Pillar 3 Risk Disclosures

Arion Bank 2024

Disclaimer

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Declaration

The Board of Directors of Arion Bank is responsible for the Bank's risk management framework and for ensuring that satisfactory risk policies and governance for controlling the Bank's risk exposure are implemented. The Board reviews on a regular basis the status of risk management issues to assess the management and monitoring of the Bank's risks.

It is the Board's assessment that the Bank has in place adequate risk management arrangements with respect to the Bank's risk profile and risk policy.

Risk statement

Arion Bank is a strongly capitalized bank. It aims to excel by offering agile and reliable financial solutions which create future value for its customers, shareholders, and wider society. The Bank provides diverse and value-adding services for its customers, guided by the principles of sustainability and responsibility. Its application of digital solutions increases customer convenience and improves operating efficiency while simultaneously mitigating operational risk by reducing the need for manual input. The Bank is committed to supporting the economy and providing financing to households and corporates through challenging and uncertain times.

The Bank's business strategy is aligned with its risk appetite as set by the Board. This is achieved by monitoring and managing the Bank's risk profile at any given time against risk limits and targets derived from the risk appetite statement. The Board reviews and approves the Bank's risk policies and enterprise risk management architecture.

The Bank is well capitalized with a capital adequacy ratio of 22.6%, and CET1 ratio of 18.2% at the end of 2024, which is within the Bank's stated risk appetite and exceeds regulatory requirements.

Credit risk is one of the Bank's primary risk factors. The Bank's credit policy underpins its credit strategy as integrated in the business plan. Credit risk is managed in line with risk appetite metrics, which address credit quality, as well as single-name, sectoral, and geographical concentration risks. In line with its risk appetite, the Bank has maintained a low level of single-name concentration in recent years. This has been achieved in part through the strategy of originating loans before distributing them through the Bank's asset management arm, to third parties, or both.

The Bank invests its own capital on a limited and selective basis in transactions, underwriting and other activities that involve market risk. Market risk is managed in accordance with the risk appetite and risk limit framework. At the end of 2024, total net equity position in the trading book and total equity position in the banking book was 1.7% and 1.5%, respectively, of normalized own funds.

The Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirements. The Bank's funding profile supports its liquidity profile. Liquidity positions are managed on a day-to-day basis using internal limits and targets in line with risk appetite and regulatory standards. The Bank's liquidity coverage ratio was 181% at the end of 2024, while the regulatory requirement was 100%.

The Bank's business units are primarily responsible for managing their own operational risks with support from control functions. The Bank's operational risk framework integrates risk management practices into processes, systems, and culture.

The Bank has no tolerance for internal fraud and compliance breaches, and the risk appetite statement further attends to observation of standards of market integrity, good practice and conduct, and minimization of incidents and mistakes.

As with the financial sector generally, the incidence of attempted fraud against the Bank's customers continues to increase and become ever more sophisticated. The Bank relies on experienced internal and external experts for advising, implementing, operating, and monitoring security controls in use, and participates in several security risk- and fraud-focused forums for threat intelligence sharing, combined with the use of automated threat intelligence. Such intelligence sharing increasingly encompasses emerging threats to shared critical infrastructure, given heightened geopolitical tensions.

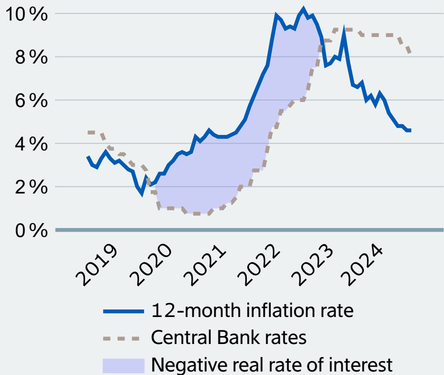
The Bank has integrated sustainability risk into its enterprise risk management framework, incorporating environmental, social, and governance factors in decision making and strategy. This is an area of rapid evolution, in which the Bank endeavours to reflect regulatory requirements and employ best practices with respect to ESG-related risk management. The Bank seeks to ensure that its activities and the services it provides do not adversely impact people or the environment and is committed to supporting the global effort to transition to a net zero carbon economy.

The Board of Directors of Arion Bank

A shifting landscape of risk

In the second half of 2024, the Central Bank of Iceland (CBI) reduced its policy rate from 9.25% to 8.5%, marking the end of two years of monetary tightening. Inflation eased to 4.8% by year-end and is trending downward. Private consumption growth has stalled, and the economy is likely to have contracted in 2024 according to Statistics Iceland. Further monetary easing is anticipated, though its pace will depend on the fiscal policies of the new centrist coalition government.

Figure Inflation and interest rates



The tourism industry has largely recovered from the impact of the Covid-19 pandemic, with 2.2m visitors passing through Keflavík Airport in 2024, maintaining the level of the previous rebound year. The industry is labor intensive and therefore exposed to a relatively volatile collective bargaining environment in Iceland. It also faces competition from similar or less expensive destinations and the continuing volcanic activity in the Reykjanes peninsula could deter potential visitors.

While the Icelandic economy remains anchored in tourism, seafood and metal production, emerging sectors such as biotechnology and fish farming show promise of significant value creation. The Bank continues to play a pivotal role in supporting economic development through its corporate advisory and lending activities.

Given Iceland‘s dependece on exports, the promise of economic turnaround is however at risk of being hindered by geopolitical shifts such as trade wars and armed conflicts. The Bank has performed stress tests that address such risks and demonstrate that the Bank‘s strong financial position supports the business plan in adverse scenarios.

Despite economic headwinds, the Bank‘s loan book expanded by 6.6% in 2024. Household lending, particularly mortgages, declined in the final quarter. Non-performing loans rose across most portfolios but remained below historical averages. The reset of fixed-rate residential mortgages in the latter half of the year did not lead to increased defaults, as many borrowers opted to refinance to indexed loans with lower monthly payments. The construction portfolio showed the highest rise in default rates due to elevated funding and construction costs amidst a real estate market slowdown.

Funding conditions improved in 2024 as funding spreads had normalized somewhat at year-end following a period of limited appetite for smaller issuances caused by reduced liquidity in global markets. This positive development went some way towards alleviating the Bank‘s competitive disadvantage against foreign financial institutions which provide credit to large corporates in Iceland. In Q2, the Bank issued a €300m benchmark senior preferred note at 125 basis points over mid-swaps, followed by a USD 125m Additional Tier 1 bond in Q3 with fixed coupon of 8.125%.

The CBI reduced the Bank‘s Pillar 2 requirement to 1.8% of total risk-weighted exposure amount (REA) in June, down from 2.1% the previous year. In December, the CBI lowered the systemic capital buffer from 3% to 2%, citing improved resilience of the financial system. The buffer for systemically important banks was simultaneously increased from 2% to 3%, resulting in a net 0.1% increase in the Bank‘s combined capital buffer requirement.

The implementation of CRR3 in Iceland, expected in 2025, will result in increased risk-weight sensitivity for real estate-backed loans, reducing capital requirements for residential mortages and corporate real estate loans. The capital need for construction loans is expected to increase. Despite some uncertainty with regard to interpretation and guidelines, the Bank expects the implementation to result in net capital relief.

The Bank‘s indexation imbalance widened to ISK 199 billion by year-end 2024, up from 105 billion in 2023 and 27 billion in 2022, driven by borrowers refinancing to indexed loans amid high nominal interest rates. The trend slowed in Q4 as indexed rates rose and expectations of further monetary easening increased.

Liquidity
Total LCR
181%

Capital adequacy
Total capital ratio
22.6%

Large exposures
No group exposure over 10% of Tier 1 capital
0.0%

CRO Message

The Icelandic stock market rebounded in September with the main index rising 16.5% over the year, including a 24.5% gain from mid-September. The Group is exposed to equity position risk through its insurance operations and market making activities. Although forward contracts are fully hedged, they were a source of earnings volatility during the year due to the different tax treatment of derivatives and underlying hedges.

The Bank continued preparing for the Digital Operational Resilience Act (DORA), in anticipation of its 2025 implementation in Iceland. Key initiatives have included adopting a state-of-the-art ISO 27001 certified Information Security Management System, deploying an enhanced operational risk framework, and investing in advanced ICT risk solutions. In 2024, these were devised Group-wide. In 2025, efforts will focus on enhancing the Group's third-party risk management.

In response to heightened geopolitical risks, extensive business continuity exercises have been conducted to address potential damage to Iceland's fiber optic undersea cables. Ensuring preparedness is crucial as a substantial part of the Bank's critical services depend on network access to third-party functions overseas.

In June 2024, the Bank reached a settlement with the CBI, agreeing to pay a ISK 580 million fine following a 2022 inspection of its anti-money laundering (AML) and counter-terrorism financing financing (CML) measures. The Bank has since undertaken extensive enhancements to its AML/CFT procedures across all operations.

In 2024, an increase was observed in crypto investment fraud, phishing on social platforms, adversary-in-the-middle attacks, and account takeovers. The Bank remains committed to customer security, investing in advanced fraud prevention tools and human resources.

Úlfar F. Stefánsson, Chief Risk Officer

1

Introduction

Arion Bank faces many risks arising from its day-to-day operations as a financial institution. The bank is small by international standards, but is classified as systemically important in Iceland, a small economy with its own currency, which is subject to sectoral concentration, fluctuations in capital flows, and exchange rate volatility.

Managing risk and taking informed decisions is a crucial component of the Bank's activities and its responsibility towards society. Risk management is therefore a core activity within the Bank.

The key to effective risk management is a process of ongoing identification of significant risk, quantification of risk exposure, action to limit risk and constant monitoring of risk.

Contents

1.1 Arion Bank at a glance
1.2 Structure and strategy
1.3 Regulatory framework

1 Introduction

1.1 Arion Bank at a Glance

Arion Bank ('the Bank') is a well-balanced and diversified universal relationship bank operating in the Icelandic financial market. The Bank is listed on the Nasdaq Iceland and Nasdaq Stockholm regulated markets. The Bank is classified as a domestic systematically important institution (D-SII) in Iceland.

The Bank, whose roots date back to 1930, is built on strong heritage and infrastructure. Arion Bank is a strongly capitalized bank that provides a broad range of banking services to corporations and individuals. The Bank's purpose is to be a driving force in the success of its customers by offering smart and reliable solutions that promote financial health and create future value for society as a whole.

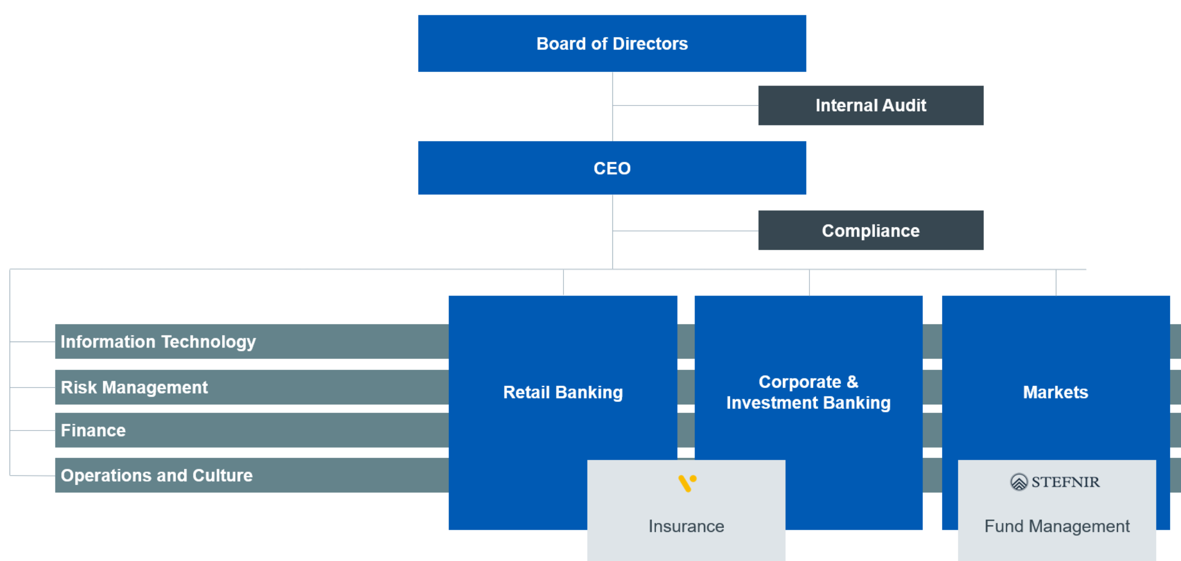
The Bank operates twelve branches across Iceland, thereof nine outside the capital area. The Bank is a leader in the development of digital solutions, improving customer convenience and increasing operational efficiency.

1.2 Structure and strategy

Arion Bank consists of three business segments: Retail Banking, Corporate & Investment Banking, and Markets. Furthermore, the Bank's strategic subsidiaries are important to its service offering: Stefnir is one of the largest fund management companies in Iceland and Vörður is the fourth largest insurance company in Iceland, providing both life and non-life insurance. This diverse service offering gives rise to a broad revenue base. The loan portfolio is well diversified between retail and corporate customers, and between different business sectors. The result is a good distribution of risk relative to the Icelandic economy.

In recent years, the Group (comprising the Bank and its subsidiaries) has emphasized its bancassurance strategy, which entails integrating the operations of Arion Bank and Vörður with the aim to apply the Bank's distribution channels, thus creating a 'one-stop shop' with a broad range of financial and insurance products under a strong brand.

Figure 1.1 Arion Bank's organizational chart



As part of the Bank's long-term vision, the Bank sees opportunities to actively participate in the growth of the Arctic region and its increasing importance in the global economy and the fight against climate change. In its activities outside of Iceland, the Bank's focus is on sectors that are familiar to the Bank, primarily segments that relate to the Iceland's knowledge and export industries.

The business is supported by four units within the Bank: Finance, Risk Management, Information Technology, and Operations & Culture. The cross-functional support unit Operations & Culture

was set up in 2023 to coordinate the delivery of strategic goals, leading transformation, and building a strong corporate culture.

The Group had 858 full-time equivalent positions at the end of the year, compared with 822 at the end of 2023.

The Bank's Annual and Sustainability Report 2024 provides further information about the Bank, such as strategy and vision, sustainability policy, and corporate governance.

1.3 Regulatory Framework

Capital and risk management disclosure requirements for financial institutions are stipulated in the Basel Framework, which capsulizes the standards of the Basel Committee on Banking Supervision. The Basel Framework encompasses three complementary pillars:

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

In 2013, the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive No. 36/2013 and the Capital Requirements Regulation No. 575/2013. This regulatory framework represented the EU's first major step in implementing the Basel III reforms, intended to strengthen banking regulation, supervision and practices, to improve banks' solvency, liquidity, governance, and risk management. The framework constitutes the cornerstone of the so-called European Single Rule Book for financial regulation.

In 2019, the EU Council adopted revised rules on capital requirements (CRD V/CRR II) and resolution (BRRD/SRM), and the latest reforms (CRD VI/CRR III) were adopted in 2024 and generally applicable from 1 January 2025, thus finalizing the Basel III implementation in the EU.

The CRR was incorporated into the EEA Agreement in late 2019, but had been in effect in Iceland since 2016 through numerous legislative acts. In June 2021, CRD V/CRR II was implemented through Act No. 44/2021 and Regulation No. 749/2021, while Bank Recovery and Resolution Directive II (BRRD II) provisions were excluded. The CRR, including CRR II, was fully transposed into national law in 2022 with Act No. 38/2022, amending Act No. 161/2002 on financial undertakings, along with pertinent BRRD II provisions via Act No. 38/2022. BRRD II was fully transposed into Icelandic law with Act No. 63/2023 and Regulation no. 700/2024 stipulates August 2026 as the end of the transitional period to reach full compliance.

The implementation of CRD VI/CRR III in Iceland is expected in the first half of 2025.

2

Risk Management

Arion Bank is in the business of taking informed risk. Risk is primarily incurred from extending credit to customers, but the Bank is exposed to a range of other risk types such as liquidity risk, market risk, operational and compliance risk, sustainability risk, and business risk, all of which are inherent in the Bank's strategy, product range, and its operating environment.

The Bank promotes a corporate culture in which risk is everyone's business, and maintains an effective risk management framework which entails the identification and quantification of significant risks and risk exposures, risk monitoring, and actions and controls to limit risks.

Contents

2.1 Internal controls and reporting lines
2.2 Three lines model
2.3 Risk policies
2.4 Risk appetite
2.5 Risk committees
2.6 The Risk Management division
2.7 The Compliance function
2.8 Reporting

2 Risk Management

2.1 Internal Controls and Lines of Reporting

The Bank is committed to the highest standards of corporate governance in its business. The Bank's 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 has in turn established governance procedures and a risk committee structure at management level. The CEO delegates decision-making responsibilities to Managing Directors, Chief Credit Officer (CCO) and others, as committee voting members, while assigning internal control responsibilities to the Chief Risk Officer (CRO) and the Compliance Officer.

Acting within an authority delegated by the Board, the Board Risk Committee (BRIC) is responsible for the oversight and review of prudential risks and capital adequacy. The BRIC reviews the Bank's risk appetite at least semi-annually, see Section 2.4, and recommends changes to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls, as well as considering potential implications of material regulatory changes.

Figure 2.1 Internal control structure

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

The Compliance Officer and Compliance function operate according to a charter for compliance defined by the Board of Directors. The Compliance Officer reports to the CEO, with unhindered access to the Board. Compliance submit quarterly Compliance Updates to the BRIC and annually to the Board of Directors.

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, chair of the Executive Risk Committee, and a non-voting member in other risk committees. The CRO reports to the CEO and has unhindered access to the Board. Section 2.6 outlines the organization of the Risk Management division.

A group-level risk assessment is periodically performed through the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP).

The Bank's subsidiaries adhere to their respective ownership policies, approved by the Board of Directors, which stipulates among other things the Group's internal control policy, risk appetite, and reporting mechanisms between the organizations. Individual subsidiaries are responsible for implementing their own risk management frameworks. The CEO, on behalf of the Board of Directors of Arion Bank, interacts with the boards of directors of individual subsidiaries. Through

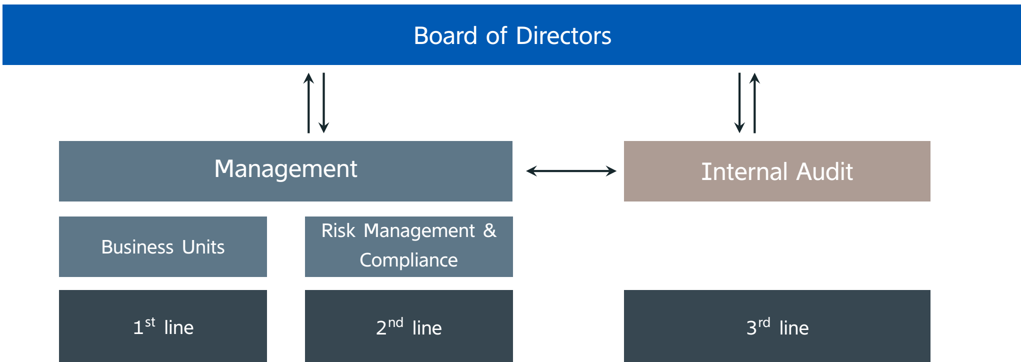
the group-level ICAAP and ILAAP, the CRO interacts with individual subsidiaries' risk officers and consolidates the assessment of capital requirements for the Bank.

For further information on the Bank's governance arrangements, refer to Corporate Governance Statement for the year 2024. The statement provides information on directorships held by Board members, on their background and expertise, and the considerations and suitability criteria used in the nomination process, including diversity.

2.2 Three Lines Model

The Bank applies the Three Lines Model for organizing the internal control system, as stipulated by its Internal Control Policy. All lines work together to contribute to the creation and protection of value, seeking alignment with the prioritized interests of stakeholders. Alignment of activities is achieved through communication, cooperation, and collaboration. This ensures the reliability, coherence, and transparency of information needed for risk-based decision making.

Figure 2.2 Three lines



The role of the Board of Directors

The Board of Directors is ultimately accountable for the internal control system at Arion Bank. The Board ensures that appropriate structures and processes are in place for effective governance, in accordance with regulatory requirements and recognized guidelines.

The Board of Directors delegates authority and responsibility formally and provides resources to management to achieve the organization's objectives, while ensuring legal, regulatory, and ethical expectations are met. It also determines the Bank's risk appetite framework. The rules of procedure of the Board of Directors can be found on the Bank's website.

For additional oversight, the Board of Directors appoints sub-committees with established charters.

The role of Management

Management comprises first and second line roles. Its responsibility is to achieve organizational objectives and manage risks by designing and implementing a control system.

First line roles are most directly aligned with the delivery of products and services and include the roles of support functions. They lead and direct actions and application of resources and have primary responsibility for maintaining appropriate structure and processes for the management of operations and risks.

Second line roles, i.e. the Risk Management and Compliance functions, support and facilitate the management of risk through complementary expertise, support, and monitoring, and through challenging the adequacy and effectiveness of risk management practices. Second line roles are separated from first line roles, and do not have first line responsibilities. Notwithstanding this separation, first line roles may be assigned second line responsibilities for complementary expertise. In order to ensure adequate independence, the second line has direct access to the Board of Directors and BRIC.

The role of Internal Audit

Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance arrangements, risk management, and controls, through systematic

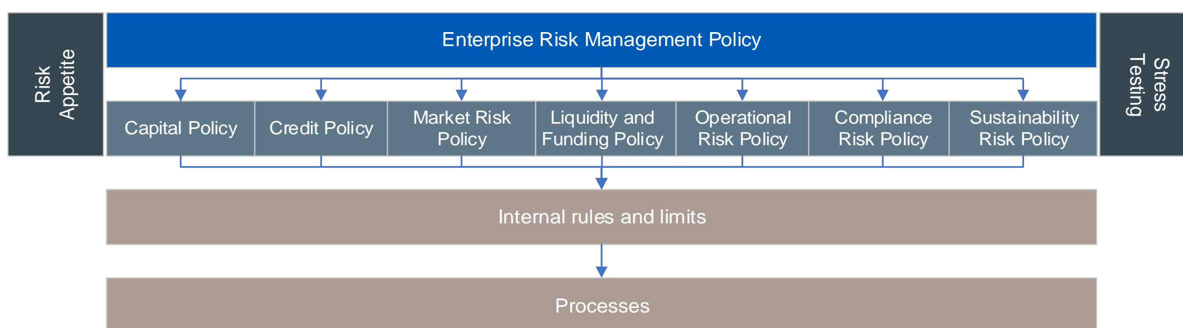
and disciplined processes, expertise, and insight. It reports its findings to management, the BAC, and the Board of Directors to promote and facilitate continuous improvement.

2.3 Risk Policies

To ensure that existing and potential material risks are identified, monitored, and managed, the Bank has an Enterprise Risk Management Policy in place. The policy is annually reviewed and approved by the Board of Directors. The policy outlines the key aspects of the Bank's risk management procedures. The Bank recognizes that risk-taking is an integral part of its business activities and must therefore be managed in an effective manner and in line with the Bank's risk appetite, see Section 2.4.

The significant risks the Bank is exposed to are defined within the risk management policy. Seven primary risk stripes have been defined: credit, market, liquidity, operational, conduct and compliance, sustainability, and business risk. The Board sets a specific policy for activities related to each risk, with the exception of business risk which is addressed in the Bank's strategy and business plan process. The policies are reviewed and approved by the Board annually. The Bank's risk management policy and risk type policies are implemented through the Bank's risk appetite framework, stress testing framework, internal rules and limits, and processes. The policies for each risk type are discussed further in the following chapters.

Figure 2.3 Risk policies implementation



2.4 Risk Appetite

A well-defined risk appetite framework is a key component of the Bank's enterprise risk management framework. The purpose of the risk appetite is to provide a common framework to the Board and management to communicate, understand, and assess the types and level of risk that the Board is willing to accept in pursuit of the Bank's strategy. The risk appetite framework is reviewed and approved by the Board semi-annually.

The Bank's risk appetite is articulated through a risk appetite statement and translated into risk limits developed and maintained by the relevant risk committee. Ongoing compliance with risk appetite is monitored by Risk Management and Compliance. The Board and BRIC are promptly notified if any risk appetite metrics are exceeded. Internal and external limits are monitored by the second line functions in accordance with the Bank's procedures.

The Bank's risk appetite is taken into consideration and aligned with the Bank's strategic objectives, business plan, operations, recovery plan, and remuneration. Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits.

The Board's direct involvement in setting and approving appetite for the Bank's most material risk exposures is a key part of ensuring the timely and appropriate disclosure of risk through the Bank's hierarchy of governance. This is complemented by in-depth management information and reporting tailored to the intended audience.

An overview of the Bank's quantitative risk appetite metrics are shown in Table 2.1. The risk appetite statement includes qualitative criteria such as tolerance statements for various operational risk and regulatory compliance breaches, as well as sustainability risk metrics pertaining to the Bank's own operations, i.e. on gender pay parity and green financing.

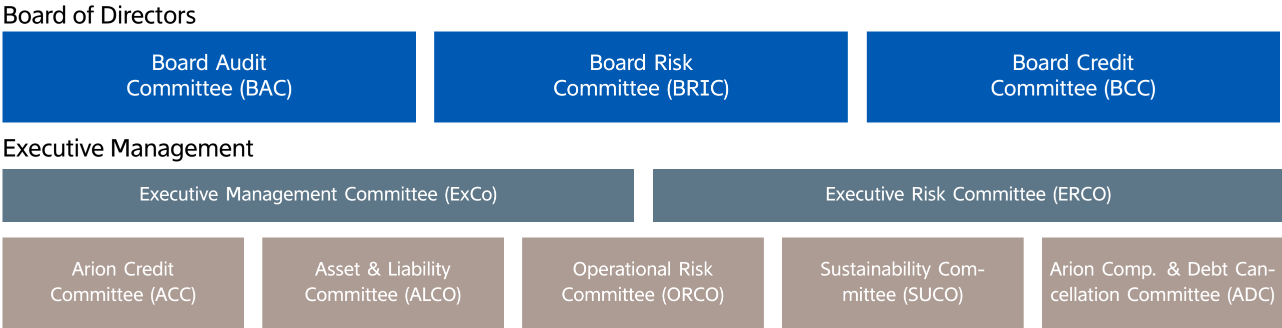
Table 2.1 Risk appetite metrics

Category	Risk metrics / risk factors
Capital adequacy	Capital adequacy ratios Leverage ratio MREL
Liquidity and funding risk	Liquidity coverage ratios Net stable funding ratio Wholesale funding over tangible assets Asset encumbrance ratio
Market risk	Foreign currency imbalance Interest rate risk and indexation risk Equity position in the banking book Equity position in the trading book, Value-at-Risk
Securities financing and counterparty credit risk	Uncollateralized exposure as per stress test
Credit risk	Sectoral and geographical concentrations Large exposures and single-name concentration Leveraged transactions Expected credit loss Share of higher-LTV residential mortgages Lending to foreign entities
Operational risk	Operational losses Downtime of critical banking services KYC adequacy ratio Enhanced due diligence adequacy ratio
Sustainability risk	Ratio of loans under Sustainability Financing Framework Gender pay gap

2.5 Risk Committees

The Bank operates several committees to manage risk. The structure of risk committees within the Bank can be split into two levels: board level and executive level. The committees define lines of responsibility and accountability within the Bank. They are charged with overseeing risk and the delegation of authority and forming a control environment for the Bank.

Figure 2.4 Risk committee structure



Board level risk committees are established by the Board and comprise members of the Board or external representatives nominated by the Board. An overview of the risk committees at Board level and their responsibilities is shown in Table 2.2.

Table 2.2 Board level committees

Committee	Responsibilities
Board Audit Committee (BAC)	The BAC assists the Board in meeting its responsibilities in monitoring the effectiveness of the Bank's internal governance and controls and in meeting its external financial reporting obligations under applicable laws and regulations. The BAC supervises accounting procedures, the organization and function of the Bank's internal audit, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The BRIC advises and supports the Board on the alignment of the Bank's risk policy, high-level strategy and risk appetite, and risk management structure. The BRIC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BRIC assesses whether incentives which may be contained in the Bank's remuneration system, including variable remuneration, are consistent with the Bank's risk policy.
Board Credit Committee (BCC)	The BCC operates under the authority of the Board, which has delegated to the Committee authority to approve certain material proposals regarding credit origination, debt cancellation, underwriting, and investments. The BCC can delegate specific authority to the CEO.

