcement of the Board's policies is delegated to the Chief Executive Officer (CEO) who in turn delegates risk management to the Chief Risk Officer (CRO) and regulatory compliance to the Compliance Officer.

The Bank is committed to the highest standards of corporate governance in its business, including risk management

The CEO, on the behalf of the Board of Directors of Arion Bank, interacts with the boards of directors of individual subsidiaries and ensures that the risk appetites of subsidiaries align with the risk appetite of the Bank. Through the group-level Internal Capital Adequacy Assessment Process (ICAAP), the CRO interacts with individual subsidiaries' risk managers and consolidates the assessment of capital requirements for the Bank.

Figure 2.1 Internal control structure

Acting within an authority delegated by the Board, the Board Audit and Risk Committee (BARC), see Table 2.1, is responsible for the overseeing and reviewing of prudential risks including, but not limited to, credit, market, capital, liquidity, operational and reputational risk. The BARC reviews the Bank's risk appetite, see section 2.5, and makes recommendations thereon to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls, and considering the implications of material regulatory change proposals.

The BARC reviews the Bank's risk appetite and makes recommendations thereon to the Board when applicable

The Compliance division's objective is to reduce the Bank's risks of legal or regulatory sanctions, material financial loss, or loss to the Bank's reputation as a result of failure to comply with laws, regulations, or sound business practices applicable to its investment services. Furthermore, the Compliance Officer is also the Bank's Money Laundering Reporting Officer (MLRO), and as such is responsible for supervising the Bank's measures in accordance with the Act No. 64/2006 on Measures against Money Laundering and Terrorist Financing.

Internal Audit is responsible for the independent review of risk management and the control environment. Its objective is to provide reliable, valuable and timely assurance to the Board and Executive Management of the effectiveness of controls, mitigating current and evolving high risks and in so doing enhancing the controls culture within the Bank. The BARC reviews and approves Internal Audit's plans and resources, and evaluates the effectiveness of Internal Audit. The Chief Internal Auditor is appointed by the Board and accordingly has an independent position in the Bank's organizational chart.

The CRO and the Risk Management function operate according to a charter for risk management defined by the Board of Directors. The CRO is a member of the Executive Management Committee and reports to the CEO with unhindered access to the Board. The CRO has overall day-to-day accountability for risk management in the Bank's parent company and periodic accountability for risk assessment in the Bank through the ICAAP. Reporting to the CRO, and working in the Risk Management division, are department heads responsible for the management of retail and corporate credit risk, market risk, liquidity risk and operational risk. Along with their teams, the department heads are responsible for overseeing and monitoring the risks and controls of their risk type. The departments interact with each business unit as part of the monitoring and management processes, see section 2.4.

2.2 THREE LINES OF DEFENSE

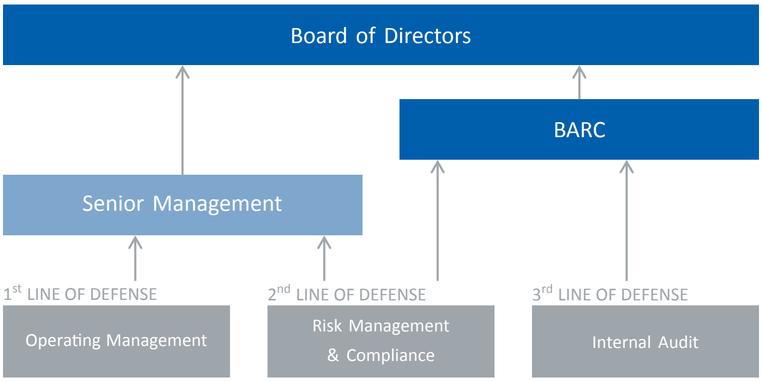
In order to ensure the effectiveness of the Bank's internal controls, to clarify responsibilities and coordinate essential risk management, and to foster the culture wherein risk is every employee's business, the Bank has adopted the three lines of defense model.

The Bank has adopted the three lines of defense model in order to ensure the effectiveness of internal controls

The model distinguishes between three lines involved in effective risk management:

- Functions that own and manage risks
- Functions that oversee risk management
- Functions that provide independent assurance of effectiveness

Figure 2.2 Three lines of defense



FIRST LINE OF DEFENSE: OPERATING MANAGEMENT

Operational management, i.e. those in charge of overseeing and designing business operations, naturally serves as the first line of defense, which owns and manages risks, as controls are designed to fit into systems and processes under their guidance.

SECOND LINE OF DEFENSE: RISK MANAGEMENT & COMPLIANCE

The second line of defense is established to ensure that the first line of defense is properly designed, in place, and operating as intended. The Bank's Risk Management and Compliance divisions are the primary second line of defense, but other divisions may also have limited second line of defense duties.

THIRD LINE OF DEFENSE: INTERNAL AUDIT

Internal Audit provides the Board of Directors and the senior management with comprehensive assurance based on the highest level of independence and objectivity within the Bank.

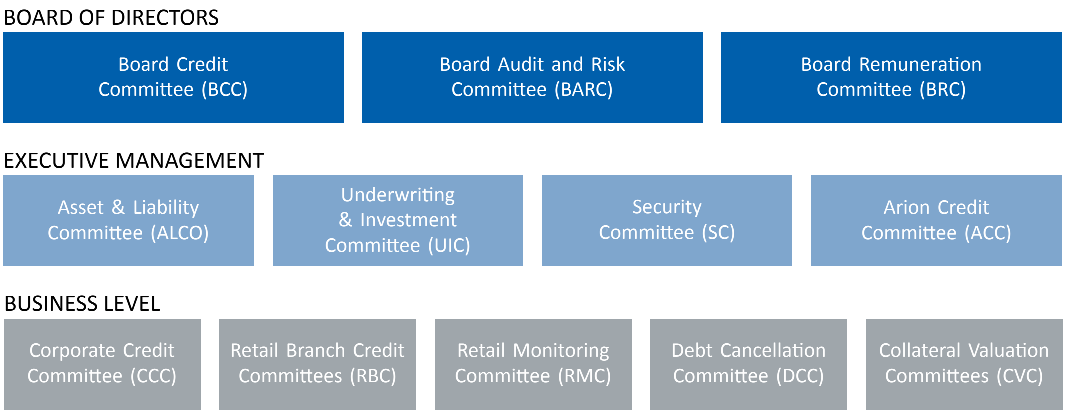
Internal Audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives.

2.3 RISK COMMITTEES

The structure of risk committees within the Bank can be split into three levels. The committees define lines of responsibility and accountability within the Bank. They are charged with overseeing risk and the delegation of authority and form a control environment for the Bank.

The risk committees define lines of responsibility and accountability within the Bank

Figure 2.3 Risk committee structure



Board level committees are established by the Board and composed of members of the Board or external representatives nominated by the Board. An overview of the committees at Board level and their responsibilities is shown in Table 2.1.

Table 2.1 Board level committees

Committee	Responsibilities
Board Audit and Risk Committee (BARC)	The Board Audit and Risk Committee provides guidance to the Board on the Bank's strategy and risk appetite, and internal risk management structure. The committee gives the Board an overview of the Bank's risk management. The recommendation to the Board on the selection of an external auditor to the Board is one of the committee's responsibilities, as is ensuring his independence. The committee supervises accounting procedures, the annual accounts and interim accounts.
Board Credit Committee (BCC)	The Board Credit Committee is the Bank's supreme credit, investment and underwriting authority. The committee is authorized to delegate its authority as necessary. Furthermore, the committee can delegate specific authority to the CEO to be used in extraordinary circumstances. The committee periodically reviews reports on various aspects of the credit portfolio.
Board Remuneration Committee (BRC)	The Board Remuneration Committee prepares a remuneration policy for the Bank that shall be reviewed by the Board at least annually and submitted to the AGM for approval. The committee advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor and on the Bank's incentive scheme and other work-related payments. The CEO proposes a salary framework for Managing Directors, the Compliance Officer and Chief Internal Auditor in consultation with the BRC.

Executive level committees which are composed of the CEO and Managing Directors or their designated representative are shown in Table 2.2.

Table 2.2 Executive level committees

Committee	Responsibilities
Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases below BCC's credit granting limits. The committee delegates limited authority and sets forth credit rules to lower credit granting bodies. ACC reviews reports concerning the credit portfolio. The CRO or his deputy is a non-voting member of the committee.
Asset and Liability Committee (ALCO)	The Asset and Liability Committee is responsible for strategic planning relating to the developments of the Bank's balance sheet as well as the planning of liquidity and funding, and capital activities.
Underwriting and Investment Committee (UIC)	The Underwriting and Investment Committee decides on underwriting and principal investments. The CRO or his deputy is a non-voting member of the committee.
Security Committee (SC)	The Security Committee is a consultation forum on security matters. The committee formulates, reviews and approves security goals and policies, monitors compliance with security policies and implements information security rules.

The third and lowest level comprises committees on business level with delegated authority from the executive level committees, see Table 2.3.

Table 2.3 Business level committees

Committee	Responsibilities
Corporate Credit Committee (CCC)	The Corporate Credit Committee makes decisions on credit cases within authorized limits and according to credit rules.
Retail Branch Credit Committees (RBC)	Seven Retail Branch Credit committees make decisions on credit cases within authorized limits and according to credit rules.
Retail Monitoring Committee (RMC)	The Retail Monitoring Committee monitors that branch employees adhere to set credit rules and supervises credit limits of branch employees and specialist employees in Retail Banking.
Debt Cancellation Committee (DCC)	The Debt Cancellation Committee deals with applications to reach composition with debtors.
Collateral Valuation Committees (CVC)	Five Collateral Valuation Committees set guidelines on collateral assessment and valuation.

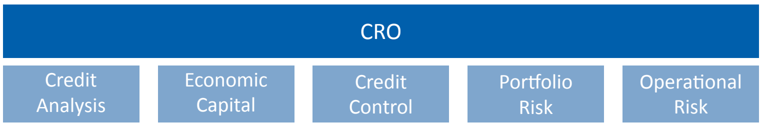
2.4 THE RISK MANAGEMENT DIVISION

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

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

Risk Management's approach is based on understanding the Bank's operational exposures and how unexpected events may affect them, coupled with sound judgment from risk takers. Good judgment and common sense is often the best risk management tool. The Risk Management division has five departments.

Figure 2.4 Structure of Risk Management division



CREDIT ANALYSIS

Credit Analysis monitors and provides support for the Bank's credit decisions and credit granting processes from loan application to loan disbursement.

The department is Risk Management's primary interface with the Bank's credit committees. Credit Analysis prepares a comment for all credit applications that are submitted to the BCC, the ACC and the CCC. The CRO or his designated representative from Credit Analysis participates in the meetings of CCC, ACC and BCC as a non-voting advisor. Credit Analysis monitors the activities of the RBC. Credit Analysis ensures that credit decisions are within a committee's credit granting authority and is authorized to escalate controversial credit decisions from one committee to a committee with higher authority.

Credit Analysis is responsible for the approval of the corporate credit rating performed by account managers by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings.

ECONOMIC CAPITAL

The Economic Capital department is responsible for the design, implementation and management of the Bank's ICAAP and interfacing with the FME in the Supervisory Review and Evaluation Process (SREP). The department is responsible for the development of credit rating models and calculates the regulatory capital requirements and manages the Bank's economic capital model, which are the basis for the internal assessment of capital requirements.

Economic Capital monitors the portfolio credit risk such as single name and industry-sector concentrations as well as monitoring financial relationships of obligors and the large exposures to financially related obligors. The department classifies the loan portfolio according to the Bank's internal classification of borrowers, which is referred to as the Early Warning System (EWS).

CREDIT CONTROL

The Credit Control department monitors weak and impaired credit exposures on a customer by customer basis, including large exposures. The department analyzes credit exposures according to the Bank's EWS, see section 4.7.1, and operates as a gatekeeper in determining when problematic loans should enter a restructuring process or legal collection. Credit Control determines the appropriate level of provisioning and reports impairments and write-offs to the ACC.

Credit Control ensures that the book value of distressed loans accurately reflects the expected recovery value of loans and is responsible for collateral and covenant supervision and reporting.

PORTFOLIO RISK

The Portfolio Risk department is responsible for analyzing, monitoring and reporting on risks resulting from balance sheet mismatches, particularly market risk and liquidity risk. This involves surveillance of the Bank's margin trading activities. Portfolio Risk interfaces primarily with the Bank's Treasury, Proprietary Trading and Capital Markets and reports its findings to the ALCO. The department analyzes and models the behaviour of the Bank's deposit base and reports to the ALCO. Additionally the department collaborates closely with the Bank's Asset Management division on various reporting and limit surveillance.

Portfolio Risk also provides various quantitative support to the Bank's business units.

OPERATIONAL RISK

The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk at Arion Bank. Operational Risk is also responsible for providing leadership and support to every business unit regarding the implementation of operational risk tools, processes, and ongoing improvements of the control environment.

Operational Risk has the objective to minimize the impact of losses suffered in the normal course of business (expected losses) and to avoid or reduce the likelihood of suffering extreme tail events (unexpected losses) resulting in large losses.

The Bank's operational risk framework comprises a number of elements which allows the Bank to manage and measure its operational risk profile and to evaluate the amount of operational risk capital that the Bank needs to hold to absorb potential losses such as the Risk and Control Self-Assessment (RCSA) and loss data collection.

SECURITY OFFICER

The Bank's Security Officer is a part of the Risk Management division and reports directly to the CRO. The Security Officer's main task is to devise a strategy on security issues, supervise security issues and report to the Security Committee and the Executive Management. The Security Officer is also responsible for the Bank's contingency plans.

2.5 RISK APPETITE

Risk Management ensures compliance with internal and external limits. The Bank's strategy towards risk exposure is outlined in the Bank's risk appetite statement. The statement, which is approved by the Bank's Board of Directors, sets out the level of risk that the Board is willing to take in pursuit of the Bank's strategy. It is furthermore intended to provide guidance and set limits for the Executive Management Committee. The Bank's risk appetite is monitored by the Risk Management division to ensure that the Bank's risk profile remains within its risk appetite. The Board and the BARC is promptly notified if any risk appetite metrics are exceeded. The Board of Directors reviews the risk appetite statement at least annually. Limits are based on the risk appetite statement and are set by the Board of Directors or other authorities to which the Board delegates limit-setting responsibilities. Limits are monitored by the Risk Management division.

Table 2.4 Risk Appetite Metrics

Risk type	Metric
Credit risk	• Sum of large exposures • Single name exposure • Expected loan loss rates • Sector concentration
Market risk	• Equity exposure • Unlisted equity exposure • Indirect equity exposure • Currency imbalance
Funding and liquidity risk	• Liquidity coverage ratio • Loans to deposits ratio • Encumbered asset ratio
Operational risk and compliance	• Tolerance statements for various compliance breaches
Solvency and earnings	• Capital ratios • Target return on equity

2.6 REPORTING

The Bank's aim is to provide relevant stakeholders with accurate and transparent risk information. Therefore, Risk Management places a strong emphasis on reporting risk and allocating sufficient resources to ensure the fulfilment of the Bank's policy. Risk information is regularly reported to the Board of Directors and its sub-committees. The CEO, the CRO and committees on the executive level, receive risk reports on a regular basis, ranging from daily monitoring reports to the Annual Report. The primary reporting within the Bank is shown in Table 2.5.

The Bank's Annual Report, Financial Statements, and Pillar 3 Risk Disclosures are all available on the Bank's website. Furthermore the Bank delivers regular reports to the FME; i.e. a monthly report on the Bank's loan portfolio quality, a quarterly report on the Bank's capital requirements (COREP) and large exposures; and the annual ICAAP report.

Table 2.5 Primary reporting within the Bank

Primary reporting	Contents	Frequency	Recipient
Credit risk portfolio report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the loan's portfolio quality.	Monthly	ACC
Liquidity and market risk report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit developments, secured liquidity, funding measures, currency and indexation imbalances, margin trading activities, and other relevant liquidity and market risk information.	Monthly	ALCO
Risk report	An aggregate report containing the credit risk portfolio report and the liquidity and market risk report, as well as information on the Bank's risk appetite and ICAAP status, operational risk and other risk management concerns.	Monthly	• Board • BARC • Exec. Com.
ICAAP	Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval.	Annually	• Board • BARC • Exec. Com.

3 CAPITAL MANAGEMENT

3 CAPITAL MANAGEMENT

An adequate amount of quality capital ensures that the Bank is able to absorb losses associated with the risks which are a part of its operation, without its solvency being jeopardized, and allows the Bank to remain a going concern even in periods of stress.

The Bank employs various techniques to estimate adequate capital levels and to ensure that the capital is fruitfully deployed. The Bank's ICAAP is the cornerstone of the Bank's capital adequacy estimations. The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance with its risk profile and future development.

3.1 CAPITAL STRUCTURE

The elements of the capital base of a financial institution are defined in Article 84 of Act No. 161/2002 on Financial Undertakings and Rules No. 215/2007, in which the EU Capital Requirement Directives (CRD) have been transposed. According to the definition, the capital base comprises Tier 1, Tier 2 and Tier 3 capital with the following restrictions. Tier 1 capital shall amount to a minimum of one-half of the capital base prior to statutory deductions according to Article 84 of Act No. 161/2002. Tier 2 capital can be up to a maximum of 50% of Tier 1 capital and Tier 3 capital can be up to a maximum of 50% of Tier 1 capital. Furthermore, Tier 3 capital may not exceed 4.8% of the risk-weighted assets of the trading book, as provided in Article 28 of Act No. 161/2002, and currency risk.

At the end of 2014 Arion Bank's capital base amounted to ISK 183,388 million of which 83% is Core Tier 1 capital

The Bank's capital base is composed of core Tier 1 and Tier 2 capital as shown in Table 3.1. Tier 1 capital comprises of share capital, share premium, other reserves, retained earnings, and non-controlling minority interests. Intangible assets and tax assets are deducted from Tier 1 capital. The Bank's Tier 2 capital consists of subordinated liabilities provided to the Bank by the Icelandic Government as a part of its sale of an 87% share in the Bank to Kaupskil hf. The Bank's subordinated liabilities mature in 2020 and are denominated in EUR, USD and GBP. The Bank may only retire them with the permission of the FME. Other statutory deductions made from Tier 1 and 2 are mainly due to minority holdings in financial institutions. The minority holdings are deducted 50% from Tier 1 and 50% from Tier 2. Arion Bank has no Tier 3 capital in its capital base.

Non-controlling interest decreased between 2014 and 2013 mainly due to the purchase of a 38% share in Valitor Holding hf. from Landsbankinn hf. in December 2014. Increase in intangible assets is mainly due to software, business relations and goodwill related to the acquisition by Valitor Holding hf. of the Danish company AltaPay A/S in December 2014.

At the end of 2014, Arion Bank's capital base amounted to ISK 183,388 million, of which core Tier 1 capital is ISK 151,850 million or 83% of the total capital base. The Bank's core Tier 1 capital grew by ISK 13,223 million between year-end 2013 and 2014 mainly due to the Bank's earnings in 2014.

Table 3.1 Capital base

31 December [ISK m]	2014	2013
Share capital	2,000	2,000
Share premium	73,861	73,861
Other reserves	1,632	1,637
Retained earnings	83,218	62,591
Non-controlling interests	1,501	4,858
Total equity	**162,212**	**144,947**
Intangible assets	(9,596)	(5,383)
Tax assets	(655)	(818)
Other statutory deductions	(111)	(119)
Tier 1 capital	**151,850**	**138,627**
Subordinated liabilities	31,639	31,918
Other statutory deductions	(101)	(106)
Tier 2 capital	**31,538**	**31,812**
Capital base	**183,388**	**170,439**

3.2 CAPITAL REQUIREMENTS

The Bank's capital requirements calculations are based on the aforementioned EU Capital Requirements Directive (CRD), which is originated in the Basel committee, Act No. 161/2002 on Financial Undertakings and FME's Rules No. 215/2007 on Capital Requirements and Risk Weighted Assets of Financial Undertakings that are based on the CRD. The CRD separates the calculation of a bank's capital requirements into two parts; Pillar 1 which outlines the regulatory capital requirements and Pillar 2 which is the Bank's own internal assessment of capital adequacy (ICAAP).

According to the Icelandic rules on capital requirements, the capital base of a financial undertaking is required to correspond to a minimum of 8% of the sum of risk-weighted assets (RWA) of credit risk, market risk, and operational risk as calculated under Pillar 1. Additional capital requirements and other factors are determined under Pillar 2, see section 3.3.

Ever since its establishment, the Bank's capital base has grown consistently due to strong profit generation and dividend payment restrictions. Table 3.2 outlines the development of the Bank's key capital and risk weighted assets figures. The average risk weight has decreased in 2014 following an increase in 2013, which was mostly due to the replacement of the Drómi bond with the underlying loan portfolio.

At the end of 2014 credit risk accounted for 85% of RWA, operational risk accounted for 12% and market risk 3%

Table 3.2 Key capital adequacy figures

31 December [ISK m]	2014	2013	2012	2011
Tier 1 capital	151,850	138,627	125,474	109,069
Capital base	183,388	170,439	159,694	141,174
Risk-weighted assets (RWA)	696,010	720,822	657,763	664,956
Pillar 1 capital requirement	55,681	57,666	52,621	53,197
Tier 1 capital ratio	21.8%	19.2%	19.1%	16.4%
Total capital ratio	26.3%	23.6%	24.3%	21.2%
RWA divided by Total assets (on balance sheet)	74.5%	76.8%	73.0%	74.5%

Table 3.3 Method of calculation of minimum capital requirements

Method of calculation of minimum capital requirements	
Credit risk	The Bank uses the standardized approach to calculate the capital requirements for credit risk. This approach entails using standard risk weights from 0% to 150%, on the Bank's assets depending on the creditworthiness of the borrower, the collateral and the type of the exposure. Replacement risk and future risk is used to calculate the capital requirements for counterparty credit risk in combination with the counterparty's risk weights.
Market risk	The Bank uses the standardized approach to calculate the capital requirements for market risk. This approach entails using a standard risk weight of 150% for equities and risk weights ranging from 0% to 100% for specific risk from traded debt instruments. The general risk is calculated in accordance with the maturity based approach. The capital requirements for currency imbalance is calculated based on the total net long position or the total net short position, which ever is the higher.
Operational risk	The Bank uses the basic indicator approach to calculate capital requirements for operational risk. This approach entails using 15% of a three-year average of the sum of net interest income and net non interest income.

The Bank's RWA are calculated using the approaches described in Table 3.3. In Table 3.4 the Bank's exposure at default, RWA and minimum capital requirements under Pillar 1 for the end of 2014 and 2013 are broken down by different risk types, and exposure classes. In table 3.6 on-balance sheet items are then broken down by sectors. The total figures for each sector differ slightly from the Bank's financial statement due to a different handling of subsidiaries and general provisions.

At the end of 2014 credit risk accounted for 85% of RWA, operational risk accounted for 12% and market risk 3%.

Figure 3.1 RWA 2014

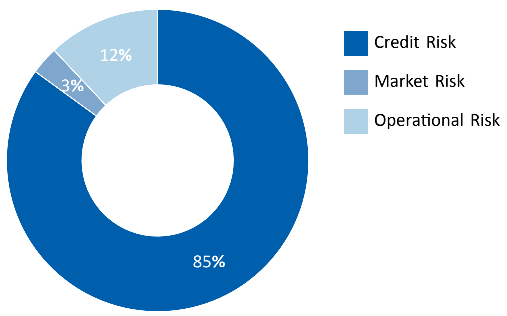


Table 3.4 Exposure, risk-weighted assets and capital requirements split by exposure class

31 December 2014 [ISK m]	Exposure at Default (EAD)				
	On-balance sheet	Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	24,614	70	-	-	-
Regional government	5,989	1,378	1,555	21.1%	124
Administrative bodies	278	5	282	100.0%	23
Institutions	108,792	24	26,738	24.6%	2,139
Corporate	128,421	23,344	138,330	91.1%	11,066
Retail	53,292	12,301	48,867	74.5%	3,909
Real estate	430,821	6,790	273,391	62.5%	21,871
Past due	22,727	1	22,834	100.5%	1,827
Other assets	44,293	-	44,063	99.5%	3,525
Equity, banking book	23,694	-	32,002	135.1%	2,560
Traded debt instruments, banking book	63,318	-	3,549	5.6%	284
Counterparty credit risk	1,026	-	381	37.1%	30
Credit risk total	**907,265**	**43,914**	**591,994**	**62.2%**	**47,360**
Market risk					
Traded debt instruments, trading book	8,625	-	583	6.8%	47
Equity, trading book	1,538	-	2,307	150.0%	185
Foreign exchange	18,897	-	18,915	100.1%	1,513
Market risk total	**29,061**	**-**	**21,805**	**75.0%**	**1,744**
Operational risk total			**82,211**		**6,577**
Total	**936,326**	**43,914**	**696,010**	**71.0%**	**55,681**

31 December 2013 [ISK m]	Exposure at Default (EAD)				
	On-balance sheet	Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	38,027	3,258	-	-	-
Regional government	5,768	2,092	1,662	21.1%	133
Administrative bodies	57	3	61	100.0%	5
Institutions	102,307	24	22,624	22.1%	1,810
Corporate	177,064	19,312	171,139	87.1%	13,691
Retail	63,688	12,320	56,641	74.5%	4,531
Real estate	360,765	3,913	230,795	63.3%	18,464
Past due	28,402	5	30,368	106.9%	2,429
Other assets	70,028	-	69,736	99.6%	5,579
Equity, banking book	16,245	-	22,831	140.5%	1,826
Traded debt instruments, banking book	57,512	-	1,654	2.9%	132
Counterparty credit risk	1,070	-	517	48.3%	41
Credit risk total	**920,935**	**40,928**	**608,029**	**63.2%**	**48,642**
Market risk					
Traded debt instruments, trading book	7,495	-	3,187	42.5%	255
Equity, trading book	1,204	-	1,806	150.0%	144
Foreign exchange	31,630	-	31,703	100.2%	2,536
Market risk total	**40,329**	**-**	**36,696**	**91.0%**	**2,936**
Operational risk total			**76,097**		**6,088**
Total	**961,264**	**40,928**	**720,822**	**71.9%**	**57,666**

Risk-weighted assets amounted to ISK 696,010 million at the end of 2014 compared to ISK 720,822 million at the end of 2013. The main factors behind the change in RWA and the increase of the capital adequacy ratio in 2014 are shown in Figure 3.2 and 3.3 respectively.

