Risk and Capital Management 2014

Pillar III risk report of Landsbankinn hf.
31.12.2014

Landsbankinn hf. in brief

Landsbankinn hf. was founded on 7 October 2008 by the Ministry of Finance on behalf of the Icelandic State Treasury. The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank is licensed as a commercial bank and operates in accordance with Act No. 161/2002 on Financial Undertakings. Landsbankinn is subject to supervision by the Financial Supervisory Authority of Iceland (FME) in accordance with Act No. 87/1998 on Official Supervision of Financial Activities.

Landsbankinn hf. is a leading Icelandic financial institution. The Group offers a full range of financial services and is the market leader in the Icelandic financial service sector with the largest branch network. Focused on commercial banking, Landsbankinn provides retail and corporate banking services, capital markets services and asset and wealth management for private banking clients.

The Icelandic State now holds 97.92% of shares in the Bank, Landsbankinn hf. holds 1.30% and 1401 current and former Landsbankinn employees hold 0.78%.

Content

The disclosures have been put together to explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks and for no other purposes. They do not constitute any form of audited financial statement and have been produced solely for the purpose of Pillar III. They should not be relied upon in making judgements about the Group. The disclosures will only be subject to external verification to the extent that they are equivalent to those made under accounting requirements.

This publication, Risk and Capital Management 2014, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2014. There may be some discrepancy between financial information in the Consolidated Financial Statement 2014 and information in the Risk and Capital Management 2014 as the report has been prepared in accordance with the Capital Requirements Directive and the Basel II capital framework, rather than in accordance with IFRS.

1 Highlights of 2014 and Outlook

Many key indicators of economic health suggest that the economy is currently fairly well balanced. The exchange rate is stable; inflation is low and relatively stable. Unemployment levels have fallen rapidly and are now close to equilibrium levels. The country's foreign debt along with household and corporate debt has decreased at the same time as the purchasing power of wages has increased. Private consumption and investment has picked up and real estate prices are on the rise. Preliminary estimates from Statistics Iceland for GDP growth in 2014, however, suggest that GDP growth was well below most forecasts for the first 3 quarters of the year. Most forecasters expect strong growth in Q4 and an upward revision of the first estimates, bringing GDP growth for the year 2014 above 2%. Most indicators thus suggest that the economy has recovered well from the financial collapse in 2008. However, it should be noted that the economy now shows some similarities to the time leading up to the last expansionary period, around and after 2004.

Monetary policy has been conservative and the government's public stance has been to show restraint in public finances, achieve a balanced budget and lower the public debt. Significant out-flows from the government treasury to lower the private debt of individuals with inflation-indexed mortgages contravenes this policy and gives cause for concern about the future. Even limited upsets could disrupt the current balance and long-awaited price stability.

Several large legacy problems remain unresolved. A final resolution of the bankruptcy estates of the fallen banks is obviously the most significant. Other large pending issues concern public finances, the unsustainable position of the Housing Financing Fund and funding short-fall of the pension obligations of the Pension Funds for State Employees.

Despite goals set by the authorities, capital controls still hold sway on domestic financial market. Limited access to international credit markets at acceptable terms and a lack of investment opportunities will continue to hamper the domestic markets. The equities market will likely be the driving force of the financial market in coming years, both due to expectations of improved performance of the largest companies and new listings. Icelandic companies listed on the OMX main list are now 13, two of which were listed in 2014 and at least three more new listings are expected in 2015. In 2014, turnover in the Icelandic stock market increased by 10.3% and market value increased by 23.4%. The foreign exchange market was more stable in 2014 than in the preceding years. The Icelandic króna appreciated by just under 2% over the year, as opposed to 11% in 2013. The Central Bank's foreign exchange market transactions reduced exchange rate volatility and strengthening of the ISK during the year. The annual inflation rate was 2.0% in the beginning of 2014 but declined throughout the year and stood at 0.8% at year-end. The Central Bank expects it to move above 2.5% in Q4 2016. The Central Bank lowered its policy rate by 0.75 percentage points in 2014. Yields of nominal treasury bonds decreased while yields on inflation-indexed bonds increased, bringing the break-even inflation rate close to the 2.5% inflation target.

Increased credit quality and decrease in arrears

Exposure-weighted average probability of default, excluding financial institutions, decreased in 2014 within the portfolio, albeit at a slower pace than previous years. Certain sectors of borrowers are showing significantly better performance than anticipated, with the construction and real estate sector leading the pace. The Bank increased the ratio of mortgages in the portfolio to 22% during the year, largely with high quality borrowers and adequate LTV ratios. This increase gives better diversification in the loan portfolio and has a positive impact to the exposure weighted average probability of default.

Internal measurements of Loss Given Default decreased in 2014 largely due to value increases in underlying collateral e.g. real estate and quota of fishing vessels. Internal processes of collateral registration were also strengthened and efforts in that area will continue in 2015.

Arrears measured by the 90 day default rate decreased significantly during the year, from 5.1% to 2.3% at year-end 2014. The Bank anticipates that this decrease will lead to decreased PD ratios and increased credit quality in 2015.

Market risk decreases while liquidity remains strong

Market risk of the Bank decreased during the year. The Bank sold significant amounts of non-core unlisted equity holdings in 2014, the sale of Promens being the largest part of equity sales.

The Bank‘s liquidity position remains strong with the ratio of LCR of the Group is 131% in total and 614% in foreign currencies, both well above regulatory requirements made by the Central Bank of Iceland.

A longer term funding measurement, the NSFR ratio, was introduced into regulations in 2014. Regulatory requirements were set at 100% for end of year when the position of the Bank was 134%, well above regulatory requirements.

Positive developments in funding

The Bank has maintained its external rating of BB+/B in 2014, while the outlook was revised from stable to positive reflecting an improvement in the economic conditions in Iceland as well as a strengthening of the Bank's asset quality and capital position.

Refinancing of the bond issued to LBI was an important step in strengthening the Bank's funding in foreign currency and is a positive step towards access to financing in international capital markets.

Equity

The Bank's equity position strengthened by 2.8 percentage points to 29.5% in 2014, despite dividend payment of ISK 19.8 billion in March 2014. All equity is common tier 1 equity (CET1). Internal estimate for Economic Capital decreased during the year with a lower risk position of the Bank and is now 14.1%. The Bank has set a capital target of at least 20% of risk weighted assets.

Outlook for 2015

The Macroeconomic Forecast of Landsbankinn Economic Research expects economic growth to continue throughout 2017. The outlook for 2015 is strong, with GDP growth expected to exceed 4%, driven mainly by increasing investment and private consumption. The increase in private consumption will be driven, among other factors, by rising disposable income and more mortgaging leeway created by the government's actions at the end of last year to reduce the debt of borrowers of inflation-indexed housing loans, increased purchasing power of wages, falling unemployment and changes to the tax system. Real estate prices rose by almost 8.5% in 2014 and a similar rise is expected 2015 driven mostly by the same factors as for private consumption. The positive developments in housing prices have fuelled housing investment which is expected to increase by 18% this year.

The economic situation in Europe, Iceland's most important market region, has been difficult of late. The positive developments that appeared to be on the horizon have diminished and uncertainty about the future of the euro currency has increased again. Economic growth in the Eurozone is expected to be slightly above 1% this year but the outlook for economic growth in the US is somewhat better with around 3% GDP growth expected in 2015. A further setback in the economic recovery in Europe could have a significant negative effect on the domestic economy in Iceland, especially tourism and the price of marine exports.

Due mainly to positive developments in terms of trade and a stable exchange rate, inflation is expected to remain under the inflation target in general for much of this year. The key uncertainty regarding the inflation outlook is the outcome of ongoing and upcoming collective wage negotiations for a large part of the labour market. Excessive wage increases could jeopardise the current low and stable inflation level and fuel higher inflation towards the end of the year.

The Bank has set the risk appetite and overall risk limits for 2015. With current market condition the Bank expects the overall risk position to be unchanged or improve slightly with increase in the credit quality of borrowers, lower market risk and favourable external conditions. The main risk factors now reside with the external economic and legal conditions for the Bank as well as its borrowers.

Uncertainties still remain in the external environment. Capital controls are still in place and have now been for 7 years. This poses a threat to normal development of financial markets within Iceland as investment and saving choices are limited which puts significant price pressure on investment assets and credit. This distorts the pricing of risk within the Icelandic economy and creates inefficiencies within the financial and real sector. Should the capital controls be prolonged for a significantly longer period there is increased risk of a sharp adjustment in the pricing of risk when they are removed which could have negative effects on the Icelandic economy.

The government of Iceland has announced plans of removing the capital controls, starting in 2015. A structured approach to the removal and successful implementation will reduce the risk of price distortion in the market and thus reduce the risk of imbalances in the economy. This could also lead to better credit rating for the Icelandic state and for Icelandic financial firms.

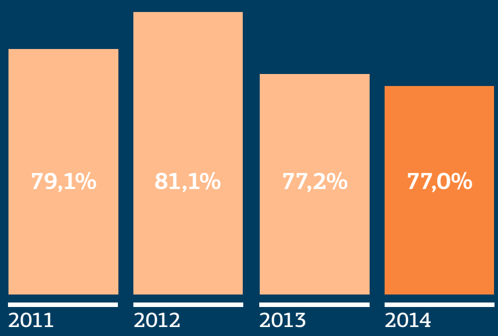
Regulatory changes in Europe with the introduction of Basel III and CRD IV have taken effect, but introduction into Icelandic law and regulation is still fragmented and appear uncoordinated. Proposed adoption and changes of Icelandic laws awaits discussion within parliament and its subcommittees, delaying the adoption for Icelandic financial firms and creating uncertainties in the market. To ensure the competitiveness and common ground for Icelandic financial firms, regulators are urged to speed up the adoption process and increase transparency of the process.

Risk in review

Risk weighted assets

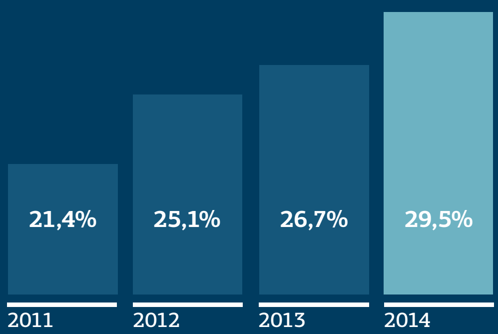
846 ISK bn

RWA to total assets



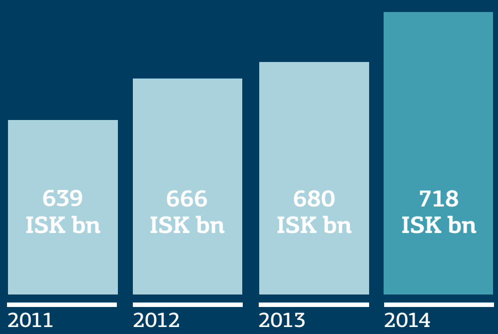
77,0%

Capital adequacy ratio



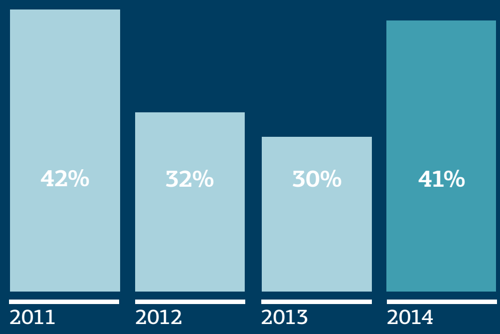
29,5%

Loans and advances to customers



718 ISK bn

Large exposures to capital base

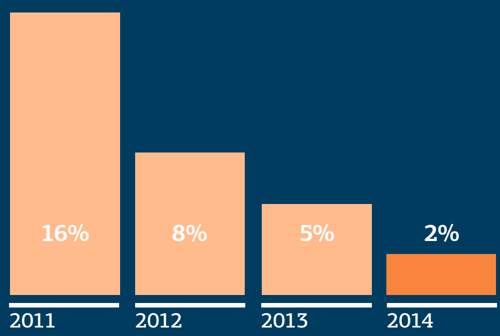


41%

Economic Capital

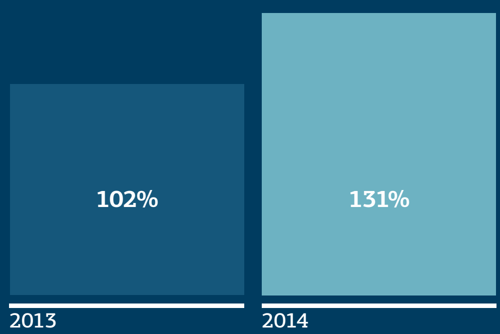
119 ISK bn

90 days past due loans



2%

Liquidity coverage ratio total



131%

Vestmannaeyjar

2 Risk Management

Risk Management

Risk is inherent in the Bank's activities and is managed through a process of on-going identification, measurement, management and monitoring, subject to risk limits and other controls. Risk identification involves finding the origins and structures of possible risk factors in the Group's operations and undertakings. Risk measurement entails measuring the identified risks for management and monitoring purposes. Finally, risk controls and limits ensure compliance with rules and procedures, as well as compliance with the Group's risk appetite.

The objective of the Group's risk policies and procedures is to ensure that the risks in its operations are detected, measured, monitored and effectively managed. Exposure to risk is managed to ensure that it will remain within limits and the risk appetite adopted by the Group will comply with regulatory requirements. In order to ensure that fluctuations which might affect the Group's equity as well as performance are kept limited and manageable, the Group has adopted several policies regarding the risk structure of its asset portfolio which are covered in more detail under each risk type.

Risk policy is implemented through the risk appetite, goal setting, business strategy, internal rules and limits that comply with the regulatory framework of the financial markets.

2.1 Risk appetite

The Group's risk appetite is defined as the level and nature of risk that it is willing to take in order to pursue its articulated strategy, and is defined by constraints reflecting the views of the Board of Directors and the Group's CEO and Executive Board.

The Group's risk appetite has been reviewed, revised and implemented for 2015. The Group's risk policy is as follows:

The Group provides universal financial service to customers. For this purpose, the Group has set itself objectives regarding financial position, asset quality, exposures and a satisfactory long-term profitability. In the pursuit of its goals, the Group only takes on risks that it understands, is able to measure and manage. The Group aims to be comparable with the leading banks in the Nordic countries in similar fields.

The Group seeks to maintain solid business relationships, having regard for its own position as well as that of customers at each time and with due regard for any internal connections between customers. The Group pursues long-term business relationships and avoids being linked to transactions that might damage its reputation.

The Group seeks to ensure diversified and sound financing and a sustainable risk profile in its balance sheet. The Group has set internal limits that provide for a strong capital and liquidity position which, along with active risk management, ensure long-term profitability and strong standing. In this manner, the Group minimises fluctuation in its operations and is well positioned to withstand stress scenarios.

The Group's corporate culture is characterised by professionalism and processes that support a high level of risk management. Managers are responsible for monitoring and managing risk within their units. Decisions are based on a thorough and professional discussion of major advantages having the long-term interests of the Group and its customers in mind. Efficient follow-up on decisions and risk monitoring are integral to the Group's operations.

2.2 Risk identification

The Group is exposed to the following material risks which arise from financial instruments:

- Credit risk
- Market risk
  - Currency risk
  - Interest rate risk
  - Other market risk
- Liquidity risk
- Operational risk

The table below provides a link between the Group's business units and the principal risks that they are exposed to. The significance of risk is assessed within the context of the Group as a

Principal risk	Personal Banking	Corporate Banking	Markets	Treasury
Credit risk	High	High	Low	Low
Operational risk	Medium	Medium	High	Medium
Market risk	Low	Low	Medium	High
Liquidity risk	n/a	n/a	n/a	High

whole and is measured based on allocation of Economic Capital within the Group.

The Group also manages other relevant risks, such as concentration, business, legal and compliance risk.

2.3 Risk management structure

The Group aims to meet the highest international standards and recommendations for banks' risk management in order to support its business model. The Group devotes substantial resources to developing and maintaining procedures and tools to fulfil this ambition.

The Group's risk management is based on guidelines, policies and instructions determined by the Board of Directors. The Group has prepared specific instructions on risk management for individual business units based on the general instructions from the Board of Directors. At the unit level, these instructions are used, among other things, as the basis for business and control procedures.

2.3.1 Risk committees

The Group's risk management governance structure at year-end 2014 is as follows:

Proper organisation of the Board's work is a prerequisite

Board of Directors

Supervision by the Board of Directors and its sub-committees
Audit Committee
Remuneration Committee
Risk Committee
Strategic Development Committee

Key risk management bodies and committees

Committee	Chair	Other members
Executive Board	CEO	Managing Directors
Risk & Finance Committee	CEO	CFO, CRO, Head of Legal Department, MD of Operation & IT
Credit Committee	CEO	CRO, MD of Corporate Banking, MD of Personal Banking
Operational Risk Committee	CRO	MD of Personal Banking, MD of Operation & IT, MD of Corporate Development & HR, Head of Compliance

for the smooth operation of the Group and the Directors' work. The establishment of sub-committees can improve treatment of issues for the Board's attention and can boost the efficacy work.

The Board assesses the need to establish sub-committees at the Board level according to the size and scope of the Group at each time, as well as the composition of the Board. The Group's corporate governance statement is required to provide information on the establishment and appointment of sub-committees. There are four sub-committees of the Board of Directors and their role is to prepare discussion by the Board of specific areas of operation and investigate in more detail matters related to them. During 2014 the former Audit & Risk Committee was split in one Audit Committee and one Risk Committee.

The Audit Committee shall endeavour to ensure the quality of the Group's annual accounts and other financial information, as well as the independence of its auditors. The Committee's function is, among other things, to supervise accounting procedures. The Committee also monitors the organisation and function of internal auditing as well as the review of the internal auditor´s remuneration. Moreover, the Committee supervises auditing of the Group's annual and consolidated accounts and assesses the independence of the Group's external auditors. It also supervises other tasks performed by external auditors and submits proposals to the Board of Directors for the selection of external auditors.

The Risk Committee monitors the organisation and effectiveness of risk management structure and compliance. The Committee monitors the management of credit, market, operating, reputational and other types of risks as and where applicable.

The Remuneration Committee establishes the Group's terms of employment as regards the salaries of the Group's CEO and Directors of the Board and submits suggestions to the Board of Directors for approval. In addition, the Remuneration Committee fulfils the function of the Board with regard to preparing and submitting proposed terms to the Board and negotiating salaries and terms of employment with the CEO. The Remuneration Committee discusses the development of wage agreements, as well as the development of wage expenditure and the number of employees. For further details on the Group's remuneration policy, see Section 9.1 of Landsbankinn's 2014 Remuneration Report.

The Strategic Development Committee prepares the Board of Directors for discussion and decisions on the future vision and strategy of the Group. The Strategic Development Committee monitors changes in the Group's operating environment and deliberates on the Group's position and business plan with an eye to strategic development. The Committee is also tasked with prioritising objectives in relation to the Group's strategy.

The Board of Directors of the Group has overall responsibility for the establishment and oversight of the Group's risk management framework and risk appetite setting. The CEO is responsible for the effective implementation of the framework and risk appetite through the corporate governance structure and committees. The CEO has established and is a member of the Executive Board, the Risk & Finance Committee and the Credit Committee.

The Credit Committee deals with credit risk – individual credit decisions, credit limits on customers and credit risk policy issues – while the Risk & Finance Committee covers primarily market risk, liquidity risk, operational risk and legal risk. The Risk & Finance Committee monitors all of the Group's risks, is responsible for enforcing the Group's risk appetite and risk limits, and reviews and approves changes to risk models before presented to the Board of Directors. The Executive Board serves as a forum for consultation and communication between the CEO and the managing directors, addressing the main current issues in each division. This committee makes all major decisions not being considered in other standing committees. The Operational Risk Committee is a forum for discussions and decisions on key operational risk issues and review of the effective implementation of the operational risk framework.

Governance pertaining to specific risks can be found in the relevant chapters.

2.3.2 Risk Management Division

The Group's Risk Management Division is responsible for the Group's risk management framework. Subsidiaries of the Group have their own risk management functions and the Risk Management Division receives information on exposures from the subsidiaries and collates them into Group exposures. The Risk Management Division is also responsible for comprehensive risk reporting on risk positions to various internal departments and committees and supervisory authorities.

The Risk Management Division is comprised of four departments.

- The Credit Management Department is responsible for risk assessment and oversight of credit decisions. The Department has veto rights regarding credit applications from customers with exposures exceeding the credit limits of individual business units and customers who have been classified as on watch list in the Early Warning System. Decisions exceeding the confirmation limits of the Risk Management Division are referred to the Group's Credit Committee;

- The Credit Risk & Economic Capital Department is responsible for providing the Group with internal models and monitoring systems as well as related processes to measure and monitor credit risk and economic capital. The Department also supports the implementation of such models and processes within the Group. In addition, the Department is responsible for credit risk, economic capital and impairment analysis and reporting within the Group;

- The Market Risk Department is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the Group's banking book. Market Risk is also responsible for monitoring all derivatives trading the Group enters into, both for hedging and trading purposes. Monitoring by Market Risk also includes monitoring the Group's FX balance and providing limit monitoring for pension funds under management by the Group;

- The Operational Risk Department is responsible for ensuring that operational risks are monitored and that the Group implements and maintains an effective operational risk management framework. The Department assists the Group's managers with operational risk self-assessment and reporting and analysis of operational incidents, and oversees continuity plans. The Operational Risk Department leads the work on the Group's certification under the ISO 27001 standard for information security.

2.3.3 Compliance

The Group's Compliance function ensures that the Group adheres to its own rules on securities trading and insider trading and that the Group's operations comply with Act No. 108/2007, on Securities Transactions, Act No. 64/2006, on Actions to Combat Money Laundering and Terrorist Financing, and other relevant legislation and regulations. Compliance also concentrates on Group adherence to codes of ethics and on limiting market abuse, minimising conflicts of interest and ensuring best practice. Compliance is one of the Group's support functions and is integral to its corporate culture.

2.3.4 Internal Audit

Group Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of its risk management, controls, and governance processes. Group Internal Audit determines whether the risk management framework, control, and governance processes as designed and represented by management are adequate and functioning, and thus supports the Group accomplish its objectives.

2.4 Risk measurement

The Group regularly monitors and assesses its current risk profile in the most important business areas and for the most important risk types. It also constantly seeks to improve the process for its risk appetite in order to supplement the risk management framework and to support the business model.

The risk appetite framework considers key risks relevant to the Group's business activities by setting risk appetite goals and limits. On an aggregate level, the risk appetite is represented in terms of credit risk, market risk, liquidity risk and funding risk. It varies how detailed they are, as well as which metrics are used, depending on their properties and are suited to enable the Group to manage risk in an efficient manner. In addition the Group measures and monitors other key risk indicators which address operational risk and process risk as well as additional credit risk, market risk, liquidity risk and funding risk measurements.

Credit risk pertains, inter alia, to the quality of the loan portfolio, probability of default, defaults, concentration risk and large exposures. Revised limits on credit risk are based on reducing the risk even further in 2015.

Measurements of market and liquidity risk were within limits the entire year and the Group has revised limits that relate to market risk in relation to the business plan.

The Group's liquidity position is very strong and the Group has reasonable scope to manoeuvre without approaching risk limits.

Economic Capital (EC) is also a key element to the management of the Group's risk and capital structure, as well as in the day-to-day financial management. EC is the capital required to cover the Group's unexpected loss one year into the future. One of the benefits of EC is the fact that it comes up with an aggregate figure for all risk types, products and business units. It thus produces one unified risk measurement expressed in a single unit of value, and the capital will at any time reflect the Group's risk the next year. Further details on EC are provided in section 3.5.

Overview of the main risk appetite measures

Risk	Metric
Credit risk	Probability of default
	Past due ratio
	Industry concentration
	Single name concentration
Market risk	Equities
	Bonds
	Currency
	Interest rate risk in the banking book
	Inflation risk
Liquidity risk	Liquidity Coverage ratio - Total
	Liquidity Coverage ratio - FX
	Core liquidity ratio
Funding risk	Net stable funding ratio
	Capital ratio

2.5 Risk monitoring

The Group allocates considerable resources for ensuring on-going adherence with the approved risk limits and for risk monitoring. It has set guidelines for reporting to relevant management bodies, including the Board of Directors, the Risk Committee, the Risk & Finance Committee and the Executive Board on developments in risk measures and risk appetite, liquidity, market related risks, the credit portfolio and such.

The Risk Committee of the Board of Directors receives thorough risk reports six times a year for different risk types as well as a monthly risk report. Risk-related material is also reported through an integrated monthly management report to the Board of Directors. The Risk & Finance Committee and the Executive Board receive a monthly risk report or more frequently if required. Furthermore, the Group has implemented an internal online risk dashboard for executive managers where up-to-date risk material is available. Once a year, an expanded ICAAP report is submitted for approval which is subject to a review by the FME's Supervisory Review and Evaluation Process (SREP). Finally, a detailed EC report is submitted to the Board of Directors once a year.

