Risk and Capital Management 2016

Pillar III risk report of Landsbankinn hf.
31.12.2016

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 National Treasury of Iceland holds 98.2% of shares in the Bank, Landsbankinn holds 1.47% of own shares and other shareholders own 0.33% of shares in the Bank.

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. 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 2016, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2016. There may be some discrepancy between this report and financial information in the Consolidated Financial Statement 2016 as the report has been prepared for the purpose of Article 18 of the Act No. 161/2002 on Financial Undertakings, cf. Article 11 of Act No. 96/2016, and the provisions in CRD IV and CRR incorporating the Basel Pillar III disclosure requirements, rather than in accordance with IFRS.

1 Highlights of 2016 and Outlook

Landsbankinn overall risk position decreased slightly in 2016 measured by RWA to total assets despite growth in the loan book. The Bank risk appetite was set to reduce risk over the year, specifically in credit risk.

Capital position

The Bank's capital position remained strong in 2016 with a year-end position of 30.2%, well above the regulatory minimum requirement of 22.1% set by the Financial Supervisory Authority of Iceland (FME). The Bank's capital target is to remain comfortably above the FME requirements and in the highest category for the RAC ratio. Both capital targets were met in the year 2016.

The Bank's capital base was reduced by ISK 8 billion between 2015 and 2016. The reduction was mainly due to dividend payments made by the Bank during the year and for a very small part a share buyback program.

The Bank measures internal capital requirements by economic capital for all material risks w.r.t. risk weighted assets. Internally estimated capital requirement reduced by ISK 13.4 billion in 2016 and the ratio to RWA was reduced by 1.2 percentage points.

Minimum capital requirements set by Icelandic regulators are high in international perspective. E.g. the minimum requirement for the Bank set by the FME is higher than equity positions in total for several Nordic peers. This position makes it difficult for the Bank and its competitors to maintain adequate ROE levels and dividend payout ratios.

Credit risk

Despite a 5% growth in the loan book economic capital need for credit risk decreased in 2016. Credit risk measured by PD levels and LGD measurements decreased during the year and were in line with risk appetite targets.

End year PD levels were 2.5%, down by 0.9 percentage points from 2015. Loans 90 days past due also decreased in 2016 ending in 1.5% of the loan portfolio. Customer migration between rating grades and early warning classification was positive thus reflecting a stronger financial position of the Bank's borrowers.

The loan portfolio is concentrated in three main areas, residential mortgages, the fishing sector and the construction and real estate sector.

The Bank is now implementing IFRS 9 which replaces IAS 39 in 2018. For this purpose the Bank has developed and tested new impairment models and methods which will run parallel with current impairment processes during 2017.

In 2016 the Bank lay the foundation for reopening its F-IRB application and is currently in discussion with the FME regarding the application process.

Market risk

Market risk measured by economic capital decreased significantly during 2016, mainly due to a lower net currency position. The Bank employed a new model on measuring interest rate and inflation risk at year end 2015 which measures economic capital in a more robust and exact manner, giving the Bank a better estimation of the correlation of the two risk factors.

Indexation imbalance increased during the year due to demand for CPI indexed linked mortgages. This imbalance is evaluated frequently and mitigation opportunities reviewed in line with the Bank's business plan and current market environment.

Liquidity risk and funding

Liquidity risk is one of the Bank's main risks and significant focus has been on the liquidity position of the Bank in 2016. LCR at year-end was 128%, well above regulatory limits and the Bank's risk appetite. The Bank will continue to focus on liquidity management in 2017 by managing lending growth and debt issuance. Medium to long term liquidity risk, measured by the NSFR in FX, was 154% at year-end well above regulatory requirements of 100%.

Standard and Poor's upgraded the Bank's credit rating to BBB in October 2016. This improved rating will impact the Bank's opportunities for favorable funding in foreign markets in 2017, as was evident on pricing of the Bank's issuance in 2016. The Bank issued debt under the EMTN programme in EUR, NOK and SEK and covered bonds and bills in the Icelandic market.

Operational risk

Weaknesses in processes or systems continue to count for most of the Bank's operational incidents in 2016. Risk Management is now tracking incidents through a centralized platform and registering a loss incident database for improved management of operational risk in the Bank. Many incidents logged are however several years old, only materialising e.g. due to litigation.

IT risk and security is of great importance to the Bank. For that purpose the Bank has for the last few years maintained the ISO 27001 certification on information security and is assessed annually by a third party for adherence to the standards.

IT risk is especially relevant to the Bank in 2017 as RB, the IT service centre for the Icelandic financial market, is in the final stages of a core banking replacement project. Changing core banking systems poses a significant operational risk to the Bank. To reduce possibilities of disruptions in operations, the Bank is making changes to many internal IT systems. It is crucial to the Bank that the rollout of the new core banking system is performed in a structured and planned manner.

