# Pillar 3 Risk Disclosures

Arion Bank 2022

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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 sustainability and responsibility, and applies digital solutions for customer convenience. The Bank is committed to supporting the economy and financing of households and corporates notwithstanding challenging and uncertain times.

The sale of Valitor hf., the Bank's payments solutions provider subsidiary, was completed in 2022, resulting in a materially positive capital impact for the Group. The bancassurance strategy was driven by the continuing integration of the operations of Arion Bank and its insurance subsidiary Vörður tryggingar hf. A new CEO of Vörður was appointed in 2022.

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's risk governance structure was further reinforced in 2022 through the establishment of a new Executive Risk Committee, chaired by the CRO. The committee is responsible for executive-level oversight of the implementation of key aspects of the Bank's enterprise risk management framework and ensuring alignment of risk frameworks with the Bank's risk appetite. The committee furthermore reviews and approves risk models, methodology and scenarios for the purpose of IFRS 9, ICAAP, ILAAP, and stress testing.

Large exposures
Sum of exposures equal to or exceeding 10% of Tier 1 capital
**21.8%**

Liquidity
LCR total requirement
**158%**

Capital adequacy
Total capital ratio
**24.0%**

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, and single-name, sectoral, and geographical concentration. In line with the stated risk appetite, the Bank has over the past years successfully reduced single-name concentration and enhanced focus and management of the risk factor, in part through the strategy to originate to distribute. At the end of 2022, the Bank's largest exposure was 11.5% of Tier 1 capital, and the 12-month expected credit loss rate was 28 bps.

The Bank invests its own capital on a limited and carefully selected 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 2022, total net equity position in the trading book and total equity position in the banking book was 0.8% and 3.8%, respectively, of normalized own funds. This is a considerable reduction in equity positions from last year, which is in line with a reduced risk appetite in 2022.

The Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirement. The Bank's funding profile supports its liquidity profile. Liquidity positions are managed on a day-to-day basis by internal limits and targets in line with the risk appetite and regulatory standards. The Bank's liquidity coverage ratio was 158% at the end of 2022, 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.

The Bank has integrated sustainability risk into its enterprise risk management framework, incorporating environmental, social and governance factors in decision making and strategy. 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. In 2022, the Bank introduced limits in relation to ESG factors into its risk appetite statement to support its objectives in this area.

The Bank is well capitalized with a total capital ratio of 24.0% and CET1 ratio of 18.8% at the end of 2022, exceeding both the regulatory requirements and the risk appetite.

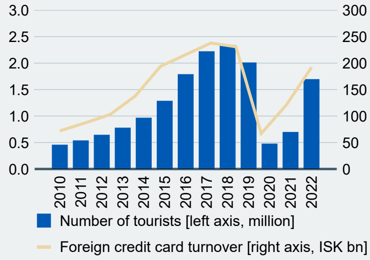
*The Board of Directors of Arion Bank*

# Resilience in the face of emerging challenges

The year 2022 was a year of recovery for the tourism industry in Iceland. The country was practically sold out, with the number of visitors close to pre-Covid levels, increased expenditure per tourist and increased length-of-stay. However, as the extraordinary challenges and uncertainties in relation to the pandemic receded, a new black swan emerged – a war in Europe – with widespread impact on the global economy.

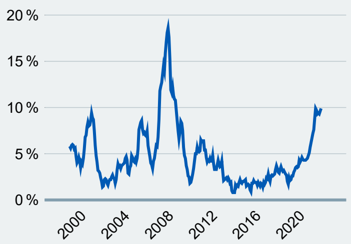
As in other economies, inflation has spiked in Iceland and interest rates increased, with resulting market turbulence and increased costs for households and businesses. Iceland however benefits from being a net commodity exporter and being largely unaffected by the energy crisis as it makes use of its renewable energy sources for electricity generation and house heating. Inflation has been driven by the real estate market, as nominal housing prices have increased by more than 40% over the last two years. This combination of inflation and high interest rates is not unfamiliar for the Icelandic economy and is reflected in the widespread use of CPI index-linked debt instruments which offer a lower re-payment burden, but possible negative nominal amortization.

**Figure** Number of visiting tourists and foreign credit card turnover. Source: Icelandic Tourist Board.




The Icelandic labor market is strong and jobs lost in the pandemic have been recovered. Net migration was very high in 2022, evidenced by a population growth rate of 3.1%, further increasing demand for housing. The completion of short-term collective wage agreements in December has reduced economic uncertainties to a considerable degree. But while key indicators for the Icelandic economy show that it is in a relatively strong position, economic developments more broadly suggest that the credit cycle is turning from a benign state and that we are entering a period of contraction.

**Figure** 12-month inflation in Iceland

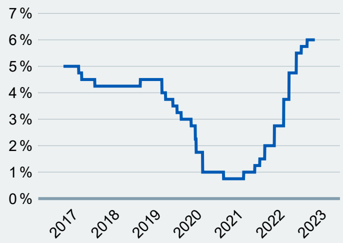



Against this backdrop, the Bank's credit quality measures remain strong, with low rates of default and high recovery rates. Given the worsening outlook however, the Bank has increased the likelihood of the pessimistic scenario for its assessment of expected credit losses as per IFRS9 and increased haircuts for real estate collateral value.

Funding risk was high on the agenda in 2022, as liquidity has tightened significantly in funding markets. This has resulted in a considerably increased cost of funding, especially for smaller issuers. The Bank completed the issuance of EUR 200m covered bonds in April and EUR 300m unsecured green bonds in September. There are no material funding maturities in 2023 following buyback of own issues. Modest lending growth can be expected in the near term, during which the Bank will build financial and operational resilience to support its customers and seize opportunities when they arise. Stress tests performed in 2022 demonstrated that the Bank's strong financial position supports the business plan in adverse scenarios. A key scenario to consider in light of recent economic and geopolitical developments is a global recession negatively affecting Iceland's terms of trade and economic activities, adversely impacting asset prices, real estate in particular, and further distressing funding markets.

The Bank reduced its risk appetite for equity positions in both trading and banking books in 2022, which is expected to contribute to a lower Pillar 2 requirement in 2023. Interest rate risk in the banking book has also diminished as the duration of fixed rate mortgages is shortening as demand for this product receded in early 2022 following a period of rising interest rates. While ensuring that its business strategy reflects risk appetite, the Bank continuously evaluates its exposures, with the aim of being flexible in the face of changing market conditions and economic outlook.

**Figure** Development of the Central Bank of Iceland benchmark rate




The Bank's sale of payment services provider Valitor hf., concluded in July, had a positive capital impact through a combination of gains from the sale and REA release. The resulting capital relief is being discharged to shareholders through the ongoing share buyback program as approved by Iceland's Central Bank. The sale simplifies the Group's structure and operations. The continued integration and cultural alignment of the Bank and insurance subsidiary Vörður tryggingar hf. is a long-term project that will further diversify the Group's revenue sources. The increased product offering and touch-points with current and potential clients improve the Group's overall capability to offer smart and reliable financial solutions across the entire spectrum of banking, savings, and insurance.

The management of operational risk has been a key focus area for the Bank and its supervisory authority over the last years. The Bank has put significant effort into developing a framework to systematically outline its operational landscape and map dependencies between risks, controls, products and services, legal requirements, systems, data assets, and processes. In 2022, the Bank undertook several initiatives to further strengthen its financial crime risk management, including the implementation of a new transaction monitoring solution.

Cyber attacks against the Bank and its customers represent a significant threat, as they are for any financial institution. In 2022, the Bank observed increased sophistication in the impersonation of the Arion brand in fraud attempts. The Bank pro-actively manages this risk through threat intelligence, brand protection, vulnerability management, securing its infrastructure, and rigorous cyber security incident response management. In 2022, the Bank has worked on updating its Information Security Management System to seek ISO 27001 certification and ensure compliance with mandatory guidelines and regulatory requirements

The Bank continued to improve its enterprise risk management (ERM) in 2022. An Executive Risk Committee, chaired by the CRO, was established in 2022, with the purpose of reviewing the implementation of risk policies and their alignment with risk appetite, as well as approving models, risk frameworks, and economic scenarios under IFRS9. Sustainability risk appetite limits were added to the risk appetite statement in the form of metrics concerning green loans and the gender pay gap. Sustainability risk has been integrated into the ERM and further initiatives are underway to fully integrate and embed ESG risk assessment in day-to-day decision-making within the Bank.

*Úlfar F. Stefánsson, Chief Risk Officer*

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# 1 Introduction

The Pillar 3 Risk Disclosures comprise information on Arion Bank's risk profile, risk management, and capital adequacy. The report is based on disclosure requirements set out in Regulation EU 575/2013 (CRR) and pertains to the conditions of the Bank's prudential consolidation, which excludes insurance subsidiaries. The disclosures contain information on new and forthcoming legislation as well as information on the Bank's remuneration policy.

## 1.1 Arion Bank at a Glance

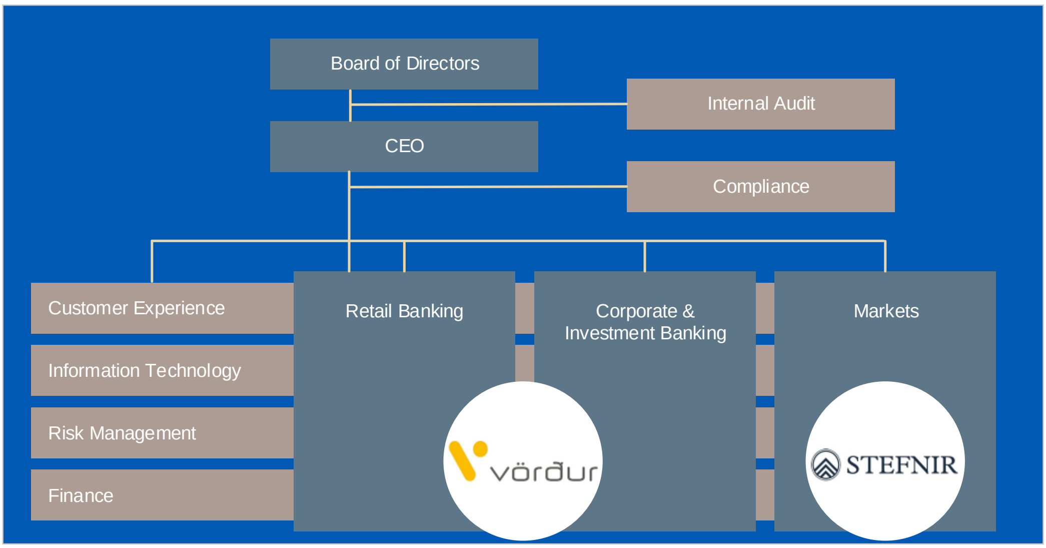
Arion Bank operates a total of 13 branches and service centers across Iceland

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) by the Financial Stability Committee of the Central Bank of Iceland.

The Bank, whose roots date back to 1930, is built on strong heritage and infrastructure. Arion Bank is a strongly capitalized bank which provides a broad range of banking services to corporations and individuals. The Bank aims to excel by offering smart and reliable solutions that create future value for customers, shareholders, and society as a whole.

The Bank operates several branches across Iceland but has been optimizing its branch network in recent years by streamlining branch premises and introducing digital branches. Numerous digital solutions have been launched in recent years, improving customer convenience, and increasing operational efficiency.

**Figure 1.1** Arion Bank's organizational chart




The Bank consists of three business segments: Retail Banking, Corporate & Investment Banking and Markets. There are four support units: Finance, Information Technology, Risk Management and Customer Experience, which was set up to coordinate the Bank's strategic advancement in optimizing the customer journey. Furthermore, the Bank's strategic subsidiaries are important to its service offering. Stefnir is the largest fund management company in Iceland and Vörður is the fourth largest insurance company, providing both life and non-life insurance. This diverse service offering means that Arion Bank's revenue base is broad. 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 2022, the Group has continued the process of integrating the operations of Arion Bank and Vörður with the aim to apply the Bank's distribution channels to drive the Group's bancassurance strategy, thus creating a 'one-stop shop' with a broad range of financial and insurance products under a strong brand.

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. 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 country's knowledge and export industries.

Iceland is uniquely positioned to become the financial hub in the Arctic

At year-end 2022, the number of full-time equivalent (FTE) positions at Arion Bank was 694 with an additional 87 FTE in subsidiaries.

The Bank's Annual and Sustainability Report 2022 provides further information about the Bank, such as strategy and vision, sustainability policy, and corporate governance.

## 1.2 Regulatory Framework

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

The Basel framework encompasses three complementary pillars:

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

Under Pillar 3, capital adequacy must be reported through public disclosures that are designed to provide transparent information on capital structure, risk exposures, and the risk assessment process.

The CRD V / CRR II package was implemented in Iceland in 2021

In 2013, the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive (CRD IV: Directive No. 36/2013) and the Capital Requirements Regulation (CRR: Regulation No. 575/2013). This regulatory framework represented the EU's first major step in implementing the Basel III reforms, aimed to strengthen regulation, supervision and risk management of banks, e.g. with increased level of capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress. 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 IV/CRR II) and resolution (BRRD/SRM), thus finalizing the Basel III implementation and setting the stage for what is widely refered to as Basel IV.

The CRR was incorporated into the EEA Agreement in late 2019. In June 2021, CRD IV/CRR II was implemented through Act No. 44/2021 and Regulation No. 749/2021, while BRRD II provisions were excluded. BRRD I is currently in effect in Iceland. 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.

## 1.3 Communication Policy

The Bank has in place a communication policy, approved by the Board of Directors, addressing the requirements laid down by law for information on risk management and capital. Accordingly, the Bank may omit information if it is not regarded as material. Information is regarded as material in disclosures if its omission or misstatement could change or influence the assessment or economic decisions of a user relying on the information.

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

## 1.4 Pillar 3 Risk Disclosures

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfill its legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures are prepared in accordance with legislative requirements regarding public disclosure, including EU Regulation 2021/637 which implements technical standards with regard to disclosure requirements under Part Eight of the CRR.

Technical standards relating to disclosure requirements under Article 449a of the CRR on ESG reporting have not yet been implemented in Icelandic law. In anticipation of their likely implementation in 2023, the Bank has begun incorporating qualitative aspects of the relevant disclosure templates in this year's report.

EBA standardized disclosure templates can be found in the Additional Pillar 3 Risk Disclosures document on the Bank's website.

Information in the disclosures refers to Arion Bank's consolidated situation as per CRR, which consists of the parent entity, Arion Bank, and its subsidiaries, excluding insurance subsidiaries; together referred to as 'the Bank'. The Bank is subject to consolidated supervision by the Financial Supervisory Authority of the Central Bank of Iceland (FSA). The basis of consolidation for financial accounting purposes differs from regulatory capital reporting purposes. The differences in the scopes of consolidation are set out in template EU LI3 in the Additional Pillar 3 Risk Disclosures. Where necessary, a distinction is made in the report between the consolidated situation and the parent entity.

The Bank is subject to consolidated supervision by the Financial Supervisory Authority of the Central Bank of Iceland (FSA)

All financial figures, calculations and information in the disclosures are based on financial information as at 31 December 2022 and presented in million krona, unless otherwise stated. Due to rounding, numbers in the disclosures may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures. The disclosures are published on an annual basis in conjunction with the Consolidated Financial Statements and the Annual and Sustainability Report. The EBA standardized disclosure templates are published quarterly, semi-annually or annually in accordance with CRR.

The disclosures are reviewed for accuracy and appropriateness, and verified and approved internally, in line with the Bank's disclosure policy. Information in the disclosures is not subject to external audit. Summarized information on risk management and capital adequacy is presented in the Bank's Consolidated Financial Statements.

# 2 Risk Management

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

Risk transparency helps employees make better decisions. The Bank's risk management policy is to maintain a strong culture in which risk is everyone's business. Senior management devotes a significant portion of its time to managing the Bank's risk.

The Bank's strategy is to have in place 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. The Bank's risk exposures fall under six primary categories: credit, market, liquidity, operational, conduct and compliance, and sustainability risk. Each category is discussed in detail in this report.

## 2.1 Internal Controls and Lines of Reporting

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

The ultimate responsibility for setting the Bank's risk and governance policies rests with the Board of Directors

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 companies. 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 Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP), the CRO interacts with individual subsidiaries' risk officers and consolidates the assessment of capital requirements for the Bank.

**Figure 2.1** Internal control structure


Acting within an authority delegated by the Board, the Board 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, and considering the implications of material regulatory change proposals.

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

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 the 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 also reports quarterly 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. The CRO has overall accountability for risk management in the Bank's parent company and monitors the risk profile of the Bank's subsidiaries using risk metrics and reporting lines defined in the respective ownership policies. A group-level risk assessment is periodically performed through the ICAAP and the ILAAP. Section 2.6 outlines the organization of the Risk Management division.

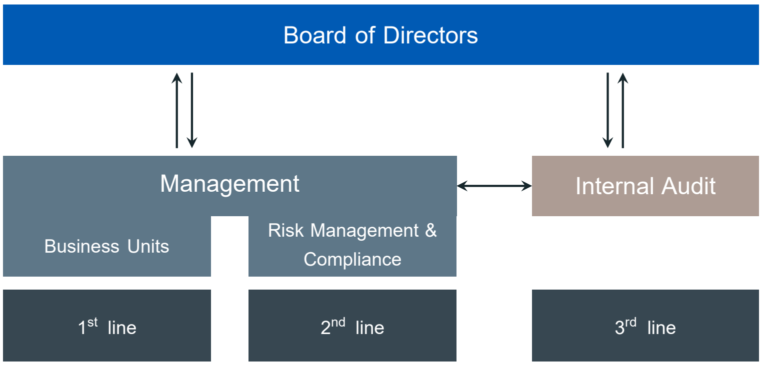
For further information on the Bank's governance arrangements, refer to Corporate Governance Statement for the year 2022. The statement provides information on directorships held by Board members, on their background and expertise, and the considerations and suitability criteria used in the nomination process, including diversity.

## 2.2 Three Lines Model

The Bank uses a Three Lines Model for organizing the internal control system. 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.

The Bank organises its internal control system using the Three Lines model

**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 determine's the Bank's risk appetite and tolerance

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 and tolerance. 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 subcommittees 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.

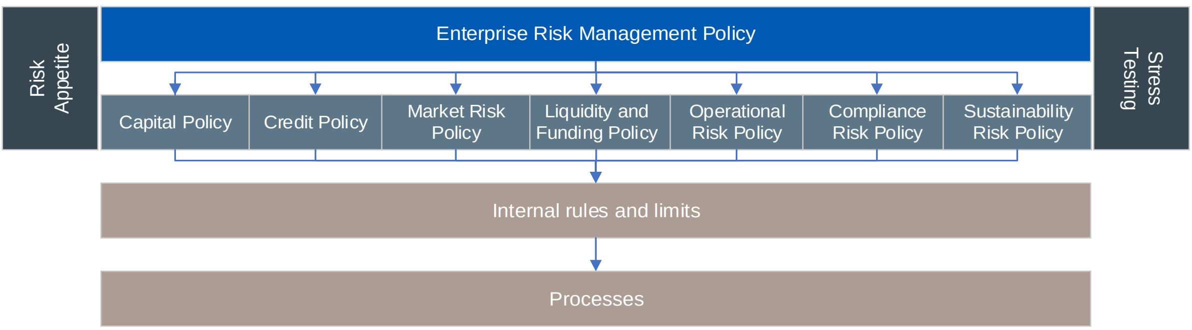
## 2.3 Risk Policies

The Bank's risk management policies define the significant risk types the Bank is exposed to. The policies are reviewed annually

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 reviewed and approved by the Board of Directors annually. The policy outlines, at a high level, the key aspects of the Bank's risk management. 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. Six risk types have been defined as significant: credit, market, liquidity, operational, conduct and compliance, and sustainability risk. For each of these risk types, the Board sets a specific policy for activities related to that risk type. 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 risk appetite is one of the key components of risk governance. A well-defined risk appetite is critical for managing risk and is essential for reinforcing a strong risk culture. In order to establish, communicate, and monitor its risk appetite, the Bank has in place a risk appetite 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 at least semi-annually.

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

Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits

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

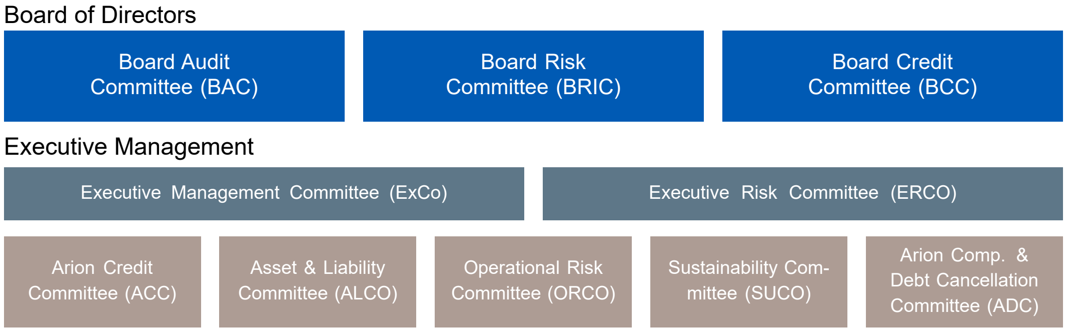
| Category | Risk metrics |
|---|---|
| Capital adequacy | Capital adequacy ratios<br>Leverage ratio<br>MREL |
| Liquidity and funding risk | Liquidity coverage ratios<br>Net stable funding ratio<br>Loans to deposits ratio<br>Asset encumbrance ratio |
| Market risk | Foreign exchange rate risk<br>Interest rate risk and indexation risk<br>Equity risk in the banking book<br>Equity risk in the trading book |
| Securities financing and counterparty credit risk | Uncollateralized exposure as per stress test |
| Credit risk | Diversification<br>Sectoral and geographical concentrations<br>Large exposures and single-name concentration<br>Expected credit loss<br>Average loan to value of residential mortgage portfolio |
| Operational risk | Operational losses<br>KYC adequacy ratio |

## 2.5 Risk Committees

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

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 role is to advise the Board on the development of the Bank's IT function, including strategy, enterprise architecture and alignment of IT function within the Bank's business.

Executive level risk committees, which are 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. 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 |

The Executive Risk Committee was established in 2022. It serves as the main forum for the Bank's risk management governance at the executive level. Its primary purpose is to ensure the appropriate implementation of all aspects of the Bank's enterprise risk management framework. The ERCO is chaired by the Bank's CRO.

One of the executive level risk committees is the Sustainability Committee. Among its responsibilities is the alignment of the Bank's overall strategy and risk appetite with the Bank's ESG commitments and good sustainability risk management practices, e.g. in the context of lending and investment decisions. The Bank's sustainability risk management framework is discussed in detail in Chapter 9 of this report.

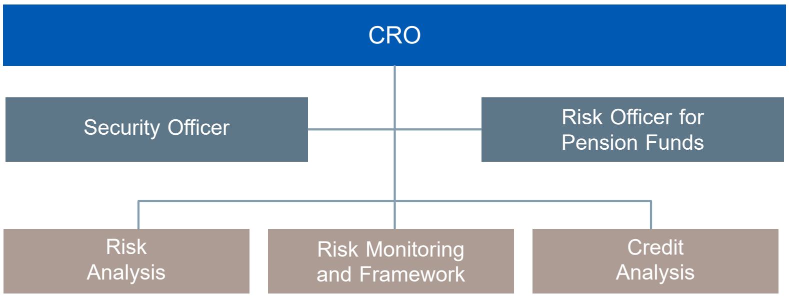
## 2.6 The Risk Management Division

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

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 three departments: Risk Analysis, Risk Monitoring and Framework, and Credit Analysis.

**Figure 2.5** Structure of Risk Management division




## Risk Analysis

The Risk Analysis department 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 and 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 varied quantitative support to the Bank's business units.

Risk Analysis provides quantitative support to the Bank's business units

## Risk Monitoring and Framework

Risk Monitoring and Framework is responsible for the internal control framework and supports the first line in managing risks. The department is responsible for monitoring credit quality of loans on a single-name basis and determining appropriate levels of provisioning for problem loans. It ensures that internal processes and controls minimize the risk of loss as effectively as possible.

Risk Monitoring and Framework ensures that the book value of distressed loans accurately reflects the expected recovery value of loans and is responsible for supervision of collateral valuation. The department is also responsible for developing and maintaining tools for identifying, measuring, monitoring, and controlling operational risk, such as Risk and Control Self-Assessment (RCSA) and loss data collection.

## Credit Analysis

Credit Analysis ensures Risk Management's involvement in credit transactions and analyzes and monitors credit cases submitted to the Bank's credit committee. Credit Analysis represents Risk Management at ACC meetings and participates in credit decisions and has the power to veto the ACC's credit decisions and escalate to the BCC for final approval. The department also administers and organizes credit committee meetings and advises on changes to the credit rules.

Credit Analysis has the power to escalate credit decisions to the BCC for final approval

Credit Analysis 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. Credit Analysis is also responsible for approving the valuation of unlisted securities used as collateral and validating the connectivity of related parties within the loan book.