Principal reporting to the Board of Directors

Annual	
ICAAP report	Evaluation of the risk profile and the solvency need. The report contains conclusions drawn from stress testing, including the effect of various scenarios on expected losses and capital needs
Economic Capital report	Thorough analysis of EC developments and EC breakdown by risk types and business units as well as capital
Biannual	
Credit risk report	Thorough risk report providing analysis of such issues as development in risk appetite, past due loans, average exposure weighted probability of default (PD), default rate vs. PD, distribution of loan portfolio in rating categories and migration analysis and other analysis of credit risk aspects
Market & Liquidity risk report	Thorough risk report providing the Group's current equity, fixed income and currency positions as well as reports on the utilisation of limits since the preceding report
Operational risk report	Thorough risk report providing analysis of operational risk aspects
Monthly	
Risk report	An aggregate report containing information on the Group's risk appetite and material from the credit, market, liquidity and operational risk reports. The report is interactive and available electronically
Executive Board report	An aggregated report containing risk related material such as risk appetite, EC and RAROC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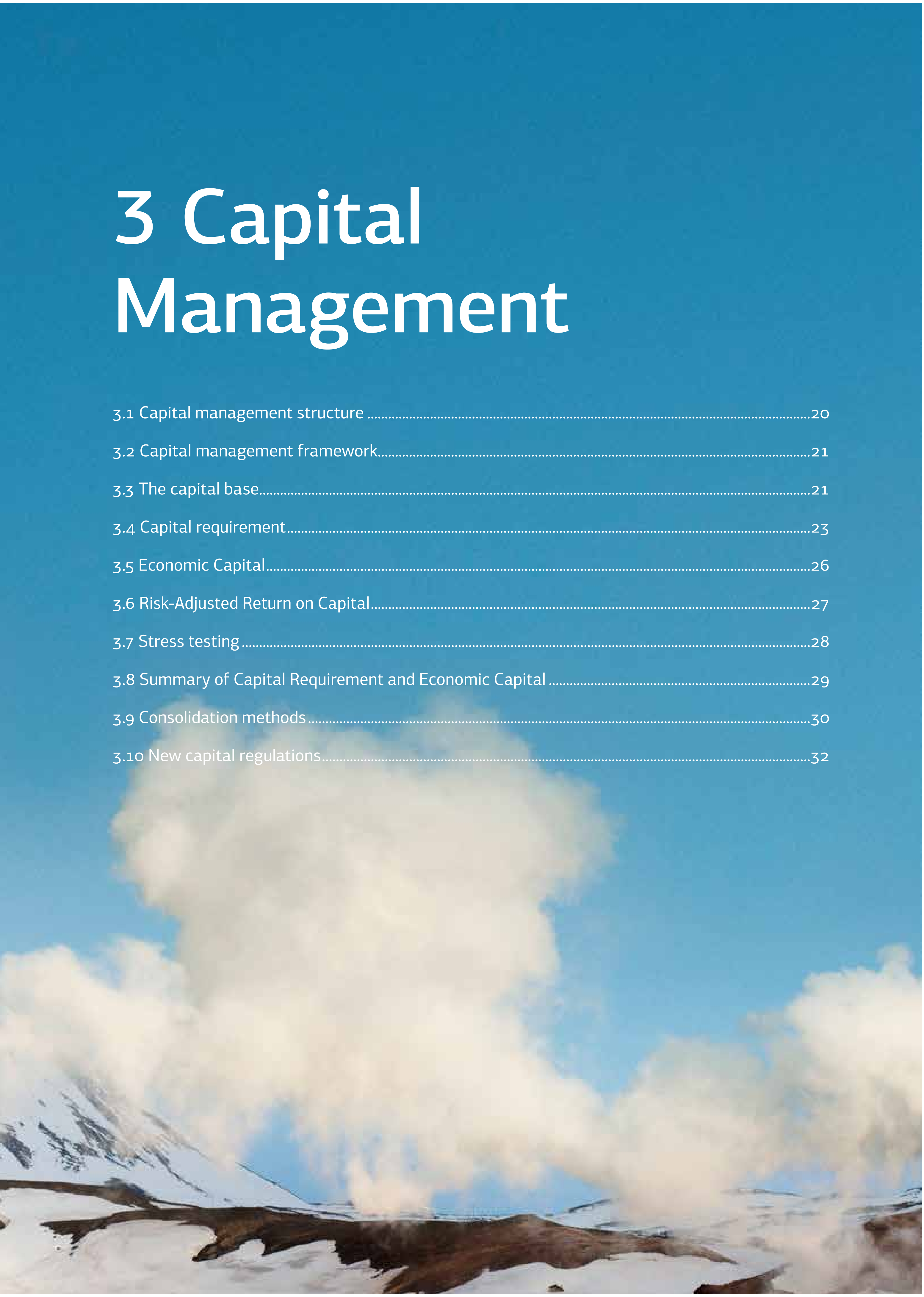


3 Capital Management

Capital Management

3.1 Capital management structure

The Group's capital management governance structure for year-end 2014 is as follows:

Capital management structure

Responsible party	Role
Board of Directors	The Board of Landsbankinn hf. is responsible for determining the Group's capital policy. The Board shall ensure that management establishes and maintains frameworks for assessing risks, relating risk to capital, as well as capital management. The Board monitors and approves the ICAAP and its methodology, scenarios and results.
CEO	The CEO decides on the overall capital management framework. The CEO shall ensure, on an on-going basis that the capital management framework is in accordance to the risk profile and business plan and functions properly. The CEO shall provide the Board of Directors with ICAAP reports and quarterly management reports on capital ratios and the capital base. The CEO shall notify the Board of material changes or exceptions from established policies that will significantly impact the operations of the capital management framework.
Finance	The Managing Director of Finance is responsible for capital management, including the capital base, capital adequacy reporting, capital planning activities and the ICAAP. Furthermore the MD of Finance shall monitor the development of capital requirements and the capital base. Finance shall review on an annual basis the capital management policy and make proposals to the Board on capital targets. Finance reports to the CEO and Board regarding capital management. Finance is responsible for liquidity management and funding as well as the stress testing framework, including scenario definition.
Risk Management	The Managing Director of Risk Management is responsible for the risk management framework, as well as the EC framework for relating capital to risk.
Internal Audit	Internal Audit shall at least annually review the capital management framework and its operations to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the Group's activities.

3.2 Capital management framework

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

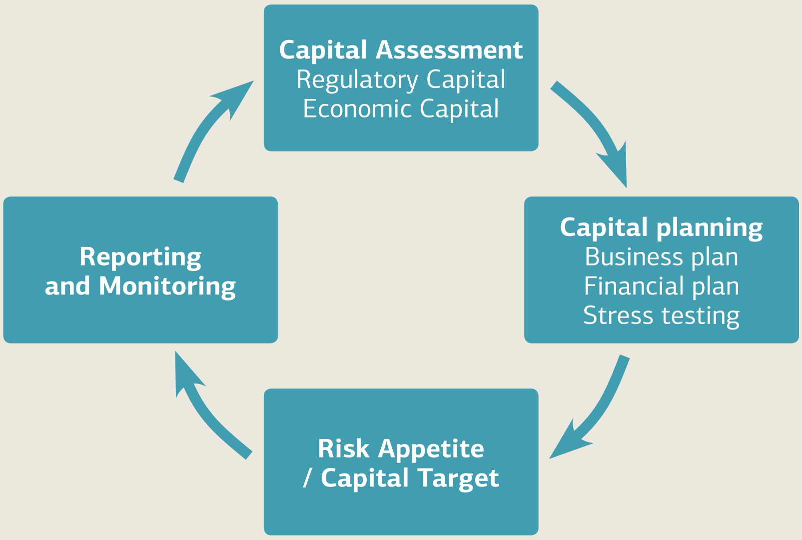
The capital management framework of the Bank comprises of 4 interdependent activities: Capital assessment, risk appetite/capital target, capital planning, and reporting/monitoring.

The Group uses the standardised approach in measuring the regulatory capital requirement for Pillar I risks.

Economic Capital (EC) is a risk measure which is applied to all material risks. It captures unexpected losses and reduction in value or income for which the Bank needs to hold capital to avoid insolvency.

The total capital ratio target is set annually as part of the Bank's risk appetite. When setting the target, EC, Pillar I and II capital requirements, expected CRD IV requirements, internal capital buffers, risk appetite, and strategic objectives are considered.

Capital management framework



The Internal Capital Adequacy Assessment Process (ICAAP) under Pillar II is the Group's own assessment of its capital need (as a percentage of RWA) and is based on EC calculations, stress tests and results of the Supervisory Review and Evaluation Process (SREP). ICAAP is the foundation of the capital planning process which includes the business plan, financial plan and stress testing.

3.3 The capital base

The Group's equity at 31 December 2014 amounted to ISK 251 billion (2013: ISK 241 billion), equivalent to 22.8% of total assets (2013: 21.0%). The capital adequacy ratio, calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings, was 29.5% at 31 December 2014 (2013: 26.7%). Under the Act the minimum requirement for this ratio is 8%. The capital base consists of Tier 1 capital and the breakdown is as follows:

The capital base

Capital base	31.12.2014	31.12.2013
Share capital	23,687	23,618
Share premium	121,275	120,700
Statutory reserve	6,000	7,046
Retained earnings	99,841	90,002
Non-controlling interests	0	-7
Intangible assets	-1,225	-585
Deferred tax assets	-83	0
Tier 1 capital	**249,495**	**240,774**
Deduction from original and additional own funds	0	-3,865
Capital base	**250,631**	**236,909**

Risk-weighted assets		
Credit risk	665,167	684,655
Market risk	83,601	99,763
Operational risk	96,836	104,500
Total risk-weighted assets	**845,604**	**888,918**

Tier 1 capital ratio	**29.5%**	**27.1%**
Capital adequacy ratio	**29.5%**	**26.7%**

The Group's capital adequacy ratio rose in 2014, because of its capital base increased and RWA decreased in equal proportions. A dividend payment of ISK 20 billion was made, approximately 70% of the previous year's after-tax earnings.

3.3.1 Tier 1 capital and statutory deductions

Tier 1 capital consists of core Tier 1 capital less statutory deductions according to requirements of the FME based on Articles 54 and 55 of Act No. 113/1996.[1] The Group makes deductions in order to determine its core Tier 1 capital:

» Carrying amounts of intangible assets

» Deferred tax assets

» Capital holdings in other credit and financial institutions amounting to more than 10% of their capital

The Group has liquidated its capital holdings (>10%) in other credit and finance institutions and thus makes no deduction to the capital base from Tier 1 capital, compared to an ISK 3.9 billion reduction in capital base in 2013.

The capital base at year-end 2014 contains no hybrid capital and no Tier 2 capital. The capital ratio increased by 2.8 percentage points during 2014.

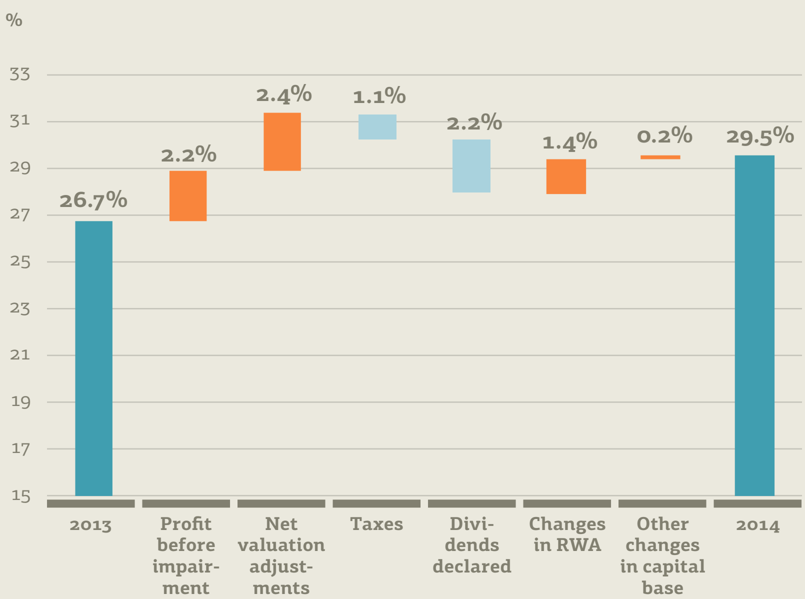
3.4 Capital requirement

The regulatory minimum capital requirement under Pillar I of the Directive is 8% of risk-weighted assets for credit risk, market risk and operational risk. The Group uses the standardized approach[2] in measuring Pillar I capital requirements for credit risk and market risk. For operational risk it uses the basic indicator approach[3] in calculating capital requirement.

Risk-weighted assets (RWA) for credit risk, the single largest risk type, amounted to 79% of total RWA. RWA for market risk amounted to 7% of RWA.

Risk weighted assets were reduced by ISK 43 billion from the previous year, or 5%.

Change in capital ratio



Change in risk weighted assets

1 Article 55, see http://www.althingi.is/lagas/127b/1996113.html
2 See Staðalaðferð http://www.stjornartidindi.is/Advert.aspx?ID=f051707c-8c23-4e99-a305-68dcb6f97a29
3 Capital requirements for operational risk are calculated by aggregating the operating revenues for the last three years and obtaining the arithmetic mean. If the aggregate operating revenues for any given year are negative, it is excluded in the calculations. The capital requirement for operational risk is equal to 15% of this mean.

Capital requirement

Capital requirement and risk-weighted assets	31.12.2014		31.12.2013	
Credit risk breakdown	**Capital requirement**	**RWA**	**Capital requirement**	**RWA**
Central governments or central banks	512	6,402	81	1,011
Regional governments or local authorities	180	2,245	221	2,768
Administrative bodies	0	0	205	2,567
Institutions	1,521	19,017	1,864	23,306
Corporations	30,555	381,941	32,946	411,819
Retail	6,797	84,960	7,818	97,723
Secured by real estate property	8,763	109,534	4,447	55,586
Past due items	1,227	15,333	2,811	35,143
Items belonging to regulatory high risk categories	0	0	1,066	13,323
Short-term claims on institutions and corporate	0	0	0	0
Other items	3,659	45,736	3,313	41,410
Credit risk	**53,213**	**665,167**	**54,772**	**684,655**
Market risk breakdown				
Traded debt instruments	1,767	22,090	2,321	29,006
Equities	3,211	40,132	4,130	51,621
Market risk	**4,978**	**62,222**	**6,451**	**80,628**
Currency risk	1,710	21,379	1,531	19,135
Operational risk	7,747	96,936	8,360	104,500
Total capital requirement and RWA	**67,648**	**845,604**	**71,114**	**888,918**

The following summarizes how the Group calculates its Economic EC for the risks included in the framework:

Economic capital

Risk	Calculation method
Credit risk	The credit risk EC model is the asymptotic single risk factor (ASRF) model from the Basel II internal rating based (IRB) approach's risk weight formula, i.e. EC equals the capital requirements of the IRB approach in the capital requirements directive. The main input to the model are the risk parameters probability of default (PD), loss given default (LGD) and exposure at default (EAD).
Market risk	Market risk EC for interest rate risk in the trading book is calculated using the standardised measurement method of the Basel framework, i.e. EC equals the Bank's capital requirements for interest rate risk. Market risk EC for equity risk, however, is calculated using the following risk weights: • 290 % for exchange traded equity exposures. • 370 % for all other equity exposures.
Currency risk	For FX positions a VaR-model is used to calculate EC 1-day 99% VaR as well as stressed VaR (SVaR) are calculated and scaled to one-year 99% VaR in accordance with the Basel framework. Stressed VaR is calculated from the worst case of the previous 250 trading days. EC for FX-risk equals the sum of the two one-year 99% VaR measures.
Concentration risk	EC for single name concentration is calculated by adjusting for the granularity and non-homogeneity in the portfolio. This is necessary as the credit risk EC model assumes that the portfolio is infinitely large and homogenous, hence the single name concentration EC is given as an add-on. An internal model is used to measure the additional EC for credit risk related to industry concentrations in the loan portfolio, i.e. a concentration add-on. EC is given by the increase in credit risk EC when a stressed correlation for the concentration in the portfolio is used.
Interest rate risk in the banking book	Interest rate risk in the banking book EC is equal to the loss of economic value resulting from a simultaneous parallel shift in the relevant interest rate curves.
Operational risk	EC for Operational risk is calculated using the basic indicator approach, which means that it equals the Group's capital requirement.
Inflation risk	Inflation risk EC is equal to the loss in economic value of inflation linked assets and liabilities resulting from a shift in the one year inflation during the next 12 months. The magnitude of the shift is defined as the 99.9% percentile of the one year inflation, estimated using a time series model.
Business risk	Economic Capital for Business risk is calculated using an internal model, which is based on the volatility of the Bank's income, before profit or loss due to any other material risk.
Legal and regulatory risk	Economic Capital for legal and regulatory risk is calculated by adding the potential loss of on-going disputes weighted by their status within the legal system.

Economic Capital ISK million	2014	2013
Credit risk - Loans to customers and credit institutions	60,401	63,770
Credit risk - Other assets	3,659	4,379
Market risk	9,403	12,124
Currency risk	1,946	2,728
Operational risk	7,747	8,360
Single name concentration risk	7,093	7,736
Industry concentration risk	4,067	3,175
Inflation risk	5,139	5,727
Interest rate risk	9,345	9,925
Business risk	3,873	4,180
Legal and regulatory risk	6,697	5,711
Total	**119,369**	**127,815**
EC/RWA	**14.1%**	**14.4%**

3.5 Economic Capital

Economic Capital (EC) is a risk measure which is applied to all material risks. It captures unexpected losses and reduction in value or income for which the Group needs to hold capital to avoid insolvency. It arises from the unexpected nature of losses as distinct from expected losses. EC is defined as the difference between unexpected losses and expected losses, where unexpected loss is defined as the 99.9% Value-at-Risk (VaR), with a one-year time horizon. The purpose of the EC framework is to enable the Group to assess the amount of capital it requires to cover the economic effects of risk-taking activities, as well as to compare different risk types using a common “risk currency”.

The objective of the EC framework is to measure unexpected losses as well as to decompose EC on various levels to enable capital allocation, limit setting, pricing of products, risk adjusted performance measurement and value based management.

The framework covers the following risk types: credit risk, market risk, currency risk, operational risk, concentration risk, interest rate risk in the non-trading book, inflation risk, legal risk and business risk.

The Group’s main focus regarding market risk in the past year was to reduce exposure to unlisted equities and that will be ongoing in 2015. As a result, EC for market risk decreased significantly in 2014. The Group introduced EC for inflation risk at year-end. EC for credit risk decreased due to lower probability of default and improved collateralisation. More significant disputes against the Group causes increased estimate of Economic

Weighted average

Credit risk as at 31 December 2014	Probability of default (PD)	Loss given default (LGD)*	Exposure at default (EAD)	Economic Capital (EC)
Financial institutions	0.1%	45.0%	50,060	828
Public entities	0.5%	44.4%	17,661	474
Individuals	4.1%	31.1%	263,099	10,039
Corporates	5.8%	42.7%	556,742	49,059
Total	**4.8%**	**39.3%**	**887,562**	**60,401**

Weighted average

Credit risk as at 31 December 2013	Probability of default (PD)	Loss given default (LGD)*	Exposure at default (EAD)	Economic Capital (EC)
Financial institutions	0.2%	45.0%	59.820	1.421
Public entities	0.9%	45.4%	15.842	553
Individuals	4.4%	33.0%	243.616	8.690
Corporates	5.5%	44.8%	603.202	53.107
Total	**4.7%**	**41.7%**	**922.480**	**63.770**

Foundation LGD is used for EC calculations and risk management. The Group has also implemented an internal LGD model for impairment use (see section 4.1.2);

Capital due to Legal and regulatory risk.

EC is estimated at 14.1% of RWA at year-end 2014.

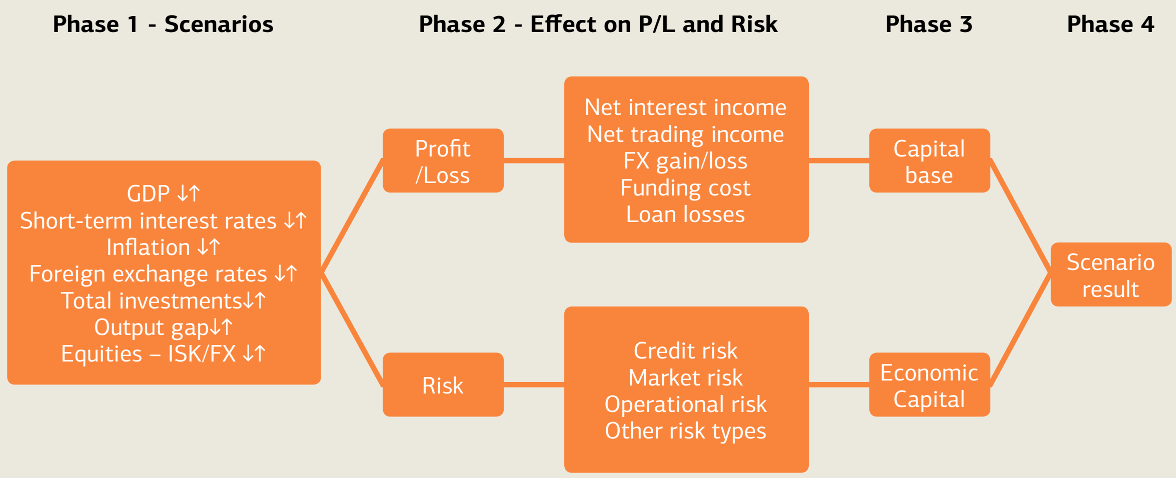
Above is a further breakdown for credit risk, probability of default by asset class as well as loss given default, exposure at default and EC.

3.6 Risk-Adjusted Return on Capital

To analyse the Group's risk adjusted profit and profitability, i.e. including the cost of risk, the measures risk adjusted profit (RAP) and Risk-Adjusted Return on Capital RAROC, have been implemented and are reported monthly to the senior management. The objective of the measures is to measure shareholder-value creation and profitability in relation to the equity capital needed to cover the risks taken on, i.e. the economic capital.

The measures enable risk-based pricing, increases incentives to measure and manage risk appropriately, focus on long term profit, as well as support the assessment of the bank's optimal capital structure.

The measures have been rigorously enforced throughout the Group. By enforcing this discipline, the Group can ensure that each of its departments is considering the cost of risk in exactly the same way, and deciding how to structure and accept transactions within the same risk appetite guidelines.



3.7 Stress testing

As a part of ICAAP and the capital planning process, internal stress tests are used as an important risk management tool in order to determine how severe, unlikely but plausible, changes in the business and macro environment affect the capital need. Stress tests reveal how the capital need varies during a stress scenario, where impact on financial statements, regulatory capital requirements and capital ratios occur. The stress test process is divided into the following steps:

- Scenario development and approval
- Scenario translation
    - Translation model to determine loan loss
    - Translation method to determine the effect on financial statements
    - Translation model to determine EC
- Calculation
- Management actions
- Analysis and reporting

In 2014, the Group developed 4 scenarios, including a baseline scenario and a recurring mild recession scenario. These scenarios forecast developments of key macro indicators over a given period. Scenarios demonstrate an alternative development of key economic variables induced by various shocks compared to the baseline macroeconomic and inflation forecast of Landsbankinn's Economic Research department.

When scenarios have been developed and approved by the Board a scenario translation is applied. The Group uses both statistical models as well as expert judgement.

The Group uses a loan loss model which incorporates macroeconomic variables and produces probability of default (PD), default rates as well as loss given default (LGD) which can then be translated into loan losses.

The effect on financial statements is then translated and calculated with a resulting impact on the capital base. The effect on risks is also translated and calculated, resulting in changes to EC, i.e. the capital need.

One of the scenarios reflects mild recession. The purpose of the scenario is to analyse how much additional capital is needed to ensure that the Group will not have to intervene with management actions, other than not paying dividends, in the case of a mild recession. Mild recession is also important to the Group's assessment of the appropriateness of the risk appetite related to capital as well as the assessment the size of the minimum internal buffer.[4]

4 The internal capital buffer is a countercyclical buffer which equals the amount of capital that is needed to ensure that the Bank stays above the minimum capital requirement during normal fluctuations of the business environment, e.g. a mild recession, and inherent risks in the Group's operations.

In addition to these two main scenarios, a baseline and mild recession, the Group applies various specialised scenarios to provide management with a better understanding of how the Group will be affected by specific events which might require management action.

3.8 Summary of Capital Requirement and Economic Capital

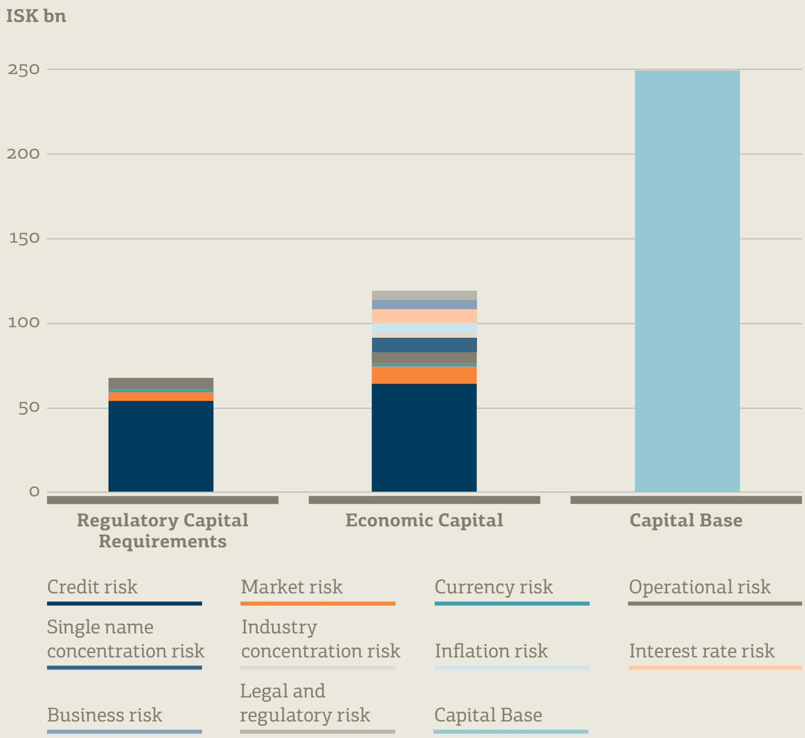
At 31.12.2014 the Group estimated its EC at ISK 119.4 billion (14.1% of RWA) and the capital requirement to be ISK 67.6 billion under Pillar I.