Economic highlights of 2016

Economic conditions and developments were in many respects very good in 2016. Unemployment levels are now close to record low levels, real wages grew by 9.5% and household debt decreased. The Icelandic króna (ISK) has appreciated substantially and inflation remained below, but close to the Central Bank of Iceland's inflation target for the third year in a row. The low level of inflation has been supported by declining import prices while imputed rent for housing has been the main driver of inflation due to rising housing prices.

In real terms, the gross domestic product (GDP) for the first nine months of 2015 increased by 6.2% compared with the same period 2015, in line with Landsbankinn Economic Research's most recent Macroeconomic Forecast (November 2016) for the whole year. The GDP growth reflects increased growth in domestic demand as domestic final expenditure increased by 9.3%. While the balance of trade in goods was positive by roughly 130 billion ISK, the contribution to economic growth of foreign trade was negative as imports (+16.6%) grew faster than exports (+10.0%). The post-crisis slack in output is thought to have been fully absorbed 2015 and a positive output gap has opened up.

The government implemented the first round of loosening capital controls on domestic residents in October 2016, and the second round of measures came into effect on Jan. 1, 2017. Under the amended regulations, residents are allowed to purchase foreign real estate and foreign exchange-denominated instruments, for example.

The CBI's Monetary Policy Committee lowered the Bank's interest rates on two occasions in 2016, first in August by 0.5 percentage points and then by 0.25 percentage points in December. The Bank's key interest rate, seven-day term deposit rate, was at end of year 2016 5.0%.

Due to significant increases in the number of foreign tourists' arrivals, improved terms of trade, and net investment inflows by non-residents, there was a significant increase in net inflow of foreign currency in 2016. Turnover in the interbank foreign exchange market increased by 42% year-on-year, and the CBI share was 55%. The CBI bought foreign currency from market makers in the amount of ISK 386 billion during the year, compared to ISK 313 billion in 2015. Despite the interventions of the CBI in the currency market the króna appreciated by roughly 18.4% in 2016. The foreign exchange reserves of the CBI increased by ISK 163 billion and amounted to ISK 815 billion at year-end.

Economic outlook for 2017

Landsbankinn Economic Research (LER) expects GDP growth will remain strong throughout 2019. LER anticipates 5.5% GDP growth in 2017, driven mainly by increasing private consumption and investment. A number of key factors that influence the development of private consumption are currently favourable. The employment situation is good, wages and disposable income have increased and the asset and debt balance of households improved significantly. Growth in gross capital formation is expected to be driven mostly by strong growth in business investment although residential investment is expected to contribute significantly with double digit growth over the next three years.

Most signs indicate that housing prices will continue to increase. Supply of new housing does not appear to be keeping up with demand. There is increased competition in the housing mortgage market and supply of credit has become more plentiful. Purchasing power looks set to continue to increase, household debt has improved considerably and rising real estate prices have provided increased scope for mortgage. These factors will all contribute to rising real estate prices in the near future.

Total export growth is expected to be driven by service exports, primarily a continuing strong growth in the tourism sector. The number of foreign travellers to Iceland increased by 40.1% 2016 and is expected to increase by further 25% in 2017. LER forecasts continued trade surplus throughout 2019 and the current account is expected to remain positive throughout the forecast period.

Inflation expected to remain roughly in line with the inflation target

Inflation at the end of 2016 was 1.9%, below the CBI's 2.5% target. Inflation first fell below the target in February 2014 and has remained below target for a continuous period of almost 3 years. Global price developments and a stronger króna have helped to keep inflation in line, with a significant deflationary contribution of imported goods. LER expects inflation to remain close to the inflation target over the next years although it is expected to pick up during 2017. The current forecast has inflation peaking at 3.2% mid-year 2018. The relatively favourable inflation outlook despite robust GDP growth is due first and foremost to significant appreciation of the ISK in 2016 and the outlook for continued strengthening of the currency throughout the forecast period. Further, inflation expectations are converging with the Central Bank's inflation target, which indicates that expectations are more firmly anchored to the target than before.

General good outlook in the equity market for companies in domestic activities

The outlook is mixed for the equity market in general in 2017, despite Economic Research's forecast for handsome economic growth, increased investment, low inflation and rising private consumption. The core operations of companies in the stock exchange are not all exposed to changing domestic demand, especially the largest companies, which weigh the heaviest in the selected shares index. LER does expect the positive economic outlook in Iceland to provide sound support for the majority of companies on the Nasdaq Iceland main list.