Figure 3.2 Change in RWA in 2014 [ISK m]

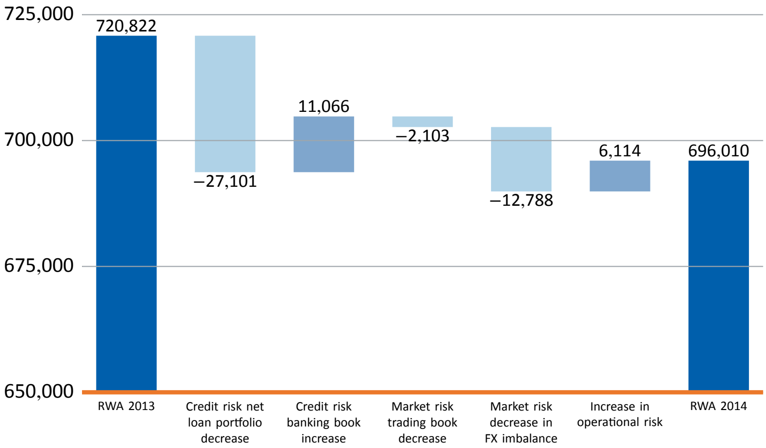


Figure 3.3 Change in capital ratio in 2014

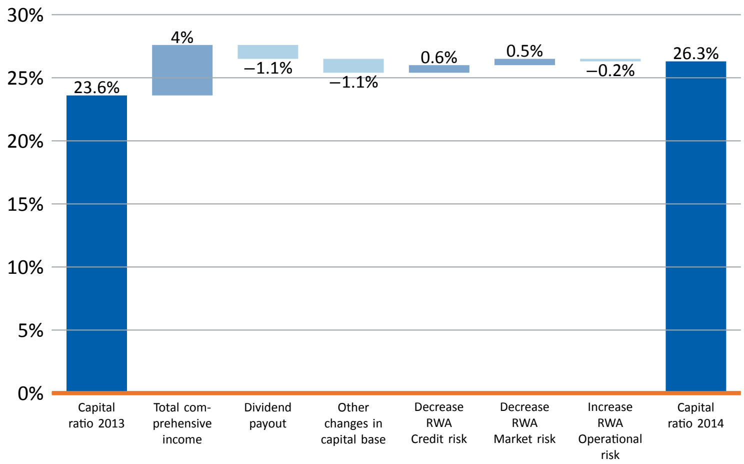


Table 3.5 shows the average quarterly exposure at default, RWA and minimum capital requirements for the year 2014. Table 3.6 shows the Bank's on-balance sheet credit exposure broken down by exposures classes and by sectors. The aggregated amounts for each sector differ slightly from that of the Bank's financial statement due to a different handling of subsidiaries and general provisions.

Table 3.5 Average quarterly exposure, risk-weighted assets and capital requirements split by exposure class

Average 2014 [ISK m]	Exposure at Default (EAD) On-balance sheet	Exposure at Default (EAD) Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	23,541	2,471	-	-	-
Regional government	4,510	1,873	1,358	21.3%	109
Administrative bodies	119	4	122	100.0%	10
Institutions	113,102	34	25,114	22.2%	2,009
Corporate	145,319	28,686	156,479	89.9%	12,518
Retail	53,569	12,201	48,974	74.5%	3,918
Real estate	416,755	5,376	272,870	64.6%	21,830
Past due	23,089	2	24,144	104.6%	1,932
Other assets	51,857	-	51,248	98.9%	5,488
Equity, banking book	21,404	-	28,841	141.6%	1,824
Traded debt instruments, banking book	63,513	-	2,014	1.5%	127
Counterparty credit risk	1,168	-	360	55.0%	46
Credit risk total	**917,946**	**50,646**	**611,525**	**63.1%**	**48,922**
Market risk					
Traded debt instruments, trading book	8,136	-	1,296	15.9%	104
Equity, trading book	2,042	-	3,063	150.0%	245
Foreign exchange	18,166	-	18,795	103.5%	1,504
Market risk total	**28,345**	**-**	**23,154**	**81.7%**	**1,852**
Operational risk total			**82,211**		**6,577**
Total	**946,291**	**50,646**	**716,89**	**71.9%**	**57,351**

Average 2013 [ISK m]	Exposure at Default (EAD) On-balance sheet	Exposure at Default (EAD) Off-balance sheet	Risk-weighted assets	Average risk weights EAD (%)	Pillar 1 capital requirement
Credit risk					
Central government	28,014	3,324	-	-	-
Regional government	6,224	1,940	1,749	21.4%	140
Administrative bodies	52	3	55	100.0%	4
Institutions	107,171	21	24,834	23.2%	1,987
Corporate	167,234	20,381	167,945	89.5%	13,436
Retail	57,357	12,391	51,951	74.5%	4,156
Real estate	322,812	2,810	211,538	65.0%	16,923
Past due	30,689	5	31,858	103.8%	2,549
Other assets	69,336	-	68,606	98.9%	5,488
Equity, banking book	23,694	-	32,002	141.6%	1,824
Traded debt instruments, banking book	107,907	-	1,592	1.5%	127
Counterparty credit risk	1,040	-	572	55.0%	46
Credit risk total	**921,531**	**40,875**	**592,701**	**61.6%**	**47,416**
Market risk					
Traded debt instruments, trading book	9,098	-	4,803	52.8%	384
Equity, trading book	1,119	-	1,679	150.0%	134
Foreign exchange	25,251	-	27,219	107.8%	2,177
Market risk total	**35,468**	**-**	**33,700**	**95.0%**	**2,696**
Operational risk total			**76,097**		**6,088**
Total	**956,999**	**40,875**	**702,498**	**70.4%**	**56,200**

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

31 December 2014 [ISK m]	Exposure at Default - On Balance Sheet									
	Central government	Regional government	Administrative bodies	Institutions	Corporate	Retail	Real estate	Past due	Other credit risk related exposure	Total on-balance sheet
Credit risk										
Agriculture	-	-	-	-	54	673	4,039	84	-	4,973
Financial and insurance services	21,060	-	-	108,792	24,004	466	2,718	141	-	158,525
Fishing industry	-	-	-	-	63,548	1,326	12,734	12	-	79,897
Individual	-	-	-	-	-	38,273	256,205	16	-	314,604
Industry, energy and manufacturing	3,509	1,754	-	-	7,798	860	12,826	49	-	25,713
Information and communication technology	-	-	-	-	4,102	1,365	18,657	991	-	23,734
Public administration, human health and social act.	45	3,263	278	-	24	616	3,342	18,839	-	7,794
Real estate and construction	-	-	-	-	5,171	2,830	73,801	252	-	81,862
Services	-	972	-	-	2,337	2,984	10,429	759	-	16,041
Transportation	-	-	-	-	1,246	531	4,442	185	-	5,548
Wholesale and retail trades	-	-	-	-	20,138	3,368	31,629	1,398	-	56,241
Other assets	-	-	-	-	-	-	-	-	44,293	44,293
Banking book - Traded debt instruments	-	-	-	-	-	-	-	-	63,318	63,318
Banking book - Equity	-	-	-	-	-	-	-	-	23,694	23,694
Counterparty credit risk	-	-	-	-	-	-	-	-	1,026	1,026
Credit risk total	**24,614**	**5,989**	**278**	**108,792**	**128,421**	**53,292**	**430,821**	**22,727**	**132,332**	**907,265**

31 December 2013 [ISK m]	Exposure at Default - On Balance Sheet									
	Central government	Regional government	Administrative bodies	Institutions	Corporate	Retail	Real estate	Past due	Other credit risk related exposure	Total on-balance sheet
Credit risk										
Agriculture	-	-	-	-	314	573	2,879	92	-	3,859
Financial and insurance services	37,999	-	-	102,307	24,968	518	232	1,591	-	167,616
Fishing industry	-	-	-	-	42,314	994	18,389	645	-	62,342
Individual	-	-	-	-	-	49,463	235,667	22,523	-	307,653
Industry, energy and manufacturing	-	66	-	-	12,125	1,108	9,912	16	-	23,226
Information and communication technology	-	-	-	-	24,315	642	635	29	-	25,621
Public administration, human health and social act.	28	4,715	57	-	98	707	2,96	30	-	8,596
Real estate and construction	-	-	-	-	7,558	3,777	69,808	1,398	-	82,542
Services	-	988	-	-	10,793	2,481	2,426	826	-	17,514
Transportation	-	-	-	-	15,165	222	4,568	1	-	19,956
Wholesale and retail trades	-	-	-	-	39,414	3,202	13,289	1,250	-	57,155
Other assets	-	-	-	-	-	-	-	-	70,028	70,028
Banking book - Traded debt instruments	-	-	-	-	-	-	-	-	57,512	57,512
Banking book - Equity	-	-	-	-	-	-	-	-	16,245	16,245
Counterparty credit risk	-	-	-	-	-	-	-	-	1,070	1,070
Credit risk total	**38,027**	**5,768**	**57**	**102,307**	**177,064**	**63,688**	**360,765**	**28,402**	**144,856**	**920,935**

Table 3.7 shows the on-balance sheet credit risk exposure broken down by exposure classes and maturity at book value for the year 2014. Table 3.8 shows collateral types broken down by exposure classes for the year 2014. Comparative information for the year 2013 is not available.

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

31 December 2014 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	21,091	3,523	-	-	24,614
Regional government	2,648	1,224	2,116	-	5,989
Administrative bodies	228	47	3	-	278
Institutions	108,792	-	-	-	108,792
Corporate	57,850	61,638	8,933	-	128,421
Retail	22,914	15,918	14,460	-	53,292
Real estate	40,958	113,107	276,756	-	430,821
Past due	4,704	566	17,456	-	22,727
Other assets	-	-	-	44,293	44,293
Equity, banking book	-	-	-	23,694	23,694
Traded debt instruments, banking book	2,020	54,594	6,704	-	63,318
Counterparty credit risk	877	149	-	-	1,026
Total on-balance sheet credit risk exposure	**262,084**	**250,766**	**326,427**	**67,987**	**907,265**

Table 3.8 Collateral types broken down by exposure classes

31 December 2014 [ISK m]	Up to 1 year	1-5 years	Over 5 years	Not specified	Total
Central government	3,510	-	-	-	3,510
Regional government	1,766	524	-	-	2,291
Administrative bodies	1	1	-	-	2
Corporate	13,599	9,219	47,186	27,014	97,017
Retail	1,011	2,652	745	2,754	7,162
Real estate	452	364,416	9,133	38,480	412,481
Past due	115	24,090	754	157	25,117
Derivatives	3,330	-	-	-	3,330
Total collateral	**23,785**	**400,903**	**57,817**	**68,406**	**550,911**

3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

The ICAAP is the Bank's internal assessment of its capital needs. The ICAAP is carried out in accordance with the CRD's Pillar 2 requirement with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure and manage the Bank's total risk exposure.

The ICAAP is the Bank's internal assessment of its capital needs

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank has sufficient capital for its risk profile. The Bank's ICAAP report is approved annually by the Board of Directors, the CEO and the CRO and submitted to the FME. The FME reviews the Bank's ICAAP report and sets capital requirements following its SREP. Arion Bank's capital base exceeds both the internal assessment of capital requirements and the FME's SREP requirements.

In addition to the above the Bank uses the ICAAP to:

- Raise risk-awareness to all the Bank's activities and to ensure that the Board of Directors and the Executive Management Committee understand the Bank's risk profile
- Carry out a process to adequately identify and measure the Bank's risk factors
- Carry out a process to monitor that the Bank's capital is adequate and used in relation to its risk profile
- Review the soundness of the Bank's risk management systems and controls that are used to assess, quantify and monitor the Bank's risks

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

Table 3.9 Risk Identification down to business units

Business Units	Credit risk	Market risk	Liquidity risk	Operational risk	Legal risk	Reputational risk	Business risk	Political risk
Asset Management	✓			✓	✓	✓	✓	✓
Corporate Banking	✓			✓	✓	✓	✓	✓
Investment Banking	✓	✓		✓	✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓	✓	✓	✓
Retail Banking	✓			✓	✓	✓	✓	✓
Other divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓	✓

The Bank's ICAAP methodology involves assessing key risks which are not believed to be adequately addressed by Pillar 1. For each such risk, a capital add-on is applied on top of the regulatory capital requirements, which are 8% of RWA. The risk elements for which additional capital is required are:

- Concentration of credit risk
- Interest rate risk in the banking book (IRRBB)
- Legal risk
- Assorted stress scenarios related to credit risk and market risk

Arion Bank's policy is to not publish the result from its ICAAP because it regards the ICAAP and the SREP as a confidential dialog between the Bank and the FME.

3.4 STRESS TESTING

The Bank's stress testing is carried out within the ICAAP. The Bank's stress test consists of sensitivity analysis and scenario analysis. Sensitivity analysis, i.e. where one risk driver is stressed to assess the potential effect on the Bank's economic value, is carried out for:

- Credit risk: several risk drivers are stressed within the loan portfolio such as changes in the credit quality due to e.g. the economic environment and high inflation
- Operational/Legal risk: such as illegality of loans and new/or changed legislation
- Market risk: such as price risk due to a decline in value of liquid and illiquid assets
- Liquidity risk: such as outflow of deposits and liquidity coverage tests

The impact is estimated on the Bank's profit and loss and the capital base as well as for the Bank's capital and liquidity ratios. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers. Estimation of risk drivers is a qualitative discussion between Risk Management and each business unit where key risks, i.e. risk factors that can result in a loss of ISK 1,000 million or more, and their possible outcome are discussed.

Scenario analyses are carried out on the Bank's business plan. As last year, one of the two scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FME.

The Bank's Economic Research department contributes an economic base case projection as well as stressed projections that are used in the Bank's capital planning and in preparation of the Bank's five year business plan.

3.5 CAPITAL CONTINGENCY PLAN

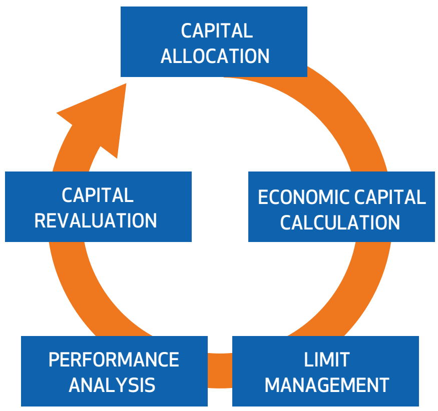
The Bank monitors its capital position and capital adequacy as a part of its on-going ICAAP. The Bank identifies risk factors that are likely to have a serious effect on the Bank's capital, estimates their affect and allocates an appropriate capital. The Bank, however, recognizes that it might encounter unexpected scenarios resulting in losses exceeding capital buffers. In worst case scenarios, where the capital adequacy ratio could fall below the legal minimum requirement, the Bank will need to take appropriate actions.

The ALCO is responsible for formalizing, implementing and maintaining the Bank's capital contingency plan.

3.6 CAPITAL ALLOCATION AND CAPITAL PLANNING

The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP. The risk-adjusted performance of the business units is periodically quarterly based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning based on the capital requirements of the business units.

Figure 3.4 Capital planning and monitoring process



3.7 CAPITAL REQUIREMENTS REGULATION (CRR) AND DIRECTIVE (CRD IV)

The Bank does not anticipate any challenges in meeting requirements of the CRD IV. The Bank has a strong capital base that consists mainly of Core Tier 1 capital. The Bank's Tier 1 ratio and capital adequacy ratio at year end 2014 was 21.8% and 26.3% respectively. Furthermore the Bank does not expect that the implementation will lead to a large increase in risk weighted assets resulting in a lower capital adequacy ratio. The Bank is applying the standardized approach and carries an average risk weight of 74.5% of its total assets.

For information regarding the status of the implementation of CRR and CRD IV see section 10.2.

The Bank does not anticipate any challenges in meeting requirements of the CRD IV

3.8 LEVERAGE RATIO

As part of the Basel III framework that is to be implemented by CRD IV, leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting the Bank's Tier 1 capital against a measure of its exposures, with special treatment for derivatives, securities financing transactions and off-balance sheet items, aimed at revealing hidden leverage on banks' balance sheets. At year-end 2014, the Bank has a strong leverage ratio of 15.4%, significantly higher than the 3% benchmark minimum currently used by the Basel Committee.

Table 3.10 The Bank's leverage ratio

31 December [ISK m]	2014	2013
On balance-sheet exposures	912,303	921,079
Derivative exposures	1,348	1,929
Securities financing transaction exposures	10,044	10,381
Off balance-sheet exposures	59,922	25,199
Total exposure	**983,617**	**958,588**
Tier 1 capital	**151,850**	**138,627**
Leverage ratio	**15.4%**	**14.5%**

4 **CREDIT** RISK

4 CREDIT RISK

Credit risk is defined as the current or prospective risk to earnings and capital arising from the failure of an obligor to discharge an obligation at the stipulated time or otherwise to perform as agreed. Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance.

Loans to customers and credit institutions are the largest source of credit risk but credit risk is also inherent in other types of assets, such as bonds, short-term debt securities, derivatives and in commitments such as unused credit lines or limits, and guarantees. Credit risk is inherent in business units connected to lending activities as well as trading and investment activities i.e. Corporate Banking, Retail Banking, Investment Banking and Treasury within Finance.

The main sources of credit risk can be divided into four categories; loan portfolio, commitments and guarantees, counterparty credit risk, and equity risk in the banking book, see Table 4.1.

Table 4.1 Sources of credit risk

Source	Description
Loan portfolio	The loan portfolio is the Bank's main asset. To maintain and improve the quality of the loan portfolio it is imperative to constantly monitor the performance of loans, counterparties and collateral, both individually and at the portfolio level.
Commitments and guarantees	The Bank often commits itself to ensuring that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on overdrafts on checking accounts, credit cards and credit lines.
Counterparty credit risk	The Bank offers financial derivative instruments to professional investors, e.g. FX, interest and securities derivatives. For further information on counterparty credit risk see, section 4.9.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made in short term trading purpose and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 5.6.

4.1 CREDIT POLICY

The Bank's credit policy contains high-level criteria for credit granting as well as outlining the roles and responsibility for further implementation and compliance. The Bank's credit policy is the base for the Bank's credit strategy as integrated in the business plan, the Bank's risk appetite towards credit exposure, the Bank's credit rules and its credit procedures and controls.

Arion Bank is a universal bank offering companies and individuals tailored solutions. Counterparties on the credit side are approved by the respective credit committee on an individual basis or by the business unit if within its credit authority. The emphasis is on keeping a high quality credit portfolio by maintaining a strict credit process and seeking business with financially strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Loans where the underlying collateral are security instruments issued by Arion Bank are prohibited as is the granting of any credit that is prohibited by law.

4.2 CREDIT GRANTING

The Board Credit Committee (BCC) is the supreme authority in the granting of credit. The Arion Credit Committee (ACC), which acts below BCC's granting limits, has the right to delegate authority within its own credit limits and sets credit granting rules and guidelines for the business units.

Risk Management is present at credit committee meetings in an advisory role ensuring that all credit decisions are in line with the Bank's credit policy. Risk Management has the power to escalate controversial credit committee decisions to a higher authority.

Credit proposals related to large exposures are presented to the BCC for approval.

For each credit application the Bank gathers information and evaluates certain elements that serve as a basis for a decision e.g. the company profile, the financial analysis of the company, the proposed collaterals, the company's credit rating and related parties and their total exposure.

The Bank generally requires collateral but a central element in the assessment of creditworthiness is the customers' ability to service the debt.

Risk Management has the power to escalate controversial credit committee decisions to a higher authority

Credit proposals related to large exposures are presented to the BCC for approval

4.3 CREDIT RISK MANAGEMENT

Managing credit risk entails diversification of risk, well informed lending decisions, good oversight of the portfolio performance and a clear identification of any sign of weaknesses for a timely recovery.

In ensuring well informed lending decisions, Risk Management's Credit Analysis department monitors credit risk before a credit decision is made and participates in credit committee meetings as an adviser. Various controls ensure that a loan is only disbursed following a thorough review of all documents and the registration of all relevant information regarding the loan and collaterals into the Bank's IT systems.

During the repayment phase Risk Management monitors the credit portfolio. The Economic Capital department aggregates the portfolio monthly on the basis of consistent criteria to analyze the outstanding risk, collateral level as well as the portfolio quality. Loans at risk are identified for further inspection and credit reports are sent to the ACC and the BARC monthly, and the Board of Directors before each meeting. The Credit Control department analyzes loans that have been classified at risk and maintains an independent and centralized overview of distressed credits. Credit Control, based on its analysis, suggests provisions and reviews write-offs.

4.4 CREDIT RATING

As outlined in chapter 3, the Bank uses the standardized method to calculate capital requirements for credit risk. Nevertheless, it is the Bank's policy to apply sophisticated credit rating models to monitor the development of credit risk and to estimate customers default probability and expected loss. These estimates come into play when evaluating a loan application, in portfolio monitoring and in collective provisioning. The Bank uses three credit rating models for three types of borrowers:

- Individuals. The model is statistical, run automatically, using the information found to have predictive power about the customer. The model was updated and recalibrated in 2014 with the aim of improving its predictive power. The model is calibrated using data in the period June 2009 to January 2013.
- SMEs. Defined as retail, corporate clients with individual exposure below ISK 65 million and related exposure below ISK 160 million (EUR 1 million, these limits were raised in May 2014 from ISK 40 million and ISK 100 million respectively). The model is statistical, run automatically, based on similar methodologies as the model for individuals. The model was updated and recalibrated in 2014 with the aim of improving its predictive power. The model is calibrated using data in the period June 2010 to June 2013.
- Larger corporates. Defined as corporate clients with individual exposure over ISK 65 million or related exposure over ISK 160 million. The model is run manually, based on quantitative information drawn from the financial statements as well as qualitative data entered by account managers. The rating result requires approval from the Credit Analysis department. The model is statistically calibrated using data in the period January 2006 to December 2012.

The rating distribution of the Bank's loan book is discussed in section 4.5.4.

4.5 CREDIT RISK EXPOSURE

The Bank's credit risk exposure consists of an on-balance sheet exposure and an off-balance sheet exposure. The on-balance sheet exposure is the book value of assets whereas the off-balance sheet exposure represents the amount that the Bank has committed to customers i.e. undrawn credit limits, unused overdrafts and guarantees.

At the end of 2014, the Bank's total credit risk exposure was ISK 956,376 million (2013: 941,435 million). Loans to customers increased by 1.8% between 2013 and 2014 and represent the largest part of the Bank's total credit exposure or 68%. Government bonds or government secured bonds represent 96% of the total bonds and debt instruments. The Bank's loans to financial institutions consist to a large extent of the Bank's deposits placed with other banks and short term money market loans or 94%. Table 4.2 shows the Bank's credit risk exposure. The average exposure during 2014 is calculated from four quarterly interim financial statements.