The add-on for Pillar I risks is ISK 15 billion (1.8% of RWA), mainly due to credit risk. Pillar II risks require ISK 36.0 billion of capital (4.3% of RWA), the biggest risk being Interest rate risk in the banking book.

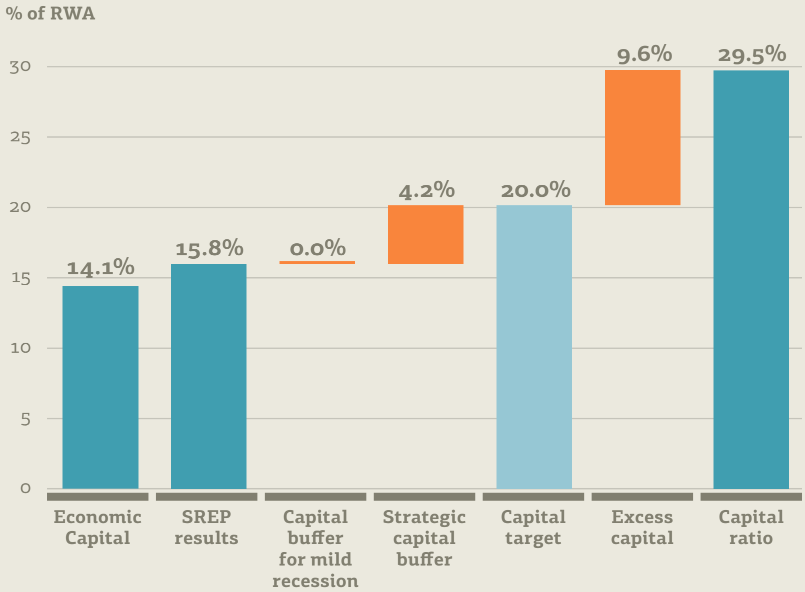
In the latest SREP, based on data from 31.12.2013, the FME determined the minimum capital requirement for the Group to be 15.8% of RWA (31.12.2012: 16.7% of RWA), consisting of the 8% regulatory capital requirement under Pillar I and a 7.8% capital requirement under Pillar II. Moreover, forthcoming Icelandic legislation, implementing the new EU CRD IV capital requirements, is expected to require the Group to hold capital buffers in addition to the existing capital requirements.

The Group intends to maintain a total capital ratio above the aggregate of the current SREP at each time and the new forthcoming capital buffers under CRD IV.

Landsbankinn Capital position as at 31.12.2014



Economic Capital vs. Capital ratio



Notwithstanding legal and regulatory requirements, the Group has set a target for total capital ratio of at least 20% of RWA.

Pillar 1 risks	RWA 2014	RWA 2013	CR 2014	CR 2013	EC 2014	EC 2013
Credit risk	665,167	684,655	53,213	54,772	64,060	68,149
Market risk	83,601	99,763	6,688	7,981	11,349	14,852
Operational risk	96,836	104,500	7,747	8,360	7,747	8,360
Total Pillar 1 risks	845,604	888,918	67,648	71,113	83,156	91,361
Pillar 2 risks						
Concentration risk					11,160	10,911
Inflation risk					5,139	5,727
Business risk					3,873	4,180
Interest rate risk in the BB					9,345	9,925
Legal- & regulatory risk					6,697	5,711
Total Pillar 2 risks					36,214	36,455
Total capital requirements					119,369	127,815
Total own funds (Capital base)			249,495	237,851	249,495	237,851
EC/RWA					14.1%	14.4%

3.9 Consolidation methods

Risk and Capital Management 2014 is based on the definition of the Landsbankinn Group used in the 2014 Annual Report and complies with IFRS. Subsidiaries are entities over which the Group has the power to govern financial and operating policies so as to obtain benefits from their activities, generally accompanied by a shareholding of over half of the voting rights. Subsidiaries are fully consolidated in the financial statements according to the acquisition method. In capital requirement calculations and EC the Group consolidates its subsidiaries with a full look-through approach; that is, the Group looks through the subsidiary and down at each individual asset.

Subsidiaries held directly or indirectly as at 31.12.2014 were as follows:

Consolidation methods

Company	Ownership interest	Activity
Eignarhaldsfélag Landsbankans ehf. (Iceland)	100%	Holding company
Horn fjárfestingarfélag hf. (Iceland)	100%	Investment company
Landsbréf hf. (Iceland)	100%	Management company for mutual funds
Hömlur ehf. (Iceland)*	100%	Holding company
Ístak hf. (Iceland)	100%	Construction company
Blámi – fjárfestingafélag ehf. (Iceland)	100%	Holding company
Span ehf. (Iceland)	100%	IT-services
Landsbanki Holdings UK plc. (United Kingdom)	100%	Holding company in liquidation
Eignarhaldsfélagið ehf. (Iceland)	100%	Holding company
Lindir Resources ehf. (Iceland)	78%	Holding company

* Manages the Group's repossessed collaterals, which consists mainly of real estate assets.

Associates are those entities in which the Group has significant influence, but not control, over financial and operating policies. Significant influence is presumed to exist when the Group holds, directly or indirectly, between 20-50% of the voting power of another entity. The Group accounts for investments in associates in the financial statement using the equity method. In capital requirement calculations and EC the Group classifies the share in each associate with an applicable risk weight. The Group has reduced its holdings in associates significantly from the previous year.

Investments in associates as at 31.12.2014 are as follows:

Associates	Ownership interest	Carrying amount at as 31 December 2014	Carrying amount as at 31 December 2013
Reiknistofa bankanna hf.	37%	552	613
Auðkenni hf.	21%	56	50
Greiðslumiðlun Íslands ehf.	48%	167	0
Other		2	13,561
Total		**777**	**14,224**

3.10 New capital regulations

The Group does not have information on amendments to acts of law and/or regulations that will, with any certainty, lead to additional requirement of economic capital buffers. While plans have been presented to commence preparation of new legislation that could potentially have such effect the Group regards such potential effect not to be certain enough to call for a requirement of economic capital buffers.

On 1 January 2014, a new framework for prudential requirements for banking entered into force in the EU. The framework, referred to as CRD IV, consists of two parts, an updated Directive (CRD IV, Capital Requirements Directive) and a Regulation (CRR, Capital Requirements Regulation).

The new CRD IV framework has not been taken into the EEA Agreement and is therefore, not yet at least, binding on Iceland under international public law. The reason for this is that CRD IV is closely linked to a new EU institutional framework for financial services, introduced with regulations in 2010. Three European supervisory authorities, mandated to work closely with national supervisors, were set up under this framework: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). These regulations have not been incorporated into the EEA Agreement and have thus not been transposed into Icelandic law. These regulations are considered to involve the transfer of executive powers that would go beyond the provisions of the Icelandic Constitution. This has postponed the incorporation of the CRD IV framework into the EEA Agreement.

CRD IV provides for the adoption of technical standards in various fields. The technical standards are prepared by EBA and stipulate more detailed provisions on the basis of the CRD IV framework. The technical standards will, for instance, include provisions on the harmonisation of the frequency and form of reporting to supervisors. All reports from European banks are expected to be submitted simultaneously and in a standardised form, to regulators and from there on to EBA.

In Iceland, the Directive is expected to be transposed through a bill of legislation amending the Act on Financial Undertakings

No. 161/2002 that is planned to be submitted to the Icelandic Parliament, Alþingi, in 2015. Preparatory work is under way for the transposition of the Regulation which is expected to be transposed through an annex to a regulation adopted on the basis of a provision in the Act on Financial Undertakings.

CRD IV includes, inter alia, the transposition of the Basel III standard that introduced provisions in the following areas: (i) a redefinition of the financial instruments that may form the capital framework of banks, aimed at increasing the quality of the capital base, (ii) new capital buffers, aimed at increasing the stability of the financial system; and, (iii) a leverage ratio that restricts the build-up of debt in financial undertakings. Basel III (and CRD IV) assumes incremental transposition, a phase-in whereby implementation will begin in 2015-16. Individual states, Sweden for one, have however availed themselves of the possibility to expedite implementation of certain provisions of Basel III.

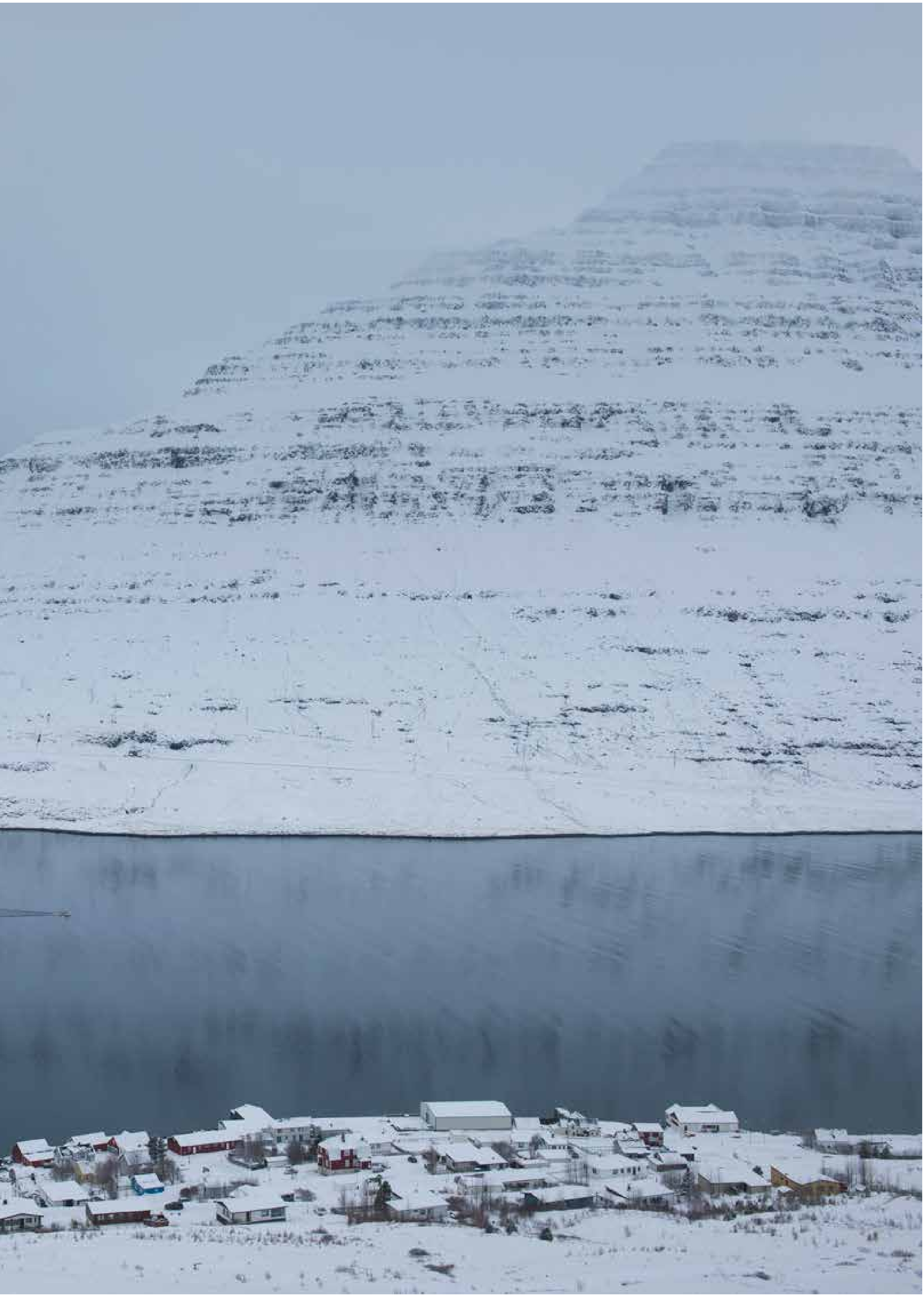
The Group does not expect the implementation of the provisions to lead, overall, to an increase in capital requirements for the Group. This view is based on the Group's strong capital and liquidity position and the already far-reaching capital requirements imposed by the FME under Pillar 2.

The Group expects that the redefinition of common equity and leverage ratio (points i and iii) will have a very limited impact on the Group, all things remaining equal. The Group expects that the introduction of the capital buffers (the capital conservation buffer, the countercyclical capital buffer, the systemic risk buffer and the systemic important institutions buffer) will lead to a review of the criteria applied by the FME for deciding how much additional capital is to be required under Pillar 2 (and together with Pillar 1). The Group thus considers that the imposition of the capital buffers will lead to a decrease in the current capital requirement under Pillar 2.

Even though all of the capital buffers would be fully implemented, the Group will neither need to revise its business plan nor risk appetite targets, due to its strong capital position.

4 Credit risk

Eskifjörður



Credit risk

Landsbankinn hf. offers loans, credits, guarantees and other credit related products as part of its business model and thus undertakes credit risk.

At the end of 2014, 79% of the Group's risk-weighted assets were due to credit risk. On the same date, total loans and advances to customers amounted to ISK 768,144 million (2013: ISK ISK 748,384 million), with ISK 718,355 million coming from lending activities (2013: ISK 680,468 million) and ISK 49,789 million from loans and advances to financial institutions (2013: ISK 67,916 million).

4.1 Credit risk management

Credit risk is mainly managed through the credit process and the Group's credit risk models which include PD, LGD and EAD modelling. The models are used for various purposes, e.g. in provisioning and management reporting.

4.1.1 Identification

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

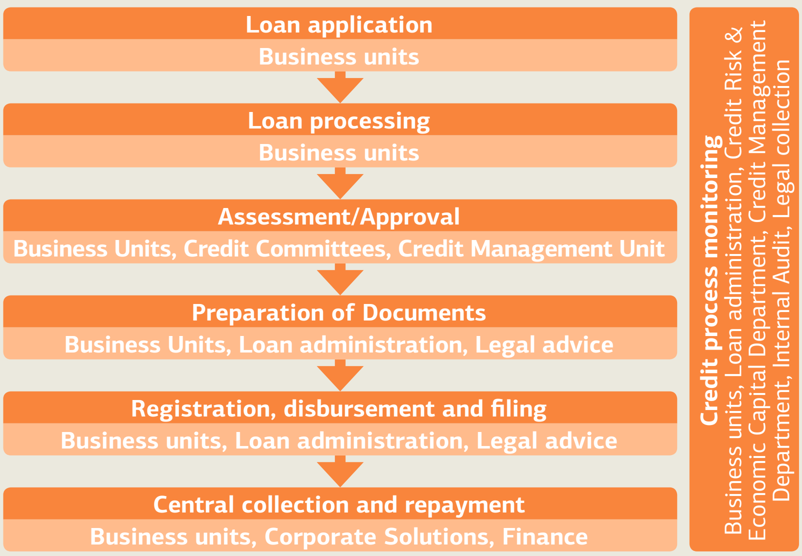
The Group's activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed.

Credit risk is the greatest single risk faced by the Group and arises principally from loans and advances to customers and from investments in debt securities, but also from commitments, guarantees and documentary credits, counterparty credit risk in derivatives contracts, and aforementioned settlement risk.

4.1.2 Assessment

Credit risk is measured in three main dimensions: probability of default (PD), loss given default (LGD) and exposure at default (EAD) For the purpose of measuring PD, the Group has developed an internal rating system, including a number of internally developed rating models. The objectives of the rating system are to provide a meaningful assessment of obligor characteristics; a meaningful differentiation of credit quality; and accurate and consistent quantitative estimates of default risk, i.e. probabilities of default (PD). Internal ratings and associated PD are essential in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an obligor rating scale which reflects exclusively quantification of the risk of obligor default, i.e. credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors from '1' to '10', '10' indicating the highest credit quality, and the grade '0' for defaulted obligors. The rating assignment is supported by rating models, which take information such as industry classification, financial accounts and payment behaviour into account.



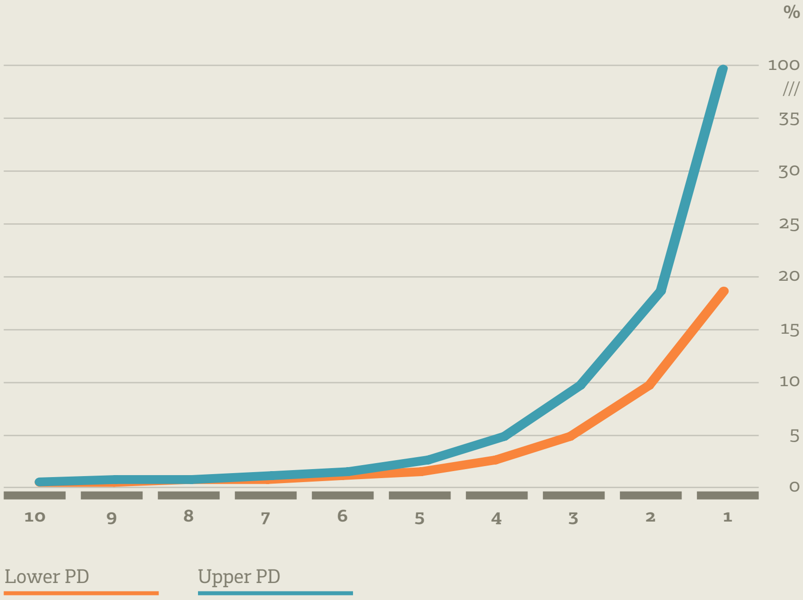
The rating assignment and approval is an integrated part of the credit approval process and assignment shall be updated at least annually or when material information on the obligor or exposure becomes available, whichever is earlier.

In 2014 the Group implemented a revised credit rating model for corporates. The revised model was developed adding two years to the source material compared to the previous model. As the former model, the new version's discriminatory power significantly exceeds the Basel II requirement of 0.5. Furthermore, the new model is well calibrated, i.e. the weighted probability of default for each rating grade is equal to the actual default rate with respect to reasonable error limits.

LGD is measured using the foundation LGD models defined in the Basel framework for the purpose of EC calculations. In addition, the Group has implemented in the business processes an internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the aforementioned Basel model.

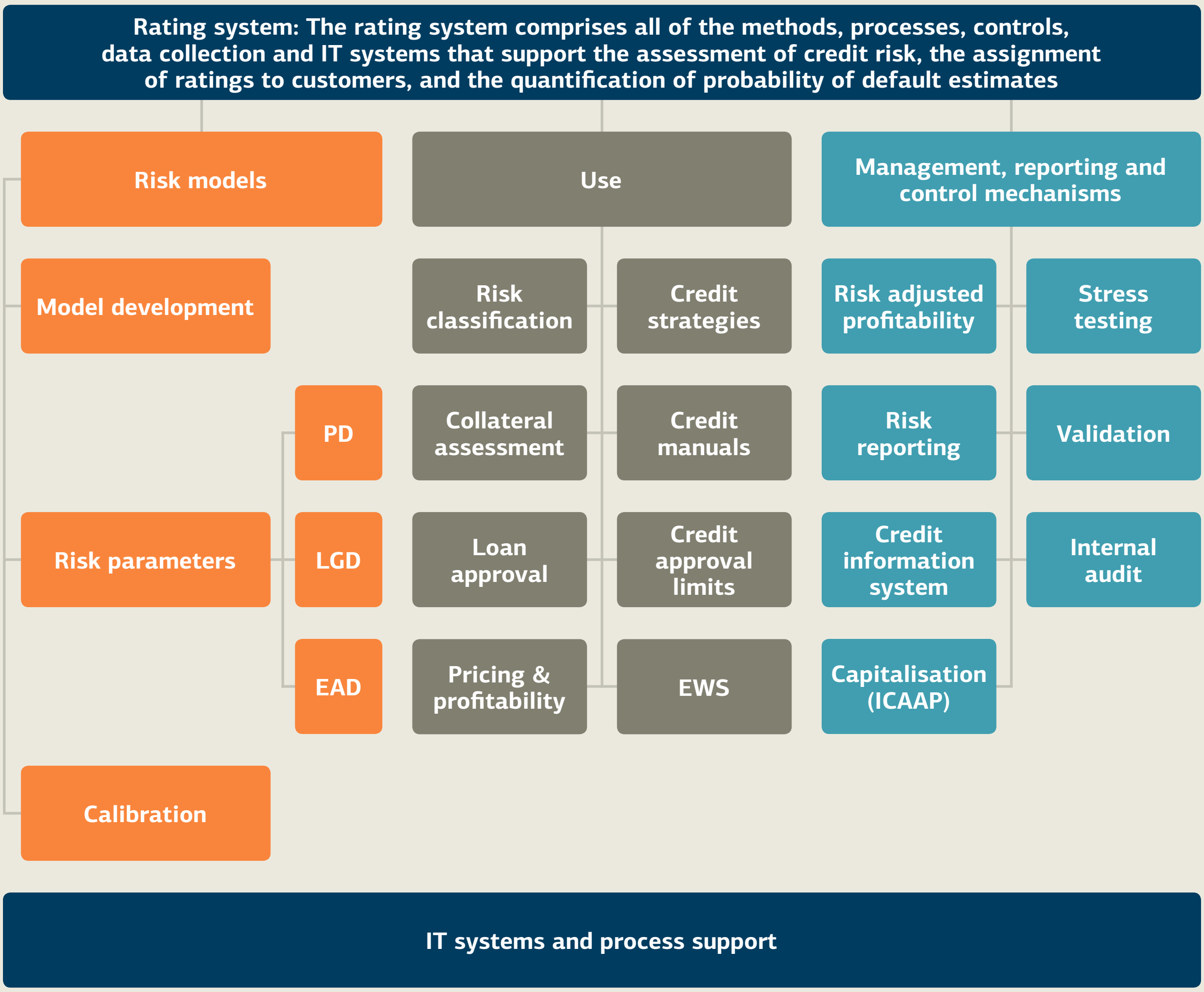
Exposure at default is an estimate of the amount outstanding (drawn amounts plus likely future drawdowns of yet undrawn lines) in case the borrower defaults.

Rating category and PD band



Internal mapping from internal rating grade to S&P rating grades

Internal rating grade	S&P	Lower PD	Upper PD
10	AAA/AA+/AA/AA-	0.00%	0.04%
9	A+/A/A-	0.04%	0.10%
8	BBB+	0.10%	0.21%
7	BBB/BBB-	0.21%	0.46%
6	BB+/BB	0.46%	0.99%
5	BB-	0.99%	2.13%
4	B+	2.13%	4.54%
3	B	4.54%	9.39%
2	B-	9.39%	18.42%
1	CCC/C	18.42%	100.00%



4.1.3 Management and policy

The Group's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk & Finance Committee, the Credit Committee, the credit departments within the Risk Management Division and the business units. The Group manages credit risk according to its risk appetite statement and credit policy approved by the Board of Directors as well as detailed lending rules approved by the CEO. The risk appetite and credit policy include limits on large exposures to individual borrowers or groups of borrowers, concentration of risk and exposures to certain industries. The CEO ensures that the risk policy is reflected in the Group's internal framework of regula-

tions and guidelines. The Group's executives are responsible for the Group's business units to execute the risk policy appropriately as the CEO is responsible for the oversight of the process as a whole.

Incremental credit authorisation levels are defined based on size of units, types of customers and lending experience of credit officers. The Group has also implemented industry policies to the credit decision process. Credit decisions exceeding authorization levels of business units are subject to confirmation by Credit Management, a department within Risk Management. Credit decisions exceeding the limits of Credit Management are subject to approval by the Group's Credit Committee. Credit decisions exceeding the limits of the Credit Committee are subject to approval by the Board of Directors which holds the highest credit authorisation within the Group.

4.1.4 Mitigation

Mitigating risks in the credit portfolio is a key element of the Group's credit policy as well as being an inherent part of the credit decision process. Securing loans with collateral is the main method of mitigating credit risk whereas for many loan products, collateral is required by legislation, as in the mortgage finance market, or is standard market practice.

The most important types of collateral are real estate, ships and financial assets (shares or bonds).

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the Group's credit policy. Credit extended by the Group may be secured on residential or commercial properties, land, securities, transport vessels, fishing vessels together with their non-transferable fishing quotas, aircraft, etc. The Group also secures its loans by means of receivables, inventory and operating assets, such as machinery and equipment. Residential mortgages involve the underlying residential property. Less stringent requirements are set for securing short-term personal loans, such as overdrafts and credit card borrowings.

The Group regularly assesses the market value of collateral received. The Group has developed models to estimate the value of the most frequent types of collateral. For collateral for which no valuation model exists, the Group estimates the value as the market value less a haircut. The haircut represents a conservative estimate of the costs to sell in a forced sale. Costs to sell include maintenance costs in the period over which the asset is up for sale, fees for external advisory services and any loss in value. For listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability.

The Group monitors the market value of mark-to-market collateral and may require additional collateral in accordance with the underlying loan agreements.

In order to limit further the credit risk arising from financial instruments, the Group enters into netting agreements, under which the Group is able to set off all contracts covered by the netting agreement against the debt in cases of default. The arrangements generally include all market transactions between the Group and the client.

Generally, collateral is not held over loans and advances to financial institutions, nor is it usually held against bonds and debt instruments.

The Group includes all collateral to which a value is assigned in accordance with its internal procedures. Guarantees are included if they imply lower risk weights than the original exposure. In addition, collateral is volatility-adjusted (by means of a haircut) in order to take into account price volatility and the expected costs of repossession and sale of the pledge.

4.1.4.1 Derivative financial instruments

In order to mitigate credit risk arising from derivatives, the Group chooses the counterparties for derivatives trading based on stringent rules, according to which clients must meet certain conditions set by the Group. The Group also enters into standard International Swaps and Derivatives Association (ISDA) master netting agreements with foreign counterparties and similar general netting agreements with domestic counterparties.