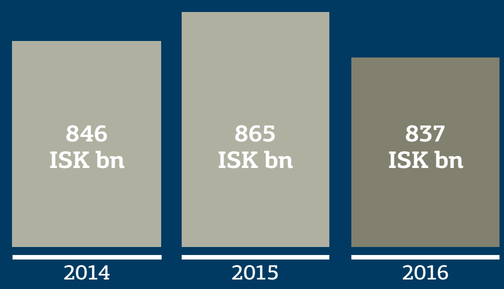
The future is subject to significant uncertainty

Economic forecast are subject to significant uncertainty regarding development of a number of domestic and foreign factors. The main domestic uncertainties are related to i.a. the development of tourism in the coming years which still is a relatively young and unformed industry in Iceland. The enormous growth in recent years raises questions whether the development is sustainable; and as a result of unexpected events, temporarily reduction in tourists' visits can always be seen. It is also unclear whether or to what extent the króna's appreciation will affect tourist arrivals to Iceland. The exchange rate is also undoubtedly the largest single factor affecting the inflation development in Iceland. If the króna appreciates more than the forecasted appreciation, a scope can be expected where it is possible to cut interest rates more and sooner than anticipated, but on the other hand, higher inflation and higher policy rates can be seen if the króna depreciates. Another major domestic risk is the economic policy. In terms of state finance, it is absolutely unclear whether sufficient fiscal control can be reached whereas there seems to be great pressure on increasing expenses, but at the same time, little readiness to raise taxes as a counterbalance. Also, the CBI's newly adopted instruments of economic policy, following the relaxation of capital controls, will be tested.

Finally, a number of foreign factors outside the Icelandic economy's control; such as uncertainty regarding the new President of the United States' strategic policy, the effect of Brexit, developments in China, the stability of European banks and commodity prices, may have significant impact on both inflation and economic outlook in Iceland.