### Chief Security Officer

The Bank's Chief Security Officer supervises physical and information security management in the Bank's second line. The Chief Security Officer reports to the CRO.

### Risk Officer for Pension Funds

The Risk Officer for pension funds managed by Arion Bank is a member of Risk Management and reports to the CRO. The Risk Officer for pension funds performs the duties assigned in the Pension Act No. 129/1997 and Regulation No. 590/2017 on risk management in pension funds.

## 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 resource to ensure the fulfillment of the Bank's policy. Risk information is regularly reported to the Board of Directors and its subcommittees. 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

| Primary reporting | Contents | Fre-quency | Recipient |
|---|---|---|---|
| Credit risk portfolio report | A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the credit quality of the loan portfolio. | Monthly | ACC |
| 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 |
| 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<br>BRIC<br>ExCo<br>ERCO |
| ICAAP | Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval. | Annually | Board<br>BRIC<br>ERCO |
| ILAAP | Evaluation of the Bank's total risk exposure and liquidity adequacy. The report is submitted for review and/or approval. | Annually | Board<br>BRIC<br>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. | Annually | Board<br>BRIC<br>ALCO |
| Internal bank-wide stress testing | 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<br>BRIC<br>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<br>BRIC |

# 3 Capital Management

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 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.

## 3.1 Governance

The Bank's capital policy and dividend policy are established by the Board of Directors based on recommendations from the Board Risk Committee (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 Internal Capital Adequacy Assessment Process (ICAAP) and allocation of capital. The Bank's stress testing framework is integrated with the Bank's business plan process and ICAAP, and is used to assess whether capital levels are acceptable under stressed conditions.

## 3.2 Capital Strategy

The Bank's target for Common Equity Tier 1 (CET1) ratio is to be 150–250bp 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, see Section 3.6.4. Relative to the total CET1 regulatory requirement of 15.8%, this implies a CET1 target of 17.3–18.3%. The Bank's management buffer accounts for volatilities in the risk-weighted exposure amount (REA) and own funds and facilitates further flexibility in the management of capital.

The Bank's capital position is in excess of its capital targets. According to the Bank's capital plan, surplus capital is to be distributed to shareholders. The Bank has issued Additional Tier 1 and Tier 2 instruments so that the Bank's AT1 ratio is 1.5% and T2 ratio is 3.7%. The AT1 position is somewhat below the normalization target but the T2 position is well in excess of the target following the issuance of ISK-denominated Tier 2 bonds in December 2022.

The Bank's dividend policy is to pay out 50% of net earnings at-

At year-end 2022 the Bank's CET1 ratio was 18.8% and total capital ratio 24.0%. The ratios account for a foreseeable equity reduction of ISK 16.0 billion through buyback of own shares and dividend distribution tributable to shareholders as dividend and in addition use special distributions to bring own funds towards the normalized composition. In line with this, the Bank intends to distribute dividends of ISK 12.7 billion and buy back shares to the amount of ISK 3.3 billion. These amounts have been subtracted from CET1 when calculating the capital ratios.

## 3.3 Legal Framework and Calculation Approaches

The Bank's capital adequacy is determined in accordance with Act No. 161/2002 on financial undertakings, which represents the Icelandic adoption of the EU Capital Requirements Directive and Regulation.

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 capital requirements are described in greater detail in Section 3.6.

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 Additional Tier 1) capital shall exceed 6%
- Total capital (Tier 1 and Tier 2) 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.

## 3.4 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 Group's Additional 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 sources of differences 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.

Credit risk accounted for 87% of the Bank's REA at year-end 2022. The Bank's REA for credit risk increased by ISK 72 billion in 2022. The increase is mainly due to loans to customers which grew by ISK 149 billion during the year. REA for operational risk decreased since following the sale of Valitor, the Bank received permission from the FSA to exclude the subsidiary's historical revenues from the calculation.

A breakdown of the Bank's REA is shown in Note 46 of the Consolidated Financial Statements and in template EU OV1.

**Figure 3.1** Development of REA [ISK m]

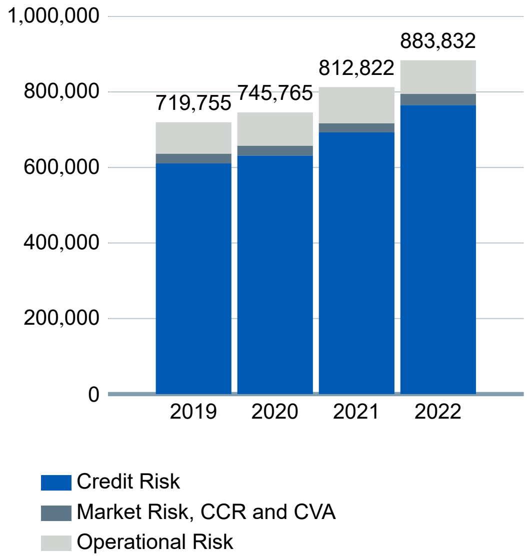



**Table 3.2** Overview of risk-weighted exposure amount (EU OV1)

| 31 December [ISK m] | REAs | | Minimum own funds requirements |
|---|---|---|---|
| | 2022 | 2021 | 2022 |
| **Credit risk (excluding CCR)** | **738,966** | **666,102** | **59,117** |
| of which the standardized approach | 738,966 | 666,102 | 59,117 |
| **CCR** | **20,655** | **10,141** | **1,652** |
| of which the standardized approach | 14,645 | 7,761 | 1,172 |
| of which CVA | 6,010 | 2,379 | 481 |
| **Market risk** | **8,880** | **13,649** | **710** |
| of which the standardized approach | 8,880 | 13,649 | 710 |
| **Operational risk** | **89,166** | **96,085** | **7,133** |
| of which standardized approach | 89,166 | 96,085 | 7,133 |
| **Amounts below the thresholds for deduction (subject to 250% risk weight)** | **26,165** | **26,845** | **2,093** |
| **Total** | **883,832** | **812,822** | **70,707** |

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.

## 3.5 Own Funds

The Bank's own funds are composed of Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 (T2) 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 public health crisis. Template EU IFRS9-FL shows the effects on capital and REA if these arrangements were not available.

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 100 million subordinated liability issued in Q1 2020.

The Bank's Tier 2 capital consists of subordinated liabilities issued in the period from Q4 2018 to Q4 2019 in SEK, NOK, ISK, and EUR and in Q4 2022 in ISK, see Note 33 in the Bank's Consolidated Financial Statements 2022. The contractual maturities range from 2028 to 2033, and the first call option becomes active as of November of 2023.

Template EU CCA provides further details on each of the Bank's own funds 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. Table 3.3 is an extract from EU CC1 with the data that is most relevant to the Bank.

**Figure 3.2** Development of own funds [ISK m]

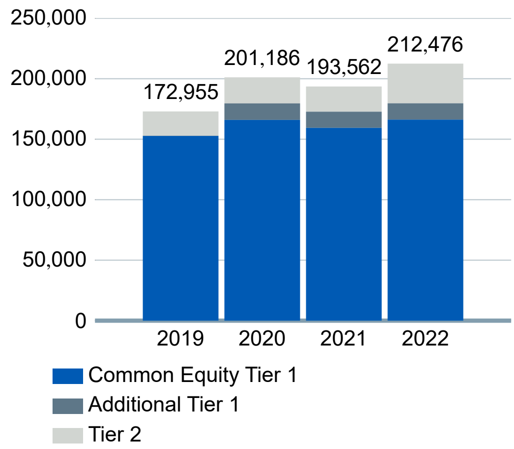


**Table 3.3** Reconciliation of own funds

| Own funds [ISK m] | 2022 | 2021 |
|---|---|---|
| **Total equity** | **188,331** | **194,598** |
| Non-controlling interest not eligible for inclusion in CET1 capital | -649 | -673 |
| **Common Equity Tier 1 capital before regulatory adjustments** | **187,682** | **193,925** |
| Intangible assets | -6,425 | -8,435 |
| Additional value adjustments and other | -224 | -240 |
| Foreseeable dividend and buyback | -15,980 | -26,773 |
| Adjustment under IFRS9 transitional arrangements | 1,142 | 920 |
| **Common equity Tier 1 capital** | **166,195** | **159,397** |
| Non-controlling interest eligible for inclusion in T1 capital | 105 | 133 |
| Additional Tier 1 capital | 13,396 | 13,225 |
| **Tier 1 capital** | **179,696** | **172,775** |
| Tier 2 instruments | 33,935 | 21,863 |
| Tier 2 instruments of financial sector entities (signif. invest.) | -1,155 | -1,056 |
| **Tier 2 capital** | **32,780** | **20,807** |
| **Total own funds** | **212,476** | **193,562** |

## 3.6 Capital Management and Capital Requirements

The Pillar 1 capital requirement for the Bank is 8% of REA. In addition to this, the Bank employs various techniques in its assessment of capital need. The Bank's Internal Capital Adequacy Assessment Process (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.

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 which the Bank must hold own funds for and may, on the basis of stress test results, issue non-binding additional capital guidance, called Pillar 2G. Finally, the Bank must hold own funds to meet the combined capital buffer requirement.

### 3.6.1 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 the Bank's internal assessment of its capital need

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank has sufficient capital for its risk profile. The Bank's ICAAP report is approved annually by the Board of Directors, the CEO, and the CRO and submitted to the 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 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 3.4.

**Table 3.4** Risk identification down to operating segment

| Business Units | Credit risk | Market risk | Liquidity risk | Operational risk | Compliance risk | Sustainability 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, a capital add-on is applied on top of the minimum 8% regulatory capital requirements. 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 that are deemed high risk
- Equity position risk

The Icelandic Financial Stability Committee is responsible for setting the Systemic Risk Buffer. Its value has been set to 3% for domestic exposures. Justification for this value is still based on the recommendation from the Financial Stability Council from 2016 where numerous systemic risk factors are cited to justify the level of the buffer. The Bank does therefore not include these risk factors in its Pillar 2 capital assessment. Among those is the lack of diversification of the Icelandic economy, which is reflected in sector concentration in the Bank's loan portfolio.

As part of the Pillar 2 capital assessment, the Bank uses internal models to assess capital needs for credit risk. Meanwhile, the FSA has published SREP guidelines, stating that *"domestic exposures are considered riskier, resulting in higher capital require-*

*ments for those institutions that do not use the internal ratings based method”,* and has specified elevated Pillar 2 risk weights for certain exposure classes: 24% for Regional government & Institutions, 61% for Commercial real estate, 80% for Retail and 109% for Corporate & other. This results in a considerable SREP capital add-on, not reflected in the Bank’s ICAAP result.

The SREP of 2022, which was based on financial figures from 31 December 2021, resulted in a Pillar 2R capital requirement of 3.5% of REA.

The SREP of 2022, which was based on financial figures from 31 December 2021, resulted in a Pillar 2R capital requirement of 3.5% of REA

### 3.6.2 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.

Stress tests provide an important management tool for the Bank

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 3.3** 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.

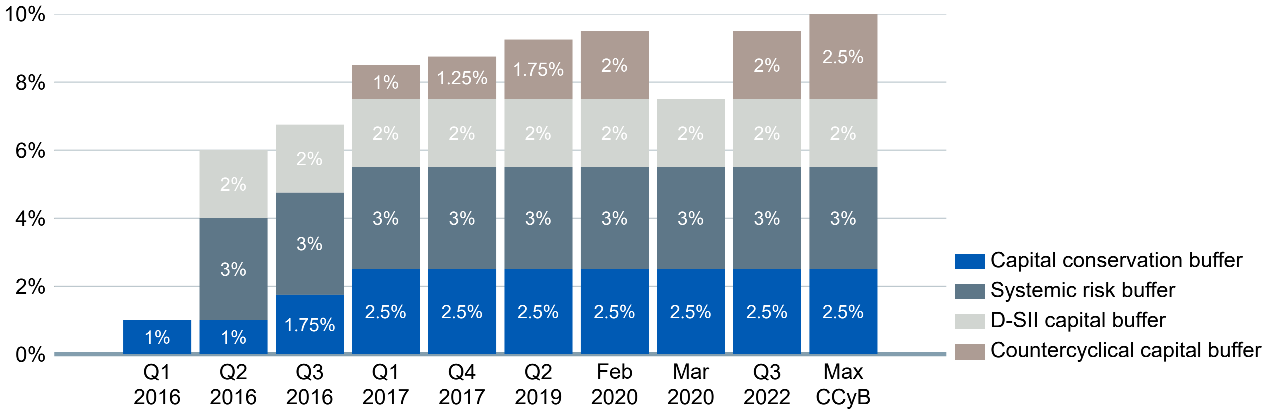
One of the stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FSA. The Bank also performs various regularly scheduled stress tests and targeted ad-hoc stress tests.

### 3.6.3 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 was set to 0% in March 2020 as a response to the COVID-19 crisis but rose again to 2% on 29 September 2022 based on a decision of the Financial Stability Committee from a year earlier.

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

**Figure 3.4** Implementation of capital buffer levels for Icelandic D-SIIs, including maximum application of countercyclical buffer




The effective countercyclical capital buffer for the Bank is determined using the weighted average of the respective capital buffer level 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 2022, the effective combined capital buffer requirement for the Bank is 9.3%. Templates EU CCyB1 and EU CCyB2 show details regarding the calculation of the countercyclical buffer requirement.

**Table 3.5** Arion Bank's capital buffer requirements at year-end 2022

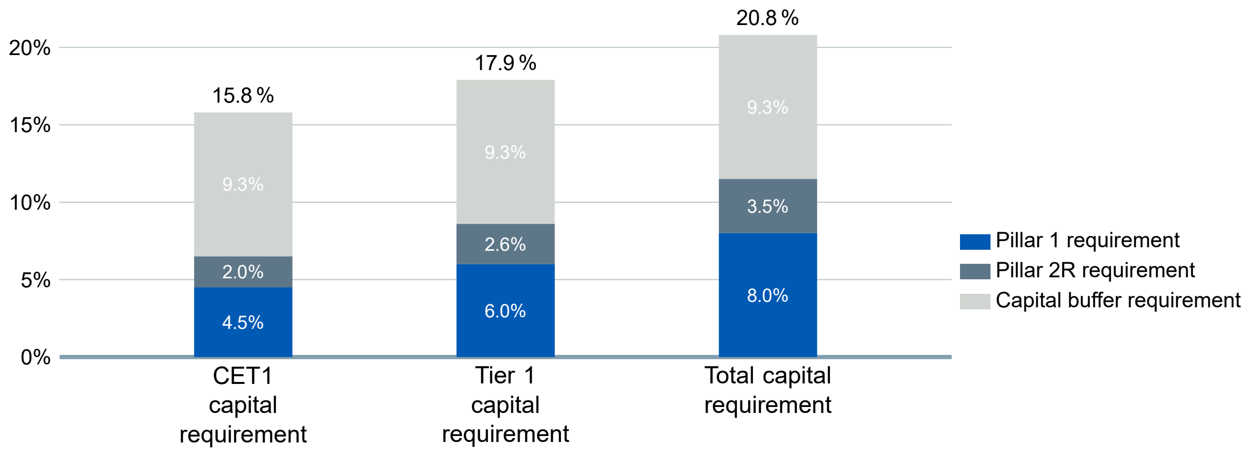
| Capital buffer | Domestic exposures | Foreign exposures | Institution-specific buffer rate |
|---|---|---|---|
| Capital conservation buffer | 2.5% | 2.5% | 2.5% |
| Systemically important institution buffer | 2.0% | 2.0% | 2.0% |
| Systemic risk buffer | 3.0% | 0.0% | 2.8% |
| Countercyclical capital buffer | 2.0% | CCyB of country | 2.0% |
| **Total** | **9.5%** | **4.5%+CCyB** | **9.3%** |
| REA credit risk weight | 92.9% | 7.1% | |

## 3.6.4 Summary of Capital Requirements

The Bank's total regulatory requirement, comprising Pillar 1, Pillar 2, and the capital buffer requirements, is 20.8%. The following figure shows how this requirement is broken down by type. Management's policy is to maintain a CET1 ratio which is 150–250bp above the CET1 requirement and utilize AT1 and T2 to the maximum extent to meet the Pillar 1 and Pillar 2 capital requirement. This implies that the target capital adequacy ratio is 22.3–23.3%.

The Bank's total regulatory requirement is 20.8% at 31 December 2022. The Bank's capital ratio benchmark is 22.3–23.3%

**Figure 3.5** Arion Bank's own funds regulatory requirements with combined capital buffer requirements at 31 December 2022



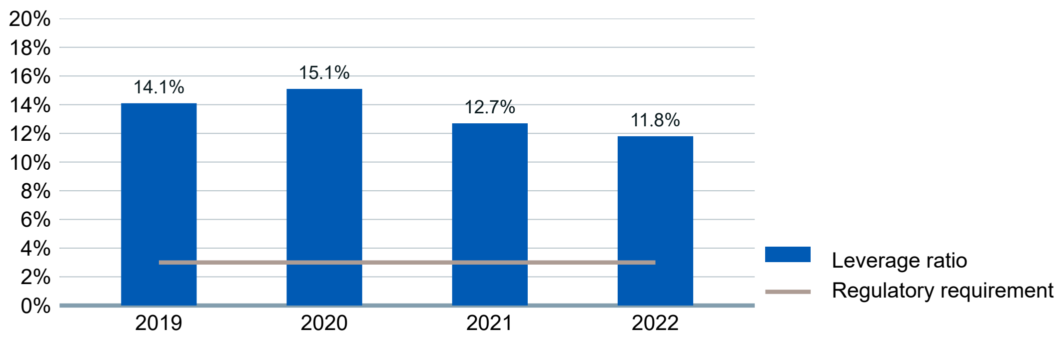

## 3.7 Leverage Ratio

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 2022, the Bank had a strong leverage ratio of 11.8%, 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 relatively high combined capital buffer requirement of 9.3%, 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 58% for the consolidated situation.

Arion Bank is a rare example of a systemically important institution that applies the standardized approach for credit risk. This is reflected in an exceptionally strong leverage ratio in international comparison

**Figure 3.6** Development of the Bank's leverage ratio



## **Capital** Management

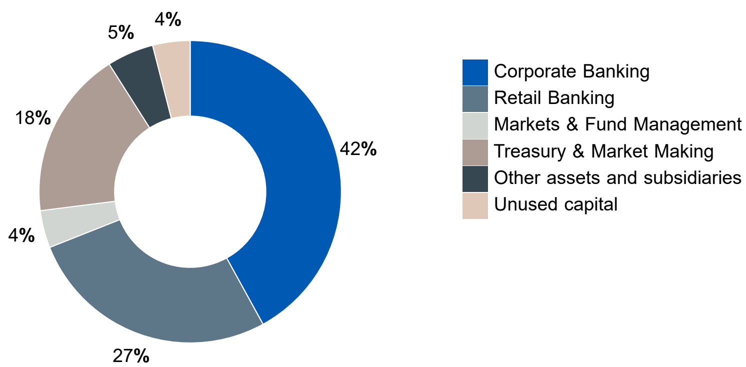
The Bank's Tier 1 capital and the total exposure increased in 2022 but the rate of increase in total exposure was significantly higher, leading to a decrease in the leverage ratio. In light of the strong leverage ratio, the Bank's management of the risk of excessive leverage is currently confined to 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.

### 3.8 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 3.8** Allocated capital for Q1 2023, 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 capital buffers and Pillar 2 requirements.

### 3.9 Capital Position

At year-end 2022, the Bank's CET1 ratio was 18.8%, well above the target CET1 ratio of 17.3–18.3% and the CET1 requirement of 15.8%. The total capital ratio was 24.0%

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

The Bank's own funds at 31 December 2022 take into account a foreseeable equity distribution of ISK 16.0 billion through dividends and share buyback. The foreseeable dividend corresponds to 50% of profits as per the Bank's dividend policy. The share buyback includes an ongoing and approved buyback from December 2022 and the remaining part of authorized buyback of own shares from the Central Bank from 5 September 2022. Therefore, this distribution will not affect the Bank's capital adequacy ratios.

**Figure 3.7** Capital planning and monitoring process

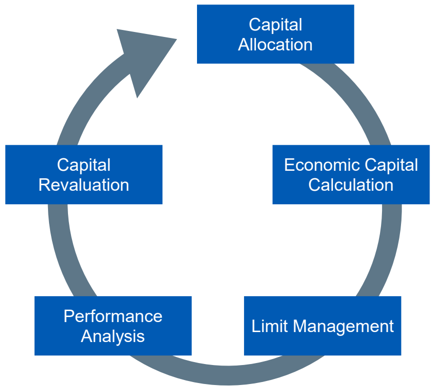
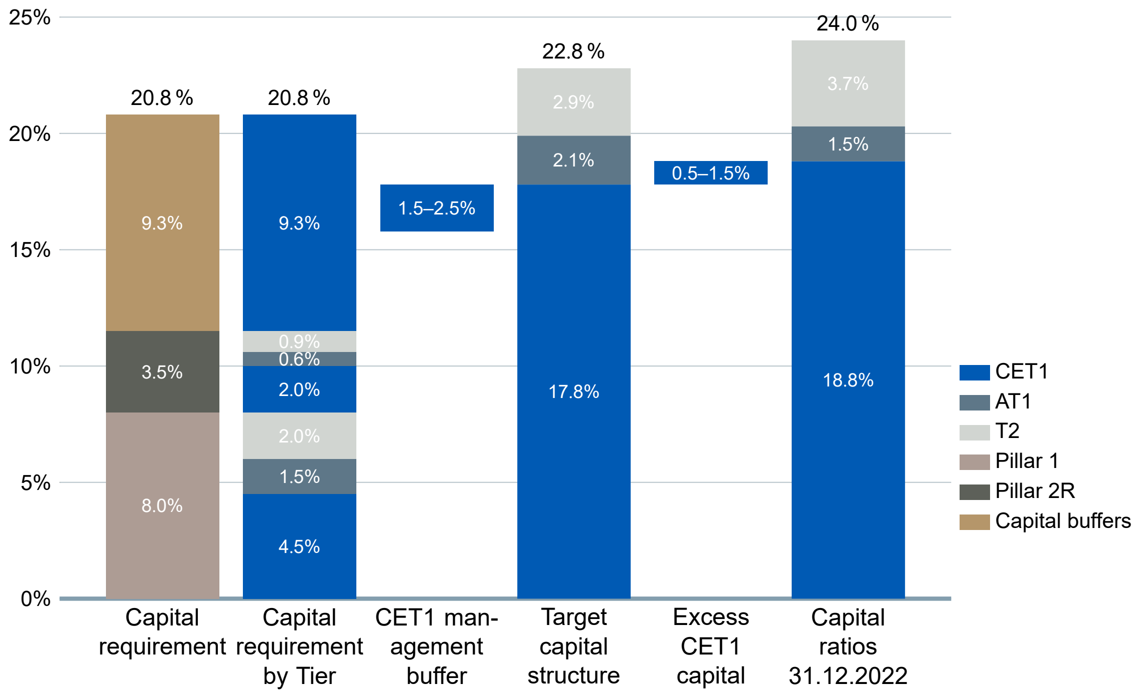


**Figure 3.9** Arion Bank's capital requirement, target capital structure and capital ratios




The template EU KM1 shows the development of key metrics related to own funds, REA, capital ratios, capital requirements and the leverage ratio. The following table shows an extract of this data.

The main driver for the change in capital position in 2022 is the Bank's strategy to normalize own funds. Thus, ISK 32.3 billion of excess capital was paid out to shareholders during the year. The Bank's REA grew by 8.7% during the year but because of the capital distribution, CET1 capital after regulatory adjustments grew only by 4.4%. Included in this number is the foreseeable capital distribution.

**Table 3.6** Overview of own funds and capital adequacy

| 31 December [ISK m] | 2022 | 2021 |
|---|---|---|
| **Own funds** | | |
| Common Equity Tier 1 (CET1) capital | 166,195 | 159,397 |
| Tier 1 capital | 179,696 | 172,755 |
| Total own funds | 212,476 | 193,562 |
| Risk-weighted exposure amount | 883,832 | 812,822 |
| CET1 capital ratio | 18.8% | 19.6% |
| Tier 1 capital ratio | 20.3% | 21.2% |
| Total capital ratio | 24.0% | 23.8% |
| **Own funds requirement** | | |
| Pillar 1: Minimum capital requirement | 8.0% | 8.0% |
| *of which CET1 requirement* | *4.5%* | *4.5%* |
| *of which Tier 1 requirement* | *6.0%* | *6.0%* |
| Pillar 2: Additional capital requirement (ICAAP/SREP) | 3.5% | 3.2% |
| *of which CET1 requirement* | *2.0%* | *1.8%* |
| *of which Tier 1 requirement* | *2.6%* | *2.4%* |
| Combined capital buffer requirement | 9.3% | 7.3% |
| *of which capital conservation buffer requirement* | *2.5%* | *2.5%* |
| *of which systemically important institution buffer requirement* | *2.0%* | *2.0%* |
| *of which systemic risk buffer requirement* | *2.8%* | *2.8%* |
| *of which countercyclical capital buffer requirement* | *2.0%* | *0.0%* |
| Total CET1 capital requirement | 15.8% | 13.6% |
| Total Tier 1 capital requirement | 17.9% | 15.7% |
| Total capital requirement | 20.8% | 18.5% |
| **Leverage ratio** | | |
| Exposure measure for leverage ratio calculation | 1,517,369 | 1,364,448 |
| Leverage ratio | 11.8% | 12.7% |

## 3.10 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 Bank Resolution and Recovery Directive (BRRD) (2014/59/EU) into Icelandic law. On the basis of this law, a Resolution Authority was set up within the Central Bank of Iceland. On 8 December 2021, the Resolution Authority published their MREL policy which details their approach for determining the mininum required amount of own funds and eligible liabilities (MREL) for credit institutions.