Loans to customers represent the largest part of the Bank's total credit exposure or 68%

Table 4.2 Breakdown of credit risk exposure

	2014		2013	
[ISK m]	31 December	Average	31 December	Average
On-balance sheet items:				
Cash and balances with Central Bank	21,063	22,626	37,999	27,983
Loans to credit institutions	108,792	113,102	102,307	107,171
Loans to customers	647,508	644,883	635,774	586,190
Bonds and debt instruments	66,466	67,562	62,171	112,988
Derivatives	1,026	1,168	1,070	1,040
Bond and debt instruments, hedging	3,212	2,068	490	660
Other assets with credit risk	3,514	5,263	5,746	4,988
Credit risk exposure on-balance sheet	**851,581**	**856,672**	**845,557**	**841,020**
Off-balance sheet items:				
Financial guarantees	9,542	10,024	9,922	9,990
Unused overdraft	38,890	38,538	37,371	36,546
Loan commitments	56,363	66,918	48,585	49,455
Credit risk exposure off-balance sheet	**104,795**	**115,480**	**95,878**	**95,991**
Total credit risk exposure	**956,376**	**972,152**	**941,435**	**937,011**

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

Table 4.3 Development of the loan portfolio

31 December [ISK m]	2014	2013	2012	2011
Cash and cash balances with Central Bank	21,063	37,999	29,746	29,200
Thereof cash with Central Bank	6,873	24,913	17,514	17,686
Loans to credit Institutions	108,792	102,307	101,011	69,103
Thereof bank accounts, and	79,592	70,671	84,164	62,175
money market loans	23,007	26,197	13,763	4,720
Loans to customers	647,508	635,774	566,610	561,550
Total loans	**777,363**	**776,080**	**697,367**	**659,853**

The growth in loans to customers between year end 2012 and 2013 is largely due to the settlement of the Dromi bond, coupled with a strong organic growth mainly in mortgage lending towards individuals. The breakdown of the Bank's loans to customers is as follows in Table 4.4.

Table 4.4 Loans to customers specified by types of loans

31 December [ISK m]	Individuals		Corporates		Total	
Type	2014	2013	2014	2013	2014	2013
Overdrafts	17,955	18,205	24,420	19,669	42,375	37,874
Credit cards	11,065	11,296	943	878	12,008	12,174
Mortgage loans	271,639	258,065	10,406	8,103	282,045	266,168
Capital lease	2,469	1,513	3,607	1,404	6,076	2,917
Other loans	31,294	34,620	300,391	311,247	331,685	345,867
Loans to customers pre provision	**334,422**	**323,699**	**339,767**	**341,301**	**674,189**	**665,000**
Provision on loans	(13,111)	(13,208)	(13,570)	(16,018)	(26,681)	(29,226)
Loans to customers net of provision	**321,311**	**310,491**	**326,197**	**325,283**	**647,508**	**635,774**

Loans to individuals represent 50% of total loans to customers and have increased by 3% year on year. The largest part of lending to individuals is mortgage lending or 81% of total loans to individuals.

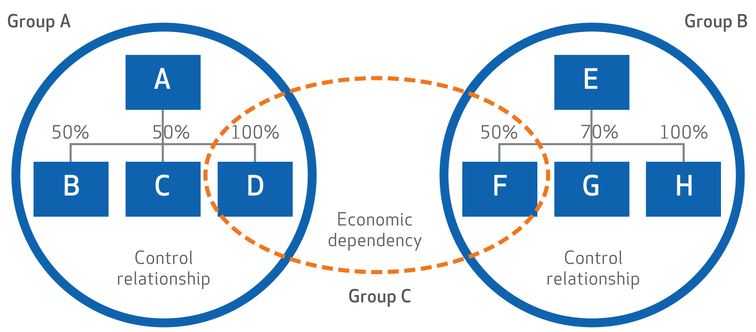
4.5.1 RELATED PARTIES AND LARGE EXPOSURE

A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's capital base according to FME Rules No. 625/2013. The legal maximum for individual large exposures, net of eligible collateral, is 25% of the capital base and the sum of all large exposures, net of eligible collateral, cannot exceed 400% of the capital base.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio by limiting large exposures to groups of related parties. No single large exposure or sum of large exposures shall exceed the Bank's internal limits, both of which are lower than the legal limits.

The Bank connects related parties according to internal rules that conform to FME rules and the EBA guidelines from 2009, both of which define the groups of related parties. The rules define the Bank's interpretation on conditions a. and b. in the FME rules and describe the roles and responsibilities in relation to the interpretation and maintenance of related parties. The rules are approved by the Board of Directors. The Bank evaluates the customers' relationship both with respect to control and economic dependencies. Economic dependencies between two companies within different groups do not necessarily combine these groups into one. This relationship is illustrated in Figure 4.1.

Figure 4.1 Related parties



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

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

At year end 2014 the Bank had two large exposures compared to three at the end of 2013 net of eligible collaterals. The largest exposure to a group of related parties at the end of 2014 was ISK 25 billion, before taking account of eligible collateral, see Table 4.5.

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

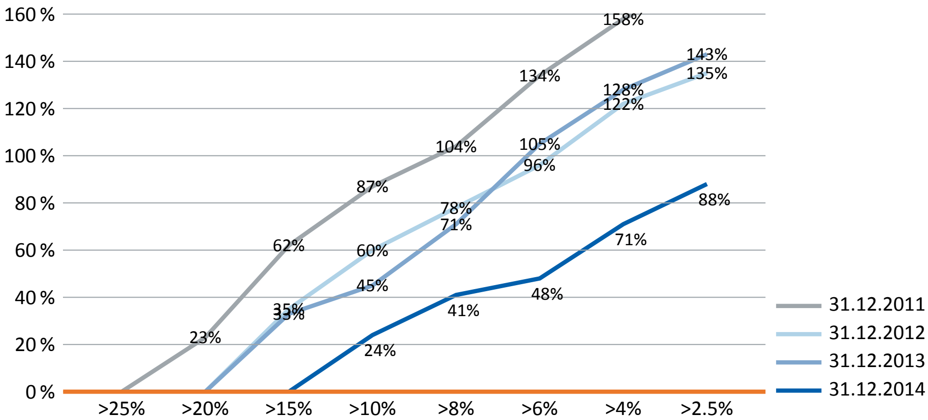
Table 4.5 The Bank's largest exposures

	2014		2013	
Related Parties	Gross	Net	Gross	Net
Group 1	14%	14%	16%	16%
Group 2	11%	10%	-	-
Group 3	<10%	<10%	12%	12%
Group 4	<5%	<5%	17%	17%
Group 5	<5%	<5%	10%	<10%
Group 6	<1%	<1%	10%	<10%
Sum of large exposures > 10%	**25%**	**24%**	**65%**	**45%**

The Bank's single-name concentration continues to decrease, see Figure 4.2. For example, the sum of large exposures, net of eligible collateral, was 24% at the end of 2014 compared with 45% at the end of 2013. The sum of large exposures exceeding 2.5%, net of eligible collateral, has decreased from 143% to 88% year-on-year.

The Bank's single-name concentration decreased during 2014

Figure 4.2 Total of net exposures to a group of related parties (without loans to financial institutions due to the Bank's own deposits)



4.5.2 CREDIT RISK EXPOSURE BY SECTOR

The Bank's loan book is diversified with regard to individuals and industry sectors. Of loans to customers, 50% are loans to individuals, of which 81% are mortgage loans. Credit exposure towards individuals represents 36% of the total credit risk exposure. Real estate activities and construction is the largest industry sector comprising 13% of loans to customers or 10% of the Bank's total credit risk exposure. According to the Bank's analysis, this distribution mirrors closely the sector distribution of credit from all lenders in the Icelandic economy. Thus, sector diversification is as good as can be expected for a bank which primarily operates in Iceland.

The Bank uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard. The internal industry classification combines NACE subclasses and singles out others to better represent the nature of the Icelandic economy and the Bank's business environment e.g. the two NACE subclasses fishing and seafood production are combined into one sector, fishing industry. An internal reclassification is made for some subclasses, mainly holding companies, the Bank applies this see-through principal to better locate the underlying sector risk.

Figure 4.3 Sector distribution of total credit risk exposure

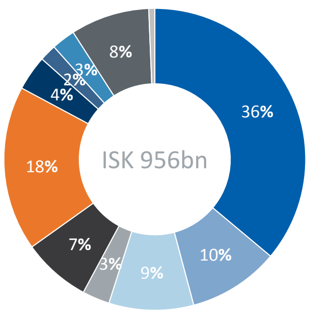


Figure 4.4 Sector distribution of loans to customers

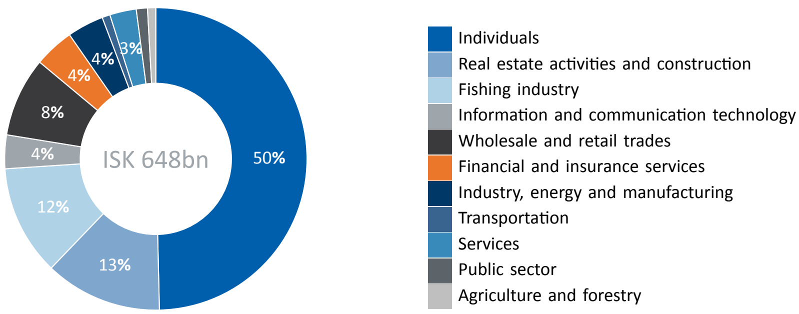


Table 4.6 Credit risk exposure broken down by industry

31 December 2014 [ISK m]	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	21,063	-	-	-	-	-	21,063
Loans to credit institutions	-	-	-	-	-	108,792	-	-	-	-	-	108,792
Loans to customers	321,311	81,228	76,340	23,314	55,034	27,693	25,284	5,529	18,382	7,746	5,647	647,508
Financial instruments	25	53	22	4	-	5,113	1,086	5	1,166	63,230	-	70,704
Other assets with credit risk	399	440	34	22	24	1,854	9	15	626	87	4	3,514
Credit risk exposure on-balance sheet	**321,735**	**81,721**	**76,396**	**23,340**	**55,058**	**164,515**	**26,379**	**5,549**	**20,174**	**71,063**	**5,651**	**851,581**
% of Credit risk exposure on-balance sheet	37.8%	9.6%	9.0%	2.7%	6.5%	19.3%	3.1%	0.7%	2.4%	8.3%	0.7%	100.0%
Off-balance sheet items:												
Financial guarantees	390	2,300	784	573	1,128	1,201	1,322	709	1,101	27	7	9,542
Unused overdrafts	22,621	2,007	578	561	4,554	1,491	1,952	264	2,038	2,384	440	38,890
Loan commitments	392	7,281	9,010	3,587	9,040	1,797	6,183	10,679	970	7,392	32	56,363
Credit risk exposure off-balance sheet	**23,403**	**11,588**	**10,372**	**4,721**	**14,722**	**4,489**	**9,457**	**11,652**	**4,109**	**9,803**	**479**	**104,795**
% of Credit risk exposure off-balance sheet	22.3%	11.1%	9.9%	4.5%	14.0%	4.3%	9.0%	11.1%	3.9%	9.4%	0.5%	100.0%
Total credit risk exposure	**345,138**	**93,309**	**86,768**	**28,061**	**69,78**	**169,004**	**35,836**	**17,201**	**24,283**	**80,866**	**6,130**	**956,376**
% of Total credit risk exposure	36.1%	9.8%	9.1%	2.9%	7.3%	17.7%	3.7%	1.8%	2.5%	8.5%	0.6%	100.0%

31 December 2013 [ISK m]	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
On-balance sheet items:												
Cash and balances with Central Bank	-	-	-	-	-	37,999	-	-	-	-	-	37,999
Loans to credit institutions	-	-	-	-	-	102,307	-	-	-	-	-	102,307
Loans to customers	310,491	83,002	60,906	24,025	55,061	27,535	22,661	18,966	19,793	8,682	4,652	635,774
Financial instruments	3	27	1	7	42	2,960	1,336	6	514	58,835	-	63,731
Other assets with credit risk	295	312	78	15	835	3,636	23	1	506	45	-	5,746
Credit risk exposure on-balance sheet	**310,789**	**83,341**	**60,985**	**24,047**	**55,938**	**174,437**	**24,02**	**18,973**	**20,813**	**67,562**	**4,652**	**845,557**
% of Credit risk exposure on-balance sheet	36.8%	9.9%	7.2%	2.8%	6.6%	20.6%	2.8%	2.2%	2.5%	8.0%	0.6%	100.0%
Off-balance sheet items:												
Financial guarantees	387	1,781	534	769	1,328	1,183	2,539	500	833	60	8	9,922
Unused overdrafts	22,282	1,433	395	591	4,095	1,951	1,653	298	2,005	2,298	371	37,371
Loan commitments	205	6,651	2,895	2,617	12,517	5,536	16,529	837	778	20	-	48,585
Credit risk exposure off-balance sheet	**22,874**	**9,865**	**3,824**	**3,977**	**17,940**	**8,67**	**20,721**	**1,635**	**3,616**	**2,378**	**379**	**95,878**
% of Credit risk exposure off-balance sheet	23.9%	10.3%	4.0%	4.1%	18.7%	9.0%	21.6%	1.7%	3.8%	2.5%	0.4%	100.0%
Total credit risk exposure	**333,663**	**93,206**	**64,809**	**28,024**	**73,878**	**183,107**	**44,741**	**20,608**	**24,429**	**69,940**	**5,031**	**941,435**
% of Total credit risk exposure	35.4%	9.9%	6.9%	3.0%	7.8%	19.4%	4.8%	2.2%	2.6%	7.4%	0.5%	100.0%

4.5.3 CREDIT RISK EXPOSURE BY MATURITY

Table 4.7 Credit risk exposure broken down by maturity

31 December 2014 [ISK m]	Book value	On demand	Up to 3 months	3 - 12 months	1 - 5 years	Over 5 years
On-balance sheet items:						
Cash and balances with Central Bank	21,063	12,285	-	8,778	-	-
Loans to credit institutions	108,792	52,119	56,673	-	-	-
Loans to customers	647,508	11,678	50,642	89,332	230,055	265,801
Bonds and debt instruments	66,466	4,350	-	2,068	52,378	7,670
Derivatives	1,026	-	742	136	148	-
Bond and debt instruments, hedging	3,212	3,212	-	-	-	-
Other assets with credit risk	3,514	47	2,283	46	1,121	17
Credit risk exposure on-balance sheet	**851,581**	**83,691**	**110,340**	**100,360**	**283,702**	**273,488**
% of Credit risk exposure on-balance sheet	100.0%	9.8%	13.0%	11.8%	33.3%	32.1%
Off-balance sheet items:						
Financial guarantees	9,542	2,373	1,234	2,389	1,753	1,793
Unused overdraft	38,890	658	10,163	17,738	10,273	58
Loan commitments	56,363	2,432	21,419	15,705	16,807	-
Credit risk exposure off-balance sheet	**104,795**	**5,463**	**32,816**	**35,832**	**28,833**	**1,851**
% of Credit risk exposure off-balance sheet	100.0%	5.2%	31.3%	34.2%	27.5%	1.8%
Total credit risk exposure	**956,376**	**89,154**	**143,156**	**136,192**	**312,535**	**275,339**
% of Total credit risk exposure	100.0%	9.3%	15.0%	14.2%	32.7%	28.8%

31 December 2013 [ISK m]	Book value	On demand	Up to 3 months	3 - 12 months	1 - 5 years	Over 5 years
On-balance sheet items:						
Cash and balances with Central Bank	37,999	28,666	-	9,333	-	-
Loans and receivables to credit institutions	102,307	47,197	55,110	-	-	-
Loans and receivables to customers	635,774	2,151	56,696	85,34	221,979	269,608
Bonds and debt instruments	62,171	5,952	1,151	13,148	38,236	3,684
Derivatives	1,070	447	90	201	332	-
Bond and debt instruments, hedging	490	490	-	-	-	-
Other assets with credit risk	5,746	53	4,014	693	973	13
Credit risk exposure on-balance sheet	**845,557**	**84,956**	**117,061**	**108,715**	**261,52**	**273,305**
% of Credit risk exposure on-balance sheet	100.0%	10.0%	13.8%	12.9%	30.9%	32.3%
Off-balance sheet items:						
Financial guarantees	9,922	2,216	2,698	2,650	1,106	1,252
Unused overdraft	37,371	949	8,909	16,108	11,345	60
Loan commitments	48,585	3,301	25,011	14,198	6,075	-
Credit risk exposure off-balance sheet	**95,878**	**6,466**	**36,618**	**32,956**	**18,526**	**1,312**
% of Credit risk exposure off-balance sheet	100.0%	6.7%	38.2%	34.4%	19.3%	1.4%
Total credit risk exposure	**941,435**	**91,422**	**153,679**	**141,671**	**280,046**	**274,617**
% of Total credit risk exposure	100.0%	9.7%	16.3%	15.0%	29.7%	29.2%

4.5.4 CREDIT EXPOSURE BY RATING

As was discussed in section 4.4 Arion Bank rates customers using one of three different rating models. Table 4.8 shows the rating status of the portfolio, for each type of rating model. In some cases, companies are temporarily unrated. At the end of 2014 only 3% of the loan portfolio, parent company, was unrated compared to 10% the year before. This 3% is primarily due to newly formed entities where no financial or historical information is available and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and some holding companies. Customers are assigned a DD rating (default) when they have been defaulting for over 90 days or provision for losses has been made against the customer's exposure. This is the Basel II definition of default. Note that the DD rating is an indication of a default event. It is not an assigned credit rating from the Bank's rating models. It is noteworthy that 4% of the corporate portfolio was assigned a default rating at the end of the year compared to 25% at the end of year 2011. Overall the number of active ratings is increasing and defaulting exposure is decreasing. Active PD values are translated into an internal rating scale of letters from CCC- to A+, seen in table 4.9. The Bank has standardized five risk classes which group the internal rating scale, shown in the same table. The Retail Banking uses these risk classes in their lending processes. The rating distributions of each model are discussed below.

Table 4.8 Breakdown of rating status by book value

	2014			2013		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Corporate credit rating model	90%	4%	6%	74%	5%	21%
Retail credit rating model						
SMEs	94%	5%	1%	91%	6%	3%
Individuals	90%	10%	0%	89%	11%	0%
Total	**90%**	**7%**	**3%**	**82%**	**8%**	**10%**

Table 4.9 Rating scale

Risk class	Rating	Lower PD	Upper PD
1	A+	0.00%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
	BBB+	0.17%	0.26%
	BBB	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	31.00%
	CCC-	31.00%	99.99%
5	DD	100.00%	100.00%

CORPORATE PORTFOLIO

Figure 4.5 shows the corporate portfolio broken down by risk classes. As seen in table 4.8 the number of unrated corporates at year end was 6% compared to 21% the year before. The overall shift, between 2013 and 2014, of good and bad ratings towards the middle can partly be explained by that. In terms of book value about 20% have been upgraded towards a better risk class, in contrast to 29% that have been downgraded. Migration analysis does not cover defaulting customers or customers that were previously unrated or rated by the SME model. The book-value weighted average PD for corporate customers was 2.9% in year end 2014 compared to 4.5% in 2013. The change in rating distribution can mainly be attributed to pure migration. However, the decreased number of unrated corporates also plays its part.

Figure 4.5 Distribution of book value rated by the corporate credit rating model

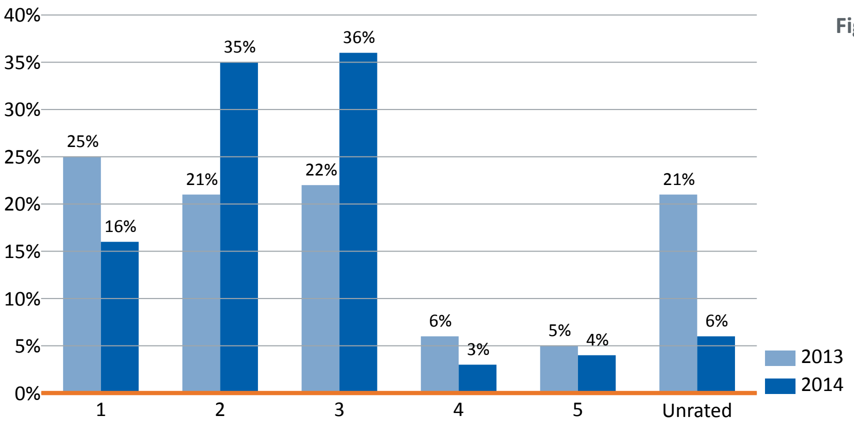


Figure 4.6 Rating migration by book value between 2013 and 2014 – Corporate

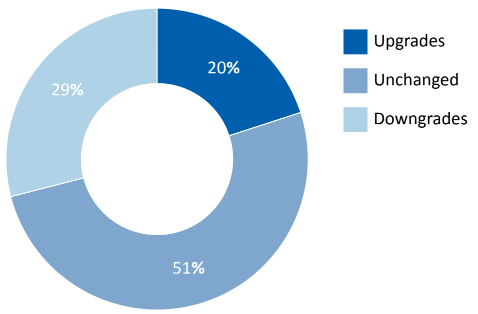
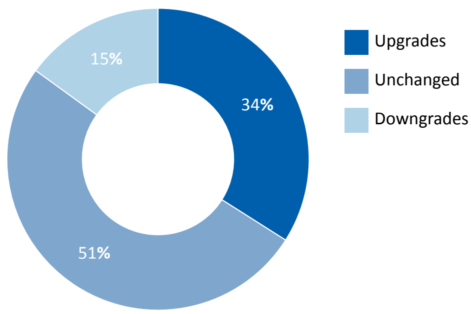


Figure 4.7 Rating migration by customer between 2013 and 2014 – Corporate



RETAIL PORTFOLIO - SMEs

Figure 4.8 shows the SME portfolio broken down by risk classes. The distribution of PD values has slightly shifted towards better values between 2013 and 2014. In terms of book value about 39% have been upgraded towards a better risk class whereas 11% have been downgraded. The book value-weighted average PD for SME portfolio was 9.3% in year end 2014 compared to 11.1% in 2013. The change in rating distribution can mainly be attributed to pure migration, i.e. an overall improvement in the rating of existing customers. However, as a part of an annual overhaul, the SME model was updated and recalibrated in 2014 with the aim of improving its predictive power. The model is calibrated using more recent data than before which might have helped to improve ratings.

Figure 4.8 Distribution of book value rated by the credit rating model for SMEs

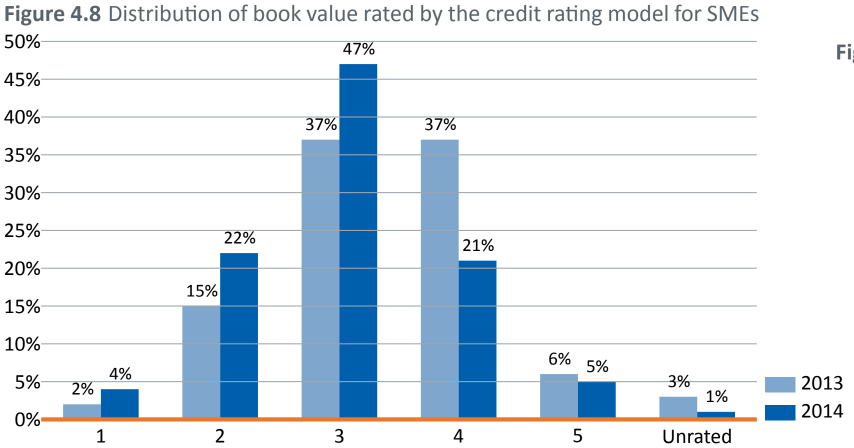


Figure 4.9 Rating migration by book value between 2013 and 2014 – SMEs

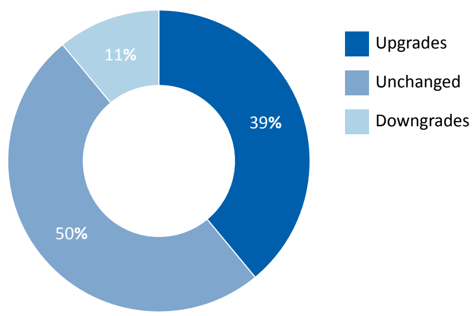
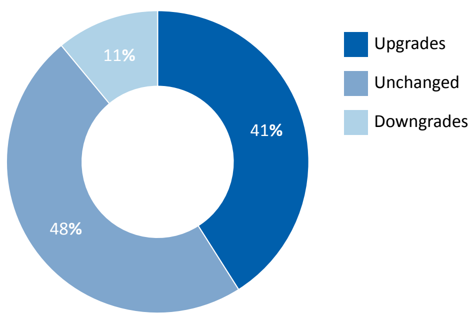


Figure 4.10 Rating migration by customer between 2013 and 2014 - SMEs



RETAIL PORTFOLIOS - INDIVIDUALS

Figure 4.11 shows the Individuals portfolio broken down by risk classes. There is a significant shift in the distribution of PD-values towards better values between 2013 and 2014. In terms of book value about 61% have been upgraded towards a better risk class whereas 6% have been downgraded. The book value-weighted average PD for individuals portfolio was 4.7% in year end 2014 compared to 8.3% in 2013. As for the SME model, the model for individuals was updated and recalibrated in 2014 with the aim of improving its predictive power. The model is calibrated using data from June 2009 to January 2013. The recent recalibration is more reliable but at the same time more optimistic than its predecessor. The decrease in the average PD between years is partly due to that but also due to pure migration.