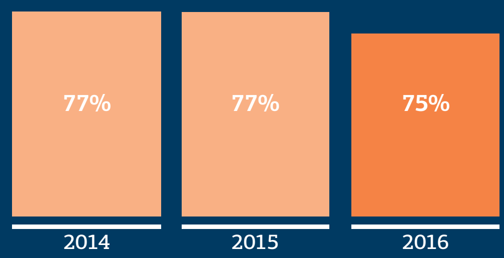
Risk in review

Risk weighted assets



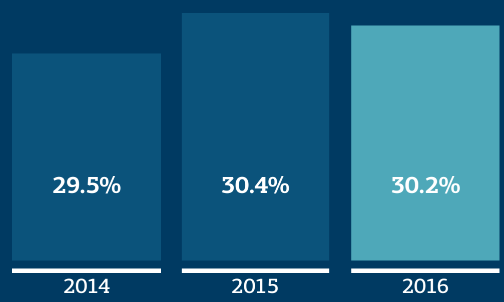
837 ISK bn

RWA to total assets



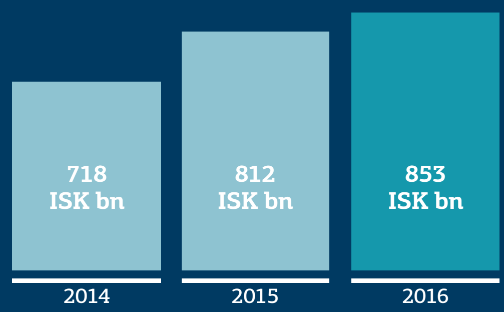
75%

Total capital ratio



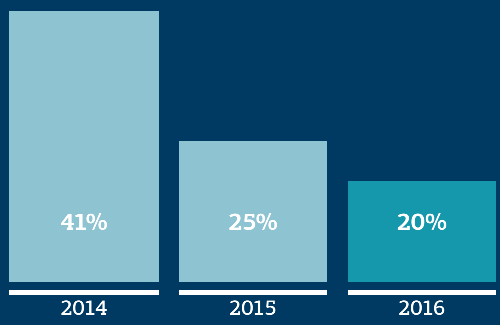
30.2%

Loans and advances to customers



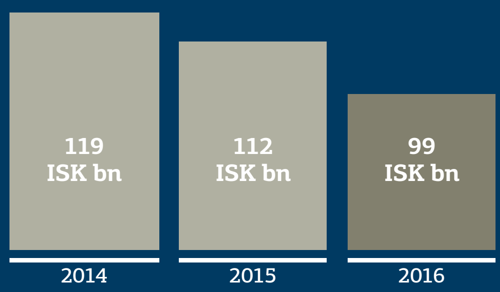
853 ISK bn

Large exposures to eligible capital



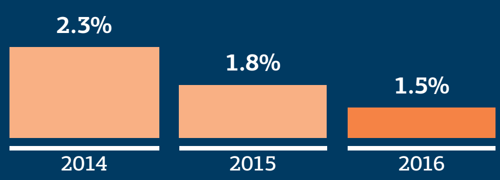
20%

Economic Capital



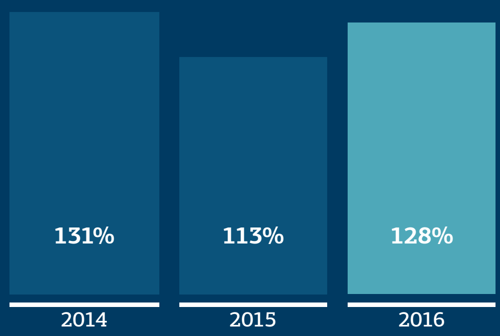
99 ISK bn

90 days past due loans

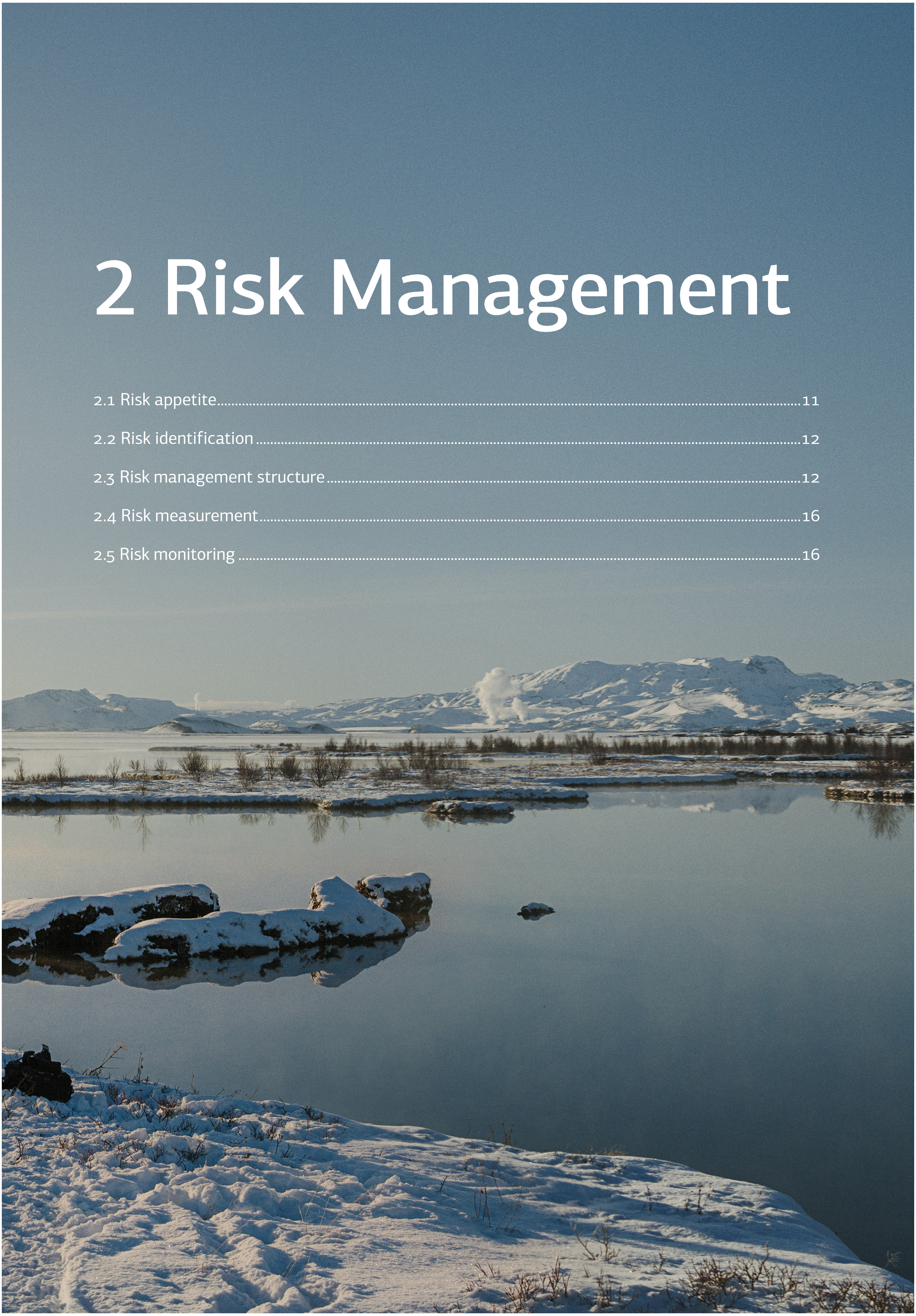


1.5%

Liquidity coverage ratio total



128%



2 Risk Management

Risk Management

Risk is inherent in the Group'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 adherence 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 policies regarding the risk structure of its asset portfolio which are covered in more detail under each risk type.