It must be noted that only BRRD I has been transposed into Icelandic law. BRRD II ((EU) 2019/879) has already entered into force in the EU and will be incorporated into the EEA agreement. The Icelandic legislative process for the implementation of BRRD II has started and is expected to be completed in 2023. A draft of the primary legislation has been published but details of the calculation of the MREL requirements and the dates which they will take effect will be published as part of the secondary legislation. According to the EEA decision on BRRD II, the final MREL requirements will take effect at latest three years after the legislative process has been completed and interim requirements one year after the legislative process has been completed.

The MREL requirement is composed of two parts, the loss absorption amount (LAA) and the recapitalization amount (RCA). As the names suggest, the purpose of the LAA is to absorb the losses from events which have happened before the resolution authority steps in. The RCA is then available for the resolution authority to ensure that the institution is fully capitalized from day one after the restructuring.

The LAA is equal to the minimum capital requirement for the institution, i.e. Pillar 1 and Pillar 2 requirement. The RCA should also equal the minimum capital requirement but for the institution post-restructuring so if the resolution plan entails asset sale the RCA should be adjusted down to account for the balance sheet reduction. On the other hand, the RCA could be increased by the so-called Market Confidence Charge (MCC) which is intended to ensure that the institution retains market confidence post-restructuring.

The Icelandic Resolution Authority has announced that for the time being there will not be any MCC supplement to the RCA. Thus, the MREL requirement will generally be twice the size of the Pillar 1 plus Pillar 2 requirement for Icelandic institutions but may in specific cases be revised down to account for expected asset sale during resolution. Furthermore, the capital buffer requirement will be independent of the MREL requirement, so that institutions must meet the capital requirement of Pillar 1 plus Pillar 2 plus buffers using own funds and also the MREL requirement of twice the Pillar 1 plus Pillar 2 using own funds and eligible liabilities not used for the buffers. The same own funds can be used to meet the Pillar 1 and Pillar 2 requirement and the MREL requirement.

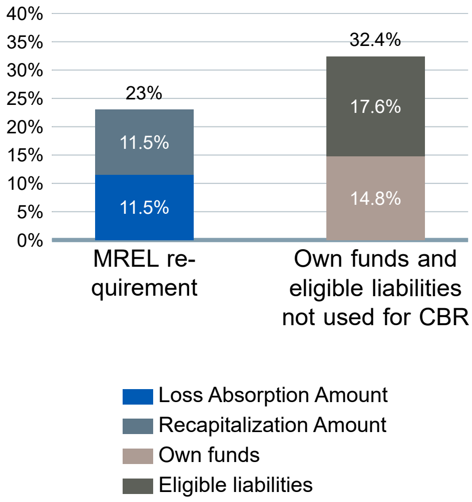
In accordance with this methodology, the Icelandic Resolution Authority presentend the Bank with an MREL requirement of 23.0% of REA based on financials from 31 December 2021. Under BRRD I, the actual requirement is set as a percentage of TLOF and is 14.7% of TLOF.

Under BRRD I, there is no specific subordination requirement for eligible liabilities. Resolution authorities have the power to introduce such a requirement but the Icelandic Resolution Authority does not intend to do so since it considers that the so-called "no creditor worse off" rule is not constraining for it during resolution because deposits already enjoy a priority during resolution according to Icelandic law.

When BRRD II takes effect, it becomes mandatory for some institutions that a part of the MREL requirement is met with own funds or liabilities which are subordinate to ordinary unsecured claims. For this, a new class of securities has been introduced into the liability structure of institutions, the so-called senior non-preferred (SNP) liabilities which are senior to own funds issuances (T1 and T2) but subordinate to ordinary unsecured claims and the so-called senior preferred (SP) liabilities. SP liabilities are defined as liabilities which satisfy all the conditions to be SNP liabilities except the subordination condition. SP liabilities are therefore pari passu with ordinary unsecured claims.

The Bank is neither a G-SII nor does it have assets exceeding EUR 100 billion and so it will not be mandatory that the Resolution Authority assigns a subordination requirement to it. However, the Bank is a D-SII so it is probable that there will be a subordi-

**Figure 3.10** MREL requirement and MREL position, percent of REA



nation requirement and the indication in the MREL policy is that the subordination requirement will be 13.5% of REA.

According to BRRD II, only SP liabilities, SNP liabilities, and own funds can be used to meet the MREL requirement. In line with that, the Bank has ensured that it meets the requirement set by the Icelandic Resolution Authority with a sufficient amount of outstanding SP liabilities.

## 3.11 CRR 3

Legislation to implement the Basel IV framework in the European Union is making its way through the EU legislative process. Dubbed CRR 3, the initial text was published by the European Commission in October 2021. Various amendments have since been proposed so the final outcome of the process is somewhat uncertain. The legislation is expected to apply in the EU from January 2025. Most likely it will be implemented in Iceland at the same time.

For Arion Bank, the key changes in the capital requirements are the following:

- *Residential Real Estate* Under the current rules, exposure secured with residental 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 valution must be used. Currently it is unclear whether a six or eight-year average must be used. Overall, the Bank expects a slight increase in REA due to these changes.
- *Corporate Loans* Various changes are proposed for corporate loans, including new risk weights for income producing real estate, changes to risk weights for loans secured by commercial real estate, new risk weighhs for construction exposures and possibly also changes to Corporate SME exposures. Taken together, these changes are expected to yield a small decrease in REA.
- *Equity* The treatment of equity exposures will be overhauled. Currently, they receive 100% risk weight under the standarized approach but will generally receive 250% under the proposals. 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.
- *Off balance sheet exposures* The credit conversion factor (CCF) for off balance sheet exposures will be changed. Loan commitments which now receive either 20% of 50% risk weight based on duration will now 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.

REA is not expected to change significantly with the adoption of CRR 3. The expectation is a reduction in REA of around 0.5% or less

- *Operational risk* Due to the small size of the Bank, capital requirements for operational risk will fall into the lowest bracket. Also, 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.

When all of these factors are taken together, REA is not expected to change significantly with the adoption of CRR 3. The expectation is a reduction in REA of around 0.5% or less.

# 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. Credit risk is the largest risk in the Bank's operations.

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 4.3.5. |

## 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 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.

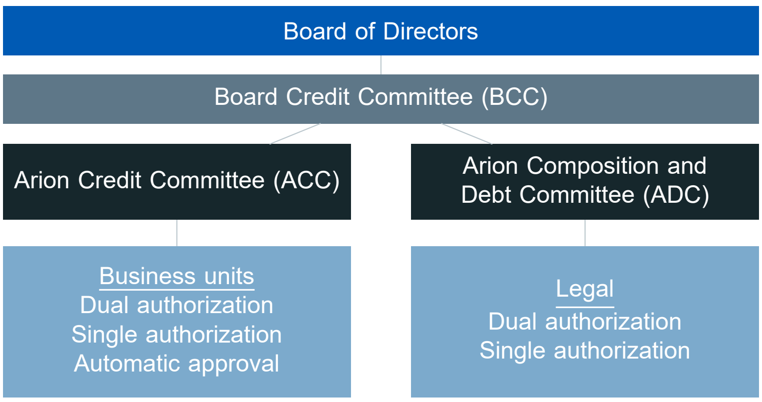
The Bank's risk appetite framework further specifies the desired level of risk exposure through qualitative and quantitiative statements. The framework addresses credit quality, collateral coverage, portfolio composition, and single-name, sectoral, and geographical concentrations. It is ensured that 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 responsibilities, rules, and criteria for credit risk arising from the Bank's operations. On 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 ADC is chaired by the CEO and the ACC is chaired by the CEO and Deputy CEO and delegates. Risk Management administers and 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 to the Board Credit Committee (BCC) if the exposure does not require risk appetite exemptions.

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. BCC reviews the credit framework on an annual basis.

**Figure 4.1** Credit approval hierarchy




In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, which outlines responsibilities, rules, and criteria for credit risk arising from the Bank's operations

## 4.2 Credit Risk Management

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

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

During the repayment phase, the credit portfolio is closely monitored by the first line and the 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 decision, Risk Management maintains statistical and expert judgement models that assess the likelihood of default and the liquidation value of collateral.

Risk Management performs a periodic review 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

### 4.3.1 Overview

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.

The exposure amounts shown are on different basis: Exposure at default amounts according to the rules on capital requirements are derived from original exposure (gross carrying value including off-balance sheet amounts), net exposure after applying specific credit risk adjustments to the original exposure, adjusted exposure value (net exposure after applying credit risk mitigation (CRM), i.e. exposure net of collateral) and exposure at default (EAD) which is the adjusted exposure value after applying credit conversion factors (CCF) to off-balance sheet items. Also shown are risk-weighted exposure amounts (REA), which is EAD multiplied with the relevant risk-weight.

**Table 4.2** Credit risk exposure and credit risk mitigation effects (EU CR4)

| 31 December 2022 [ISK m] | Net exposures before CCF and CRM | | EAD post CCF and CRM | | REAs and REA density | |
|---|---|---|---|---|---|---|
| | On-balance sheet | Off-balance sheet | On-balance sheet | Off-balance sheet | REAs | REA density |
| Central governments or central banks | 211,059 | 140 | 213,833 | 1 | 60 | 0.0% |
| Regional governments or local authorities | 7,536 | 1,768 | 7,876 | 426 | 1,659 | 20.0% |
| Public sector entities | 0 | 0 | 0 | 0 | 0 | 0.0% |
| Multilateral development banks | 0 | 0 | 275 | 3 | 0 | 0.0% |
| Institutions | 25,629 | 2 | 27,160 | 40 | 11,069 | 40.7% |
| Corporates | 387,075 | 120,477 | 375,848 | 44,483 | 405,852 | 96.6% |
| Retail | 127,993 | 56,802 | 126,256 | 10,092 | 93,347 | 68.5% |
| Secured by mortgages on immovable property | 555,813 | 3,618 | 555,694 | 1,044 | 197,577 | 35.5% |
| Exposures in default | 9,849 | 206 | 9,694 | 55 | 11,656 | 119.6% |
| Exposures associated with particularly high risk | 2,189 | 0 | 2,189 | 0 | 3,130 | 143.0% |
| Covered bonds | 18,898 | 0 | 18,898 | 0 | 3,780 | 20.0% |
| Collective investments undertakings | 2,068 | 0 | 2,068 | 0 | 1,485 | 71.8% |
| Equity | 15,470 | 0 | 15,470 | 0 | 30,500 | 197.2% |
| Other items | 19,495 | 0 | 19,495 | 0 | 19,661 | 100.9% |
| **Total** | **1,383,072** | **183.013** | **1,374,755** | **56.143** | **779.775** | **54.5%** |

**Table 4.2** Continued

| 31 December 2021 [ISK m] | Net exposures before CCF and CRM | | EAD post CCF and CRM | | REAs and REA density | |
|---|---|---|---|---|---|---|
| | On-balance sheet | Off-balance sheet | On-balance sheet | Off-balance sheet | REAs | REA density |
| Central governments or central banks | 182,762 | 146 | 186,481 | 5 | 62 | 0.0% |
| Regional governments or local authorities | 3,424 | 3,227 | 3,931 | 1,451 | 1,067 | 19.8% |
| Public sector entities | 908 | 24 | 608 | 9 | 308 | 49.9% |
| Multilateral development banks | 0 | 0 | 531 | 0 | 0 | 0.0% |
| Institutions | 28,753 | 6,488 | 28,753 | 1,323 | 10,451 | 34.7% |
| Corporates | 325,461 | 118,748 | 313,164 | 47,066 | 340,966 | 94.7% |
| Retail | 122,876 | 53,246 | 120,462 | 11,172 | 91,293 | 69.4% |
| Secured by mortgages on immovable property | 475,452 | 3,757 | 475,396 | 1,579 | 168,056 | 35.2% |
| Exposures in default | 13,499 | 308 | 13,208 | 85 | 16,566 | 124.6% |
| Exposures associated with particularly high risk | 1,599 | 0 | 1,599 | 0 | 2,398 | 150.0% |
| Covered bonds | 21,001 | 0 | 21,001 | 0 | 4,200 | 20.0% |
| Collective investments undertakings | 5,330 | 0 | 5,330 | 0 | 5,028 | 94.3% |
| Equity | 17,859 | 0 | 17,859 | 0 | 32,518 | 182.1% |
| Other items | 27,692 | 0 | 27,692 | 0 | 27,795 | 100.4% |
| **Total** | **1,226,617** | **185,944** | **1,216,016** | **62,689** | **700,710** | **54.8%** |

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, reamained stable in 2022 with a slight decrease from 54.8% to 54.5%. For further breakdown see Tables 4.2 and 4.3.

**Table 4.3** Exposure at Default (post CRM and CCF) by exposure classes and risk-weights (EU CR5). The last column refers to ratings from external rating agencies. CRR exposures are included in this table.

| 31 December 2022 [ISK m] | Risk weights | | | | | | | | | Of which |
|---|---|---|---|---|---|---|---|---|---|---|
| Exposure classes | 0% | 20% | 35% | 50% | 75% | 100% | 150% | Other | Total | unrated |
| Central gov. or central banks | 213,669 | 302 | 0 | 0 | 0 | 0 | 0 | 0 | 213,972 | 6,054 |
| Regional governments or local authorities | 0 | 8,302 | 0 | 0 | 0 | 0 | 0 | 0 | 8,302 | 0 |
| Public sector entities | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Multilateral dev. banks | 278 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 278 | 278 |
| Institutions | 0 | 34,120 | 0 | 8,493 | 0 | 0 | 0 | 0 | 42,613 | 0 |
| Corporates | 0 | 159 | 0 | 2,876 | 0 | 425,919 | 153 | 0 | 429,107 | 420,157 |
| Retail exposures | 0 | 0 | 0 | 0 | 136,833 | 0 | 0 | 0 | 136,833 | 136,833 |
| Exposures secured by mortgages on immovable property | 0 | 0 | 538,710 | 9,678 | 0 | 8,348 | 0 | 0 | 556,737 | 556,737 |
| Exposures in default | 0 | 0 | 0 | 0 | 0 | 5,906 | 3,843 | 0 | 9,748 | 9,748 |
| Exposures associated with particularly high risk | 102 | 0 | 0 | 0 | 0 | 0 | 2,087 | 0 | 2,189 | 2,189 |
| Covered bonds | 0 | 18,898 | 0 | 0 | 0 | 0 | 0 | 0 | 18,898 | 0 |
| Units or shares in collective investments undertakings | 0 | 0 | 0 | 0 | 0 | 1,248 | 93 | 727 | 2,068 | 2,068 |
| Equity exposures | 467 | 0 | 0 | 0 | 0 | 4,671 | 0 | 10,331 | 15,470 | 15,470 |
| Other items | 0 | 0 | 0 | 0 | 0 | 19,219 | 0 | 135 | 19,354 | 19,495 |
| **Total** | **214,516** | **61,782** | **538,710** | **21,047** | **136,833** | **465,312** | **6,175** | **11,192** | **1,455,569** | **1,169,029** |

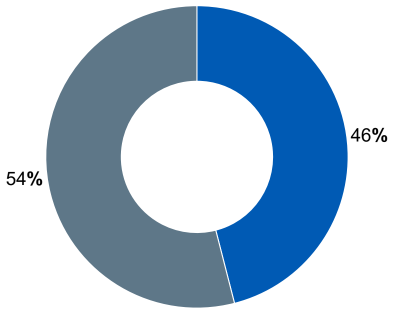
**Table 4.3** Continued

| 31 December 2021 [ISK m] | Risk weights | | | | | | | | | Of which |
|---|---|---|---|---|---|---|---|---|---|---|
| Exposure classes | 0% | 20% | 35% | 50% | 75% | 100% | 150% | Other | Total | unrated |
| Central gov. or central banks | 187,984 | 311 | 0 | 0 | 0 | 0 | 0 | 0 | 188,295 | 7,390 |
| Regional governments or local authorities | 0 | 5,382 | 0 | 0 | 0 | 0 | 0 | 0 | 5,382 | 0 |
| Public sector entities | 0 | 1 | 0 | 615 | 0 | 0 | 0 | 0 | 616 | 0 |
| Multilateral dev. banks | 531 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 531 | 531 |
| Institutions | 0 | 31,788 | 0 | 8,130 | 0 | 31 | 0 | 0 | 39,948 | 31 |
| Corporates | 0 | 16 | 0 | 5,488 | 0 | 358,981 | 0 | 0 | 364,485 | 367,598 |
| Retail exoposures | 0 | 0 | 0 | 0 | 132,231 | 0 | 0 | 0 | 132,231 | 132,629 |
| Exposures secured by mortgages on immovable property | 0 | 0 | 464,685 | 7,142 | 0 | 5,147 | 0 | 0 | 476,975 | 477,031 |
| Exposures in default | 0 | 0 | 0 | 0 | 0 | 6,745 | 6,548 | 0 | 13,293 | 13,359 |
| Exposures associated with particularly high risk | 0 | 0 | 0 | 0 | 0 | 0 | 1,599 | 0 | 1,599 | 1,599 |
| Covered bonds | 0 | 21,001 | 0 | 0 | 0 | 0 | 0 | 0 | 21,001 | 0 |
| Units or shares in collective investments undertakings | 0 | 0 | 0 | 0 | 0 | 189 | 934 | 4,207 | 5,330 | 5,330 |
| Equity exposures | 838 | 0 | 0 | 0 | 0 | 6,691 | 0 | 10,331 | 17,859 | 17,859 |
| Other items | 0 | 0 | 0 | 0 | 2,029 | 25,256 | 0 | 407 | 27,692 | 27,692 |
| **Total** | **189,352** | **58,500** | **464,685** | **21,375** | **134,260** | **403,039** | **9,081** | **14,945** | **1,295,238** | **1,051,049** |

## 4.3.2 Credit Risk Exposure by Sector

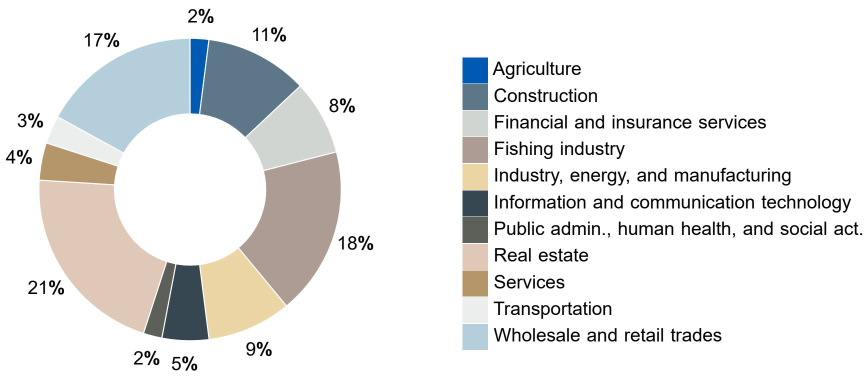
The Bank's loan book is diversified with regard to individuals and industry sectors. Credit exposure to individuals represents 54% of loans to customers, of which 88% are mortgage loans.

**Figure 4.2** Loans to customers, by counterparty type




Real estate activities is the largest industry sector comprising 21% 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 4.3** 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 has determined that its exposure to the tourism industry was 7% of loans to customers at the end of 2022, compared to 8% in 2021. The tourism exposure draws mainly from four standard industry sectors: Wholesale and retail trades (60%), Real estate (15%), Transportation (9%), and Services (7%).

7% of loans to customers are dependent on tourism activities

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

### 4.3.3 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% towards counterparties domiciled in Iceland.

The majority of the 9% 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).

**Figure 4.4** Geographic distribution of total exposure

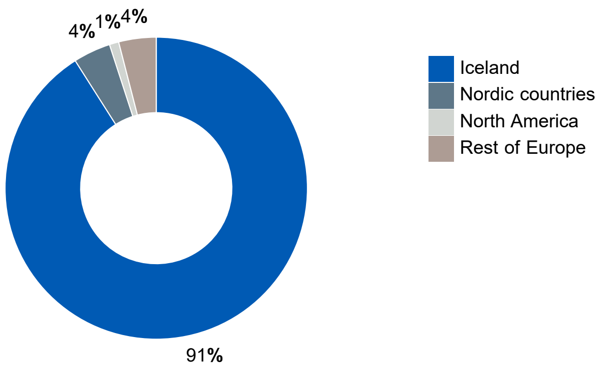
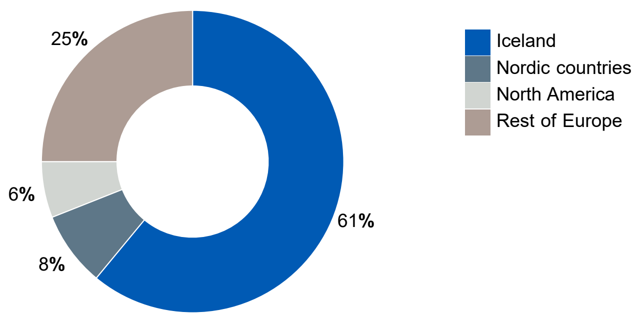



**Figure 4.5** Geographic distribution of total exposure to credit institutions, central governments and central banks




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

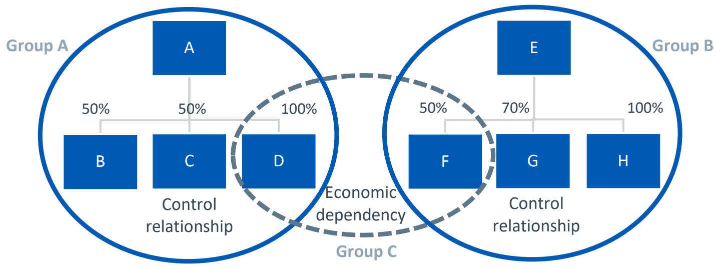
### 4.3.4 Connected Clients and Large Exposures

A large exposure is defined as an exposure to a group of connected clients which exceeds 10% of the Bank's Tier 1 capital. This definition changed with the adoption of CRR II in June 2021. Previously, the definition was 10% of eligible capital which corresponded to own funds for the Bank. According to 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 special exceptions granted by the Arion Credit Committee (ACC) or 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 4.6.

**Figure 4.6** Connected clients




Party relations are monitored both prior to granting a loan and during the lifetime of the loan

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

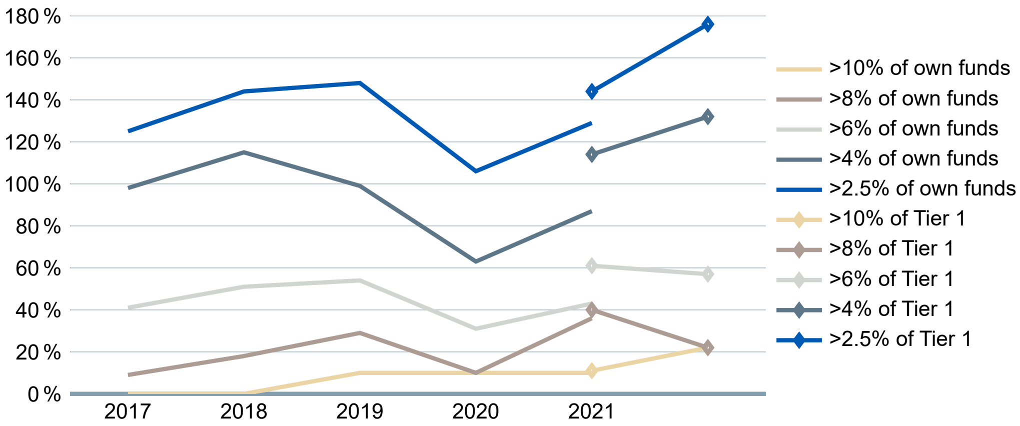
Customers' exposures are updated daily and are available at any time in the Bank's systems. Furthermore, an exposure report for a group of connected clients is updated weekly and is accessible at any time to Risk Management, Corporate and Investment Banking, and Retail Banking. Exposures that exceed 5% of Tier 1 capital are reported monthly to the ACC and to the BRIC.

Two exposures to groups of connected clients within Loans to Customers were classified as *large exposures* at year-end 2022

At year-end 2022 the Bank had two large exposures within loans to customers, totaling ISK 39.1 billion before accounting for eligible collateral. At year-end 2021 the Bank had one large exposure.