In addition to the three Board-level risk committees, the Board has established the Board Remuneration Committee (BRC) and the Board Tech Committee (BTC). The BRC's main role is to prepare a remuneration policy for the Bank. The policy is reviewed by the Board at least annually and submitted to the Annual General Meeting (AGM) for approval. The BTC's purpose is to assist the Board in overseeing the role of technology in executing the business strategy of the Bank, including major IT investments, IT strategy, and operational efficiency.

Executive level risk committees, which are primarily composed of the CEO and Managing Directors, or their designated representatives, are shown in Table 2.3.

Table 2.3 Executive level risk committees

Committee	Responsibilities	Chair
Executive Risk Committee (ERCO)	The ERCO oversees the implementation of risk policies and ensures that the Bank's limit framework adheres to risk appetite. The committee reviews the Bank's ICAAP, ILAAP, and stress testing, and approves economic scenarios, credit models, and specific provisions under IFRS9. The ERCO approves the rules and procedures of other risk committees, and defines credit rules for the ACC.	CRO
Arion Credit Committee (ACC)	The ACC makes decisions on credit cases within limits set by the BCC. ACC reviews reports concerning the credit portfolio and has an advisory role to the CEO on credit related matters. Risk Management is authorized to veto all decisions or escalate to the BCC for final approval.	CEO
Arion Composition and Debt Cancellation Committee (ADC)	The ADC deals with applications to reach composition with debtors, within limits set by the BCC.	CEO
Asset and Liability Committee (ALCO)	The ALCO is responsible for strategic planning relating to the development of the Bank's balance sheet as well as the planning of liquidity and funding, capital activities, and decides on underwriting and investment exposures within limits set by the BCC. The CRO or their deputy is a non-voting participant in committee meetings and is authorized to escalate decisions relating to investments, divestments, and underwriting to BCC for final approval.	CFO
Operational Risk Committee (ORCO)	The ORCO is responsible for managing operational risk and compliance, which includes information security, financial crimes, regulatory compliance, and data managment. The CRO, the Compliance Officer, and the Chief Security Officer are non-voting members.	CEO
Sustainability Committee (SUCO)	The SUCO promotes the consideration of environmental, social, and governance factors in the Bank's decision making and oversees regulatory implementation that relate to the sustainability agenda. The SUCO reviews risk assessments of ESG factors and climate risk impact and oversees ESG disclosures as well as the Bank's Green Financing Framework.	CEO

2.6 The Risk Management Division

The Risk Management division focuses on the identification, quantification, monitoring, and control of risk. The division facilitates informed decision making in all risk areas of the Bank by providing expertise and support. Risk Management ensures compliance with internal and external limits, and standards and regulations. Strong emphasis is placed on reporting risk to relevant stakeholders in a clear and meaningful manner.

The Risk Management division is divided into four departments: Credit Risk, Balance Sheet Risk and Models, Operational and Sustainability Risk, and Security.

Figure 2.5 The Risk Management Division

Credit Risk

The unit Credit Risk monitors the Bank's credit decision process and reviews and challenges, ex-ante, credit cases submitted to the ACC, where Risk Management has the power veto the committee's credit decisions or escalate to the Board Credit Committee (BCC) for final approval. The unit advises on changes to the Bank's credit rules.

Credit Risk is responsible for the approval of corporate credit ratings, performed by account managers, by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings. The unit is also responsible for supervising the valuation of collateral and validating the connectivity of related parties within the loan book.

The department is responsible for monitoring credit quality of loans on a single-name basis and determining appropriate levels of provisioning for non-performing loans.

Balance Sheet Risk and Models

The unit Balance Sheet Risk and Models is responsible for analyzing, monitoring, and reporting on risks on a portfolio level, including credit risk, market risk, and liquidity risk. The department is also responsible for capital adequacy, credit modelling, and stress testing.

Within the scope of market risk are risks resulting from balance sheet mismatches, i.e. interest rate risk, foreign exchange risk, and risks arising from the Bank's trading activities. The department interfaces with the Bank's Treasury, Market Making, and Capital Markets and reports its analysis and stress testing results for market, funding, and liquidity risk to ALCO.

The department is responsible for the development of credit rating models, assessment of expected credit loss under IFRS 9, the calculation of regulatory capital requirements, development of economic capital models, methodology for allocation of capital, and stress tests.

The department also provides various quantitative support to the Bank's business units.

Operational and Sustainability Risk

The unit Operational and Sustainability Risk is responsible for the internal control framework and supports the first line in managing operational risks. It seeks to ensure that internal processes and controls minimize the risk of loss as effectively as possible. The department develops and maintains tools for identifying, measuring, monitoring, and controlling operational risk, such as Risk and Control Self-Assessment (RCSA) and loss data collection.

The department is also responsible for supporting the Bank's adherence to requirements and guidelines in the area of sustainability, and develop the Bank's approach to assessing climate-related financial risks and risks related to social and governance factors.

Security

Headed by the Bank's Chief Security Officer (CSO), the unit supervises physical and information security management in the Bank's second line. The unit is responsible for maintaining the Bank's Information Security Management System (ISMS), which has been ISO 27001:2022 certified. The unit supports the first line in relation to external fraud.

2.7 The Compliance Function

The Compliance function focuses on the identification, monitoring, and control of conduct risk, compliance risk, and financial crime risk.

The role of Compliance is to apply effective precautionary measures to ensure that the Bank complies with applicable regulatory requirements, and to foster an affirmative corporate culture in this respect. Key compliance processes include advice and support, training, and compliance monitoring.

The Compliance Officer also serves as the Bank's Data Protection Officer and Money Laundering Reporting Officer.

2.8 Reporting

The Bank's aim is to provide accurate and transparent risk information to relevant stakeholders. Risk Management places a strong emphasis on risk reporting and on allocating adequate resources to ensure the fulfillment of the Bank's policy. Risk information is regularly reported to the Board of Directors and its sub-committees. The CEO, the CRO, and executive-level committees 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 2.4.

The Bank's Annual and Sustainability Report, Financial Statements, and Pillar 3 Risk Disclosures are all available on the Bank's website. Furthermore, the Bank delivers regular reports to the FSA; 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 annual reports on the Bank's Recovery Plan, ICAAP, ILAAP, and stress testing.

Table 2.4 Primary reporting within the Bank

Report	Contents	Fre-quency	Recipient
Credit risk 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 credit quality of the loan portfolio.	Monthly	ACC/ADC
Liquidity report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit developments, secured liquidity, funding measures, and other relevant liquidity information.	Monthly	ALCO
Market risk report	A report containing analysis of key market risk developments, including information on foreign exchange, indexation and index risk, margin trading, and other relevant market risk information.	Monthly	ALCO
Operational risk report	An overview of relevant risk measures for operational and compliance risk, including a summary of deviation events, major IT incidents, loss data analysis, and net promoter score.	Monthly	ORCO
Sustainability risk report	Selected sustainability risk measures, including development of green products and gender equality	Monthly	SUCO
Risk report	An aggregate report containing the credit risk portfolio report, the liquidity and market risk report, and the operational risk report as well as information on the Bank's risk appetite, recovery indicators, ICAAP status, and other risk management concerns.	Monthly	Board BRIC ExCo ERCO
ICAAP	Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval prior to onward submission to regulatory authorities.	Annually	Board BRIC ERCO
ILAAP	Evaluation of the Bank's total risk exposure and liquidity adequacy. The report is submitted for review and/or approval prior to onward submission to regulatory authorities.	Annually	Board BRIC ERCO
Recovery plan	A plan providing measures to be taken by the Bank to restore its financial position following a significant deterioration of its financial situation. A status report on recovery indicators is submitted monthly to the ALCO. The plan in its entirety is submitted annually to regulatory authorities.	Annually	Board BRIC ALCO
Internal bank-wide stress test	Evaluation of the impacts on the Bank's earnings and own funds, the Bank's capital and liquidity ratios, and other risk appetite metrics under various stress scenarios. The report is submitted for review and/or approval.	Annually	Board BRIC ERCO
Compliance updates	An aggregate report covering key events regarding both compliance risk and financial crime risk	Quarterly	BRIC
Compliance report	An annual report summarizing previous year with regards to both compliance risk and financial crime risk	Annually	Board BRIC

3

Capital Management

The Bank employs various techniques to estimate adequate capital levels and to ensure that capital is fruitfully deployed. The Bank's ICAAP is the cornerstone of the Bank's capital adequacy assessment and 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 strategy.

CET 1 capital ratio

18.2% (19.7%)

Capital adequacy ratio

22.6% (24.1%)

Leverage ratio

12.2% (12.4%)

Contents

3.1 Governance and policy
3.2 Capital adequacy requirements
3.3 Capital management
3.4 Capital ratios
3.5 Leverage ratio
3.6 MREL
3.7 CRR3

3 Capital Management

3.1 Governance and Policy

The Bank's capital policy and dividend policy are established by the Board of Directors based on recommendations from the BRIC. The policies are reviewed on an annual basis.

The Bank's CEO is responsible for carrying out the Bank's capital strategy in adherence to set policies. As established by the CEO, this responsibility is part of the principal authority of the Asset and Liability Committee (ALCO). The CRO is responsible for compliance with regulatory requirements and supervises the Bank's ICAAP and allocation of capital. The Bank's stress testing framework is integrated with the Bank's business planning process and ICAAP, and is used to assess whether capital levels are acceptable under stressed conditions.

The Bank's medium term target for Common Equity Tier 1 (CET1) ratio is to be 150 to 250bps above the regulatory requirement and maintain maximum utilization of Additional Tier 1 (AT1) and Tier 2 (T2) capital to meet Pillar 1 and Pillar 2 capital requirements. Relative to the total CET1 regulatory requirement of 15.3%, this implies a CET1 target of 16.8–17.8%.

The Bank's dividend policy is to pay out 50% of net earnings attributable to shareholders as dividend and in addition use special distributions to bring own funds towards the normalized composition. In 2025, the Bank intends to distribute dividends above this level. Thus the intention is to pay ISK 16.0 billion as dividends, representing 61% of 2024 net earnings. Additionally, a buyback of ISK 3 billion has been approved by the Board and the FSA. These amounts have been subtracted from CET1 capital when calculating the capital ratios.

3.2 Capital Adequacy Requirements

An adequate amount of capital ensures that the Bank is able to absorb losses associated with the risks that are inherent in its operations without its solvency being jeopardized and allows the Bank to remain a going concern, even in periods of stress. The Bank's capital adequacy is determined in accordance with Act No. 161/2002 on Financial Undertakings, through which EU Capital Requirements Directive and Regulation have been adopted.

The Bank's calculation of REA is based on standardized approaches for the assessment of credit risk, counterparty credit risk, credit valuation adjustment risk, market risk, and operational risk. The total regulatory capital requirement is presented as a percentage of REA and consists of the items shown in the following table:

Table 3.1 Capital requirements

Source	Description
Pillar 1 requirement	The 8% minimum regulatory requirement
Pillar 2R requirement	The additional capital requirement determined by the Bank's own internal assessment of capital adequacy (ICAAP) and FSA's subsequent supervisory regulatory assessment process (SREP)
Combined capital buffer requirement	The aggregated capital requirement due to four capital buffers, the level of which is determined by law (capital conservation buffer) and by the FSA following guidance from the Financial Stability Council (buffers for systemic risk, systemically important financial institutions (SII), and countercyclical effects)

As part of the SREP, the results of internal or external bank-wide stress tests may result in non-binding additional capital guidance, defined as Pillar 2G.

The Pillar 1 requirement may be met with different capital instruments, restricted as follows, expressed as a percentage of REA:

- Common Equity Tier 1 (CET1) capital shall exceed 4.5%
- Tier 1 (CET1 and AT1) capital shall exceed 6%
- Total capital shall exceed 8%

The same proportion applies to the Pillar 2 capital add-on, i.e. it can be composed of 56.25%

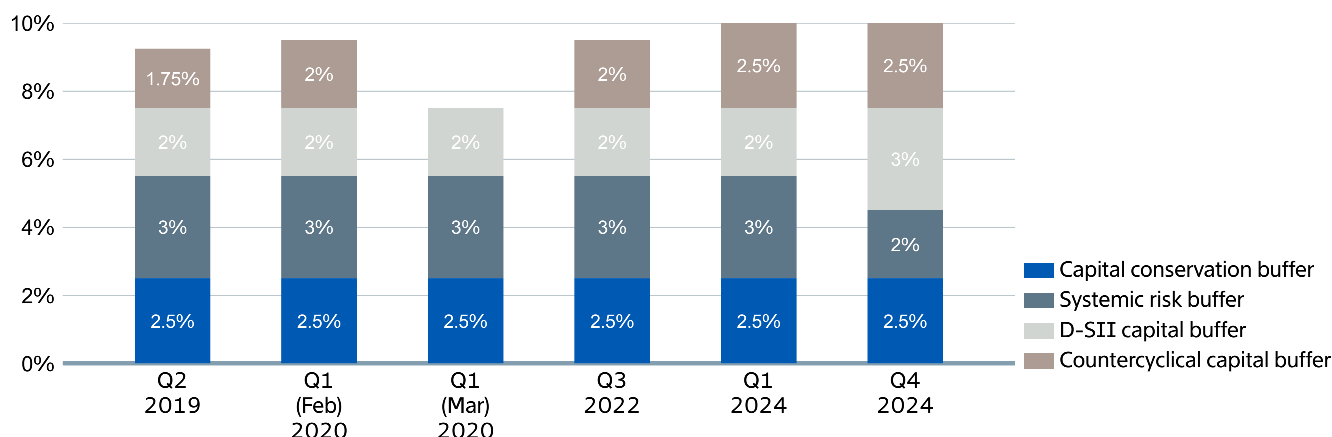
CET1 capital, 18.75% AT1 capital, and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

Capital Buffers

Capital buffers were incorporated into Icelandic law with the adoption of CRD IV / CRR. The systemic risk buffer only applies to domestic exposures and is applied cumulatively with the D-SII buffer. The countercyclical buffer rose to 2.5% on 16 March 2024 based on a decision of the Financial Stability Committee from 14 March 2023. On 4 December 2024, the systemic risk buffer for domestic exposures was lowered from 3.0% to 2.0% and the D-SII buffer was raised from 2.0% to 3.0%.

The development of the capital buffers is shown in the chart below. The requirements are presented as percentage of REA.

Figure 3.1 Implementation of capital buffer levels for Icelandic D-SIIs



The effective countercyclical capital buffer for the Bank is determined using the weighted average of the respective capital buffer levels in the countries where the Bank has exposure and the weighting is based on the percentage of the relevant REA in each country. The same method is used for the determination of the effective systemic risk buffer, where the buffer only applies to domestic exposures.

Given the Bank's geographic credit risk profile at year-end 2024, the effective combined capital buffer requirement for the Bank is 9.8%. The change in the rates for the systemic and D-SII buffers in December 2024 caused the effective buffer rate for the Bank to rise by 0.1 percentage point. Templates EU CCyB1 and EU CCyB2 show details regarding the calculation of the countercyclical buffer requirement.

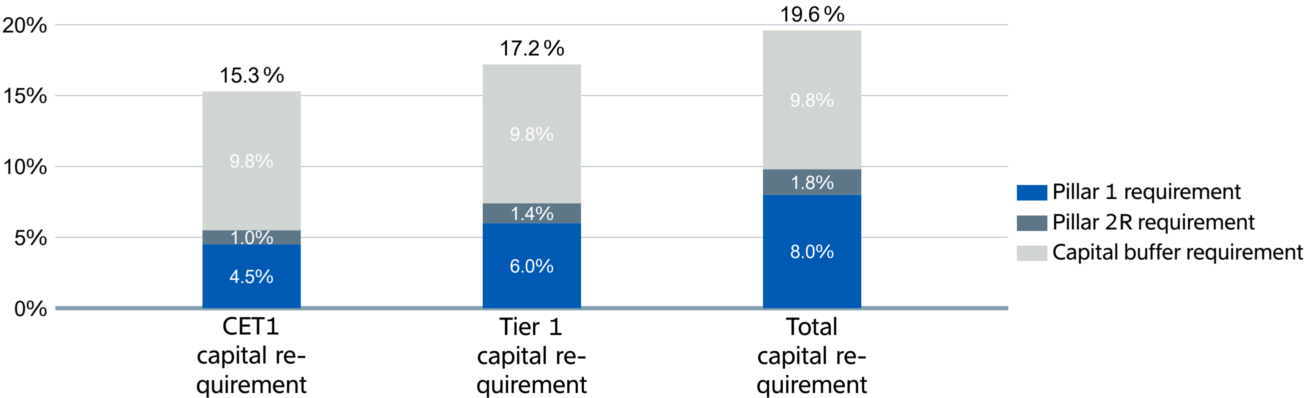
Table 3.2 Arion Bank's capital buffer requirements at year-end 2024

Capital buffer	Domestic exposures	Foreign exposures	Institution-specific rate
Capital conservation buffer	2.5%	2.5%	2.5%
Systemically important institution buffer	3.0%	3.0%	3.0%
Systemic risk buffer	2.0%	0.0%	1.9%
Countercyclical capital buffer	2.5%	CCyB of country	2.4%
Total	10.0%	5.5%+CCyB	9.8%
REA credit risk weight	93.8%	6.2%	

Arion's Capital Requirements

The Bank's total regulatory requirement, comprising Pillar 1, Pillar 2, and the capital buffer requirements, is 19.6%. The following figure shows how this requirement is broken down by type.

Figure 3.2 Arion Bank's own funds regulatory requirements with combined capital buffer requirements at 31 December 2024



3.3 Capital Management

In addition to regulatory capital requirements, the Bank performs its own assessment of capital need and allocates capital to business units on a quarterly basis. The Bank's ICAAP and stress testing are key elements of the Bank's capital management framework and are performed on an annual basis. In addition to providing quantitative analysis, the processes are an important tool for management that give an insightful understanding of the risks associated with the Bank's operations and business planning.

Internal Capital Adequacy Assessment Process

The ICAAP is the Bank's internal assessment of its capital need. The ICAAP is carried out in accordance with the Act No. 161/2002 on financial undertakings 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 scope of ICAAP excludes insurance subsidiaries which perform their independent Own Risk and Solvency Assessment (ORSA).

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank is sufficiently capitalized. The Bank's ICAAP report is approved annually by the Board of Directors, the CEO, and the CRO and submitted to the FSA.

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

- Raise risk-awareness of all the Bank's activities and to provide a detailed view of the Bank's risk profile for management and the Board of Directors.
- 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 appropriately 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 Bank's subsidiaries participate in the process of identifying and evaluating high risk areas, and discuss their management of risk, in cooperation with Risk Management. The result from the identification phase serves as the basis for the risk assessment within the Bank's ICAAP. Risk categories identified for the operating segments are shown in Table 3.3.

Table 3.3 Risk identification down to operating segment

Business Units	Credit risk	Market risk	Liquidity risk	Opera-tional risk	Compli-ance risk	Sustain-ability risk	Business risk
Retail Banking	✓			✓	✓	✓	✓
Corporate and Investment Banking	✓			✓	✓	✓	✓
Markets	✓	✓		✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓	✓	
Other divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓

The Bank's ICAAP methodology involves assessing key risks that are not believed to be adequately addressed under Pillar 1. For each risk factor, economic capital is assessed using internal models. If it exceeds the minimum 8% regulatory capital requirement, an add-on is applied. The main risk elements for which additional capital is required are:

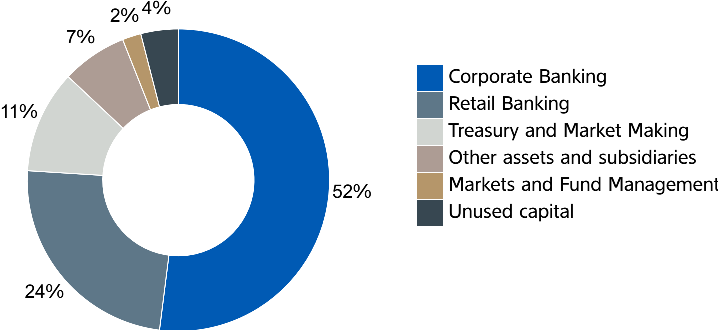
- Interest rate risk in the banking book (IRRBB) and indexation risk
- Single name concentration of credit risk
- Credit risk for segments of the loan portfolio
- Equity position risk

Following the ICAAP process, the FSA conducts the supervisory review and evaluation process (SREP). In that process the FSA sets the Pillar 2R capital requirement and may, on the basis of stress testing results, issue non-binding additional capital guidance, called Pillar 2G. The SREP of 2023, which was based on financial figures from 31 December 2023, resulted in a Pillar 2R capital requirement of 1.8% of REA.

Capital Allocation and Capital Planning

The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP and SREP. The risk-adjusted performance of the business units is based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning on a quarterly basis, based on the Bank's rolling business plan for each business unit. Capital is allocated both based on current need and on the basis of a 6-month forward horizon.

Figure 3.3 Allocated capital for Q4 2024, current need and 6 month horizon



The focus of capital management at the Bank is to normalize the capital structure in the medium term and consequently maintain the Bank's capitalization comfortably above the regulatory minimum, including the combined capital buffer requirement and the Pillar 2 requirement.

Stress Testing

Stress tests provide an important management tool for the Bank. The results of stress tests raise risk awareness and improve general understanding of the Bank's operations and are to be considered for strategic, capital, and contingency planning. The results of stress tests are incorporated into the review of the risk appetite and the Bank's limit framework.

The Bank's stress testing framework outlines the scope and responsibilities for stress testing in the Bank. Within the framework's scope are the ICAAP and ILAAP, which are carried out in parallel, the Recovery Plan, as well as firm-wide and regulatory internal stress tests on the Bank's business plan. The framework is aligned with FSA's guidelines No. 2/2015 and EBA's Guidelines on Stress Testing (EBA-GL-2018-04). Stress testing at the Bank consists of sensitivity analysis and scenario analysis.

Stress testing involves estimating the impact of the stress scenario on the Bank's earnings and capital adequacy as well as the impact for the Bank's liquidity ratios, other risk appetite metrics, and recovery indicators. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers and suggests relevant stressed scenarios.

Figure 3.4 The stress testing process at the Bank.

Scenario description - the story	Macro economic impact - time series	PD / LGD / IFRS9 stages	Micro economic impact - translation	Assumptions in business model altered - effects reported	Management actions
Cross department workshops, meetings and collaboration with the Chief Economist	Chief Economist, Risk Management, Finance	Risk Management	Finance, Chief Economist, Risk Management	Finance, Risk Management	Finance, Risk Management

Scenario analyses are carried out on the Bank's business plan. The Bank's Chief Economist 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. The design of the bank-wide internal stress test is challenged and reviewed by the Executive Risk Committee and the Board Risk Committee.

One of the stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FSA. The Bank also performs various regularly scheduled stress tests and targeted ad-hoc stress tests.

3.4 Capital Ratios

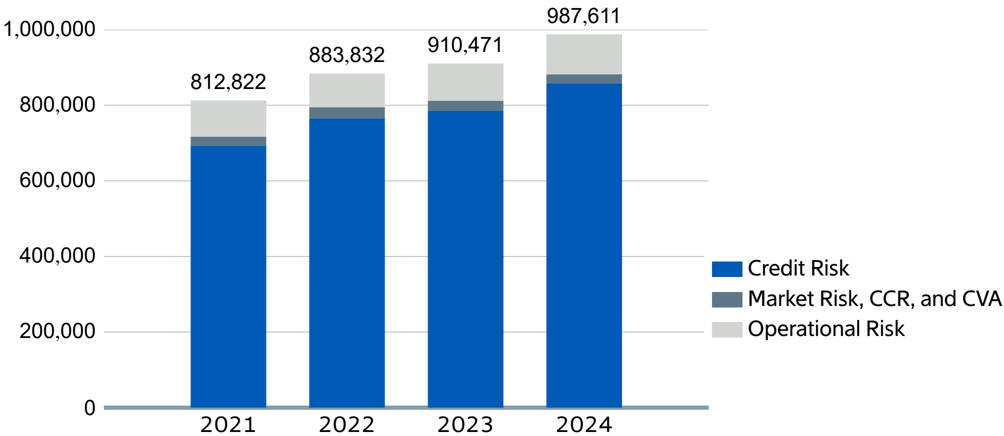
Scope of Consolidation and Exposure Amounts

The Bank's consolidated situation for prudential purposes and capital adequacy is different from the accounting consolidation. The Bank owns an insurance subsidiary, Vörður, which is fully consolidated in the Group financial statements. For prudential purposes, it is consolidated using the equity method and is excluded from supervision on a consolidated bases as stipulated by CRR. Vörður is supervised by the FSA and its solvency requirements are calculated in accordance with the Icelandic Insurance Companies Act.

For further details on the companies within the scope of consolidation, please refer to the template EU LI3 in the Pillar 3 Risk Disclosures. Template EU LI1 shows the difference in amounts between the carrying values in the financial statements and the carrying values under the scope of regulatory consolidation and a breakdown of the framework under which these amounts fall.

The main source of difference between the carrying values as reported in the financial statements and the exposure amounts for regulatory purposes are off balance sheet amounts which fall under the credit risk framework and potential future exposure for items under the counterparty credit risk framework. Template EU LI2 shows a reconciliation between these amounts.

Figure 3.5 Development of REA [ISK m]



Credit risk accounted for 87% of the Bank's REA at year-end 2024. The Bank's REA for credit risk (excluding CCR) increased by ISK 71 billion in 2024. The increase is mainly due to loans to customers which grew by ISK 77 billion during the year.

A breakdown of the Bank's REA is shown in Note 47 of the Consolidated Financial Statements and in template EU OV1.

The Bank's holdings of the own funds instruments of Vörður which are not deducted from own funds are instead risk weighed at 250%. Template EU INS1 shows these amounts. The Bank is not a part of a financial conglomerate and thus template EU INS2 does not apply to it.

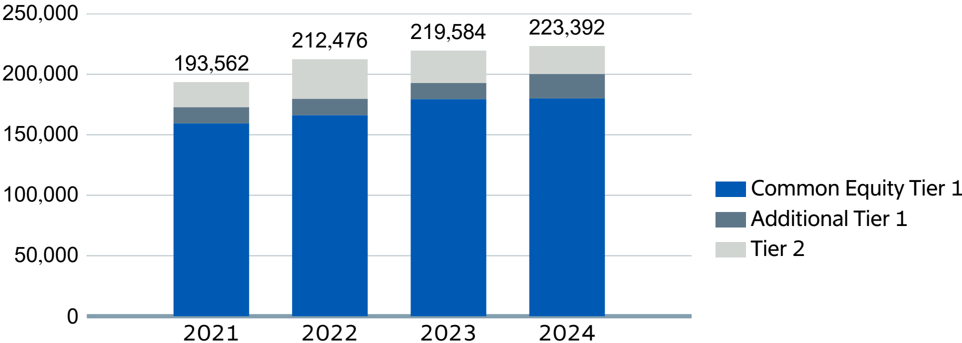
The Bank does not use the internal ratings based (IRB) approach for any exposures and it does not have any exposure to securitizations. EU templates related to these types of exposures are therefore omitted.

Own Funds

The Bank's own funds are composed of Common Equity Tier 1, Additional Tier 1, and Tier 2 issuances and the size of each layer of own funds is presented net of regulatory adjustments.

CET1 capital before regulatory adjustments consists exclusively of equity issued by Arion Bank. The regulatory adjustments to CET1 are primarily the deduction of intangible assets and the deduction of foreseeable dividends. Other items are smaller. The Bank applies the IFRS9 transitional arrangements, as amended by Regulation (EU) 2020/873, to phase in the effects on capital of the impairments requirements of IFRS9, in particular the increased impairments related to the effects of the Covid-19 pandemic. Template EU IFRS9-FL shows the effects on capital and REA if these arrangements were not available.

Figure 3.6 Development of own funds [ISK m]



The Bank uses the simplified approach for the calculation of additional value adjustments and thus template EU PV1 does not apply.

The Bank's Additional Tier 1 capital consists of a USD 125 million subordinated liability issued in 2024 and the amount still outstanding on a USD 100 million liability issued in 2020.