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

2.1 Risk appetite

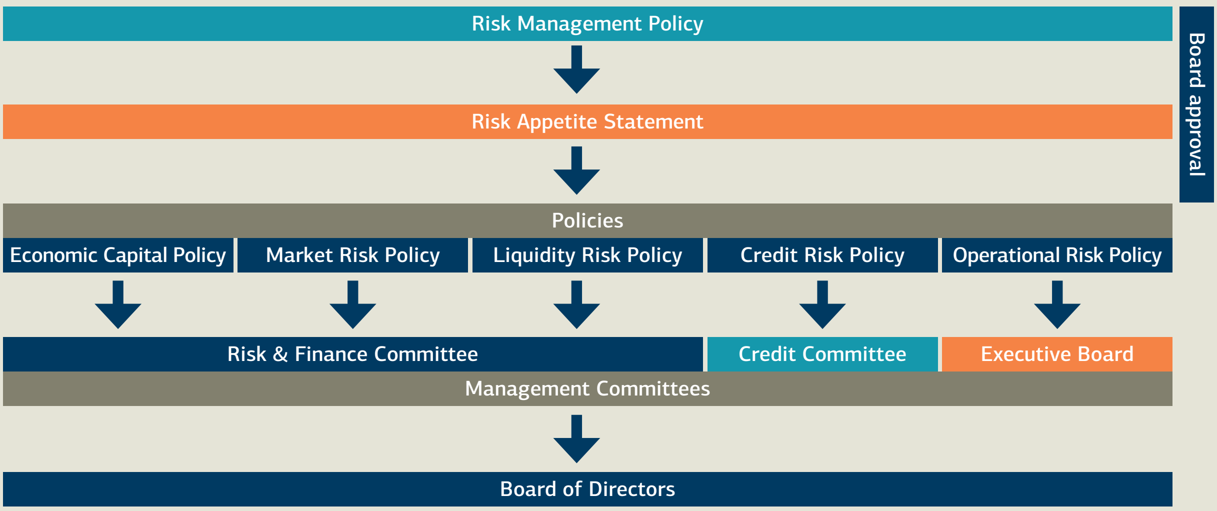
The Group's risk appetite is defined as the level and nature of risk that the Bank is willing to take in order to pursue its articulated strategy, and is defined by constraints reflecting the views of the Board of Directors and the Bank's CEO and Executive Board.

The Group's risk appetite was reviewed, revised and implemented for 2016. The Group's risk policy is as follows:

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

The Bank 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 Bank pursues long-term business relationships and aims to avoid being linked to transactions

Figure 2-1



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

Table 2-1

that might damage its reputation.

The Bank seeks to ensure diversified and sound financing and a sustainable risk profile in the balance sheet. The Bank 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 Bank aims to minimise fluctuation in its operations and is well positioned to withstand stress scenarios.

The Bank'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 Bank and its customers in mind. Efficient follow-up on decisions and risk monitoring are integral to the Bank'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

Table 2-1 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 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 best practice 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 policies set by 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 2016 is shown in Tables 2-2 and 2-3.

Proper organisation of the Board's work is a prerequisite 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 the efficacy of work.

The Board assesses the need to establish sub-committees at the Board level according to legal requirements and 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 for the Board of specific areas of operation and obtain deeper insight in more detail matters related to them.

The Audit Committee shall endeavour to ensure the quality of the Group's financial statements 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. Moreover, the Committee supervises auditing of the Group's financial and consolidated statements 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 the Bank's risk management structure and compliance. The Committee monitors the management of credit, market, operating and other types of risks as and where applicable.

The Remuneration Committee is comprised of three Board members. The Committee guides the Board of Directors and the CEO on the terms of employment with respect to the salaries of key management and remuneration policy. The Committee ensures that the remuneration of key management is within the remuneration policy's framework and reports accordingly to the Board of Directors annually. According to the Act on

Board of Directors Table 2-2

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 Table 2-3

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

the Senior Civil Servant's Board No. 47/2006 the Senior Civil Servant's Salary Board determines the remuneration of the Bank's CEO. In December 2016, Parliament passed a new Act on the Senior Civil Servant's Board. The new Act No. 130/2016 enters into force on 1 July 2017 and repeals and replaces Act No. 47/2006. The new Act stipulates that the Board of Directors determines the remuneration of the Bank's CEO. For further details on the Group's remuneration policy, see Section 9.1 of Landsbankinn's 2016 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 w.r.t. 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.

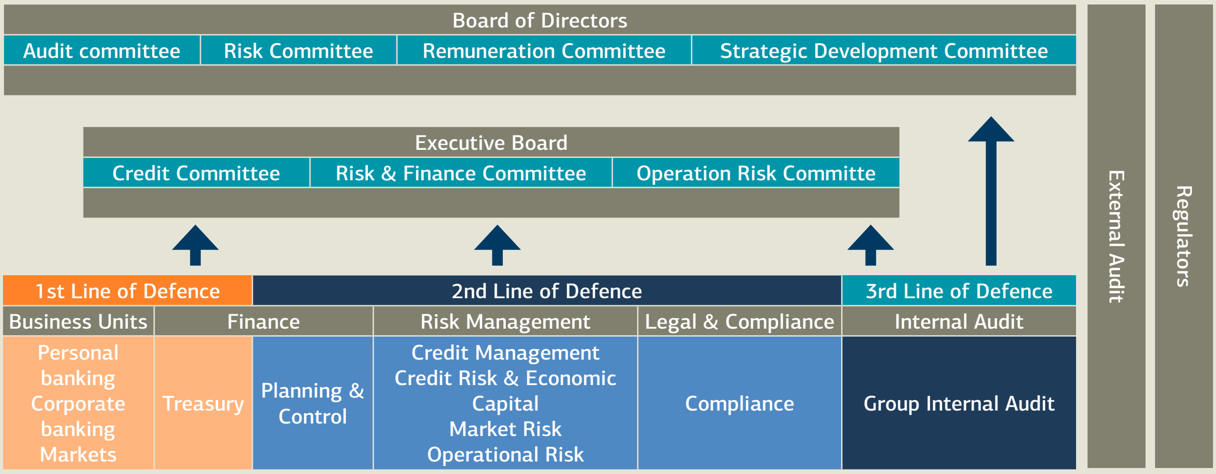
The Credit Committee deals with credit risk – individual credit decisions, credit limits on customers and credit risk policy – while the Risk & Finance Committee covers primarily market risk, liquidity risk and legal risk. The Risk & Finance Committee monitors the Group's overall risk position, is responsible 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 and takes decisions on operating matters not being considered in other standing committees. The Operational Risk Committee is a forum for discussions and decisions on 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 Bank's Risk Management Division is responsible for the Bank's risk management framework. Subsidiaries of the Bank 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.