The sum of group exposure exceeding 10%, net of eligible collateral, increased from from 11% to 22% of Tier 1 capital year-on-year, as a result from the additional large exposure previously described. The sum of group exposures exceeding 2.5%, net of eligible collateral, also increased from 144% to 176% of Tier 1 capital, see Figure 4.7. However, the sum of group exposure exceeding 8% decreases from 40% to 22% of Tier 1 capital, indicating that there are no group exposures in the range from 8% to 10% of Tier 1 capital.

**Figure 4.7** Total of net exposures to groups of connected clients (excluding loans to financial institutions)




## 4.3.5 Equity Positions in the Banking Book

Exposure limits for equity positions in the banking book are set in the Bank's risk appetite statement. 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 4.4** Equity exposure in the banking book

| 31 December 2022 [ISK m] | Listed | Unlisted | Total |
|---|---|---|---|
| Investments in associates, non-core | | 42 | 42 |
| Equity instruments with variable income | 1,487 | 3,857 | 5,344 |
| Fund shares - Bonds | | 699 | 699 |
| Fund shares - Other | 4 | 2,198 | 2,202 |
| **Total equity exposure in the banking book** | **1,491** | **6,795** | **8,286** |
| Unrealized gain/loss at year-end 2022 | | | 2,264 |
| **31 December 2021 [ISK m]** | **Listed** | **Unlisted** | **Total** |
| Investments in associates, non-core | | 42 | 42 |
| Equity instruments with variable income | 2,164 | 6,060 | 8,224 |
| Fund shares - Bonds | | 2,032 | 2,032 |
| Fund shares - Other | 28 | 3,341 | 3,369 |
| **Total equity exposure in the banking book** | **2,192** | **11,475** | **13,667** |
| Unrealized gain/loss at year-end 2021 | | | 4,286 |

## 4.4 Collateral Management and Valuation

Accurately valued collateral is one of the key components in mitigating credit risk. 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 as follows:

- 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

In addition to securing collateral, mitigation of credit risk is achieved through use of guarantees, master netting agreements, 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.

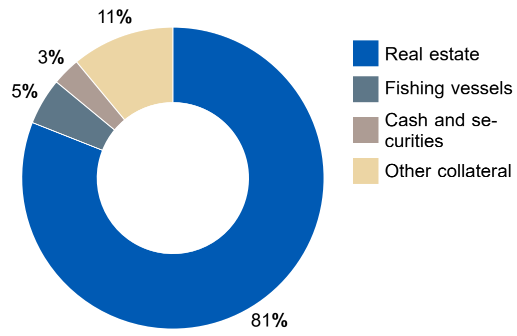
The standards and guidelines cover the following subjects:

- 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 (CMS) to consolidate the Bank's collateral data. Table 4.5 shows the collateral held by the Bank for loans to customers, broken down by business sector. Collateral held at year-end is to the largest extent real estate collateral, which makes up 81% of the total collateral. At year-end 2022 loans to customers were secured by collateral conservatively valued at ISK 982,360 million, which results in a collateral coverage ratio of 90.6% compared to 92.0% at the end of 2021.

The credit exposure towards the Central Bank of Iceland and financial institutions is unsecured as it is due to the Bank's own deposit accounts and money market loans.

**Figure 4.8** Collateral by type



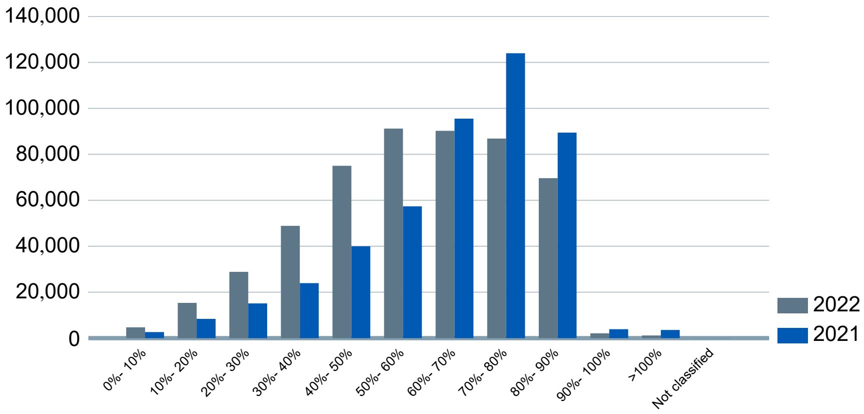

The collateral coverage ratio of loans to customers at the end of 2022 was 90.6% compared to 92.0% at the end of 2021

**Table 4.5** Collateral for loans to customers. The collateral value is capped by gross carrying amount.

| 31 December 2022 [ISK m] | Cash and securities | Real estate | Fishing vessels | Other collateral | Total collateral | Unsecured ratio % 2022 | Unsecured ratio % 2021 |
|---|---|---|---|---|---|---|---|
| Individuals, Mortgages | 9 | 513,564 | 0 | 32 | 513,605 | 0.0% | 0.0% |
| Individuals, Other | 508 | 18,219 | 16 | 18,928 | 37,671 | 45.2% | 47.1% |
| Real estate activities | 916 | 101,801 | 0 | 368 | 103,085 | 2.1% | 1.1% |
| Construction | 211 | 41,181 | 47 | 2,493 | 43,932 | 20.4% | 2.7% |
| Fishing industry | 1,126 | 14,306 | 49,535 | 13,038 | 78,005 | 14.7% | 1.6% |
| Information and communication technology | 110 | 1,441 | 0 | 14,822 | 16,373 | 33.5% | 77.0% |
| Wholesale and retail trade | 30 | 51,741 | 0 | 26,856 | 78,627 | 7.5% | 9.4% |
| Financial and insurance activities | 23,059 | 6,423 | 0 | 7,470 | 36,952 | 10.7% | 14.6% |
| Industry, energy, and manufacturing | 295 | 25,658 | 0 | 13,243 | 39,196 | 11.2% | 6.0% |
| Transportation | 87 | 1,128 | 1,043 | 3,199 | 5,457 | 61.2% | 54.1% |
| Services | 132 | 11,049 | 1,104 | 3,975 | 162,600 | 15.1% | 12.8% |
| Public sector | 11 | 2,107 | 6 | 173 | 2,297 | 78.3% | 66.3% |
| Agriculture and forestry | 0 | 10,014 | 0 | 886 | 10,900 | 5.2% | 2.3% |
| **Total** | **26,494** | **798,632** | **51,751** | **105,483** | **982,360** | **9.4%** | **8.0%** |

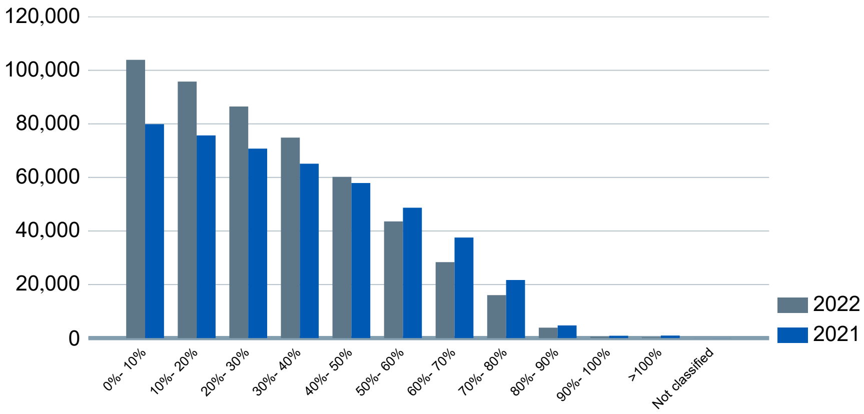
Figures 4.10 and 4.11 show the mortgage portfolio broken down by loan to value bands based on the gross carrying amount of the mortgages. In Figure 4.10 a prime mortgage exposure to a particular borrower appears in a single bar in the chart (whole-loan approach). In Figure 4.11 however, an alternative 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.

**Figure 4.10** Loan to value of mortgage loans [ISK m], whole-loan approach



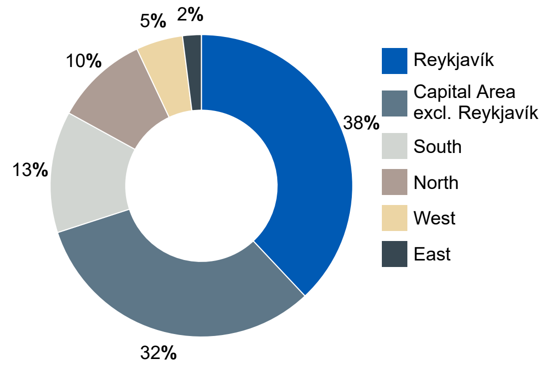

As of 30. September 2022, the Bank has adopted a new real estate valuation model povided by an external party, which replaces the government tax value and is used when the observed market value becomes older than two years. The new model gives an estimate of current value on a monthly basis and explains the downward shift of the loan to value between 2022 and 2021.

**Figure 4.11** Loan to value of mortgage loans [ISK m], loan-splitting approach




At year-end 2022 86% of the mortgages, by value, had loan to value below 80%, compared to 79% at the end of 2021, according to the whole-loan approach. However, according to the split-loan approach, 99% of mortgages had loan to value below 80%. Furthermore, according to the loan-splitting approach, 83% of the mortgages were below 55% loan to value, compared to 77% at the end of 2021. The 55% mark is relevant for REA calculation under CRR 3, see Section 3.11. As shown in Figure 4.9, the mortgage properties are primarily located in the Capital Area or 70%

**Figure 4.9** Mortgage portfolio by location



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 evaluations 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. The Bank's model structure changed slightly in 2022, with the introduction of a new model for construction project finance.

**Table 4.6** Probability of Default models

| Model for: | Description |
|---|---|
| Large corporates | Defined as corporate clients with a) individual exposure over ISK 300 million or b) individual exposure over ISK 150 million and related exposure over ISK 300 million. The model is statistical and is based on quantitative information drawn from financial statements as well as qualitative data entered by account managers and approved by lending units. |
| Retail corporates | Defined as corporate clients with a) individual exposure below ISK 150 million or b) individual exposure between ISK 150 million and ISK 300 million and related exposure below ISK 300 million. The model is statistical, runs automatically, and uses quantitative internal and external information found to be predictive of default. |
| Other entities | The Bank has different models for other entities - holding companies, state related entities and municipalities, unions, etc. A new model has been implemented for construction project finance. |
| 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. |

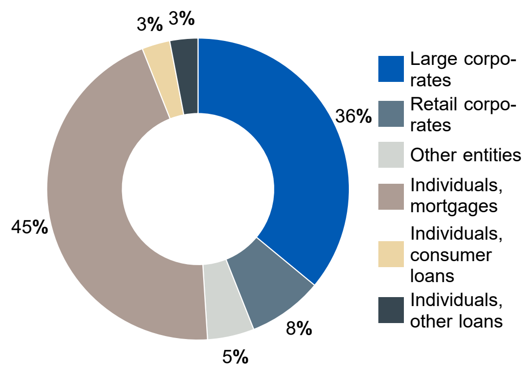
The Bank's probability of default (PD) models are developed within Risk Analysis, a department within Risk Management, while the validation of the models is performed independently by another department in Risk Management, Risk Monitoring and Framework.

### 4.5.1 Credit Exposure by Rating

Table 4.7 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.

Around 0.9% of the portfolio, by exposure, was assigned a default rating at the end of 2022, which is 0.5 percentage points lower than at the end of 2021. Active PD values are translated into an internal rating scale of letters from AAA to CCC-. The scale is shown in Table 4.8. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

**Figure 4.12** Distribution of exposure by portfolio



# Credit Risk

**Table 4.7** Breakdown of rating status by exposure

| Rating Model | 2022 | | | 2021 | | |
|---|---|---|---|---|---|---|
| | % Active credit rating | % DD | % Unrated | % Active credit rating | % DD | % Unrated |
| Large corporates | 99.2% | 0.6% | 0.2% | 98.1% | 1.4% | 0.5% |
| Retail corporates | 97.3% | 2.7% | 0.0% | 96.0% | 4.0% | 0.0% |
| Other entities | 99.8% | 0.0% | 0.2% | 99.0% | 1.0% | 0.0% |
| Individuals, mortgages | 99.2% | 0.8% | 0.0% | 99.1% | 0.9% | 0.0% |
| Individuals, consumer loans | 99.3% | 0.7% | 0.0% | 99.5% | 0.5% | 0.0% |
| Individuals, other exposures | 97.5% | 2.0% | 0.5% | 97.1% | 2.9% | 0.0% |
| **Total** | **99.0%** | **0.9%** | **0.1%** | **98.5%** | **1.4%** | **0.2%** |

**Table 4.8** Rating scale

| Risk class | Rating | Lower PD | Upper PD |
|---|---|---|---|
| 0 | AAA | 0.000% | 0.006% |
| | AA+ | 0.006% | 0.018% |
| | AA | 0.018% | 0.029% |
| | AA- | 0.029% | 0.045% |
| | A+ | 0.045% | 0.07% |
| | A | 0.07% | 0.11% |
| | A- | 0.11% | 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% |

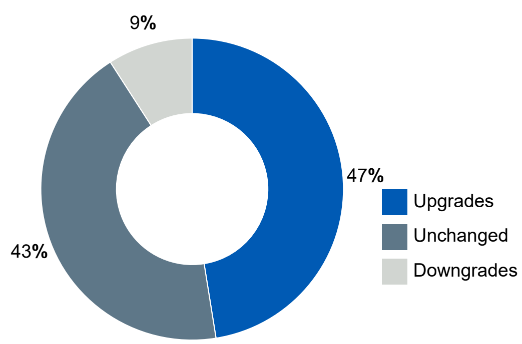
The rating distributions of each of the four largest portfolios are discussed below.

## Large corporates

The exposure-weighted average PD for the large corporate portfolio was 1.6% at year-end 2022, compared to 2.6% at year-end 2021. In terms of exposure (Figure 4.13), approximately 47% have been upgraded towards a better risk class, in contrast to 9% that have been downgraded. The reason for this decrease in the average PD or the shift is partly because corporations are no longer receiving a COVID-19 specific adjustment. 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 4.14 shows the large corporates portfolio broken down by

**Figure 4.13** Risk class rating migration by exposure between 2021 and 2022 – Large Corporates



ratings. The distribution of PD values has shifted towards better values from 2021 to 2022, especially visible for risk class 0.

**Figure 4.14** Distribution of exposure by rating for large corporates

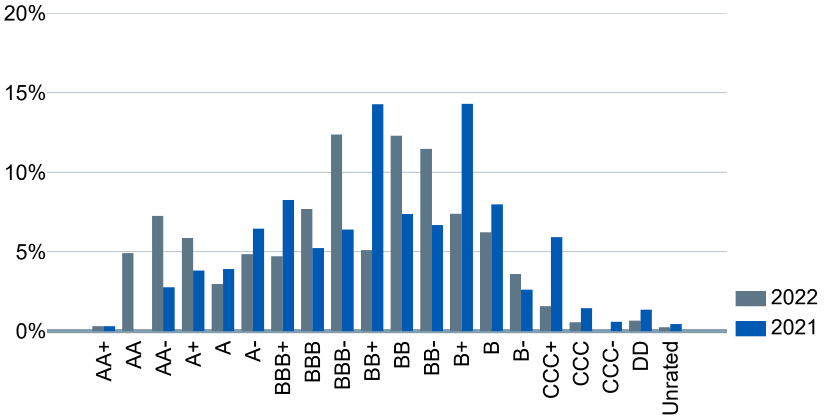
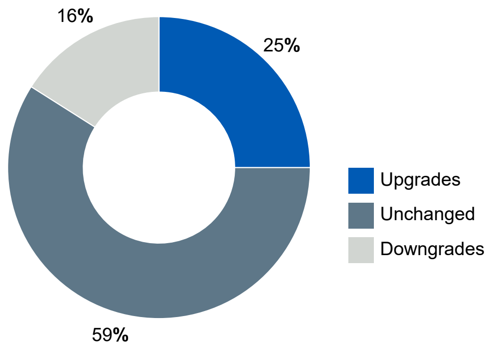



**Figure 4.15** Risk class rating migration by exposure between 2021 and 2022 – Retail Corporates




## Retail corporates

The exposure-weighted average PD was 3.1% at year-end 2022, compared to 3.4% at year-end 2021. In terms of exposure (Figure 4.15), 25% have been upgraded towards a better risk class whereas 16% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.16 shows the retail corporate portfolio broken down by ratings. The distribution of PD values has shifted slightly when comparing 2021 to 2022, mostly visible for risk class 1. The change can partly be attributed to pure migration but is also due to removal of the COVID-19 shift.

**Figure 4.16** Distribution of exposure by rating for retail corporates

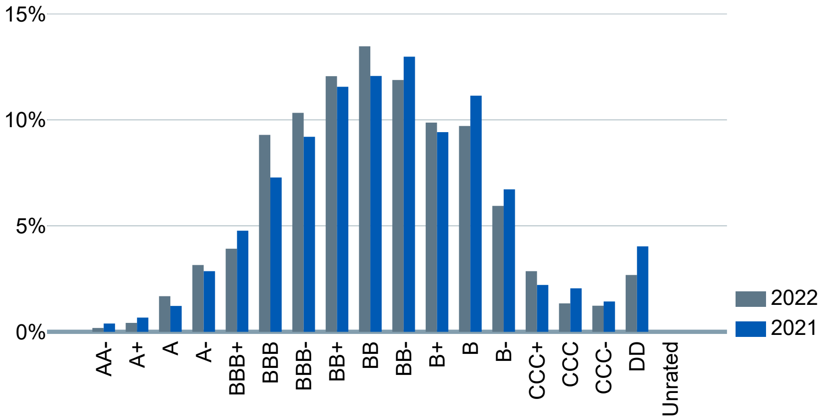
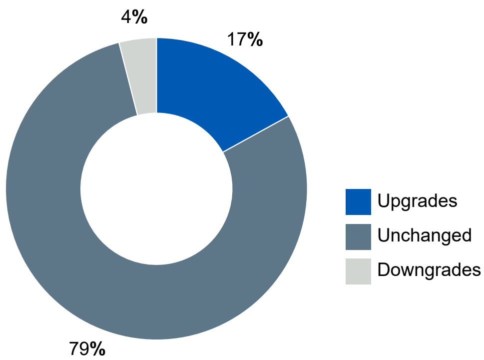



**Figure 4.17** Risk class rating migration by exposure between 2021 and 2022 - mortgages to Individuals

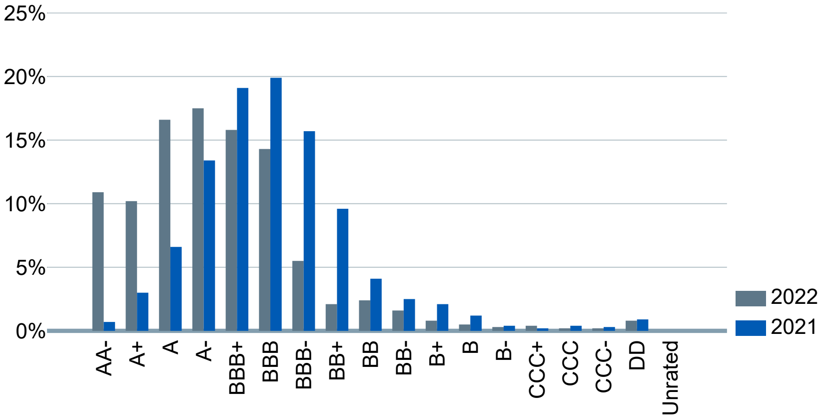



## Mortgages to individuals

The exposure-weighted average PD for the mortgage portfolio was 0.5% in year-end 2022, compared to 0.8% in year-end 2021. In terms of exposure (Figure 4.17), approximately 17% of mortgages have migrated towards an improved credit grade and 4% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.18 shows the mortgage portfolio broken down by ratings. A very clear shift towards lower average PD or better values from 2021 to 2022 can be seen, especially visible for risk classes 0 and 1. The change can partly be attributed to a recalibration of the Individual Mortgages rating model.

**Figure 4.18** Distribution of exposure by rating for mortgages to individuals




## Consumer loans

Figure 4.20 shows the consumer loans (overdrafts, credit cards, and unsecured short-term loans) portfolio to individuals broken down by ratings. A very similar credit profile is observed between years.

**Figure 4.20** Distribution of exposure by rating for consumer loans

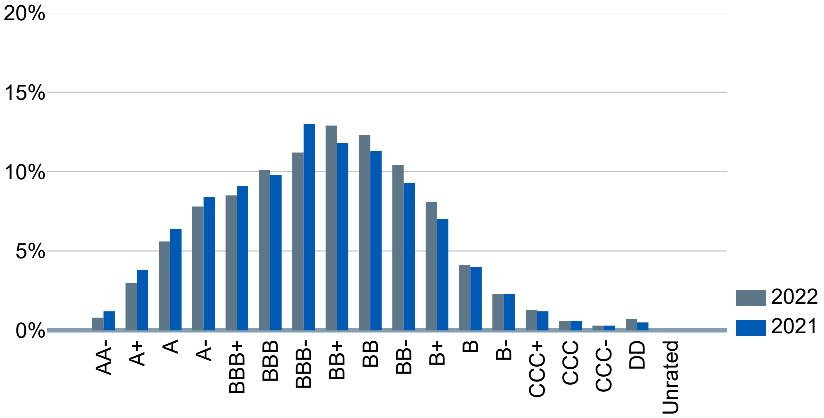
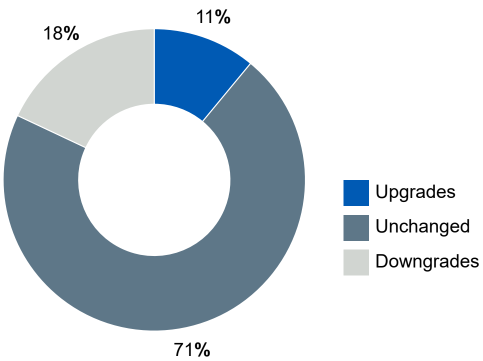



**Figure 4.19** Risk class rating migration by exposure between 2021 and 2022 - Consumer loans




## Model performance

At year-end 2022 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 2021 and observed default rates in 2022 are shown in the following table. The corporate portfolio includes a COVID-19 specific adjustment to PD estimates which largely explains the difference between the average PiT PD at the end of 2021 and observed default rates for those portfolios. As mentioned in the Large corporates section above, the Bank is no longer applying any COVID-19 related adjustments to its PD estimates.

**Table 4.9** Model performance. Observed default rates in 2022 compared to point-in-time probability of default predicted at year-end 2021

| Model portfolio | Average PiT PD at the end of 2021 | Avg. observed default rate in 2022 |
|---|---|---|
| Mortgages | 0.7% | 0.5% |
| Consumer Loans | 1.0% | 0.9% |
| Retail Corporates | 2.1% | 2.0% |
| Large Corporates | 3.6% | 0.8% |

In Figures 4.21 and 4.22, the actual default rate for each grade in 2022 is compared to the PiT and TtC (through-the-cycle) probability of default at the end of 2021 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. No defaults were observed in the highest rating grades for individuals and corporates in 2022.

**Figure 4.21** Comparison of actual default rate in 2022 and predicted default probability - Individuals

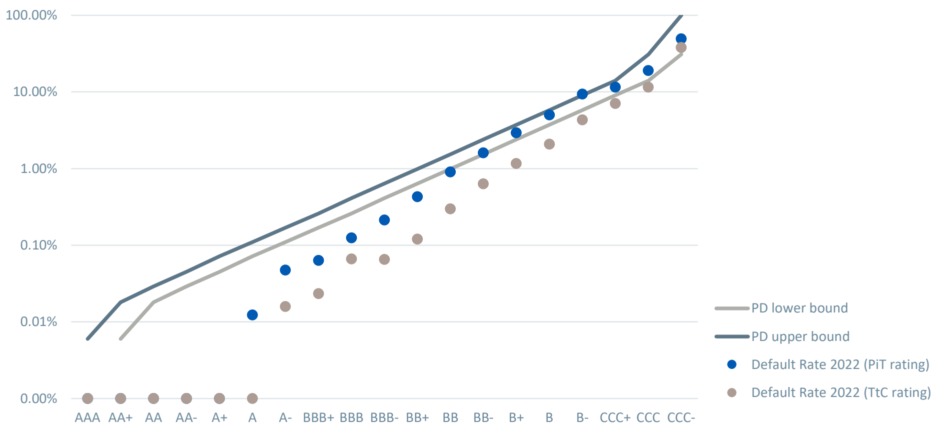
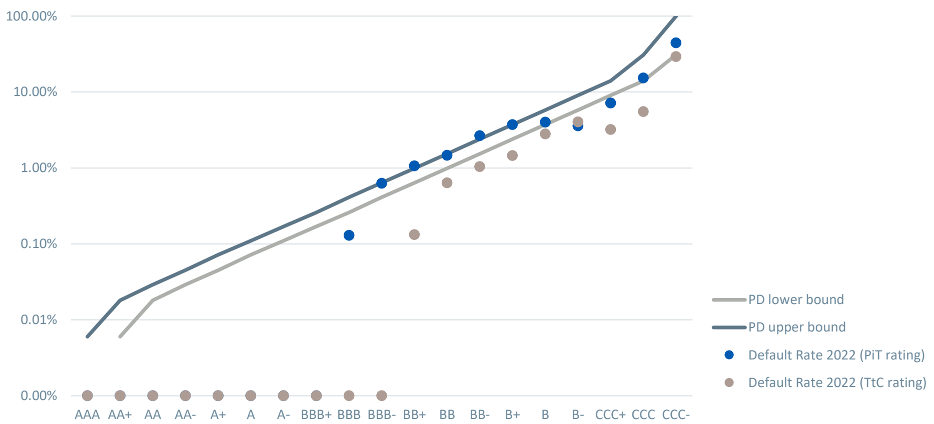



**Figure 4.22** Comparison of actual default rate in 2022 and predicted default probability - Corporates



## 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.

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

From the outset of and throughout the COVID-19 pandemic, the Bank enhanced its monitoring and reporting, internally and externally, to focus on risk factors possibly impacted by the imposed social and travel restrictions. This includes credit risk, market risk, liquidity risk and operational risk. The focus has endured and indeed broadened following the Russian invasion of Ukraine. In addition to the previously mentioned risks, development of potential cyber threats for the Bank related to the war were closely monitored as well as borrowers with revenue stream depending on export or import to and from Russia or Ukraine.