Figure 4.11 Distribution of book value rated by the credit rating model for individuals

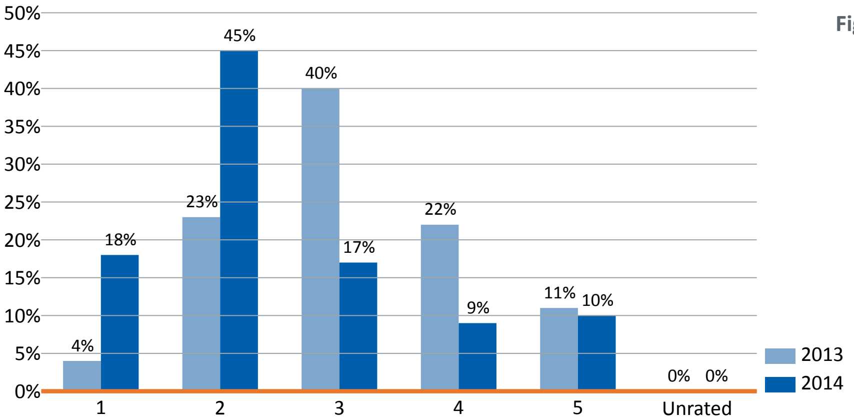


Figure 4.12 Rating migration by book value between 2013 and 2014 - Individuals

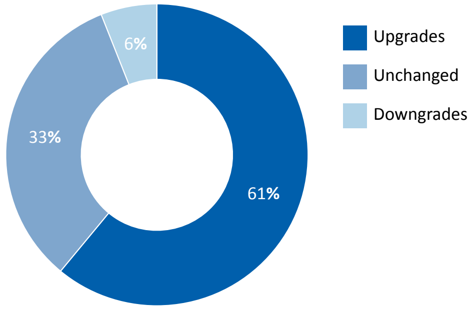
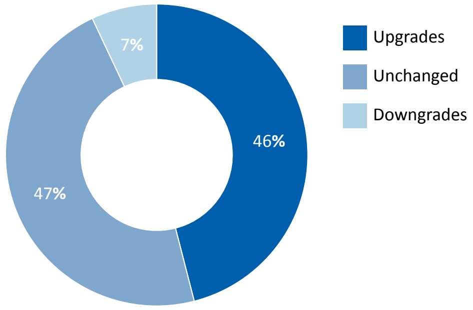


Figure 4.13 Rating migration by customer between 2013 and 2014 – Individuals



MODEL PERFORMANCES

All three rating models in use have passed internal validation tests and the discriminatory power exceeds the Bank's internal requirements. Furthermore, the prediction accuracy is satisfactory as the average PD estimates are generally close to the observed default rates. The average default rate for individuals in 2014 was 3.6% compared to 3.3% predicted by the rating model for individuals. The default rate for SMEs in 2014 was 5.2% compared to the 5.9% predicted by the rating model for SMEs. For the corporate portfolio the default rate was 6.1% compared to 4.7% predicted. Note that here the default rate is measured by number of customers, not book value-weighted. Figures 4.14 and 4.15 compare actual default rate in 2014 with predicted default probability for individuals, SMEs and corporate.

Figure 4.14 Comparison of actual default rate in 2014 and predicted default probability - Individuals

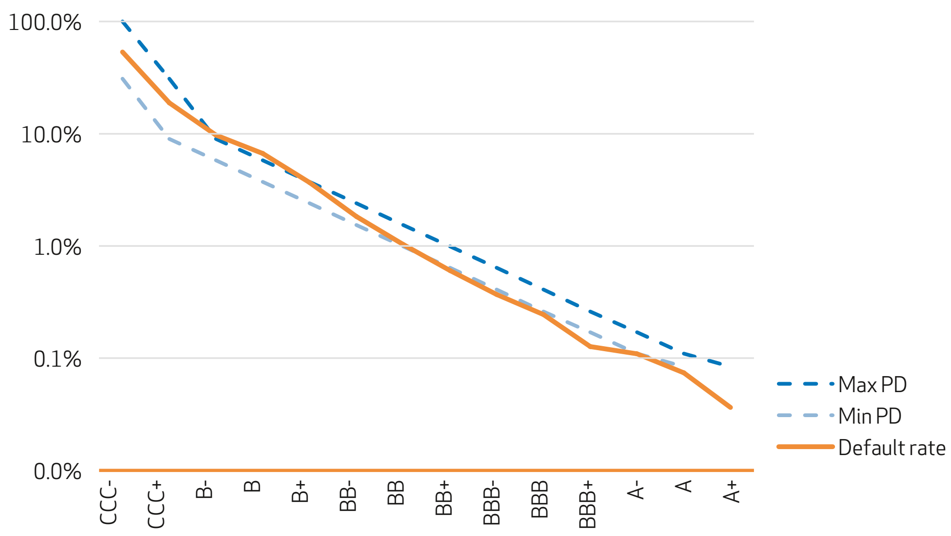
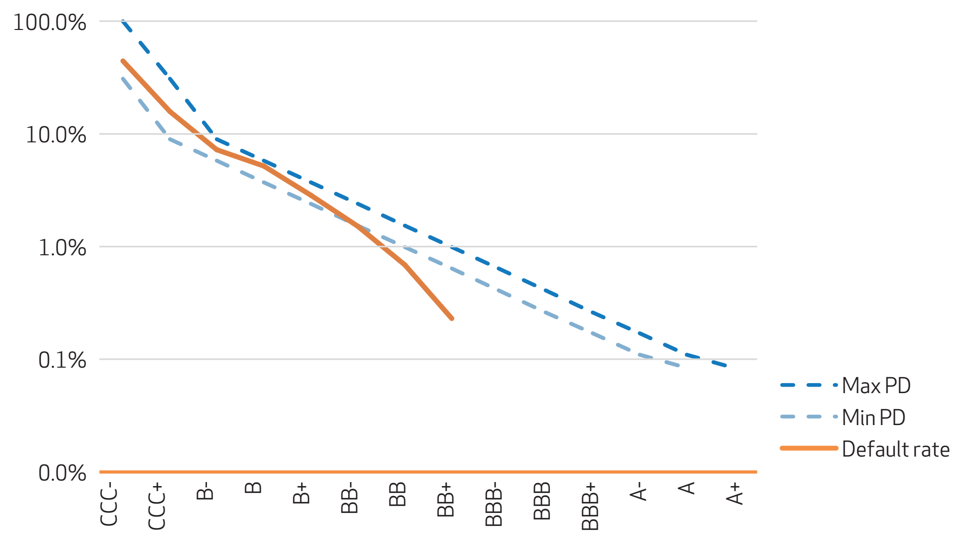


Figure 4.15 Comparison of actual default rate in 2014 and predicted default probability - SMEs and Corporate



4.5.5 CREDIT RISK EXPOSURE BY GEOGRAPHIC AREA

The Bank is not significantly exposed to foreign countries other than foreign credit institutions, which is mainly due to the Bank's deposits placed with other banks and short time money market loans. Loans to customers outside Iceland amounted to ISK 39,531 million or 6% of the total loans to customers of which ISK 9,789 million are due to individuals currently domiciled outside Iceland.

Table 4.10 Geographic distribution of credit risk exposure

31 December 2014 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	21,063	-	-	-	-	21,063
Loans to credit institutions	34,540	21,550	32,869	10,763	9,070	108,792
Loans to customers	607,977	24,161	13,579	867	924	647,508
Bonds and debt instruments	46,155	1,752	11,506	7,053	-	66,466
Derivatives	984	5	37	-	-	1,026
Bonds and debt instruments, hedging	3,212	-	-	-	-	3,212
Other assets with credit risk	3,021	53	349	86	5	3,514
Credit risk exposure on-balance sheet	**716,952**	**47,521**	**58,340**	**18,769**	**9,999**	**851,581**
% of Credit risk exposure on-balance sheet	84.2%	5.6%	6.9%	2.2%	1.2%	100.0%
Off-balance sheet items:						
Financial guarantees	9,238	304	-	-	-	9,542
Unused overdraft	38,158	379	213	81	58	38,890
Loan commitments	48,553	16	7,794	-	-	56,363
Credit risk exposure off-balance sheet	**95,949**	**698**	**8,007**	**81**	**58**	**104,795**
% of Credit risk exposure off-balance sheet	91.6%	0.7%	7.6%	0.1%	0.1%	100.0%
Total credit risk exposure	**812,901**	**48,219**	**66,347**	**18,850**	**10,057**	**956,376**
% of Total credit risk exposure	85.0%	5.0%	6.9%	2.0%	1.1%	100.0%

31 December 2013 [ISK m]	Iceland	Nordic	Rest of Europe	North America	Other	Total
On-balance sheet items:						
Cash and balances with Central Bank	37,999	-	-	-	-	37,999
Loans to credit institutions	24,946	26,858	38,937	7,100	4,467	102,307
Loans to customers	598,490	18,061	15,209	3,058	956	635,774
Bonds and debt instruments	47,960	2,841	7,919	3,451	-	62,171
Derivatives	1,048	-	22	-	-	1,070
Bonds and debt instruments, hedging	490	-	-	-	-	490
Other assets with credit risk	5,184	6	549	6	1	5,746
Credit risk exposure on-balance sheet	**716,117**	**47,766**	**62,637**	**13,614**	**5,424**	**845,557**
% of Credit risk exposure on-balance sheet	84.7%	5.6%	7.4%	1.6%	0.6%	100.0%
Off-balance sheet items:						
Financial guarantees	9,917	4	-	0	-	9,922
Unused overdraft	36,600	399	224	68	81	37,371
Loan commitments	48,448	40	98	0	-	48,585
Credit risk exposure off-balance sheet	**94,965**	**442**	**321**	**69**	**81**	**95,878**
% of Credit risk exposure off-balance sheet	99.0%	0.5%	0.3%	0.1%	0.1%	100.0%
Total credit risk exposure	**811,082**	**48,208**	**62,958**	**13,683**	**5,504**	**941,435**
% of Total credit risk exposure	86.2%	5.1%	6.7%	1.5%	0.6%	100.0%

Figure 4.16 Geographic distribution of total credit risk exposure by country

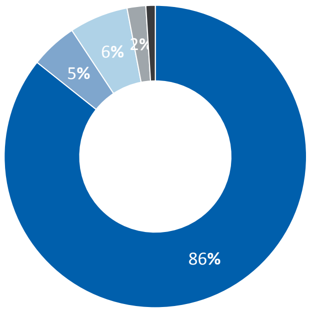
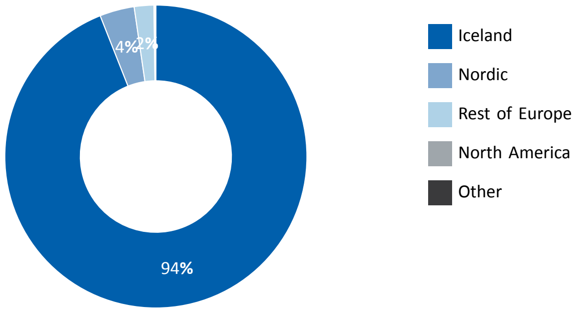


Figure 4.17 Geographic distribution of loans to customers



4.6 COLLATERAL MANAGEMENT AND VALUATION

Accurately valued collateral is one of the key components in mitigating credit risk. The Bank's initial valuation of collateral takes place during the credit approval process. Credit rules outline the acceptable levels of collateral for a given counterparty and exposure type. The collateral obtained by the Bank is typically as follows:

- Retail loans to individuals: Mortgages in residential properties.
- Corporate loans: Real estate properties, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

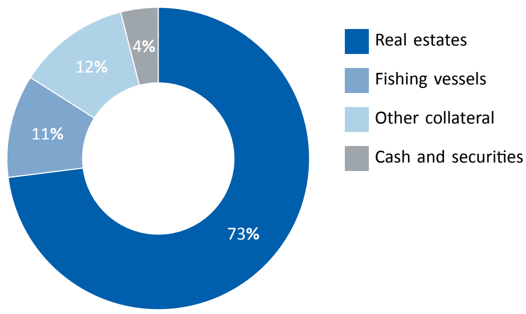
Other instruments used to mitigate credit risk include pledges, guarantees and master netting agreements.

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

- Agriculture
- Fishing Vessels and Fishing Quota
- Real Estate
- Securities
- Inventory and Trade Receivables

The Bank operates a collateral management system (CMS) to consolidate the Bank's collateral data. Table 4.11 shows the collateral held by the parent company, broken down by business sector. Collateral held at year end is to the largest extent real estate collateral making up 73% of total collateral and the unsecured ratio of the total credit portfolio is 37.8%. At the end of 2014 loans to customers are secured by collateral, conservatively valued at ISK 547,581 million, for a collateral coverage ratio of 81% compared with 77% at the end of 2013. The credit exposure towards the Central Bank and financial institutions is unsecured as it is due to the Bank's own deposits accounts and money market loans.

Figure 4.18 Collateral by type



The collateral coverage ratio of loans to customers at end 2014 is 81% compared with 77% at the end of 2013

Table 4.11 Collateral, parent company

31 December 2014 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans to credit institutions	-	-	-	-	-	100.0%
Loans to customers	20,455	400,903	57,817	68,406	547,581	18.8%
Individuals	589	282,889	43	1,093	284,614	14.9%
Real estate activities and construction	754	67,907	11	3,034	71,706	13.8%
Fishing industry	100	7,980	57,462	3,190	68,732	11.9%
Information and communication technology	33	2,077	-	18,603	20,713	12.7%
Wholesale and retail trade	367	16,826	5	30,632	47,830	14.9%
Financial and insurance services	12,108	2,584	-	2,886	17,578	49.3%
Industry, energy and manufacturing	6,007	10,391	47	4,325	20,770	19.4%
Transportation	86	601	153	3,019	3,859	30.9%
Services	384	3,377	96	1,348	5,205	72.4%
Public sector	22	3,718	-	152	3,892	50.3%
Agriculture and forestry	5	2,553	-	124	2,682	54.7%
Bond, debt instruments and derivatives	3,330	-	-	-	3,330	95.0%
Total	**23,785**	**400,903**	**57,817**	**68,406**	**550,911**	**36.7%**

31 December 2013 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans and receivables to credit institutions	-	-	-	-	-	100.0%
Loans to customers	24,302	358,588	53,140	78,120	514,150	22.7%
Individuals	659	269,700	49	362	270,770	16.2%
Real estate activities and construction	3,887	55,427	12	1,053	60,378	31.7%
Fishing industry	89	3,039	52,878	2,361	58,368	9.1%
Information and communication technology	26	1,842	-	20,452	22,320	30.2%
Wholesale and retail trade	6,664	10,095	5	28,447	45,212	28.0%
Financial and insurance services	12,416	441	-	9,116	21,973	29.5%
Industry, energy and manufacturing	180	8,645	46	10,719	19,590	17.1%
Transportation	69	563	51	2,310	2,995	84.3%
Services	285	3,314	98	2,994	6,691	63.1%
Public sector	22	3,190	-	170	3,382	62.3%
Agriculture and forestry	5	2,331	-	136	2,472	48.5%
Bond, debt instruments and derivatives	2,867	-	-	-	2,867	95.5%
Total	**27,169**	**358,587**	**53,139**	**78,120**	**517,015**	**41.1%**

Figure 4.19 shows the mortgage portfolio broken down to LTV bands. At the end of 2014, 68% of the mortgages, by value, had loan-to-value below 80% compared to 61% and 55% at the end of 2013 and 2012, respectively. The increase in loans with LTV above 110% is due to re-classification of certain loans as mortgages. As shown in figure 4.20 the mortgage property is primarily located in the Greater Reykjavik area or 73% of the portfolio, by value.

Figure 4.19 Loan to value of mortgage loans

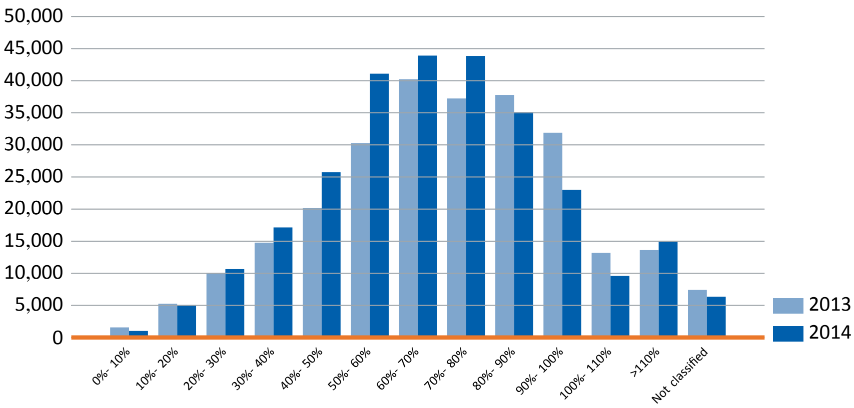
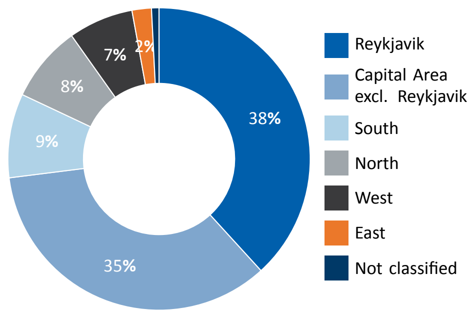


Figure 4.20 Mortgage portfolio location



4.7 CREDIT MONITORING AND VALUATION

The Bank is highly focused on the performance of the loan portfolio. To monitor the performance the Bank relies on an Early Warning System (EWS) a forward-looking classification system for loans and borrowers. The monthly EWS classification is a prelude to the credit review by the Credit Control department. The need for impairment and/or financial restructuring is identified and evaluated during the review.

4.7.1 THE EARLY WARNING SYSTEM

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

The EWS attempts to anticipate deterioration in the customer credit quality

The classification is based on borrowers' contractual arrangement with the Bank, i.e. timeliness of payments and loan terms, financial ratios and credit rating with different criteria applied to different industrial sectors. Table 4.12 shows an aggregation of the EWS to illustrate the different categories and underlying criteria.

Table 4.12 The Early Warning System - an aggregate review

Category	Provision	Default	(Debt/EBITDA) /LTV	Equity ratio	Credit Rating	Covenant breach
Green	No	< 30	< 4.0 - 5.0 / < 75 % -80 %	> 15 % - 25%	≥B -	None
Yellow	No	30 - 90	4.0 - 6.0 / < 75 % -90 %	10 % - 25%	CCC+	Minor
Orange	No	> 90	> 5.0 - 6.0 / 90% - 100%	< 10% - 20%	< CCC+	Serious
Red	Yes	> 90	> 5.0 - 6.0 / > 100%	< 10% - 20%	< CCC+	Serious
< ISK 100 million	x	x			x	

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

The classification is intentionally strict since its main purpose is to draw attention to plausible evidence of impairment e.g. payment difficulties of borrowers with resulting credit loss by the Bank. Risk Management has the authority to reassess the classification if an account manager has solid arguments for the change.

4.7.2 CREDIT MONITORING AND PROVISIONS

The Credit Control department monitors individual credits based on selected samples. The samples are determined by the size of the exposure and its risk. The risk measurements are based on the EWS as described previously. The level-of-detail in credit monitoring depends on credit size and loan volume. Credit monitoring consists of quarterly review by the Credit Control department which usually involves communication with borrowers' account managers. Borrowers in the Red and Orange category with mortgages undir ISK 50 million and other loans under 5 million are automatically analyzed along with individual samples. Semi-annual valuation reports are made for borrowers with credit exposure above 10% of capital base and for borrowers in the Orange and Red category with credit exposure above ISK 500 million. 57% of total loans, by value, are analyzed, see Table 4.13. In addition to the analysis statistics, the table shows whether the monitoring involves interviewing the responsible account manager and whether a detailed valuation report for the credit is required.

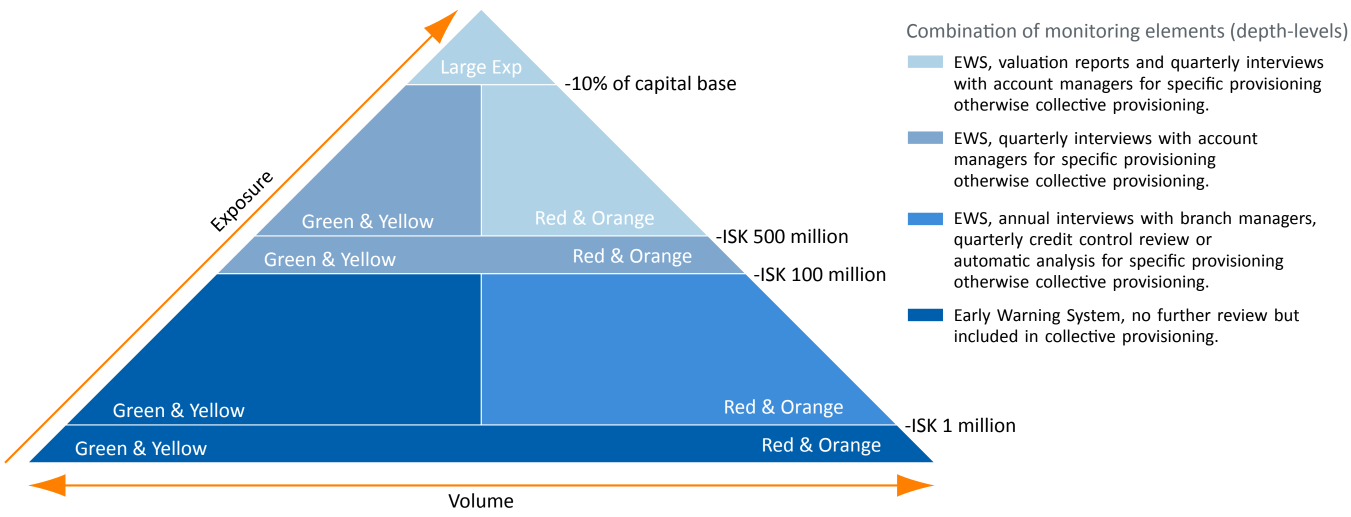
57% of total loans, by value, are individually analyzed

Table 4.13 Credit monitoring

Credit size	Total exposure	Total analyzed	Interview	Valuation report	Total customers	Customers analyzed
≥10% of capital base	6%	6%	All quarterly	All	12	12
≥500 million	39%	39%	All quarterly	Red+Orange	387	387
≥100 million	7%	7%	All annually	none	709	709
≥1 million	47%	5%	Red+Orange annually	none	25,650	1,766
< 1 million	2%	0%	none	none	50,974	0
Total	**100%**	**57%**			**77,732**	**2,874**

Figure 4.21 describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.

Figure 4.21 Monitoring of exposures



As a result of the Credit Control's analysis a specific provision for impairment is determined based on the customer's aggregate exposure, the realizable value of collateral in accordance with the valuation committees' guidance (see section 4.6) etc. Special provisioning is based on the FME's Rules No. 834/2003 on the Annual Accounts of Credit Institutions and shall reflect estimated loss on loans.

Collective provisioning is applied to credits other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default but have been determined not to require specific impairment. Collective provisions are estimates of expected loss, see section 4.8.3 based on the borrower's probability of default (PD), loss given default values (LGD) and exposure at default (EAD). The probability of default is based on the Bank's internal rating system, see section 4.4, and the LGD is is based on the Bank's own model for loss given default, see section 4.8.3.

4.8 PORTFOLIO CREDIT QUALITY

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio. To this end, it follows the development of credit rating, defaults, loan impairments and the progress of the recovery of distressed loans.

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio

4.8.1 DEFAULTS

Figures 4.22 and 4.23 show the development of serious defaults from the end of 2010 for individuals and corporates, using the facility default and cross default methods. In the latter method, all exposure to the customer is considered in default if one facility is in default. Defaults have steadily decreased during the period mainly due to the progress made in restructuring problem loans and the resolution of the legal uncertainty surrounding the FX loans.