Figure 2-2



The Risk Management Division is comprised of five departments.

- The Credit Management Department reviews credit decisions made by the Bank's business units when credit applications exceed the business units limits. The Department has veto rights on those credit applications. Confirmation by Credit Management implies that Credit Management has reviewed the credit application and does not exercise its veto rights. Credit applications exceeding the confirmation limits of the Risk Management Division are referred to the Bank's Credit Committee;

- The Credit Risk & Economic Capital Department is responsible for providing the Bank with internal models on credit risk and credit 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 Bank. In addition, the Department is responsible for credit risk, economic capital and impairment analysis and reporting within the Bank;

- The Market Risk Department is responsible for measuring, monitoring and reporting on market risk, liquidity risk and interest rate risk in the Group's banking book. The Department develops and maintains the Bank's market risk models and maintains the Group's Market Risk Policy and Liquidity Risk Policy as well as implementing proccesses to measure and monitor market risk and liquidity risk within the Group. Market Risk is also responsible for monitoring all derivatives trading the Bank enters into, both for hedging and trading purposes, as well as FX balance monitoring for the Group;

- The Operational Risk Department is responsible for ensuring that the Group's operational risks are monitored and that the Bank implements and maintains an effective operational risk management framework. The Department assists the Bank's managers with operational risk assessment incidents related to normal operations and operational loss incidents analysis, and oversees business continuity plans. The Department is partly responsible for the security system of the online bank. The Operational Risk Department leads the work on the Group's certification under the ISO 27001 standard for information security;

- Restructuring is responsible for corporate and individual debt restructuring – both for over indebted individuals as of those who are unable to service their loans due to illness or humanitarian reasons – and appropriated assets. This includes selling and renting out real estate assets which the Bank has acquired through foreclosure or as a part of debt restructuring. In addition the Department sells cars, equipment and other items that the Bank has acquired through foreclosure.

2.3.3 Compliance

The Bank's Compliance Department 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. 67/2006, 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 Group's operations. The Board has oversight of Group Internal Audit and appoints the Chief Internal Auditor. It helps the Group 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 targets and limits. On an aggregate level, the risk appetite is represented in terms of credit risk, market risk, liquidity risk and funding risk. Each statement varies in detail, 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, market, liquidity and funding risk measurements.

Economic capital (EC) is 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 estimated capital required to cover the Group's unexpected loss one year into the future. One of the benefits of EC is that it presents an aggregate figure for all risk types, products and business units. It thus produces 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.

Table 2-4

Overview of the main risk appetite measures

Risk	Metric
Credit risk	Expected loss
	Probability of default
	Loss given default
	Industry concentration
	Single name concentration
Market risk	Equities
	Fixed income
	Currency
	Interest rate risk and inflation risk in the banking book
	Inflation risk
Liquidity risk	Liquidity Coverage ratio Total
	Liquidity Coverage ratio FX
Operational risk	Change in RWA
Funding risk	Net stable funding ratio
	Economic Capital
	Equity position
	Risk Adjusted Capital

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 of the balance sheet.

The Board of Directors receives thorough risk reports six times a year for different risk types as well as a monthly risk overview. 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 to the Board for approval, which is then subject to the FME's