### 4.6.1 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 6% in December 2022. Indications at year-end 2022 suggest that the real estate market is cooling, as intended. The CBI introduced new measures in 2021, including a maximum debt-service to income (DTI) at 35% (40% for first-time buyers). In June 2022, the CBI added a minimum interest rate criteria for the DTI measure, where for indexed loans the criterium is a 3% rate on a 25-year loan, aimed at reducing the appetite for indexed loans. The Bank's residential mortgage portfolio has however continued to grow in 2022, with an increased demand for indexed loans, which offer lower monthly payments.

As part of its proactive management of credit risk, the Bank has tightened its debt capacity criteria for mortgages and shortened the maximum maturity for new indexed loans.

The renewed demand for indexed mortgages can be observed in Figure 4.23. The share of indexed loans decreased from 63% of the residential mortgage portfolio at year-end 2019 to 36% at year-end 2021, but despite the aforementioned macroprudential measures, the ratio has increased again to 40% and is expected to rise further.

**Figure 4.23** Development of residential mortgages [ISK m]

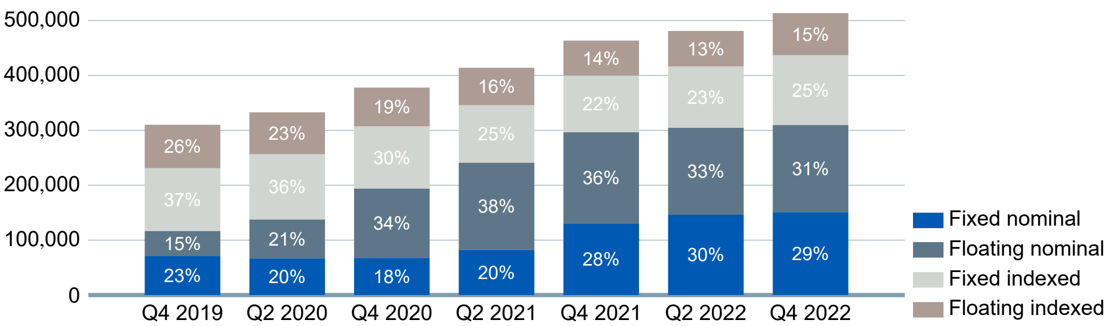
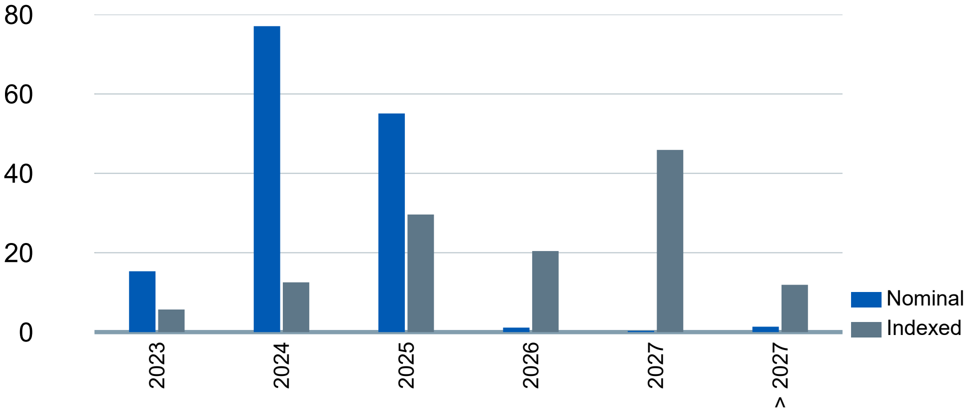


Figure 4.23 also shows a sharp increase in fixed nominal residential mortgages, as the demand picked up significantly when interest rates started to rise in 2021. The interest rate reset profile for fixed rate mortgages can be seen in Figure 4.24, where the bulk of fixed nominal rate loans are reset in 2024 and 2025.

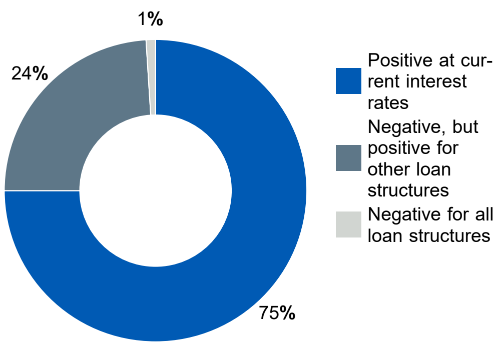
**Figure 4.24** Interest rate reset profile for fixed rate mortgages [ISK bn]




The Bank has put significant effort into analyzing the impact of inflation and rising interest rates on borrowers, especially individuals and companies in the real estate sector. Two major studies were carried out on the Bank's mortgage portfolio.

The Bank carried out an analysis on mortgages originated from March 2020 to June 2022, which was a period of historically low interest rates. The analysis entailed reassessing borrowers' debt servicing capacity by applying the interest rate offered at the reference date, as if the loans had originated later at higher rates. This was done multiple times over the course of 2022 as interest rates and inflation continued to rise. The most recent analysis was conducted at the end of 2022, see Figure 4.25. That study showed that of the mortgages still on the Bank's balance sheet, 24% would not have passed the debt servicing assessment with the same loan structure. However other structures would have been available in almost all cases and only in 1% of cases the debt servicing assessment would have yielded a negative result for all possible loan structures.

**Figure 4.25** Analysis of the debt servicing assessment of the mortgage portfolio under current interest rates




Another analysis focused on the anticipated reset of fixed nominal rates of residential mortgages over the next 2 years. Based on forecasts of inflation and interest rate development, the analysis showed that, on a loan basis, most fixed nominal mortgages are expected to get a median increase of about 12% on monthly payments, where the first quartile shows a 1% increase and the third quartile a 21% increase.

Consequently, a stress test was performed assuming that inflation persists with increased cost of living, interest rates remain at high levels and real estate prices decrease considerably, which impacts loan-to-value and thus the ability to refiance. In the stress test, 15% of borrowers no longer have the capacity to meet monthly payments following the end of the fixed period. The analysis then assumes that these borrowers refinance towards a lower monthly payment structure. This yields that 2% of borrowers are unable to service the debt. The analysis shows that the risk is limited and Bank has means to support its customers if problems arise in case interest rates remain high, albeit this would in some cases reduce the equity generation of borrowers through amortization. The analysis is focused on the cost of debt, cost of living and income development, and does not touch on possible increase to default rates resulting from increased unemployment rate and economic slowdown.

### 4.6.2 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 measurements, 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 measurement of impairment, see Note 58 on Expected credit losses in the Bank's Consolidated Financial Statements for 2022.

### 4.6.3 Past Due Exposures

Figures 4.26 and 4.27 show the development of past due exposures from year-end 2016 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 viewpoint, both values are shown for two years. The past due exposures for loans to individuals increased marginally in 2022, while past due exposures for corporates have continued to decrease this year following a significant increase in 2019 and 2020, due to large single-name defaults.

Customer loans that are more than 90 days past due represent 0.31% of the total loan book at year-end 2022, measured at facility level

Figure 4.26 Development of past due exposures to individuals

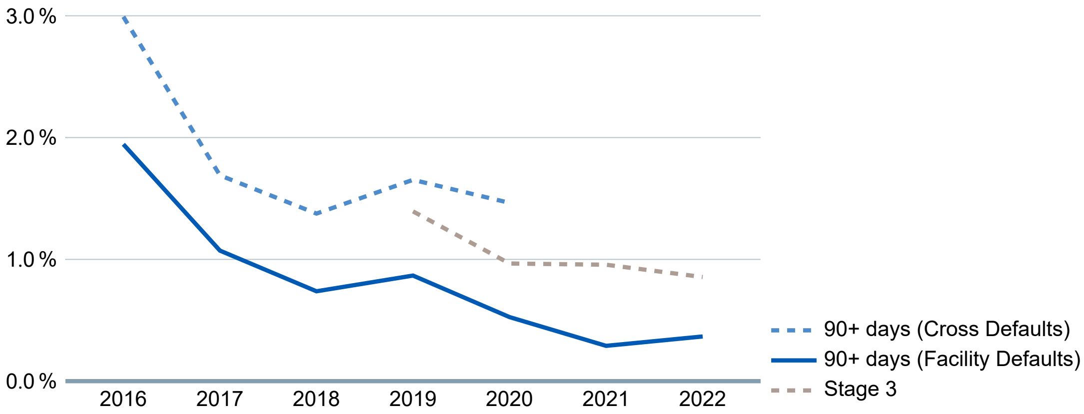
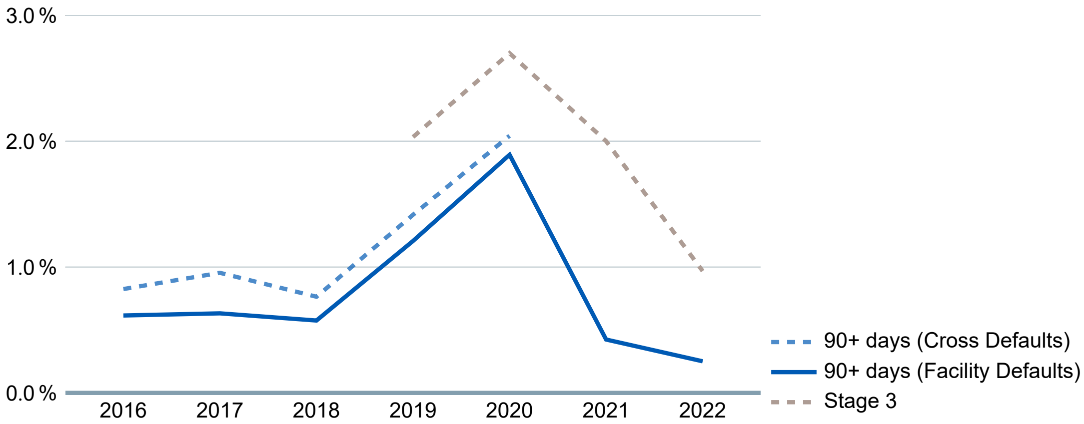



Figure 4.27 Development of past due exposures to companies, parent company




Loans to customers that are more than 90 days past due were 0.34% of the total loan book at year-end 2022 when measured at facility level. The ratio of loans in Stage 3 was 1.2%, thereof 1.0% for individuals and 1.4% for corporates.

Template EU CQ3 shows credit quality by past due days.

### 4.6.4 Moratoria and Forbearance

The Bank has adopted the definition of forbearance in article 47b in 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.

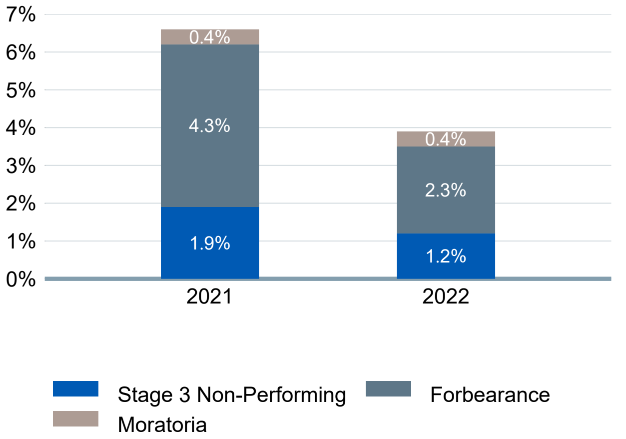



**Figure 4.28** Development of Default, Forbearance, and Moratoria. Shown as percentage of total gross carrying amount

In 2021 the Bank started offering summer holiday payment moratoria for prime mortgages. In 2022 a total of 2.2% of gross carrying amount for prime mortgages received that resource, compaired to 1.8% in 2021. In Figure 4.28 moratoria due to summer holiday, maternity leave, and job loss are all listed under Moratoria, as well as moratoria due to COVID, which were fully expired at year-end 2022.

Forborne loans decreased from 4.3% in 2021 to 2.3% in 2022. The decrease was mostly in the Wholesale and retail trades sector, which includes hotel operations, followed by Real Estate and Construction, and Transportation sectors. Forborne loans in the tourism sector were 51% of total gross carrying amount of all forborne loans at year-end 2022, compared to 52% at year-end 2021.

For further information, see Note 43 on forbearance in the Bank's Consolidated Financial Statements for 2022.

## 4.6.5 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 following business year. 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.

Expected credit loss is calculated using the formula $ECL = PD \cdot LGD \cdot EAD$

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 Sections 4.5 and 4.5.1. 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 4.10 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 also into account. The ECL values shown are impacted by the IFRS9 macroeconomic forecasts.

**Table 4.10** Expected credit loss by exposure type

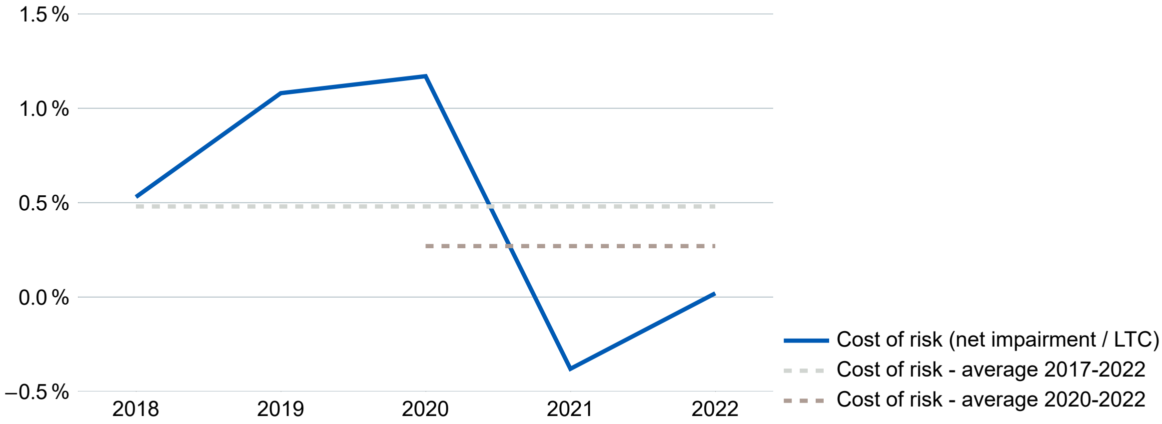
| 31 December 2022 | PD | LGD | EL |
|---|---|---|---|
| Corporates - Large | 1.6% | 12.8% | 0.5% |
| Corporates - Retail | 3.1% | 7.6% | 0.6% |
| Corporates - Other | 1.9% | 21.2% | 0.8% |
| Individuals - Mortgages loans | 0.5% | 1.4% | 0.0% |
| Individuals - Other | 1.6% | 30.1% | 0.7% |
| **Weighted average** | **1.2%** | **8.7%** | **0.3%** |

| 31 December 2021 | PD | LGD | EL |
|---|---|---|---|
| Corporates - Large | 2.6% | 8.8% | 0.4% |
| Corporates - Retail | 3.4% | 6.9% | 0.4% |
| Corporates - Other | 2.2% | 21.3% | 0.4% |
| Individuals, Mortgages loans | 0.8% | 1.2% | 0.0% |
| Individuals - Other | 1.5% | 30.1% | 0.8% |
| **Weighted average** | **1.7%** | **7.1%** | **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 macroeconomic forecasts affect the calculation of the impairment under the IFRS9 standard, this measure is rather volatile in the short term but such volatility is averaged out over longer term.

Figure 4.29 shows the development of the cost of risk for the years 2018–2022 for the parent company, along with two average values; over the whole period and, to reflect better on the current period, the average value over the years 2020–2022. There, the average is 0.27%, compared to 0.48% for the 5 year period. The cost of risk measure is shown for the parent company to reflect better on 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 4.29** Cost of Risk development




## 4.6.6 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 in CRR. The Bank's implementation complies with the guidelines and is suited to the Bank's size and procedures. The guideline requires 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.

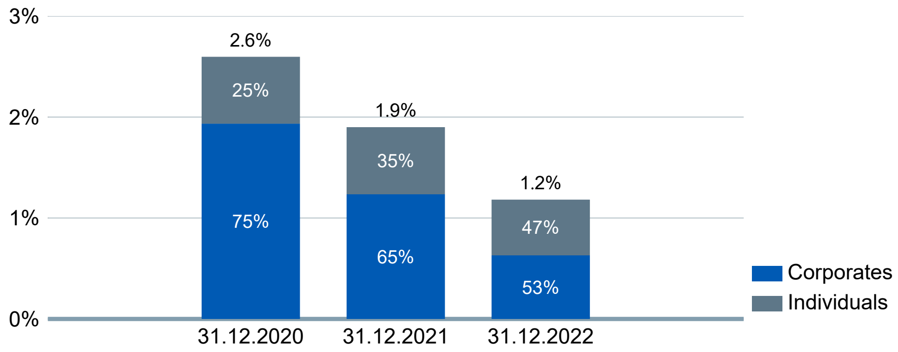
The definition can be divided into three types of default; unlikely to pay, 90 days past due and cross-default, and probation with or without forbearance. Default is considered on an obligor level for companies. For individuals, default is considered on the level of each PD model and cross default on 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 2022, the problem loans ratio for the Bank is 1.2% of the loan portfolio and has decreased since the end of 2021 from 1.9%.

The problem loans ratio is 1.2%, at gross carrying value

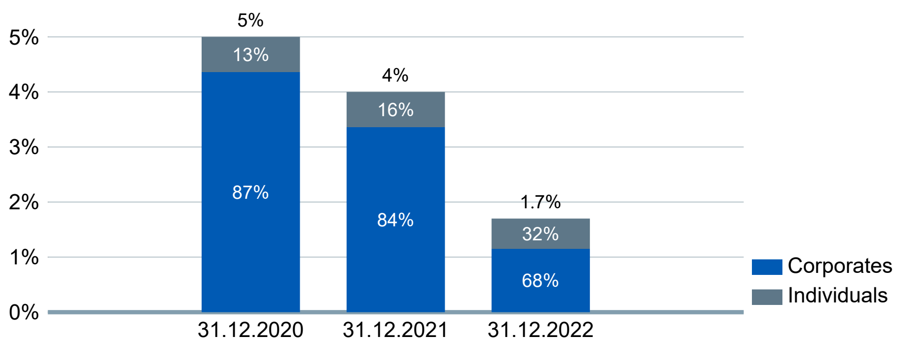
At year-end 2022, 53% of problem loans are, by value, loans to corporates and 47% to individuals.

**Figure 4.30** Development of problem loans (Group)



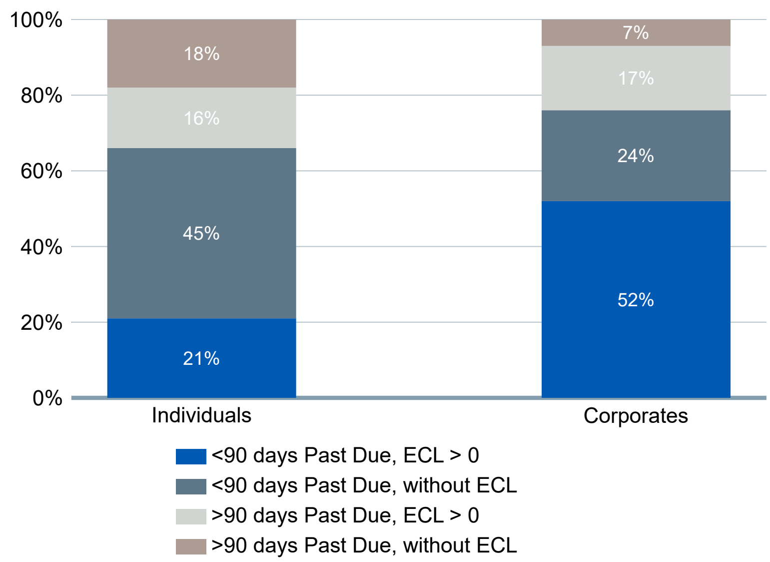

In Figure 4.29 the cost of risk for the parent company is shown and for comparison the development of problem loans for the parent company is shown in Figure 4.31. This is done to show companies that have been consolidated during the collection and restructuring processes. At year-end 2022, the problem loans ratio for the parent company is 1.7% of the loan portfolio and has decreased since the end of 2021 from 4.0%. The decrease is due to write offs and restructuring of problem loans.

**Figure 4.31** Development of problem loans (Parent company)




The breakdown of problem loans by status is shown in Figure 4.32. Around 46% of the problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

**Figure 4.32** 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 lending, or repurchase agreement defaulting before the final settlement of the contract's cash flows.

The Bank offers financial derivative instruments to investors. Table 4.11 shows derivative trading activities currently permitted. The derivative instruments are classified according to primary risk factor and type of derivative instrument.

**Table 4.11** 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.

The margin-call process is monitored by Risk Management

Note 24 in the Bank's Consolidated Financial Statements provides a breakdown of the aggregated 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.

**Table 4.12** CCR exposures by standardized risk-weights and exposure class (EU CCR3)

| 31 December 2022 [ISK m] | Risk weights | | | | | |
|---|---|---|---|---|---|---|
| Exposure classes | 0% | 20% | 50% | 75% | 100% | Total |
| Central governments and central banks | 138 | | | | | 138 |
| Regional governments or local authorities | | | | | | |
| Institutions | | 7,806 | 8,466 | | | 16,271 |
| Corporates | | | 100 | | 8,676 | 8,776 |
| Retail | | | | 485 | | 485 |
| **Total** | **138** | **7,806** | **8,566** | **485** | **8,676** | **25,670** |

**Table 4.13** Composition of collateral for exposures to CCR (EU CCR5)

| 31 December 2022 | Collateral used in derivative transactions | | | | Collateral used in SFTs | |
|---|---|---|---|---|---|---|
| [ISK m] | Fair Value of Collateral received | | Fair Value of Collateral posted | | Fair Value of Collateral received | Fair Value of Collateral posted |
| Item | Segregated | Unsegregated | Segregated | Unsegregated | | |
| Cash - domestic currency | | 3,583 | | | 7,019 | |
| Cash - other currency | | 2,519 | | 16,913 | | |
| Domestic sovereign debt | | | | | 219 | 3,620 |
| Other sovereign debt | | | | | | |
| Local government debt | | | | | | |
| Institutions | | | | | 9,133 | 14,152 |
| Corporate bonds | | 723 | | | | |
| Equity securities | | 12,295 | | | | |
| Other collateral | | 17 | | | | |
| **Total** | | **19,136** | | **16,913** | **16,371** | **17,772** |

# 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, equity risk, currency risk, and indexation 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 for market risk arising from the Bank's operations. On the management level, the Asset and Liability Committee (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 EU Capital Requirements Regulation (CRR) No. 575/2013, 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. | Explicit position limits and hedging requirements. Daily monitoring. |
| Banking Book | Balance sheet imbalances, e.g. mismatches between assets and liabilities in terms of currency denomination, indexation, and term fixing of interest rates. | Board of Directors' risk appetite and strategic management of ALCO. Natural hedging and explicit derivatives hedging. Monthly monitoring. |

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 risk | Interest rate risk is quantified as the change in fair value and/or variability in net interest income, after simulating yield curve movements. 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. |
| Indexation risk | Indexation risk is quantified using the net balance of CPI-linked assets and liabilities. In assessing possible loss to earnings due to indexation, the CPI is simulated in conjunction with interest rate movements. |

## 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 requirements (EU MR1)

| 31 December 2022 [ISK m] | REAs | Capital requirements |
|---|---|---|
| **Outright products** | | |
| Interest rate risk (general and specific) | 4,109 | 329 |
| Equity risk (general and specific) | 3,384 | 271 |
| Foreign exchange risk | 1,387 | 111 |
| Commodity risk | | |
| Options (non-delta) | | |
| Securitization (specific risk) | | |
| **Total** | **8,880** | **711** |

In the ICAAP process, the Bank considers various market risk factors where the Pillar 1 capital requirements may not be sufficient. Additional capital requirements are found to 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.