Figure 4.22 Development of default on individuals, parent company

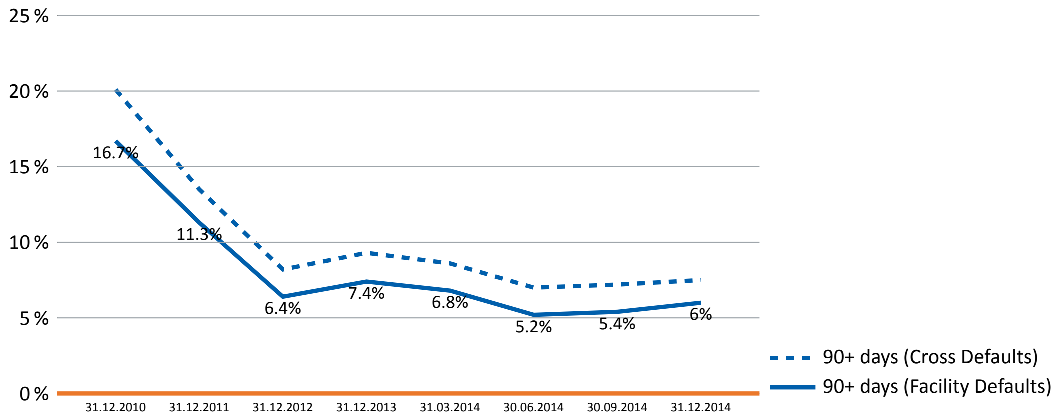
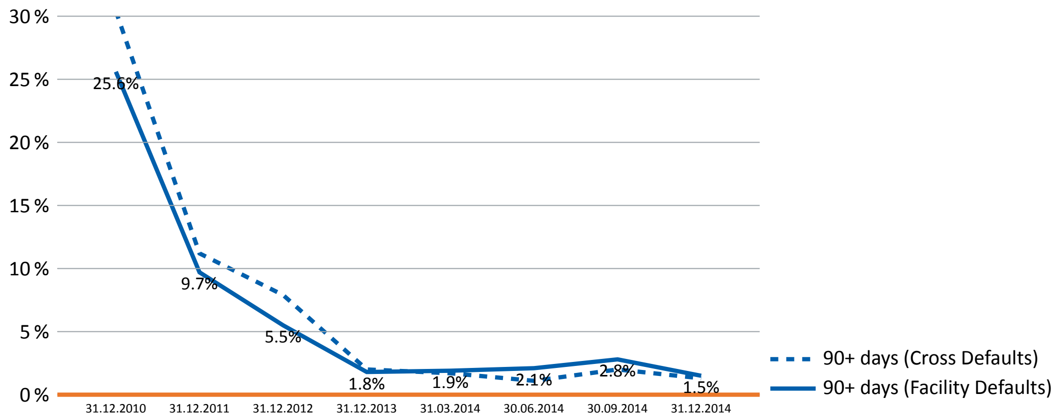


Figure 4.23 Development of default on companies, parent company



Customer loans that are past due more than 90 days are 3.6% of the total loan book at year end if measured at facility level. The cross default ratio more than 90 days is 4.4%, at the parent company level, 7.5% for individuals and 1.3% for corporates. Table 4.14 shows the breakdown of facility and cross-default for the parent company down to sectors.

Customer loans that are past due more than 90 days are 3.6% of the total loan book at year end if measured at facility level

Table 4.14 Defaults by sector, parent company

31 December 2014 [ISK m]	Facility level		Cross default	
	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Individuals	6.0%	82.1%	7.5%	82.9%
Wholesale and retail trade	2.5%	6.1%	3.1%	5.9%
Real estate activities and construction	1.4%	5.3%	1.6%	4.7%
Fishing industry	1.0%	3.3%	1.3%	3.5%
Public sector	3.2%	1.1%	3.2%	0.9%
Agriculture and forestry	3.7%	0.8%	4.0%	0.7%
Services	0.9%	0.6%	1.0%	0.5%
Financial and insurance activities	0.3%	0.4%	0.3%	0.3%
Industry. energy and manufacturing	0.2%	0.2%	0.2%	0.2%
Transportation	0.3%	0.1%	1.3%	0.3%
Information and communication technology	0.1%	0.1%	0.1%	0.0%
Total past due > 90 days as a % of loans to customers	**3.6%**	**100%**	**4.4%**	**100%**

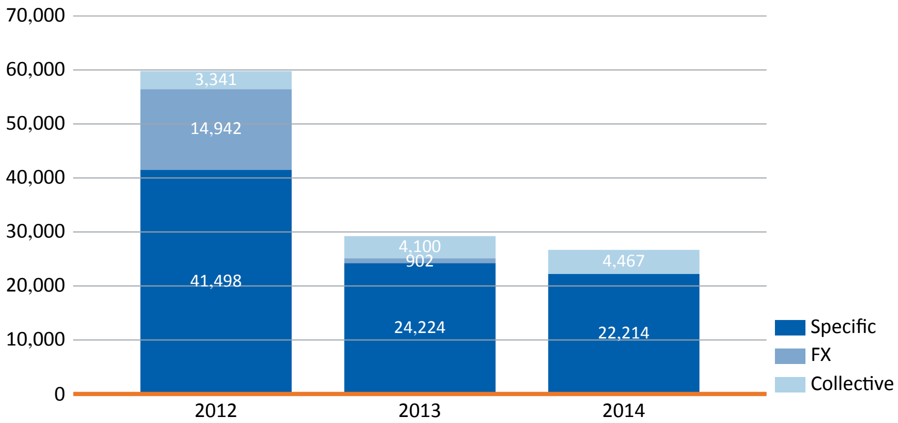
31 December 2013 [ISK m]	Facility level		Cross default	
	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days	Past due > 90 days as a % of total loans within sector	% contribution to past due > 90 days
Individuals	7.4%	78.8%	9.3%	81.3%
Wholesale and retail trade	2.3%	4.3%	2.3%	3.7%
Real estate activities and construction	1.7%	5.6%	2.0%	5.5%
Fishing industry	1.1%	2.3%	1.2%	2.0%
Public sector	0.4%	0.1%	0.4%	0.1%
Agriculture and forestry	2.4%	0.3%	2.6%	0.3%
Services	4.8%	2.9%	4.9%	2.4%
Financial and insurance activities	5.9%	5.5%	4.1%	4.6%
Industry. energy and manufacturing	0.1%	0.0%	0.3%	0.2%
Transportation	0.0%	0.0%	0.0%	0.0%
Information and communication technology	0.1%	0.1%	0.1%	0.1%
Total past due > 90 days as a % of loans to customers	**4.5%**	**100%**	**5.5%**	**100%**

4.8.2 IMPAIRMENT AND PROVISIONS

Loan impairment is recognized when credit monitoring has shown that there is objective evidence of credit losses and has made appropriate provision for these losses (see section 4.7.2). Note that loans which were acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

At the end of 2014 the Bank's total provision for impairment on loans to customers amounted to ISK 26,681 million. Figure 4.24 shows the development of provisions from 2012 were the provisions have been divided into specific provisions, where the provision is due to the borrower's credit quality, FX rulings, where the provision is primarily due to losses from the legal uncertainty for foreign currency loans, and collective provisions, which are calculated for all loans that do not have specific provisions, to account for expected loss rates.

Figure 4.24 Changes in the provision for losses on loans to customers [ISK m]



At year end 2012, a provision of ISK 14,942 million had been made for losses due to court rulings for illegal FX loans, in addition to ISK 4,625 million that were transferred to liabilities. The provision is reduced to ISK 902 million at year end 2013 which reflects that the process of recalculating illegal FX loans is nearing completion. At the end of 2014 such provisions are negligible. Specific provisions due to borrower credit quality have been similarly reduced by 46% from 2012, largely due to progress in corporate loan restructuring. This also explains the relative increase of the collective provisions since a larger part of the loan portfolio at year end does not have specific provisions.

The sum of specific loan impairments at the end of 2014 was ISK 22,214 million, compared with ISK 25,126 million at year end 2013. Table 4.15 shows the gross carrying amount of impaired loans to customers as well as the specific impairment to this amount broken down by industry sector.

Table 4.15 Impaired loans to customers by sector

31 December [ISK m]	2014 Impairment amount	2014 Gross carrying amount	2013 Impairment amount	2013 Gross carrying amount
Individuals	11,016	21,621	11,711	19,110
Real estate activities and construction	1,396	1,981	1,763	3,868
Fishing industry	1,115	2,366	1,229	3,769
Information and communication technology	251	251	164	190
Wholesale and retail trade	751	831	4,034	5,985
Financial and insurance services	6,739	6,756	4,513	6,080
Industry, energy and manufacturing	296	474	463	1,029
Transportation	18	18	71	365
Services	375	641	818	1,918
Public sector	27	35	8	35
Agriculture and forestry	230	340	352	790
Total	**22,214**	**35,314**	**25,126**	**43,139**

Table 4.16 shows the geographical distribution of impaired loans.

Table 4.16 Impaired loans to customers by geographic area

31 December [ISK m]	2014 Impairment amount	2014 Gross carrying amount	2013 Impairment amount	2013 Gross carrying amount
Iceland	21,104	33,371	19,724	34,962
Nordic	660	1,153	618	983
Rest of Europe	317	579	2,058	2,171
North America	92	98	2,710	4,997
Other	40	112	16	26
Total	**22,214**	**35,314**	**25,126**	**43,139**

4.8.3 EXPECTED LOSS

Expected Loss is defined as the amount of credit loss which the Bank expects, on average, during a typical business year. The Bank budgets for expected loss and holds capital for unexpected loss (see chapter 3.2).

The Bank has refined its Expected Loss (EL) model, taking advantage of enhanced collateral management within the Bank and the experience gained from the economic difficulties in the past few years. Among the areas which benefit from these refined EL calculations are the determination of collective provisions (see section 4.8.2), impairment predictions in the annual budget and the pricing of credit, where credit spreads take into account the exposure's expected loss, cost of capital and operational cost.

Expected Loss is calculated using the formula $EL = PD \cdot LGD \cdot EAD$ where each credit exposure's EL is derived from the customer probability of a Basel II default (PD), the loss given default (LGD) for the credit type and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see sections 4.4 and 4.5.4.

The main components of LGD are:

- the *cure-rate* of the exposure, which describes the probability that the customer returns to performing after a Basel II default and for all defaulted loans there is no write-off and time to resolution is less than or equal one year, and
- the *collateral gap* of the defaulted exposure

The collateral gap was estimated based on collateral value with the appropriate haircut. Table 4.17 shows the Expected Loss rate for various types of performing loans at end 2014.

Table 4.17 Expected loss down to exposure type

Exposure Class	PD	LGD	EL
Corporate	3%	14%	0.4%
SME	9%	20%	1.8%
Individual - Mortgage	4%	6%	0.3%
Individual - Other	6%	47%	2.8%
Total	**4%**	**13%**	**0.65%**

4.8.4 PROBLEM LOANS

The basic elements of loan quality are whether the loan is past due or individually impaired. Table 4.18 shows the impairment and past due status of the Bank's various asset classes. Past-due loans are not impaired if they are sufficiently collateralized.

Table 4.18 Credit quality by class of financial asset

31 December 2014 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	21,063	-	-	21,063
Loans to credit institutions	108,792	-	-	108,792
Loans to customers				
Loans to corporates	308,588	15,114	2,495	326,197
Loans to individuals	277,859	32,847	10,605	321,311
Financial instruments	70,704	-	-	70,704
Other assets with credit risk	3,514	-	-	3,514
Credit quality	**790,520**	**47,961**	**13,100**	**851,581**

31 December 2013 [ISK m]	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers				
Loans to corporates	304,880	9,789	10,614	325,283
Loans to individuals	268,485	34,607	7,399	310,491
Financial instruments	63,731	-	-	63,731
Other assets with credit risk	5,746	-	-	5,746
Credit quality	**783,148**	**44,396**	**18,013**	**845,557**

Table 4.19 shows a breakdown of loans to individuals and corporates which are past due but not impaired, by the number of days in default. Note that loans more than 90 days in default are down by 30% from the previous year.

Table 4.19 Number of days in default for loans which are not impaired

31 December 2014 [ISK m]	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,553	2,434	2,267	565	3,295	15,114
Loans to individuals	3,436	10,589	5,974	847	12,001	32,847
Total past due but not impaired loans	**9,989**	**13,023**	**8,241**	**1,412**	**15,296**	**47,961**

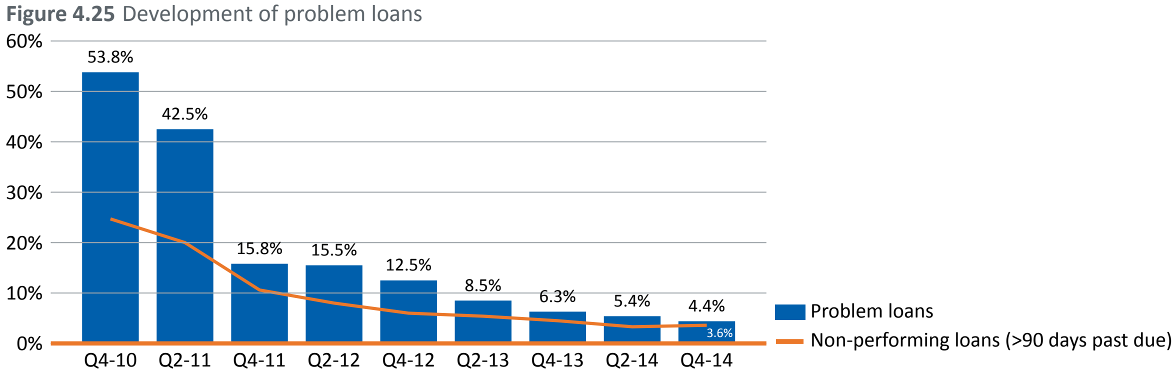
31 December 2013 [ISK m]	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,550	1,550	923	111	2,655	9,789
Loans to individuals	3,719	7,505	3,751	543	19,089	34,607
Total past due but not impaired loans	**8,269**	**9,055**	**4,674**	**654**	**21,744**	**44,396**

The Bank defines as *problem loans*, loans that are more than 90 days past due and loans that are not past due but individually impaired. This corresponds to the Basel II definition of default. The ratio of problem loans has steadily decreased since its peak in 2010 mostly due to the progress made in problem-loan restructuring and the resolution of the legal uncertainty surrounding FX loans.

At year end 2014 problem loans constitute 4.4% of loans to customers and have decreased from 53.8% from 2010 or by 91%, see Figure 4.25. 80% of problem loans, by value, at year end 2014 are due to individuals and 20% is due to corporates.

Problem loans, as a percentage of loans to customers, have decreased from 53.8% at the end of 2010 down to 4.4% or by 91%

Figure 4.25 Development of problem loans



The breakdown of problem loans by status and collateral are shown in Figure 4.26 and 4.27. Approximately 15% of the problem loans are impaired without being over 90 days past due. This is primarily explained by provision for losses from loans in restructuring or recently restructured loans where the borrower has not yet demonstrated full recovery.

Of the total problem loans ISK 23.227 million are secured with collateral that corresponds to a collateral coverage of 87%. Real estate collateral represents 92% of the total collateral amount; fishing vessels represent 7% and other collateral the remaining 1%.

Figure 4.26 Breakdown of problem loans by status

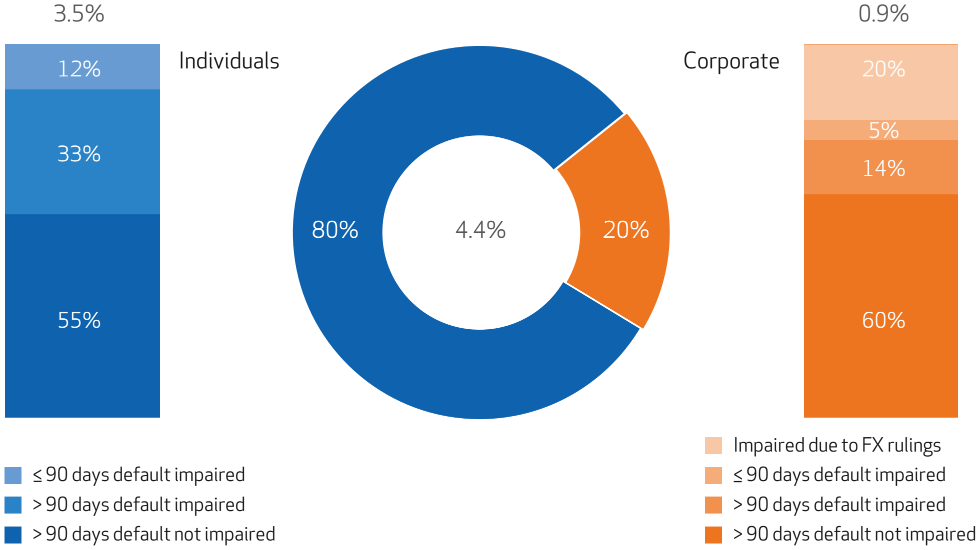
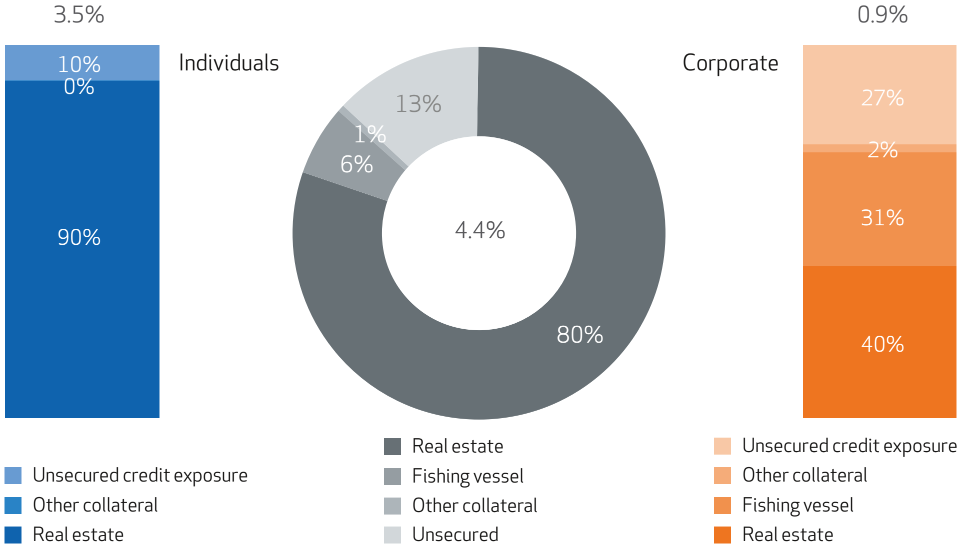


Figure 4.27 Collateral coverage of problem loans



4.8.5 LOAN RESTRUCTURING AND FME'S LOAN PORTFOLIO ANALYSIS (LPA)

Following the bank crisis in late 2008 the FME introduced a loan classification system designed to monitor the Icelandic banks' progress in restructuring the debt of distressed borrowers, which had increased significantly in the wake of the crisis. The system, which is called Loan Portfolio Analysis (LPA), categorizes borrowers, not individual exposures, into three groups; performing, performing after restructuring and non-performing. Each group is divided into subcategories, as shown in Table 4.20.

Table 4.20 FME's categorization

Category	Subcategory
Performing	• No restructuring
Performing after restructuring	• NPV swap • Extension of term only • Debt-equity swap • Partial write-off
Non-performing	• Payments postponed • Legal dispute • Previously restructured • 90 days past due • Transferred to workout • In collection

The loan portfolio is analyzed monthly based on the FME's LPA standard and reported to the FME. Figure 4.28 show the development of the LPA ratio for the total loan portfolio, by quarter, since the end of 2010. During the period, non-performing loans to customers, as defined by the LPA, had fallen from approximately 50% to 7.1%.

The loan portfolio is analyzed monthly based on the FME's LPA standard and reported to the FME

Figure 4.28 Development of the LPA

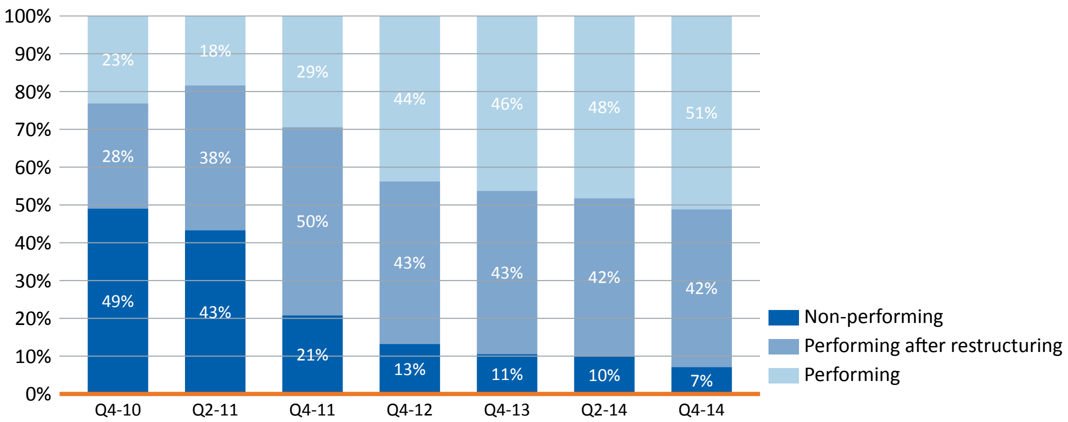
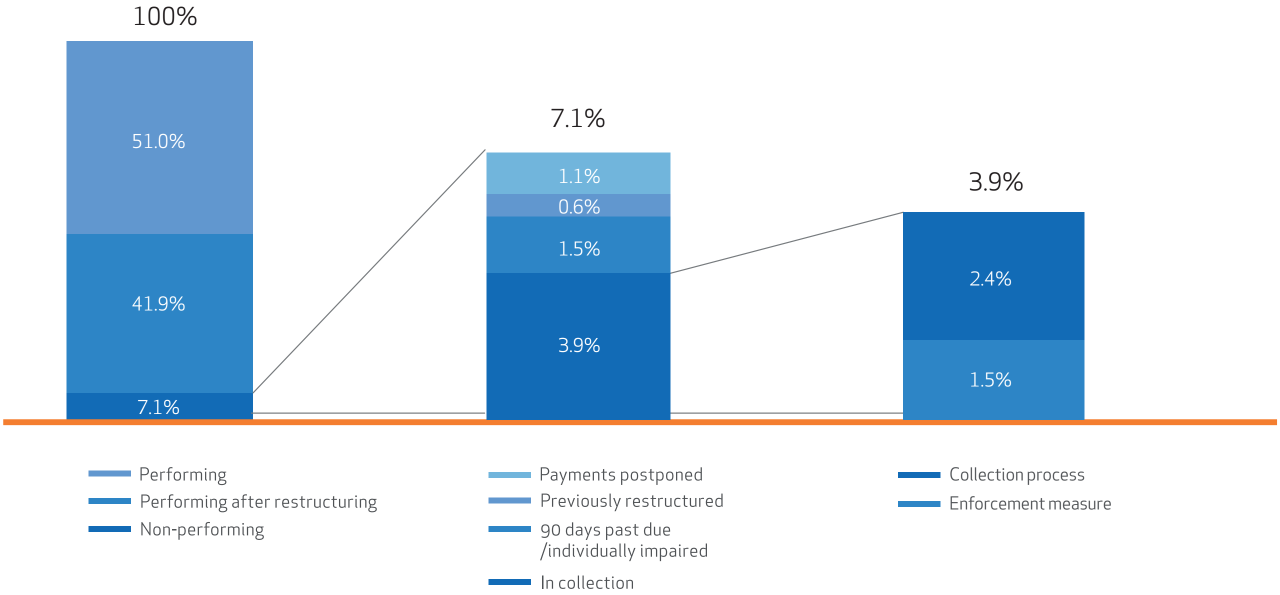


Figure 4.29 shows a breakdown of non-performing loans into its sub-categories at the end of 2014. During 2014, there were no new cases transferred to workout, also there were no case at workout at end of 2014. Loans in legal collection have decreased from 4.3% to 3.9% between 2013 and 2014.

Figure 4.29 Breakdown of LPA metric



4.9 COUNTERPARTY CREDIT RISK

Counterparty credit risk is the risk of the Bank's counterparty in a derivative contract defaulting before final settlement of the derivative contract's cash flows.

The Bank offers financial derivative instruments to professional investors. Table 4.21 shows derivative trading activities that are currently permitted. The derivative instruments are classified according to primary risk factor and the type of derivative instrument.

Table 4.21 Permitted derivative trading activities

Primary risk factor	Swaps	Forwards	Options
Interest rate	x		
Foreign exchange	x	x	x
Securities		x	x
Commodities		x	x

Value-changes are made in response to changes in interest rates, exchange rates, security prices and commodity prices. Counterparty credit risk arising from derivative financial instruments is the combination of the replacement cost of instruments with a positive fair value and the potential for future credit risk exposure. Replacement risk and future risk is used to calculate the capital requirement for counterparty credit risk in combination with the counterparty's risk weights.

The Bank sets limits on the total exposure and on the customer's negative value, net of collateral, to control the Bank's risks associated with these instruments. These limits are generally client-specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. The margin-call process is monitored by Risk Management. As shown in section 3.2, capital requirements for counterparty credit risk in the Bank's current operations are quite limited.

The margin-call process is monitored by Risk Management

Table 4.22 shows the Bank's exposure towards counterparty credit risk gross and net of collateral.