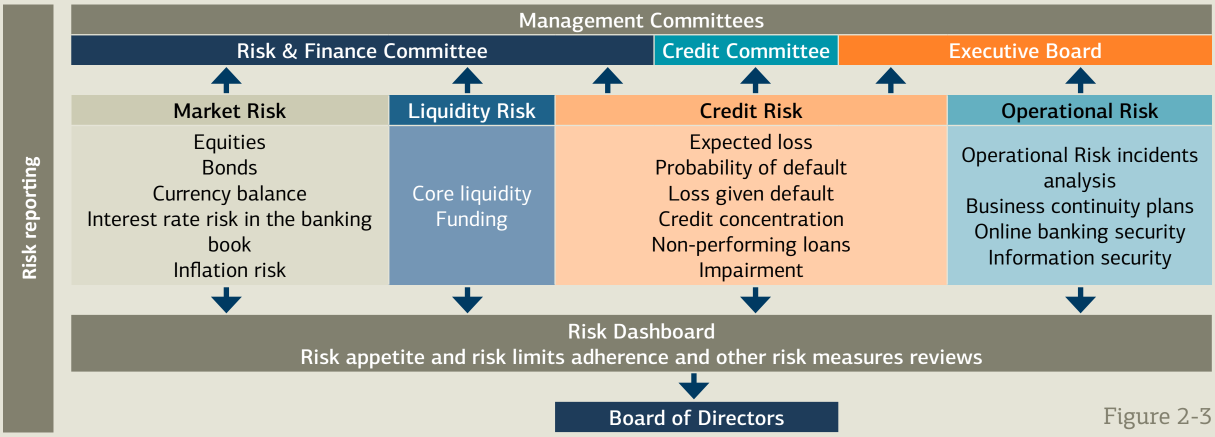


Figure 2-3

Supervisory Review and Evaluation Process (SREP). Finally, a detailed EC report is submitted to the Board of Directors once a year.

In May of 2015, Landsbankinn was designated as a D-SIB (Domestic systemically important bank), this in turn required Landsbankinn to be compliant to the Basel Committee on Banking Supervision "Principles for effective risk data aggregation and risk reporting (BCBS 239) before May 2018. The board of directors of the Bank has authorised and approved the "Risk data and reporting policy" which details how the Bank fulfills the BCBS239 standard. The Pillar III report uses the principles and guidelines set within the Risk data and reporting policy.

Table 2-5

Principal reporting to the Board of Directors

Annual	
Risk and Capital Management report	Pillar III disclosures
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 RWA and other related aspects
Bi-annual	
Credit risk report	Thorough risk report summarising the Group's credit risk exposures and any concerns regarding credit risk
Market & Liquidity risk report	Thorough risk report summarising the Group's liquidity risk and market risk exposures and any concerns regarding liquidity and/or market risk
Operational risk report	Thorough risk report providing analysis of operational risk aspects
Monthly	
Risk report	An aggregate report containing information on the Group's risk appetite and material from the credit, market, liquidity and operational risk reports
Executive Board report	An aggregated report containing risk related material such as risk appetite, EC and RAROC

3 Capital Management

Capital Management

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 Group's total capital ratio decreased by 0.2 percentage points in 2016 to 30.2%;
- A dividend payment of ISK 1.2 pr. share or ISK 28.5 billion was made in 2016, approximately 80% of the previous year's earnings after tax
- Both Economic capital (EC) and Risk-weighted assets (RWA) decreased during 2016 resulting in a EC/RWA ratio of 11.8% compared to 13.0% in year-end 2015

Economic capital

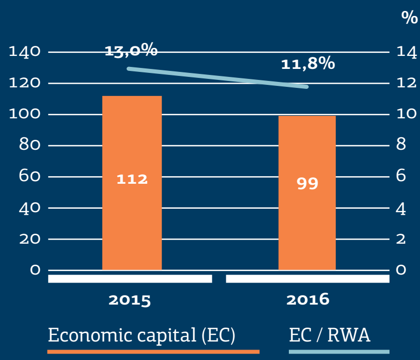


Table 3-1

Capital management structure

Responsible party	Role
Board of Directors	The Board of Landsbankinn 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 approves the ICAAP reports.
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 according to the Group's risk profile and business plan and functions properly. The CEO shall provide the Board of Directors with annual ICAAP s and monthly 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 ICAAP stress testing framework, including definition of scenarios.
Risk Management	The Managing Director of Risk Management is responsible for the risk management framework, as well as the Economic capital 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.

19 All amounts are in ISK millions Risk and Capital Management 2016

3.1 Capital management structure

The Group's capital management governance structure for year-end 2016 is as follows:

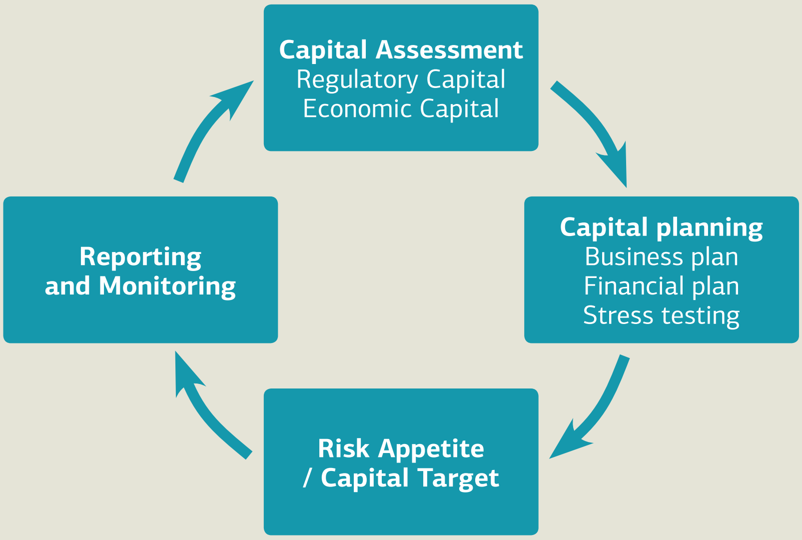
3.2 Capital management framework

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 standardised approaches in measuring the regulatory capital requirement for Pillar I risks and Economic capital for capital management purposes.