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

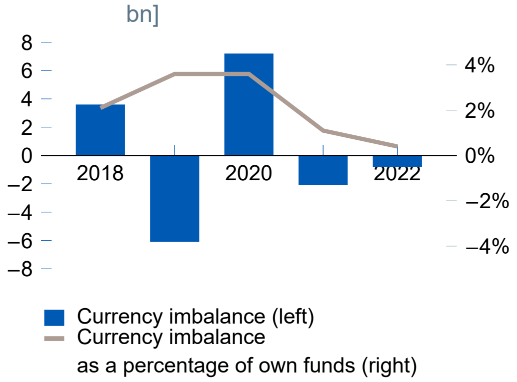


**Table 5.4** Net position of assets and liabilities by currency and Value-at-Risk results

| Foreign currency [ISK m] | Net Exposure | 10 day 99%VaR |
|---|---|---|
| EUR | 493 | 18 |
| USD | -734 | 34 |
| GBP | 32 | 2 |
| DKK | 80 | 3 |
| Other | -631 | 61 |
| Diversification | - | -82 |
| **Total** | **-760** | **36** |

At year-end 2022, the Group's currency imbalance was 0.4% 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.

## 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 2022, the total amount of CPI-linked assets was ISK 275.3 billion and the total amount of CPI-linked liabilities was ISK 248.7 billion. Therefore, the net CPI-linked imbalance was ISK 27 billion, which means that deflation would result

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 15.2 billion at year-end 2022.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. The period from 2014 to 2020 was largely unprecedented as inflation has been around or below the Central Bank of Iceland target inflation of 2.5%. In 2021, inflation started rising again and was measured at 9.6%. The Bank measures its capital requirements due to indexation risk in conjunction with interest rate risk as inflation is a dominant factor in the dynamics of interest rates and therefore cannot be viewed independently.

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

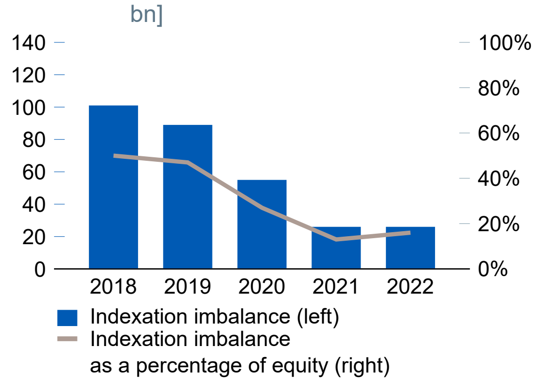



**Figure 5.3** 12-month inflation in Iceland


## 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. A substantial part of liabilities such as deposits have floating interest rates while assets in general have longer 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.

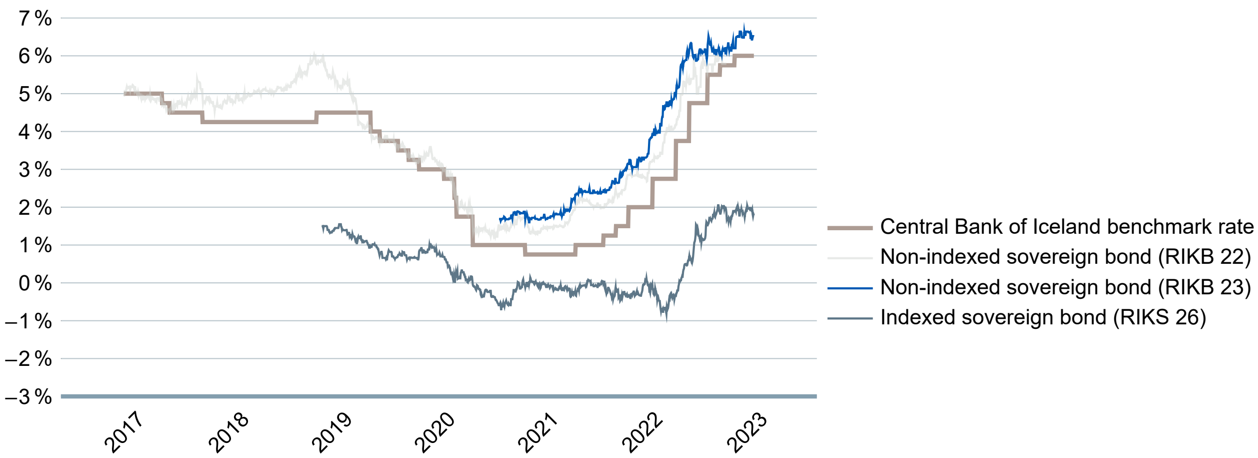
For a breakdown of the Bank's interest-bearing assets and liabilities by interest-fixing periods, see Note 44 of the Consolidated Financial Statements.

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.

As the Central Bank policy rate increased from 0.75% to 6.0% from mid-2021 to 2022, 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. Now as the payment burden has become heavier for floating-rate loans and inflation concerns subside, there has been an increased demand for indexed fixed-rate loans, as these offer lower monthly payments.

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

**Figure 5.4** Development of the Central Bank of Iceland benchmark rate and yields of sovereign bonds



Figures 5.5 to 5.6 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 indexed mortgages and covered bonds [ISK m]

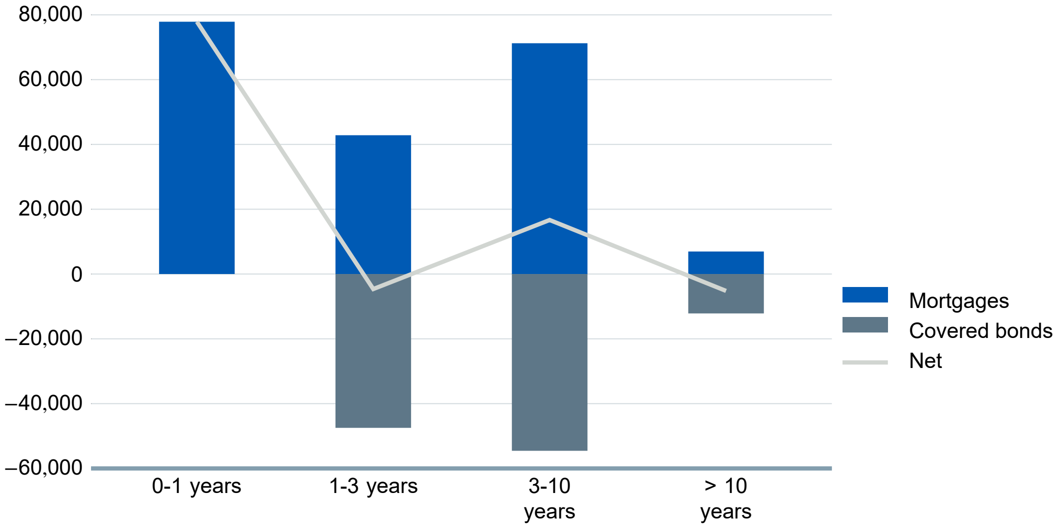



**Figure 5.6** Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]

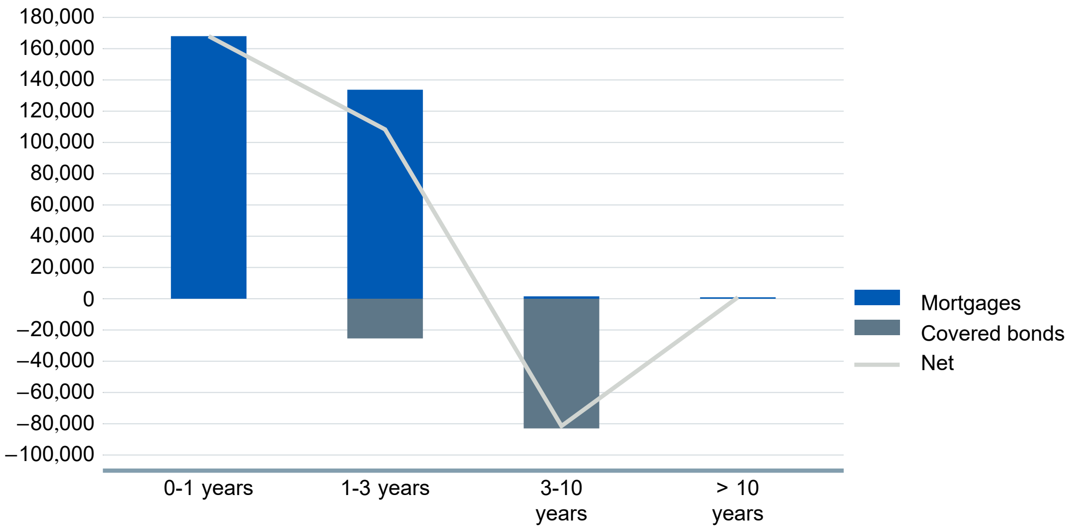



Table 5.5 shows the fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched 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, the Bank has become increasingly mindful of the sensitivity to fair value changes as interest rates remain on an upward trajectory.

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

| | 2022 | | 2021 | |
|---|---|---|---|---|
| 31 December [ISK m] | -100bps | +100bps | -100bps | +100bps |
| ISK, CPI index-linked | -1,994 | 2,782 | -2,250 | 2,418 |
| ISK, Non Index-linked | -1,106 | 886 | 2,308 | -2,322 |
| Foreign currencies | -36 | 32 | 338 | -461 |

In EBA Guidelines EBA/GL/2018/02, there are defined six supervisory shock scenarios 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 if they should occur. New guidelines on IRRBB and regulatory technical standards on IRRBB standardized approach and supervisory outlier tests have been developed by 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 interest 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 and loss to net interest income due to changes to the CPI. 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 and non-strategic derivatives positions and associated hedge positions. The purpose of strategic derivatives is to reduce imbalances on the balance sheet and hedge against market risk. Non-strategic derivatives are however offered to the Bank's customers to meet their investment and risk management needs. Financial instruments in the trading book are exposed to price risk, i.e. the risk that arises due to possible losses from adverse movements in the market prices at which securities in the Bank's holding are valued.

### 5.8.1 Market Making and Proprietary Trading

Securities positions in relation with 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] | 2022 | 2021 |
|---|---|---|
| Bonds | 4,547 | 4,763 |
| Equity | 1,651 | 2,318 |
| **Total** | **6,198** | **7,081** |

Market making and proprietary trading is subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD, and trader. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2022 average and maximum exposure in both equity and bonds.

**Table 5.7** The Bank's proprietary trading exposure

| | Bonds | | |
|---|---|---|---|
| 31 December 2022 [ISK m] | Long | Short | Net |
| Year-end | 4,547 | 0 | 4,547 |
| Average | 6,836 | -167 | 6,669 |
| Maximum | 10,410 | -1,527 | 10,088 |

| | Equity | | |
|---|---|---|---|
| 31 December 2022 [ISK m] | Long | Short | Net |
| Year-end | 1,651 | 0 | 1,651 |
| Average | 3,628 | -26 | 3,602 |
| Maximum | 6,539 | -219 | 6,539 |

### 5.8.2 Trading Derivatives

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

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 2022 [ISK m] | No. of contracts | Assets | Liabilities | Net | Underlying positions | Main risk factor |
|---|---|---|---|---|---|---|
| Forward exchange rate agreements | 179 | 2,297 | 57 | 2,24 | 43,312 | Market risk |
| Interest rate and exchange rate agreements | 14 | 29 | 153 | -124 | 9,169 | Market risk |
| Bond swap agreements | 31 | 272 | 14 | 259 | 6,340 | Credit risk |
| Share swap agreements | 550 | 3,693 | 974 | 2,719 | 27,966 | Credit risk |
| Commodity swap agreements | 19 | 15,505 | 15,505 | 0 | 69,720 | Credit risk |
| Options | 2 | 0 | 0 | 0 | 6 | Market risk |
| **Total** | **795** | **21,796** | **16,703** | **5,094** | | |

| 31 December 2021 [ISK m] | No. of contracts | Assets | Liabilities | Net | Underlying positions | Main risk factor |
|---|---|---|---|---|---|---|
| Forward exchange rate agreements | 153 | 174 | 266 | -92 | 32,78 | Market risk |
| Interest rate and exchange rate agreements | 21 | 117 | 171 | -54 | 14,536 | Market risk |
| Bond swap agreements | 51 | 165 | 20 | 144 | 18,029 | Credit risk |
| Share swap agreements | 585 | 348 | 3,53 | -3,183 | 29,772 | Credit risk |
| Commodity swap agreements | 0 | 0 | 0 | 0 | 0 | Credit risk |
| Options | 5 | 0 | 14 | -14 | 685 | Market risk |
| **Total** | **815** | **804** | **4,001** | **-3,199** | | |

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.

### 5.8.3 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 2022, 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.

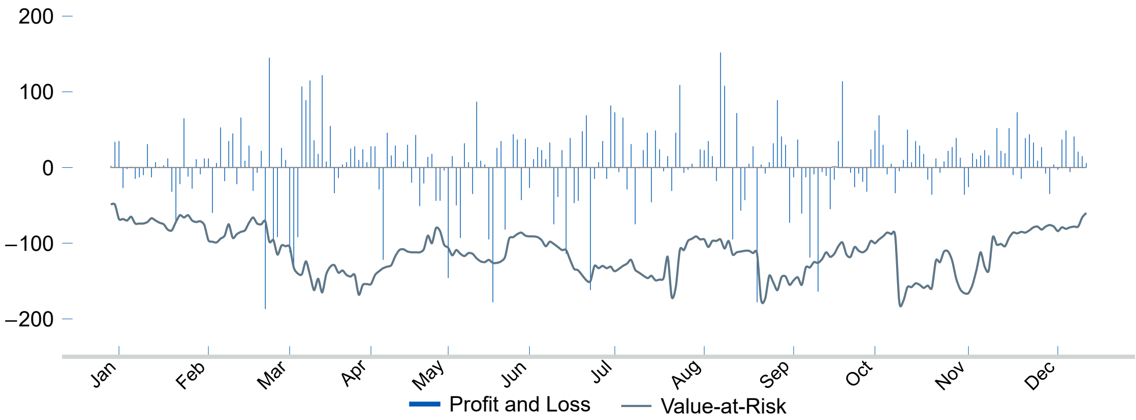
**Table 5.9** Value-at-Risk for the trading book with a 99 percent confidence level over a 10-day horizon

| 31 December 2022 [ISK m] | 10 day 99%VaR |
|---|---|
| Equities | 121 |
| Equity options | 0 |
| Bonds | 145 |
| Bond options | 0 |
| Interest rate swaps | 27 |
| Diversification effects | -102 |
| **Trading book Total** | **191** |

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 191 million over a 10-day period.

Figure 5.7 further shows the daily profit and loss of the Bank's trading book for 2022 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss exceeded the VaR 6 times during the 250 business days, but exceeding 2.5 times is to be expected by the risk measure. This reflects the market turbulence for the past year.

**Figure 5.7** Backtesting of the Bank's one-day 99 percent Value-at-Risk for 2022 [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.

## 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 liquidity and funding risk. On the management level, the Asset and Liability Committee (ALCO) is the principal authority for management and monitoring of liquidity and funding.

At year-end 2022, Arion Bank's strong liquidity position was reflected in the LCR values, namely 158%, 720% and 115% for total, foreign currency balances and ISK respectively

According to the liquidity and funding policy, the Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirement. The Bank maintains a sufficient level of liquid assets in order 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 assets 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 and emphasis is placed on managing it. The Bank's liquidity risk is managed by the Treasury department on a day-to-day basis and monitored by Risk Management. Treasury provides all divisions with funds for their activities in exchange for a charge of internal interest. A small part of the Bank's total liquidity risk is due to subsidiaries which have their own liquidity management.

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 each ALCO meeting, liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, stress tests, and any relevant information or risk management concern regarding liquidity and funding risk.

For best practice liquidity management, the Bank follows 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.

### 6.2.1 Internal Liquidity Adequacy Assessment Process

In conjunction with the ICAAP, see Section 3.6.1, 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 Supervisory and Review Process (SREP).

### 6.2.2 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 likelihood of a large scale funding crisis is relatively small, however, it is important to evaluate this risk and formulate contingency plans should one occur.

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

## 6.3 Liquidity and Funding Risk Measurement

In December 2010, the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks.

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. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator.

The Central Bank of Iceland recently revised the Liquidity Coverage Requirements for Credit Institutions, effective 1 January 2023. The new guidelines dictate that the bank must maintain a minimum Liquidity Coverage Ratio (LCR) Total of 100% and a minimum LCR in Icelandic krona (ISK) of 50%. Additionally, there are specific regulations regarding the LCR in Euro (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.

Minimum NSFR requirements for banks in the EU came into force along with CRR II in June 2021. However, Iceland has had a country specific minimum NSFR requirements for foreign currencies since 2014 which have now been aligned with CRR II. According to CRR II, banks are 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 the above requirements, the Bank further monitors and reports the LCR for currencies for which aggregated liabilities exceed 5% of its total liabilities. The Bank reports the LCR and NSFR measures to the Central Bank of Iceland on a monthly basis.

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.

# Liquidity Risk

## 6.4 Liquidity Position

At year-end 2022, the Bank's liquidity buffer amounted to ISK 237,247 million, or 16% of total assets and 31% of total deposits. Composition of the Bank's liquidity buffer is shown in Note 45 of the Bank's Consolidated Financial Statements.

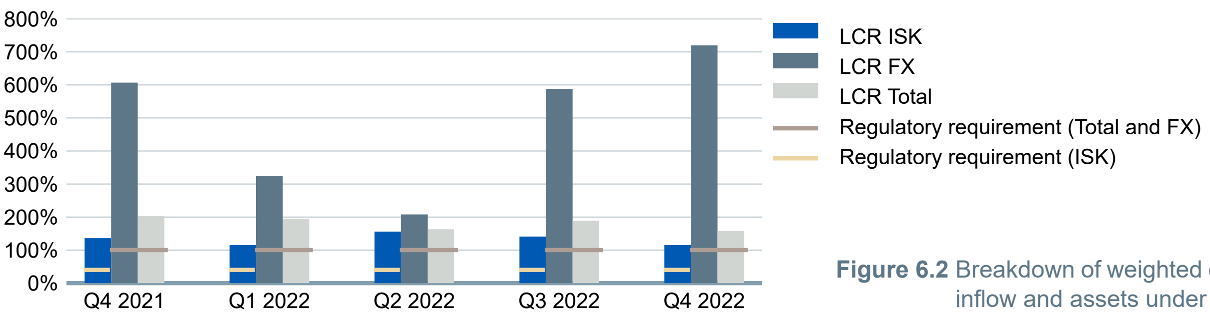
The Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 158%, 720% and 115% for total, foreign currency balances, and ISK, respectively.

**Table 6.1** Liquidity Coverage Ratio

| 31 December 2022 | ISK | FX | Total |
|---|---|---|---|
| Liquidity Coverage Ratio | 115% | 720% | 158% |
| LCR Central Bank requirements | 40% | 100% | 100% |

The Bank has held a strong liquidity position throughout 2022, both in foreign currencies and in total, with the LCR well above the regulatory minimum of 100%. The development of LCR-ISK, LCR-FX 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




## 6.4.1 Breakdown of LCR

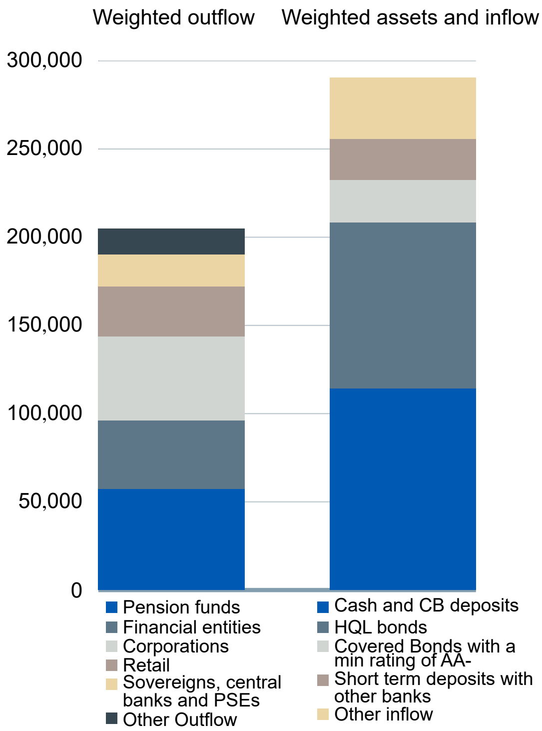
In general, total inflow is capped at 75% of total outflow. As a result, the Bank's foreign currency position in nostro and money market accounts, which contribute to cash inflow under LCR, is not fully utilized for foreign currency LCR.

At 31 December 2022, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 292,283 million, substantially exceeding the weighted outflow of ISK 204,740 million. Of the total stressed outflow, ISK 190,138 million are due to deposits which are further analyzed in Section 6.4.2 on deposit categories. Figure 6.2 further shows the contribution of the Bank's main components to the LCR's weighted outflows, inflows, and assets.

## 6.4.2 Deposit Categories

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

**Figure 6.2** Breakdown of weighted outflow, inflow and assets under LCR's stressed scenario as of 31 December 2022 [ISK m]

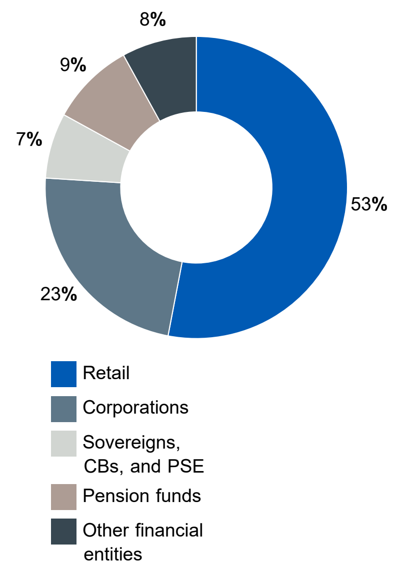


withdrawal under stressed conditions.

Figure 6.3 shows the distribution of the Bank's deposit base.

At year-end 2022, 53% of the Bank's deposit base is due to retail clients. The Bank has placed emphasis on increasing its retail deposit base.

Figure 6.3 Distribution of deposits by LCR categories at year-end 2022




### 6.4.3 Concentration of Deposits

As seen in Figure 6.4, 79% of the Bank's deposits mature within 30 days. At year-end 2022, 19% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors as seen in Figure 6.5.

Figure 6.5 Concentration of deposits on demand within 30 days

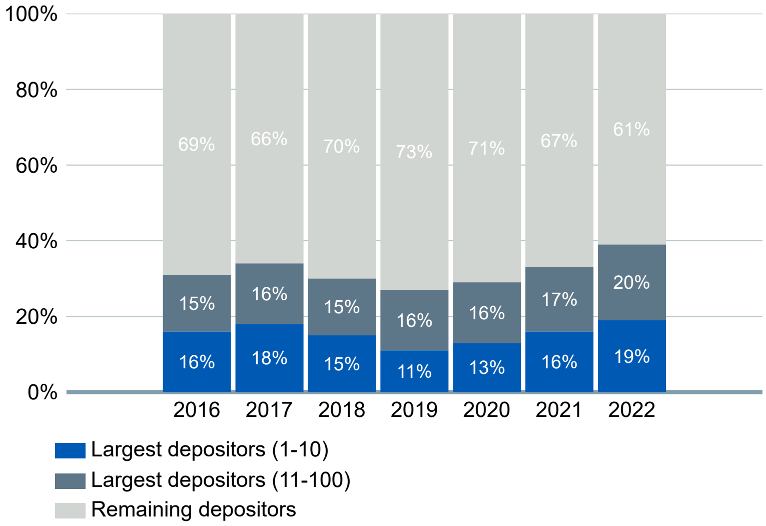
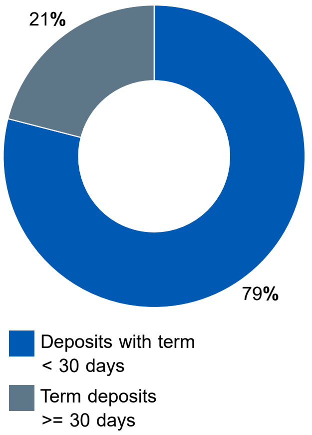



Figure 6.4 Deposit term distribution




## 6.5 Funding

### 6.5.1 Overview

Over the past few years, the Bank has taken significant steps to diversify its funding options, issuing green bonds in euros and Icelandic krona and issuing covered bonds in euros. 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 September 2022 Arion Bank issued green bonds in euros for the second time. The green bonds had 3-year maturities and amounted to €300 million. The bonds were sold at rates corresponding to a 2.65% margin over interbank rates. BofA Securities Europe SA, J.P. Morgan SE, Nomura Financial Products Europe, and Citigroup Global Markets Europe managed the issue for the Bank. The bonds were issued under the Bank's green financing framework. The framework sets out clearly and transparently the conditions which the Bank's loans need to meet in order to be considered green.