Commensurate collateral and margin requirements are in place for all derivative contracts the Group enters into. Collateral management and monitoring is performed daily and derivative contracts with clients are fully hedged.

The Group's supervision system monitors both derivatives exposure and collateral value and calculates a credit equivalent value for each derivative intraday. It also issues margin calls and manages netting agreements.

Amounts due to and from the Group are offset when the Group has a legally enforceable right to set off a recognised amount and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. External ratings are used where applicable to assist in managing the credit risk exposure of bonds. Otherwise the Group uses fair value estimates based on available information and the Group's own estimates.

4.1.5 Control and monitoring

The Group monitors exposures to identify signs of weakness in customer earnings and liquidity as soon as possible. To monitor customers, the Group uses – supplemental to ratings – an Early Warning System which classifies credit exposures to four credit risk groups (green, yellow, orange and red). The colour classification is the following:

- Green customers are considered as performing without signs of repayment problems;
- Yellow customers are on watch list 1. They have temporary difficulties and may need some instalments postponed or modification of terms or loan covenants;
- Orange customers are on watch list 2. They are still under the supervision of the relevant business unit but are likely to go through debt restructuring or postponement of instalments;
- Red customers are under supervision by Corporate Solutions and need restructuring, or are in legal collection. Restructuring options may include deferred payments, interest and/or debt forgiveness, collateral or guarantees being collected or that the management of the customer‘s operations possibly being taken over by the Group and subsequently sold.

The Credit Risk & Economic Capital Department within Risk Management is together with the business units responsible for the verification of colour-coding of customers and the transfer of customers from business units to Corporate Solutions if necessary.

4.1.6 Impairment process

Group policy requires that individual financial assets above materiality thresholds are reviewed at least quarterly, and more frequently when circumstances require. Impairment allowances on individually assessed accounts are determined on a case-by-case basis by evaluating incurred losses at the reporting date. Collectively assessed impairment allowances are permitted in the following cases: (i) portfolios of homogenous loans that are individually below materiality thresholds, and (ii) losses that have been incurred but not yet identified, using the available historical experience together with experienced judgement and statistical techniques.

Should the expected cash flows be re-examined and the present value of the cash flows (calculated using the effective interest rate) be revised, the difference is then recognised in profit or loss (as either impairment or net adjustments to loans and advances). Impairment is calculated using the effective interest rate, before any revision of the expected cash flows. Any adjustments to the carrying amount which result from revising the expected cash flows are recognised in profit or loss. The impact of financial restructuring of the Group’s customers is reflected in loan impairment, or net adjustments to loans and advances, as the expected cash flow of customers has changed.

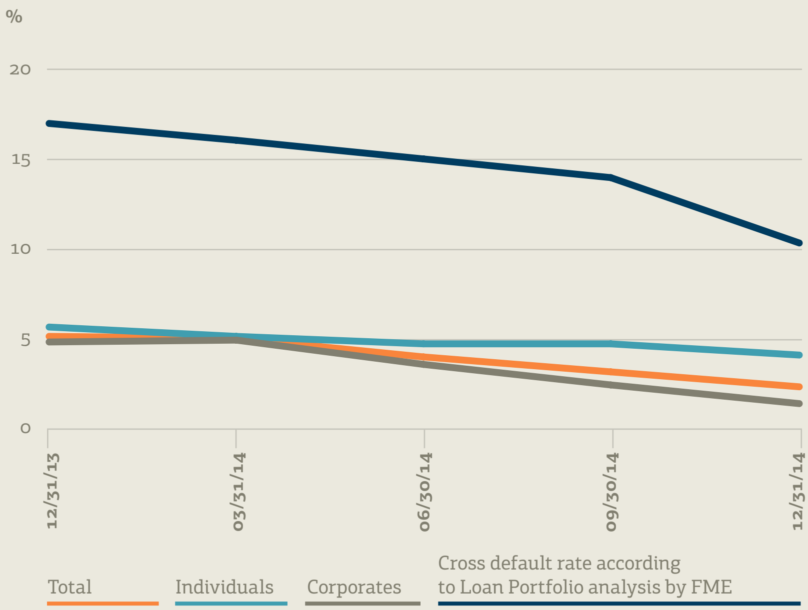
4.2 Credit portfolio

4.2.1 Credit exposure

The Group's credit exposure shown in the tables below is defined as balance sheet items and off-balance-sheet items that carry credit risk, and the exposure is calculated net of accumulated loan impairment charges. Most of the exposure derives from lending activities in the form of loans with and without collateral.

At the end of 2014, the total carrying amount was ISK 1,071 billion. Some ISK 718 billion are derived from lending activities, ISK 244 billion from bonds and debt instruments, and ISK 0.08 billion is derived from the carrying amount of derivatives.

90 days past due ratio



4.2.1.1 Credit exposure from lending activities

At the end of 2014, the Group's total credit exposure from lending activities amounted to ISK 718,355 million, against ISK 680,468 million at the end of 2013. This represents an increase of 5.6%. In 2014, credit demand continued to remain fairly low in the corporate area and did not result in a significant increase in credit exposure. Credit exposure to individuals grew, mainly due to an increase in household mortgage lending.

Lending capacity in the Icelandic banking system, as well as credit supply, has exceeded demand in the past few years. As a result, lending operations have extensively focused on services to existing customers and refinancing of their loans as well as restructuring clients in financial distress. The impact of financial restructuring on a number of clients, both individuals and corporations, and the recalculation of FX-linked debt reduced the 90 days past due ratio from 5% to 2%. Since the beginning of 2014 credit exposure in over 90 days past due decreased from ISK 36 billion to ISK 17 billion. The decrease is mainly due to the fact that corporate loans were restructured, returned to performing standing or written off in part or whole. In part, this is also due to more accurate analysis and increased monitoring of new defaults, where emphasis is put on reacting before default occurs. The cross-default[5] ratio has decreased as well and was 10% in year end 2014.

5 The cross- default rate is not according to Basel II default, but according to the wider default definition used in the FME's Loan Portfolio Analysis report.

The following table shows the classification of the Group's financial assets.

The credit portfolio

As at 31 December 2014

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	10,160	-	-	-	-	10,160
Bonds and debt instruments	113,074	106,788	23,727	-	-	243,589
Equities and equity instruments	-	5,871	23,562	-	-	29,433
Derivatives instruments	-	78	-	-	-	78
Loans and advances to financial institutions	49,789	-	-	-	-	49,789
Loans and advances to customers	718,355	-	-	-	-	718,355
Other financial assets	19,733	-	-	-	-	19,733
Total	**911,111**	**112,737**	**47,289**	**-**	**-**	**1,071,137**

As at 31 December 2013

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	21,520	-	-	-	-	21,520
Bonds and debt instruments	111,902	151,894	26,799	-	-	290,595
Equities and equity instruments	-	3,965	32,310	-	-	36,275
Derivatives instruments	-	654	-	-	-	654
Loans and advances to financial institutions	67,916	-	-	-	-	67,916
Loans and advances to customers	680,468	-	-	-	-	680,468
Other financial assets	6,366	-	-	-	-	6,366
Total	**888,172**	**156,513**	**59,109**	**-**	**-**	**1,103,794**

Credit exposure from lending activities

As at 31 December 2014	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	307,168	416,971	44,005	768,144
Loans and advances to customers	307,144	411,211	0	718,355
Past due loans	12.4%	2.1%	0.6%	6.1%
Impaired	9.5%	5.6%	0.0%	6.9%
Loans and advances to customers past due more than 90 days	4.7%	0.5%	0.0%	2.3%

As at 31 December 2013	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	292,615	394,085	61,684	748,384
Loans and advances to customers	292,456	388,085	0	680,468
Past due loans	15.9%	5.5%	0.0%	10.0%
Impaired	5.4%	8.1%	0.0%	7.0%
Loans and advances to customers past due more than 90 days	7.7%	3.2%	0.0%	5.1%

At the same time, the portfolio quality has for the most part remained unchanged overall, during the year, resulting in an exposure weighted average probability of default of 4.8% (discussed further in section 5.2.3). Usually some time passes after restructuring is completed until its effects are seen in the loan portfolio. It can be assumed that the impact of restructuring already completed has not yet fully emerged.

Developments in the quality of the Group's credit portfolio have been positive since taking over part of the domestic operations of LBI hf. upon the Bank's foundation in 2008, although the decrease in average probability of default experienced in 2014 was slower than anticipated.

At the end of the year, the impairment ratio was 5.0% as compared to 6.4% the previous year. The decrease is due to reduction in past due loans and larger total gross amount.

The industry breakdown below shows the Group's credit exposure broken down by industry sectors. The breakdown follows ISAT2008 based on the European Union's industry breakdown, NACE Rev. 2.

Credit exposure from lending activities

As at 31 December 2014	Personal Banking	Corporate Banking	Treasury	Total
Financial institutions	24	5,760	44,005	49,789
Public entities	1,935	11,773	-	13,708
Individuals	235,764	3,168	-	238,932
Corporates	69,444	395,134	-	464,578
Fisheries	8,262	147,761	-	156,023
Construction and real estate companies	13,887	98,993	-	112,880
Holding companies	2,211	40,650	-	42,861
Retail	10,970	28,148	-	39,118
Services	19,565	36,823	-	56,387
Information, technology and communication	2,392	17,406	-	19,798
Manufacturing	7,085	21,676	-	28,760
Agriculture	5,073	3,678	-	8,751
Other	1	1,136	-	1,137
Total	**307,168**	**416,971**	**44,005**	**768,144**

As at 31 December 2013	Personal Banking	Corporate Banking	Treasury	Total
Financial institutions	158	6,073	61,684	67,916
Public entities	2,019	7,996	-	10,015
Individuals	199,006	2,480	-	201,485
Corporations	80,798	241,868	-	468,968
Fisheries	10,612	135,690	-	146,302
Construction and real estate companies	9,341	117,892	-	127,233
Holding companies	12,391	43,423	-	55,814
Retail	11,549	24,424	-	35,974
Services	29,699	16,918	-	46,617
Information, technology and communication	2,743	16,716	-	19,459
Manufacturing	10,230	15,107	-	25,337
Agriculture	4,173	3,541	-	7,714
Other	672	3,846	-	4,518
Total	**281,981**	**258,416**	**61,684**	**748,384**

Collateral value

At 31 December 2014			Collateral types			
Collaterals after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	1,935	0	35	0	43	2,013
Individuals	260,452	472	408	2,449	235	282,416
Corporates	0	0	0	0	0	
Construction and real estate companies	97,317	18	647	393	2,655	101,031
Holding companies	8,168	0	52	29,975	482	38,677
Fisheries	11,123	155,421	36	14,623	23,911	205,114
Manufacturing	9,080	382	415	6,075	8,874	24,825
Agriculture	8,116	17	7	0	1,850	9,989
Information, technology & communication	578	2	140	1,002	5,784	7,506
Retail	13,557	456	192	662	18,969	33,836
Services	30,174	608	726	1,940	11,361	44,808
Other	17	0	0	50	892	959
Total	**440,518**	**157,375**	**2,656**	**57,169**	**75,056**	**732,774**

At 31 December 2013			Collateral types			
Collaterals after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	2,362	0	44	0	96	2,502
Individuals	178,271	456	1,064	3,686	21,655	205,131
Corporates	166,661	140,026	2,765	53,835	75,095	438,381
Construction and real estate companies	97,092	33	1,103	372	2,249	100,849
Holding companies	6,855	0	118	33,851	2,915	43,738
Fisheries	10,763	138,676	541	9,240	23,701	182,921
Manufacturing	9,425	389	297	6,510	3,892	20,513
Agriculture	5,658	15	5	0	556	6,234
Information, technology & communication	454	4	53	1,990	6,285	8,786
Retail	12,289	18	292	282	16,938	29,819
Services	23,713	891	357	1,590	18,558	45,109
Other	412	0	0	0	1	413
Total	**347,294**	**140,481**	**3,872**	**57,521**	**96,846**	**646,014**

Note: The item Other includes such collateral as financial claims, invoices, liquid assets, vehicles, machines, aircraft and inventories.

4.2.2 Risk concentration

Concentration risk includes (i) single name concentrations of large (connected) individual counterparties[6] and (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location, instrument type or other.

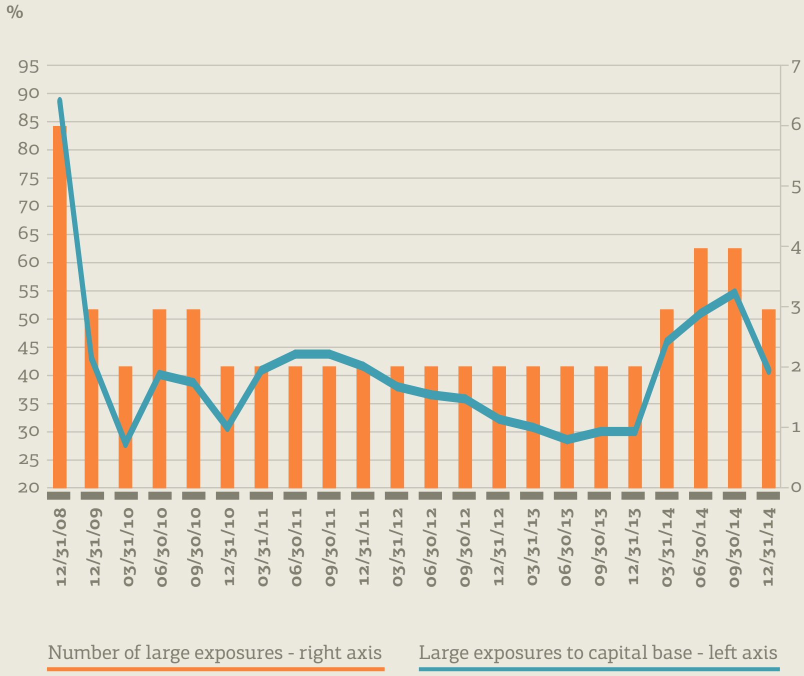
Limit management for single name and segment concentrations is set, monitored and managed through the Group's risk appetite and its limit management system. The Group's risk profile for concentration risks is reported monthly to the Risk & Finance Committee and the Board of Directors according to internal guidelines.

The Group uses the identification of risk concentrations in the credit portfolio as a credit risk management parameter. Risk concentrations arise in the credit portfolio as an inevitable consequence of the Group's business strategy. Concentration risk is credit risk related to the degree of diversification in the credit portfolio and includes both single name concentration risk and segment concentration risk.

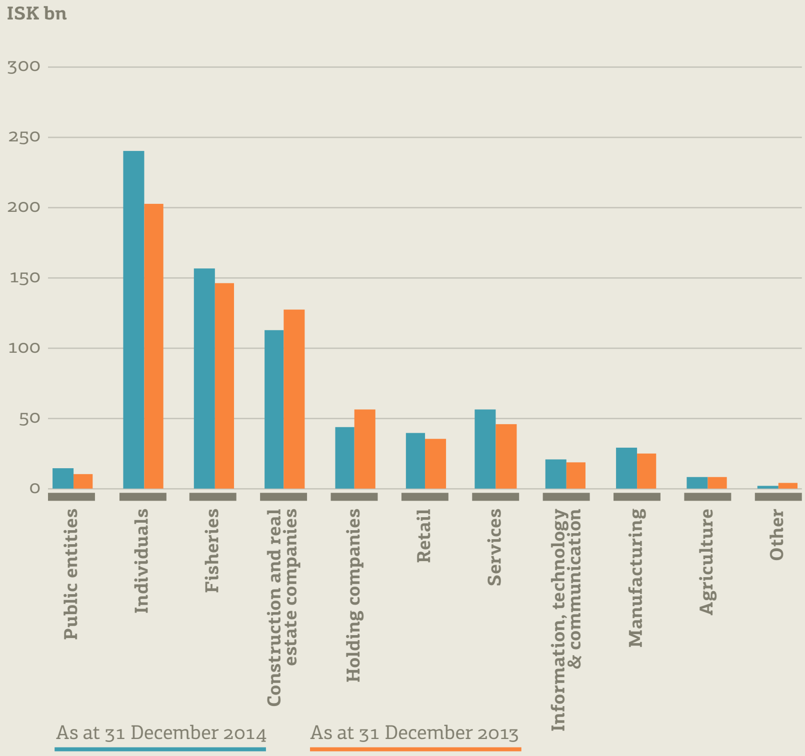
According to the FME rules on large exposures (216/2007), exposures to a single customer or a group of related customers – after the deduction of particularly secure claims – may not exceed 25% of the capital base. In addition, the sum of exposures that each equal or exceed 10% of the capital base may not total more than 400% of the capital base.

6 Single name exposures are calculated according to the FME rules on large exposures (216/2007).

Large exposures



Industry segmentation of credit exposure



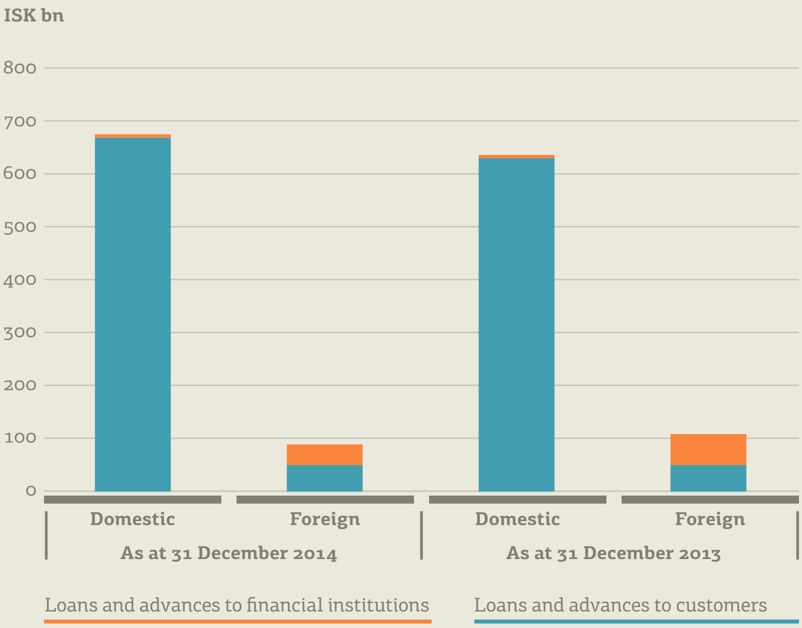
The Group's risk profile for large exposures is reported monthly to the management and Board of Directors according to internal guidelines. Since the end of 2008, both the number and the sum of exposures that exceed 10% of the capital base have been substantially reduced.

As for single name concentration the Group's Board of Directors has introduced portfolio limits for the year 2014 for segment concentration in the Group's risk appetite.

It is a logical consequence of the Group's business model that credit exposure from lending activities is concentrated to some industries. At the end of 2014, lending to retail customers represented 33% of the Group's total credit exposure (year-end 2013: 30%). Most of the demand from retail customers is for property financing and the Group's lending to retail customers is therefore mostly secured on real estate.

The Group's credit exposures are primarily to Icelandic corporate customers. Fisheries represent the largest exposure to a single industry sector.

Credit exposure by geagraphical area



Customers domiciled in Iceland accounted for 93% of the Group's total credit exposure (2013: 93%). Exposure to foreign counterparties relates mainly to the management of the Group's foreign liquidity reserves.

4.2.3 Migration analysis

Migration analysis in this section is based on the Group's rating scale and PD estimates.

At the end of 2014, the average exposure-weighted PD was 4.8% (2013: 4.7%). Excluding loans to financial institutions, which as mentioned above relates to the management of the Group's foreign liquidity reserves, the exposure-weighted PD was 5.1% (2013: 5.3%).

The Group experienced both positive and negative migration within different industry sec-

Probability of default (PD)

(%)		31.12.2014	31.12.2013
Financial institutions		0.1%	0.2%
Public entities		0.5%	0.9%
Individuals		4.1%	4.4%
Corporates		5.8%	5.5%
	Construction and real estate companies	6.9%	7.5%
	Holding companies	4.7%	5.1%
	Fisheries	5.7%	4.2%
	Manufacturing	5.0%	4.8%
	Agriculture	6.5%	6.1%
	Information, technology & communication	4.3%	4.3%
	Retail	4.3%	6.5%
	Other	3.6%	5.8%
	Services	6.4%	6.2%
Total		**4.8%**	**4.7%**

tors in 2014. A fairly unchanged overall average probability of default is due, to a large extent, to the significant increase in the fisheries industry. The increase in the sector is due to lower credit ratings of limited number of customers with relatively large credit exposures rather than being representative of a lower quality in the sector's loan portfolio in general. Reduced credit exposure to financial institutions also has an impact of overall higher exposure weighted probability of default.

The charts below show the rating grade distribution of the loan portfolio broken down by individuals and corporates.

The figures show the rating grade migration for corporates and individuals during 2014, based on existing customers at year-end 2013 and 2014. Migration is shown both in terms of number of customers and exposure.

Migration analysis does not cover customers in default, i.e., customers in rating category 0.

Out of the total exposure in the corporate portfolio, approximately 67% migrated up or down during 2014. This corresponds to 58% of counterparties. Upward migration was fairly higher than downward migration during 2014.

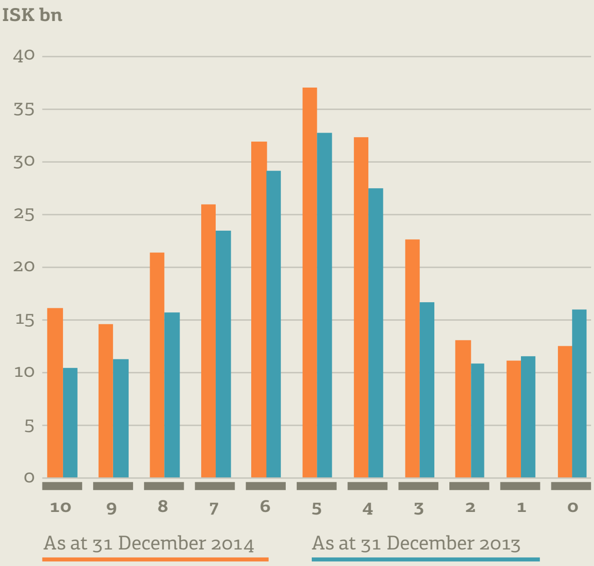
In the individual portfolio, approximately 67% migrated either up or down in 2014 with respect to exposure and 57% in terms of customer numbers.

On an overall level, migration had a positive impact on credit risk economic capital during 2014 and reduced IRB credit risk economic capital for corporations by approximately 8%. This calculation does not take into account the changes in exposure distribution nor rating distribution of lost and new customers or customers who defaulted during the year.

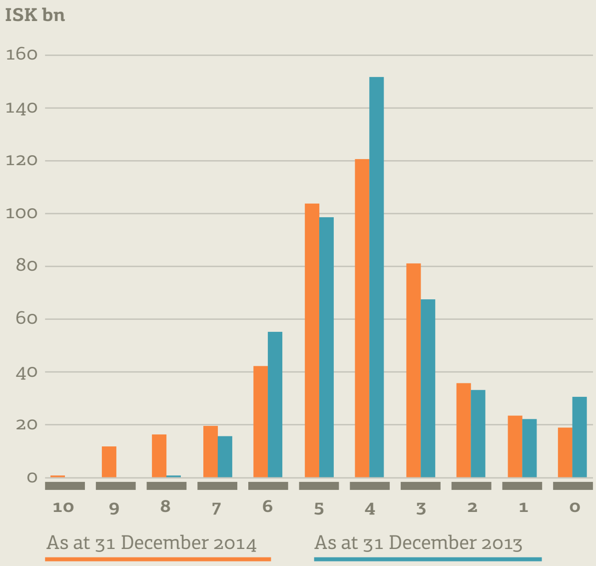
The rating and risk grade distribution changes mainly due to three factors: Changes in rating grade for existing customers, or pure migration; different rating grade distribution of new customers and customers leaving the Group, compared to the rating grade distribution of existing customers during the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

Altogether, the percentage of upgrades was higher than the percentage of downgrades mainly because of the corporate segment. At the end of 2014, the average exposure-weighted PD for corporate customers was 5.8%

Rating grade distribution - Individuals



Rating grade distribution - Corporations



(2013: 5.5%). For individuals, the average exposure-weighted PD was 4.1% (2013: 4.4%). As mentioned before the increase in the fisheries sector has an impact of increase to the measurement value.

The default rate, which is measured by number of customers and not exposure weighted, for corporate customers for 2014 was 4.6% as compared to the predicted 9.2%. For individual rating grades, the default rate was mainly lower than expected, except for grade 7, though not significant. There were no defaults in grades 8, 9 and 10.

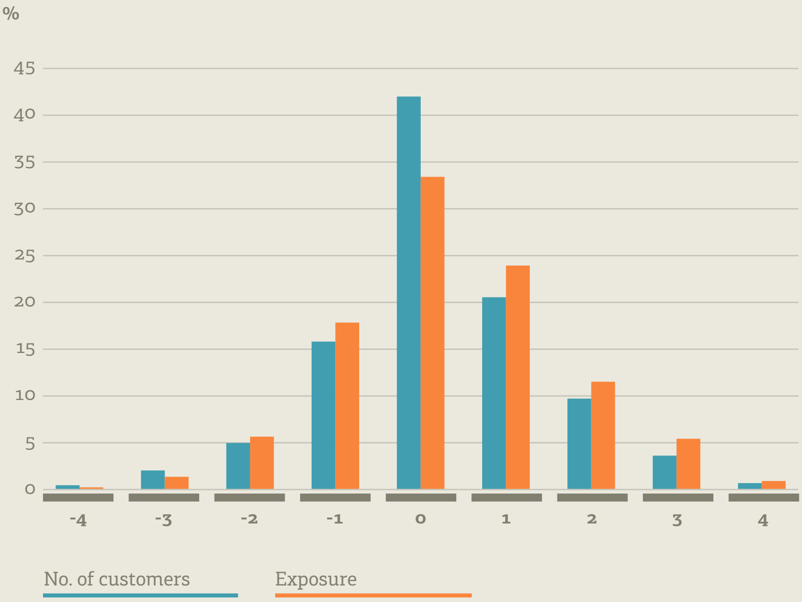
The default rate for individuals for 2014 was 2.8% as compared to the predicted 3.2%.