The Bank's Tier 2 capital consists of subordinated liabilities issued in 2019 in ISK, and EUR, in 2022 in ISK, and in 2024 in SEK, see Note 34 in the Consolidated Financial Statements. The

contractual maturities range from 2029 to 2034 and each facility has a call option five years before the contractual maturity.

Template EU CCA provides further details on each of the Bank's own funds and eligible liabilities instruments.

Template EU CC1 presents the composition of the Bank's own funds. The Bank's own funds are reconciled with the balance sheet in the Group's financial statements via template EU CC2 and cross references to the relevant rows in template EU CC1 are provided.

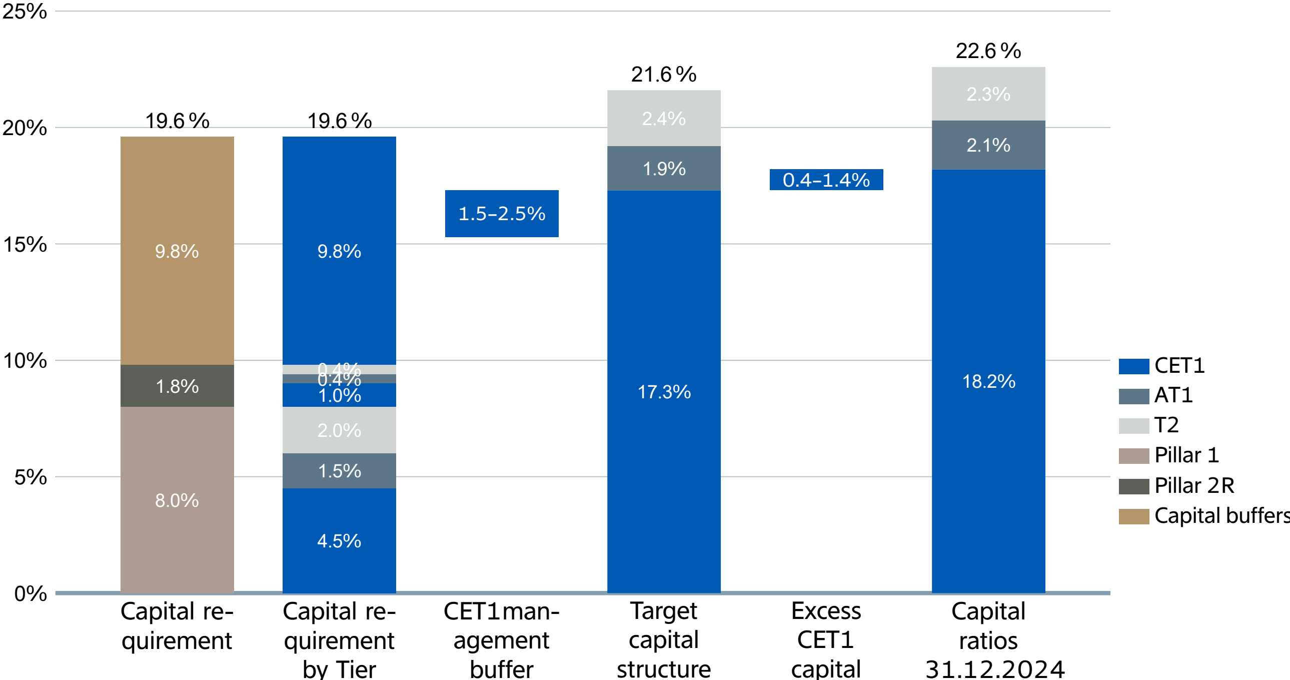
Capital Position

At year-end 2024, the Bank's CET1 ratio was 18.2%, well above the CET1 requirement which was 15.3%. The total capital ratio was 22.6%.

The following figure shows the Bank's capital position and the capital requirement, along with a normalized capital structure.

The Bank's own funds at 31 December 2024 take into account a foreseeable equity distribution of ISK 19 billion through dividends and share buyback. The Bank's dividend policy is to pay dividends corresponding to 50% of net earnings each year. The foreseeable equity distribution at year-end 2024 is ISK 5.9 billion above the value which the dividend policy would dictate.

Figure 3.7 Arion Bank's capital requirement, target capital structure and capital ratios.



The Bank's capital position was very strong at the end of 2023 with CET1 ratio of 19.7%. During 2024, the Bank paid out excess CET1 capital in the amount of ISK 12.5 billion, this reduction was however offset by an ISK 6.2 billion increase in capital due to the exercise of warrants. When the ISK 5.9 billion dividends and buyback beyond the Bank's dividend policy are taken into account then it can be said that an equity reduction of ISK 12.2 billion beyond the Bank's dividend policy is accounted for in the change in the CET1 ratio between year-end 2023 and year-end 2024. At year-end 2024, the CET1 ratio was 18.2%. This position is still above the Bank's medium term target which is a CET1 management buffer of 150–250bps and supports the Bank's issuer ratings from Moody's which is A3 with stable outlook.

The template EU KM1 shows the development of key metrics related to own funds, REA, capital ratios, capital requirements, and the leverage ratio.

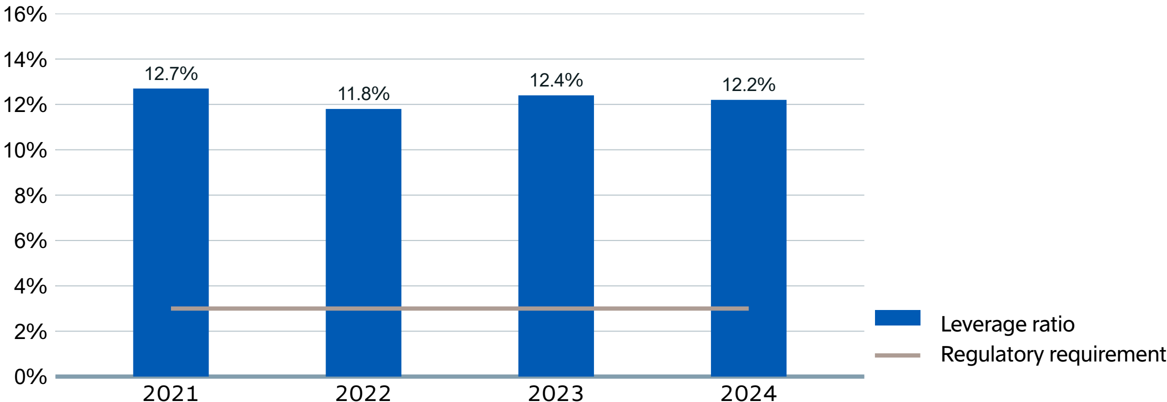
3.5 Leverage Ratio

The 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.

At year-end 2024, the Bank had a strong leverage ratio of 12.2%, significantly higher than the 3% minimum prescribed by CRR. The ratio is exceptionally high in international context, and reflects the particular case of the major Icelandic financial institutions, which are classified as systemically important while applying the standardized approach for credit risk. As such, Arion Bank has a very high combined capital buffer requirement of 9.8%, which is applied to a standardized REA. The Bank's average risk-weight, the ratio of the risk-weighted exposure amount and the exposure measure for the leverage ratio, is 60% for the consolidated situation.

Figure 3.8 Development of the Bank's leverage ratio



The Bank's Tier 1 capital and the total exposure increased in 2024 but the rate of increase in Tier 1 was lower due to capital reduction. This lead to a decrease in the leverage ratio. In light of the strong leverage ratio, the Bank's management of the risk of excessive leverage is currently confined to the monitoring of the Board of Directors' risk appetite for leverage.

For further details on the Bank's leverage ratio, please refer to templates EU LR1, EU LR2 and EU LR3.

3.6 MREL

The Icelandic law on the resolution of credit institutions and investment funds, Act no. 70/2020, entered into force on 1 September 2020. This transposed the BRRD (2014/59/EU) into Icelandic law. BRRD II was transposed into Icelandic law with Act No. 63/2023, and Rules 800/2024 of the Central Bank of Iceland.

In October 2024, the Central Bank of Iceland's Resolution Authority made a decision on the minimum requirement for own funds and other eligible liabilities (MREL), in accordance with Act No. 70/2020, based on year-end 2023 data.

The requirements are expressed as a fraction of total REA (MREL-TREA), and as a fraction of the total exposure measure (MREL-TEM). The requirement for MREL-TREA, which can only be met with eligible liabilities and own funds not used to fulfill the combined buffer requirement, was set at 19.6%, double the combined Pillar 1 and Pillar 2R requirement. The Bank's MREL-TREA adequacy ratio at year-end 2024 was 26.0%. The MREL-TEM requirement was set at 6.0%, double the leverage ratio requirement per the CRR. The Bank's MREL-TEM adequacy ratio was 21.6% at year-end 2024.

BRRD II introduces a subordination requirement for eligible liabilities, whereby a part of the MREL requirement must be met with own funds or liabilities that are subordinate to ordinary unsecured claims. As a consequence, a new class of securities has been introduced into the liability structure of institutions, the so-called senior non-preferred liabilities, which are senior to own funds issuances (T1 and T2), but subordinate to ordinary unsecured claims and senior preferred liabilities. The subordination requirement for the Bank according to the decision of the Resolution Authority is 13.5% of REA and will apply from 1 August 2026.

In the MREL policy published by the Resolution Authority, it is pointed out that under certain circumstances the Resolution Authority can give a permission for liabilities which are not subordinated to be counted toward the subordination requirement. Firstly, according to CRR Article 72b(3), senior preferred liabilities may be counted towards the subordination requirement for up to 3.5% of REA. Secondly, according to CRR Article 72b(4), all senior preferred liabilities may be counted towards the subordination requirement provided that excluded liabilities which rank pari

passu with the senior preferred liabilities do not exceed 5% of own funds and eligible liabilities. It should be noted that only one of these methods can be used at any given time and they are subject to further conditions and permission from the Resolution Authority.

Template EU KM2 shows key metrics relating to MREL, while templates EU TLAC1 and EU TLAC3b show the MREL composition and creditor ranking, respectively.

3.7 CRR 3

Legislation to implement the finalized Basel III framework in the European Union (CRR 3, (EU) 2024/1623) took effect in January 2025. The changes to market risk have however been postponed, at least until 2026 and possibly longer. Changes to Icelandic law are needed to implement CRR 3 in Iceland. These changes are expected to take effect in Q3 2025.

For Arion Bank, the key changes to capital requirements are summarized in Table 3.4.

When all of these factors are taken together, REA is expected to decrease somewhat with the adoption of CRR 3. The expectation is a reduction in REA of up to 2%, representing a capital relief of around ISK 5 billion, although some uncertainty remains.

Table 3.4 Impact of CRR 3

Exposure type	Impact
Residential real estate	Under the current rules, exposure secured with residential real estate property has risk weight 35%. This applies subject to certain conditions being fulfilled and provided LTV < 80%. For loans with LTV above 80%, it is allowed to split the exposure in two parts, and the portion which is secured with LTV below 80% receives 35% risk weight and the other portion will receive risk weight based on the characteristics of the borrower. In principle, the same method will apply under CRR 3 but the numbers will be different, the portion which is below LTV 55% will receive 20% risk weight and what is above LTV 55% will receive risk weight based on characteristics of the borrower. Furthermore, the property valuation methods will be changed. Instead of using the most up-to-date valuation available, an average valuation over six years must be used. However, at loan origination the six year average does not apply. Overall, the Bank expects a capital relief due to these changes.
IPRE	Loans secured by income producing real estate (IPRE) will under CRR 3 be risk weighted based in the maximum LTV for the Bank's loans secured by that real estate. This is a significant change in methodology. It can introduce a cliff effect where if the real estate valuation is too conservative then the RW can jump to a higher bracket. To address this, the Bank will ensure that valuations for commercial real estate are conservative at an appropriate level matching requirements laid out in CRR 3. Still, the Bank expects an increased capital burden for these loans.
ADC	Land acquisition, development and construction will be a separate asset class under CRR 3. The risk weight will be 150% unless the loans are financing the construction of residential real estate and the loans have characteristics representing low risk, in which case the risk weight will be 100%. EBA has been tasked with issuing guidelines quantifying these low risk characteristics. EBA has published a consultation paper on this topic where they have used an extremely conservative approach. The responses from stakeholders indicate that the approach of EBA will more or less eliminate the risk sensitivity envisaged in the regulation. Although the final guidelines have not been published, the Bank expects an increase in REA for these loans.
Corporate loans	For other corporates exposure, changes to risk weights for loans secured by commercial real estate and other changes are expected to yield a decrease in REA.
Equity	The treatment of equity exposures will be overhauled. Currently, they receive 100% risk weight under the standardized approach but will generally receive 250% in the new framework. This will lead to an increase in REA. However, currently these exposures receive a capital requirement add-on under Pillar 2. This should no longer be needed. Therefore, the total effect on capital requirement from this change will be small and these changes will gradually take effect during a five-year transition period.
Off-balance sheet exposures	The credit conversion factor (CCF) for off-balance sheet exposures will be changed. Loan commitments which now receive either 20% or 50% risk weight based on duration will generally receive 40% CCF. Also, certain unconditionally cancellable commitments which now receive 0% CCF will receive 10% CCF. This will lead to an increase in REA.
Operational risk	Due to the small size of the Bank, capital requirements for operational risk will fall into the lowest bracket. A limit will be introduced on the extent that interest income contributes to this requirement. These two factors are expected to lead to a reduction in REA.

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 to loans, guarantees, or other credit instruments, resulting in capital or earnings being dependent on counterparty, issuer, or borrower performance.

Risk exposure amount (ISK)

863.6 bn (792.2 bn)

Credit REA density

53.0% (57.6%)

Problem loans (% of loan portfolio)

2.3% (1.7%)

Cost of risk

9 bps (13 bps)

Contents

4.1 Governance and policy
4.2 Credit risk management
4.3 Credit risk exposure
4.4 Collateral management
4.5 Credit rating
4.6 Portfolio credit quality
4.7 Counterparty credit risk

4 Credit Risk

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

Table 4.1 Sources of credit risk

Source	Description
Loans to customers	The loan portfolio is the Bank's main asset. Loans to customers comprise loans to individuals and loans to corporates which, for the purpose of this report, include loans to municipalities and public sector entities. Types of instruments include collateralized loans such as property loans, construction loans, mortgages, vehicle loans, and uncollateralized short and long term loans such as overdrafts and cashflow loans.
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 allowances on checking account overdrafts, credit cards, and credit lines. Commitments and guarantees are unused amounts and are classified as off-balance sheet exposures.
Balances with the Central Bank and loans to credit institutions	The Bank maintains cash and balances with the Central Bank in the form of certificates of deposits, mandatory reserve deposits, and other balances. Furthermore, the Bank holds money-market deposits and deposits in nostro accounts with credit institutions. Such exposures form a significant part of the Bank's liquidity buffer.
Bonds and debt instruments	The Bank trades and invests in bonds and debt instruments, both listed and unlisted. High quality bonds form a significant part of the Bank's liquidity buffer.
Financial derivatives	Counterparty credit risk arises from forward contracts, swaps, and options. The exposures are subject to position limits, hedging requirements, and collateral requirements. Eligible underlying market factors are interest rates, foreign exchange rates, securities, and commodities. The Bank also uses derivatives for market risk hedging and engages in securities lending. See further information in Section 4.7.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made for short term trading purposes 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 4.3.

4.1 Governance and Policy

The Bank's credit risk policy and credit risk appetite are established by the Board of Directors and reviewed on an annual basis.

According to the policy, the Bank offers various forms of credit to individuals and organizations, and maintains a diversified loan portfolio composition to avoid excessive risk concentration. The Bank favors long-term relationships and sustainable development with an emphasis on innovative and export-driven companies. The Bank is active in the financing of real estate and, as such, facilitates home ownership and real estate development. The Bank finances and supports market transactions and market activities of its clients and thus promotes efficiency and liquidity in financial markets.

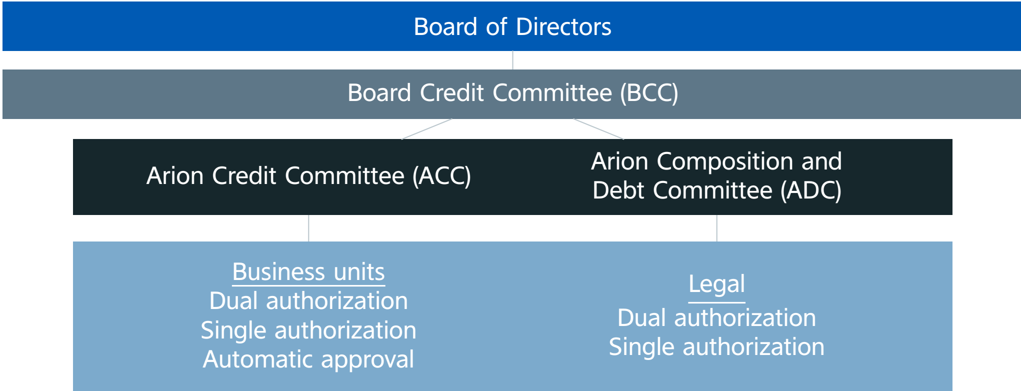
The Bank's risk appetite framework further specifies the desired level of risk exposure through qualitative and quantitative statements. The framework addresses credit quality, collateral coverage, portfolio composition, and single-name, sectoral, and geographical concentrations. It is ensured that the Bank's credit strategy and business model conform to its credit risk policy and risk appetite.

In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, which outlines underwriting rules, responsibilities and authorizations. At the management level, the Arion Credit Committee (ACC) is the principal authority for credit origination and credit management, and the Arion Composition and Debt Cancellation Committee (ADC) is responsible for debt cancellation, debt restructuring, and composition agreements. The ACC and the ADC are chaired by the CEO or respective delegates. Risk Management attends all committee meetings and is authorized to reject or escalate decisions.

The ACC and the ADC operate within limits set by the Board of Directors, which is the Bank's supreme authority in matters relating to credit risk exposures. The Board delegates credit decisions that exceed the authority of the ACC and the ADC and do not require risk appetite exemptions to the Board Credit Committee (BCC).

The Executive Risk Committee, chaired by the CRO, approves changes to the credit framework and ensures alignment with the Bank's risk appetite and credit risk policy. The BCC reviews the credit framework on an annual basis.

Figure 4.1 Credit approval hierarchy



4.2 Credit Risk Management

Credit risk management entails diversification of risk, well-informed lending decisions, good oversight of portfolio performance, and the identification of weaknesses to facilitate timely recovery.

To ensure well-informed lending decisions, borrowers' key risk and performance indicators are analyzed and made available to the credit committee. Credit applications address certain elements that serve as the basis for a decision, such as the customer profile, financial analysis of the customer, repayment ability, proposed collateral, credit rating of the customer, and connected clients and their total exposure. The credit is assessed on its own merit and in the context of the Bank's detailed credit framework and criteria. 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 collateral in the Bank's systems.

During the repayment phase, the credit portfolio is closely monitored by the first and second line. Credit risk metrics are aggregated monthly, based on consistent criteria, to analyze the credit quality, expected loss, collateral coverage, single-name, sectoral and geographical concentrations, and early warning indicators. For the purpose of measuring credit risk and facilitating manual and automatic credit decisions, Risk Management maintains statistical and expert judgement models that assess the likelihood of default and the liquidation value of collateral.

Risk Management performs periodic reviews of the loan book, which entails analysis of individual exposures in cooperation with the first line. The process ensures continuous monitoring of credit risk, with the aim of identifying early warning signs, problem loans, and sector development. Specific impairments are determined as part of the process.

Monthly credit risk reports are sent to the ACC, the BRIC, and the Board of Directors.

4.3 Credit Risk Exposure

The Bank is exposed to credit risk from both on-balance sheet exposures and off-balance sheet exposures. The tables in this section do not include exposures on the Bank's trading books or counterparty credit risk (CCR) exposures unless otherwise stated.

By far the largest source of credit risk REA is loans to customers. This exposure mostly falls into the exposure classes Corporates, Retail, and Secured by mortgages. The Bank's credit risk-weight density, or REA density, measured as REA relative to EAD, decreased in 2024 from 57.6% to 53.0%. For further breakdown see templates EU CR4 and EU CR5.

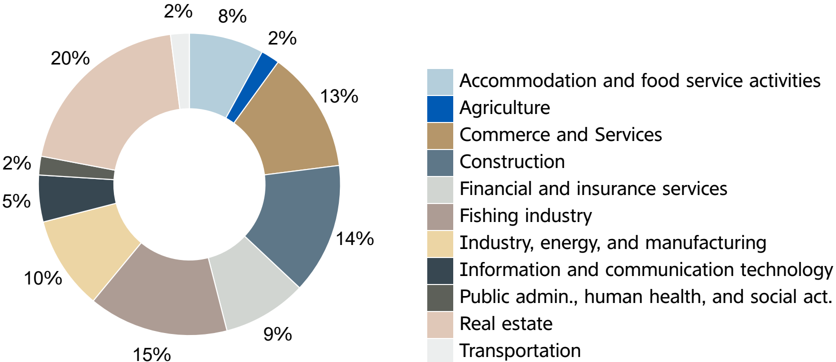
Credit Risk Exposure by Sector

The Bank's loan book is diversified with regard to individuals and industry sectors. Credit exposure

to individuals represents 52% of loans to customers, of which 89% are mortgage loans.

Real estate activities is the largest industry sector comprising 20% of loans to corporates or 10% of the Bank's total net credit risk exposure. According to the Bank's analysis, the sector distribution of the corporate loan book mirrors the sector distribution of credit from all lenders in the Icelandic economy, in line with the Bank's risk appetite. The Bank's sector diversification is as good as can be expected for a bank which primarily operates in Iceland.

Figure 4.2 Sector distribution of loans to corporate entities



Arion Bank monitors the risk associated with the tourism industry. The Bank has not modified its standard industry classification to incorporate a separate tourism sector, opting instead to monitor the exposure internally alongside the standard sectors. To define the tourism industry, the Bank has adopted a classification from the Central Bank of Iceland which identifies, primarily, 19 activities from ISAT08 as core tourism activities. According to this definition, the Bank's exposure to the tourism industry was 7% of loans to customers at the end of 2024, compared to 7% in 2023. The tourism exposure draws mainly from sectors: Accommodation and food service activities (52%), and Real estate activities (21%).

For EBA standardized disclosures of credit risk exposure by sectors please refer to template EU CQ5.

Credit Risk Exposure by Geographic Area

The Bank is not significantly exposed to credit in other countries than Iceland. The total net exposure is 91.6% towards counterparties domiciled in Iceland, 3.9% towards counterparties domiciled in the Nordic countries, 3.4% in rest of Europe, and 1.1% in North America.

The majority of the 8.4% foreign credit exposures is due to liquid assets in foreign currencies, which includes short term deposits and money market loans at credit institutions, and sovereign bonds, the counterparties of which have high grade or upper medium grade credit ratings from certified external credit agencies (ECAI).

The geographic distribution of the total net exposure to credit institutions, central governments, and central banks is 66% towards counterparties in Iceland, 9% towards counterparties in the Nordic countries, 17% towards counterparties in the rest of Europe, and 8% towards counterparties in North America.

For EBA standardized disclosures of credit risk exposure by geographic area please refer to template EU CQ4.

Connected Clients and Large Exposures

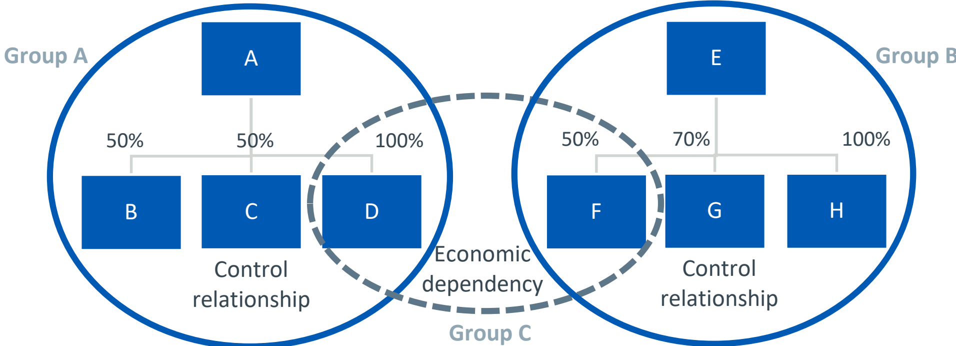
A large exposure is defined as an exposure to a group of connected clients which exceeds 10% of the Bank's Tier 1 capital. According to the CRR, the legal maximum for individual large exposures, net of eligible collateral, is 25% of Tier 1 capital.

The Bank seeks to limit its credit concentration risk through diversification of the loan portfolio by limiting large exposures to groups of connected clients. No single large exposure shall exceed limits expressed in the Bank's risk appetite without a special exemption granted by the Board of Directors.

The Bank connects clients according to internal rules that comply with the Act on financial undertakings No. 161/2002 and relevant EBA guidelines. The internal rules define criteria that comply with the regulatory conditions and describe the roles and responsibilities related to the interpretation and maintenance of connected clients. The Bank evaluates the relationship of customers

with respect to both control and economic dependencies. Economic dependencies between two companies within different groups of connected clients do not necessarily combine these groups into one but could rather result in a separate group. This relationship is illustrated in Figure 4.3.

Figure 4.3 Connected clients

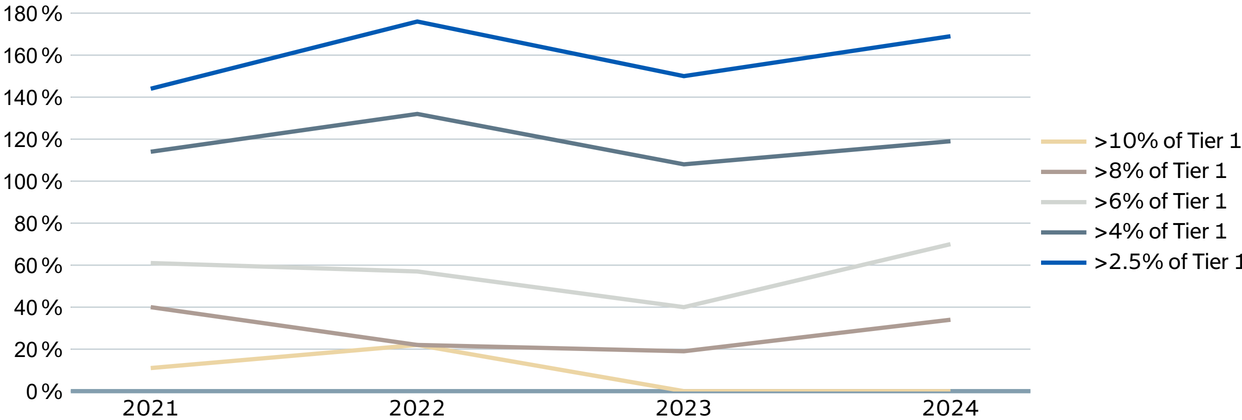


Account managers are responsible for maintaining and reviewing party relations both prior to the granting of a loan and during its lifetime. Risk Management monitors the party relations and manages the Bank's relationship database.

At year-end 2024 the Bank had no large exposures just like at year-end 2023.

The sum of group exposure exceeding 10%, net of eligible collateral, remained at 0% like at year-end 2023. The sum of group exposures exceeding 2.5%, net of eligible collateral, increased from 150% to 169% of Tier 1 capital, see Figure 4.4. Furthermore, the sum of group exposures exceeding 8% increased from 19% to 34% of Tier 1 capital.

Figure 4.4 Total of net exposures to groups of connected clients (excluding loans to financial institutions)



Equity Positions in the Banking Book

Exposure limits for equity positions in the banking book are defined in the Bank's risk appetite statement. Equity in the banking book primarily comprises investments that are not made for short-term trading purposes and assets repossessed as a result of credit recovery, i.e. restructuring or collection.