In April 2022 Arion Bank issued euro-denominated covered bonds amounting to €200 million. The issue was additional to the 5-year €300 million issue in autumn 2021, bringing the total issue to €500 million. The bonds were sold at rates corresponding to a 0.37% margin over interbank rates. Barclays Bank Ireland PLC managed the issue for the Bank.

In the domestic market, Arion Bank issued a new green bond series in Icelandic krona. The new series ARION 241020 GB attracted a positive response and bonds amounting to ISK 6,020 million were sold to a broad group of Icelandic investors. The bonds have a maturity of 2 years and 9 months and bear floating nominal 3M REIBOR rates + 0.70 margin. The bonds pay interest every three months and a single repayment of the principal at maturity in 2024. The bonds were issued under the Bank's green financing framework.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In 2022 the Bank issued covered bonds amounting to ISK 10.1 billion.

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 with benchmark covered bonds issued by the Bank.

In December 2022 Arion Bank issued two series of subordinated bonds in Icelandic krona which are classed as Tier 2, amounting to a total of ISK 12,100 million. A total of ISK 9,860 million at a yield of 5.01% was sold in series ARION T2I 33 which is an indexed coupon bond, paying interest twice a year. A total of ISK 2,240 million at a yield of 9.46% was sold in series ARION T2 33 which is a nominal coupon bond, paying interest twice a year. Both series mature on 15 December 2033 and can be called by the issuer on 15 December 2028 and on all subsequent interest due dates.

Moody's Investors Service rated Arion Bank for the first time. Arion Bank received the long-term rating A3 and the short-term rating Prime-2 for deposits in foreign and domestic currencies. Arion Bank was rated Baa1 as an issuer of unsecured bonds. The deposits rating and issuer rating have a positive outlook.

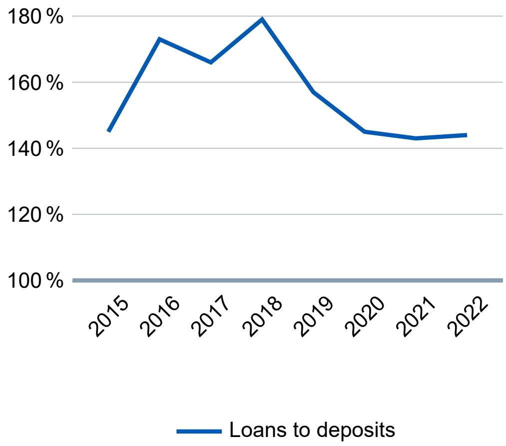
The credit rating reflects Arion Bank's robust capital position, which materializes in its solid leverage ratio and positive and improving profitability on core activities, low default rate, and adequate liquidity. These factors counterbalance the risk related to individual borrowers, geographical concentration, market risk, and risk related the Bank's regular funding on the bond markets.

The positive outlook reflects the Bank's enhanced risk profile and Moody's expectation of reduced volatility in ROE over the next 12–18 months.

S&P Global Ratings affirmed Arion Bank's BBB rating and the outlook remains stable. The Bank's short-term rating is A-2.

S&P upgraded Arion Bank's covered bond rating from A- to A with stable outlook. The covered bond rating now has the same credit rating as the Icelandic government. The credit rating of covered bonds reflects Arion Bank's strength as an issuer, the solid frame-

**Figure 6.6** Development of loans to deposits



work of the Icelandic financial system and the quality of the Bank's mortgage loan portfolio.

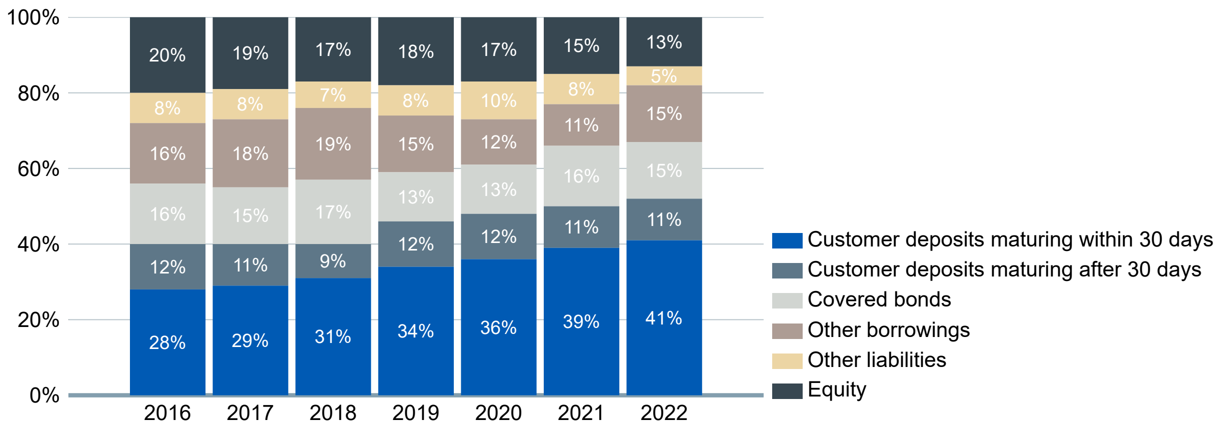
S&P believes Arion Bank's improved ROE supports the Bank's ability to deal with the consequences of a possible price correction on the real estate market. S&P also expects the Bank to see off competition from pension funds on the mortgage market should it materialize.

The stable outlook also matches S&P's expectations that the Bank's own funds will remain very robust and that ROE will continue to be good over the next two years and will be generally higher than competitors. Net interest margin and commissions will increase from the low point reached during the Covid-19 pandemic and loan losses are expected to drop to 0.30% of total lending. S&P also assumes that it will be possible to rein in costs despite high inflation as the Bank will continue to provide services to most of its customers via digital channels.

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 144% as at 31 December 2022 as seen in Figure 6.6.

Figure 6.7 shows the development of the Bank's funding profile.

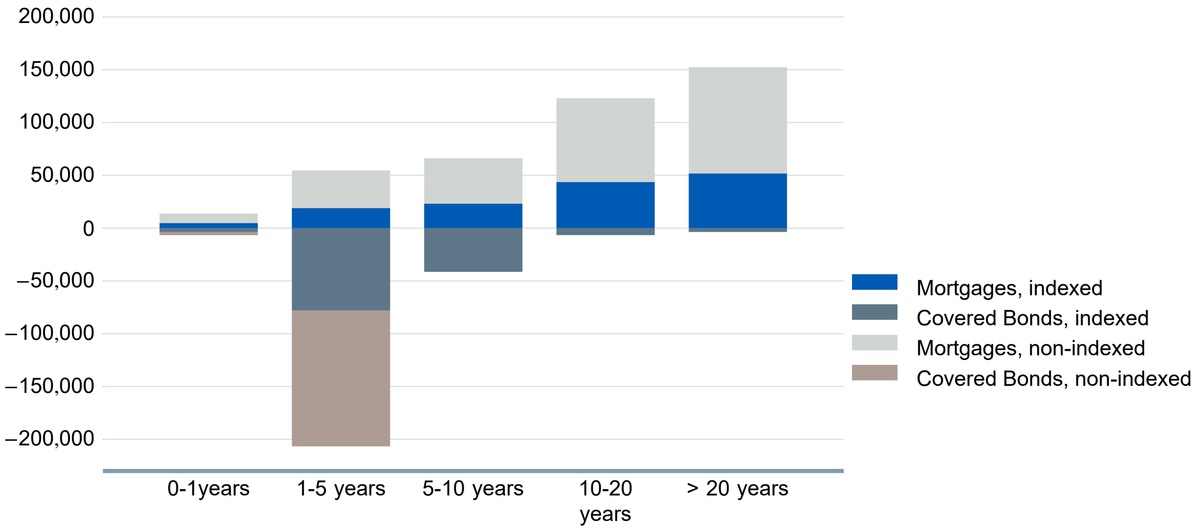
**Figure 6.7** Development of funding by type




## 6.5.2 Secured Liabilities

At year-end 2022, the Bank had an outstanding amount of covered bonds totalling ISK 213 billion. Figure 6.8 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 6.8** 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, is unchanged from year-end 2021 at 19%. 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 | 2022 | 2021 |
|---|---|---|
| Asset encumbrance ratio | 19% | 19% |

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

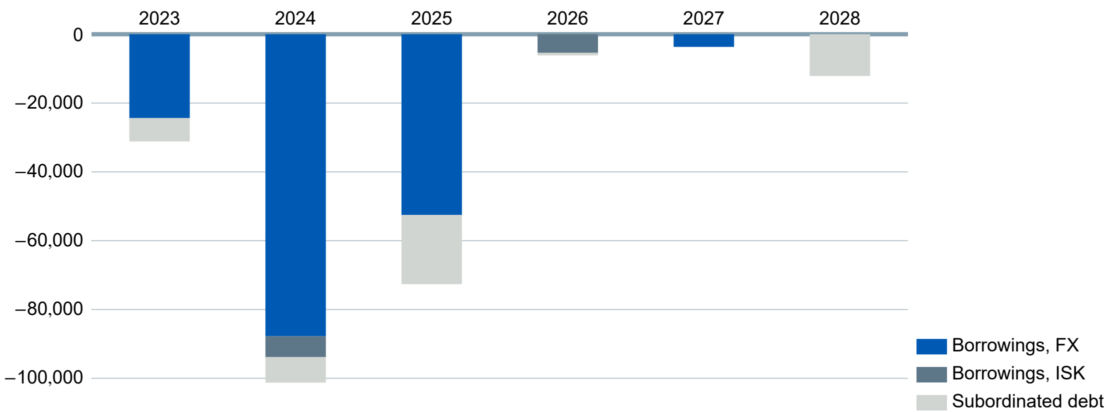
## 6.5.3 Unsecured Borrowings

Unsecured borrowings are mostly foreign currency denominated. Figure 6.9 shows the Bank's maturity profile of borrowings other than covered bonds. The maturity date 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.

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

**Figure 6.9** Maturity profile of borrowings, other than covered bonds [ISK m]



## 6.5.4 NSFR

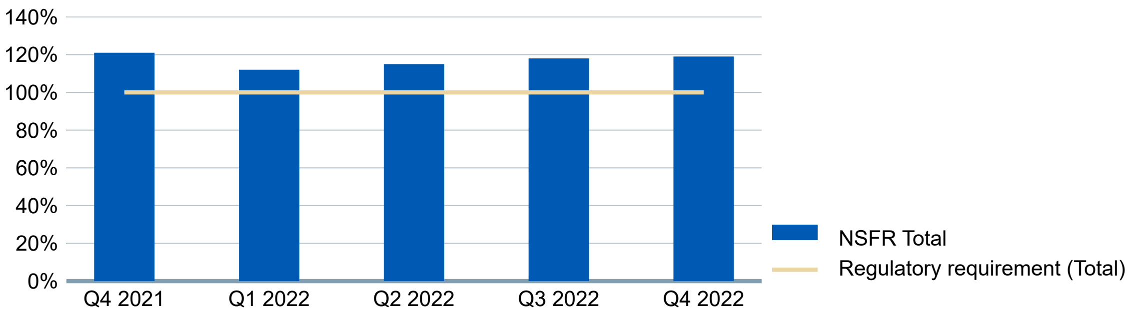
The Bank's Net Stable Funding Ratio in all currencies (NSFR-Total) was 119% at year-end 2022, well above the regulatory minimum of 100%. The Bank's NSFR has been well above the minimum regulatory requirement in 2022, as seen in Figure 6.10. Template EU LIQ2 provides details on ASF items and RSF items which are the basis for the calculation of the NSFR.

The Bank's NSFR is at 119% at year-end 2022

**Table 6.3** Net Stable Funding Ratio

| 31 December 2022 | Total |
|---|---|
| Net Stable Funding Ratio | 119% |
| NSFR Central Bank requirements | 100% |

**Figure 6.10** Development of the Bank's NSFR



# 7 Operational Risk

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

Over the past years, Arion Bank has put significant effort into the development of a comprehensive operational risk system and framework. The goal was to identify, 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 new operational risk system and framework supports the Bank in achieving its goals and highlights areas in its operations in need of specific attention to minimize the risk of direct or indirect losses.

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

## 7.1 Governance and Policy

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost-effective manner, weighing cost and benefit. 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, as well as well trained and qualified staff.

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 Operational Risk Policy, the Bank's CEO has set up an operational risk framework, which outlines responsibilities, rules, and frameworks for operational risk arising from the Bank's operations. On the management level, the Operational Risk Committee (ORCO) is the principal authority for the management and monitoring of operational risk.

An operational risk report is generated by Risk Management monthly and presented to ORCO. The report gives an overview of relevant risk measures for operational and compliance risk, such as a summary of deviation events and IT major incidents, loss data analysis, change management, and net promoter score. Operational risk is also a subject of the Bank's Risk Report, which is presented monthly to the Board Risk Committee and Board of Directors.

The Bank applies the standardized approach for the calculation of capital requirements for operational risk.

## 7.2 Operational Risk Management

Each business unit is responsible for managing its operational risks inherent to their operation by identifying, measuring, and mitigating those risks. Risk Management and Compliance are responsible for developing and maintaining tools to identify, measure, and mitigate risks. The internal control units monitor and report on the Bank's operational and compliance risks.

The Bank applies the standardized approach for the calculation of capital requirements for operational risk

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 and challenging them to align the business environment with the Bank's strategy to maximize potential return for the stakeholders in a cost-effective and risk-minded manner.

Arion Bank has implemented a framework for assessing operational risk based on the standard risk taxonomy developed by the Operational Riskdata eXchange Association (ORX), which is the largest operational risk management association in the financial services sector. ORX splits operational risks into 16 primary categories and 61 subcategories. The taxonomy includes legal risk, conduct risk, and regulatory compliance. By implementing the ORX framework, the Bank has taken steps to further standardize other risk categories for risk assessment and analysis purposes.

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

### 7.2.1 Risk assessment

Risk assessments are split into two different categories: ad-hoc project risk assessments and regular operational risk assessments. Project risk assessments are conducted for all major projects and reviewed over the project lifecycle as part of the Bank's change management system. They are a part of the Bank's product approval process.

Operational risk assessments are generally conducted on a yearly basis starting with the ICAAP / ILAAP risk assessment process, followed by ad-hoc cross functional assessments for key products, services, and supporting processes. During the risk assessment process, the likelihood and magnitude of each risk is assessed as well as the mitigating capabilities of relevant controls. The risk level is determined based on financial and non-financial effects such as materiality thresholds, negative impact on the Bank's customers, reputational damage, and compliance failure. Based on the overall inherent risk level, possible mitigating actions are planned.

### 7.2.2 Control framework

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

Internal controls are designed to minimize losses from operational risk events to an acceptable level with the goal of optimizing operating efficiency. Controls are furthermore designed to ensure compliance with laws and regulations and to deliver and gather reliable information on a timely basis. The Bank's controls are tested and monitored based on their significance.

As an example, the Bank's Internal Control over Financial Reporting (ICFR) is a set of controls designed to provide reasonable assurance regarding the reliability of financial reporting and reduce the risk of misstatement. ICFR controls are tested regularly based on materiality, and the results are presented to the Board Audit Committee.

### 7.2.3 Loss event analysis

The Bank maintains an extensive database of operational deviations. Operational deviations are events that occur in the day-to-day operation which lead to direct or indirect financial loss or events which could have caused financial loss but do not, so called near-misses. Impact from these events can also be in the form of reputational damage or regulatory enforcement.

The Bank's employees are ultimately responsible for registering deviation events. Risk Management maintains a platform for employees to register these events. The Bank maintains a no-blame policy when it comes to deviation events.

The Bank's employees are ultimately responsible for registering deviation events. Risk Management maintains a platform for employees to register these events

Gathering information on these events provides meaningful information on the Bank's operational risk profile and the effectiveness of its internal controls. All events in the database are categorized as per the Bank's risk taxonomy and assigned to relevant business units. This categorization allows the Bank to better identify where the weaknesses within the operation may lie, both down to specific functions of the operation and business units. For severe events a more detailed analysis is performed where the exact root cause of the event is identified to prevent the event from happening again.

The two figures below show the comparison of registered events/financial loss between 2021 and 2022 down to risk category.

## **Operational** Risk

**Figure 7.1** Distribution of loss events by number, parent company

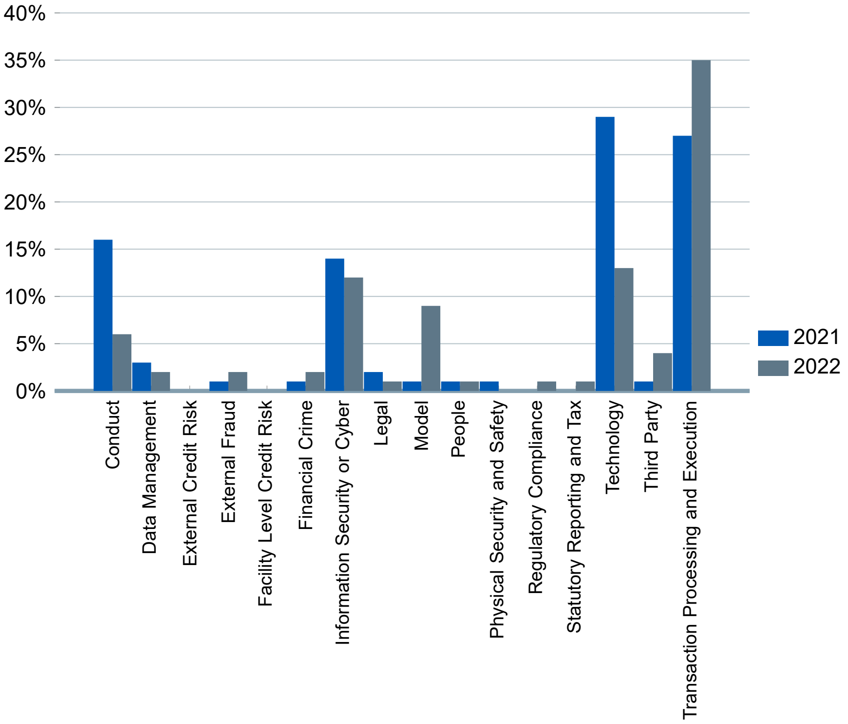
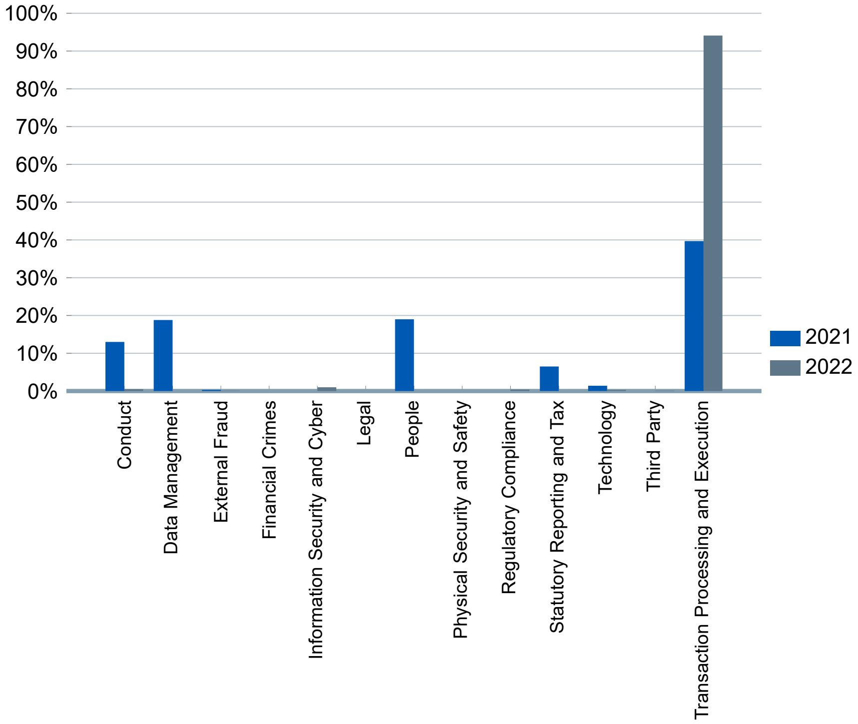



**Figure 7.2** Distribution of loss events by amount, parent company




### 7.2.4 Corrective actions

Any issues arising from the operational risk assessments, loss event analysis, control testing, findings resulting from internal or external audits, or regulatory demands are used to enhance the internal controls of the Bank and improve the Bank's operational risk profile. Once an issue has been identified and the 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.

Risk Management is responsible for providing a platform where the corrective actions can be stored, and their progress documented. In September 2021, a new and improved platform was implemented by Risk Management. The new platform allows responsible business units to access their corrective actions more easily and gives Risk Management a better overview of outstanding actions.

## 7.3 Primary Operational Risks

### 7.3.1 IT risk and cyber security

Information and cyber security practices within the Bank have a foundation in globally recognized and proven security standards and frameworks, collaboration with trusted partners and vendors in information security, and security awareness amongst employees.

The Bank follows a risk-based approach to information security to ensure business continuity by guarding the confidentiality, integrity, and availability of its data, systems, and services and complying with current laws and regulations. An effective three lines governance model is in place to secure the quality and effectiveness of the Bank's Information Security Program.

The Bank's Chief Security Officer (CSO) is responsible for overseeing IT and security risks and the day-to-day operation of the Bank's information security. The Operational Risk Committee (ORCO) is responsible for implementing and enforcing the Bank's security policy.

Information security risk is managed according to the Bank's Information Security Management System (ISMS) based on best practices and standards.

### 7.3.2 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

The Bank has a business continuity management system (BCMS) to ensure that critical operations can be maintained and recovered in a timely fashion in the event of significant operational disruption

- 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 and challenge to the business units.

The Bank uses a risk-based approach for managing conduct and compliance risk. In addition to the regular operational risk assessments, the Bank performs an annual compliance risk assessment, assessing 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 Board Risk Committee on the execution of the Conduct and Compliance Policy, and an annual report to the Board of Directors.

Arion Bank was not found in violation of any laws or regulations or the subject of any fine or conviction in 2022. Information on the main legal cases relating to Arion Bank can be found in the following section on legal risk.

Arion Bank was not found in violation of any laws or regulations or the subject of any fine or conviction in 2022

Arion Bank was not denied registration, authorization, membership, or permission to conduct certain business activities or operations during the year, nor was it subject to withdrawal, revocation, or termination of registration, authorization, membership or permission. There were no issues relating to disclosure obligations in 2022.

In 2022, the Bank received no complaint concerning a breach of data protection from the Data Protection Authority or a third party. The Bank reported 15 incidents to the Data Protection Authority where there was breach of confidentiality. In all cases, the risk to an individual’s rights and freedoms were minimal or limited.

No incidents of theft or loss of personal data were reported during the year. Approximately 80% of employees completed personal data protection training during the year.

### 7.3.3 Financial crime

The Policy on Combating Financial Crime sets out the principles and standards for combating financial crime, i.e., 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 behaviour or transactions. Approximately 95% 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, but the Compliance function is responsible for providing complementary expertise and support, to coordinating the Bank's measures and for investigating and reporting any suspicious activities.

The Bank uses a risk-based approach for managing financial crime risk. In addition to the operational risk assessments, the Bank performs a bi-annual holistic financial crime risk assessment, taking into account different risk factors relating to geography, customers, products, and delivery channels, as well as the Icelandic National 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 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. Summary statistics for 2022 are as follows:

- Adequate customer due diligence, a key performance metric for the Bank, was measured at year-end 2022 at 96%
- The Bank submitted 620 reports of suspicion of money laundering to the Financial Intelligence Unit of the Icelandic Police
- In total, the Bank terminated 119 client relationships based on enhanced due diligence checks because of high-risk indicators
- No issues relating to bribery or corruption were identified in 2022.

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.

## 7.4 Litigation

Litigation is not uncommon in the banking industry due to the nature of the business. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank accounts for any adverse effects the claims may have on its financial standing. The Bank assesses capital need in relation to litigations as part of ICAAP and holds additional capital for exceptional cases.