4.2.4 Loan impairment

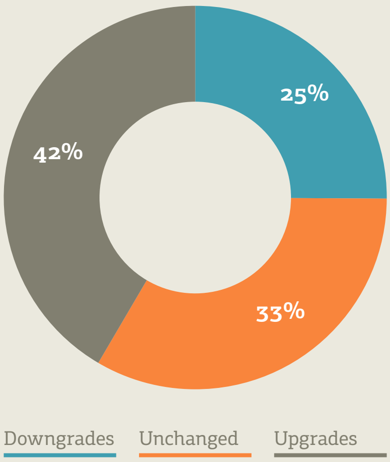
Total allowance for impairment totalled ISK 41 billion in 2014, as compared to ISK 51 billion in 2013. Allowances decreased in nearly all industry sectors during 2014 while the overall carrying amount increased. The decrease in allowances is mainly due to written-off loans, improved collaterals and lower past due rate.

At the end of 2014, 92% of the portfolio consisted of claims that were neither past due nor impaired. The accumulated impairment loss amounted to ISK 2 billion.

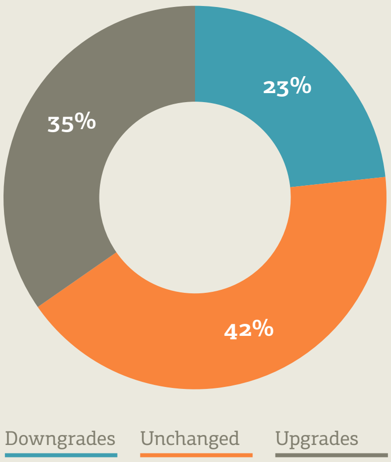
Rating migration of corporates in 2014



Rating migration of corporates in 2014 Carrying amount



Rating migration of corporates in 2014 No. of customers



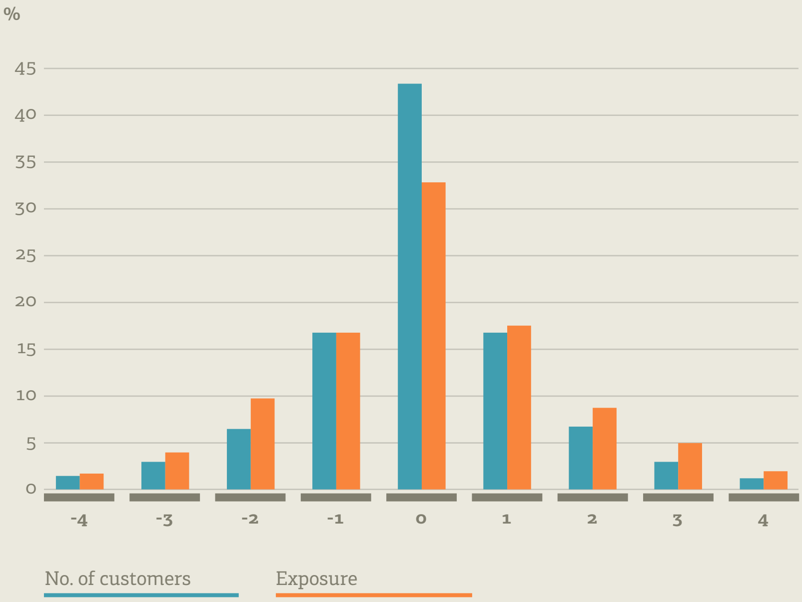
4.2.5 Credit risk analysis by industry sectors

This section describes developments in credit quality in selected segments of the Group's lending portfolio in the years 2014 and 2013.

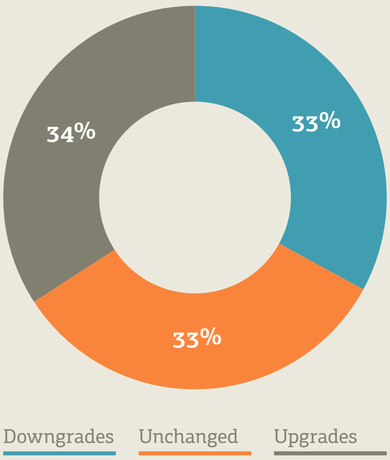
4.2.5.1 Fisheries

The Icelandic fisheries and seafood industry has entered calmer waters after the storm that followed the collapse of the banking system and devaluation of the Icelandic króna (ISK). In fact, those events have resulted in positive changes to the operating environment of the fisheries and seafood industry. While debt grew considerably with devaluation of the króna, the ability of the industry to service its debt grew even more. The ratio of EBITDA and EBIT on the one hand and liabilities on the other hand has not been more favourable in years. At year-end 2012, the liabilities of the Icelandic fishing industry amounted to 5.4 of EBITDA. This ratio averaged 10.9 in the years 2004 to 2009. Statistics Iceland has delayed its publication of the 2013 overview of performance in the fisheries and seafood industry. This performance overview comprises both fishing and processing. According to the forecast of Landsbankinn Economic Research for EBITDA for fishing less fishing fees for 2013 and developments in

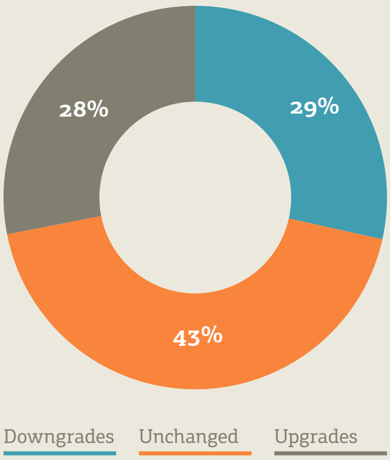
Rating migration of individuals in 2014



Rating migration of individuals in 2014 Carrying amount



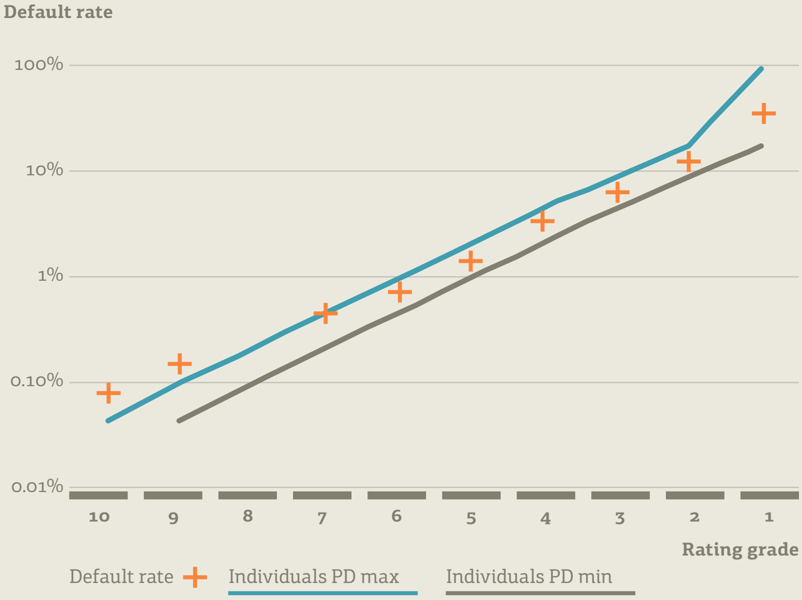
Rating migration of individuals in 2014 No. of customers



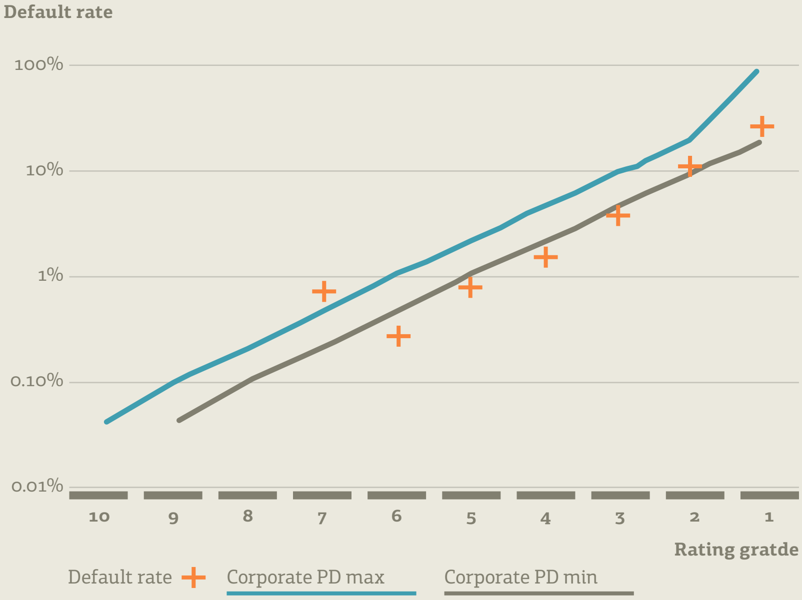
the ISK exchange rate in 2012-2013, the ratio of EBIDTA to liabilities can be expected to stand at 5.7 in 2013 and 5.2 for 2014. This year the ratio can be expected to drop to 4.9. The seafood product purchase price index in foreign currency began trending upward last spring, peaking at a historic high in November and 10% higher than at the beginning of the year. Average prices for the first 11 months of the year were 5% higher than average prices in 2013. Last year's price increases counterbalance lower catches, which dropped by one fifth between years. This reduction is due mostly to last year's poor capelin season.

The outlook for this year is fair as the catch quota for capelin has been set at 580,000 tonnes, one of the highest quotas in recent years. The high catch quota for capelin could increase the revenues of the Icelandic fisheries and seafood industry by ISK 21 billion. There is some uncertainty regarding price developments and demand for Icelandic seafood products, most notably in Europe which, with a market share of 80%, is by far the largest market region for Iceland seafood. Economic growth in Europe contracted last year but slow and fragile growth is expected this year and next. Frail economic recovery in the region will likely hinder price increases in the next couple of years.

12 month default rate vs. probability of default band - Individuals 2014



12 month default rate vs. probability of default band - Corporates 2014

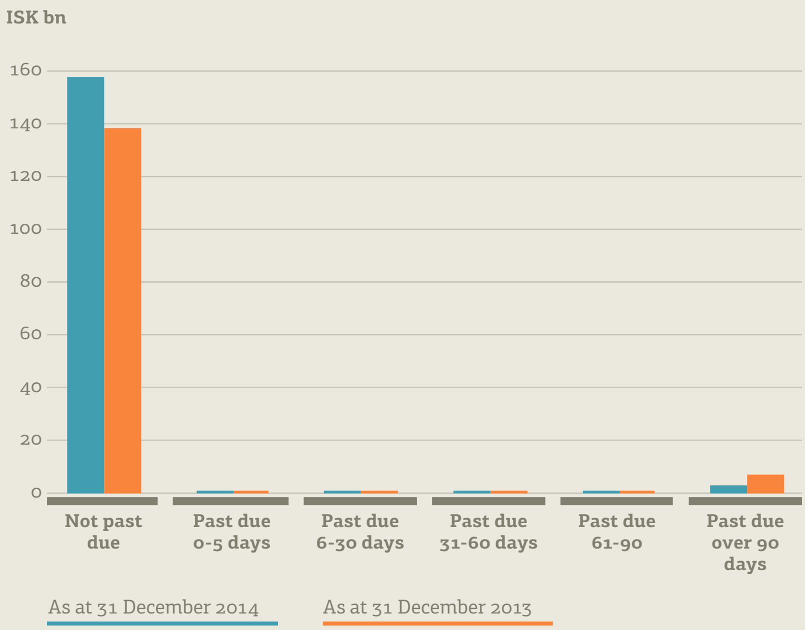


Loan impairment

	Individual allowance	Collective allowance	Total
Open 1.1.2014	-41,278	-9,666	-50,944
New provisions	-19,209	0	-19,209
Reversals	16,852	1,827	18,679
Provisions used to cover write-offs	9,917	0	9,917
Translation difference	-13	123	110
Closing 31.12.2014	-33,731	-7,716	-41,447

	Individual allowance	Collective allowance	Total
Open 1.1.2013	-28,523	-15,507	-44,030
New provisions	-16,686	0	-16,686
Reversals	1,659	5,815	7,474
Provisions used to cover write-offs	2,156	0	2,156
Translation difference	116	26	143
Closing 31.12.2013	-41,278	-9,666	-50,944

Gross carrying amount - Past due Fisheries



Loans and advances to customers in the fisheries industry amounted to ISK 156 billion as at 31 December 2014 (2013: ISK 146 billion). Credit exposure to the sector represented 22% of the Group's loan portfolio

The chart shows the gross carrying amount of loans and advances to customers in the fisheries industry that have failed to make payments which had become contractually overdue by one or more days.

Impaired exposure in the sector amounts to ISK 12 billion and the amount of not individually impaired loans is ISK 151 billion. The collective allowance is ISK 0.6 billion.

At the end of 2014, the loans and advances to fisheries customers in rating grades 4-6 represented 51% of the total.

The sector's average exposure-weighted PD was 5.7% as at 31 December 2014 and increased

Loan impairment

	1.1.-31.12.2014		
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-19,209	0	-19,209
Write-offs	-14,905	0	-14,905
Provisions used to cover write-offs	9,917	0	9,917
Reversals	18,679	0	18,679
Recoveries	3,242	0	3,242
Translation difference	110	0	110
Impairment loss for the period	-2,166	0	-2,166
Impairment of claims reversed	0	128	128
Net impairment loss for the period	-2,166	128	-2,038

	1.1.-31.12.2013		
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-16,686	0	-16,686
Write-offs	-7,430	0	-7,430
Provisions used to cover write-offs	2,156	0	2,156
Reversals	7,474	0	7,474
Recoveries	6,369	0	6,369
Translation difference	143	0	143
Impairment loss for the period	-7,975	0	-7,975
Impairment of claims reversed	0	269	269
Net impairment loss for the period	-7,975	269	-7,706

significantly during the year due to some few customers – performing but with low rating grades – which are still facing difficulties connected to the recent financial crises. Credit extended by the Group to the fisheries industry is mainly secured by transport and fishing vessels together with their non-transferable fishing quotas, or 76% of the total sector's collateral.

Fisheries	**As at 31 Dec. 2014**	**As at 31 Dec. 2013**
Gross carrying amount	162,507	155,176
Performing - Individual allowance	-4,497	-6,745
Non-performing - Individual allowance	-1,350	-1,348
Collective allowance	-637	-782
Carrying amount	156,023	146,302

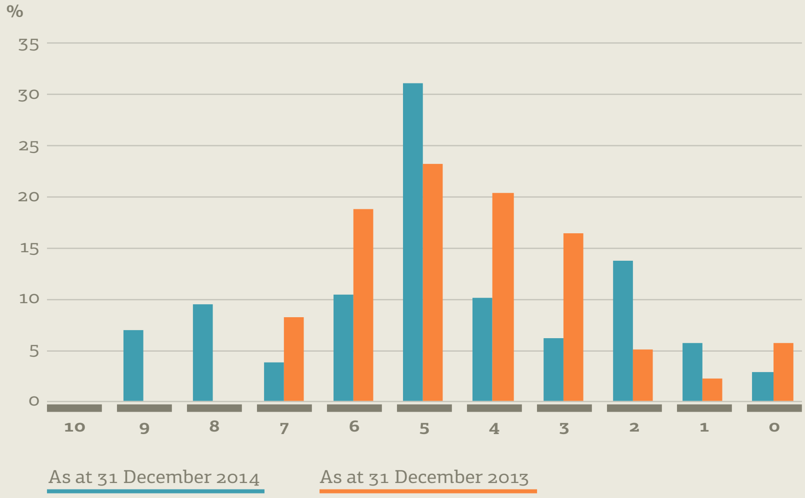
Loans and advances to customers in the fisheries industry, broken down by colour classification, migrated negatively during 2014. As at 31 December 2014, loans classified as green were 73% of the sector's portfolio as compared to 76% at year-end 2013.

4.2.5.2 Construction and real estate companies

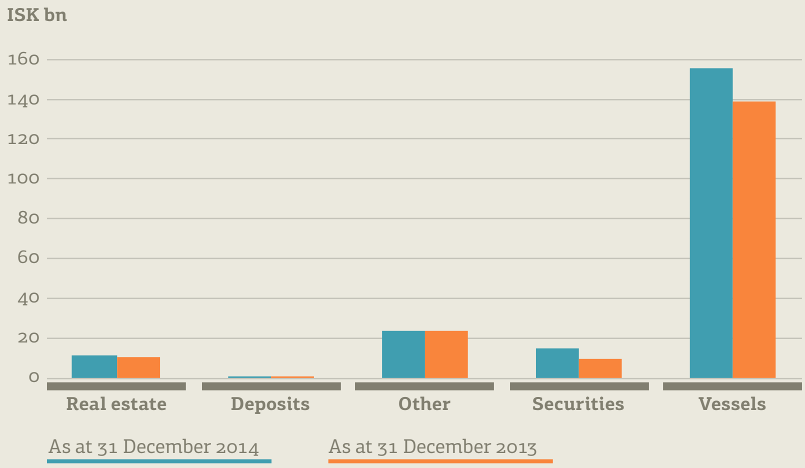
Investment in residential housing was high in the years leading up to the economic collapse, reaching 6.5% of domestic product in 2007. Investment in residential housing then fell sharply in real terms in 2008-2010, down to 2.2% of domestic product. Since then, it has trended slightly upward. Investment in residential housing increased by 6.9% in real terms in 2012 and by 10.8% in 2013 and had then reached 2.7% of domestic product. Since the year 2000, investment in residential housing has averaged 4.2% of domestic product, so the current level remains below average.

There is a great deal of uncertainty in forecasts for investment in residential housing and such forecasts have often proved to be off the mark in recent years. All indicators currently point to considerable growth in investment this year. As an example, investment in residential housing increased by one fourth between years during the first half of 2014 and construction costs have increased but little in the same period while real estate prices have grown significantly. Conditions are more favorable for the construction industry now than in a long time. Purchasing power has increased, a multitude of varied housing loan products are on offer and mortgage rates are low in a historical context. Currently, the largest problem in the market is that the purchasing capacity of large groups, most notably young people, is low and many families have not sold properties due to, amongst other things, uncertainty and a negative capital position. That being said, the position of households has improved significantly and with the recent downward correc-

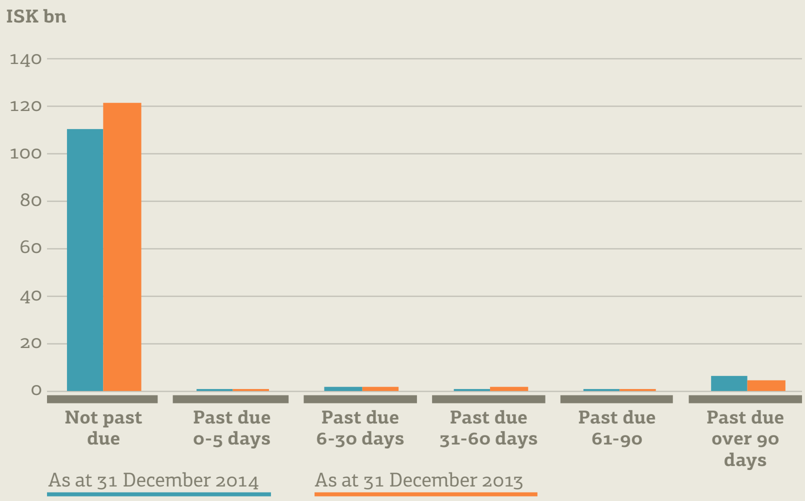
Loans and advances to fishery customers per rating grade



Fisheries - Collateral types

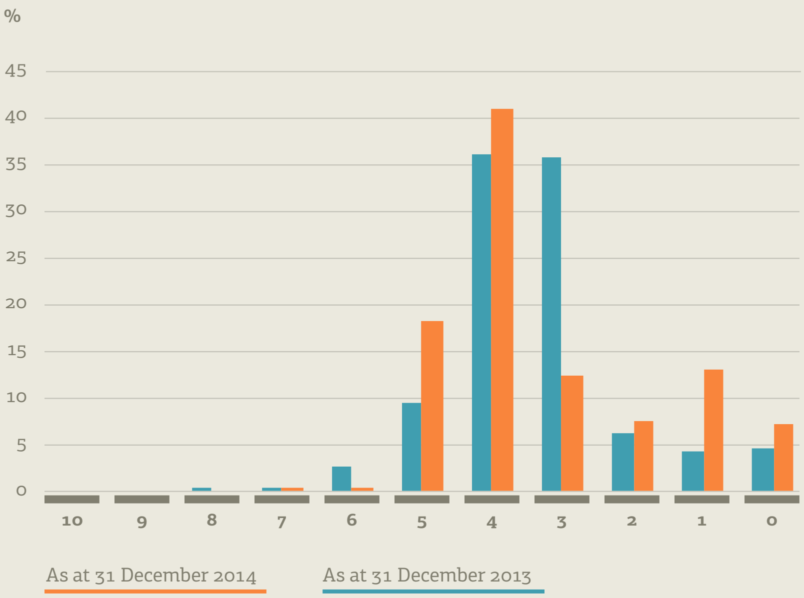


Gross carrying amount - Past due Construction and real estate companies

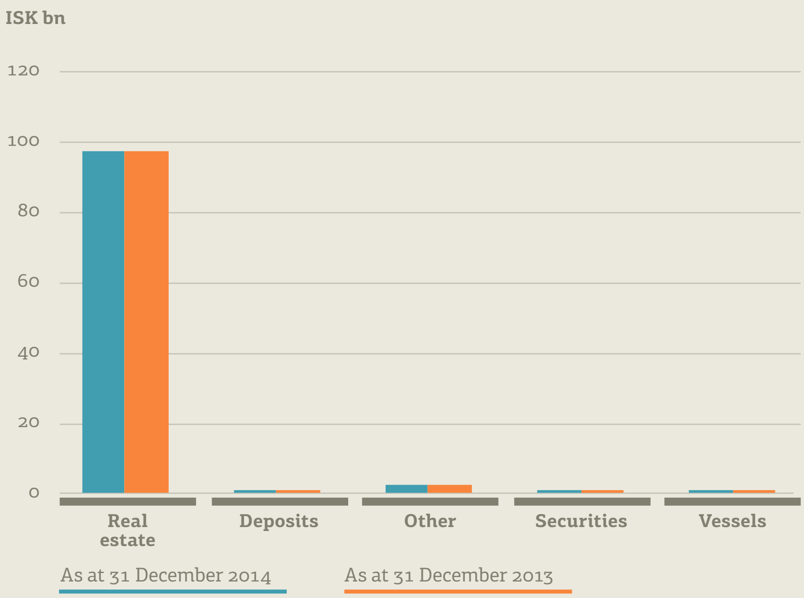


Construction and real estate companies	As at 31 Dec. 2014	As at 31 Dec. 2013
Gross carrying amount	119,926	136,224
Performing - Individual allowance	-2,850	-3,704
Non-performing - Individual allowance	-2,644	-3,098
Collective allowance	-1,552	-2,191
Carrying amount	112,880	127,232

Loans and advances to Construction and real estate customers per rating grade



Construction and real estate companies - Collateral types



tion of the principal on indexed housing loans, there should be more room for movement.

Loans and advances to construction and real estate companies amounted to ISK 113 billion as at 31 December 2014 (2013: ISK 127 billion). Credit exposure to the sector represented 16% of the Group's loan portfolio.