Table 4.22 Counterparty credit risk exposure gross and net of collateral

31 December 2014 [ISK m]	Position	Collateral	Exposure
Financial institution	500	110	390
Funds	(260)	1,874	-
Corporate	(93)	463	-
Retail Corporate	(41)	2,192	-
Retail Individuals	15	315	-
Total	**121**	**4,954**	**390**

31 December 2013 [ISK m]	Position	Collateral	Exposure
Financial Institution	449	-	449
Funds	(10)	1,213	-
Corporate	349	288	61
Retail Corporate	(288)	1,327	-
Retail Individuals	(192)	386	-
Central Bank	1	-	1
Total	**309**	**3,214**	**511**

5 MARKET RISK

5 MARKET RISK

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flow of financial instruments. The risk arises from market making and dealing, and positions in bonds, equities, currencies, derivatives, and any other commitments depending on market prices and rates. Market risk consists of price risk, currency risk, inflation risk and interest rate risk.

5.1 MARKET RISK POLICY

The Bank's market risk policy is to invest its own capital on a limited and carefully selected basis in transactions, underwritings and other activities that involve market risk, i.e. interest rate risk, equity price risk in the trading book and foreign exchange risk.

5.2 MARKET RISK MANAGEMENT

Risk Management's Portfolio Risk department is responsible for measuring and monitoring market risk exposure and price fluctuations in markets. The department takes proactive steps towards market risk management, which involves reviewing exposures and potential shortfalls and analyzing scenarios with traders. Issues of concern are escalated to the relevant Managing Director (MD) and the CRO.

The performance, exposure and relevant risk measures are summarized and reported to the relevant employees and MDs on a daily basis. Exposures and relevant risk measures are reported on a regular basis to ALCO and the Board of Directors.

Market risk controls vary between trading and banking (non-trading) books where the trading book holds positions with trading intent, according to the EU Capital Requirements Directive, Annex VII, that are actively managed on a daily basis. For example, the limit framework for the trading book is explicit and is monitored daily, but such a framework does not apply to the banking book due to the nature of the exposure. However, the banking book market risk exposure is monitored and reported on a monthly basis. The Board of Directors has set limits on various market risk exposures in the Bank's risk appetite statement.

The Portfolio Risk department is responsible for monitoring compliance with the limits that have been set. This entails daily monitoring and reporting usage and breaches of limits to relevant parties such as the CEO, CFO, CRO, relevant MDs or traders.

The Portfolio Risk department is responsible for monitoring compliance with the limits that have been set

5.3 MARKET RISK MEASUREMENT

Market risk exposure and price fluctuations in markets are measured on an end-of-day basis. The Bank uses various risk measures to calculate market risk exposure, see Table 5.1.

Table 5.1 Methods of market risk measurement

Market risk type	Measurement methods
Equity risk	Exposure in equity is measured with net and gross positions.
Interest rate risk	Interest rate risk is quantified by using shifts in yield curves and is measured as the difference in value between the original market value and the calculated market value after shifting the yield curve. This is done for all positions sensitive to interest rates and all yield curves.
Foreign exchange risk	Foreign exchange risk is quantified using the net balance of assets and liabilities in each currency, and their total sum. The assets and liabilities must include current positions, forward positions, delta positions in FX derivatives and the market value of derivatives in foreign currency. The Value-at-Risk method is used to quantify possible losses.
Indexation risk	Indexation risk is quantified using the net balance of CPI-linked assets and liabilities. When stress testing the effect of indexation, the CPI is simulated in conjunction with interest rate shifts.

5.4 FOREIGN EXCHANGE RISK

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to the currency imbalance between assets and liabilities where FX denominated assets are a greater part of the Bank's balance sheet than liabilities. As of the end of 2014 the Bank has an effective net position in foreign currency of ISK 18,897 million so that a 10% depreciation of the Icelandic krona, for example, would result in a profit of ISK 1,890 million for the Bank. The opposite would be true for a 10% appreciation of the Icelandic krona.

The parent company's currency imbalance of ISK 4,828 million has been relatively stable and is within the limit set by the Central Bank of Iceland. The consolidated currency imbalance is considerably higher due to foreign asset of subsidiaries, mainly equity holdings and assets related to operations outside Iceland.

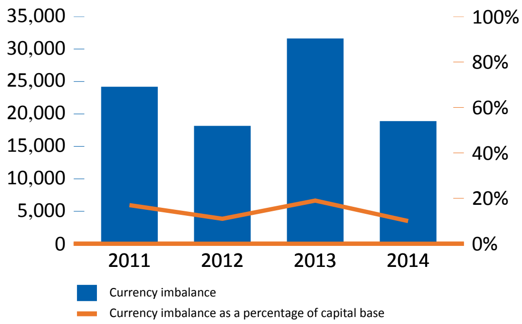
The Bank has strived to decrease the currency risk of its borrowers by limiting lending in foreign currency to customers with foreign exchange linked revenues.

Table 5.2 shows the net position of assets and liabilities by foreign currency at the end of 2014. Table 5.3 shows the Value-at-Risk for the net currency positions.

Table 5.2 Net position of assets and liabilities by currency

Foreign currency [ISK m]	Net Exposure
EUR	6,325
GBP	4,862
USD	3,331
DKK	1,036
JPY	938
Other	2,405
Total net position	**18,897**

Figure 5.1 Development of the Bank's currency imbalance [ISK m]



The Bank has strived to decrease the currency risk of its borrowers by limiting lending in foreign currency to customers with foreign exchange linked revenues

Table 5.3 Value-at-Risk for net currency positions with a 99 percent confidence level over a 10 day horizon

Foreign currency [ISK m]	10 day 99%VaR
EUR	142
USD	130
CHF	14
GBP	158
JPY	48
Nordic	78
Other	24
Diversification	(181)
Total Value-at-Risk	**413**

It should be noted that the historical data used for VaR calculations is collected over a period when capital controls have been in place and the result should be interpreted as risk given the current circumstances. Additional currency risk should be expected in relation to the removal of capital controls.

5.5 INDEXATION RISK

Indexation risk is defined as the risk of loss due to movements in the Consumer Price Index (CPI), i.e. inflation or deflation. A considerable part of the Bank's balance sheet consists of indexed assets and liabilities, the value of which is directly linked to the CPI. This risk factor should not be mistaken for inflation risk which represents the risk of loss in real value due to inflation.

At the end of 2014, the total amount of CPI-linked assets amounted to ISK 289,168 million and the total amount of CPI-linked liabilities amounted to ISK 204,042 million. Therefore, the net CPI-linked imbalance was ISK 85,126 million, which means that deflation would result in a loss for the Bank. The indexation imbalance has increased in 2014 by ISK 17,250 million. The most significant movement in the year was due to a prepayment of a part of the Bank's structured covered bonds in July 2014. However new indexed statutory covered bonds were issued in December 2014. In 2015, it is foreseen that the Government's debt relief program will, ceteris paribus, result in a reduced imbalance.

The Bank strives to keep its indexation imbalance stable. The Bank views the imbalance as an important hedge against loss of equity in real value terms. The price of the hedge is reflected in higher volatility of earnings in nominal terms. With the current imbalance at 52% of equity, a stable economic environment with low inflation is ideal for the Bank.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. However the economy is currently in uncharted territory with unprecedented levels of low inflation. The Bank measures its capital requirements due to indexation risk in conjunction with interest rate risk as inflation is a dominant factor in the dynamics of interest rates and therefore cannot be viewed independently.

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

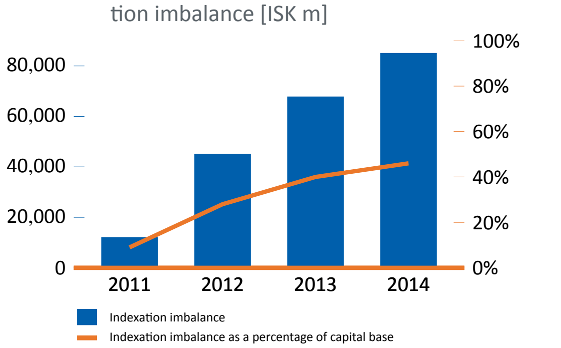
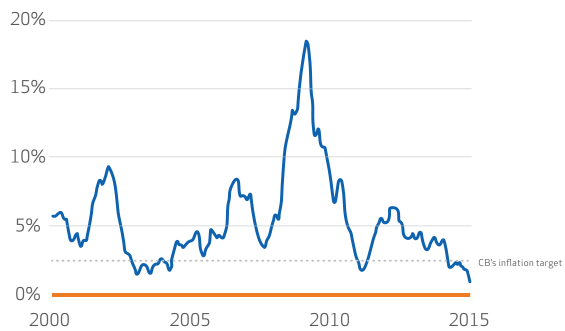


Figure 5.3 Twelve month inflation in Iceland.



5.6 EQUITY RISK IN THE BANKING BOOK

Equity positions in the banking book are mostly associates, strategic investments and foreclosed equity holdings.

Exposure limits for the banking book are set in the Bank's risk appetite statement. The risk appetite acknowledges the fact that equity positions in the banking book are, to a large extent, foreclosure assets due to the post 2008 restructuring process and therefore not all voluntarily taken by the Bank. Strategies for various types of exposure are set, such as a disposal schedule for non-core assets.

Securities listed on an active market are priced at their quoted price but for securities with infrequent transactions or low trading volume the price is determined by using valuation techniques. Such techniques include net present value calculations, comparison to similar instruments for which observable market prices exist and other valuation models. For more information on the accounting techniques regarding securities in the banking book, see Note 22 in the Consolidated Financial Statements of Arion Bank for 2014.

The equity exposure in the banking book is shown in Table 5.4.

Table 5.4 Equity exposure in the banking book

31 December 2014 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core	-	17,884	17,884
Equity instruments with variable income	6,559	11,596	18,155
Fund shares - Bonds	-	1,101	1,101
Fund shares - Other	520	3,918	4,438
Total equity exposure in the banking book	**7,079**	**34,499**	**41,578**
Realized gain/loss in 2014			723
Unrealized gain/loss in 2014			17,145

5.7 INTEREST RATE RISK IN THE BANKING BOOK

Interest rate risk is the risk of losses caused by changing interest rates and it normally increases with longer interest-fixing periods of asset and liabilities. The Bank's operations are subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods. A large amount of liabilities such as deposits have floating interest rates while assets in general have longer interest-fixing periods. This mismatch results in an interest rate risk for the Bank.

The Bank's strategy for managing interest rate risk is to strive for an interest rate balance between assets and liabilities. The Bank does this by targeting lending practices. Table 5.5 shows the Bank's interest-bearing assets and liabilities by interest-fixing period at the end of 2014. Assets and liabilities with zero duration, such as overdrafts and general deposit accounts, are included in the 0-1M time bucket. The interest-fixing period is not to be confused with the maturity of assets and liabilities.

The Bank's operations are subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods

Table 5.5 Assets and liabilities at fair value by interest fixing period

Assets [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not speci-fied	Total fair value	Total book value
Balances with Central Bank	15,808	-	-	-	-	-	-	-	15,808	15,808
Loans to credit institutions	108,792	-	-	-	-	-	-	-	108,792	108,792
Loans to customers	292,275	99,427	23,579	78,887	2,845	33,417	126,831	-	657,261	647,508
Bonds	39,330	4,901	9	14,241	6,138	1,528	319	-	66,466	66,466
Derivatives and hedging securities*	-	-	-	-	-	-	-	10,130	10,130	10,130
Total interest bearing-assets	**456,205**	**104,328**	**23,588**	**93,128**	**8,983**	**34,945**	**127,150**	**10,130**	**858,457**	**848,704**
Non-interest-bearing assets	-	-	-	-	-	-	-	85,032	85,032	85,032
Total	**456,205**	**104,328**	**23,588**	**93,128**	**8,983**	**34,945**	**127,150**	**95,162**	**943,489**	**933,736**

Liabilities and Equity [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Not speci-fied	Total fair value	Total book value
Due to Central Bank and credit institutions	22,503	373	-	-	-	-	-	-	22,876	22,876
Deposits from customers	437,842	12,931	989	3,270	-	-	101	-	455,133	454,973
Covered bonds	-	11,757	-	6,994	1,124	24,850	82,700	-	127,425	129,058
Other borrowings	54,375	14,996	-	319	-	-	-	-	69,690	71,522
Subordinated liability	-	31,639	-	-	-	-	-	-	31,639	31,639
Bonds - short positions	-	3,611	-	1,008	133	-	478	-	5,230	5,230
Derivatives and hedging securities*	-	-	-	-	-	-	-	9,143	9,143	9,143
Total interest bearing-liabilities	**514,720**	**75,307**	**989**	**11,591**	**1,257**	**24,850**	**83,279**	**9,143**	**721,136**	**724,441**
Non-interest-bearing liabilities	-	-	-	-	-	-	-	47,083	47,083	47,083
Equity	-	-	-	-	-	-	-	162,212	162,212	162,212
Total	**514,720**	**75,307**	**989**	**11,591**	**1,257**	**24,850**	**83,279**	**218,438**	**930,431**	**933,736**

Derivatives and hedging securities [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(1,009)	(40)	2,207	-	-	-	(171)	987

Total [ISK m]	0-1M	1-6M	6-12M	1-5Y	5-10Y	10-20Y	>20Y	Total
Net position	(59,524)	28,981	24,806	81,537	7,726	10,095	43,700	137,321

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

Table 5.6 shows the sensitivity of the fair value of interest-bearing assets and liabilities in the banking book to a shift of all yield curves upwards by 100 basis points (1%), by currency and interest-fixing periods at the end of 2014. Note that the Bank's book value is not affected in the same way as the fair value.

Table 5.6 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book

31 December 2014 [ISK m]	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	Total
ISK, non-indexed	(21)	(5)	(837)	(18)	(73)	(955)
ISK, CPI-indexed	(19)	(55)	(898)	(84)	(3,469)	(4,525)
EUR	33	11	(197)	(143)	-	(296)
GBP	8	(4)	(87)	(69)	-	(152)
CHF	(3)	(1)	-	-	-	(4)
USD	(4)	(11)	(72)	(104)	-	(190)
JPY	(1)	-	-	-	-	(2)
Other	(15)	(18)	-	-	-	(32)

To further analyze interest rate risk in the banking book, the Bank applies a stressed parallel shift to the yield curves based on guidelines from the European Banking Authority (EBA)[1]. Table 5.7 shows the loss in fair value in the banking book due to the aforementioned shock at the end of 2014.

Table 5.7 Loss in fair value in banking book due to standard interest rate shock movements

Currency	Shift (bps)	0-1Y	1-5Y	5-10Y	10-20Y	>20Y	All periods
ISK, non-indexed	400	(97)	(20)	(3,064)	(20)	(151)	(3,352)
ISK, CPI-indexed	180	(34)	(99)	(1,589)	(148)	(5,734)	(7,604)
EUR	200	65	21	(384)	(270)	-	(568)
GBP	200	16	(7)	(169)	(133)	-	(293)
CHF	200	(5)	(2)	-	-	-	(7)
USD	200	(8)	(21)	(142)	(196)	-	(368)
JPY	200	(3)	(1)	-	-	-	(3)
Other	200	(29)	(35)	-	-	-	(63)
All currencies total		**(93)**	**(164)**	**(5,348)**	**(767)**	**(5,885)**	**(12,258)**

The following table shows the total loss in both fair value and book value due to the same interest rate shock movements as in the previous table. The main reason for the significant difference between the Bank's losses in book value and fair value is that the portfolio of mortgages under the structured covered bonds programme carry considerable unrealized gain as they are booked at amortized cost, see Note 22 in the Bank's consolidated statements.

Table 5.8 Loss due to interest rate shock movements on fair value and book value basis

Currency [ISK m]	Fair value	Book value
ISK, non-indexed	(3,352)	(2,939)
ISK, CPI-indexed	(7,604)	-
FX	(1,302)	(1,302)
Total loss	**(12,258)**	**(4,241)**

[1]CEBS guidelines, Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process, 3 October 2006

Capital requirements due to interest risks and indexation risk are calculated through simulations of movements in interest rates and the value of the CPI. The connection between interest rates and the CPI are calibrated to historical data and economic fundamentals. Significant diversification is observed due to the close connection between inflation and interest rates.

5.8 TRADING BOOK

The trading book is defined as the Bank's proprietary trading positions and non-strategic derivatives positions and associated hedge positions. The purpose of strategic derivatives is to reduce imbalances on the balance sheet and hedge against market risk. Non-strategic derivatives are however offered to the Bank's customers to meet their investment and risk management needs. Financial instruments on the trading book are exposed to price risk, i.e. the risk that arises due to possible losses from adverse movements in the market prices at which securities in the Bank's holding are valued.

5.8.1 PROPRIETARY TRADING

Securities positions within the Bank's proprietary trading activities are shown in Table 5.9.

Table 5.9 Positions within the Bank's proprietary trading

31 December [ISK m]	2014	2013
Bonds	(2,331)	1,821
Equity	1,538	1,204
Total	**(793)**	**3,025**

Proprietary trading is subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD and trader. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2014 average and maximum exposure in both equity and bonds.

Table 5.10 The Bank's proprietary trading exposure

	Bonds		
31 December 2014 [ISK m]	Long	Short	Net
Year-end	3,147	(5,478)	(2,331)
Average	3,916	(4,186)	(270)
Maximum	7,224	(5,731)	3,611

	Equity		
31 December 2014 [ISK m]	Long	Short	Net
Year-end	1,538	-	1,538
Average	2,207	(11)	2,196
Maximum	2,995	(104)	2,995

5.8.2 TRADING DERIVATIVES

The Bank's derivative operation is twofold: a) a trading operation where the Bank offers a variety of derivatives to customers to meet their investment and risk management needs and b) a strategic operation where the Bank uses derivatives to hedge various imbalances on its own balance sheet in order to reduce risk such as currency risk. This section covers trading derivatives.

The domestic equity market is markedly growing following a relatively inactive period subsequent to the financial crisis in 2008. Volume has increased following successful IPOs and a broader range of investment opportunities is helping the market back on its feet. Derivative trading activity related to the domestic equity market has markedly increased.

Trading derivatives are subject to a rigid limit framework where exposure limits are set per customer, per security, per interest rate etc. Forward contracts with securities are traded within Capital Markets and bear no market risk since they are fully hedged in the Bank's hedge book. Derivatives for which the Bank takes on market risk are traded within Treasury and are subject to interest rate limits per currency and an open delta position limit for each underlying security.

The Bank's derivative position is shown in Table 5.11.

Table 5.11 Derivatives

31 December 2014 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	50	21	171	(150)	6,664	Market risk
Interest rate and exchange rate agreements	14	140	271	(131)	9,539	Market risk
Bond swap agreements	17	40	34	6	4,473	Credit risk
Share swap agreements	198	230	397	(167)	6,576	Credit risk
Options	20	478	31	447	2,026	Market risk
Total	**299**	**909**	**904**	**5**		

31 December 2013 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	19	44	14	30	5,262	Market risk
Interest rate and exchange rate agreements	10	151	21	130	6,549	Market risk
Bond swap agreements	28	4	54	(50)	5,872	Credit risk
Share swap agreements	141	33	632	(599)	5,640	Credit risk
Options	6	447	13	434	574	Market risk
Total	**204**	**679**	**734**	**(55)**		

Counterparty credit risk is the risk of the Bank's counterparty in a derivative contract defaulting before final settlement of the derivative contract's cash flows. This risk is addressed in section 4.9.

5.8.3 INTEREST RATE RISK IN THE TRADING BOOK

Interest rate risk in the trading book is subject to an exposure limit framework. Table 5.12 shows the first order sensitivity of the value of long and short positions on the trading book to a shift of all yield curves upwards by one basis points (0.01%) by currency at the end of 2014. The trading book exposure is dominated by CPI-indexed and non CPI-indexed Icelandic Government bonds, along with cross-currency swaps.

Table 5.12 First order sensitivity of long and short bond positions and swaps in the Bank's trading book

Long positions [ISK m]	MV	Duration	BPV
ISK, CPI-indexed	1,924	6.3	(1.2)
ISK, non-indexed	3,353	(2.1)	0.7
FX	22,844	0.1	(0.2)
Total	**28,121**	**0.3**	**(0.7)**

Short positions [ISK m]	MV	Duration	BPV
ISK, CPI-indexed	1,003	6.1	(0.6)
ISK, non-indexed	7,139	0.4	(0.3)
FX	22,243	0.1	(0.2)
Total	**30,385**	**0.4**	**(1.1)**

6 **LIQUIDITY** RISK

6 LIQUIDITY RISK

Liquidity risk is the current or prospective risk that the Bank, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can only secure them at excessive cost. Liquidity risk arises from the inability to manage unplanned changes in funding sources.

An important source of funding for the Bank is deposits from individuals, corporations and institutional investors. The Bank's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits.

6.1 LIQUIDITY RISK AND FUNDING POLICY

The Bank's liquidity and funding strategy is to diversify the funding profile of the Bank by establishing access to domestic and international debt markets and prudently manage the maturity profile of liabilities. Additionally the Bank's strategy is to always maintain sufficient liquidity by maintaining a high level of liquid assets and available funding to near term liabilities and expected payment outflows. An important part of the liquidity strategy is to pre-fund what the Bank estimates to be the likely cash-need during a liquidity crisis and hold such excess liquidity in the form of highly marketable securities that may be sold or pledged to provide funds.

At year-end 2014, the Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 174% and 254% for the respective total and foreign currency balances. Under the liquidity rules issued by the Central Bank of Iceland, financial institutions are required to maintain a Liquidity Coverage Ratio (LCR) above 70% from 1 January 2014 and 80% from 1 January 2015, with that limit increasing annually by ten percentage points until a 100% requirement takes effect in 2017. The rules also require a minimum of a 100% Liquidity Coverage Ratio for foreign currency positions.

At year end 2014, Arion Bank's strong liquidity position was reflected in high LCR values, namely 174% and 254% for the respective total and foreign currency balances

Table 6.1 Liquidity Coverage Ratio

31 December 2014	FX	Total
Liquidity Coverage Ratio	254%	174%
LCR Central Bank requirements (2014)	100%	70%
LCR Central Bank requirements (2015)	100%	80%

The high liquidity reserve requirements reflect the uncertainty of the stickiness of deposits and the fact that a large part of the Bank's liabilities are short-term or demand deposits, while the contractual maturity of assets is longer. Furthermore, Icelandic banks are faced with extraordinary uncertainties due to expected deposit outflow in relation to the lifting of capital controls.

It is evident, since the Central Bank of Iceland is not a reliable lender of last resort in foreign currency, that it is prudent for the Bank to hold even higher reserves in foreign currency than in Icelandic krona. Furthermore, a large part of the Bank's deposits in foreign currency is owned by entities in winding-up proceedings and due to uncertainties concerning the resolution process the Bank holds liquid assets to match all possible outflows in relation to these deposits. Indeed, the Bank's foreign deposit base is almost entirely covered by cash and liquid assets in foreign currencies.

The Bank's foreign deposit base is almost entirely covered by foreign cash and liquid assets

The Bank actively monitors its liquidity reserve and has made progress in understanding and modelling the behaviour of its deposit base. The Bank's liquidity risk strategy is reviewed at least annually.

On 1 December 2014 the Central Bank of Iceland adopted new funding requirements for foreign currencies based on the Net Stable Funding Ratio (NSFR) introduced in the Basel III framework. The NSFR for financial institutions' foreign currency positions shall be greater than 80% until the end of year 2015, 90% in 2016 and 100% from 1 January 2017. The Bank's NSFR in foreign currencies is at 155% at year-end 2014 while the total NSFR is 96%.

Table 6.2 Net Stable Funding Ratio

31 December 2014	FX	Total
Net Stable Funding Ratio	155%	96%
NSFR Central Bank requirements	80%	N/A

6.2 LIQUIDITY RISK MANAGEMENT

Liquidity risk is a key risk factor and emphasis is placed on managing it. The Bank's liquidity risk is managed by the Treasury department on a day-to-day basis and monitored by the Portfolio Risk department. The Treasury department provides all divisions with funds for their activities against a charge of internal interest.

The Bank's ALCO is responsible for liquidity management within the risk appetite set by the Board. Processes and reports regarding the liquidity status are regularly reviewed by the committee.

Liquidity risk is controlled by limit management and monitoring. Active management of liquidity is only possible with proper monitoring capabilities. An internal liquidity report is issued daily for Treasury and Risk Management staff and for each ALCO meeting liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, appropriate stress tests and any relevant information or risk management concern regarding liquidity and funding risk.

The Bank mitigates liquidity risk at all times by staying within liquidity risk limits for secured liquidity and short-term deposits. This is reflected by the Bank's risk appetite. In addition to this, the Bank has taken active measures to increase term deposits from institutional investors and retail and SME clients.

For best practice liquidity management, the Bank follows FME's *Guidelines for Financial Institutions' Sound Liquidity Management*, No. 2/2010, which are based on *Principles for Sound Liquidity Risk Management and Supervision*, issued by the Basel Committee.