The largest cases concerning the Bank and possible impact on its financial position can be put into two categories: a) court cases and b) cases before supervisory authorities. To the Bank's knowledge, no administrative procedures are pending or under investigation by supervisory authorities. Two cases warrant a review:

Firstly, the Bank received a letter from the Consumers' Association of Iceland in April 2020. The letter, which was also delivered to Landsbankinn and Íslandsbanki, claimed that contractual terms on variable rate mortgages to individuals were illegal due to lack of transparency and predictability of interest rate decisions. The letter called for revised terms and compensation to borrowers who, according to the Association, have suffered damages. In light of these claims, the Bank conducted a review of its terms and processes for interest rate decisions, concluding that no changes were required and that the Association's claims against the Bank are unfounded. According to information published on the Consumer Association's website, all three banks have rejected the Association's claims. In May 2021, the Consumers' Association issued an article on its website calling for participants in a class action lawsuit. The intention is to commence court proceedings against Icelandic credit institutions to provide court precedents for loans with variable rates. Arion Bank has received information requests from a legal firm representing approximately 1200 individuals, of which 378 are borrowers of Arion Bank. One case has been filed against the Bank and with a judgment of the District Court of Reykjavík on the 7th of February 2023 the Bank was acquitted. The plaintiff will appeal the judgment. Considering the District Court's judgment as well as an external opinion, commissioned by the Bank on its legal position, the Bank believes it likely that it will be acquitted of the claims on appeal.

Secondly, in July 2020 the FSA decided to levy an administrative fine on the Bank in the amount of ISK 87.7 million, allegedly for failing to disclose inside information in a timely manner. The decision has been published on FSA's website. Arion Bank paid the fine but filed a claim with the district court of Reykjavik in October 2020 demanding that FSA's decision be annulled. A statement by FSA was submitted in the case in November 2020. Principal proceedings in the case were held in March 2022 and with a judgment in April 2022, the FSA was acquitted. The Bank has appealed the ruling.

In 2022 there were some legal matters or unresolved legal claims that were considered contingent liabilities. A further description of these cases can be found in Note 38 in the Consolidated Financial Statements for 2022.

# 8 Sustainability risk

Sustainability risk is defined as the risk that certain activities or practices compromise the Bank's assets or reputation or the ability of future generations or segments of society to meet their own needs. This can be due to negative effects on the environment, natural or cultural resources, or social conditions.

The Bank is exposed to risks in relation to environmental, social, and governance (ESG) factors, directly through its own operations and indirectly through financial services provided to 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 institutions, such as compliance risk, market risk, and credit risk. For this reason, sustainability risk must be considered in the Bank's risk management and processes. Regulators, customers, investors, and rating agencies are placing increased emphasis on sustainability-related issues which leads to increasing reporting requirements and expectations of transparency.

The 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, and is committed to supporting the global effort to transition to a net zero carbon economy

This chapter is prepared with a view to EBA's draft implementing standards on prudential disclosure on ESG risks in accordance with Article 449a in CRR and recommendations from the Task Force on Climate-related Financial Disclosures (TCFD).

## 8.1 Governance

ESG risks are incorporated in the Bank's enterprise risk management framework and a Sustainability Committee is a part of the Bank's risk governance structure. The CEO chairs the committee and other members are the CFO, and MDs of Retail Banking, Corporate and Investment Banking, Markets, and Customer Experience. The CRO, the director of Corporate Communications and Sustainability, and the Sustainability Officer are non-voting members. Representatives from the Bank's subsidiaries, Stefnir and Vörður, attend the committee meetings when relevant.

The Sustainability Committee's primary role and responsibilities are the following:

- 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
- Review risk assessment of ESG factors and other assessments of climate risk impact, for example the estimation of Arion Bank's financed carbon emissions
- Oversee the Bank's Green Financing Framework
- Ensure the Bank's employees are adequately educated and aware of ESG factors and sustainable finance.

The Bank's sustainability risk policy is established by the Board of Directors and reviewed on an annual basis. As stated in the policy, the 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, and is committed to supporting the global effort to transition to a net zero carbon economy. The Bank supports Iceland's Climate Action Plan and the UN's Sustainable Development Goals.

At the end of 2022 the Bank's Board of Directors approved an updated incentive scheme for the Bank's permanent staff. The scheme is based on clear financial and non-financial objectives and is subject to regulatory limitations and controls. The non-financial measures are related to, among other things, overall customer satisfaction, knowledge of customers (KYC), staff education, and gender equality.

The Bank has a dedicated Sustainability Team which reports to the CEO and is supported by the Risk Management division, which is responsible for sustainability risk reporting and monitoring to ensure that identified risks remain within risk appetite limits.

**Figure 8.1** Arion Bank's emphasized UN Sustainable Development Goals


## 8.2 Strategy

The Bank engages with its customers, where appropriate, and supports them in adopting more sustainable practices. The Bank's first sustainability policy covering a specific sector — the fishing industry — was developed over 2022 and approved by the Bank's Sustainability Committee at the beginning of 2023. Sustainability policies such as this one will cover those sectors that have the greatest climate and environmental impact. The policies will 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 risk appetite. Fishing is a key industry in the Bank's loan portfolio and for Iceland as a whole.

### 8.2.1 Upcoming regulatory requirements

In June 2020 the European Parliament adopted a regulation on sustainability-related disclosures in the financial sector – the Sustainable Finance Disclosure Regulation (SFDR), as well as a regulation on the establishment of a framework to facilitate sustainable investment (the Taxonomy Regulation).

The SFDR requires financial market participants and financial advisers to disclose both the principal adverse impact of their investments and how they take sustainability risk into account in the investment process. Finally, the regulation requires the participant's financial products to be categorised according to their sustainability levels.

The Taxonomy Regulation establishes a classification framework that defines certain criteria for determining whether an economic activity qualifies as environmentally sustainable. The aim of the Taxonomy Regulation is to allow financial market participants and issuers to

- Use a coherent approach and metrics to measure environmental characteristics
- Enhance investor confidence
- Raise awareness of the environmental impact of financial products or corporate bonds
- Create visibility and address "greenwashing" concerns.

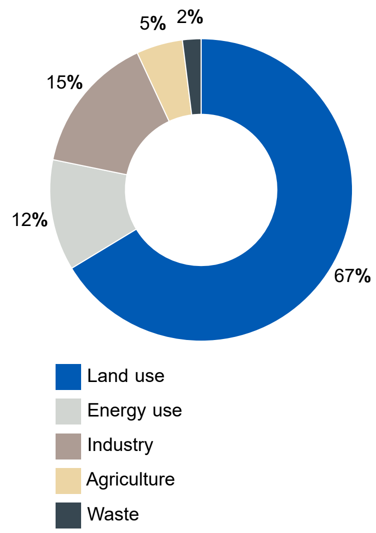
The Taxonomy Regulation applies to companies within the scope of the Non-Financial Disclosure Regulation (NFDR), i.e. large public-interest companies with more than 500 employees, including but not limited to banks, listed companies, insurance companies, and companies designated by national authorities as public-interest entities.

An Act implementing the Taxonomy Regulation and SFDR has not been passed by the Icelandic Parliament but is expected to come into force on June 1st, 2023.

The Bank has taken initial steps to comply with the EU Taxonomy Regulation and estimates that 89% of total assets on the balance sheet are within the scope of the regulation. The next step, which is currently in progress, is to assess which in-scope assets are considered Taxonomy-eligible.

Most of the Bank's Taxonomy-eligible assets are in the loan portfolio. To begin with, it is unlikely that data from companies that meet the NFRD criteria will be available. Furthermore, buildings in Iceland generally do not have Energy Performance Certificates (EPC) nor is Primary Energy Data (PED) available which is required, amongst other criteria, to demonstrate compliance with the technical screening criteria of the EU Taxonomy. As a result, the Bank's Green Asset Ratio (GAR) is expected to be very low to begin with.

**Figure 8.2** Iceland's carbon equivalent emissions in 2020, excluding international transportation. Source: Environmental Agency of Iceland




## 8.3 Environmental Risk

Environmental risks comprise transition risks and physical risks and the Bank assesses both inside-out risks (the impact from the Bank's operations) and outside-in risks (impact through the Bank's credit and investment portfolios). For example, through its credit exposure to the fishing industry, the Bank is exposed to transition risk as a result of the clean energy transition of vessels and to physical risk as climate changes may result in temperature changes and ocean acidification in the North Atlantic Ocean, which would affect the fishing stock around Iceland and in turn the Bank's credit risk.

As the Bank's loan portfolio and financial activities reflect the Icelandic economy to a large extent, it is relevant to review the emissions profile of Iceland, which is somewhat atypical. Emissions from energy use is low in comparison to other countries as almost all of Iceland's electricity production and heating comes from renewable sources (hydro and geothermal). According to Iceland's carbon accounting for 2020, 66.6% of Iceland's emissions was from land use, land use change, and forestry (LULUCF). This ratio is relatively high and indeed in some countries LULUCF is a carbon sink. Other primary emissions contributors are aluminium and silicon production, energy use from road transportation and fishing vessels, agriculture, and waste.

Iceland's Climate Action Plan is focused on these high-impact areas and stipulates clean energy transition in transportation and increased efforts in afforestation, revegetation, and wetland reclamation as primary goals. The Bank has approved an environmental and climate policy where it commits to supporting Iceland's goals in relation to the Paris Climate Agreement and to achieve the ambitious goal of carbon neutrality in Iceland by 2040.

# Sustainability risk

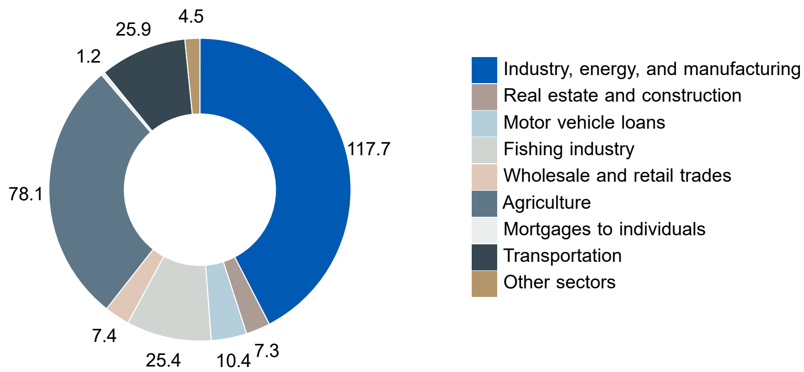
## 8.3.1 Financed emissions

One of Arion Bank's environmental and climate targets for the year 2022 was to assess and disclose financed emissions associated with the Bank's loans and investments for the year 2021.

In 2021 the Bank became a signatory to the Partnership for Carbon Accounting Financials (PCAF), which is a global partnership of financial institutions that work together to develop and implement a harmonized approach to assess and disclose the greenhouse gas (GHG) emissions associated with their loans and investments. At the end of 2022, Arion Bank published its first report on financed emissions which is based on PCAF methodology.

Estimated indirect emissions at Arion Bank in 2021 from lending and investment were approximately 280 ktCO2e. These emissions were almost entirely from the Bank's loan portfolio, i.e. primarily from corporate loans, or 95% of the Bank's financed emissions in 2021.

**Figure 8.3** Arion Bank's financed emissions [kt$CO_2$e] due to the loan book in 2021




Knowledge of the carbon footprint of the Bank's lending and investment is a critical part of managing climate risk and setting environmental and climate goals.

## 8.3.2 Carbon-related assets

The Bank has assessed its loan book using TCFD definition and classification of carbon-related assets. TCFD has defined the non-financial industries which are more likely to be financially impacted than others due to their exposure to certain transition and physical risks around greenhouse gas (GHG) emissions, energy, or water dependencies associated with their operations and products.

The table below shows the Bank's loans, based on an assumption of a static balance sheet, to sectors which are defined as important for tackling climate change according to the recommendations of TCFD.

Given Iceland's unique position with regard to its geographical location and sources of energy, the Bank has adapted the industry categories to the situation in Iceland and has made use of the National Inventory Report of the Environment Agency of Iceland which describes the total emissions of greenhouse gases in Iceland.

**Figure 8.4** Ratio of carbon-related assets to the total loan book at year-end 2022.

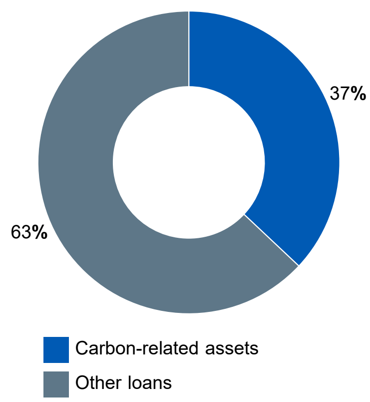


**Table 8.1** Overview of carbon-related assets in the loan book using the TCFD definition

| Carbon-related assets [ISK m] | 2022 | 2021 |
|---|---|---|
| **Agriculture, Food and Forest Products** | **127,139** | **109,476** |
| Paper and Forest Products | 964 | 279 |
| Fishing | 91,526 | 78,171 |
| Packaged Food and Meats | 6,609 | 4,855 |
| Agriculture | 27,573 | 25,756 |
| Beverages | 467 | 415 |
| **Material and Buildings** | **209,232** | **168,173** |
| Chemicals | 196 | 93 |
| Metals and mining | 9,943 | 711 |
| Capital Goods | 40,859 | 42,623 |
| Construction Materials | 2,904 | 2,251 |
| Real Estate Management and Developement | 155,330 | 122,494 |
| **Transportation** | **13,576** | **12,831** |
| Automobiles and Components | 18 | 61 |
| Air Freight | 6,075 | 6,308 |
| Passenger Air Transportation | 2 | 159 |
| Maritime Transportation | 5,619 | 4,642 |
| Trucking Services | 1,862 | 1,660 |
| **Other** | **49,852** | **45,411** |
| Accommodation | 42,973 | 38,377 |
| Other tourism | 6,879 | 7,034 |
| **Total carbon-related assets** | **399,799** | **335,891** |

## 8.3.3 Green Financing Framework

In 2021 the Bank published a comprehensive green financing framework. Since then it has completed four green bond issuances based on the framework, two of which were in 2022.

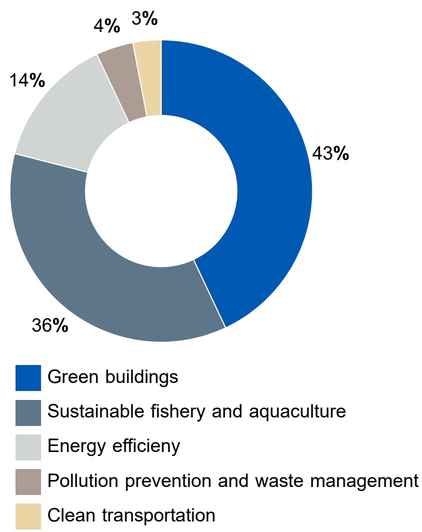
The green financing framework classifies green loans into eight categories:

- Sustainable fishery and aquaculture
- Sustainable forestry and agriculture
- Renewable energy
- Clean transportation
- Green buildings
- Energy efficiency
- Pollution prevention and control
- Sustainable water / wastewater management

The Bank's green deposits were initially used exclusively to finance green car loans but have now been merged into the green financing framework and are thus, along with green bond issuance, used to fund green loans that support the UN Sustainable Development Goals 6, 7, 9, 11, 12, 13, 14, and 15.

The Bank's green financing is a key tool to support the objective stated in the EU Commission's Action Plan to Promote Sustainable Growth to *reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth*. The Bank's sustainability policies for high-impact sectors will comple-

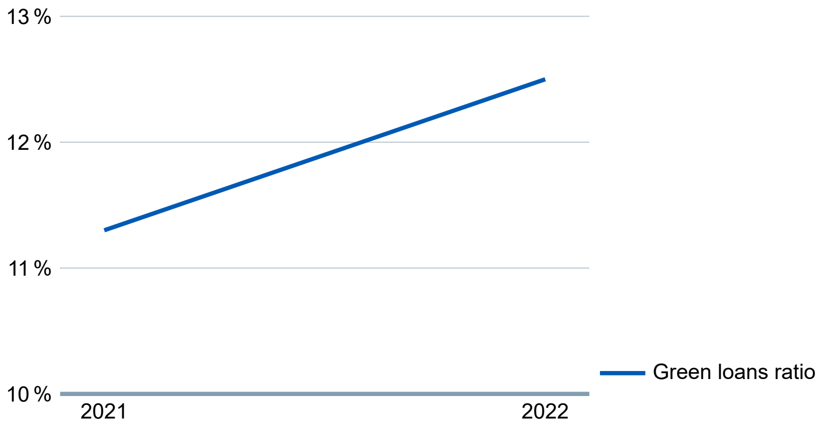
**Figure 8.5** Green loans under the Bank's Green Financing Framework by category at year-end 2022



ment the green framework by focusing on the overall sustainability criteria in the Bank's lending operations, thus avoiding activities that undermine the green agenda (i.e. *"brown"*). The policies also serve as a useful tool to engage with the Bank's customers in a constructive manner and support their transition to more sustainable practices – this is arguably the most significant contribution from financial institutions.

The Bank has set a sustainable financing target. At year-end 2022 green loans under the framework accounted for 12.5% of the total loan portfolio. The Bank's objective is for this ratio to exceed 20% by 2030. This entails that the Bank maintains a rate of growth of green loans under the framework that is more than double the growth rate of total loans to customers until 2030. The progress will be disclosed annually and the target may be revised as further opportunities arise in green financing.

**Figure 8.6** The ratio of green loans in the loan book at year-end 2021 and 2022




The Bank's objective is that in 2030, at least 20% of loans to customers fall under the Bank's Green Financing Framework

Stefnir Fund Management has introduced a number of investment options which support green solutions and are guided by the principle of sustainability. Stefnir - Scandinavian Fund - ESG has received an AAA ESG rating from MSCI.

## 8.4 Social Risk

Social risks include factors such as diversity and gender pay equality, health and safety, discrimination, and human rights.

The Bank has adopted a clear equality and human rights policy, which was reviewed in 2021, and a 3-year action plan. The objective of the policy and action plan is to create an environment where people of similar education, work experience, and responsibility have equal opportunities and terms, irrespective of gender, gender identity, sexual orientation, origin, nationality, skin colour, age, disability, religion, and other characteristics. The Bank's action plan places greater emphasis on balancing gender ratios at the Bank, not just at management level but throughout different job families, committees and business units.

The Bank has set the following targets in the area of gender pay equality:

- Median pay of men / median pay of women < 1.3 (actual: 1.29)
- Gender pay gap within 1% (actual: 0.4%) according to equal pay analysis.

## Sustainability risk

In 2022 social factors relating to gender pay equality were defined in the Bank's Risk Appetite Framework. The risk appetite is monitored by Risk Management and reported to the BRIC and the Board of Directors.

A code of conduct for suppliers, which focuses on sustainability and social responsibility, was introduced in 2021. The code forms part of new buying agreements or is an appendix to existing agreements.

The chapter Responsible banking in the Bank's Annual and Sustainability Report outlines the Bank's activities, collaborations and sponsorships, whereby it is giving back to the society.

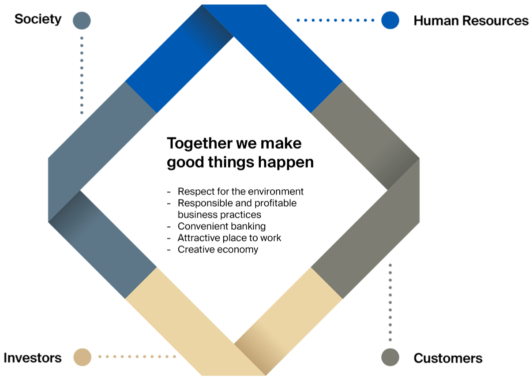
## 8.5 Governance Risk

Governance risk touches on consideration of board diversity and independence, ethics and code of conduct, and disclosure practices.

The Bank's is recognized as having achieved excellence in corporate governance by the Icelandic Chamber of Commerce, Confederation of Icelandic Enterprises, and Nasdaq Iceland, and complies with various acts and guidelines to that respect as further outlined in the Bank's Corporate Goverance Statement.

It states the following: *Good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers, and other stakeholders, such as the Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision-making, with the objective of generating lasting value. The Board of Directors places great importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognized guidelines on corporate governance.*

**Figure 8.7** Arion Bank's main focuses in sustainability




The Bank's Board of Directors consists of independent members and two out of five members are women. In addition to considering independence and diversity within the Board, the role of the Bank's Nomination Committee is to promote good corporate governance and select a team with wide and versatile qualification and experience in accordance with the Bank's Suitability Policy. The Board assesses its work, practices, and procedures on an annual basis and evaluates the performance of the CEO, Internal Auditor, and other employees as applicable.

According to the Bank's Internal Control Policy, it operates under a three lines model, with dedicated second line control functions and internal audit performing third line duties. See further details in Chapter 2, including committee structure. The Bank promotes high ethical standards in its work and is conscious of the fact that its operations affect different stakeholders and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. Ethical and code of conduct standards are considered in the Bank's outsourcing arrangements as per the Bank's Outsourcing Policy.

The Bank's credit policy places an emphasis on sustainability and increasing the percentage of green loans and quantifiable targets have been set. The Bank's credit rules stipulate that environmental, social, and governance factors must be considered when assessing loans. If a lending decision involves ethical issues and/or potential risks related to financial crime, the environment, social issues, and governance, among other things, a member of the Credit Committee (ACC) or the Risk's Management representative has the authority to refer the case to the Bank's CEO. The Bank's CEO will then review the relevant case with the parties concerned. In 2023 the Bank will continue to make environment, social and governance (ESG) factors more important when assessing loans

## 8.6 Risk Management

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

### 8.6.1 ESG risk assessment

At the beginning of 2022, a special risk assessment of ESG factors at the Bank was made, and the assessment was reviewed at the beginning of 2023.

The main social risks relate to employee equality and diversity, disclosure on social factors, and relations with stakeholders. The main environmental risks were insufficient action in environmental and climate issues in connection with goods and services at the Bank, employees' compliance with the Bank's environment and climate policy, and the risk of greenwashing. The assessment revealed that the main governance risks were anti-money laundering measures and know-your-customer, data protection, and ESG reporting. The management of these risk at the Bank was rated as adequate or strong

Climate and environmental risks are assessed in the Bank's Internal Capital Adequacy Assessment Process and considered in the Bank's stress testing program.

### 8.6.2 Risk Appetite for ESG factors

In 2022 the Bank defined sustainability risk statements and metrics that have now been included in the Bank's Risk Appetite Framework. Therefore, ESG metrics are now shown in the monthly Risk Report which is reported to the Board of Directors, BRIC, and the executive management. Examples of metrics displayed in the Risk Report are development of green assets, defined by the Bank's Green Financing Framework, green liabilities, gender ratio in the Bank's management, and outcome of equal pay certification.

### 8.6.3 Sustainable lending and investing

The Bank's credit policy states that the Bank favors sustainable development and ESG factors are considered in credit decisions as stipulated in the Bank's credit framework. The Bank's Institutional Asset Management division has introduced rules of procedure on responsible investment, thus incorporating ESG risks in investment decisions and Stefnir Fund Management operates in accordance with its Policy on Responsible Investments and has its own independent ESG committee.

For further information on the Bank's sustainability agenda, profile, and objectives, see the Annual and Sustainability Report

## Sustainability risk

2022, which includes various non-financial information on ESG factors.

# 9 Remuneration

Arion Bank has a remuneration policy in place in accordance with Act No. 2/1995 on Public Limited Companies, Act No. 161/2002 on Financial Undertakings, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), European Banking Authority (EBA) Guidelines on gender neutral and sound remuneration policies of 2 July 2021 (EBA/GL/2021/04), and FSA's Rules No. 388/2016 on Variable Remuneration. 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. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

## 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 FSA's Rules No. 388/2016 on Variable Remuneration. 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, furthermore, 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 2022, see Note 12.

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

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 and reconfirmed by the Board of Directors in December 2021, to be applied in 2023 based on 2022 performance. 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 2022 in the form of variable remuneration once the annual financial statement for 2022 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, in which case it will be in the form of shares in the Bank which may not be sold for a period of three years.

A restated performance-based variable remuneration system was approved in December 2021 and will apply in 2023 based on performance in 2022

The criterion used for the Bank's remuneration system to determine whether incentive payments will be paid in 2023, in part or in full, is whether the Bank's return on equity (ROE) in 2022 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 2022 performance, a range of factors will be taken into consideration, such as ROE of the Bank, its individual divisions, cost-to-income ratio, bancassurance ratio, compliance with the law and code of ethics, knowledge of the customer (KYC/AML), and the number of different services used by customers.

The objective of the Bank's scheme is to reflect its objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders, and employees

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 four times in the year 2022. 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.

The Board Remuneration Committee monitors the incentive scheme, ensuring compliance with laws, regulations and best practices. The Board Risk Committee annually assesses whether incentives 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 2023, in part or in full, depends on a comparison of the Bank's return on equity (ROE) in 2022 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 EBA templates EU REM1–REM5 in 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 |
| BRC | Board Remuneration Committee |
| BRIC | Board Risk Committee |
| BRRD | Bank Recovery and Resolution Directive |
| BTC | Board Tech Committee |
| CCF | Credit Conversion Factor |
| 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 |
| KYC | Know Your Customer |
| LAA | Loss Absorption Amount |
| LCR | Liquidity Coverage Ratio |
| LGD | Loss Given Default |

# Abbreviations

| | |
|---|---|
| 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 |
| 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 |
| UCITS | Undertaking for Collective Investment in Transferable Securities |
| UN | United Nations |
| VaR | Value at Risk |

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