Table 4.2 Equity exposure in the banking book

31 December 2024 [ISK m]	Listed	Unlisted	Total
Investments in associates	-	749	749
Equity instruments	-	2,298	2,298
Investments in funds	-	1,627	1,627
Total equity exposure in the banking book	-	4,675	4,675

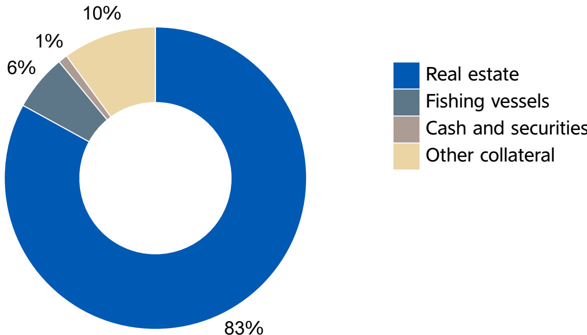
31 December 2023 [ISK m]	Listed	Unlisted	Total
Investments in associates	-	698	698
Equity instruments	-	4,219	4,219
Investments in funds	-	1,766	1,766
Total equity exposure in the banking book	-	6,683	6,683

4.4 Collateral Management and Valuation

The Bank's initial valuation of a 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 one of the following:

- Cash and securities: Cash, treasury notes and bills, asset backed bonds, listed equity, and funds that consist of eligible securities
- Real estate: Residential property, commercial real estate, and land
- Vessels: Ships with assigned fishing quota and other vessels
- Other collateral: Fixed and current assets including vehicles, equipment, inventory, and trade receivables

Figure 4.5 Collateral by type



In addition to securing collateral, mitigation of credit risk is achieved through the use of guarantees, master netting agreements and credit support annexes, and applicable terms and conditions.

Collateral valuation standards and guidelines have been set by the ACC to ensure coordinated collateral value assessment. Risk Management reviews the standards and guidelines for appropriateness and opines on individual cases as needed.

The standards and guidelines cover the following subjects:

- Agriculture
- Fishing vessels and fishing quota
- Inventory, trade receivables, and other movable assets
- Project financing
- Real estate
- Securities

The Bank operates a collateral management system to consolidate the Bank's collateral data. Table 4.3 shows the collateral held by the Bank for loans to customers, broken down by sector. Collateral held at year-end is to the largest extent real estate collateral, which makes up 83% of the total collateral. Loans to customers were secured by collateral conservatively valued at ISK 1.13 billion, which results in a collateral coverage ratio of 91.6% compared to 92.8% at the end of 2023.

The credit exposure to the Central Bank of Iceland and financial institutions is unsecured.

Credit Risk

Table 4.3 Collateral for loans to customers. The collateral value is capped by book value.

31 December 2024 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2024	Unsecured ratio % 2023
Individuals, Mortgages	404	569,959	0	0	570,363	0.1%	0.1%
Individuals, Other	122	14,055	23	20,342	34,542	49.6%	54.5%
Real estate activities	1,610	113,229	0	1,582	116,421	1.3%	1.6%
Construction	198	74,662	17	4,104	78,981	6.4%	2.5%
Fishing industry	1,124	17,612	60,155	6,838	85,729	2.2%	4.1%
Commerce and services	899	28,035	1,235	31,004	61,173	18.2%	13.2%
Accommodation and food service activities	14	42,570	0	4,173	46,757	2.1%	7.4%
Financial and insurance activities	7,435	16,455	0	16,220	40,110	23.7%	2.8%
Industry, energy, and manufacturing	750	38,534	0	17,607	56,891	7.5%	5.7%
Transportation	4	1,189	2,031	6,636	9,860	3.8%	28.1%
Information and communication technology	16	1,437	0	8,534	9,987	67.4%	44.6%
Public sector	13	2,224	5	187	2,429	74.5%	82.7%
Agriculture and forestry	0	11,490	0	518	12,008	2.0%	3.2%
Total	12,589	931,451	63,466	117,745	1,125,251	8.4%	7.2%

Figures 4.6 and 4.7 show the mortgage portfolio broken down by loan to value bands based on the gross carrying amount of the mortgages. In Figure 4.6 a prime mortgage exposure to a particular borrower appears in a single bar in the chart (whole-loan approach). In Figure 4.7 however, an alternative representation of the loan to value profile is shown, where each exposure is split into pieces and each piece is placed into the appropriate loan to value band. A single exposure can therefore be spread between several bands on the bar chart with the loan-splitting approach.

The value of real estate is based on observed market value for two years from purchase, and is then replaced by an estimated value based on a third party statistical model, which is updated on a monthly basis. The downward shift of the loan to value between 2023 and 2024 can be attributed to continued appreciation of property values.

Figure 4.6 Loan to value of mortgage loans [ISK m], whole-loan approach

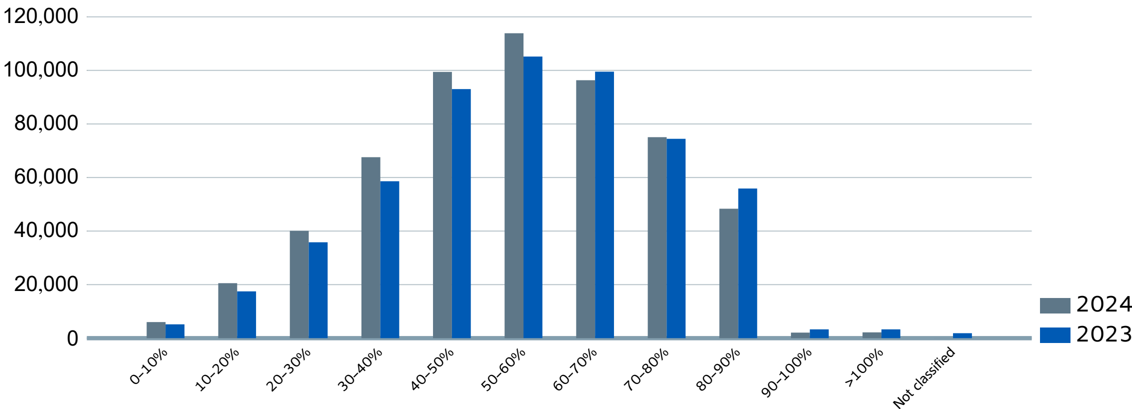
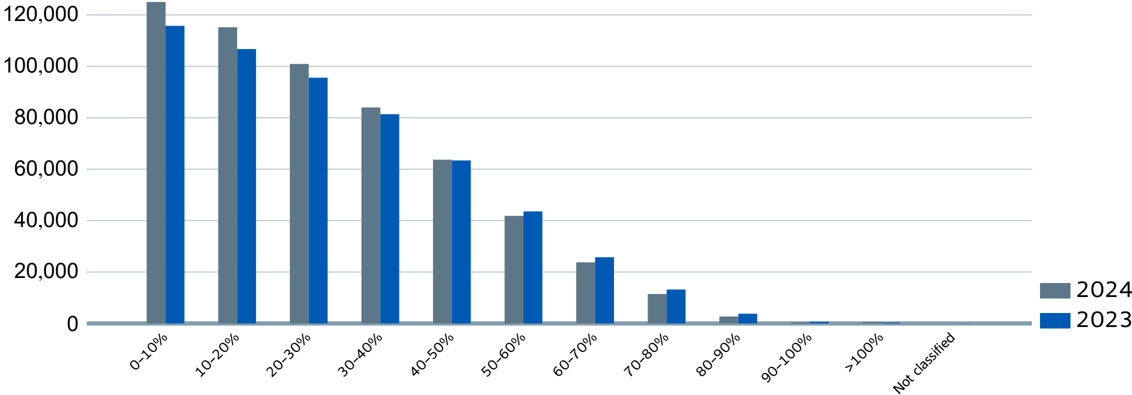


Figure 4.7 Loan to value of mortgage loans [ISK m], loan-splitting approach



At year-end 2024, 91% of mortgages, by value, had a loan-to-value ratio below 80%, compared to 89% at the end of 2023, according to the whole-loan approach. However, according to the loan-splitting approach, 99% of mortgages had loan-to-value ratio below 80%. According to the loan-splitting approach, 90% of mortgages were below 55% loan-to-value, compared to 86% at the end of 2023. The 55% mark is relevant for REA calculation under CRR 3, see Section 3.7. The mortgaged properties are primarily located in the Capital Area or 70% of the portfolio, by value.

4.5 Credit Rating

As outlined in Chapter 3, the Bank uses the standardized approach 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. These estimates are used extensively within the Bank as they play a role in both the manual and automatic evaluation of loan applications, portfolio monitoring, calculation of loss allowance, and internal economic capital calculations.

The Bank applies different credit rating models to different types of borrowers and exposures. The Bank has also created separate application versions of some of the models in order to rate new exposures and loan commitments.

Table 4.4 Probability of Default models

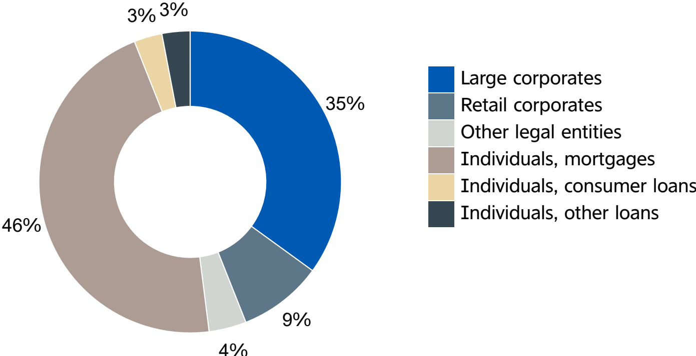
Model for:	Description
Large corporates	Defined as corporate clients with a) exposure over ISK 500 million or b) exposure over ISK 300 million and related exposure over ISK 500 million. The hybrid model is based on quantitative information drawn from financial statements as well as qualitative data entered by account managers, reviewed and approved by risk management.
Retail corporates	Defined as corporate clients with a) exposure below ISK 300 million or b) exposure between ISK 300 million and ISK 500 million, and related exposure below ISK 500 million. The model is statistical, runs automatically, and uses quantitative internal and external information found to be predictive of default.
Other legal entities	The Bank has different models for other legal entities – holding companies, construction financing, state related entities and municipalities, unions, etc.
Individuals, mortgages	Applied to all mortgages, for which there are standard loan collateral agreements. The model is statistical, runs automatically, and is based on historical behavior and characteristics of the customer and the exposure.
Individuals, consumer loans	Applied to all consumer loans – credit cards, overdrafts, etc. The model is statistical, runs automatically, and is based on historical behavior of customers and characteristics of the customer and the exposure.
Individuals, other exposures	The Bank has different models for other smaller exposure portfolios to individuals – car loans, guarantees, loans for work purposes, and other loans.

The Bank's probability of default (PD) models are developed within Balance Sheet Risk and Models, a department within Risk Management, while the validation of the models is performed independently by another department in Risk Management, Operational and Sustainability Risk.

Credit Exposure by Rating

Table 4.5 shows the portfolio's rating status, by exposure. A default rating grade (DD) is assigned to an exposure when it has been in arrears for over 90 days or the customer is deemed unlikely to pay.

Figure 4.8 Distribution of exposure by portfolio



Around 1.9% of the portfolio, by exposure, was assigned a default rating at the end of 2024, which is 0.5 percentage points higher than at the end of 2023. Active PD values are translated into an internal rating scale of letters from AAA to CCC-. The scale is shown in Table 4.6. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

Table 4.5 Breakdown of rating status by exposure

	2024			2023		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	97.3%	2.4%	0.3%	98.9%	1.1%	0.0%
Retail corporates	95.6%	4.4%	0.0%	95.3%	4.7%	0.0%
Other entities	99.9%	0.0%	0.1%	99.5%	0.0%	0.4%
Individuals, mortgages	98.7%	1.3%	0.0%	98.9%	1.1%	0.0%
Individuals, consumer loans	99.3%	0.7%	0.0%	99.2%	0.7%	0.0%
Individuals, other exposures	97.7%	2.3%	0.0%	97.5%	2.5%	0.0%
Total	98.0%	1.9%	0.1%	98.6%	1.4%	0.0%

Table 4.6 Rating scale

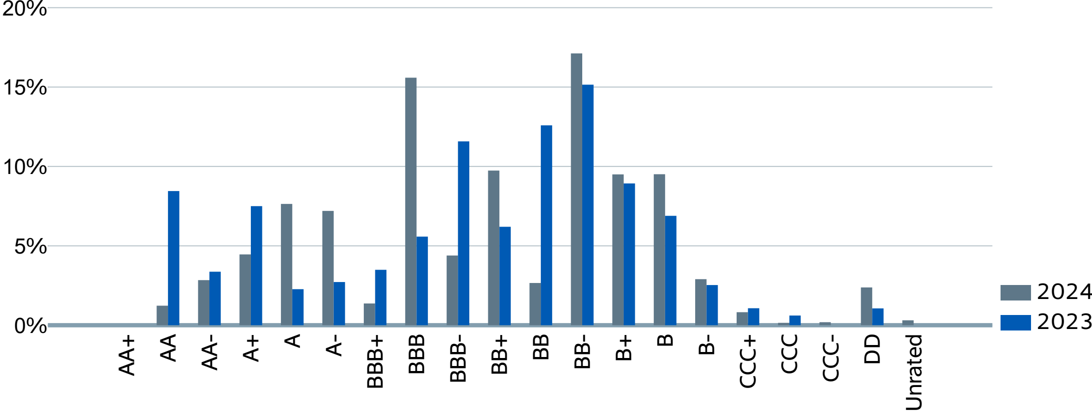
Risk class	Rating	Lower PD	Upper PD
0	AAA–A-	0.000%	0.17%
1	BBB+	0.17%	0.26%
	BBB	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	14.00%
	CCC	14.00%	31.00%
	CCC-	31.00%	99.99%
5	DD	100.00%	100.00%

The rating distributions of each of the four largest portfolios are discussed below.

Large corporates

The exposure-weighted average PD for the large corporate portfolio was 1.7% at year-end 2024, which was a 0.1 increase from year-end 2023. In terms of exposure, approximately 13% have been upgraded to a better credit rating, while 23% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated (e.g. new customers), or rated by the model for retail corporates.

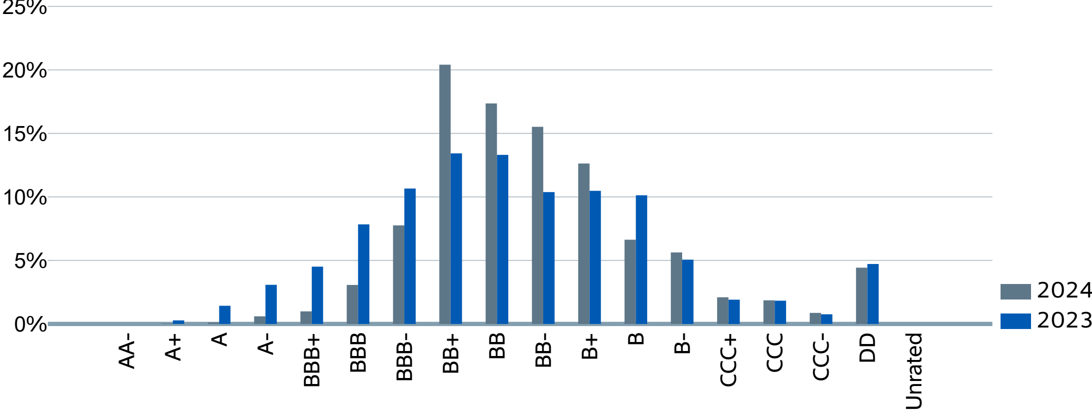
Figure 4.9 Distribution of exposure by rating for large corporates



Retail corporates

The exposure-weighted average PD was 3.0% at year-end 2024, compared to 2.8% at year-end 2023. In terms of exposure, 19% have been upgraded to a better rating whereas 34% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

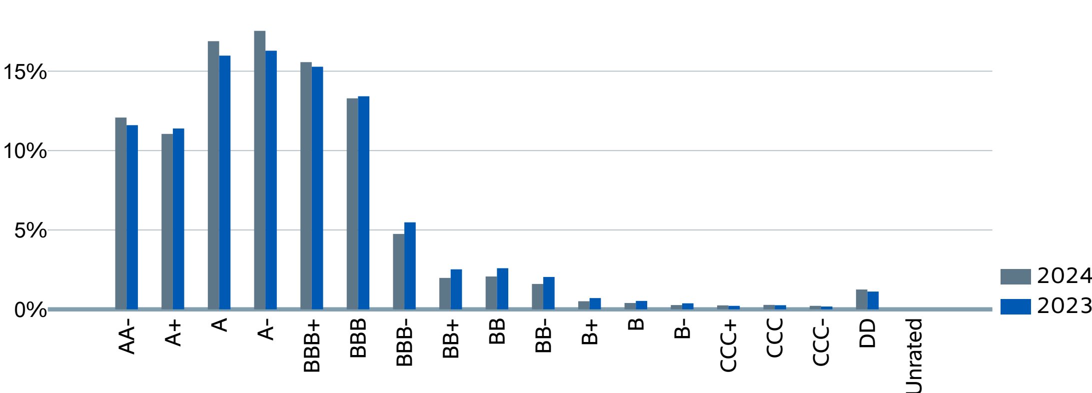
Figure 4.10 Distribution of exposure by rating for retail corporates



Mortgages to individuals

The exposure-weighted average PD for the mortgage portfolio was 0.5% in year-end 2024, compared to 0.5% in year-end 2023. In terms of exposure, approximately 16% of mortgages have been upgraded to an improved credit rating and 11% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

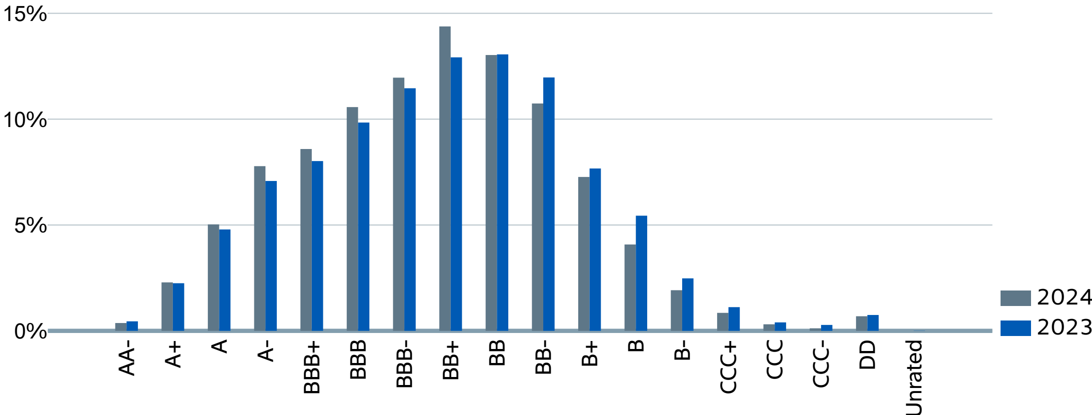
Figure 4.11 Distribution of exposure by rating for mortgages to individuals



Consumer loans

Figure 4.12 shows the consumer loans (overdrafts, credit cards, and unsecured short-term loans) portfolio broken down by rating. A very similar credit profile is observed between years. In terms of exposure, approximately 18% of mortgages have been upgraded to an improved credit rating and 17% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.12 Distribution of exposure by rating for consumer loans



Model performance

At year-end 2024 the discriminatory power of the four rating models with the largest exposure is in line with or exceeds the Bank's internal requirements and the prediction accuracy is satisfactory. The comparison values for the average PiT (point-in-time) PD estimates at the end of 2023 and observed default rates in 2024 are shown in the following table.

Table 4.7 Model performance

Model portfolio	Average PiT PD, end of 2023	Average TtC PD, end of 2023	Avg. observed default rate in 2024
Mortgages	0.4%	1.7%	0.8%
Consumer Loans	1.0%	1.5%	1.1%
Large Corporates	2.5%	5.9%	5.6%
Retail Corporates	1.7%	4.1%	2.4%

In Figures 4.13 and 4.14, the actual default rate for each grade in 2024 is compared to the PiT and TtC (through-the-cycle) probability of default at the end of 2023 for individuals (Mortgages and Consumer loans) and corporates (Large and Retail corporates), respectively. The dots representing PiT ratings are a measure of model performance but the TtC dots that are generally below the PD bands are indicative of a benign credit environment. In the figures the highest-rated rating

classes are grouped together due to their relatively low exposure.

Figure 4.13 Comparison of actual default rate in 2024 and predicted default probability – Individuals

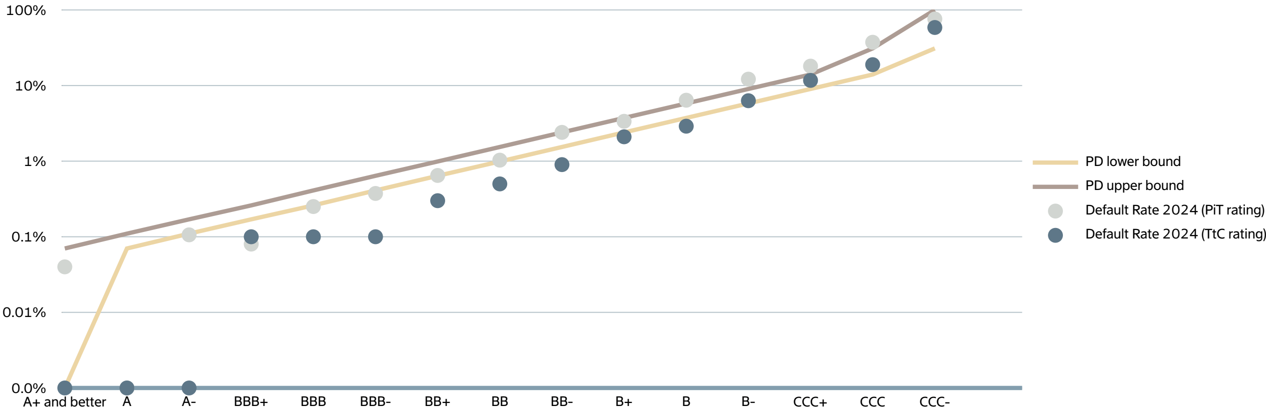
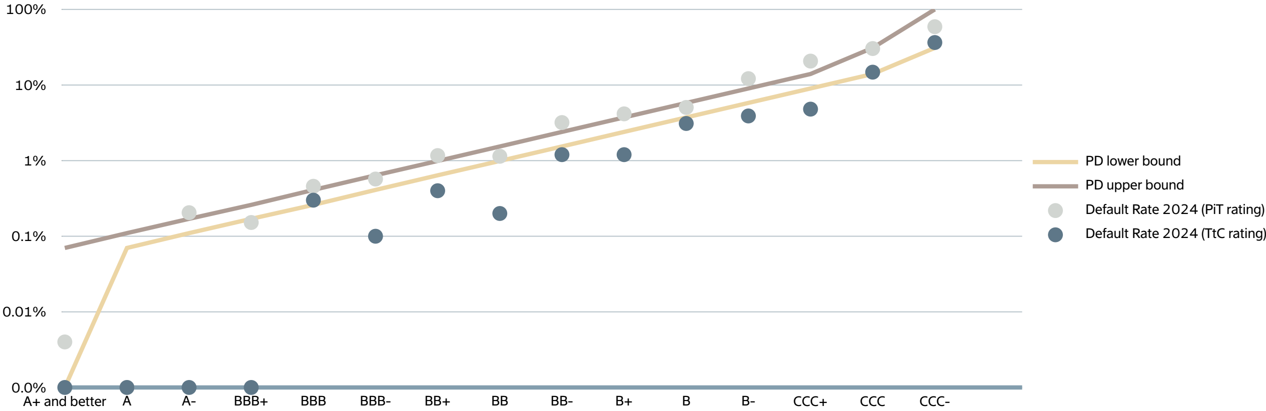


Figure 4.14 Comparison of actual default rate in 2024 and predicted default probability – Corporates



4.6 Portfolio Credit Quality and Provisions

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio. The credit portfolio quality is regularly aggregated and assessed in terms of industry concentration, single-name concentration, product type, and credit rating. Risk Management presents its findings to the ACC and the BRIC on a monthly basis.

Grindavík events

The impact of the volcanic events in the vicinity of Grindavík on the Group's loan portfolio have decreased in 2024, following the legislation that was passed last February regarding purchase of residential properties from households forced to relocate from Grindavík. A large number of homeowners in Grindavík have sold their properties to Fasteignafélagið Þórkatla, a property management company established on the basis of the legislation, (hereafter Þórkatla). The Bank's exposure to Þórkatla is predominantly in the form of senior debt that matches the mortgage exposure - which is paid up as part of process, the Bank subsequently giving up any recourse to the original borrower. While the government provides the majority of Þórkatla's equity, its contribution is also in the form of senior debt, pari passu to the Bank's.

As a result of this arrangement, the Bank's exposure increasingly shifts to Þórkatla. Having stood at ISK 1.8 billion prior to the launch of the repurchasing scheme, the Bank's residential mortgage exposure in the affected area has now been reduced to ISK 89 million, with a commensurate increase in the exposure to Þórkatla (ISK 1.75 billion). Exposure to corporates is ISK 3.94 billion.

The Bank's valuation of residential mortgages in Grindavík is based on the assumption that borrowers will sell their properties to Þórkatla, as has largely been the case. The assessment of recovery for loans secured by residential property in Grindavík is a scenario analysis which considers the likelihood of further payout from the Natural Catastrophe Fund of Iceland due to past or future

events and the likelihood of sale or lease of properties in the future if Grindavík becomes habitable again. The analysis is based on input from geophysicists. The result for 31.12.2024 is around 25% impairment and negative fair value change on the remaining residential mortgages and the Bank's exposure to Þórkatla, respectively (combined amount ISK 465 million). The impairment on the corporate portfolio is ISK 815 million.

Interest rate increase and reset of fixed nominal rates

Following an unprecedented period of low interest rates during the pandemic, the Central Bank responded to inflationary pressures through steep increases to its policy rate, which rose from 0.75% in May 2021 to 9.25% in December 2023 and then decreased to 8.50% at year-end 2024. The Bank's residential mortgage portfolio continued to grow in 2024, with an increased demand for index-linked loans, both with floating and fixed interest rates, since index-linked loans offer lower monthly payments.

The renewed demand for index-linked mortgages can be observed in Figure 4.15. The share of index-linked loans decreased from 49% of the residential mortgage portfolio at year-end 2020 to 36% at year-end 2021, before rising to 62%.

Figure 4.15 Development of residential mortgages [ISK m]

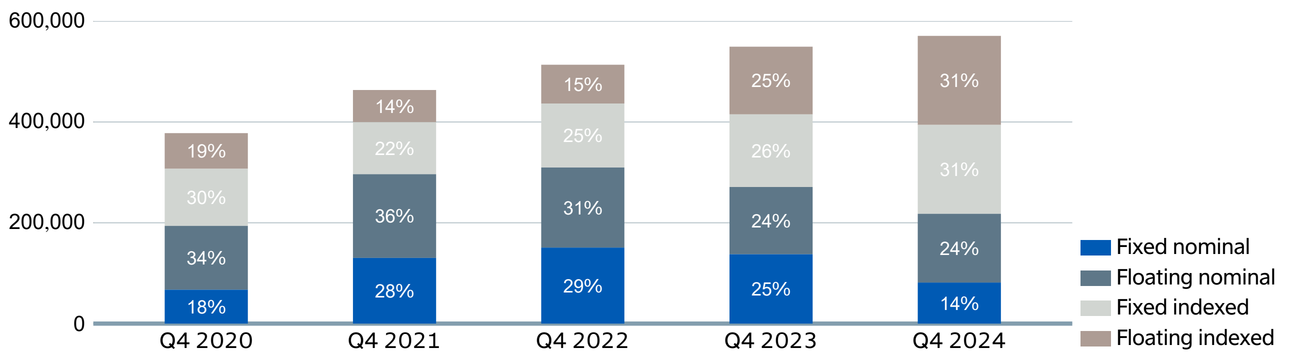
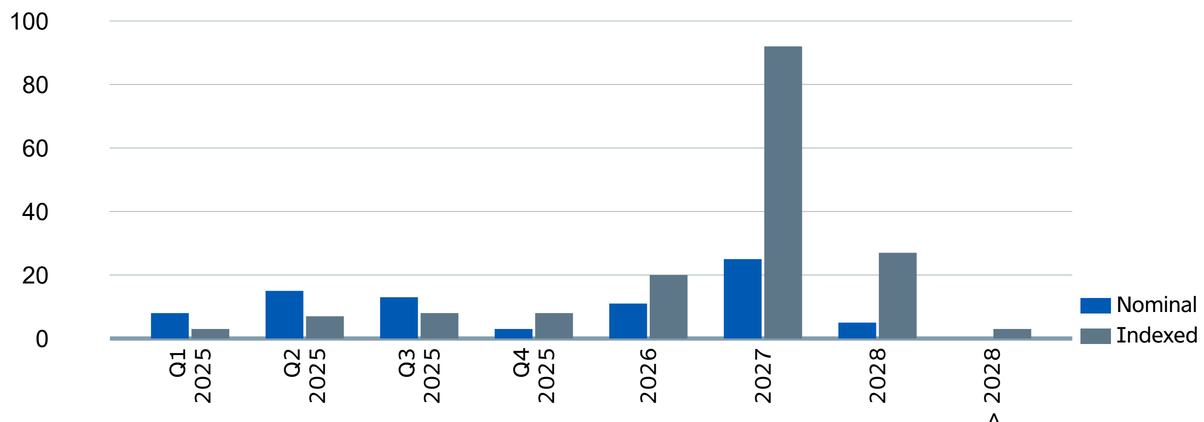


Figure 4.15 also shows the development of fixed nominal-rate residential mortgages. Demand for this product picked up significantly when interest rates started to rise in 2021, a trend that has since reversed. The interest rate reset profile for fixed rate mortgages can be seen in Figure 4.16, where the bulk of fixed indexed-rate loans are scheduled to reset in 2027.