6.3 LIQUIDITY AND FUNDING RISK MEASUREMENT

In December 2010 the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks. The Central Bank of Iceland has implemented LCR requirements for total and foreign currency positions as well as NSFR requirements for foreign currencies. The Bank reports the LCR and NSFR measures to the Central Bank of Iceland on a monthly basis.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions in a period of 30 days. Different outflow weights are applied to each deposit category and the measure is thus dependent on the stickiness of each bank's deposit base. The ratio is therefore comparable throughout the banking sector.

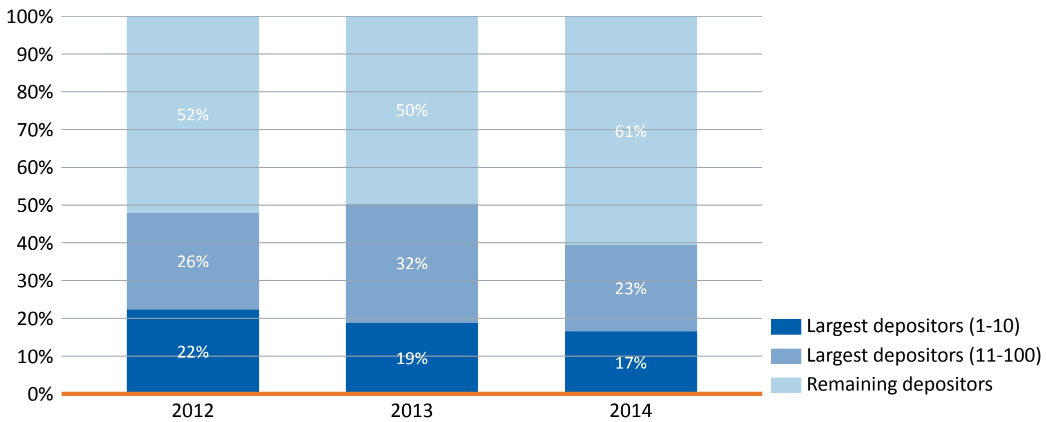
While the focus of LCR is on short term liquidity, the NSFR is aimed at requiring banks to maintain an overall stable funding profile. Under NSFR, funding with maturity greater than one year is considered stable. Different weights are applied to funding with shorter maturities depending on the type of funding. The aggregated weighted amounts are defined as the Available Stable Funding (ASF). Similarly, on-balance and off balance sheet items on the asset side are weighted differently, depending on its liquidity and maturity, to form a bank's Required Stable Funding (RSF) under NSFR. The ratio of the two gives the NSFR.

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

In addition to lowering the proportion of deposits maturing within 30 days of the total deposit base, concentration of those deposits has been reduced. At the end of 2013 19% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors. At the end of 2014 this ratio had gone down to 17%. The proportion of the next ninety largest depositors also decreased, from 32% to 23%.

At the end of 2013 19% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors. At the end of 2014 this ratio had gone down to 17%

Figure 6.1 Concentration of deposits on demand within 30 days



6.3.1 BREAKDOWN OF LCR AND NSFR

Table 6.3 shows the key figures behind the Bank's Liquidity Coverage Ratios. In general, total inflow is capped at 75% of total outflow. As a result, the Bank's foreign currency position in nostro and money market accounts, which contribute to cash inflow under LCR, is not fully utilized for foreign currency LCR.

Table 6.3 Breakdown of LCR

31 December 2014 [ISK m]	FX	Total
Inflow from deposits at credit institutions	49,928	51,283
Other inflow	25,875	47,090
Total inflow *	**75,802**	**98,373**
Deposit outflow	20,472	128,420
Other outflow	13,982	27,305
Total outflow	**34,454**	**155,724**
Net outflow	**8,613***	**57,352**
Cash on hand and Central Bank deposits	2,629	21,416
Government bonds and other repo-eligible bonds	18,202	37,924
Liquidity facility	-	39,350
Total level 1 assets**	**20,831**	**98,690**
Total level 2 assets**	**1,043**	**1,043**
Total high quality liquid assets	**21,875**	**99,734**
Liquidity Coverage Ratio	254%	174%

*Total inflow is capped at 75% of total outflow.

**For detailed definition, see Central Bank Rules No. 1031/2014.

Table 6.4 shows a breakdown of the Bank's Net Stable Funding Ratio.

Table 6.4 Breakdown of NSFR, parent company and ABMIIF consolidated, other subsidiaries excluded

31 December 2014 [ISK m]	FX	Total
Equity and Tier II	19,073	179,786
Secured Financing	55,169	168,469
Unsecured Financing	10,066	12,176
Retail / SME deposits	10,586	190,405
Other deposits	8,621	46,400
Other liabilities	28	605
Available stable funding	**103,542**	**597,841**
Liquid assets	1,094	10,502
Loans to customers, performing	65,121	473,023
Securities	1	14,565
Other assets	4,361	124,508
Off-balance sheet	273	1,458
Required stable funding	**70,850**	**624,055**
Balance	**4,079**	**-**
Net stable funding ratio	155%	96%

6.3.2 DEPOSIT CATEGORIES

As per the LCR methodology, the Bank's deposit base is categorized based on the type of deposit holders. Deposits are also classified as stable or less stable based on business relations and insurance scheme coverage. Each category is given an expected outflow weight based on stickiness, i.e. the likelihood of withdrawal under stressed conditions.

Table 6.5 shows the distribution of the Bank's deposit base broken down by deposit categories as per the LCR methodology. The associated LCR outflow weight is shown for each category. Figure 6.2 shows the contribution of each category, in order of magnitude, to the stressed outflow under LCR. In Table 6.6, the development of the deposit base is shown between years.

Table 6.5 Distribution of deposits by LCR categories. The expected stressed outflow weight is shown for each category.

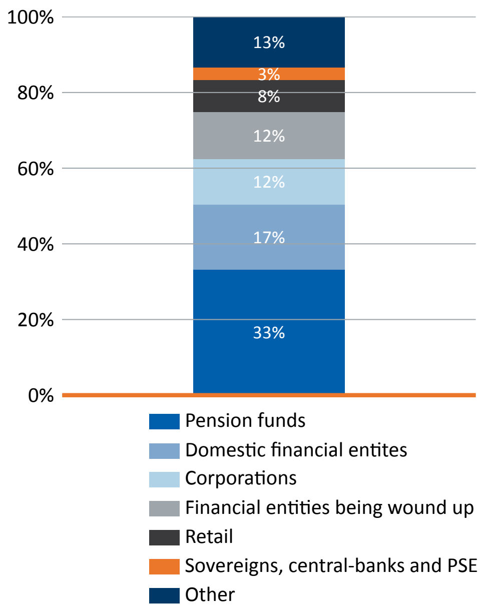
31 December 2014 [ISK m]	Deposits maturing within 30 days					
Category	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total
Retail	78,659	10%	36,076	5%	53,803	168,538
SME	36,060	10%	3,895	5%	6,011	45,966
Operational relationship	-	25%	-	5%	1,190	1,190
Corporations	36,961	40%	830	20%	5,873	43,664
Sovereigns, central-banks and PSE	12,196	40%	-	-	2,870	15,066
Financial entities being wound up	19,796	100%	-	-	67,105	86,901
Pension funds	36,824	100%	-	-	19,765	56,589
Domestic financial entites	22,634	100%	-	-	16,752	39,386
Foreign financial entites	4,532	100%	-	-	522	5,054
Other foreign parties	3,425	100%	3,026	25%	2,082	8,533
Total	**251,087**		**43,827**		**175,973**	**470,887**

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

Table 6.6 Distribution of deposits by LCR categories

Category	2014	2013
Retail	35.8%	33.5%
SME	9.8%	8.7%
Operational relationship	0.3%	0.3%
Corporations	9.3%	13.0%
Sovereigns, central-banks and PSE	3.2%	5.4%
Financial entities being wound up	18.5%	15.8%
Pension funds	12.0%	13.6%
Domestic financial entites	8.4%	8.2%
Foreign financial entites	1.1%	0.5%
Other foreign parties	1.8%	1.0%
Total	**100%**	**100%**

Figure 6.2 Source of impact on LCR outflow from deposits categories



6.4 FUNDING

Significant progress has been made over the past years in diversifying the Bank's funding profile.

At the end of 2011 Arion Bank replaced Kaupthing hf. as the issuer under Kaupthing hf.'s ISK 200 billion structured covered bond program, consisting of four series of CPI-linked annuity bonds with final maturities from 2031 to 2048. As a result, Arion Bank acquired all assets and liabilities in relation to the program. The Bank has the right to prepay the bonds before final maturity. This right was utilized in 2014 with a payment of over ISK 20 billion. At the end of 2014 the remaining three issues were admitted to trading on NASDAQ Iceland. The aggregate outstanding balance at year-end 2014 was ISK 101,150 million.

In connection with Kaupskil's equity injection on 8 January 2010, the Bank received a loan secured with a portfolio of assets, equivalent to ISK 61,300 million, from the Central Bank of Iceland. The loan is denominated in foreign currencies and the currency composition can be adjusted to balance the FX position of the Bank. At the same time the Bank received a subordinated loan from the Icelandic Government of ISK 29,500 million, as a Tier 2 capital injection. In addition the Bank paid the Icelandic Government a dividend of ISK 6,074 million in 2011 but was at the same time granted a subordinated loan for the same amount. At the end of 2014 the outstanding balance of the subordinated liability was ISK 31,639 million. In early 2015, the interest rate spread on the subordinated loan steps up to 5% which gives the Bank an incentive to repay the loan.

In 2014, the Bank issued a total of ISK 16.5 billion in CPI-linked covered bonds under the statutory covered bond program based on Icelandic covered bond legislation. The bonds have final maturities in 2021 and 2029, and pays 3.5% fixed interest rates. That brings the total issues under that program, indexed and non-indexed, to ISK 27.9 billion. The Bank is open to issuing both indexed and fixed rate bonds. Likely maturities will range from 3 to 10 years depending on market demand. The covered bond program allows for issuance in other currencies than ISK but such bond issues are not expected in the near term future. The funding base was further diversified in 2014 with the issuance of commerical papers in October 2014, a total of ISK 3.2 billion.

In January 2015, the Bank repurchased NOK 59 million of its NOK 500 million (ISK 11.2 billion) senior unsecured bond issue. This issue, which was listed on the Oslo Stock Exchange in 2013, was at the time the first international bond offering by an Icelandic financial institution since 2007. The bonds were bought under favourable market conditions. In March 2015 the Bank announced a EUR 300 million (ISK 45 billion) bond issue under the Euro Medium Term Note programme, which is set to change its funding profile in foreign currency and lower the Bank's cost of funding.

Table 6.7 shows the Bank's borrowings and subordinated liabilities as at 31 December 2014. The development of the Bank's total funding by type is shown in Table 6.8.

Figure 6.3 Development of the market spread for the Bank's NOK bond issue

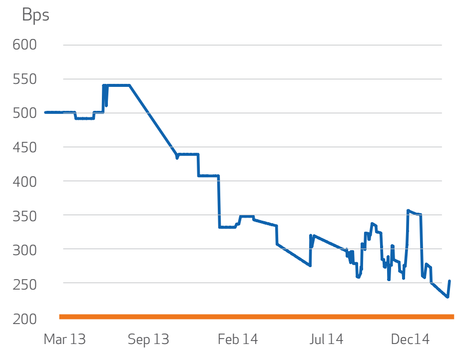


Table 6.7 List of borrowings and subordinated liabilities

31 December 2014	Issued	Maturity	Maturity type	Currency	Terms of interest	Amount
Covered bonds	2012	2015	At maturity	ISK	Fixed, 6.5%	1,134
Covered bonds	2013	2019	At maturity	ISK	Fixed CPI linked, 2.5%	5,232
Covered bonds	2014	2021	At maturity	ISK	Fixed CPI linked, 3.5%	4,508
Covered bonds	2014	2029	At maturity	ISK	Fixed CPI linked, 3.5%	14,493
Covered bonds	2005	2033	Amortizing	ISK	Fixed CPI linked, 3.75%	2,541
Covered bonds	2012	2034	Amortizing	ISK	Fixed CPI linked, 3.6%	6,165
Covered bonds	2008	2045	Amortizing	ISK	Fixed CPI linked, 4.0%	77,557
Covered bonds	2006	2048	Amortizing	ISK	Fixed CPI linked, 3.75%	17,428
Senior unsecured bond	2013	2016	At maturity	NOK	Floating, NIBOR + 5%	8,478
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1%	2,130
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1%	1,714
Central Bank loan, secured	2010	2022	At maturity	Various FX	Floating, LIBOR + 3%	55,102
Bills issued						3,186
Other						912
Total borrowings						**200,580**
Tier II capital	2010	2020	At maturity	Various FX	Floating, LIBOR + 4%	31,639
Total borrowings and subordinated liabilities						**232,219**

Table 6.8 Breakdown of funding by type

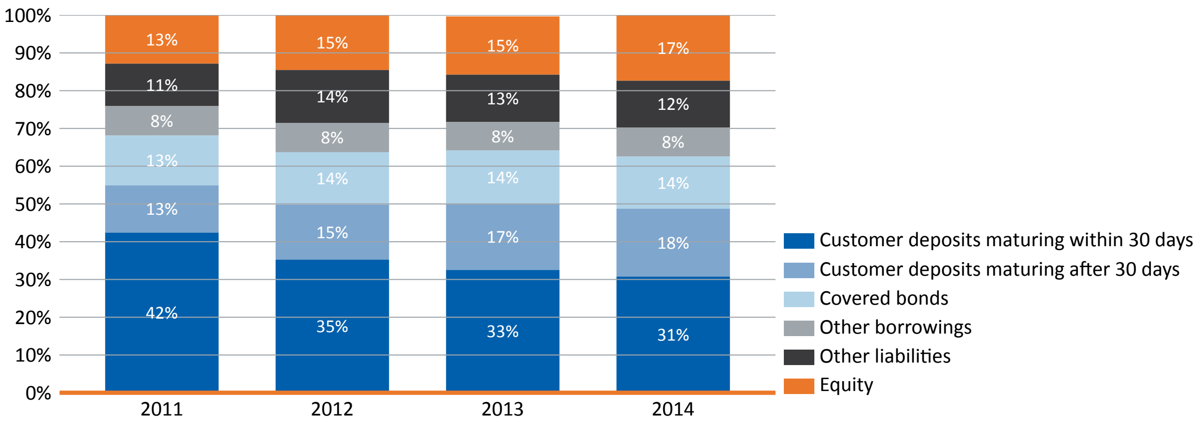
31 December	2014	2013	2012	2011
Due to credit institutions and Central Bank	2.4%	3.0%	3.7%	1.8%
Customer deposits	48.7%	50.3%	49.8%	54.9%
Borrowings	21.5%	21.8%	21.7%	21.0%
Subordinated loans	3.4%	3.4%	3.8%	3.6%
Financial liabilities	1.0%	1.0%	1.5%	0.6%
Tax liabilities	0.5%	0.5%	0.4%	0.4%
Other liabilities	5.1%	4.7%	4.7%	4.9%
Equity	17.4%	15.4%	14.5%	12.8%
Total	**100%**	**100%**	**100%**	**100%**

Figure 6.4 shows the development of the Bank's funding profile. It shows progress has been made in diversifying the profile, particularly in the development of total deposits and the lengthening of the maturity of deposits: At the end of 2011 deposits maturing within 30 days accounted for 42% of the Bank's funding compared to 31% at the end of 2014.

At the end of 2011 deposits maturing within 30 days accounted for 42 % of the Bank's funding compared to 31 % at the end of 2014

LIQUIDITY RISK

Figure 6.4 Development of funding by type



Tables 6.9 and 6.10 show the breakdown by maturity of assets and liabilities.

Table 6.9 Breakdown of assets by contractual maturity

Assets 31 December	2014	2013	2012	2011
On demand	9.0%	9.0%	13.0%	11.5%
Up to 3 months	11.8%	12.5%	7.5%	7.0%
3 - 12 months	10.7%	11.6%	11.4%	10.7%
1 - 5 years	30.5%	27.9%	30.9%	35.0%
Over 5 years	29.3%	29.2%	28.6%	26.5%
With no maturity	8.7%	9.8%	8.6%	9.3%
Total	**100%**	**100%**	**100%**	**100%**

Table 6.10 Breakdown of liabilities by contractual maturity

Liabilities 31 December	2014	2013	2012	2011
On demand	36.1%	33.3%	36.6%	50.1%
Up to 3 months	18.2%	21.5%	22.3%	9.7%
3 - 12 months	10.7%	11.5%	6.8%	7.1%
1 - 5 years	9.5%	6.7%	8.0%	5.6%
Over 5 years	24.5%	26.1%	25.4%	26.0%
With no maturity	1.1%	0.9%	0.9%	1.5%
Total	**100%**	**100%**	**100%**	**100%**

Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base will continue to be an important funding source and the focal point of liquidity risk management. The ratio of loans to deposits was 142% as at 31 December 2014. The development of the loans to deposits ratio is shown in Table 6.11. The increase from 2011 to 2012 is explained by the acquirement of Kaupthing's structured covered bonds program. However the cash flow profile of mortgages pledged to the associated mortgage fund are well matched with that of the covered bonds liabilities and therefore pose limited funding risk. The increase in 2013 was due to the settlement of the Drómi bond, reflecting the transfer of both loans and deposits from the SPRON estate to the Bank. In 2014 loans to customers grew by 2% while deposits from customers reduced by 4%, with both changes contributing to an increased loans-to-deposits ratio.

The covered bonds are also an important funding source and its payment profile is largely matched by the corresponding pledged mortgages, see Figure 6.5. Other liabilities are mostly foreign currency denominated with no significant redemption until 2020 as seen in Figure 6.6. As the Bank's foreign currency deposits are almost entirely covered by liquid assets, these other FX liabilities are a source of funding for loans to customers in foreign currency. The duration of those liabilities is greater than that of the loans, so there is low maturity gap risk for the Bank's foreign currency position.

There is low maturity gap risk for the Bank's foreign currency position

The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, has decreased from 30% to 27% in the year 2014. Table 6.11 shows the development of this ratio and the loans-to-deposits ratio.

Table 6.11 Development of the Bank's loans to deposits ratio and asset encumbrance ratio

31 December	2014	2013	2012	2011
Loans to deposits ratio	142%	135%	126%	115%
Asset encumbrance ratio	27%	30%	31%	24%

Figure 6.5 Maturity profiles of covered bonds and corresponding pledged mortgages [ISK m]

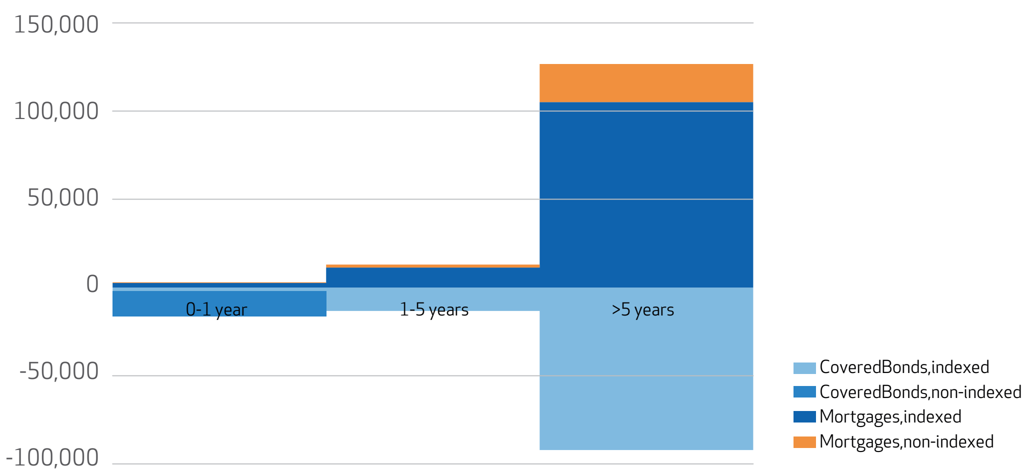
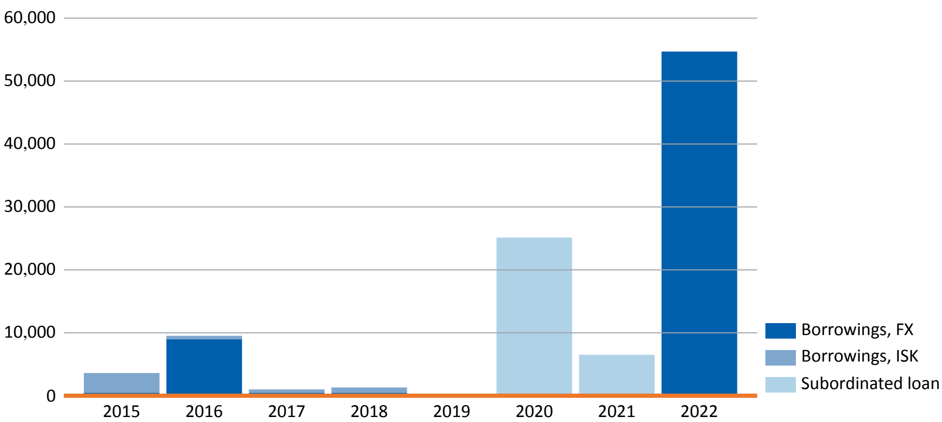


Figure 6.6 Maturity profiles of borrowings, other than covered bonds, and subordinated liabilities [ISK m]



In January 2014, the international credit ratings agency Standard & Poor's (S&P) assigned a BB+ rating to Arion Bank with stable outlook. In October the outlook was changed to positive in line with S&P's change in outlook on the Icelandic sovereign rating. S&P has partly attributed to its view the Bank's stable long-term funding and strong liquidity position, with high coverage of maturing debt.

For comparison, the current rating of the Icelandic sovereign currently stands at Baa3, BBB-, BBB by Moody's, S&P and Fitch, respectively. As at January 2015, the outlook of the latter two ratings were positive.

In January 2014, the international credit ratings agency Standard & Poor's (S&P) assigned a BB+ rating to Arion Bank with stable outlook

6.5 CONTINGENCY FUNDING PLAN

The Bank monitors its liquidity position and funding strategies on an on-going basis, but recognizes that unexpected events, economic or market conditions, earning problems or situations beyond its control could cause either a short or long-term liquidity crisis. To monitor liquidity and funding, Treasury prepares a monthly liquidity worksheet that projects sources and uses of funds. The worksheet is an integral component of the contingency funding plan. Although it is unlikely that a funding crisis of any significant degree could materialize, it is important to evaluate this risk and formulate contingency plans should one occur.

7 **OPERATIONAL** RISK

7 OPERATIONAL RISK

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

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

- IT risk is defined as the risk arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity.
- Legal risk is defined as the risk to the Bank's interests resulting from instability in the legal and regulatory environment, as well as risk arising from ambiguous contracts, laws or regulations.
- Reputational risk is defined as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors or regulators that can adversely affect the Bank's ability to maintain existing, or to establish new, business relationships and continued access to sources of funding.

Each business unit within the Bank is primarily responsible for managing their own operational risk. The Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk.

The Bank uses the Basel II basic indicator approach for the calculation of capital requirements for operational risk.

Each business unit within the Bank is primarily responsible for managing their own operational risk

7.1 OPERATIONAL RISK POLICY

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank reduces its exposure to operational risk with a selection of internal controls and quality management, and well-educated and qualified staff.

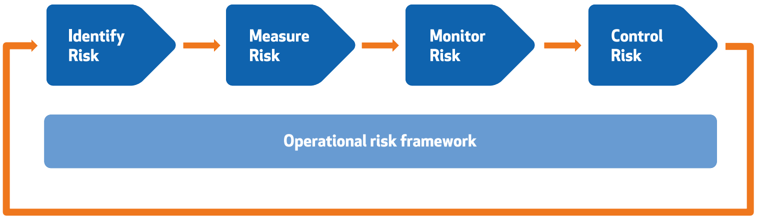
This policy defines operational risks at a high-level and delegates responsibility for further implementation and compliance within the Bank.

7.2 OPERATIONAL RISK MANAGEMENT

The operational risk framework at the Bank aims at integrating risk management practices into processes, systems and culture. The Operational Risk department serves as a partner to senior management supporting and challenging them to align the business control environment with the Bank's strategy by measuring and mitigating risk exposure, contributing to optimal return for the stakeholders.

OPERATIONAL RISK

Figure 7.1 Operational risk cycle



There are four main components to the Bank's operational risk framework:

- Loss Data Collection
- Risk and Control Self-Assessment (RCSA)
- Key Risk Indicators
- Issue Management

LOSS DATA COLLECTION

Internal operational risk events with a direct or indirect financial impact are captured in the Bank's loss database as well as near misses. The Bank chooses to not have a threshold amount on loss events as all events can enhance the Bank's understanding of its own operational risk. Losses are categorized according to the Basel II event categories for operational risk. The information is utilized for the identification, evaluation and monitoring of operational risk. It is analyzed to understand the root cause of the event in order to be able to mitigate the risk and enhance the Bank's internal controls. Operational Risk department reports these incidents and follows up on control enhancements if deemed necessary.