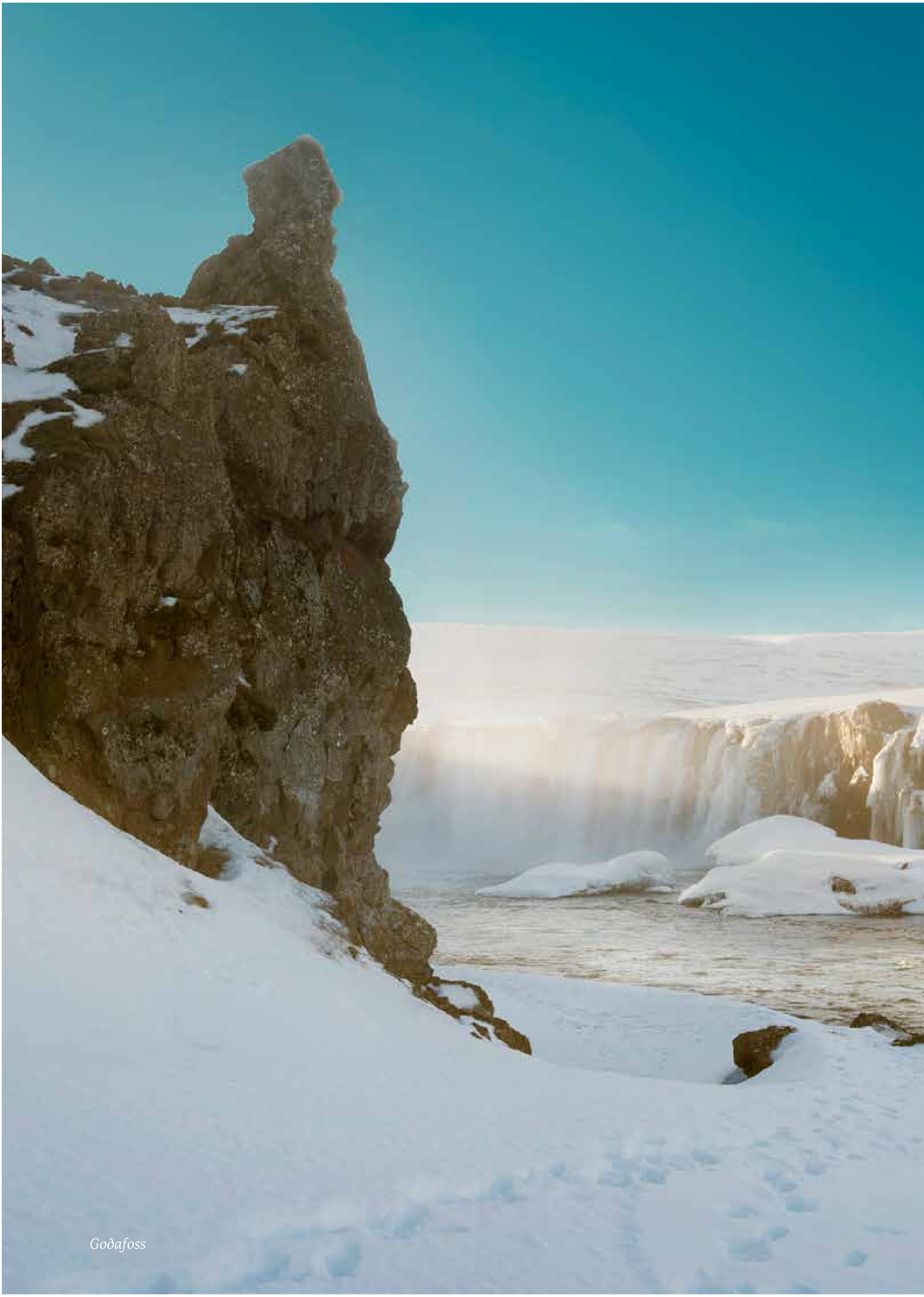
The chart shows the gross carrying amount of loans and advances to construction and real estate companies that have failed to make payments which had become contractually overdue by one or more days.

Impaired exposure in the sector amounts to ISK 11 billion and the amount of not individually impaired loans is ISK 109 billion. The collective allowance is ISK 1.5 billion.

Positive developments and improvement in the sector's credit quality can mainly be seen in a significant migration from the lowest rating grades, 1 and 2, to higher ones. Credit extended by the Group to construction and real estate companies is well secured, mainly on real estate.

The sector's average exposure-weighted PD was 6.9% as at 31 December 2014 and improved during the year.

Loans and advances to customers in the construction and real estate sector, broken down by colour classification, migrated positively during 2014. Loans classified as green were 75% of the sector's portfolio as at 31 December 2014 as compared to 67% at year-end 2013.



Goðafoss

5 Market risk

Market risk

Market risk is the risk that changes in market prices will adversely impact the fair value or future cash flows of financial instruments. Market risk arises from open positions in currency, equities and interest rate products, all of which are exposed to general and specific market movements and changing volatility levels in market rates and prices, for instance in interest rates, credit spreads, foreign exchange rates and equity prices. The majority of the Group's products and exposures that entail market risk consist of equities, government bonds and open currency positions.

5.1 Market risk management and policy

The Board of Directors is responsible for determining the Group's market risk appetite and the Risk & Finance Committee is responsible for developing detailed market risk management policies and setting market risk limits. Market risk is managed centrally by Treasury as well as within trading units. The objective of market risk management is to identify, locate and monitor market risk exposures and analyse and report them to appropriate parties. Together, the risk appetite of the Bank and the market risk policies set the overall limits that govern market risk management within the Bank.

The Group separates its exposure to market risk into trading and non-trading portfolios, managing each separately. Trading portfolios include positions arising from market-making, hedges for derivative sales and proprietary position-taking. Non-trading portfolios include positions arising from the Group's retail and commercial banking operations and proprietary position-taking as part of asset and liability management within Treasury. Treasury is also responsible for daily liquidity management, creating exposure to market risk.

Market risk mitigation is reflected in the Group's overall risk appetite by identifying the target level and strategy of market risk factors. The Bank has continued to reduce exposure in unlisted equities as well as strengthening controls and processes involving market risk management.

Other market risk mitigation plans are made on a case-by-case basis involving hedging strategies and risk reduction through diversification.

5.2 Control and monitoring

The aim of the market risk management process is to quickly detect and correct deficiencies in compliance to policies, processes and procedures. The Bank monitors early indicators that can provide warning of an increased risk of future losses. Market risk indicators need to be concise, reported in a timely manner, give clear signals and highlight portfolio risk concentrations and reflect current risk positions. The risk reports show the Group's total risk in addition to summarizing risk concentration in different business units and asset classes as well as across other attributes, as appropriate.

Market risk arising from trading and non-trading activities is measured, monitored and reported on a daily, weekly and monthly basis, and the detailed limits set by the Risk & Finance Committee are monitored by Market Risk.

5.3 Market risk exposure

The table on next page summarizes the Group's exposure to market risk at year-end 2014:

The source of the majority of the Group's equity exposure is in unlisted equities that are, for the most part, legacy positions obtained through corporate restructuring or acquired when the Bank was established in 2008. The Bank's main focus in 2014 has been on reducing this exposure and that will be ongoing in 2015.

Total exposure subject to market risk

	Net position at year-end (ISK m)	
	2014	2013
Equities and equity instruments	**29.433**	**36.275**
Listed	5.700	6.439
Unlisted	22.064	28.190
Fund shares	1.669	1.646
Bonds and debt instruments	**243.589**	**283.607**
Net FX position	**20.320**	**14.457**

Exposure to bonds and debt instruments has been reduced considerably mainly due to lower liquidity position in FX.

The Group also faces counterparty credit risk arising from derivative contracts with customers and foreign banks. Counterparty credit risk is, however, very low compared to other credit risk and is mitigated through strict collateral requirements and limits. The Group does not have any exposure to securitisation positions.

5.4 Measuring market risk

The Bank uses risk-weighted assets (RWA) and Economic Capital (EC) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. Risk-weighted assets are determined by applying specific risk weights to the Group's assets, following capital requirement regulations. Several other indicators are used as measures of market risk as well, including

Total market risk (RWA measure) at year-end

	2014		2013	
	RWA	Ratio to RWA	RWA	Ratio to RWA
Equity price risk	40,132	4.7%	51,621	5.8%
Interest rate risk (trading book)	22,090	2.6%	29,006	3.3%
Foreign exchange risk	21,379	2.5%	19,135	2.2%
Total	**83,601**	**9.9%**	**99,763**	**11.2%**

Value-at-Risk (VaR), daily profits and losses and net positions across different attributes such as the currency and issuer.

Total market risk, measured as ratio of risk-weighted assets to total RWA, was 9.9% at year-end 2014, dropping by 1.3 percentage points over the year. The reduction is mainly due to lower equity exposure in unlisted equities combined with shorter duration and less exposure to counterparties with high risk weights in the fixed income trading portfolio. The average duration of the Group's fixed income portfolio is low.

Foreign exchange risk was 2.5% at year-end and is well within the Group's risk appetite.

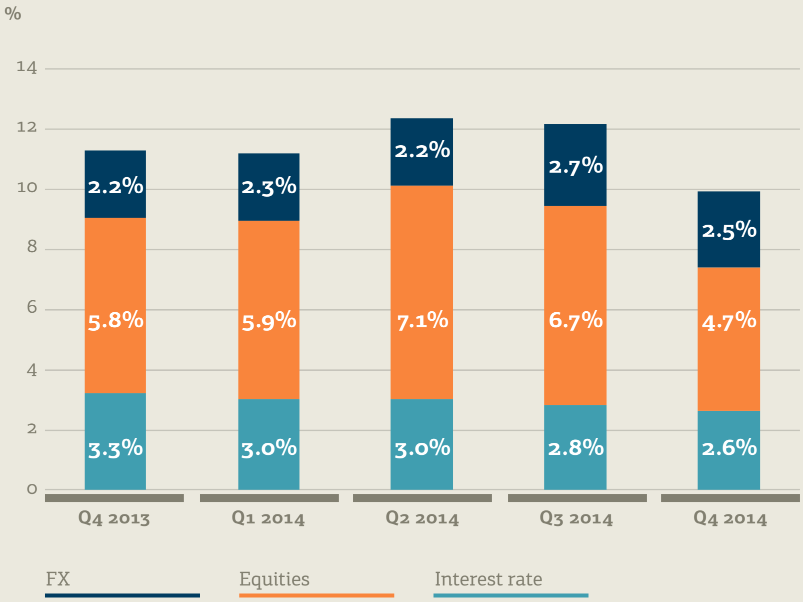
One of the key objectives for 2015 will be to further reduce equity price risk by selling unlisted equities.

5.4.1 Equity price risk

Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments.

The Bank's main equity portfolios consist of a trading portfolio strictly focused on listed equities as part of market making and a proprietary portfolio containing both listed and unlisted equities as part of asset and liability management. Furthermore, the Bank has a hedge portfolio for derivative sales, containing listed equities.

Total market risk (Ratio to total RWA)



Equities and equity instruments

	Net position at year-end (ISK m)	
	2014	**2013**
Listed	5,700	6,439
Unlisted	22,064	28,190
Fund shares	1,669	1,646
Total	**29,433**	**36,275**

Bonds and debt instruments

	Net position at year-end (ISK m)	
	2014	**2013**
Trading	63,556	59,582
Non-trading	180,033	224,025
Total	**243,589**	**283,607**

The Bank's total equity exposure at year-end is summarized on page 62.

5.4.2 Interest rate risk

Interest rate risk is the risk of loss arising from the impact of changes in market interest rates. The Bank separates its fixed income portfolios into trading and non-trading portfolios. The trading portfolios contain exposures due to market making and proprietary trading, highly concentrated on government-guaranteed bills/bonds as well as corporate issuances. The Bank's non-trading portfolios consist of a liquidity management portfolio and a proprietary portfolio for asset and liability management.

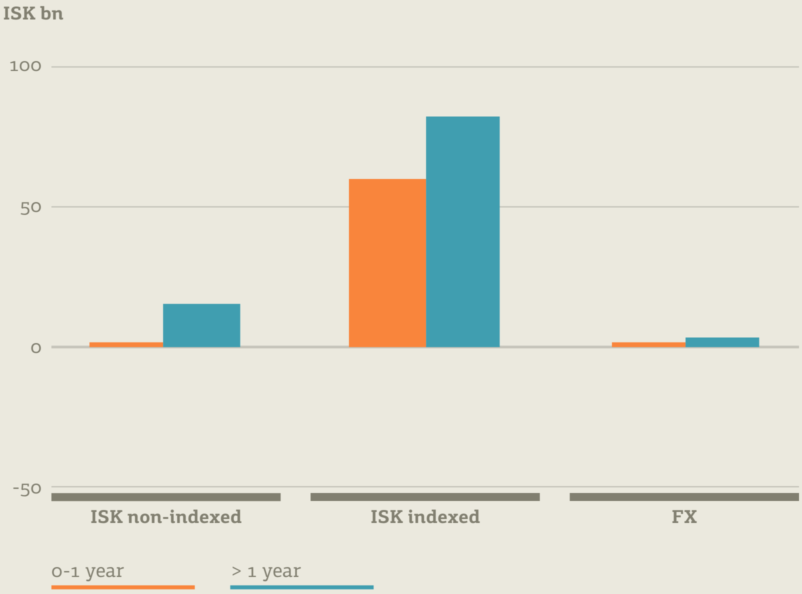
Overall, the Group's interest rate risk due to bonds and debt instruments in the trading book is low, mainly consisting of government bonds with low average duration. The Group's net interest rate exposure at year-end 2014 is summarized on page 62.

Lower non-trading exposure is due to reduced liquidity position in FX as previously mentioned.

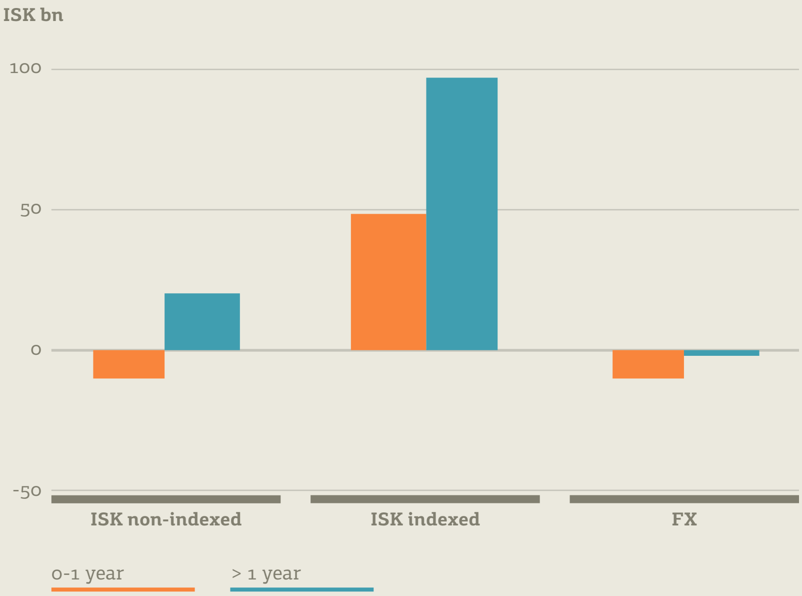
5.4.2.1 Interest rate risk in the banking book

Interest rate risk in the banking book is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. Changes in interest rates on the Bank's assets and liabilities impact its interest rate margin and/or the value of its shareholders' equity. This risk is

Asset and liability mismatch at year-end 2014



Asset and liability mismatch at year-end 2013



Interest rate risk in the banking book at year-end

		2014		2013	
	Shift (bps)	EC (ISK m)	% of equity	EC (ISK m)	% of equity
ISK non-indexed	400	1,976	0.8%	2,781	1.2%
ISK indexed	240	6,501	2.6%	6,479	2.7%
EUR	200	557	0.2%	329	0.1%
USD	200	171	0.1%	106	0.0%
GBP	200	68	0.0%	143	0.1%
JPY	200	17	0.0%	24	0.0%
CHF	200	15	0.0%	19	0.0%
Other	200	40	0.0%	43	0.0%
Total		**9,345**	**3.7%**	**9,925**	**4.2%**

primarily the result of duration mismatch of assets and liabilities. The total mismatch of assets and liabilities in the banking book at year-end 2014 and 2013 is shown in the graphs on page 63.

The Bank employs a monthly stress test of the interest rate risk in the Bank's banking book by measuring the impact of shifting the relevant interest rate curves for every currency. The table below summarizes the impact of these shifts on the Bank's equity at year-end:

5.4.3 Foreign exchange risk

Foreign exchange risk (FX risk) is the risk of adverse movements due to exchange rate fluctuations. Foreign exchange risk within the Bank may arise from holding assets in one currency and liabilities in another, or from a spot or forward foreign exchange trade, currency swaps or other currency contracts which are not matched with an offsetting contract. The net FX balance at year-end 2014 can be seen below:

5.4.4 Other market risk

Other market risk within the Bank is comprised only of inflation risk. Inflation risk is the risk that the fair value or future cash flows of CPI-indexed financial instruments may fluctuate due to changes in the Icelandic CPI index. Mismatch between CPI-linked assets and liabilities exposes the Bank to inflation risk. The Group's total CPI indexation balance at year-end amounted to ISK 158 bn as compared to ISK 165 bn at year-end 2013. The Group intends to further reduce the imbalance in 2015.

In a scenario of ongoing high (low) inflation, floating unindexed interest rates are likely to remain higher (lower) than would be the case in the reverse scenario, thus counterbalancing the positive (negative) income effects for the Group in the longer term.

The Group has developed a model to determine economic capital for inflation risk (see section 3.5) using historical observations for inflation.

5.5 Market risk VaR

A value-at-risk (VaR) model is used to compute Economic Capital for FX risk. Landsbankinn uses VaR as a common ground for measuring market risk in different products. An internal VaR model is in place for the quantification of market risk, including FX risk.

The Group calculates VaR at the 99% confidence interval with a time horizon of one day using one year of historical data. Since FX positions are regarded as highly liquid instruments, choosing the time horizon to be one day is convenient. Data quality of exchange rates and exposure is good and readily available. The Group calculates both parametric and historical daily VaR for its trading books in equity, fixed income and FX.

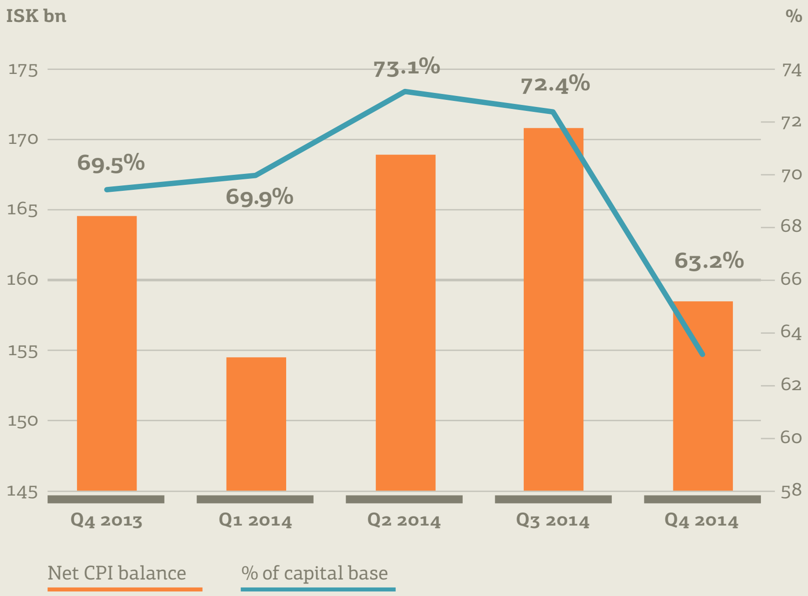
Back-testing is used to evaluate the quality and accuracy of the Group's VaR model. Back testing is done according to the Basel II market risk framework. This method basically compares the output of the model (i.e. VaR numbers) to actual and hypothetical P&L values ("hypothetical" means using changes in portfolio value that would occur were end-of-day positions to remain unchanged). A period of one year is applied as a general reference.

Back-testing shows that the model works well, having less than four outliers on an annual basis, which is equal to the expected number of outliers given the confidence level.

Net FX balance

	Net position at year-end (ISK m)	
	2014	2013
CHF	-418	-266
EUR	17,276	15,492
GBP	578	-830
JPY	233	-643
USD	786	1,150
Other	1,865	-448
Total	**20,320**	**14,454**

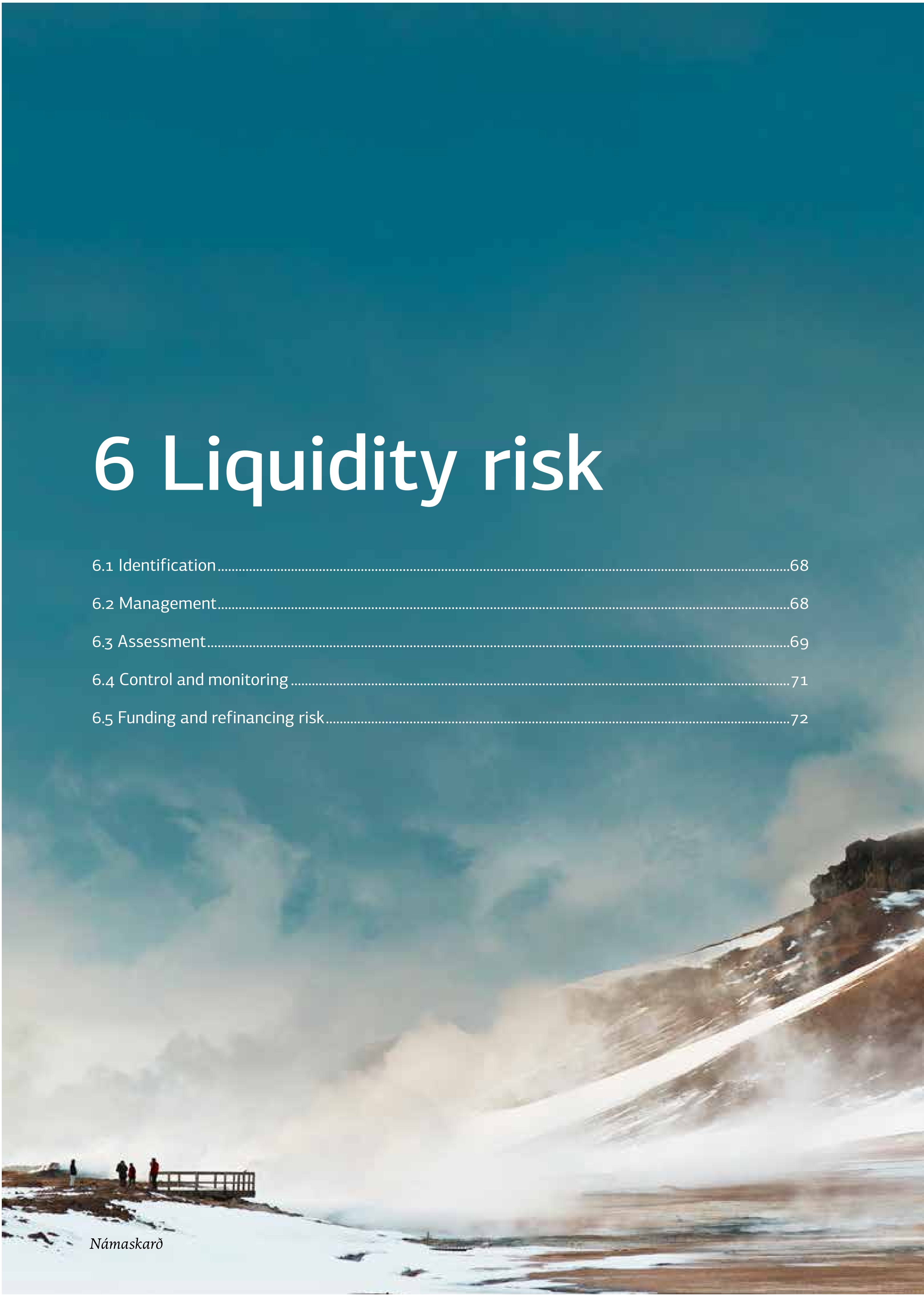
Indexation imbalance



5.5.1 Stress test / sensitivity analysis

The Group conducts quarterly sensitivity analysis of both its trading and non-trading portfolios with regards to equity and interest rate risk as well as a quarterly sensitivity analysis of its net FX balance, measuring sensitivity to currency risk.

6 Liquidity risk



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Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in meeting its obligations associated with financial liabilities that are settled by delivering cash or another financial asset, or of having to do so at excessive cost. This risk arises from earlier maturities of financial liabilities than financial assets.

Liquidity risk is identified as one of the Group's key risk factors. Accordingly, the Bank places great emphasis on liquidity risk management, reflected in both its risk appetite as well as in internal liquidity management policies and rules. The liquidity position of the Bank has remained strong, both in foreign currency and ISK and all liquidity risk factors have been well within the limits of the Bank's risk appetite during 2014.

Landsbankinn received a public credit rating from Standard and Poor's (S&P), BB+ / B with a stable outlook, in January 2014. In October 2014, S&P revised the outlook for the Bank from stable to positive and affirmed the long- and short-term ratings[7].

6.1 Identification

The Board has set a liquidity risk management policy for the Group. Liquidity risk management refers to the internal policies and procedures containing quantitative and qualitative objectives, limits and reporting put in place. The policy describes the manner in which the Group identifies, evaluates, measures, monitors, manages and reports its liquidity. The policy clearly outlines the structure, responsibilities and controls for managing liquidity risk within the Group and includes a contingency liquidity plan, along with a communication strategy. The contingency plan provides a framework for detecting an upcoming liquidity event with predefined early warnings and actions for preventing temporary or longer term liquidity disruptions.

6.2 Management

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

The policy aims to ensure that the Group does that by maintaining an adequate level of unencumbered, high-quality liquid assets that can readily be converted into cash. The Group

Short-term liquidity risk

- Intra-day
- 30 days (LCR)
- Stress testing

Longer-term liquidity risk

- Medium to long-term (NSFR)
- Cash flow projections
- Stress testing

Structural issues

- Balance sheet mismatches and maturity profiling
- Concentration of liquidity
- Contingency planning

7 http://corporate.landsbankinn.com/lisalib/getfile.aspx?itemid=b2ba50ef-5520-11e4-a834-0050568800ef

LCR and NSFR regulatory implementation schedule

	2013	2014	2015	2016	2017
FX	100%	100%	100%	100%	100%
Total	60%	70%	80%	90%	100%

NSFR

	2013	2014*	2015	2016	2017
FX	N/A	80%	80%	90%	100%

* From December 1st

has also implemented stringent stress tests that have a realistic basis in the Group's operating environment to further measure the Group's ability to withstand different and adverse scenarios of stressed operating environments.

The Group's liquidity risk is managed centrally by Treasury and is monitored by Market Risk. This allows management to monitor and manage liquidity risk throughout the Group. The Risk & Finance Committee monitors the Group's liquidity risk, while the Bank's Internal Audit function assesses whether the liquidity management process is designed properly and operating effectively.

The Group's liquidity management process entails procedures, measurements, monitoring and reporting of both short-term and longer-term liquidity risk as well as structural issues in the balance sheet.

The liquidity management policy is largely built on the international framwork on liquidity risk measurements, standards and monitoring defined in Basel III, as well as taking the Bank's current operating environment, into account.