Figure 4.16 Interest rate reset profile for fixed rate mortgages [ISK bn]



The Bank regularly carries out analysis of its mortgage portfolio to forecast the potential impact from interest rate resets on customers' credit quality. The most recent analysis was conducted in Q3 2023 and showed that monthly payments increase by 62% on average and that 64.6% of borrowers that had a positive credit assessment at origination of the loan would have maintained the assessment after the interest rate reset. If borrowers with a negative credit assessment choose to refinance with index-linked loans, 96.5% would achieve positive assessment.

To support borrowers nearing their reassessment date, the Bank has introduced capped interest payments where the remaining interest is applied to the principal.

Impairment and Provisions

Provisions for credit loss are made according to the IFRS9 three-stage expected credit loss model. For credit impaired loans, Stage 3 provisions are made based either on a portfolio level assessment or by individual assessment of credits, depending on the size of the exposure and other factors which affect whether an individual assessment is warranted. For loans that are not impaired, provisions are either made for a 12-month expected credit loss (Stage 1) or a lifetime expected credit loss (Stage 2). Expected credit loss calculations are based on the borrower's probability of default (PD), loss given default (LGD), and the exposure at default (EAD).

For corporate exposures, a cross-default approach is applied, i.e. if a corporate borrower has one impaired credit then all exposures to this borrower are moved to Stage 3 and classified as risk class 5 (DD rating). For individuals, the same applies within each credit model portfolio and a default in one portfolio can result in a default in other portfolios if the defaulting exposure is significant.

The level of detail for credit monitoring depends on the size of the exposure, where factors such as delinquency by the borrower, forbearance measures, and the internal credit rating (see Section 4.5) are considered. For larger borrowers, interviews with account managers are also conducted.

For further information on the measurement of impairment, see Note 59 on Expected credit losses in the Bank's Consolidated Financial Statements for 2024.

Past Due Exposures

Figures 4.17 and 4.18 show the development of past due exposures from year-end 2017 for individuals and corporates at facility level and cross-default level. Until 2020 cross-default at obligor level is shown, but since the introduction of a new definition of default it is more relevant to study exposure in Stage 3. In order to show the effects of this change in perspective, both values are shown for two years. Stage 3 exposures for loans to individuals increased in 2024, as did Stage 3 exposures for corporates which have significantly increased in 2024, due to two large single-name defaults.

Figure 4.17 Development of past due exposures to individuals

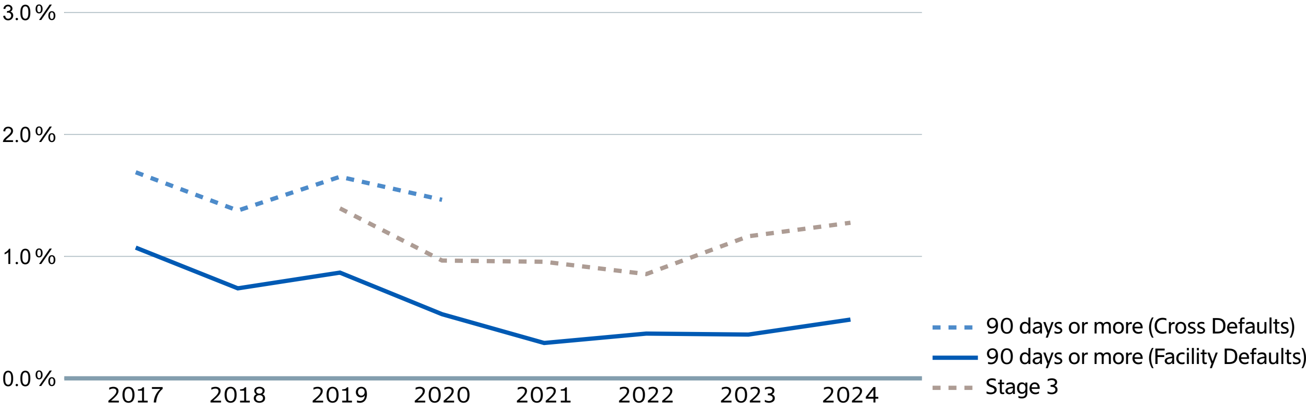
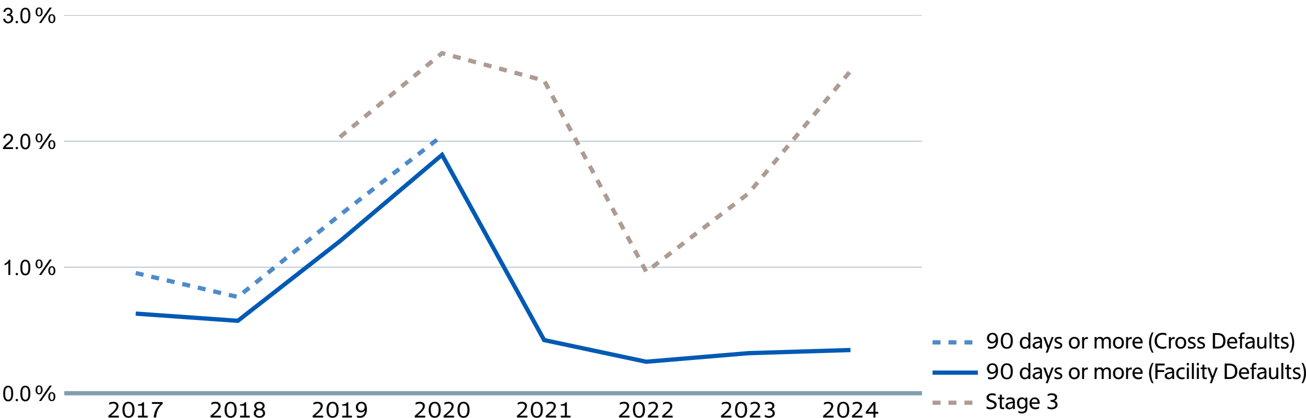


Figure 4.18 Development of past due exposures to companies, parent company



Loans to customers that are 90 days or more past due were 0.41% of the total loan book at year-end 2024 when measured at facility level. The ratio of loans in Stage 3 was 1.9% of book

value, an increase of 0.5 percentage points from year-end 2023. The ratio of loans in Stage 3 was 1.3% for individuals and 2.6% for corporates.

Template EU CQ3 shows credit quality by past due days.

Moratoria and Forbearance

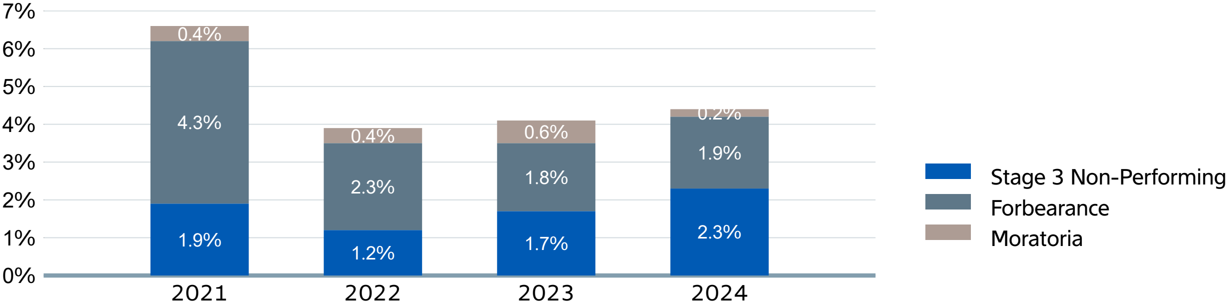
The Bank has adopted the definition of forbearance in Article 47b of the CRR. According to the definition, an exposure is considered forborne if concessions, such as modification of terms or debt refinancing, have been granted due to the client's current or expected financial difficulties and those concessions would not have been granted in the absence of those financial difficulties.

The Bank is willing to consider forbearance measures in situations when a client is unable to comply with terms and conditions due to financial difficulties if there is a realistic possibility that the terms and conditions can be met again. This is especially considered in cases when the Bank and the client have enjoyed a long-standing business relationship.

The decision to apply a forbearance measure is subject to the Bank's credit granting mechanism, as described in Section 4.1, and for potential forbearance cases there is, as a part of the relevant individual's or credit committee's decision, a determination of whether the concession constitutes forbearance.

Credit quality of forborne exposures is shown in templates EU CQ1.

Figure 4.19 Development of Default, Forbearance, and Moratoria. Shown as percentage of total gross carrying amount



Following the earthquakes and volcanic eruptions in the Grindavík region in 2023, the Bank offered moratoria to residential property owners in the region. Most of the owners accepted the moratoria.

In Figure 4.19 moratoria due to summer holiday, maternity leave, job loss and moratoria due to events in Grindavík are all listed under Moratoria.

The gross carrying amount of stage 3 exposures increased from 1.7% in 2023 to 2.3% in 2024, mainly due to exposures in the construction sector. Then decrease in moratoria from 0.6% in 2023 to 0.2% in 2024 is primarily due to fewer people needing moratoria because of job loss, additionally no one has a moratorium due to events in Grindavík at year-end 2024.

For further information, see Note 44 on forbearance in the Bank's Consolidated Financial Statements for 2024.

Expected Credit Loss

The 12-month expected credit loss (ECL) is defined as the amount of credit loss that the Bank expects, on average, in the next twelve months. The Bank accounts for expected credit loss according to the IFRS9 three stage model. In addition, the Bank holds capital to be able to meet unexpected loss.

The Bank has developed an ECL model for IFRS9 calculations. This model is also used for 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 credit loss is calculated using the formula $ECL = PD \cdot LGD \cdot EAD$ where each credit exposure's ECL is derived from the facility's probability of default (PD), loss given default (LGD), and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see Section 4.5. For impairment calculations, ECL values are calculated in several different scenarios and the impairment is based on the weighted average ECL.

The main components of LGD are:

- the cure-rate of the exposure, which describes the probability that the customer returns to a non-defaulting status, without a write-off and any loss occurring for the Bank, within 18 months from the default event
- the collateral gap of the defaulted exposure, with haircuts based on historical evidence and expert judgment
- assessment of recoveries of defaulted non-collateralized exposures, conditional on non-cure

The main components of EAD are:

- the expected outstanding amount at a given time in respect to the repayments schedule
- the expected prepayment to be made based on historic values

Table 4.8 shows the 12-month Expected Loss rate for different customer and exposure classes for exposures in Stage 1 and Stage 2. The PD and LGD values are weighted by the corresponding exposure, taking off-balance sheet items into account. The ECL values shown are impacted by the IFRS9 macro-economic forecasts.

Table 4.8 Expected credit loss by exposure type

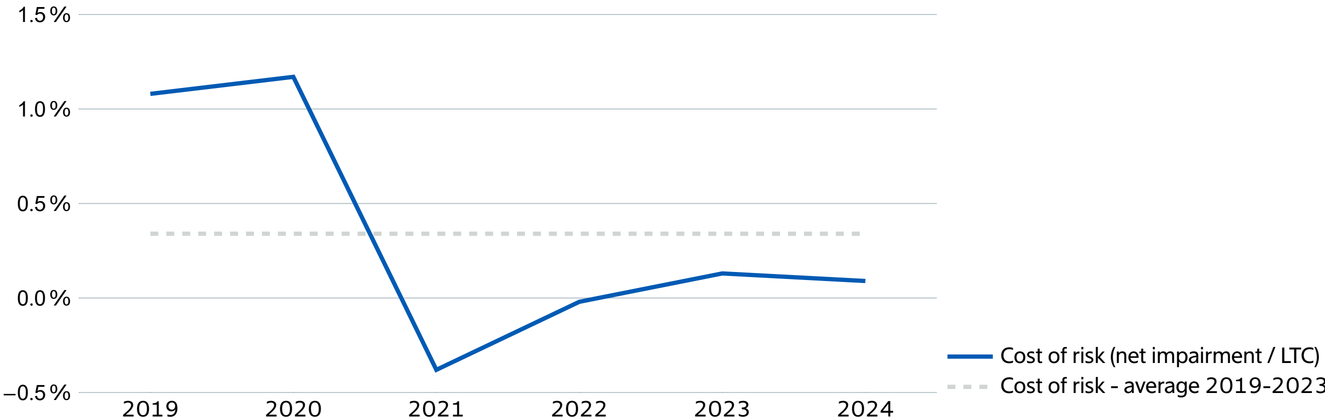
31 December 2024	PD	LGD	EL
Corporates - Large	1.7%	10.1%	0.4%
Corporates - Retail	2.9%	8.8%	0.6%
Corporates - Other	2.5%	20.8%	0.8%
Individuals - Mortgages loans	0.5%	1.8%	0.0%
Individuals - Other	1.3%	32.0%	0.8%
Weighted average	1.3%	8.0%	0.3%

31 December 2023	PD	LGD	EL
Corporates - Large	1.5%	9.8%	0.4%
Corporates - Retail	2.7%	8.0%	0.5%
Corporates - Other	2.3%	23.4%	0.9%
Individuals - Mortgages loans	0.5%	2.1%	0.1%
Individuals - Other	1.5%	31.9%	0.8%
Weighted average	1.2%	8.0%	0.3%

To provide a long-term view on the Bank's credit losses, the so-called cost of risk measure can be calculated. This is defined as the net impairment from the income statement divided by the average book value of loans to customers at the beginning and the end of the year. Since macro-economic forecasts affect the calculation of the impairment under IFRS9, this measure is rather volatile in the short term but such volatility is averaged out over a longer time horizon.

Figure 4.20 shows the development of the cost of risk for the years 2019–2024 for the parent company, along with the average value. The average is 0.34%. The cost of risk measure is shown for the parent company to better reflect historical credit losses, as in some cases the Bank takes over and consolidates a failed company, after which further losses do not go through the Group's net impairment line.

Figure 4.20 Cost of Risk development



Problem Loans

The Bank has implemented EBA Guidelines 2016/07, which provide a further explanation and details of the definition of default in Article 178 of the CRR. The Bank's implementation complies with the guidelines and is suited to the Bank's size and procedures. The guidelines require the Bank to consider the co-debtor group for a facility and a cross-default mechanism if the obligor is in default on a large obligation.

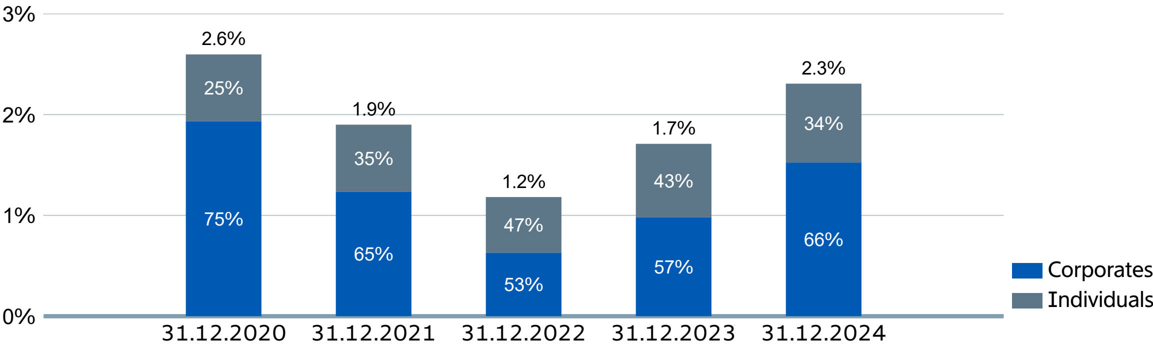
The definition can be divided into three types of default; unlikely to pay, 90 days past due and cross-default, and probation with or without forbearance. Default is considered on an obligor level for companies. For individuals, default is considered on the level of each PD model and cross default on an obligor level applies when the exposure in default is significant.

For 90 days past due, the amount in arrears must be above a relative threshold of 1% and an absolute threshold of ISK 15,000 for retail exposures and ISK 75,000 for other exposures.

The Bank has aligned its definition of problem loans with IFRS9. Problem loans are defined as loans in Stage 3 and the problem loans ratio is calculated based on the gross carrying value of loans. At year-end 2024, the problem loans ratio for the Bank is 2.3% of the loan portfolio and has increased since the end of 2023 from 1.7%.

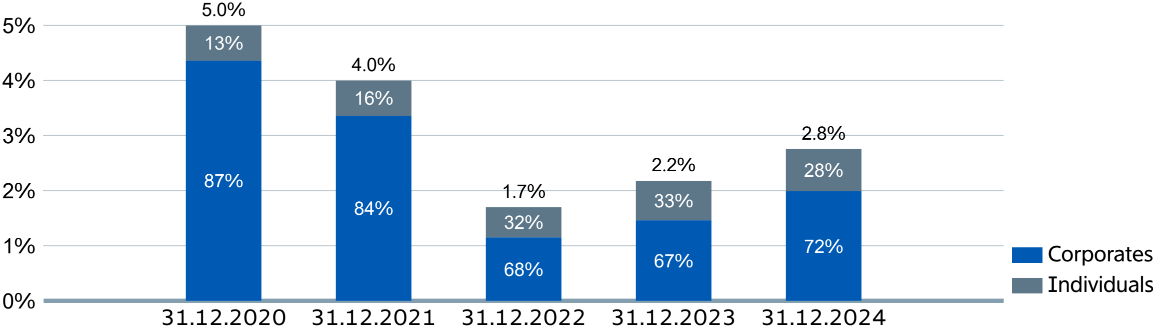
At year-end 2024, 66% of problem loans are, by value, loans to corporates and 34% to individuals.

Figure 4.21 Development of problem loans (Group)



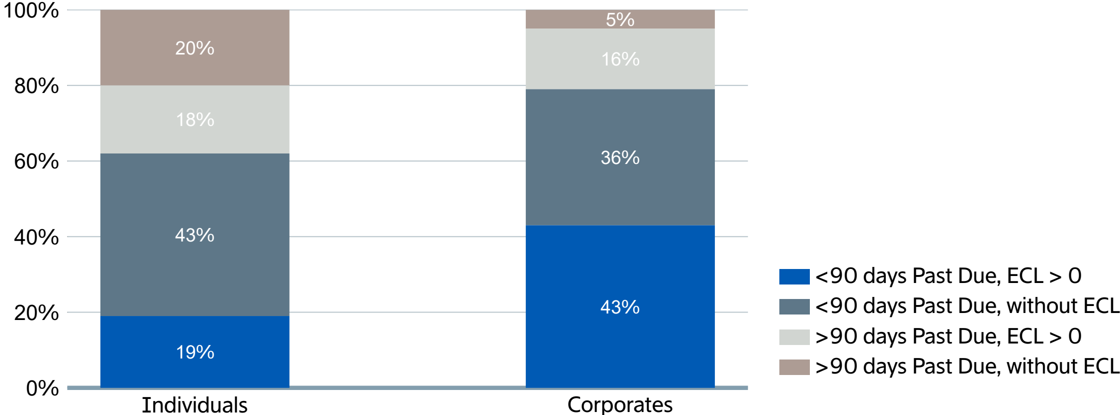
In Figure 4.20, the cost of risk for the parent company is shown and, for comparison, the development of problem loans for the parent company is shown in Figure 4.22. This is done to show companies that have been consolidated during the collection and restructuring processes. At year-end 2024, the problem loans ratio for the parent company is 2.8% of the loan portfolio and has increased since the end of 2023 from 2.2%.

Figure 4.22 Development of problem loans (Parent company)



The breakdown of problem loans by status is shown in Figure 4.23. Around 48% of the problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

Figure 4.23 Breakdown of problem loans by status



4.7 Counterparty Credit Risk

Counterparty credit risk is the risk of the Bank's counterparties in derivative transactions, securities financing transactions, securities lending, or repurchase agreements defaulting before the final settlement of the contracts' cash flows.

The Bank offers financial derivative instruments to investors. Table 4.9 shows derivative trading activities currently permitted. The derivative instruments are classified according to primary risk factor and type of derivative instrument.

Table 4.9 Permitted derivative trading activities

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

To limit and control the counterparty credit risk associated with derivatives trading, the Bank requires collateral and sets limits on customer's total exposure. Generally, collateral is required to cover potential future 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. These exposure limits are generally client-specific and may refer specifically to different categories of contracts.

Note 25 in the Bank's Consolidated Financial Statements provides a breakdown of the aggregate underlying notional and fair value by derivative type.

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. The REA for counterparty credit risk is calculated using the standardized method introduced in CRR II. This accounts for the replacement cost, potential future exposure, and the credit mitigation from collateral. For further information see e.g. tables EU CCR3 and EU CCR5 in the Bank's Pillar 3 Additional Disclosures for 2024.

5

Market Risk

Market risk is defined as 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 balance sheet imbalances on the banking book and trading positions in bonds, equities, currencies, derivatives, and any other commitments depending on market prices and rates.

The primary market risk factors are interest rate risk, indexation risk, equity risk and foreign exchange risk.

Risk exposure amount (ISK)

15.8 bn (15.8 bn)

Trading book 10-day 99% VaR (ISK)

323 mn (531 mn)

Indexation imbalance (ISK)

199 bn (105 bn)

Contents

5.1 Governance and policy
5.2 Market risk management
5.3 Market risk measurement
5.4 Capital requirements
5.5 Foreign exchange risk
5.6 Indexation risk
5.7 IRRBB
5.8 Trading book

5 Market Risk

5.1 Governance and Policy

The Bank's market risk policy and market risk appetite are established by the Board of Directors and reviewed on an annual basis.

In accordance with the market risk policy, the Bank's CEO has set up a market risk framework, which outlines responsibilities, rules, and limit framework. On the management level, ALCO is the principal authority for management and monitoring of market risk.

According to the policy, the Bank invests its own capital on a limited and carefully selected basis in transactions, underwritings, and other activities that involve market risk. The Bank aims to limit market exposure and imbalances between assets and liabilities in balance with its strategic goals for net profit.

5.2 Market Risk Management

Market risk controls vary between trading and banking (non-trading) books where the trading book holds positions with trading intent, according to the CRR, that are actively managed on a daily basis. The limit framework for the trading book is explicit and subject to daily monitoring, while such a framework does not apply to the banking book due to the nature of the exposure. 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.

Table 5.1 Sources of market risk

Origin	Source	Risk Management
Trading Book	Positions held for market making and proprietary trading purposes. Trading derivatives and associated hedge positions managed within Treasury and Capital Markets.	Risk appetite portfolio limits and value-at-risk limits. Specific position limits and hedging requirements. Daily monitoring and ALCO oversight.
Banking Book	Balance sheet imbalances, e.g. mismatches between assets and liabilities in terms of currency denomination, indexation, and term fixing of interest rates.	Risk appetite limits. Internal pricing, natural hedging, derivatives hedging. Monthly monitoring and ALCO oversight.

Risk Management is responsible for measuring and monitoring market risk exposure and compliance with the limit framework. The performance, exposure, and relevant risk measures for the trading book are summarized and reported to the relevant employees and managing directors on a daily basis. Exposures and relevant risk measures are reported on a regular basis to ALCO, BRIC, and the Board of Directors.

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 5.2.

Table 5.2 Market risk measurement methods

Market risk type	Measurement methods
Equity risk	Exposure to equity is measured with net and gross positions. VaR and stress tests are used to assess risk of loss under current and severe circumstances. Indirect positions are also monitored, e.g. equity collateral.
Interest rate and indexation risk	Interest rate and indexation risk is quantified as the change in fair value and/or variability in net interest income, after simulating changes to yield curves and CPI. This is done for all positions sensitive to interest rates. Prepayment risk and behavioral duration of non-maturing deposits is reflected in the Bank's models.
Foreign exchange risk	Foreign exchange risk is quantified using the net balance of assets and liabilities in each currency. This includes current positions, forward positions, delta positions in FX derivatives, and the market value of derivatives in foreign currency. The VaR method is used to quantify possible losses.

5.4 Capital Requirements

The Bank's capital requirements for market risk under Pillar 1 are calculated using the standardized method as defined in CRR. They are summarized in template EU-MR1.

Table 5.3 Market risk minimum capital requirement (EU MR1)

31 December 2024 [ISK m]	REA	Capital requirement
Outright products		
Interest rate risk (general and specific)	5,165	413
Equity risk (general and specific)	7,681	615
Foreign exchange risk	2,947	236
Commodity risk		
Options (non-delta)		
Securitization (specific risk)		
Total	15,793	1,263

As part of the ICAAP, the Bank considers various market risk factors where the Pillar 1 capital requirement may not be sufficient. Additional capital may be needed for foreign exchange risk, interest rate risk in the banking book which includes indexation risk, and the risk that a prolonged stressed period leads to losses from trading book activities.

5.5 Foreign Exchange Risk

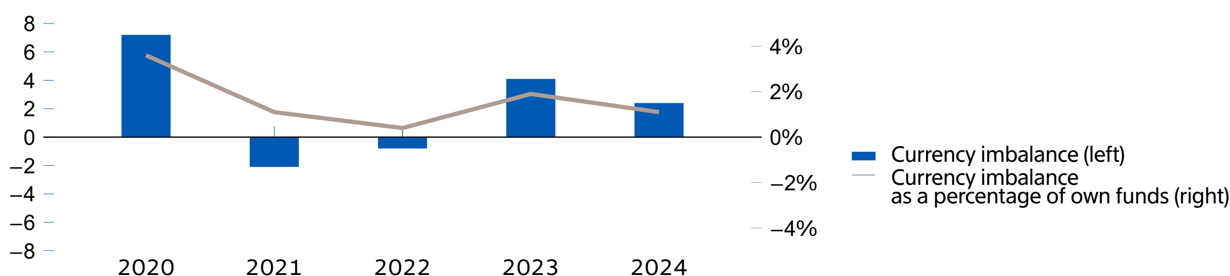
Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to imbalances between assets and liabilities for different currencies.

Table 5.4 Net position of assets and liabilities by currency and Value-at-Risk results

Foreign currency [ISK m]	Net Exposure	10 day 99%VaR
EUR	2,248	35
USD	537	15
DKK	-70	1
SEK	-447	13
Other	101	7
Diversification	-	-29
Total	2,369	42

At year-end 2024, the Group's currency imbalance was 1.1% of total own funds. According to the Central Bank's rules No. 784/2018, the currency imbalance may not exceed 10% of total own funds or ISK 25bn, whichever is lower.

Figure 5.1 Development of the Bank's Currency imbalance [ISK bn]



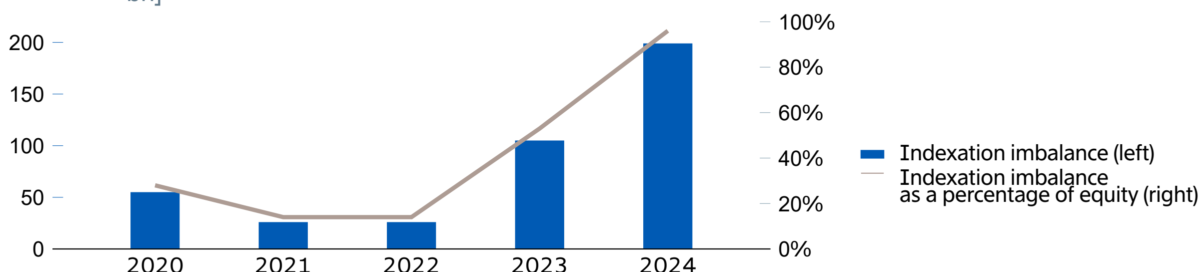
5.6 Indexation Risk

Indexation risk is defined as the risk of loss in earnings 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 year-end 2024, the total amount of CPI-linked assets was ISK 505.0 billion and the total amount of CPI-linked liabilities was ISK 305.6 billion. Therefore, the net CPI-linked imbalance was ISK 199.3 billion.