RISK AND CONTROL SELF-ASSESSMENT

The Bank performs a Risk and Control Self-Assessment (RCSA) in order to identify risks, both inherent and residual. The risks are assessed based on severity and likelihood of an event occurring as well as the effectiveness of the internal control environment. The assessment of the severity of an event includes both financial losses and reputational damage. Actions are planned for risks with extreme, high or moderate impact due to insufficient controls. The goal is to bring relevant risks to acceptable levels by enhancing the control environment. The Operational Risk department follows up on the planned actions with the units.

KEY RISK INDICATORS

The Bank uses Key Risk Indicators (KRIs) to provide an early warning that may be indicative of increasing risk and/or ensure that risks remain within established tolerance levels.

With increasingly powerful software and hardware, growing use, network connections and especially public access to the Internet, the need to ensure the security of data and equipment increases. To understand security risks better the Bank conducts a special Information Security Risk Assessment on the Bank's most important assets, according to Guidelines No. 2/2014 on the Information Systems of Regulated Parties published by the Financial Supervisory Authority (FME). Information security means that information is protected against a variety of threats in order to ensure business continuity, minimize damage and maximize performance. Information security includes ensuring confidentiality, integrity and availability.

Figure 7.2 Operational risk strategy

Information security includes ensuring confidentiality, integrity and availability

ISSUE MANAGEMENT

Any issues arising from the RCSA, the auditing process, loss data collection or from any other internal or external event can result in remediation and enhancements of internal controls. Once the issues are identified, analyzed and assessed, the Operational Risk department is in charge of following up with the business and support units on planned actions. The Bank has insurance policies to cover operational risk exposure.

IT RISK

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

7.3 OPERATIONAL RISK MEASUREMENT

Operational risk is inherent in all activities of the Bank. The Bank aims to proactively manage its risks and to reduce the frequency and severity of operational risk events. The operational risk strategy is designed to align to the risk appetite set forth by the Bank's Board of Directors. The Bank aims to reduce its exposure to operational risk with a selection of internal control and quality management, and well-educated and qualified staff.

The primary controls in operational risk management are included but not limited to the following:

- Operational risk culture
- Segregation of duties
- Four-eyes principle
- Working processes
- Employee training
- New product process

The new product process is a process where a new product or service that is currently not offered to clients or a significant change to an existing product or service is introduced to all potential stakeholders where they are able to provide feedback. The new product process is in place to ensure appropriate level of cross communication with all stakeholders, and an adequate preliminary assessment prior to implementation.

The Bank uses various internal controls to minimize the risk of loss from operational risk events

Figure 7.3 shows the distribution of reported loss events by number. Execution, Delivery & Process Management accounted for 40% and External Fraud accounted for 29% of the total events in 2014.

Figure 7.3 Distribution of loss events by number

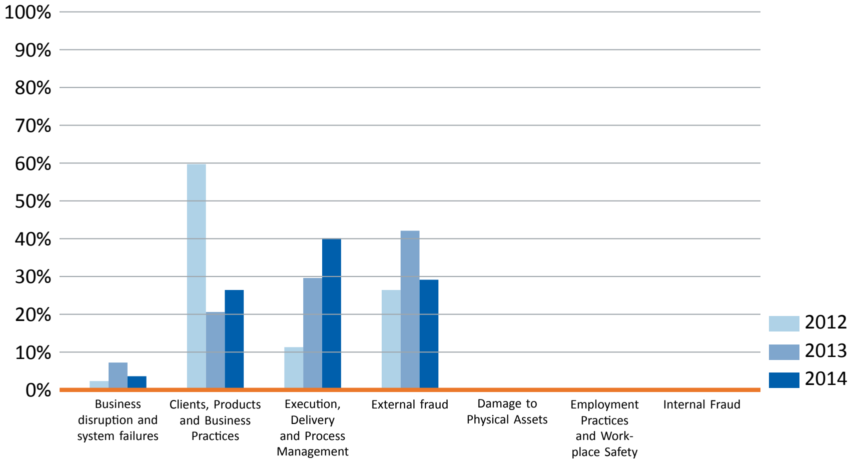
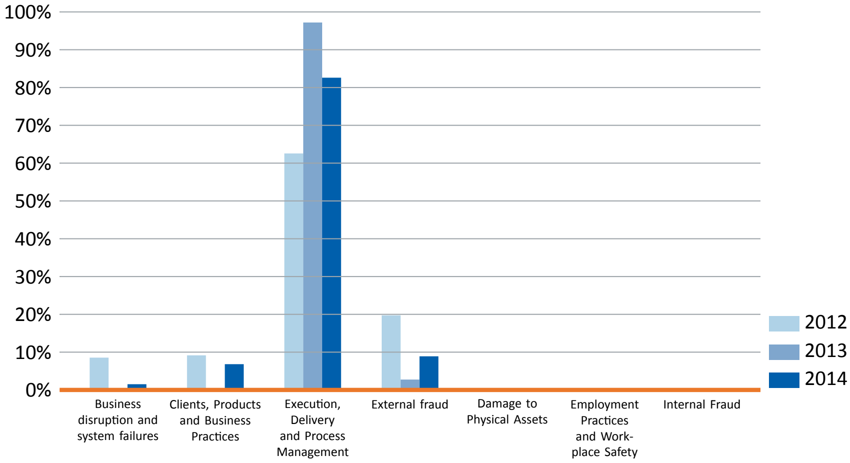


Figure 7.4 shows the distribution of reported loss events by amount. Execution, Delivery and Process Management accounted for 83% of total losses in 2014.

Figure 7.4 Distribution of loss events by amount



Loss data is also used to assess that the capital held aside for operational risk is sufficient under stressed conditions. This is done by stressing both the frequency and severity of the different Basel categories based on internal scenarios derived from the RCSA process.

The Bank collects a number of KRIs such as:

- Number of major incidents (MI) in IT
- Settlement failures
- Transaction rollbacks
- System downtime

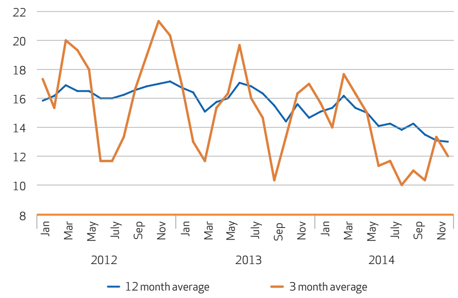
Major Incident - MI is a significant event causing serious operational interruption in IT or an operational failure in a system classified as important. The purpose of the MI Process is to ensure firm, coordinated and controlled action in the occurrence of MI, in order to restore service as soon as possible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

The Bank uses external risk transfer in the form of insurance, including reinsurance, to cover certain aspects of crime risk and professional liability, including the liability of directors and officers.

KRIs as well as operational risk concerns are reported monthly to the Board of Directors, BARC and the Executive Management Committee. Operational reports are sent on a regular basis to the relevant business units within the Bank.

All issues that are identified through any of the operational risk framework tools are used to enhance the internal control environment of the Bank. The Operational Risk department follows up on planned actions and collects information on the internal control system of each unit.

Figure 7.5 Development of Major Incidents in IT



Operational risk is reported monthly to the Board of Directors, BARC and the Executive Management Committee

8 OTHER MATERIAL RISK

In addition to the previously mentioned risk types, the Bank faces other types of risks. Of these risk types, the Bank has identified business risk and political risk as material risk. Other risk types are not considered material, and will not be discussed further.

8.1 BUSINESS RISK

Business risk is defined as risk associated with uncertainty in profits due to changes in the Bank's operations and competitive and economic environment. Business risk is present in most areas of the Bank. Business risk is considered in the Bank's ICAAP.

Legality of indexation of the principal of mortgage loans to consumers to the Consumer Price Index (CPI) is being debated before the Icelandic Courts. Judgments in two cases were pronounced in the District Court of Reykjavík in February 2015 were it was concluded that the loan agreements should not be annulled. The Supreme Court will hear one of the cases in May of this year. The Bank follows these court cases closely.

Competition is one of the factors that the Bank is constantly monitoring. To safeguard its own competitive practices, the Bank has set a competition compliance policy. According to the compliance policy, the Bank endeavours to protect and encourage active competition for the good of the consumer, the business sector and society at large. It is furthermore the Bank's policy to practice effective and powerful competition on all the markets on which it operates. An integral component of the Bank's competition policy is to ensure that the Bank complies with competition law at all times.

An integral component of the Bank's competition policy is to ensure that the Bank complies with competition law at all times

The Bank and Valitor hf. reached a settlement with the Icelandic Competition Authority (ICA) in December 2014 concerning an investigation into the structure of the payment card system. The central issue in the settlement concerned changes to the way in which interchange fees, which card companies pay to the banks, are decided and the awarding of customer loyalty points. The Bank has already implemented the agreed changes. As part of the settlement the Bank paid a fine of ISK 450 million and Valitor hf. ISK 220 million. Further, under the settlement changes were made to the ownership of Valitor hf., with the Bank's acquisition of stake of Landsbankinn hf. in Valitor Holding hf.

In July 2013 Kortaþjónustan hf. filed a suit, against the Bank and Valitor hf., as well as Landsbankinn hf., Íslandsbanki hf. and Borgun hf., claiming damages for the alleged loss suffered by Kortaþjónustan hf. in relation to the above mentioned case. The case is being contested before the District Court of Reykjavík.

The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. in 2010. The complaints from BYR hf. and MP banki hf. concern the terms of the Bank's mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition.

In 2010 Tryggingamiðstöðin hf. sent a complaint concerning the Bank´s alleged tying of banking services and insurance to the ICA. In 2014 the ICA announced that it had dismissed the complaint.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set in a decision No. 4/2008 of the Authority. Valitor hf. appealed the decision to the Competition Appeals Committee. In August the Committee confirmed the decision of the Competition Authority. Valitor hf. has referred the decision to the courts of law for annulment.

In 2009 Kortaþjónustan hf. issued a summons towards Valitor hf., Borgun hf. and Greiðsluveitan ehf. claiming damages for the alleged loss suffered by Kortaþjónustan hf. due to alleged breaches of competition law and based on a settlement with the ICA published in ICA Decision No. 4/2008. The case was dropped in September 2014, and a new claim filed based on the findings of court appointed evaluators on alleged damage of Kortaþjónustan hf. The case has been settled with payment of damages to Kortaþjónustan hf. of ISK 250 million.

The Bank faces competition in the marketplace. Competition from less regulated financial institutions has been increasing in recent years, for example the use of specialized funds that are able to offer better terms for quality loans. The Icelandic State is also a large market player in retail services through its ownership in Landsbankinn hf., The Icelandic Housing Financing Fund and the Icelandic Student Loan Fund, standing behind the majority of all loans to individuals. This heavy involvement by the State in the marketplace is to an extent a risk factor due to irrational market behaviour at times. The Bank responds by offering more versatile services. Another threat is competition from foreign banks that target strong Icelandic companies with revenues in foreign currency. The capital controls increase companies' incentives to move part or all of their business abroad.

8.2 POLITICAL RISK

Political risk is defined as the risk to the Bank's interests resulting from political instability, and therefore instability in the legal and regulatory environment. Considering the present political and economic environment in Iceland, the Bank faces political risk. Iceland is part of the EEA Agreement and applies therefore most of the European Union legislation in the financial services sector. In recent years the number of special Icelandic rules in the field of financial services has increased. Given discussions in the Icelandic Parliament there is a certain possibility that the Government will resort to regulatory restrictions that are different and more stringent than reforms being discussed in the rest of Europe. Foreseeable changes in legislation that might affect the Bank are discussed in chapter 10. These risk factors are considered in the Bank's ICAAP.

9 REMUNERATION

Arion Bank has a remuneration policy in accordance with Act No. 2/1995, on Public Limited Companies that also complies with Act No. 161/2002, on Financial Undertakings and Rules No. 700/2011 on Remuneration Policy for Financial Undertakings. The policy is an integral part of Arion Bank's strategy to protect the long-term interests of the Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

Arion Bank's remuneration policy is reviewed annually by the Board and submitted and voted on at the Bank's annual general meeting. Arion Bank's remuneration policy is published on its website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2014, see Note 10. The Bank's main objective with regard to employee remuneration is to offer competitive salaries in order to be able to attract and retain outstanding employees. The Bank's objective is also to ensure that jobs at the Bank are sought after by qualified people.

The Board Remuneration Committee (BRC), which is established by the Board of Directors of Arion Bank, provides guidance to the Board on the Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor, and on the Bank's variable remuneration scheme and other work-related payments. The CEO decides on a salary framework for Managing Directors and the Compliance Officer in consultation with the Head of Human Resources taking into consideration the size of the relevant division and level of responsibility.

In 2013 a variable remuneration scheme was implemented within the Bank. The scheme is in accordance with Rules established by the FME on Remuneration Policy for Financial Undertakings. A local consultancy company was hired to write the scheme in cooperation of the Bank's CEO, COO and the BRC Committee. The scheme was presented to the FME as provided for by law.

About 100 employees were offered to take part in the scheme. They include the CEO, Managing Directors, many heads of divisions as well as several other employees. Excluded are the CRO, the Internal Auditor, the Compliance Officer, the head of Research and all the employees they manage.

The objective of the scheme is to incentivize employees to help the Bank achieve its objectives. Well defined measures concerning risk and compliance are an integral part of the scheme. In accordance with the FME Rules, Risk Management, Compliance and Internal Audit review and analyze whether the variable remuneration scheme complies with the aforementioned rules and the Bank's remuneration policy.

The objective of the scheme is to incentivize employees to help the Bank achieve its objectives

According to FME's rules the maximum amount of a yearly variable remuneration is 25% of employee's annual salary. 40% of the amount is deferred for three years.

Parameters deciding the amount of the payments are on four levels:

- The performance of the Bank as a whole (these include return on equity, return on risk-weighted assets and costs-to-net income)
- Performance of individual divisions
- Performance of individuals
- Compliance with internal and external rules

In the year 2014 the Bank made provision for variable remuneration, including salary related expense.

Boards of directors of individual subsidiaries decide on an incentive scheme for the subsidiaries.

Apart from the Bank itself, as of the end of 2014 the only entity in the Arion Bank Group subject to Rules No. 700/2011, which has a variable remuneration scheme, is the asset management company Stefnir hf.

10 UPCOMING AND NEW LEGISLATION

As a financial undertaking the Bank, and many of its subsidiaries, must comply with various laws and regulations. The legal environment is dynamic and the Bank must therefore constantly monitor upcoming changes in legislation, in order to meet the requirements made at any given time. The following section lists several factors the Bank deems necessary to mention in this regard.

10.1 NEW LEGISLATION

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

Under the Act the temporary provisions of the Emergency Act which authorize the FME to intervene into the financial sector by taking over the operation of a financial undertaking was extended to 31 December 2015 without material change.

The Act came into force on 26 March 2014.

AMENDMENTS TO THE ACT ON INSURANCE ACTIVITIES (NO. 56/2010) AND THE ACT ON INSURANCE MEDIATION (NO. 32/2005)

The changes to the Acts make more stringent demands on the transparency of corporate governance and stricter disclosure requirements concerning assets which have priority in bankruptcies and concerning the position of companies which have entered bankruptcy proceedings without having had their operating licences revoked. The Act also contains more detailed provisions on board directorships and directorships in other companies, designed to prevent cross-directorships. According to the amended legislation the majority of directors of insurance companies have to be independent of companies within the same group.

The Act came into force on 6 May 2014.

AMENDMENTS TO THE ACT ON INTEREST AND INDEXATION (NO. 38/2001)

The limitation period for claims relating to illegal currency-linked lending was extended from four to eight years. The extension was deemed necessary due to the great extent of legal disputes over alleged illegal currency linked lending and due to the fact that disputes have not been fully resolved.

The Act came into force on 14 May 2014.

ACT ON THE FINANCIAL STABILITY COUNCIL (NO. 66/2014)

Under the Act a special Financial Stability Council was set up which is designed to be a venue for consultation on financial stability and to coordinate the Government´s response to a financial crisis. The Council can give the Government instructions which the authorities must then comply with but the Council has no power or authority to gather information on private individuals.

The Act came into force on 16 May 2014.

UPCOMING AND NEW LEGISLATION

ACT OF DEBT RELIEF OF INDEXED MORTGAGES (NO. 35/2014)

The Act specifies the arrangement of debt relief on indexed mortgages for the period 1 January 2008 to 31 December 2009. The debt relief extends to mortgages which were granted to individuals by pension funds, the Housing Financing Fund (HFF) and financial institutions. Debt reductions from other measures, such as payment adjustment, conditional debt adjustment and the 110% method shall be deducted from the debt relief and the total amount can be a total of ISK 4 million per household. With the Act the Minister of Finance was authorized the enter into agreements with pension funds, the HFF and financial institutions on the execution and settlement of the debt relief in accordance with the Act.

The Act came into force on 16 May 2014.

ACT ON PRIVATE PENSIONS AND DISPOSAL OF PRIVATE PENSION TO PAY DOWN MORTGAGE (NO. 40/2014)

Under the Act, owners of private pension savings are given temporary permission to use part of the supplementary contributions to pay down the principal of loans which are secured with a mortgage in residential property or to acquire residential property for own use. The withdrawals provided for by the Act are tax free.

The Act came into force on 16 May 2014.

AMENDMENTS TO THE ACT ON SECURITIES TRANSACTIONS (NO. 108/2007) AND THE STOCK EXCHANGE ACT (NO. 110/2007)

The amendments ensure that a financial institution cannot offer investors services without having already placed the customer in the appropriate category. The financial institution shall also notify of a transaction with financial instruments by using the customer's ID number. Until the amendment entered into force a special transaction number was given.

The Act came into force on 26 March 2014.

ACT ON CROSS-BORDER PAYMENTS IN EUROS (NO. 78/2014)

The Act introduces provisions from two sets of EU Regulations which concern cross-border payments in euros. Minor changes are made to the laws on payment services. The Regulations should grant payers and companies coordinated, secure, user-friendly and reliable payment services in euros at competitive prices within the EEA and ensures that fees on cross-border payments in euros with the EEA are comparable to fees in payments domestically.

The Act came into force on 16 May 2014.

ACT ON AMENDMENTS TO THE ACT ON PUBLIC LIMITED COMPANIES, ACT ON PRIVATE LIMITED COMPANIES AND ACT ON ANNUAL ACCOUNTS

The amendments aims to eliminate legal uncertainty surrounding the rights of companies to be market makers for their own account and on the rights of companies to repurchase own stock. With the change companies cannot buy own stock for a price that is higher than the last independent transaction or the highest available bid price in a trading system, whichever is higher. The objective is to promote equality amongst shareholders and to prevent companies to have undue effect on price formation when they buy own stock. In addition, under the amendment, companies will be required to give information regarding the board's gender ratio in the board's report in the annual account.

The Act came into force on 1 January 2015.

10.2 UPCOMING LEGISLATION

BILL ON MORTGAGE CREDIT

The Ministry of Finance and Economic Affairs has published a report on a new framework for consumer mortgage in response to the need for reform in the Icelandic mortgage credit market and the Mortgage Credit Directive 2014/17/EU. The Mortgage Credit Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property, aims to keep consumers more informed and protected against the risk involved in mortgage credit. A bill is scheduled to be submitted to Parliament in the spring session 2015.

IMPLEMENTATION OF THE CRD IV PACKAGE (CRD IV/CRR)

The EU Capital Requirements Directive is one of the two legal acts comprising the new CRD IV package. The other element is the Capital Requirements Regulation (CRR). The CRD IV implements Basel III which pronounces strict criteria for capital, that must be met by own funds in order to ensure that banks can effectively absorb loss in time of stress. The CRD IV strengthens the requirements with regard to corporate governance arrangements and processes and introduces new rules aimed at increasing the effectiveness of risk oversight by boards, improving the status of the risk management function and ensuring effective monitoring by supervisors of risk governance. Even though the CRD IV has not been incorporated into the EEA Agreement, the Government established a working committee in November 2012 with the role of presenting a proposal for the Ministry of Finance and Economic Affairs implementing the CRD IV. The implementation will be divided into two to three separate parts. A bill amending the Act on Financial Undertakings has already been submitted to Parliament in March 2015, mostly concerning governance, remuneration, management of risk and capital buffers. A second bill amending the Act on Financial Undertakings is scheduled to be submitted to Parliament in spring 2015 mostly on supervisory review and evaluation process and sanctions. Thirdly, the CRR will be implemented.

It is not possible at this stage to discuss the significance of possible changes to the system for the Bank's financial position and operations.

BILL ON RECOVERY AND RESOLUTION OF FINANCIAL INSTITUTIONS

The bill will be based on Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms. The framework introduces contingency plans for financial institutions which shall be submitted to a national authority, on how they intend to restructure their operations if faced with difficulties or if chances are that they cannot meet their obligations in full. The Directive gives an array of restructuring powers to minimize the cost to taxpayers of its failure, such as the so called bail-in mechanism that requires the private sector to bear the costs first. A resolution fund will be established, financed in advance by credit institutions and investment firms, and used to finance the restructuring of failing banks.

A bill is scheduled to be submitted to Parliament in the spring session 2015.

UPCOMING AND NEW LEGISLATION

BILL ON NEW ACT ON DEPOSIT GUARANTEE SCHEMES

Recently, the European Union published a new Directive on Deposit Guarantees, namely Directive 2014/49/EU. According to the new Directive, deposit guarantees will take part in the early intervention of resolution authorities in the management of financial institutions in difficulty. Prior the EU had amended the Directive on Deposit Guarantee Schemes, introducing a higher and set guarantee protection with a minimum and maximum protection of the equivalent of EUR 100,000, a faster repayment period, a provision on minimum target level of available financial means and a provision on cooperation of authorities.

A bill of law implementing the directives is scheduled to be submitted to Parliament in the spring session 2015.

BILL ON DERIVATIVES AND SHORT SELLING

The bill will implement the European Market Infrastructure Regulation (EMIR) and Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps (Regulation on short selling and CDS). The main issues in EMIR are 1) clearing of all standard OTC derivative contract through a central counterparty, 2) reporting of all derivatives to trade repositories (OTC and other derivatives), 3) comprehensive requirements on risk management of derivatives that are not cleared through a central counterparty and 4) common rules for central counterparties and trade repositories. The Regulation on short selling and CDS puts restrictions on short selling, especially regarding short selling of government bonds.

The bill is expected to be implemented in the autumn of 2015.

BILL ON NEW ACT ON ALTERNATIVE INVESTMENT FUND MANAGERS

The bill will be based on Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM Directive). No harmonized regulatory framework exists on the management of alternative investment fund management, aside from a few articles in the Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment Funds No. 128/2011 and in other legislation on the financial market. The aim of the AIFM Directive is to create a harmonized regulatory framework for alternative investment fund managers, decrease risk in the management of funds and increase investor protection e.g. by putting increased organizational requirements on the management of funds.

A bill is scheduled to be submitted to Parliament in the autumn session 2015.

11 ABBREVIATIONS

ACC	Arion Credit Committee
AIFM	Alternative Investment Fund Managers
ALCO	Asset and Liability Committee
ASF	Available Stable Funding
BARC	Board Audit and Risk Committee
BCC	Board Credit Committee
BCM	Business Continuity Management
BPV	Basis Point Value
BRC	Board Remuneration Committee
CCC	Corporate Credit Committee
CEBS	Committee of European Banking Supervisors
CEO	Chief Executive Officer
CMS	Collateral Management System
COO	Chief Operating Officer
COREP	Common Reporting
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Customer Relationship Management
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CVC	Collateral Valuation Committees
DCC	Debt Cancellation Committee
EAD	Exposure at Default
EBA	European Banking Authority
EEA	European Economic Area
EL	Expected Loss
EMIR	European Market Infrastructure Regulation
EMTN	Euro Medium Term Note
ESÍ	Central Bank of Iceland Holding Company
EU	European Union
EWS	Early Warning System
FME	Financial Supervisory Authority Iceland
HFF	Housing Financing Fund
ICA	Icelandic Competition Authority
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRRBB	Interest Rate Risk in the Banking Book
ISFI	Icelandic State Financial Investments
ITIL	Information Technology Infrastructure Library
KRI	Key Risk Indicator
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LPA	Loan Portfolio Analysis
LTV	Loan to Value
MD	Managing Director
MI	Major Incident
MLRO	Money Laundering Reporting Officer
MV	Market Value
NSFR	Net Stable Funding Ratio
PD	Probability of Default
RCSA	Risk Control Self-Assessment
RBC	Retail Branch Credit Committees
RMC	Retail Monitoring Committee
ROAC	Return on Allocated Capital
RSF	Required Stable Funding
RWA	Risk-Weighted Assets
SC	Security Committee
SME	Small and Medium Enterprises
SO	Seurity Officer
SREP	Supervisory Review and Evaluation Process
UIC	Underwriting and Investment Committee
UCITS	Undertaking for Collective Investment in Transferable Securities
VaR	Value at Risk

LIST OF TABLES

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