6.3 Assessment

The Group measures two key indicators, LCR and NSFR, to monitor and manage short-term liquidity risk and medium to long-term liquidity risk respectively.

The Central Bank of Iceland issued new rules on commercial banks' foreign currency funding ratio in December 2014 which set requirements for a minimum NSFR in foreign currencies. The Central Bank Rules are based on the standards defined in Basel III but are adapted to Icelandic conditions e.g. including special requirements on foreign currency funding and treatment of risk related to the winding-up of the old banks. The Central Bank rules on liquidity have been in effect for the past year.

The implementation schedule presented above shows the requirements of the LCR and NSFR set forth by the regulators.

In addition to measuring and monitoring the LCR and NSFR, the Bank follows FME guidelines No. 2/2010 on best practices for managing liquidity in banking organisations. The guidelines further promote sound management and supervision of liquidity within the Bank which is reflected in the Bank's risk appetite and internal processes and policies.

The Bank submits monthly reports on its liquidity position to the Central Bank and the FME.

6.3.1 Liquidity Coverage Ratio (LCR)

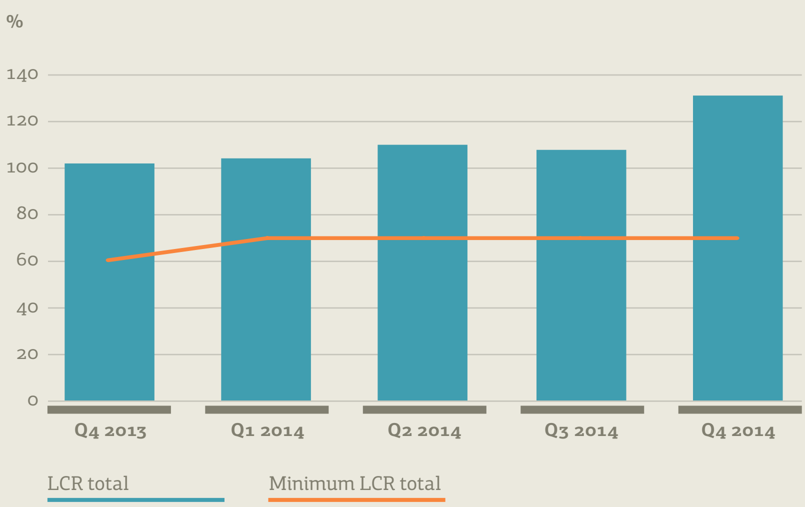
The Group measures the Liquidity Coverage Ratio (LCR) as a key indicator for short-term liquidity. The objective of the ratio is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The ratio is calculated as follows:

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{maximum (25\% outflow; outflow-inflow)}}$$

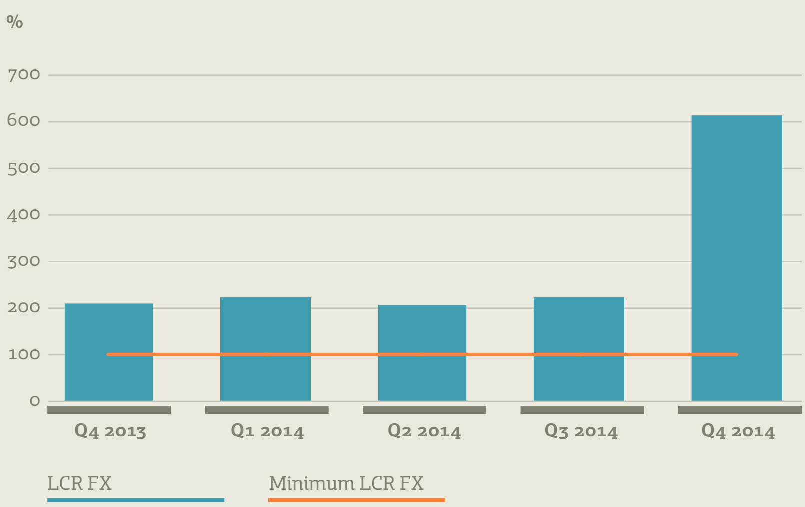
The Group's LCR as of 31 December 2014 was 131% and 614% for foreign currencies.

The significant increase in LCR in foreign currency at year-end 2014 is mostly due to lenghtening of maturities of short-term FX deposits. It should be noted that in 2014 the Central Bank made changes to the Liquidity Rules

Liquidity Coverage Ratio (total)



Liquidity Coverage Ratio (FX)



regarding treatment of certain FX deposits. These provisions took effect at January 1st 2015.

6.3.2 Net Stable Funding Ratio (NSFR)

The Net Stable Funding Ratio has a longer time horizon and its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities. The aim of NSFR is to promote more medium and long term funding. It establishes a minimum acceptable amount of stable funding based on the Bank's liquidity risk profile and limits over-reliance on short-term wholesale funding when markets are liquid.

NSFR is defined as the ratio between the amount of available stable funding to the amount of required stable funding:

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

Available stable funding is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR. The amount of such stable funding required of the Bank is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet (OBS) exposures. The Group's NSFR in foreign currencies as of 31 December 2014 was 134%

6.4 Control and monitoring

The Bank's Treasury Department is responsible for day-to-day liquidity management which entails closely monitoring current trends and potential market developments that may present significant and complex challenges for the Bank's liquidity strategy.

Liquidity risk is primarily controlled through tolerance limits set in the Bank's risk appetite. Limit management is supplemented by regular monitoring and reporting of liquidity position under normal and stressed business conditions.

The Risk Management Division of the Bank regularly monitors the Group's liquidity position and internal and external events and factors that may affect the liquidity position.

6.4.1 Liquidity Contingency Plan

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

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

- A list of potential confidence crisis scenarios and their likely effects on the Bank's liquidity position;
- A list of potential liquidity events and their effects on the Bank's liquidity management.

The Contingency Plan is supplemented by monitoring of the early warning indicators along with their defined warning and trigger levels.

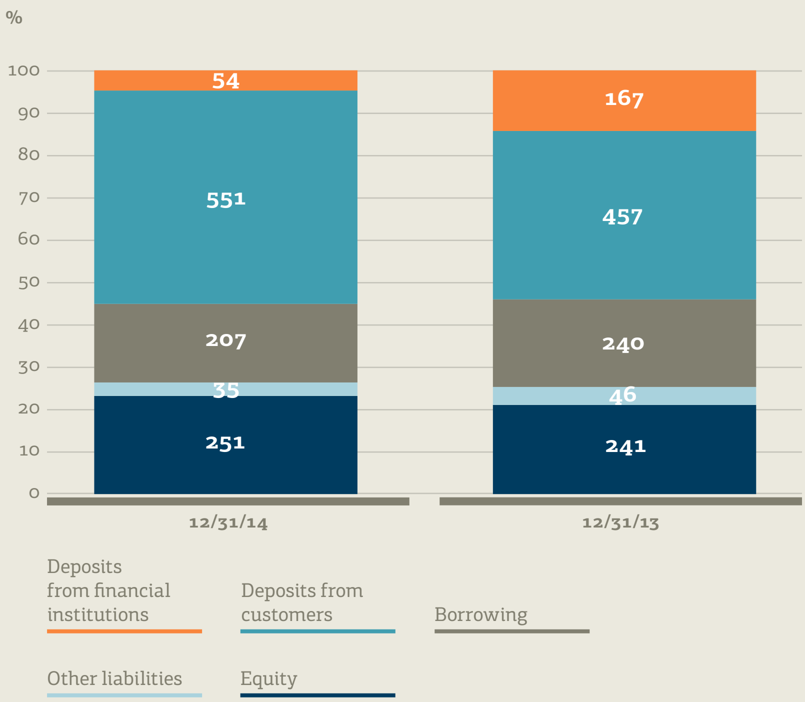
6.4.2 Stress test / sensitivity analysis

Various stress tests have been constructed to try to efficiently model how different scenarios affect the Group's liquidity position and liquidity risk. The stress tests are conducted weekly and measure the Group's ability to withstand deposit withdrawals under various levels of adverse conditions. These stress tests are set up to measure the Group's ability to operate in its current environment in Iceland, e.g. measure the effect of an easing of capital controls, as well as more general stress tests, e.g. loss of confidence in the Bank or a deposit competition/pricing scenario and other severe stress tests. The Group also performs other internal stress tests which may vary from time to time.

6.5 Funding and refinancing risk

Landsbankinn's funding profile in foreign currency changed in December when an agreement between LBI hf. and Landsbankinn on amendments to the settlement bonds negotiated in December 2009 entered into force. The final payment from Landsbankinn to LBI hf. will now take place in October 2026 instead of October 2018 and Landsbankinn is authorised to make full or partial prepayment, without cost, at any time during the term.

Funding profile



6.5.1 Funding

Landsbankinn's funding is primarily divided into four parts. Deposits from customers are the Bank's primary source of funding but the Bank also funds itself through borrowing in the form of bond issues, primarily in FX, as well as with deposits from financial institutions. Last but not least the Bank finances itself with contributions from owners in the form of equity. The figure to the right shows the Bank's funding structure as of 31 December 2014. Landsbankinn paid the equivalent of ISK 30 bn upon signing the agreement with LBI hf.

6.5.2 Borrowing

The main form of borrowing undertaken by Landsbankinn is through a foreign currency denominated bonds issue to LBI hf. Furthermore, the Bank has set up a covered bonds programme and issued covered bonds denominated in ISK.

Secured bonds

Landsbankinn issued foreign currency denominated bonds to LBI hf. in December 2009 as part of settlement when assets and liabilities of LBI hf. (formerly Landsbanki Islands hf.) transferred to Landsbankinn. On 8 May 2014, Landsbankinn and LBI hf. reached an agreement on amendments to the bonds and that agreement came into force on 4 December 2014. The outstanding amount will be paid in ten bonds, maturing every second year. The bonds are denominated in EUR, GBP and USD. A breakdown of annual installments, under the initial agreement as well as the amended agreement, is provided in the figure to the right. Interest rates will remain unchanged at a 2,9% margin until October 2018, stepping up to a 3,5% margin for the 2020 tranche to end at a 4,05% margin for the final maturity in 2026.

The amended agreement allows Landsbankinn, under certain circumstances, to postpone payments maturing in 2018 and 2020. In addition, the provisions of the amended agreement lower the minimum collateral requirement for the bonds from 125% to 115%.

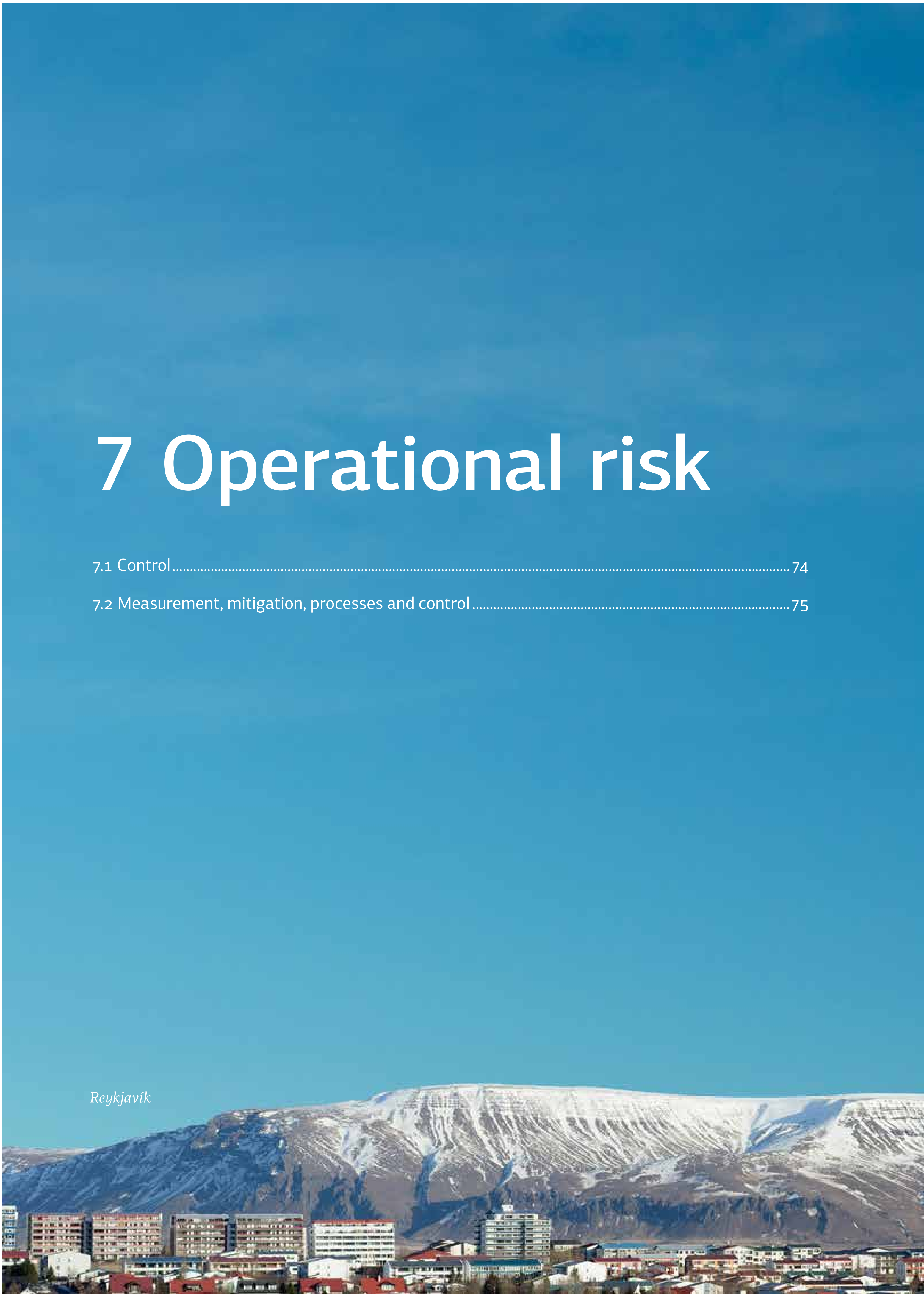
Landsbankinn paid the equivalent of ISK 30 billion upon entry into force of the agreement with LBI hf. and the total outstanding amount of the bonds at as 31 December 2014 was ISK 200 billion.

Covered bonds

Landsbankinn has set up a covered bonds programme, the purpose of which is to provide funding for the Bank's mortgage loan portfolio and hedge the Bank's fixed interest rate risk exposure. Landsbankinn issued two new series of bonds in 2014; LBANK CB 17, a 3 year non-indexed fixed rate bond and LBANK CB 19, a 5 year non-indexed fixed rate bond. The Bank also issued another tranche to an outstanding bond issue, LBANK CB16. At year-end, the total issue of covered bonds outstanding amounted to approximately ISK 7.5 billion.

Annual installments of secured bonds in foreign currency

7 Operational risk



Reykjavík

Operational risk

Landsbankinn is exposed to operational risk through its activities. Loss may result from inadequate or failed internal processes, people and systems, or from external events. This includes factors such as legal and compliance risk and IT risk.

Legal and compliance risk is the risk to earnings and capital arising from failure to comply with statutory or regulatory obligations whereas IT risk deals with the risk of failure in IT systems. Both factors are relevant in the Bank's current environment.

The Bank identifies the types of operational risk to which it is exposed in order to better understand its operational risk profile and assess its vulnerability to these risks. The aim is to identify and assess the operational risk inherent in all existing or new material products, activities, processes and systems.

Effective operational risk identification and assessment processes are crucial in establishing a framework for operational risk monitoring and control.

In identifying operational risk, the Bank examines both internal and external factors that could adversely affect its performance and prevent the achievement of its objectives, such as:

- Risk culture, human resource management practices, organizational changes and employee turnover
- The nature of the Bank's customers, products, contractors and activities, including sources of business, distribution mechanisms and volume of transactions
- The design, implementation, review and operation of the processes and systems involved in the operating cycle of the Bank's products and activities
- The external operating environment and industry trends, including political, legal, technological and economic factors, as well as the competitive environment and market structure

7.1 Control

The Board of Directors sets the Bank's policy regarding operational risk and risk appetite. Detailed rules on operational risk are in two parts. The first part is approved by the Board; the second part by the CEO. The rules set out the policy regarding operational risk, the roles and responsibilities of stakeholders in the Bank and the operational risk tolerance in terms of limits.

The Operational Risk Committee is responsible for all risk relating to operational risk, including IT risk and physical security. All rules connected to the remit of the Operational Risk Committee are approved by it.

The Operational Risk Department is a part of the Risk Management Division and is responsible for developing and maintaining the framework for managing operational risk and supporting the organization in the implementation of the framework. The Department is also responsible for ISO 27001 certification.

Internal Audit is responsible for auditing the effectiveness of the operational risk framework and the work of the Operational Risk Department.

Operational risk measurements are reported to the Board in a comprehensive manner as a part of the regular reporting done by Risk Management on a monthly basis. Managing directors receive semi-annual reports on the key risk indicators relevant to operations under their control.

7.2 Measurement, mitigation, processes and control

In order to understand the effects of the exposures to operational risks the Bank continually assesses its operational risks. A number of tools are used to identify and assess operational risk.

- Self-assessment. The Bank assesses its operations and activities against a menu of potential risk vulnerabilities. As a part of this internally driven procedure, the Bank has set up a well-documented process to identify strengths and weaknesses in the operational risk environment. The self-assessment is done by senior directors for operations under their control and then reported up to managing directors. This is done on a two year cycle and more often if there are material changes in the operational risk environment of departments. The self-assessment identifies control gaps, enabling appropriate corrective action to be taken;
- Risk mapping. This process involves mapping all reported incidents by risk type and to business units. This exercise reveals areas of weakness, leads to corrective action and assists in prioritizing subsequent management action;
- Key risk indicators (KRIs) are statistics and/or metrics, often financial, which can provide insight into the Bank's risk position. These indicators are reviewed periodically to alert the Bank of changes that indicate risk concerns;
- The Bank is certified in adherence to ISO 27001, the international standard on information security. This standard helps the Bank in assessing and monitoring operational risk in the certified areas.

For the last 3 years, "Execution, delivery and process management" has had by far the largest number of events, or 43 in 2012, 27 in 2013 and 49 in 2014.

The Bank categorizes operational incidents into deviation from rules or processes, weakness in processes or systems, external circumstances or security violations.

7.2.1 Mitigation

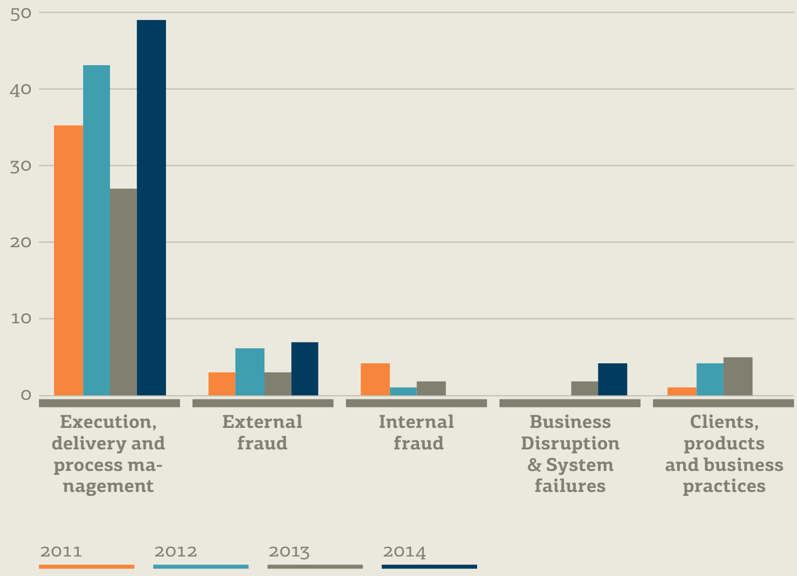
The Bank utilizes insurance as a part of its mitigation technique when it comes to operational risk. This is done through a Bankers' Comprehensive Crime policy.

Clear procedures are in place regarding the mitigating actions that result from self-assessment. There are separate procedures in place for how the Bank handles operational incidents and corrective and mitigating actions resulting from these incidents.

The architecture of the Bank's information systems is based on two mirrored data centres, primary and secondary, located in two different buildings linked with high speed communication. This setup allows the Bank to run its core systems with access to mission critical data even though one data centre (for instance the primary data centre) becomes unusable. In the event of a failure, core systems will switch automatically from one site (the failed one) to the other.

There are business continuity plans in place for all operations considered to be mission critical to the Bank. These plans are all tested on a yearly basis, apart from the IT Department's plan which is tested more frequently.

Number of loss incidents based on Basel II classification



7.2.2 Control and monitoring

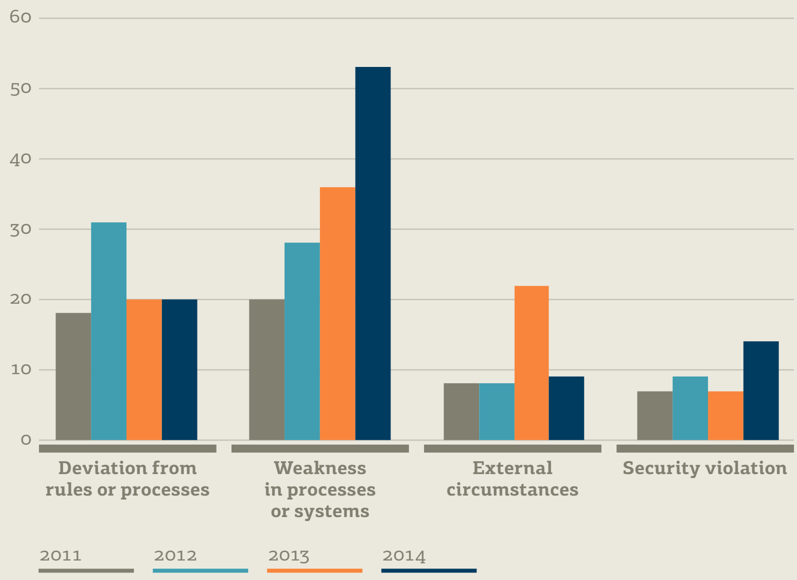
The Board and the CEO set detailed rules on operational risk governance and responsibilities. Day-to-day management of operational risk is a part of all managers' responsibilities and they are also responsible for monitoring and controlling the operational risk in their departments. Managers evaluate operational risk through risk self-assessment, focusing on key risks identified with top-down management involvement.

Information security, physical security, education and training activities are important components of the management of operational risk and close co-operation is maintained with the relevant departments involved in these processes. Internal Audit and Compliance are key functions in the framework which the Bank has established to monitor and control operational risk.

Incident reporting, auditing and follow-up is an important part of operational risk management as the identification and remedial action helps to limit losses resulting from inadequate and failed processes. The Operational Risk Department is responsible for business continuity management and for maintaining the Bank's disaster recovery plans.

A number of documents, policies, rules and work procedures cover key aspects of the responsibilities of the Operational Risk Department. Those include the Bank's policy on information security, rules on operational risk, rules on information security, rules on operational risk assessment and rules on documents and document handling.

Operational incidents



Austfirðir

8 Disclosure Policy

Disclosure Policy

8.1 Introduction

The Basel II Accord, implemented in the European Union through the Capital Requirements Directive (CRD 2006/48&49/EC ('the Directive')) establishes a revised regulatory capital framework across Europe governing the amount and nature of capital that must be maintained by credit institutions. The Directive is included in Icelandic financial legislation as part of the European Economic Area (EEA) agreement, but discrete national requirements for Icelandic banks on Pillar III disclosures have not yet been determined by the Icelandic Financial Supervisory Authority (FME).

The Basel II framework consists of three 'Pillars':

- Pillar I sets out the minimum capital amount that meets the firm's credit, market and operational risk;
- Pillar II requires the firm to assess whether its Pillar I capital is adequate to meet its risks (Internal Capital Adequacy Assessment Process, ICAAP) and is subject to annual review by the FME in the Supervisory Review and Evaluation Process (SREP);
- Pillar III requires disclosure of specified information about the underlying risk management controls and capital position.

This publication, Risk and Capital Management 2014, reviews the Group's organisation and processes relating the identification and management of the risk type characteristic of a financial group with its type of business concept. It also describes the Group's risk position on the basis of the requirements under Pillar III.

8.2 Disclosure policy

In accordance with the Directive, the Group has adopted a formal disclosure policy in that it will comply with the requirement to publicly disclose relevant information.

The rules provide that one or more of the required disclosures may be omitted if it is believed that the information is immaterial. Materiality is based on the criteria that the omission or misstatement of material information would be likely to change or influence the assessment or decision of a user relying on that information for the purposes of making economic decisions. If disclosure is considered to be immaterial, it will be stated in the relevant section.

One or more of the required disclosures may be omitted where it is believed that the information is regarded as proprietary or confidential. Proprietary information is that which, if it were shared, would undermine a competitive position. Information is considered to be confidential where there are obligations binding the Group to confidentiality with customers and counterparties. If information is omitted for either of these reasons, it will be stated in the relevant section along with the rationale. Further general information on the subject of required disclosures will be published where appropriate.

8.3 Frequency of publication

The disclosures will be reviewed on an annual basis at a minimum and, if appropriate, more frequently. Disclosures will be published as soon as is practicable following any revisions.

8.4 Verification

The disclosures have been put together to explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks and for no other purposes. They do not constitute any form of audited financial statement and have been produced solely for the purpose of Pillar III. They should not be relied upon in making judgements about the Group. The disclosures will only be subject to external verification to the extent that they are equivalent to those made under accounting requirements.

The disclosures are reviewed and approved by the Group's Board of Directors and Executive Board.