Figure 5.2 Development of the Bank's Indexation imbalance [ISK bn]



The indexation imbalance of the Bank's consolidated situation, which excludes insurance operations, and is the scope of prudential requirements for which these disclosures apply, was ISK 181.4 billion at year-end 2024.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. In the period from 2014 to 2020 inflation was around or below the Central Bank of Iceland target inflation of 2.5%. In 2021, inflation started rising again and peaked at 10.2% in February 2023. Inflation has since decreased and measured 4.8% at year-end 2024. 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.

5.7 Interest Rate Risk in the Banking Book

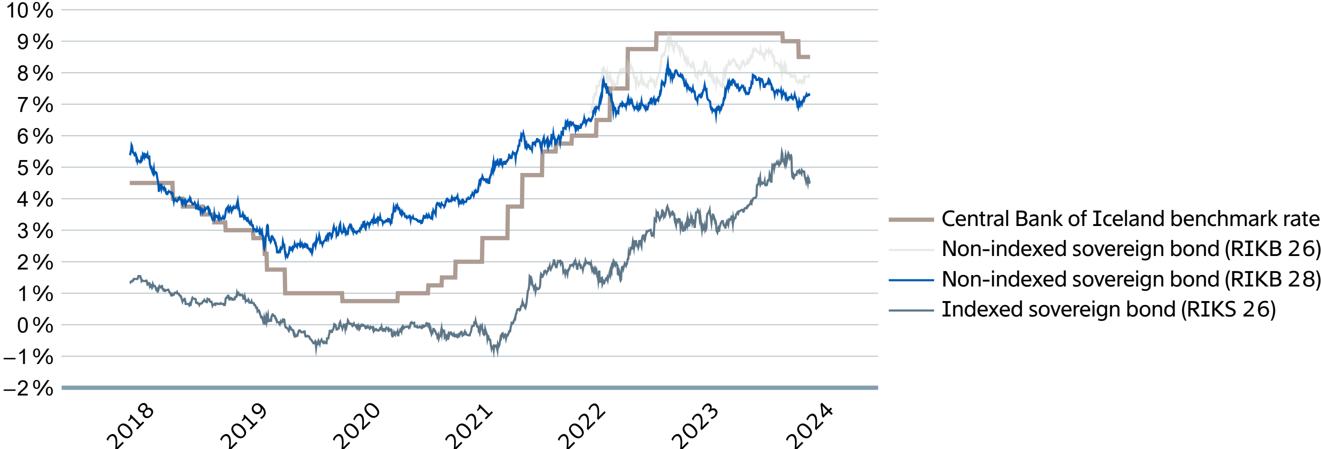
Interest rate risk is the risk of loss through changes in fair value or net interest income caused by changing interest rates. The Bank's balance sheet is subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods.

The Bank's strategy for managing interest rate risk is to strive for a balance in the interest-fixing profile between assets and liabilities.

The Bank's interest rate risk for foreign currencies is limited as foreign-denominated assets predominantly have short fixing periods and the Bank generally applies cash flow hedging for its foreign-denominated fixed-rate borrowings. For domestic rates, longer fixing periods are more common.

Prior to and during the COVID-19 pandemic, as interest rates declined and refinancing conditions improved, there was a surge in prepayments and loan refinancing. Many customers shifted from fixed-rate to floating-rate loans, leading to a reduction in the average duration of the Bank's assets and putting pressure on the Bank's net interest income due to tighter margins on deposit funding. However, following the pandemic, interest rates rose, and many customers quickly moved back to fixed-rate loans, which increased the average duration of the Bank's assets and increased the Bank's interest rate risk for nominal rates.

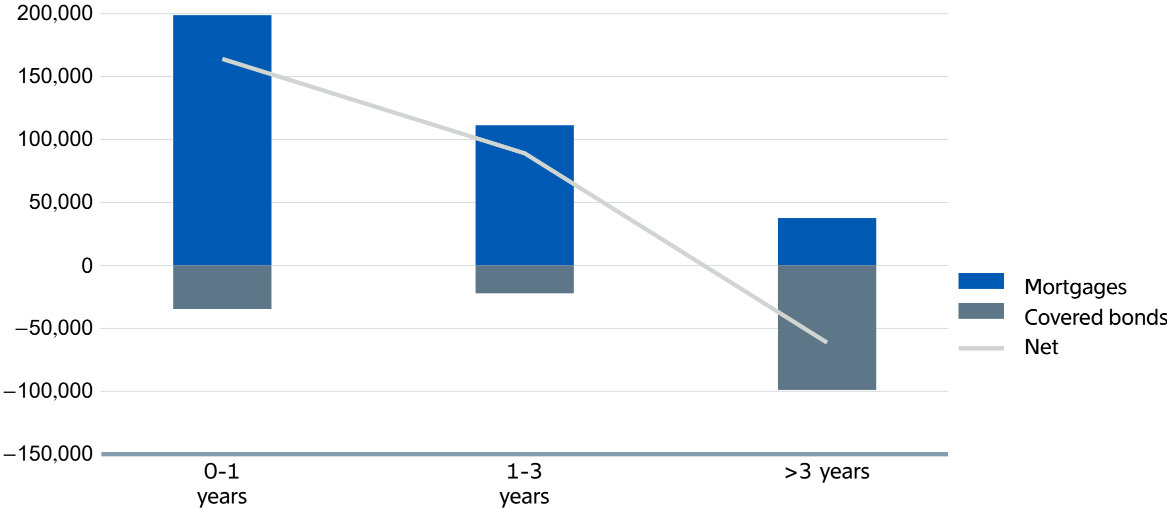
Figure 5.3 Development of the Central Bank of Iceland benchmark rate and yields of sovereign bonds



As the Central Bank policy rate increased from 0.75% to 9.25% from mid-2021 to August 2023, the appetite for fixed-rate loans has receded significantly. This has resulted in a decrease in the average duration and lower interest rate risk for nominal rate assets. Although the policy rate has since decreased to 8.0% (at time of writing) and inflation concerns subside, the payment burden remains heavy for non-indexed floating-rate loans. Consequently, demand for indexed loans has increased as these offer lower monthly payments. However, as the demand has predominantly been for floating rate loans, interest rate risk for the indexed profile has increased as fixed-rate covered bonds issuances have not been matched on the asset side.

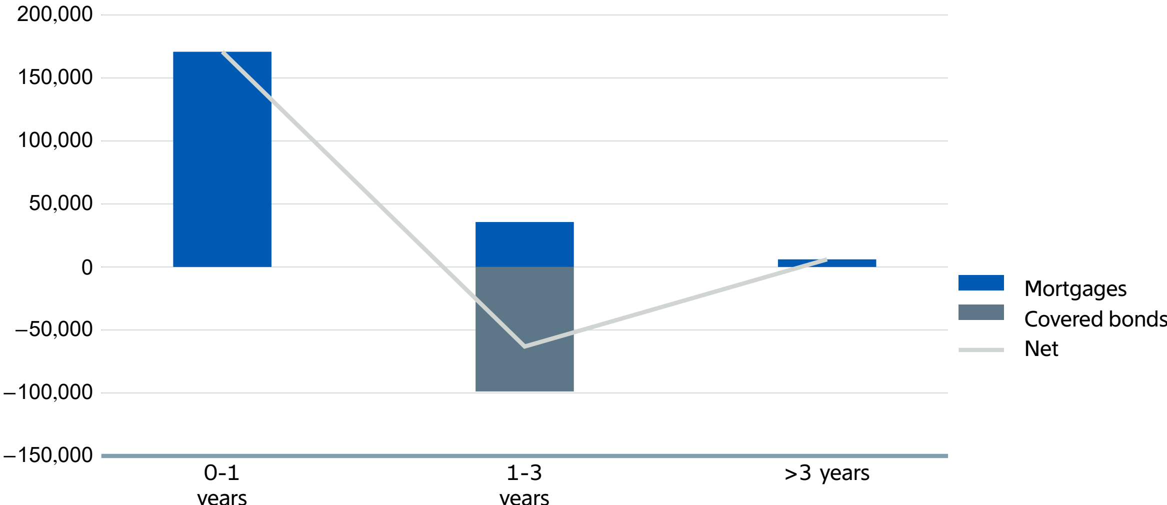
For a breakdown of the Bank's interest-bearing assets and liabilities by interest-fixing periods, see Note 45 of the Consolidated Financial Statements.

Figure 5.4 Interest fixing profile of the Bank's indexed mortgages and covered bonds [ISK m]



Figures 5.4 to 5.5 show the Bank's interest fixing profile for the Bank's mortgages to individuals and covered bonds, indexed and non-indexed.

Figure 5.5 Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]



The fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts is shown in table 5.5. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched liabilities and the expected behavior of non-maturing deposits. For non-maturing deposits, the longest repricing maturity is 3 years and the average repricing maturity of core non-maturing deposits is 1.5 years. Note that the Bank's book value is not affected in the same way as the fair value. Fixed-rate loans rose in response to the low interest rates observed in 2020 and 2021. However, with the sharp increase in interest rates in 2022 and 2023, the Bank has become increasingly mindful of the sensitivity to fair value changes.

Table 5.5 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book by interest rate base

	2024		2023	
31 December [ISK m]	-100bps	+100bps	-100bps	+100bps
ISK, CPI index-linked	-1,724	1,652	-1,855	1,721
ISK, Non index-linked	-2,181	2,146	-1,487	1,462
Foreign currencies	-229	197	-418	416

In EBA Guidelines EBA/GL/2018/02, six supervisory shock scenarios are defined for changes in interest rates. These are called parallel up, parallel down, flattener, steepener, short rates up, and short rates down. Template EU-IRRBB1 shows the effect these shocks would have on the net fair value of the Bank's assets and liabilities and the Bank's net interest income should they occur. New guidelines on IRRBB and regulatory technical standards on IRRBB standardized approach and supervisory outlier tests have been developed by the EBA based on authority granted in CRD V. They are based on the same principles as the current guidelines and will form the basis for the SREP assessment for IRRBB.

The capital assessment for interest rate risk in the banking book for domestic rates is calculated through simulations of nominal and real yield curve movements and the value of the CPI. The dynamics between interest rates and the CPI are calibrated to historical data and economic fundamentals. Significant diversification is observed due to the relationship between inflation and nominal rates. Prepayment rates are dynamic in the model as changing interest rates affect customers' repayment spreads. Economic capital is the 1% worst loss due to fair value losses or loss to net interest income. For foreign currencies, the Bank applies a 200bps shock interest rate hike.

5.8 Trading Book

The trading book is defined as the Bank's positions held with trading intent, which includes market making and proprietary trading positions as well as 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 offered to the Bank's

customers to meet their investment and risk management needs. Financial instruments in the trading book are exposed to price risk, i.e. the risk of possible losses from adverse movement in the market prices at which securities in the Bank's possession are valued.

Market Making and Proprietary Trading

Securities positions in relation to the Bank's market making and proprietary trading activities are shown in Table 5.6.

Table 5.6 Positions within the Bank's market making activities and proprietary trading

31 December [ISK m]	2024	2023
Bonds	9,642	7,377
Equity	3,737	3,115
Total	13,379	10,492

Market making and proprietary trading are 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 2024 average and maximum exposure in both equity and bonds.

Table 5.7 The Bank's proprietary trading exposure

	Bonds		
31 December 2024 [ISK m]	Long	Short	Net
Year-end	9,642	0	9,642
Average	10,740	-57	10,683
Maximum	17,356	-798	17,356

	Equity		
31 December 2024 [ISK m]	Long	Short	Net
Year-end	3,737	0	3,737
Average	3,755	-7	3,748
Maximum	4,620	-66	4,603

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.

Trading derivatives are subject to a rigid limit framework where exposure limits are set per customer, per security, per interest rate etc. Forward contracts on securities are traded within Capital Markets and bear no direct market risk since they are fully hedged. Commodity swap agreements are also fully hedged. 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.

Table 5.8 Derivatives on the trading book

31 December 2024 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	89	130	482	-352	20,315	Market risk
Interest rate and exchange rate agreements	2	0	50	-50	160	Market risk
Bond swap agreements	28	87	2	85	3,523	Credit risk
Share swap agreements	647	2,596	2,018	578	20,877	Credit risk
Commodity swap agreements	0	0	0	0	0	Credit risk
Options	0	0	0	0	0	Market risk
Total	766	2,813	2,551	262		

31 December 2023 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	135	308	178	130	30,239	Market risk
Interest rate and exchange rate agreements	4	4	67	-63	938	Market risk
Bond swap agreements	24	67	50	16	2,070	Credit risk
Share swap agreements	516	3,062	1,029	2,033	24,766	Credit risk
Commodity swap agreements	19	15,505	15,280	225	69,720	Credit risk
Options	4	1	1	0	18	Market risk
Total	702	18,947	16,606	2,341		

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 4.7.

Trading Book Risk

The trading book's profit or loss is calculated daily. Table 5.9 shows the 10-day 99% Value-at-Risk for the trading book position at the end of 2024, based on historical data collected over the previous 250 business days. The risk of loss is calculated for each instrument and portfolio within the trading book, as well as for the aggregate portfolio. Loss due to currency risk is not taken into account in the loss distribution as it is addressed in the Bank's VaR calculations for currency risk which covers both the banking book and the trading book.

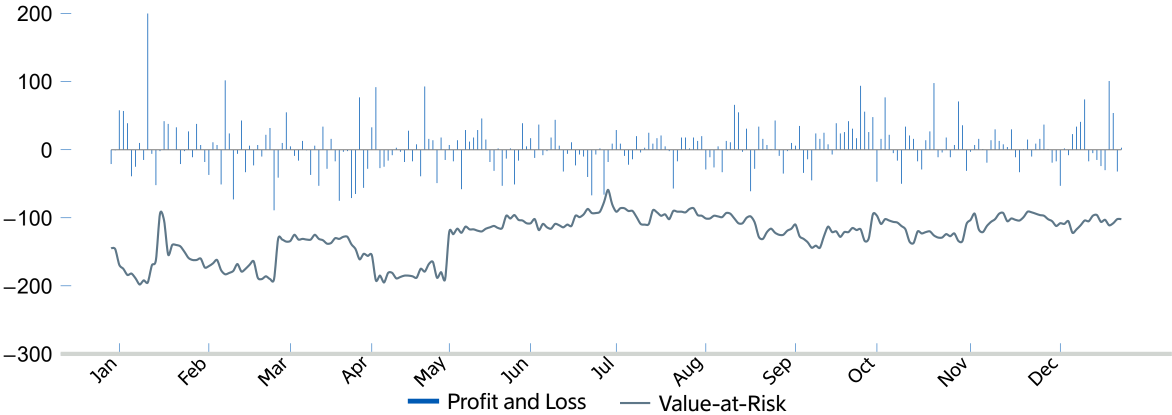
Table 5.9 Value-at-Risk for the trading book with a 99 percent confidence level over a 10-day horizon

31 December 2024 [ISK m]	10 day 99%VaR
Equities	244
Equity options	0
Bonds	201
Bond options	0
Interest rate swaps	1
Diversification effects	-123
Trading book Total	323

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 323 million over a 10-day period.

Figure 5.6 further shows the daily profit and loss of the Bank's trading book for 2024 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss never exceeded the VaR during the 250 business days, but exceeding 2.5 times is to be expected by the risk measure.

Figure 5.6 Backtesting of the Bank's one-day 99 percent Value-at-Risk for 2024 [ISK m]



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 or loss of funding sources. An important source of funding for the Bank is deposits from individuals, corporations, and institutional investors. As the maturity of loans generally exceeds the maturity of deposits, the Bank is exposed to liquidity risk.

Liquidity Coverage Ratio

181% (192%)

Net Stable Funding Ratio

118% (119%)

Asset encumbrance ratio

20% (21%)

Contents

6.1 Governance and policy
6.2 Liquidity risk management
6.3 Liquidity and funding risk measurement
6.4 Liquidity position
6.5 Funding

6 Liquidity Risk

6.1 Governance and Policy

The Bank's liquidity and funding policy and related risk appetite statements are established by the Board of Directors and reviewed annually.

In accordance with the liquidity and funding policy, the Bank's CEO has set up a liquidity and funding framework, which outlines responsibilities, strategy, and methods in relation to the Bank's management of liquidity and funding risk. On the management level, ALCO is the principal authority for management and monitoring of liquidity and funding.

According to the liquidity and funding policy, the Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirements. The Bank maintains a sufficient level of liquid assets to meet expected and unexpected cash flows and collateral needs, without it having adverse financial impact on the Bank. The Bank shall have a funding profile that supports its liquidity profile and allows the Bank to withstand extended periods of stress without reliance on volatile funding or external support. The Bank manages its asset and liability mismatches, seeks a balanced maturity profile, and diversifies its funding between deposits and wholesale funding.

6.2 Liquidity Risk Management

Liquidity risk is a key risk factor for the Bank and is managed accordingly. The Bank's liquidity risk is managed by Treasury on a day-to-day basis and monitored by Risk Management. Treasury provides all divisions with funds for their activities in exchange for an internal interest charge. A small part of the Group's total liquidity risk is due to subsidiaries.

The ALCO is responsible for liquidity management conforming to the policies and risk appetite set by the Board. The committee meets at least monthly to review liquidity reports and make strategic decisions on liquidity and funding matters.

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 at ALCO meetings monthly, liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, stress tests, recovery indicators, and any relevant information or risk management concern regarding liquidity and funding risk.

For best practice liquidity management, the Bank follows the FSA'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 in 2008. The subsequent introduction of standards such as the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) – seen as complementary to the aforementioned guidelines – led to the creation of new regulatory requirements that are key inputs into the Bank's approach to liquidity and funding risk management and discussed in more detailed below.

Internal Liquidity Adequacy Assessment Process

In conjunction with the ICAAP, see Section 3.3, the Bank runs the Internal Liquidity Adequacy Assessment Process (ILAAP) with the purpose of assessing the Bank's liquidity position. The ILAAP is carried out in accordance with the Act on Financial Undertakings 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 liquidity risk.

The Bank's ILAAP report is approved annually by the Board of Directors, the CEO, and the CRO and submitted to the FSA. The FSA reviews the Bank's ILAAP report as part of the SREP.

Contingency Plan for Liquidity Shortage

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.

The Bank's Contingency Plan for Liquidity Shortage is continuously active and the contingency level is reviewed at ALCO meetings monthly, based on various analyses and stress tests. ALCO re-

views a liquidity risk report from Risk Management and receives projections on sources of funding and the use of funds from Treasury.

The contingency plan is linked to the Bank's Recovery Plan which is triggered if recovery indicators indicate a possible recovery situation. In adverse circumstances, the Bank's emergency team takes over control from ALCO.

6.3 Liquidity and Funding Risk Measurement

In December 2010, the Basel Committee on Banking Supervision issued Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the LCR and the NSFR, designed to coordinate and standardize liquidity risk measurements between banks.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions over 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. The LCR is the Bank's key risk indicator for short-term liquidity.

While the focus of LCR is on short term liquidity, the NSFR is aimed at requiring banks to maintain an overall stable funding profile. In the context of 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 their liquidity and maturity, to form a bank's Required Stable Funding (RSF) under NSFR. The ratio of the two gives the NSFR.

According to the Central Bank's Liquidity Coverage Requirements for Financial Institutions, effective 1 January 2023, the Bank must maintain a minimum Liquidity Coverage Ratio (LCR) Total of 100% and a minimum LCR in ISK of 50%. Additionally, there are specific requirements regarding the LCR in EUR whereby the Bank must maintain a minimum LCR EUR of 80% if its liabilities in EUR constitute 10% or more of its overall liabilities.

The Bank is required to maintain a minimum of 100% for NSFR in total and to monitor the NSFR in significant currencies, i.e currencies having at least 5% share of the their total liabilities.

In addition to these regulatory requirements, the Bank monitors and reports its LCR for currencies for which aggregate liabilities exceed 5% of its total liabilities. The Bank reports the LCR on a monthly basis and the NSFR on a quarterly basis to the Central Bank of Iceland.

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

6.4 Liquidity Position

At year-end 2024, the Bank's liquidity buffer amounted to ISK 264,506 million, or 16% of total assets and 31% of total deposits. Composition of the Bank's liquidity buffer is shown in Note 46 of the Bank's Consolidated Financial Statements.

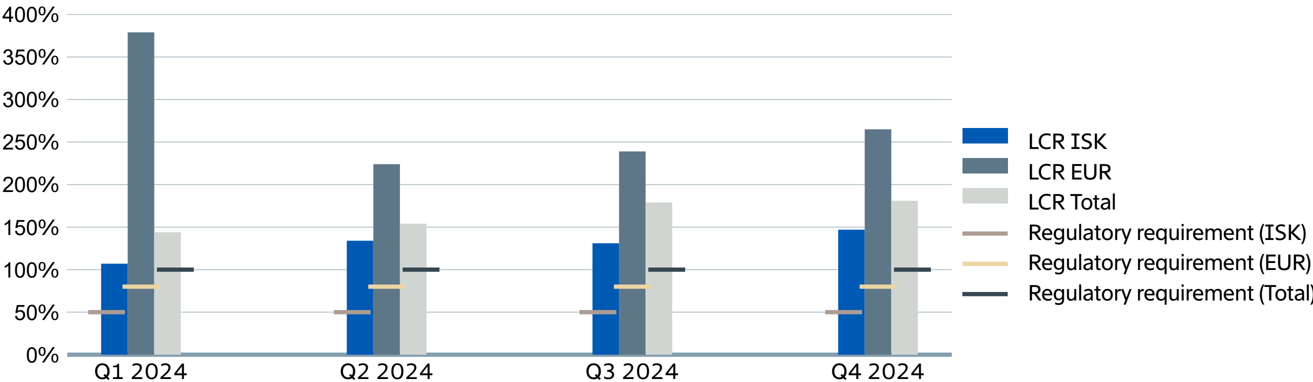
The Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, 181%, 265% and 147% for total, EUR, and ISK, respectively.

Table 6.1 Liquidity Coverage Ratio

31 December 2024	ISK	EUR	Total
Liquidity Coverage Ratio	147%	265%	181%
LCR Central Bank requirements	50%	80%	100%

The Bank maintained a strong liquidity position throughout 2024, in ISK, EUR and in total, with an LCR well above the regulatory minimums. The development of LCR ISK, LCR EUR and LCR Total is shown in figure 6.1. Standardized disclosure on the calculation of the LCR are provided in template EU LIQ1.

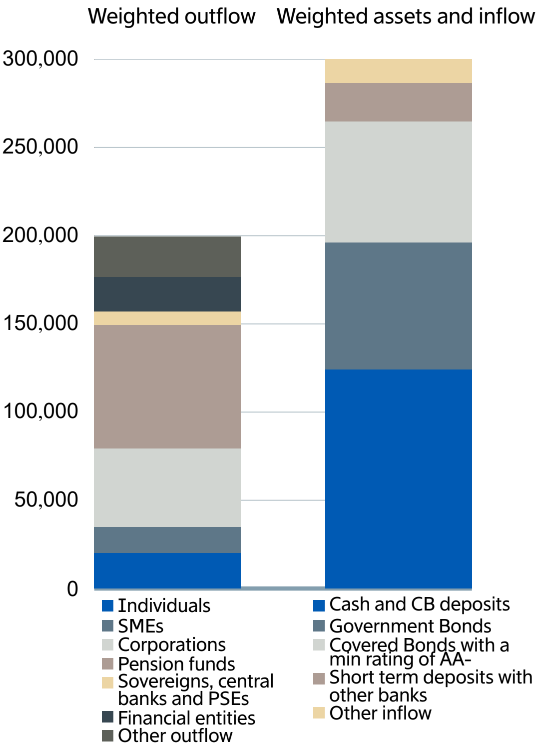
Figure 6.1 Development of the Bank's LCR



Breakdown of LCR

At 31 December 2024, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 317.4 bn, substantially exceeding the weighted outflow of ISK 199.3 bn. Of the total stressed outflow, ISK 176.6 bn are due to deposits which are further analyzed in the following section. Figure 6.2 further shows the contribution of the Bank's main components to the LCR's weighted outflows, inflows, and assets.

Figure 6.2 Weighted outflow, inflow and assets under LCR's stressed scenario as of 31 December 2024 [ISK m]

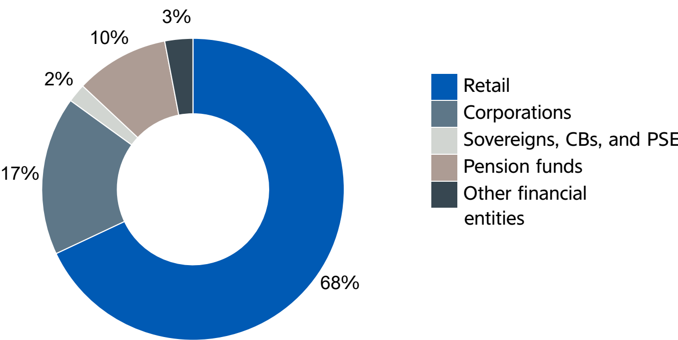


Deposit Categories

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.

At year-end 2024, 68% of the Bank's deposit base is due to retail clients. Figure 6.3 shows the distribution of the Bank's deposit base.

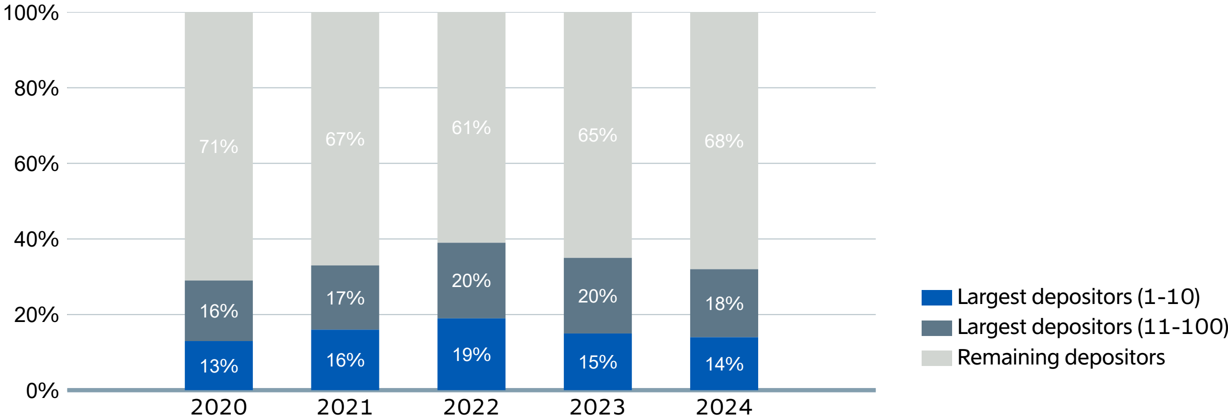
Figure 6.3 Distribution of deposits by LCR category at year-end 2024



Concentration of Deposits

At year-end 2024, 73% of the Bank's deposits mature within 30 days. Of those, 14% belonged to the 10 largest depositors as shown in Figure 6.4.

Figure 6.4 Concentration of deposits on demand within 30 days



6.5 Funding

Over the past few years, the Bank has taken significant steps to diversify its funding options, issuing green bonds in EUR and ISK, covered bonds in euros, as well as unsecured and subordinated bonds in the domestic market. The Bank pursues prudent funding and liquidity management strategies which is reflected in the Bank's strong liquidity ratios and steady maturities of long-term debt over the next few years.

In May 2024, Arion Bank issued EUR 300 million senior preferred notes with a maturity of 4.5 years. The notes pay a coupon of 4.625% which corresponds to a spread of 175bps over mid-swaps in EUR. Demand for the notes was 8.5 times supply and offers were received from around 190 investors from more than 25 countries in Europe and Asia. The final order book was EUR 2.6 billion. The strength of the order book allowed Arion Bank to print the tightest Icelandic bank EUR Senior preferred instrument in more than two years. In September 2024, the Bank issued additional Tier 1 bonds amounting to USD 125 million. The bonds have a fixed coupon of 8.125% and have a standalone and consolidated 5.125% CET1 trigger with equity conversion. Offers were received from more than 35 investors in the United Kingdom, Europe, Asia, and Iceland. The issuance strengthens the Bank's own funds and helps maintain an optimal capital structure.

In October 2024, Arion issued 3-year green senior preferred bonds amounting to NOK 500 million and SEK 500 million. The bonds are floating rate and were priced at a spread of 120bps over 3-month NIBOR and STIBOR.

In November 2024, the Bank issued Tier 2 floating rate bonds for total of SEK 225 million. The bonds have a 10NC5 structure which is callable in five years' time. The bonds are floating rate and were priced at a spread of 265bps over 3-month STIBOR.

In the domestic market, Bank concluded two issues of senior preferred bonds in the series ARION 28 1215. The total issue amounted to ISK 3.32 billion at yields of 4.42% and 5.10%. The series

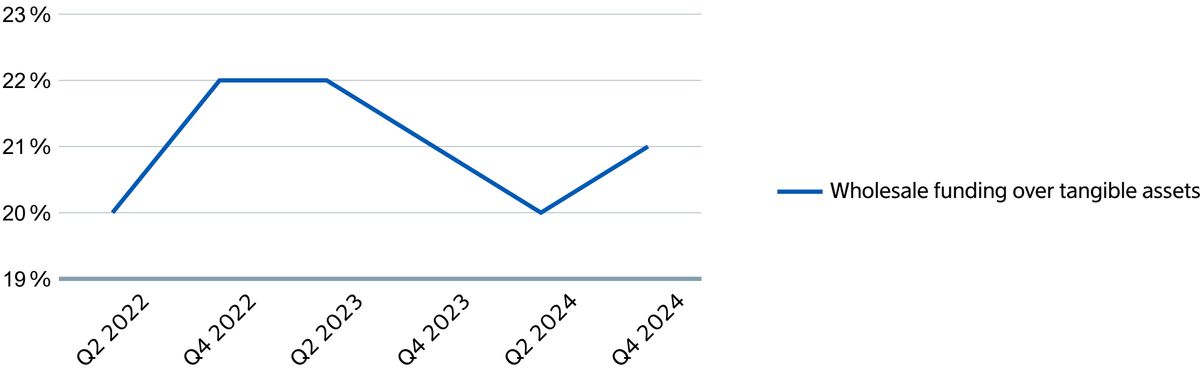
is inflation-indexed and has semi-annual interest payments, maturing on 15 December 2028.

The Bank continued to issue covered bonds secured in accordance with the Covered Bond Act No. 11/2008. In 2024, the Bank issued bonds amounting to ISK 50.7 billion (of which ISK 9.0 billion were for own use).

Arion Bank renewed its agreement with Kvika, Íslandsbanki, and Landsbankinn on market making for covered bonds issued by Arion Bank on Nasdaq Iceland. The purpose of the agreement is to stimulate trading of benchmark covered bonds issued by the Bank.

Moody's Investors Service (Moody's) affirmed the Bank's A3 rating for senior unsecured debt and upgraded its rating for covered bonds from Aa2 to Aa1, following the upgrading of the Icelandic sovereign rating. S&P upgraded the Bank's long-term rating from BBB to BBB+ with a stable outlook. At the end of April, Arion Bank decided to end its rating relationship with S&P Global Ratings and to proceed with Moody's as its sole ratings agency in order to meet the expectations of investors and other stakeholders in terms of high quality, recognized credit ratings.

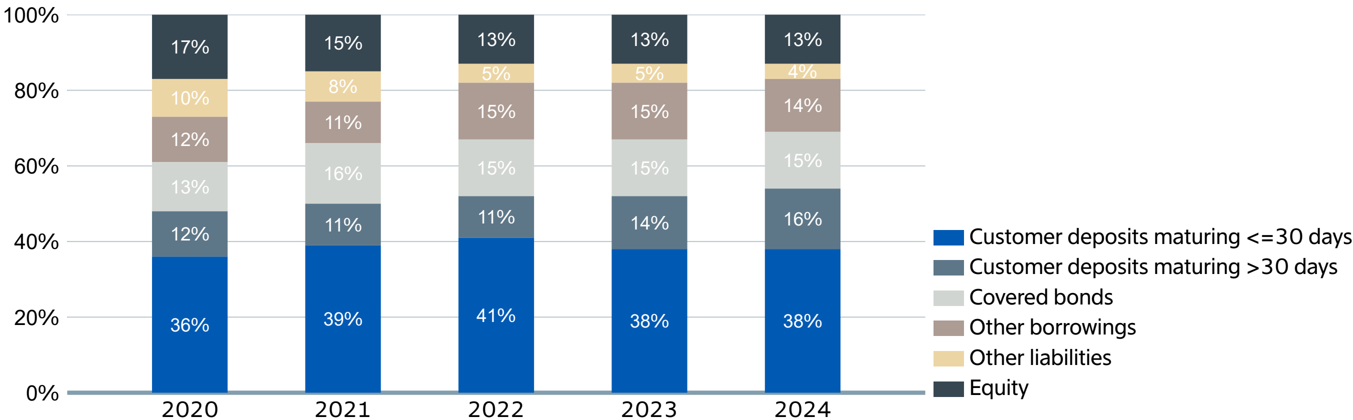
Figure 6.5 Development of wholesale funding over tangible assets



Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base continues to be an important funding source and the focal point of liquidity risk management. The ratio of loans to deposits was 143% as at year-end 2024. The ratio of wholesale funding over tangible assets, meanwhile, was 21%.

Figure 6.6 shows the development of the Bank's funding profile.

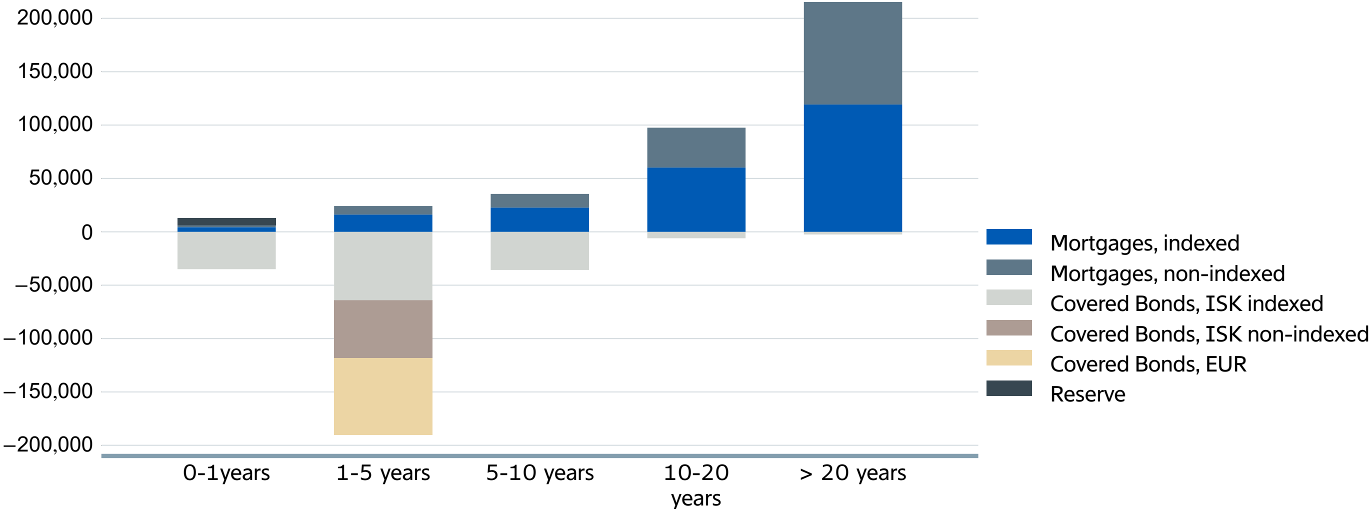
Figure 6.6 Development of funding by type



Secured Borrowings

At year-end 2024, the Bank had an outstanding amount of covered bonds totalling ISK 248 billion. Figure 6.7 shows the contractual payment profile of the Bank's covered bonds and corresponding pledged mortgages. Note that the behavioral maturity of mortgages is generally much shorter than the contractual maturity.

Figure 6.7 Contractual cashflow profile of covered bonds and corresponding pledged mortgages [ISK m]



The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, was 20% at year-end 2024. The development of the asset encumbrance ratio is shown in Table 6.2.

Table 6.2 Development of the Bank's asset encumbrance ratio

31 December	2024	2023	2022
Asset encumbrance ratio	20%	21%	19%

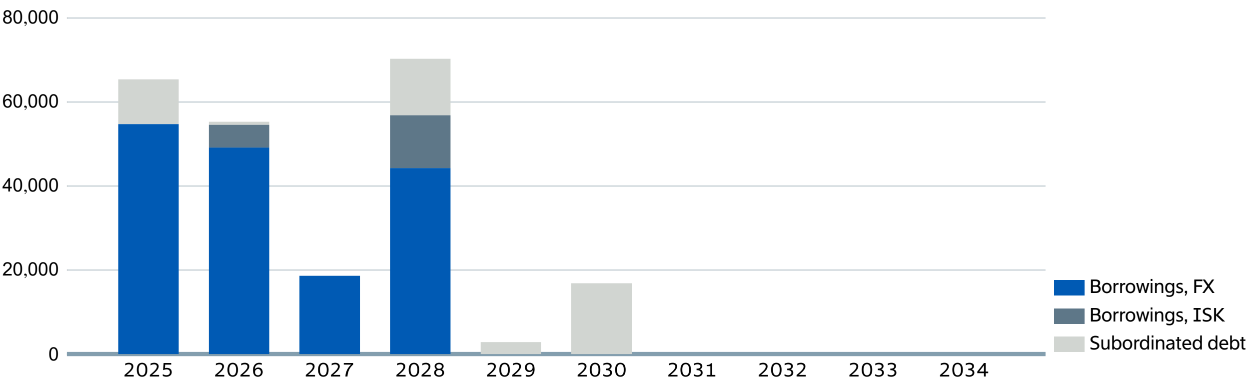
Templates EU AE1, EU AE2 and EU AE3 provide details on encumbered and unencumbered assets and collateral received.

Unsecured Borrowings

Unsecured borrowings are mostly foreign currency-denominated. Figure 6.8 shows the Bank's maturity profile of borrowings other than covered bonds, and includes AT1 instruments. The maturity dates for Tier 2 capital instruments are shown at the earliest callable date.

As the Bank's foreign currency deposits are effectively entirely covered by liquid assets, these other FX liabilities are a source of funding for loans to customers in foreign currency. The maturity of those liabilities is greater than that of the loans, so there is low maturity gap risk for the Bank's foreign currency position.

Figure 6.8 Maturity profile of borrowings, other than covered bonds [ISK m]



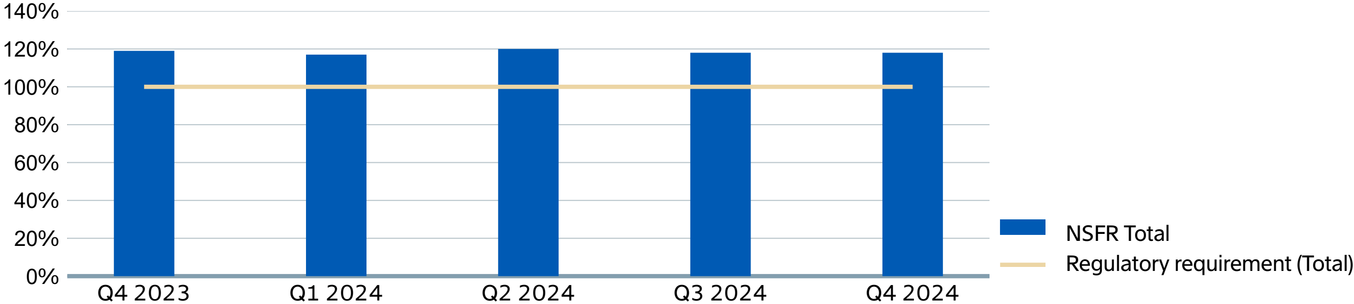
NSFR

The Bank's Net Stable Funding Ratio in all currencies (NSFR-Total) was 118% at year-end 2024, well above the regulatory minimum of 100%. The development of the NSFR over 2024 can be seen in Figure 6.9. Template EU LIQ2 provides details on ASF items and RSF items which are the basis for the calculation of the NSFR.

Table 6.3 Net Stable Funding Ratio

31 December 2024	Total
Net Stable Funding Ratio	118%
NSFR Central Bank requirements	100%

Figure 6.9 Development of the Bank's NSFR



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. Business and strategic risk, model risk, third party risk, business continuity, and IT and Security risk are among other subcategories of operational risk.

Operational risk is managed through a system of risk assessments, controls, loss event analysis, audits and corrective actions, with a focus on key risk areas.

Risk exposure amount (ISK)

106 bn **(98.8 bn)**

Operational loss events

455 **(410)**

Contents

7.1 Governance and policy
7.2 Operational risk management
7.3 ICT risk
7.4 Conduct and regulatory compliance
7.5 Financial crime

7 Operational Risk

In recent years, the Group has put significant effort into the development of a comprehensive operational risk system and framework which has now become operational. The Group has begun building on this foundation that has been established over the past years and is now leveraging the insights it provides. The new framework identifies and centrally registers, in a comprehensive and systematic manner, the dependencies between risks, controls, operational deviations and corrective actions, in relation to products, services, systems, data assets, legal requirements, and processes. The framework supports the Bank in achieving its goals and highlights areas in its operations in need of attention to minimize the risk of direct or indirect loss.

7.1 Governance and policy

The Bank's Operational Risk Policy and operational risk appetite are established by the Board of Directors and reviewed on an annual basis. In accordance with the Bank's Operational Risk Policy, the Bank's CEO has established an operational risk governance structure, which outlines responsibilities, rules and framework for operational risk management. On the management level, the Operational Risk Committee (ORCO) is the principal authority for the management and monitoring of operational risk.

The Bank's Operational Risk Policy aims to reduce the frequency and impact of operational risk events, while balancing costs and advantages. The Bank follows the Basel Committee's Principles for the Sound Management of Operational Risk. Operational risk is managed through a system of risk assessments, controls, loss event analysis, audits and corrective actions, with a focus on key risk areas. For all key risk areas, the Bank reduces its exposure to operational risk with a selection of internal controls, quality management, and well trained and qualified staff.

An operational risk report is generated by Risk Management monthly and presented to the ORCO. The report provides an overview of relevant operational risk indicators and compares them to the risk appetite as approved by the Board of Directors. The report covers operational and compliance risks, such as a summary of deviations and major IT incidents, loss-data analysis, and the state of customer due diligence. Additionally, operational risk is a subject of the Bank's Risk Report, which is presented monthly to the Board Risk Committee (BRIC) and the Board of Directors.

The Bank applies the standardized approach for the calculation of capital requirements for operational risk, for further information see Template OR1 in the Additional Pillar 3 disclosures.

7.2 Operational Risk Management

Operational risk is present across all the Bank's operations. While each business unit is responsible for managing operational risks inherent to their operation by identifying, mitigating, and monitoring risks, Risk Management and Compliance are responsible for developing and maintaining tools to manage those risks. The internal control units monitor and report on the Bank's operational and compliance risks, identifying risk concentrations and promoting a sound risk culture.

The Bank's operational risk management framework aims to integrate risk management practices in day-to-day operations by focusing on key risk areas. The risk structure is set up to enable the Bank to have a holistic and consistent overview of its risk profile and mitigating actions. As second line functions, Risk Management and Compliance serve as a partner to senior management, supporting them on aligning the business environment with the Bank's strategy to maximize potential return for stakeholders in a cost-effective and risk-minded manner.

The Bank maintains various insurance coverages for the Group, its employees, and directors. The insurance coverage limits monetary loss caused by serious unexpected events, wrongful acts or legal liabilities that occur despite other operational risk management procedures.

Operational Risk Management Processes

Risk assessment

The Bank's risk assessment procedures are divided in two stages; top-down assessments and bottom-up assessments. The top-down assessments are performed by management and are holistic, while the bottom-up assessments are performed within each department and are more comprehensive. This ensures that the entire organization is involved in risk management, fostering an effective risk culture.

Through the top-down risk assessment, key risk themes are identified that could hinder the Bank's strategy and objectives. The top-down risk assessments are performed annually, and the results are conveyed to the Bank's divisions for further analysis where they are used as guidance for the bottom-up risk assessment.

Through the bottom-up risk assessment, key risks that could disrupt operational tasks and customer services are identified. This includes assessing risks related to products, services, systems, models, and changes, and addressing the key risk themes previously identified by management in the top-down risk assessment. On an annual basis, the assessments are reviewed and updated to ensure that the Bank's risk registry accurately reflects the Bank's risk profile.

Additionally, bottom-up risk assessments are performed to identify risks arising from specific domains that may introduce either permanent or temporary risks, including products, systems, models, anti-money laundering, outsourcing, and significant projects or engagements.

Control management

Risks that have been identified as inherently significant or high are required to be mitigated with controls. The controls are documented through individual control documentation, processes and procedures built on a uniform methodology to increase efficiency and standardization. The goal is to bring relevant risks to acceptable levels by enhancing risk awareness and implementing mitigating activities.

Internal controls are designed to reduce losses from operational risk events to an acceptable level, thereby optimizing operating efficiencies. Furthermore, controls are designed to ensure compliance with laws and regulations and to deliver and gather reliable information in a timely manner. The Bank's controls are tested and monitored according to their significance.

Employee training is an essential component of the internal control framework aimed at managing risk within the Bank. A comprehensive training program equips employees with the knowledge and skills to effectively carry out their roles and identify and mitigate risks in their environment. The Bank encourages continuous education on laws and regulatory requirements, and the honing of professional and personal skills. Regular and targeted training ensures that employees are informed about emerging risks and best practices, enhancing the bank's risk management culture. Employee training is one of the Bank's KPIs, monitored through a training index based on data from the Bank's training system.

Loss event analysis

Risk management maintains a database of operational deviations that occur in the Bank's day-to-day operation. Deviations are classified as events which lead to direct or indirect monetary losses, or events which could have caused monetary loss but did not. Impact from these events can also be in the form of reputational or regulatory damages. The Bank maintains a no-blame policy when it comes to deviation reporting.

Gathering information on these deviations provides insight into the Bank's operational risk profile and the effectiveness of internal controls. All deviations in the database are categorized as per the Bank's risk taxonomy, based on the standard risk taxonomy developed by the Operational Riskdata eXchange Assocation (ORX), that is used to categorize risk events. This categorization allows the Bank to assess and analyze operational deviations down to specific functions of the operations. For severe deviations, a formal analysis is performed where the root cause of the event is identified and measures to prevent the event from reoccurring are identified.

In 2024, the risk categories Transaction processing and execution, Technology, and Information Security / Cyber accounted for 80% of the total number of reported deviations. However, the risk categories Regulatory compliance and Transaction processing and execution accounted for 99.7% of the total loss amount attributed to operational risk events.

Corrective actions

Any issues arising from operational risk assessments, loss event analysis, control testing, findings resulting from internal or external audits, or regulatory demands are used to enhance the Bank's internal controls and to improve its operational risk profile. Once an issue has been identified and relevant corrective action determined, the work of implementing the action is assigned to a business unit. The business unit is responsible for the completion of the corrective action, while Risk Management and/or Compliance provide the business units with support and guidance.

New Product Approval (NPA)

The Bank's NPA Process aims to ensure that the review and approval of new products and significant changes is conducted in a professional manner, based on a thorough understanding and

application of policies, procedures, and controls. It emphasizes oversight and risk assessments, assuring that risks are identified and considered before implementation, and safeguarding that new products and services align with the Bank's risk profile.

Business continuity

The Bank's Business Continuity Policy aims to ensure continuous operation and service to customers, by implementing preventive measures and establishing documented responses and recovery plans in the event of operational disruptions. Risk management is responsible for regularly carrying out business impact analyses (BIA), where the potential impact of severe business disruptions is evaluated, and an appropriate response is defined.

As part of this effort, a list of the Bank's critical banking services (CBS) has been established, which informs the activation of the business continuity plan (BCP) during emergencies. The list of CBSs is reflected in the Bank's risk management system, and provides an overview of systems which the CBS' are dependent on. The list and dependencies are reviewed and updated at regular intervals along with the BIA.

Outsourcing (third-party risk management)

By managing outsourcing and third party risk, the Bank aims to ensure that risks related to third parties are appropriately identified, assessed and mitigated before entering into, during, and when exiting an outsourcing agreement. Outsourcing agreements are subject to the Bank's outsourcing rules, which are based on EBA Guidelines on outsourcing arrangements and the Central Bank's Financial supervision's guidelines regarding the risk management of information systems for supervised entities.

Model risk

The risk arising from the use of models is managed through various implemented controls, including model monitoring and validation. Models are validated at predetermined intervals, where the timing and scope of the validation is determined in a risk-based manner based on the complexity, usage, and significance of each model.

Reputational risk

Managing reputational risk involves considering the potential harm to the Bank's reputation due to operational failures, misconduct, or external events. The Bank's framework for effective management of reputational risk includes the implementation of internal controls, monitoring of reputational risk indicators, and transparent and proactive stakeholder communication. Maintaining stakeholder trust through ethical practices and regulatory compliance, while monitoring and addressing reputational threats, is essential to protect the Bank's market position and ensure sustainability.

7.3 Information and Communication Technology (ICT) risk

The organization's information security strategy is designed to ensure business continuity while safeguarding the confidentiality, integrity, and availability of its data, systems, and services. By adhering to global standards, the Bank underscores its commitment to meeting legal and regulatory requirements for information security. This dedication is evident throughout the organization, promoting a resilient and high-quality data security management system that permeates every operational level and protects the Bank's digital ecosystem.

The Chief Security Officer (CSO) oversees IT and security risk management and monitoring, as well as the day-to-day operations of the Bank's information security framework. Complimenting this, the ORCO is responsible for the oversight of ICT security risk. Together, these entities collaborate to ensure the Bank maintains robust information security management, continuously enhancing its resilience against evolving cyber threats.

The Bank's integration of ISO standards supports a sustainable and robust digital environment, capable of withstanding and recovering from operational disruptions. To uphold the highest levels of security and compliance, the Bank employs the three lines governance model, a structured framework ensuring the quality, efficiency, and effectiveness of its security practices. Each line of defense plays a critical role in risk management and operational oversight, reinforcing the Bank's excellence in information security.

In 2024, the Group achieved a significant milestone by obtaining ISO 27001:2022 certification for the Information Security Management System (ISMS) of Stefnir and Vörður, both under the Arion group. This accomplishment marked the second phase of the Group's broader initiative to achieve full ISO 27001:2022 certification across its operations.

This certification highlights the Group's proactive and strategic approach to managing data security risks. It reflects the Group's commitment to adhering to the best practices and principles of the ISO 27001:2022 standard. Furthermore, this achievement demonstrates alignment with the Digital Operational Resilience Act (DORA), as the Group effectively integrates ISO 27001 controls and processes to meet DORA's regulatory requirements.

7.4 Conduct and Regulatory Compliance

The Conduct and Compliance Policy sets out the principles and standards for conduct and compliance and the management of associated risks at Arion Bank.

Conduct risk is defined as the risk of any action of the Bank, or its representatives, leading to customer detriment or having adverse effect on market integrity, whereas compliance risk is defined as the risk of not complying with applicable rules and guidelines. The Bank has no tolerance for breach of compliance which is systemic, severe, repeated, intentional, or the result of gross negligence, nor misconduct that results in unfair outcomes for its customers, is likely to have material negative impact on market integrity, or the Bank's reputation.

- The key processes for managing conduct and compliance risk are: A process for risk assessment, planning and reporting of conduct and compliance risk
- Suitable procedures and processes, including a detailed process for product development, whistleblowing, and for managing conflicts of interest
- Horizon scanning and change management process
- Providing staff with ready access to training and support on matters relating to conduct and compliance
- Monitoring and testing process.

Staff are expected to conduct themselves with integrity and perform their duties with due skill, care and diligence. Staff is also expected to promptly alert of any suspicion or knowledge of misconduct. Each business unit within the Bank is primarily responsible for managing the conduct and compliance risks inherent in their operation, with the Compliance function acting as a second line, providing support to the business units.

The Bank uses a risk-based approach for managing conduct and compliance risk. The Bank performs regular operational risk assessments, which amongst others assess the relative importance of different legal requirements for the Bank's operations and the effectiveness of controls in place to ensure compliance. Based on this risk assessment, the Board of Directors approves an annual Compliance Plan to prioritize the Bank's risk mitigating measures.

The Compliance function provides quarterly compliance briefs to the BRIC on the execution of the Conduct and Compliance Policy, and an annual report to the Board of Directors. Additionally, conduct and compliance risk meters are included in the Operational Risk Report presented monthly to ORCO, and the Bank's Risk Report presented monthly to the BRIC and the Board of Directors.

The FSA carried out an on-site inspection regarding AML/CTF at the Bank in 2022, with a final report received in April 2023. In the report, the FSA identified and reported deficiencies in the Bank's compliance with the relevant Act and regulations. In June 2024, the matter was concluded based on a settlement whereby the Bank agreed to take remediating actions and pay a fine of ISKm 585. The finalisation of remediating actions has been validated and reported to the FSA by the Bank's Internal Audit Function.

Information on legal cases relating to Arion Bank can be found in the Annual Financial Statements for 2024, available here.

7.5 Financial crime

The Policy on Combating Financial Crime sets out the principles and standards for the Bank's approach on measures against money laundering and terrorist financing, financial sanctions, bribery and corruption. The Bank implements and upholds both domestic and internationally recognized standards in this regard.

The Bank uses a selection of measures to combat financial crime, including:

- A process for financial crime risk assessment, planning and reporting
- Suitable procedures and processes, including a detailed process for customer due diligence, and anti-bribery and corruption procedures

- Providing staff with ready access to training and support on matters relating to financial crime
- Monitoring and testing process, including sophisticated solutions for transaction monitoring, customer screening, and sanctions screening
- A process for reporting suspicious transactions and activities.

Staff are expected to remain aware of financial crime risk through participation in regular training, and to promptly report any suspicious behavior or transactions. Approximately 98% of employees completed mandatory AML/CTF training during the year.

Each business unit within the Bank is primarily responsible for managing the financial crime risk inherent in its operation. The Compliance function is responsible for providing expertise and support, and coordinating, monitoring and assessing the Bank's AML/CTF measures.

The Bank uses a risk-based approach for managing financial crime risk. In addition to operational risk assessments, the Bank performs a holistic financial crime risk assessment, taking into account different risk factors relating to geography, customers, products and technology, and delivery channels, as well as the Icelandic National Risk Assessment.

The Compliance function provides quarterly compliance briefs to the Board Risk Committee on the status of the execution of the Policy on Combating Financial Crime, and an annual report to the Board of Directors.

In line with regulatory requirements, the Bank has in place a policy on internal alerts which applies to any suspected irregularity, involving employees, directors, shareholders, vendors, contractors, or any party who perform duties on behalf of the Bank. Via specialised whistle-blower software, employees are anonymously able to raise their concerns in this regard. Compliance is responsible for implementing and maintaining the necessary controls and procedures, and for maintaining awareness through training.

E-training on the Bank's anti-corruption measures is available for all staff and annual participation is mandatory for certain groups of employees whose tasks are considered to pose higher risks in this regard.

Internal Audit has the primary responsibility for investigating suspected fraudulent acts or suspicious malpractices, and issues reports to the appropriate personnel, and, as appropriate, to the Board Audit Committee.

8

Sustainability Risk

Sustainability risk is defined in the Bank's Enterprise Risk Management framework as the risk associated with environmental, social or governance (ESG) related events or conditions that can result in a negative financial and/or non-financial impact on the Bank or its clients.

Sustainability risk is a driver of other risk types, such as credit risk and market risk. It can materialize in the short term, the medium term and the long term.

Sustainable lending (% of total lending)

15.5% (10.7%)

Total financed emissions

289 ktCO2e (245)

Contents

8.1 Governance and policy
8.2 Business strategy
8.3 Risk management

8 Sustainability Risk

Sustainability risk is a driver of other risk types, such as credit risk and market risk. It can materialize in the short term, the medium term and the long term. The Bank assesses both inside-out risks (negative impact from the Bank's operations on people or the environment) and outside-in risks (negative materialization of environmental, social or governance (ESG) factors on the Bank through their counterparties or invested assets).