This publication, Risk and Capital Management 2014, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2014. There may be some discrepancy between financial information in the Consolidated Financial Statement 2014 and information in the Risk and Capital Management 2014 as the report has been prepared in accordance with the Capital Requirements Directive and the Basel II capital framework, rather than in accordance with IFRS.

8.5 Media and location of publication

The disclosures will be published on the Landsbankinn hf. website and will also be made available upon written request to Investor Relations, ir@landsbankinn.is.

9 APPENDIX

9.1 Landsbankinn's 2014 Remuneration report

9.1.1 Introduction

Landsbankinn hf. emphasises hiring and employing exceptional personnel. The aim of the remuneration policy is to make Landsbankinn a desirable workplace for qualified employees to ensure the bank's competitiveness, continued development and acceptable profitability. The remuneration policy shall support sound operations in the long term and not encourage unreasonable risk-taking. It is the bank's aim that the terms of employment of executives and other employees are competitive without being leading in the market. In determining terms of employment, responsibility and performance shall be taken into account, as well as equal rights perspectives.

9.1.2 Governance

The remuneration policy of Landsbankinn shall be approved by its Board of Directors. Furthermore, the remuneration policy shall be submitted to the bank's AGM for approval or rejection. The remuneration policy may be reviewed more than once yearly and any amendments submitted to a shareholders' meeting for approval. The remuneration policy serves as an indicative guideline for the bank and the Board of Directors. The Board of Directors shall enter any deviations from the remuneration policy and substantiation thereof in the minutes. Deviations shall be presented to the bank's next AGM.

The Remuneration Committee of Landsbankinn is comprised of three Directors. The role of the Remuneration Committee is to guide the Board of Directors and CEO in deciding on the terms of employment of key executives and to advise on the remuneration policy. The Committee shall ensure that the terms of employment of the bank's executives are within the framework provided by the remuneration policy and report on its implementation yearly in connection with the bank's AGM. The Committee shall monitor the developments of collective bargaining agreements, trends in salary expenses and number of employees. The Board of Directors has issued Terms of Reference for the Committee in which its role and duties are defined.

Until the AGM 19 March 2014 the Remuneration committee members were Tryggvi Pálsson (chairman), Helga Björk Eiríksdóttir and Kristján Þ. Davíðsson. After the AGM the Remuneration committee members are Tryggvi Pálsson (chairman), Helga Björk Eiríksdóttir and Jóhann Hjartarson.

9.1.3 Remuneration and risk-taking

9.1.3.1 General

The agreement made by the Minister of Finance on behalf of the State, Landsbankinn hf. and Landsbanki Íslands hf. dated 15 December 2009 provided that Landsbankinn offer an one-off employee incentive scheme. The incentive scheme shall comply with FME rules on performance-linked remuneration with financial undertakings. The incentive scheme allocated shares to employees, with delivery in October 2013 and January 2014. Employees now hold a total of 0,78% of Landsbankinn's hf. shares. Proposals for a performance-linked salary system and accompanying changes to the remuneration policy shall be submitted to an extraordinary shareholders meeting. Until such time, the Board of Directors may not approve linking salaries to performance.

9.1.3.2 Allocation of shares to employees

Beside the allocation of shares to employees, no proposals for a performance-linked salary system and accompanying changes to the remuneration policy have been submitted to an extraordinary shareholders meeting. Until such time, the Board of Directors may not approve linking salaries to performance.

9.1.4 Remuneration policies for Landsbankinn Board of Directors and CEO

Directors shall receive set monthly remuneration in accordance with the decision of the AGM each year as provided for in Article 79 of Act No. 2/1995, on Public Limited Companies. In determining the remuneration amount, consideration shall be taken to the hours spent on the job, the responsibilities borne by the Directors and the company's performance. The Remuneration Committee presents the Board of Directors with a substantiated proposal for remuneration to Directors in the coming operating year. The Board of Directors deliberates on the Committee's proposal and submits a final proposal on remuneration to the AGM. The bank reimburses Directors domiciled outside the capitol region for travel expenses. Directors may not conclude severance agreements with the bank.

The Board of Directors appoints the Bank's CEO. The terms of employment of the CEO shall be competitive with the terms offered managers in larger companies and in the financial market without leading the market. The CEO hires the Bank's key executives and their terms of employment shall be competitive without leading the market.

Landsbankinn makes public the terms of employment of Directors and key executives in its annual report.

Eskifjörður

CRD, annex XII, part 2, point 6 c)

Credit exposure (EAD)	2013	2014	
ISK million	At 31 December	Average	At 31 December
Standardised approach for credit risk			
Central governments and central banks	236,196	231,879	186,940
Corporate customers	429,442	394,179	384,705
Institutions	69,666	62,946	50,088
Regional governments and local authorities	13,407	11,192	10,870
Retail customers	148,336	132,847	126,934
Retail exposures secured by real property	122,433	199,959	228,538
Standardised approach for credit risk, total	**1,019,480**	**1,033,002**	**988,076**
Total credit exposure (EAD)	**1,019,480**	**1,033,002**	**988,076**

9.2 Further disclosures required under Pillar III

This appendix addresses further disclosure requirements stipulated by the EU Capital Requirements Directive (CRD).

9.2.1 Credit risk

In this section the Group in some cases reports exposure values as Exposure at Default (EAD). This is addressed specifically where applicable. Risk and Capital Management 2014, section 4, on the other hand, is based on accounting data.

CRD, annex XII, part 2, point 6 e)

Credit exposure (EAD) broken down by industry

At 31 December 2014 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agriculture	Other
Standardised approach for credit risk												
Central governments and central banks	-	186,940	-	-	0	-	-	-	-	-	-	-
Corporate	-	6,507	3,261	153,910	81,506	38,703	28,103	29,994	17,142	19,346	4,911	1,322
Institutions	50,088	-	-	-	-	-	-	-	-	-	-	-
Regional governments and local authorities	-	10,105	38	-	143	-	-	539	45	-	-	-
Retail	-	101	82,777	3,247	11,611	1,936	7,267	12,470	839	3,211	3,433	43
Retail exposures secured by real property	-	333	158,980	6,091	33,018	3,972	6,521	14,320	266	4,265	707	65
Standardised approach for credit risk total	**50,088**	**203,987**	**245,056**	**163,248**	**126,278**	**44,610**	**41,891**	**57,322**	**18,292**	**26,822**	**9,052**	**1,429**
Total credit exposure (EAD)	**50,088**	**203,987**	**245,056**	**163,248**	**126,278**	**44,610**	**41,891**	**57,322**	**18,292**	**26,822**	**9,052**	**1,429**

CRD, annex XII, part 2, point 6 e)

Credit exposure (EAD) broken down by industry

At 31 December 2013 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agriculture	Other
Standardised approach for credit risk												
Central governments and central banks	-	235,942	-	-	-	-	-	254	-	-	-	-
Corporate	-	2,848	2,484	141,927	110,576	40,372	42,267	40,311	20,654	24,116	3,858	29
Institutions	69,666	-	-	-	-	-	-	-	-	-	-	-
Regional governments and local authorities	-	12,688	-	-	16	-	-	702	-	-	-	-
Retail	-	599	91,197	3,994	14,845	2,152	10,268	15,465	1,396	5,201	3,181	37
Retail exposures secured by real property	-	18	121,214	2	414	127	186	429	-	44	1	-
Standardised approach for credit risk total	**69,666**	**252,095**	**214,895**	**145,923**	**125,851**	**42,652**	**52,721**	**57,161**	**22,050**	**29,361**	**7,040**	**66**
Total credit exposure (EAD)	**69,666**	**252,095**	**214,895**	**145,923**	**125,851**	**42,652**	**52,721**	**57,161**	**22,050**	**29,361**	**7,040**	**66**

CRD, annex XII, part 2, point 6 f)

Credit exposure (EAD) broken down by maturity

At 31 December 2014 (ISK million)	< 1 year	≥ 1 year < 2 years	≥ 2 years < 3 years	≥ 3 years < 4 years	≥ 4 years < 5 years	≥ 5 years	Total
Standardised approach for credit risk							
Central governments and central banks	73,793	6,412	19	106,690	3	23	**186,940**
Corporate	122,997	48,851	43,191	43,881	40,131	85,655	**384,705**
Institutions	50,027	3	14	19	1	24	**50,088**
Regional governments and local authorities	2,104	429	2,074	84	288	5,891	**10,870**
Retail	45,649	4,106	6,976	6,860	7,702	55,641	**126,934**
Retail exposures secured by real property	6,418	5,331	2,895	1,111	8,745	204,038	**228,538**
Standardised approach for credit risk, total	300,987	65,132	55,169	158,644	56,872	351,272	**988,076**
Total credit exposure (EAD)	**300,987**	**65,132**	**55,169**	**158,644**	**56,872**	**351,272**	**988,076**

CRD, annex XII, part 2, point 6 f)

Credit exposure (EAD) broken down by maturity

At 31 December 2013 (ISK million)	< 1 year	≥ 1 year < 2 years	≥ 2 years < 3 years	≥ 3 years < 4 years	≥ 4 years < 5 years	≥ 5 years	Total
Standardised approach for credit risk							
Central governments and central banks	109,817	6,249	7,715	72	107,762	4,580	**236,196**
Corporate	8,820	121,598	53,501	49,161	31,093	165,269	**429,442**
Institutions	66,950	2,510	60	11	70	65	**69,666**
Regional governments and local authorities	1,049	6,577	1,663	761	254	3,103	**13,407**
Retail	34,819	21,213	8,767	6,616	12,225	64,696	**148,336**
Retail exposures secured by real property	60	222	189	81	152	121,729	**122,433**
Standardised approach for credit risk, total	221,516	158,369	71,895	56,702	151,555	359,442	**1,019,480**
Total credit exposure (EAD)	**221,516**	**158,369**	**71,895**	**56,702**	**151,555**	**359,442**	**1,019,480**

Loans and advances by industry sectors

31/12/14	Gross carrying amount	Gross not individually impaired	Collective allowance	Individually impaired: Of which performing: Gross carrying amount	Individually impaired: Of which performing: Individual allowance	Individually impaired: Of which non-performing: Gross carrying amount	Individually impaired: Of which non-performing: Individual allowance	Carrying amount
Financial institutions	49,789	49,789	0	0	0	0	0	49,789
Public entities	13,831	13,717	-25	59	-57	56	-42	13,708
Individuals	254,955	228,952	-2,240	7,119	-3,776	18,884	-10,007	238,932
Corporates	491,015	439,910	-5,452	37,612	-12,195	13,493	-7,653	465,715
Construction and real estate companies	119,926	109,274	-1,552	6,119	-2,850	4,534	-2,644	112,880
Holding companies	45,451	31,250	-603	13,443	-1,451	758	-535	42,861
Fisheries	162,507	150,959	-637	8,881	-4,497	2,667	-1,350	156,023
Manufacturing	30,837	24,323	-433	5,276	-1,015	1,238	-629	28,760
Agriculture	9,269	8,785	-104	126	-122	358	-293	8,751
ITC	20,454	20,219	-486	86	-61	149	-109	19,798
Retail	42,198	37,788	-491	2,752	-1,621	1,657	-968	39,118
Services	59,228	56,167	-1,137	929	-579	2,133	-1,125	56,387
Other	1,145	1,145	-8	0	0	0	0	1,137
Total	**809,591**	**732,368**	**-7,716**	**44,790**	**-16,028**	**32,433**	**-17,702**	**768,144**

Loans and advances by industry sectors

				Individually impaired				
				Of which performing		Of which non-performing		
31/12/13	Gross carrying amount	Not individually impaired	Collective allowance	Gross carrying amount	Individual allowance	Gross carrying amount	Individual allowance	Carrying amount
Financial institutions	67,916	67,916	0	0	0	0	0	67,916
Public entities	10,149	10,065	-58	70	-63	14	-12	10,015
Individuals	217,719	193,669	-3,114	11,866	-6,341	12,184	-6,779	201,485
Corporates	503,544	436,665	-6,494	49,980	-18,262	16,898	-9,819	468,968
Construction and real estate companies	136,224	122,365	-2,191	5,925	-3,704	7,934	-3,098	127,233
Holding companies	59,808	45,547	-738	12,641	-1,836	1,620	-1,420	55,814
Fisheries	155,176	130,702	-782	22,454	-6,745	2,020	-1,348	146,302
Manufacturing	26,814	25,225	-355	1,148	-923	441	-198	25,337
Agriculture	8,514	7,728	-102	388	-370	398	-329	7,714
ITC	20,096	19,847	-426	181	-150	68	-61	19,459
Retail	41,666	34,081	-825	5,742	-3,454	1,843	-1,414	35,974
Services	50,375	46,620	-1,013	1,502	-1,082	2,253	-1,663	46,617
Other	4,871	4,550	-64	0	0	321	-289	4,518
Total	**799,328**	**708,315**	**-9,666**	**61,917**	**-24,667**	**29,096**	**-16,610**	**748,384**

The tables below show the Group's maximum credit risk exposure at 31 December 2014 and 2013, For on-balance sheet assets, the exposures set out below are based on net carrying amounts as reported in the statement of financial position, Off-balance sheet amounts in the tables below are the maximum amounts the Group might have to pay for guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities,

At 31 December 2014	Financial institutions	Public entities*	Individuals	Fisheries	Construction and real estate companies	Services	Retail	Holding companies	Manufacturing	Agriculture	Information, technology and communication	Other	Carrying amount
Cash and balances with Central Bank		10,160											10,160
Bonds and debt instruments	101	221,293			13345			7,808				1042	243,589
Derivative instruments	38		7					1				32	78
Loans and advances to financial institutions	49,789												49,789
Loans and advances to customers	-	13,708	238,932	156,023	112,880	56,387	39,118	42,861	28,760	8,751	19,798	1,137	718,355
Other financial assets	913	343	331		614	711	130	71	16,554	1	3	62	19,733
Total on-balance sheet exposure	**50,841**	**245,504**	**239,270**	**156,023**	**126,839**	**57,098**	**39,248**	**50,741**	**45,314**	**8,752**	**19,801**	**2,273**	**1,041,704**
Off-balance sheet exposure	**2,648**	**13,688**	**22,507**	**28,197**	**33,802**	**12,652**	**11,143**	**5,150**	**8,974**	**525**	**3,423**	**706**	**143,415**
Financial guarantees and underwriting commitments	45	611	572	7,740	1,917	2,250	2,240	3,525	559	37	673	331	20,500
Undrawn loan commitments	0	7,238	0	17,956	29,877	578	4,926	913	6,510	182	1,763	174	70,117
Undrawn overdraft/Credit card facilities	2,603	5,839	21,935	2,501	2,008	9,824	3,977	712	1,905	306	987	201	52,798
Maximum exposure to credit risk	**53,489**	**259,192**	**261,777**	**184,220**	**160,641**	**69,750**	**50,391**	**55,891**	**54,288**	**9,277**	**23,224**	**2,979**	**1,185,119**
Percentage of carrying amount	4,5%	21,9%	22,1%	15,5%	13,6%	5,9%	4,3%	4,7%	4,6%	0,8%	2,0%	0,3%	100,00%

*Public entities consist of central government, state-owned enterprises, central banks and municipalities

At 31 December 2013	Financial institutions	Public entities*	Individuals	Fisheries	Construction and real estate companies	Services	Retail	Holding companies	Manufacturing	Agriculture	Information, technology and communication	Other	Carrying amount
Cash and balances with Central Bank		21,520											21,520
Bonds and debt instruments	844	265,482			13860			9,655				755	290,596
Derivative instruments	606	1					30					17	654
Loans and advances to financial institutions	67,916												67,916
Loans and advances to customers		10,015	201,485	146,302	127,233	46,617	35,974	55,814	25,337	7,714	19,459	4,518	680,468
Other financial assets	3,743	327	458	99	1193	438	20	1	5	40	2	41	6,367
Total on-balance sheet exposure	**73,109**	**297,345**	**201,943**	**146,401**	**142,286**	**47,055**	**36,024**	**65,470**	**25,342**	**7,754**	**19,461**	**5,331**	**1,067,520**
Off-balance sheet exposure	**4,568**	**16,832**	**20,818**	**20,191**	**23,508**	**14,355**	**8,249**	**8,064**	**7,723**	**395**	**4,088**	**646**	**129,440**
Financial guarantees and underwriting commitments	26	705	506	1,666	2,486	5,529	1,738	34	593	28	1,012	41	14,364
Undrawn loan commitments	1,500	9,687	49	16,613	19,626	807	1,238	7,225	5,348	35	2,007	433	64,569
Undrawn overdraft/Credit card facilities	3,042	6,441	20,263	1,912	1,396	8,019	5,273	805	1,782	332	1,069	173	50,507
Maximum exposure to credit risk	**77,677**	**314,177**	**222,762**	**166,592**	**165,794**	**61,410**	**44,273**	**73,534**	**33,065**	**8,149**	**23,549**	**5,977**	**1,196,959**
Percentage of carrying amount	6,5%	26,2%	18,6%	13,9%	13,9%	5,1%	3,7%	6,1%	2,8%	0,7%	2,0%	0,5%	100,0%

*Public entities consist of central government, state-owned enterprises, central banks and municipalities

The loan-to-value (LTV) ratio expresses the maximum exposure of credit risk (gross carrying amount of loans and off-balance sheet items) as a percentage of the total appraised value of collateral. Loan-to-value is one of the key risk factors that are assessed when qualifying borrower for a loan. The risk of default is always at the forefront of lending decisions, and the likelihood of a lender absorbing a loss in the foreclosure process increases as the collateral value decreases. A high LTV indicates that there is less of a cushion to protect against price falls or increases in the loan if repayment is not made and interest is added to the outstanding balance.

31/12/14	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised				
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	Without collateral	Allowance for impair-ment	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	52,438	0	52,438
Public entities	36	86	198	807	1,127	2,767	437	23,626	-124	27,396
Individuals	9,553	19,669	30,984	57,321	117,527	76,566	52,710	83,369	-16,022	261,439
Corporates										
Fisheries	3,715	13,169	22,288	55,862	95,033	84,488	59,605	11,184	-6,484	184,221
Construction and real estate companies	903	2,586	6,605	25,102	35,195	107,463	60,068	11,069	-7,046	146,682
Holding companies	268	184	2,021	11,463	13,937	30,422	16,525	6,241	-2,590	48,011
Retail	168	2,384	2,250	8,704	13,505	32,111	18,744	7,725	-3,080	50,261
Services	742	1,929	3,869	7,640	14,180	39,746	21,702	17,955	-2,841	69,040
ITC	47	65	61	50	223	15,891	7,032	7,762	-656	23,220
Manufacturing	141	521	4,659	4,424	9,744	20,396	12,465	9,670	-2,077	37,734
Agriculture	413	579	1,544	809	3,345	5,228	3,415	1,222	-519	9,275
Other	1	0	0	0	1	1,097	942	754	-8	1,844
Total	**15,986**	**41,171**	**74,478**	**172,182**	**303,816**	**416,175**	**253,645**	**233,016**	**-41,447**	**911,561**

31/12/13	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised				
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	Without collateral	Allowance for impair-ment	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	72,484	0	72,484
Public entities	24	60	209	1,169	1,462	4,969	294	20,550	-134	26,847
Individuals	2,370	10,978	19,567	33,728	66,643	119,759	86,272	52,135	-16,234	222,304
Corporates										
Fisheries	3,758	6,695	22,194	35,242	67,889	99,711	69,672	7,768	-8,874	166,494
Construction and real estate companies	348	4,546	5,167	12,397	22,458	123,137	66,030	14,138	-8,992	150,741
Holding companies	495	245	1,143	2,709	4,592	50,895	34,908	12,384	-3,994	63,878
Retail	153	1,050	1,623	3,604	6,429	34,635	17,244	8,851	-5,692	44,223
Services	235	3,789	2,791	9,922	16,736	27,608	16,282	20,386	-3,757	60,973
ITC	20	45	90	68	223	19,107	8,316	4,853	-636	23,547
Manufacturing	97	183	1,275	6,389	7,944	16,658	9,403	9,935	-1,476	33,060
Agriculture	89	311	306	1,477	2,184	5,556	2,565	1,170	-800	8,109
Other	2	0	0	112	114	522	231	4,881	-355	5,164
Total	**7,591**	**27,901**	**54,366**	**106,817**	**196,675**	**502,557**	**311,216**	**229,536**	**-50,944**	**877,824**

9.2.2 Market risk

CRD, annex XII, part 2, point 10 c)

The Group uses a valuation hierarchy for disclosure of inputs to valuation used to measure fair value in accordance with international accounting standards (IFRS).

At 31 December 2014

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Bonds and debt instruments	107,418	15,066	8,031	130,515
Equities and equity instruments	7,525	0	21,908	29,433
Derivative instruments	0	78	0	78
Total	**114,943**	**15,144**	**29,939**	**160,026**

Financial liabilities	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Derivative instruments	0	332	0	332
Short positions	5,077	0	0	5,077
Contingent bond	0	0	0	0
Total	**5,077**	**332**	**0**	**5,409**

At 31 December 2013

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Bonds and debt instruments	152,473	15,547	10,674	178,694
Equities and equity instruments	8,209	1	28,064	36,274
Derivative instruments	0	654	0	654
Total	**160,682**	**16,202**	**38,738**	**215,622**

Financial liabilities	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Derivative instruments	0	583	0	583
Short positions	6,988	0	0	6,988
Contingent bond	0	0	0	0
Total	**6,988**	**583**	**0**	**7,571**

CRD, annex XII, part 2, point 12 a) - e)

Equities outside the trading book are valued at fair value, with value adjustment in the income statement. For information on separation of equity exposure into trading/non-trading portfolios, see Section 5.4.1.

The following tables show the reconciliation for fair value measurement in equities valued using unobservable inputs.

2014	
Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2014	28,064
Total gains (losses) recognised in income statement	5,894
Purchases	360
Sales	-15,889
Settlements	0
Dividend received	-1,054
Transfers into Level 3	4,533
Carrying amount at 31 December 2014	**21,908**

2013	
Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2013	29,876
Total gains (losses) recognised in income statement	5,561
Purchases	56
Sales	-8,432
Settlements	0
Transfers into Level 3	1002
Carrying amount at 31 December 2013	**28063**

9.2.3 The use of special instruments or methodologies

CRD, annex XII, part 3, point 1 (e) (i-iii)

By rating category	Credit exposure (EAD)		Exposure-weighted (EAD) Average LGD [%]		Exposure weighted (EAD) Average risk weight [%]	
Corporate customers	At 31 December 2014	At 31 December 2013	At 31 December 2014	At 31 December 2013	At 31 December 2014	At 31 December 2013
IRB-F approach						
10	0	-	56	-	19	-
9	18,266	-	44	-	25	-
8	18,429	-	43	-	38	-
7	23,358	17,582	41	41	59	55
6	42,533	61,755	38	45	85	82
5	109,276	104,757	43	45	112	108
4	121,993	161,949	42	45	140	134
3	77,513	73,194	42	45	177	169
2	31,135	32,144	44	46	229	219
1	20,539	17,784	44	45	271	258
0	24,120	75,843	47	46	0	0

CRD, annex XII, part 3, point 1 (e) (iv-v) & point 2 (d)

By rating category	Off Balance (EAD)		Exposure weighted (EAD) Average ccf [%]		Credit exposure (EAD) covered by guarantors	
Corporate customers	At 31 December 2014	At 31 December 2013	At 31 December 2014	At 31 December 2013	At 31 December 2014	At 31 December 2013
F IRB approach						
10	0	-	20	-	0	0
9	5,236	-	49	-	0	0
8	2,683	-	50	-	0	0
7	2,369	1,553	49	36	0	0
6	2,395	16,132	49	46	0	0
5	11,101	10,295	49	40	16	65
4	8,777	6,749	49	49	891	2,536
3	5,499	6,279	49	48	23	4,079
2	363	1,738	49	50	14	27
1	370	2,887	44	62	20	247
0	545	1,732	49	49	0	0

CRD, annex XII, part 3, point 1 (g) & (h)-(i)

Expected losses vs. Actual value adjustments

	Central governments and central banks	Corporate customers	Institutions	Regional governments and local authorities
2014				
Actual Value adjustments	0	11,254	0	0
Expected loss	0	9,133		0
2013				
Actual Value adjustments	0	17,816	0	0
Expected loss	0	16,455	0	0

Note: Actual value adjustments and expected loss are not directly comparable. Actual value adjustments are defined as new individual impairment charges plus write-offs charged directly to the income statement without taking reversals and recoveries into account. Expected loss is defined as the expected loss at the beginning of the period (1 January) on the basis of PD (through the cycle), LGD and CF for exposures that have not defaulted. For defaulted exposures, the expected loss equals the loan impairment charge.

CRD, annex XII, part 3, point 2 (e)-(g)

CREDIT EXPOSURE (EAD) SECURED ON COLLATERAL RECIVED (AFTER VOLATILITY ADJUSTMENT)

At 31 December 2014

Approach		Guarantees	Credit derivatives	Eligable financial collateral	Real property	Other eligable collateral	Total
IRB-F	Corporate customers	754	-	14,747	101,778	-	117,279
	IRB approach, total	754	-	14,747	101,778	-	117,279

At 31 December 2013

Approach		Guarantees	Credit derivatives	Eligable financial collateral	Real property	Other eligable collateral	Total
IRB-F	Corporate customers	2,521	-	9,169	13,946	-	25,635
	IRB approach, total	2,521	-	9,169	13,946	-	25,635

Útgefandi: Landsbankinn
Ábyrgðarmaður: Perla Ösp Ásgeirsdóttir
Hönnun: Jónsson & Le'macks
Umbrot: Guðmundur Ragnar Steingrímsson
Ljósmyndir: Marino Thorlacius
Prentun: Litróf ehf.