Arion Bank seeks to ensure that its activities and the financial services it provides do not result in an unacceptable impact on people or the environment. The Bank is committed to support the global effort to transition to a net zero carbon economy. The Bank engages with its customers, where appropriate, and supports them in adopting more sustainable practices.

8.1 Governance and policy

Sustainability risk is defined in the Bank's Enterprise Risk Management framework as the risk associated with environmental, social or governance (ESG) related events or conditions that can result in a negative financial and/or non-financial impact on the Bank or its clients.

Sustainability risk is not a fully stand-alone risk type and may increase the severity or likelihood of other financial and non-financial risks faced by financial insitutions, such as compliance risk, market risk, and credit risk. For this reason, sustainability risk must be embedded in the Bank's risk management framework and its processes, rather than being considered in isolation.

The Bank has adopted a risk policy on sustainability, approved by the Board of Directors and reviewed annually. This policy stipulates that the Bank should ensure that its operations and services do not negatively impact people or the environment. Key performance and risk indicators relating to ESG factors are now part of the monthly risk report to the Board, and the Bank's risk appetite statement includes a subset of these indicators.

Arion Bank has a Sustainability Committee (SUCO) and the management of risk in connection with ESG factors is defined as part of the Bank's risk management system. The CEO is the chairman of the committee, the role of which is to monitor the Bank's performance in connection with its policy and commitment on sustainability and to ensure that ESG factors are considered in decisions and plans made by the Bank. The Sustainable Financing Committee and Equality Committee are subcommittees of the SUCO.

In addition to the CEO, the SUCO comprises the managing directors of Retail Banking, Corporate & Investment Banking, Markets, Operations & Culture, and Finance. The Chief Risk Officer, the Head of Corporate Communications, the Head of Operational & Sustainability Risk, and the Bank's Sustainability Officer attend meetings but do not have voting rights. Meetings are also attended by representatives of Stefnir and Vörður if required.

The Sustainability Committee's primary responsibility is to:

- decide on the Bank's commitments related to sustainability and review the Bank's performance in relation to those commitments
- align the Bank's strategy and risk appetite considering the ESG commitments and sustainability risk management's review risk assessment of ESG factors and other assessments of climate risk impact and oversee ESG disclosures in line with best practices
- oversee the Bank's Sustainable Financing Framework
- ensure the Bank's employees are adequately educated and aware of ESG factors and sustainable finance.

More information on the Bank's governance framework and lines of reporting can be found in Chapter 2 of this report.

Reporting

Sustainability risk reporting is provided to SUCO quarterly. The reporting includes selected sustainability risk metrics and risk appetite measures, KPIs, updates on the development of sustainable products and gender equality. Sustainability risk is also part of the ICAAP process, which is subject to robust governance culminating in approval by the Board of Directors.

Remuneration

The Bank has integrated sustainability KPIs as part of its remuneration policy, and has had equal pay certification since 2015. Chapter 9 contains detailed information about the Bank's remuneration policy.

8.2 Business strategy

Arion Bank places great importance on environmental and social issues and good corporate governance in its operations. It wants to act as a role model in responsible and profitable business practices, considering the environment, the economy, and society. Social responsibility and sustainability are part of the Bank's day-to-day activities. The Bank's code of ethics informs responsible decision-making at the Bank.

The Bank has set a number of sustainability targets for 2030. These are largely restated and updated targets that were already in place in 2024, and include the following:

- Sustainable lending to be at least 20% of the total loan portfolio by 2030
- Targets on financed emissions should be validated by the Science-Based Targets initiative (SBTi)
- Sector-specific sustainability policies for the most impactful sectors
- Monitoring of suppliers' environmental and climate impact
- Carbon-reduction target set and met by 2030.

In 2024, the Bank published an exclusion list of business activities including lending and corporate advisory services.

Climate targets

At the end of 2023 the Bank pledged to follow the methodology of the SBTi when setting reduction targets for financed emissions. The calculation of financed emissions using the Partnership for Carbon Accounting Financials (PCAF) methodology will be used in setting these targets. Affirmation of these targets by SBTi means that Bank's targets are science-based and efforts to reduce emissions are based on scenarios where global warming does not exceed 1.5°C. The has also joined the UN-convened Net-Zero Banking Alliance, a global group of banks committed to ambitious climate action.

The way banks manage and allocate funds can greatly influence sustainable development both locally and globally. Arion Bank's sustainability policy is designed to support Iceland's climate action plan, aiming to fulfil the Paris Climate Agreement obligations and achieve carbon neutrality in Iceland by 2040.

The Bank has published sustainability policies for seafood and industry, energy, manufacturing, and agriculture. Reflecting its growing focus on the Arctic region as part of its business strategy, a sustainability policy specifically for the Arctic has also been published. These policies outline the Bank's criteria and approach to promoting sustainability in the economy through its lending operations and business relationships, in line with the Bank's commitments and within its risk appetite. In developing these policies, the Bank draws on the government's climate plans, as well as the plans and actions of its customers with respect to ESG factors.

For further information on the Bank's sustainability agenda, profile, and objectives, see the Annual and Sustainability Report 2024, which includes a variety of non-financial information on ESG factors.

Sustainable financing framework

The Bank's Sustainable Financing Framework was published in August 2024 and applies to the Bank's financing, deposits and loans which are classed as environmentally and/or socially sustainable. The new framework replaces the Bank's Green Financing Framework, published in 2021, which has been integral to the Bank's green lending programme and green bond issues. The Bank has since issued six green bonds on the basis of the frameworks.

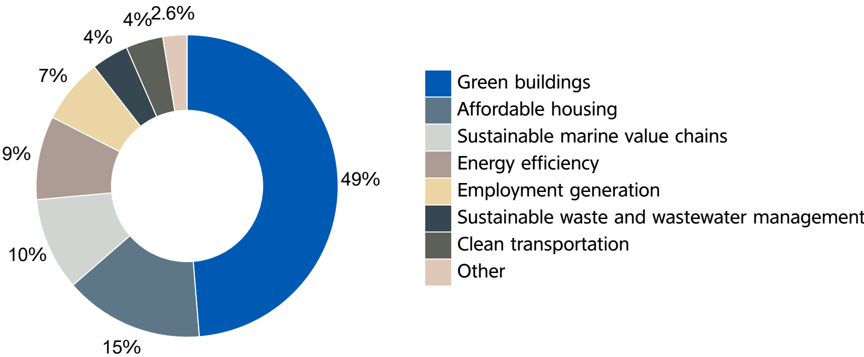
New features of the Sustainability Financing Framework include social categories used to designate projects as having a positive impact on society. The circular economy has been given added weight, and the classification of green projects has been refined. Based on the framework, the Bank can issues Sustainable Financing instruments including, but not limited to, covered bonds, bonds, loans, commercial paper, repurchase agreements, and deposits. The use of proceeds from these instruments is restricted to the financing of eligible assets as defined under the Framework.

Eligible assets are divided into several categories with specific inclusion and exclusion criteria. The Framework details the processes for identifying eligible assets, for reporting on the use of the framework and for external review. Prior to the introduction of the Green Financing Framework, the Bank had a framework for green deposits. These frameworks have now been merged.

The Sustainable Financing Framework classifies sustainable loans into 11 categories:

- Sustainable marine value chains and marine ecosystem management
- Sustainable forestry and agriculture
- Renewable energy
- Clean transportation
- Green buildings
- Energy efficiency
- Sustainable waste and wastewater management
- Affordable housing
- Education
- Healthcare
- Employment creation and the alleviation of unemployment.

Figure 8.1 Sustainable loans under the Bank's Sustainable Financing Framework by category at year-end 2024



At the end of 2024, sustainable lending was 15.5% of the Bank's total loan portfolio. The Bank's target is to increase the percentage of sustainable loans under the framework to at least 20% by 2030. For more information see: Sustainable Financing Framework

European Investment Fund

The European Investment Fund (EIF) and Arion Bank have entered into an agreement to facilitate new loans for small and medium-sized enterprises (SMEs) in Iceland. This allows Arion Bank to lend up to ISK 15 billion to Icelandic businesses under the framework. This framework is financed by the EU's InvestEU programme, which focuses on sustainability, innovation, digital transformation, and the cultural and creative sectors. Loans provided under this framework will offer more favourable terms, aiming to support sustainability and environmental initiatives, the digital transformation of society, and the cultural sector.

8.3 Risk management

The Risk Management Division plays an active role in the management of ESG risk. To reflect the increasing importance of this risk factor, one of the division's units is now explicitly responsible for supporting ESG risk management across the Bank. Integrating ESG risk in such a way into the existing structure of Risk Management serves the aforementioned goal of recognizing ESG risk as potentially amplifying other risks and ensures that it is given appropriate consideration and in the appropriate context.

Credit risk is the Bank's primary risk. The Bank's credit policy emphasises sustainability, and credit rules stipulate that ESG factors are assessed as part of the credit rating process. Both inside-out and outside-in risks and impacts are assessed in the current framework.

The Bank is actively building out its capabilities with respect to managing ESG risk. A key enabler is data against which to measure risk, and which can form the basis of a monitoring and reporting framework consistent with the Bank's existing arrangements. Arion Bank leverages outputs from

PCAF and Taxonomy reporting to guide its sustainability efforts, while also identifying specific risk drivers related to credit exposures. However, data availability challenges persist, particularly with counterparties and Iceland-specific data compared to other European nations. Despite these hurdles, the Bank strives to develop a robust set of indicators and limits aligned with the Board's risk appetite.

In 2024 the Bank engaged with the Icelandic Meteorological Office about integrating its new Climate Atlas into the Bank's assessment of physical risk in its loan portfolio. The Meteorological Office is yet to publish the atlas, but this solution has the potential to address the lack of country-level data necessary to perform this assessment.

The first line is responsible for evaluating its own ESG risks as part of the annual risk assessment process. This involves identifying potential ESG risks, assessing their likelihood and impact, and documenting all relevant risks and mitigations in the Bank's risk registry. The inherent risk related to human resources and social factors is generally assessed as low. In terms of environmental issues, the risks of greenwashing and the environmental and climate impacts on lending and investments were assessed as the main risks. The results also show that the Bank's main governance-related risks are linked to anti-money laundering measures, breaches related to KYC requirements, and data protection issues. The controls for these risks within the Bank were generally assessed as satisfactory or strong.

The Bank offers a variety of training programmes and courses focused on sustainability and sustainability risk management. These educational programmes are designed to equip staff with the knowledge and skills needed to identify, assess, and manage sustainability risk, and ensuring alignment with the Bank's overarching goal of promoting responsible and sustainable financial practices.

ESG credit risk assessment

In early 2024, SUCO established an ESG working group mandated to perform and maintain a risk assessment for climate-related financial risks between industries and geographies, including both transition and physical risks. The working group also evaluated the impact of selected social and governance factors. The purpose was to establish a foundation and support for employees of the Bank responsible for credit and investment decision, and investment advice, by incorporating outside-in sustainability risk into the overall risk assessment. Risk Management has now incorporated the assessment into the credit risk assessment system as a benchmark. Loan and fund managers will be tasked with evaluating how their project compares to industry benchmarks, ensuring efficient and uniform methodology for assessing sustainability risks in the Bank.

ESG sector analysis

The Bank has conducted a sector-based analysis to evaluate environmental, social and governance risk in its loan portfolio. The resulting heat map represents a qualitative assessment of the possible impact of various risk drivers on different sectors. The analysis is based on possible developments for the next 15 years.

Environmental risk was estimated to have the highest possible impact on the Bank´s portfolio. Environmental risk entails both transition risk, the potential cost of moving towards a low-carbon economy, and physical risk (acute and chronic), which pertains to the possible impacts from climate change. Transition risk is identified as the most significant factor, driven by potential regulatory changes and technological advancements. The sectors that were assessed to have the highest possible impact were Fisheries, Sea-based aquaculture, materials and mining, shipping and construction. Concerning physical risk, ocean acidification was concluded to potentially have the greatest impact on the seafood sector.

Social risk comprises such factors as employee rights, human rights, diversity, and equality. The main risk driver identified as having the highest potential impact involves labour rights and human rights within the supply chain.

Governance risk involves the dangers of poor governance practices, corruption, bribery, and legal compliance violations, as well as the security of sensitive information. Information and cyber security risk, specifically whether an industry handles significant amounts of sensitive personal data and/or how cyber security is managed, is highlighted as a primary concern.

Product governance

Arion Bank is committed to providing products and services that create value for clients and shareholders, in a sustainable manner, and which meets clients' needs. The Board of Directors approves the New Products and Significant Changes policy, which is implemented taking into consideration

the Bank's Sustainability Risk Policy. Therefore, ESG is considered in the product approval process ensuring that sustainability is at the forefront in the development of new products and changes within the Bank.

PCAF

Arion Bank is a signatory to the PCAF, a global partnership of financial institutions that work together to develop and implement a harmonized approach to assessing and disclosing the greenhouse gas (GHG) emissions associated with their loans and investments. Assessing and disclosing the greenhouse gas emissions financed through lending and investments is a prerequisite for the Bank's ability to set targets on reducing emissions. The PCAF disclosures are now incorporated into the Bank's 2024 Annual and Sustainability Report. To calculate financed emissions for business loans and investments, financial data from the Bank's counterparties is required. As the data has not yet been published, the calculation in the report covers lending and investments for the financial year 2023.

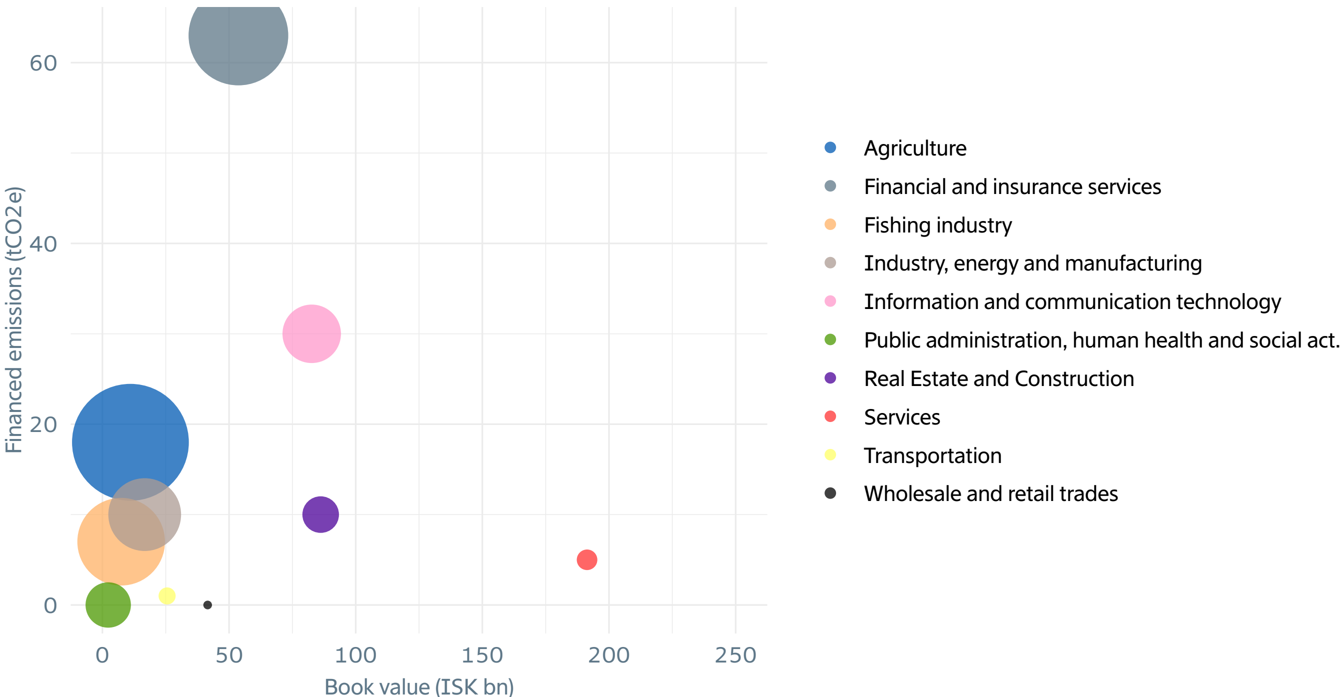
Total financed emissions at Arion Bank in 2023 from the Bank's lending and investments including emissions from sovereign bonds (excluding LULUCF) was 289 ktCO2e, which is an 18% increase year-on-year. If financed emissions from sovereign bonds are excluded, total emissions drop to 161 ktCO2e, which represents a 5% increase year-on-year. Apart from changes due to sovereign bonds, the increase between 2022 and 2023 is primarily due to the growth of the Bank's lending and increased own investments. It should also be noted that the emission factors used to estimate financed emissions for corporate loans were updated year-on-year.

Corporate loans account for 90% of the Bank's total financed emissions from its lending portfolio. These emissions increase by just over 3% year-on-year, from 140 to 144 ktCO2e, while emission intensity decreases from 0.29 to 0.28 tCO2e/ISKm, indicating that every ISK million lent by the Bank in 2023 emits proportionally less than it did in 2022.

The Agriculture sector has the highest emission intensity of any sector, while only accounting for 13% of the financed emissions. Real Estate and Construction on the other hand account for 35% of all corporate loans while only accounting for 3% of the financed emissions. Meanwhile, the emission intensity of the mortgage portfolio is 0.004 tCO2e/ISKm. Therefore, opportunities to decrease financed emissions lie mostly within corporate loans and sovereign bonds. Further information on PCAF disclosures can be found in the 2024 Annual and Sustainability Report.

The chart below shows Arion Bank's financed emissions (tCO2e) by book value (ISKm) by sectors. Bubble size is determined by relative emission intensity for each sector.

Figure 8.2 Financed emissions



Green Asset Ratio

The Green Asset Ratio (GAR) is a key performance indicator for credit institutions. The indicator shows the ratio of a financial institution's assets which finance economic activities aligned to the EU Taxonomy. While the GAR has its merits it falls short in giving insights into the state of sustainable financial services in Iceland. The indicator is mostly affected by the distribution of the loan portfolio, with loans to household as the largest group of assets included in the denominator. Due to lack of data availability, these assets cannot be assessed against the Taxonomy technical screening criteria, and therefore 45% of total covered assets cannot be considered environmentally sustainable until such data becomes available. This however could indicate that all the Bank's mortgages aren't financing environmentally sustainable assets, but fails to acknowledge that a majority of Icelandic households are heated with renewable energy.

Furthermore, disclosure by corporates obligated to disclose taxonomy information is still in development stages, and therefore a majority of those corporates are unable to meet the technical screening criteria required of them to identify eligible or aligned activities. Furthermore, loans to non-financial corporations only account for about 1,8% of the total coverage of eligible assets. The Bank's GAR is therefore very low, or 0,0003% based on turnover. Further information can be found in an annex to the 2024 Consolidated Financial Statement.

Suppliers Code of Conduct

The Bank has a Code of Conduct for suppliers designed to set expectations with respect to environmental, social and governance issues. For 2024, the Bank set the target that at least 90% of new suppliers who have a contract with the Bank must have undergone a supplier assessment where environmental, social and governance performance is assessed and that the same proportion of suppliers has accepted the Bank's Code of Conduct. During the year, 91% of Arion Bank's new suppliers, who fall under that definition and have a contract with the Bank, underwent the assessment.

9

Remuneration

Arion Bank's remuneration policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, employees, customers, and other stakeholders in an organized and transparent manner.

The Bank's main objective concerning employee remuneration is to attract and retain oustanding individuals, while ensuring that the remuneration policy does not encourage excessive risk-taking.

Contents

9.1 Arion Bank's remuneration policy
9.2 Remuneration components
9.3 Corporate governance arrangements
9.4 Quantitative information

9 Remuneration

9.1 Arion Bank's remuneration policy

Arion Bank's remuneration policy is framed in accordance with regulatory requirements, such as those established in Article 57a of Act No. 161/2002 on Financial Undertakings and the EBA Guidelines on sound remuneration policies. The Bank's remuneration policy is reviewed annually by the Board and submitted and approved at the Bank's annual general meeting. Arion Bank's remuneration policy is published on the Bank's website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2023, see Note 12. Arion Bank's remuneration policy is, furthermore, consistent with the integration of sustainability risks for the purposes of Article 5 of Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (SFDR).

The Bank's main objective concerning employee remuneration is to offer competitive salaries in order to attract and retain outstanding and qualified individuals. The Bank, furthermore, aims to ensure that the policy does not encourage excessive risk taking, but rather supports the Bank's long-term goals and sound operation. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, employees, customers, and other stakeholders in an organized and transparent manner. In accordance with Article 79a of Act No. 2/1995 on Public Limited Companies, Article 57a of Act No. 161/2002 on Financial Undertakings, and rules on good corporate governance, the Board of Directors of Arion Bank approves the Bank's remuneration policy with respect to salaries and other payments to the Board Directors, Chief Executive Officer, Managing Directors, Compliance Officer, and Internal Auditor.

9.2 Remuneration components and parameters

According to Article 57b of Act No. 161/2002 on Financial Undertakings, the combined amount of variable remuneration, including deferred payments, may not exceed 25% of annual salary of the recipient employee excluding the bonus. The rules require a deferral of at least 40% of the variable remuneration for a period of no less than four years and in the case of the CEO and employees reporting directly to the CEO, this shall be five years unless the total aggregate is less than 10% of the fixed salary of the employee, in which case the variable remuneration does not require deferral and may be paid in full.

In accordance with the rules, Risk Management and Compliance perform a risk assessment of the incentive scheme and Internal Audit regularly reviews its structure, execution, and impact on the Bank's operations. The current performance-based system was originally approved in December 2020. The current scheme, to be applied in 2025 based on 2024 performance, was approved by the Board of Directors in November 2023. Under the scheme all employees of the Bank, excluding internal controls units, are included and can receive up to 10% of their fixed annual salary for 2024 in the form of variable remuneration once the annual financial statement for 2024 has been published, on condition that the targets set out in the scheme have been reached. Managers and those employees who have the greatest influence on the Bank's value creation are eligible to receive an incentive payment of up to 25% of their fixed annual salary. Part of the payment (5%) is in cash but the remaining 20% is either in the form of shares in the Bank or share options, but subject to deferral of 40% and a sale restriction for a period of three years for delivered shares.

Risk Management, Compliance and Internal Audit are excluded.

The criterion used for the Bank's remuneration system to determine whether incentive payments will be paid in 2025, in part or in full, is whether the Bank's return on equity (ROE) in 2024 is higher than the weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn, and Kvika. Failure to reach this target means that no variable remuneration will be paid. The total amount paid out in incentive payments, furthermore, may not be higher than the amount by which the Bank's ROE exceeds the weighted ROE of competitors.

When estimating the variable remuneration to be paid in respect of 2024 performance, a range of factors will be taken into consideration, such as ROE of the Bank, cost-to-income ratio, bancassurance ratio, compliance with the law and code of ethics, knowledge of the customer (KYC/AML), the Bank's Sustainalytics rating, customer satisfaction score, mandatory education health, and various other metrics.

The objective of the scheme is to reflect the Bank's objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders, and employees. The Board of Directors re-evaluates on an annual basis the

incentive scheme and its key targets in accordance with the Bank's remuneration policy, taking into consideration the current status of the Bank, market conditions, and that variable remuneration is awarded in a manner which promotes sound risk management in line with the Bank's risk policy and does not induce excessive risk-taking.

9.3 Corporate governance arrangements

The Board Remuneration Committee (BRC) and the Board Risk Committee (BRIC), which are established by the Board of Directors of Arion Bank, provide 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, as well as the Bank's remuneration scheme and other work-related payments. The BRC convened five times in the year 2024. The committee consists of at least three members, the majority of whom must be independent of the Bank and the Bank's day-to-day management. The CEO, Managing Directors, and other employees of the Bank cannot be members of the Committee.

The main responsibilities of the BRC are to review and propose changes to the Bank's remuneration policy to the Board, which proposes the changes to a shareholders' meeting. In addition, the BRC is tasked with ensuring that wages and other employment terms are in accordance with laws, regulations and best practices as current from time to time. The Committee decides on a salary framework for Managing Directors and the Compliance Officer, taking into consideration the size of the relevant division and level of responsibility.

A performance-based variable remuneration system has been in place since 2013 and both BRC and BRIC have a role as regards its design and annual review. BRC reviews and monitors the scheme, before submitting it to the Board, and BRIC's role is to assess annually whether incentives which may be contained in the Bank's system are consistent with the Bank's risk policy.

9.4 Quantitative information on remuneration

According to disclosure requirements set out in Article 450 of the Capital Requirements Regulation (EU) No. 575/2013, financial undertakings are required to provide aggregate quantitative information on total remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution.

The criterion used for the Bank's variable remuneration scheme to determine whether an incentive payment will be paid in 2025, in part or in full, depends on a comparison of the Bank's return on equity (ROE) in 2024 with that of a weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn, and Kvika. For quantitative information on remuneration, please refer to the Bank's Additional Pillar 3 Risk Disclosures.

10 Abbreviations

ACC	Arion Credit Committee
ADC	Arion Composition and Debt Cancellation Committee
AGM	Annual General Meeting
ALCO	Asset and Liability Committee
AML	Anti-Money Laundering
ASF	Available Stable Funding
AT1	Additional Tier 1
BAC	Board Audit Committee
BCC	Board Credit Committee
BCMS	Business Continuity Management System
BICRA	Banking Industry Country Risk Assessment
BRC	Board Remuneration Committee
BRIC	Board Risk Committee
BRRD	Bank Recovery and Resolution Directive
BTC	Board Tech Committee
CCF	Credit Conversion Factor
CCO	Chief Compliance Officer
CCR	Counterparty Credit Risk
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CFO	Chief Financial Officer
CMS	Collateral Management System
COREP	Common Reporting
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Credit Risk Mitigation
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CSO	Chief Security Officer
CVA	Credit Valuation Adjustment
D-SII	Domestic Systemically Important Institution
EAD	Exposure at Default
EBA	European Banking Authority
ECAI	External Credit Assessment Institution
EEA	European Economic Area
ECL	Expected Credit Loss
ERCO	Executive Risk Committee
ERM	Enterprise Risk Management
ESG	Environmental, Social, and Governance
EU	European Union
FATF	Financial Action Task Force
FRTB	Fundamental Review of the Trading Book
FSA	Financial Supervisory Authority of the Central Bank of Iceland
FTE	Full-time equivalent
G-SII	Global Systemically Important Institution
GHG	Greenhouse Gas
ICAAP	Internal Capital Adequacy Assessment Process
ICFR	Internal Controls over Financial Reporting
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal Ratings Based
IRRBB	Interest Rate Risk in the Banking Book
ISAT08	Icelandic industry classification based on NACE Rev. 2
ISMS	Information Security Management System
ktCO2e	Kilotonnes of carbon dioxide equivalent
KYC	Know Your Customer

Abbreviations

LAA	Loss Absorption Amount
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
LULUCF	Land use, land-use change and forestry
MCC	Market Confidence Charge
MD	Managing Director
MREL	Minimum requirement for own funds and eligible liabilites
NFDR	Non-Financial Disclosure Regulation
NSFR	Net Stable Funding Ratio
ORCO	Operational Risk Committee
ORSA	Own Risk and Solvency Assessment
ORX	Operational Riskdata eXchange Association
PCAF	Partnership for Carbon Accounting Financials
PD	Probability of Default
PiT	Point-in-Time
PSD	Payment Services Directive
PSE	Public Sector Entities
RB	Reiknistofa bankanna hf.
RCA	Recapitalization Amount
RCSA	Risk Control Self-Assessment
REA	Risk-weighted Exposure Amount, previously referred to as Risk-Weighted Asset (RWA)
ROAC	Return on Allocated Capital
ROE	Return on Equity
RSF	Required Stable Funding
SA-CCR	Standardized Approach for Counterparty Credit Risk
SFDR	Sustainable Finance Disclosure Regulation
SDRs	Swedish Depositary Receipts
SII	Systemically Important Institution
SME	Small and Medium Enterprise
SNP	Senior Non-Preferred
SP	Senior Preferred
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SFT	Securities Financing Transaction
SUCO	Sustainability Committee
T1	Tier 1
T2	Tier 2
TCFD	Task Force on Climate-related Financial Disclosures
TtC	Through-the-cycle
UCITS	Undertaking for Collective Investment in Transferable Securities
UN	United Nations
VaR	Value at Risk