Capital management framework Figure 3-1



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, regulatory capital buffers, internal capital buffers, risk appetite, and strategic objectives are considered.

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

The Group's most recent capital requirements, as determined by the FME, are as follows (as a percentage of RWA):

Table 3-2	SREP based on data from 31.12.2015	SREP based on data from 31.12.2014
Pillar I	8.0%	8.0%
Pillar II	6.0%	6.3%
Minimum capital requirement	14.0%	14.3%
Systemic risk buffer	2.7%	3.0%
Capital buffer for systematically important institutions	2.0%	2.0%
Countercyclical capital buffer	0.9%	0.0%
Capital conservation buffer	2.5%	2.5%
Combined buffer requirement	**8.1%**	**7.5%**
Total capital requirement	**22.1%**	**21.8%**

20 All amounts are in ISK millions Risk and Capital Management 2016

of the capital planning process which includes the business plan, financial plan and stress testing.

The Bank's target for the Group's minimum total capital ratio is to be comfortably above FME's total capital requirements plus the fully phased-in capital buffers.

The Bank also aims to be in the highest category for risk-adjusted capital ratio, as determined and measured by the relevant credit rating agencies.

In October 2016 the international rating agency Standard & Poor's (S&P) upgraded Landsbankinn's long- and short-term credit ratings from BBB-/A-3 to BBB/A-2 with a positive outlook. The positive outlook reflects S&P's view of continued improvement in the operating environment for Icelandic banks. It also mirrors its expectations that the Bank's risk-adjusted capital (RAC) ratio will remain

The capital base consists of Tier 1 and Tier 2 capital and the breakdown is as follows: Table 3-3

The capital base

Capital base	**31.12.2016**	**31.12.2015**
Share capital	23,648	23,782
Share premium	120,847	122,105
Reserve	10,875	6,000
Retained earnings	95,834	112,614
Total equity attributable to owners of the Bank	251,204	264,501
Intangible assets	-2,634	-2,012
Common equity Tier 1 capital (CET1)	248,570	262,489
Non-controlling interests	27	30
Tier 1 capital	**248,597**	**262,519**
Subordinated liabilities	388	639
Regulatory amortisation	-203	-157
General credit risk adjustment	4,024	0
Tier 2 capital	**4,209**	**482**
Total capital base	**252,806**	**263,001**

Risk-weighted assets		
Credit risk	728,428	737,720
Market risk	16,519	31,919
Operational risk	91,811	95,843
Total risk-weighted assets	**836,758**	**865,482**
CET1 ratio	**29.7%**	**30.3%**
Tier 1 capital ratio	**29.7%**	**30.3%**
Total capital ratio	**30.2%**	**30.4%**

21 All amounts are in ISK millions Risk and Capital Management 2016

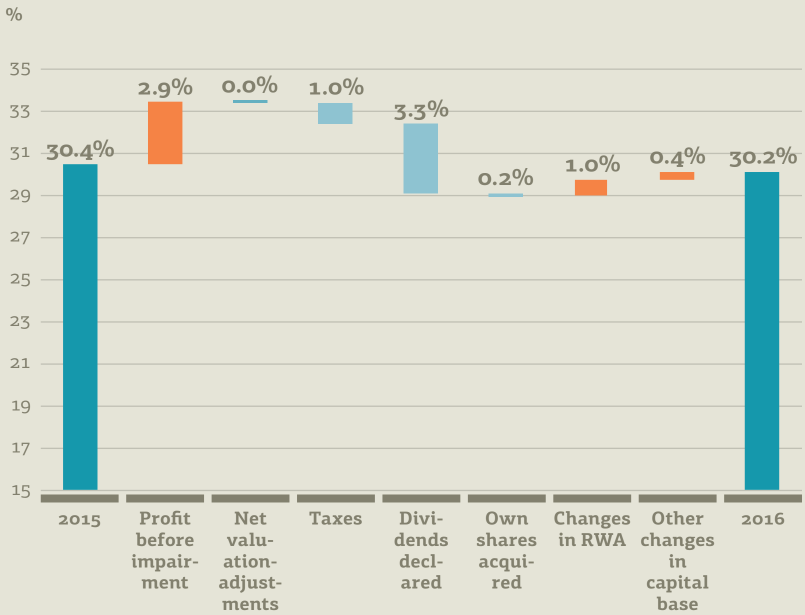
above 15%, which is the highest category for risk-adjusted capital ratio, over the next two years, despite extraordinary dividends. The RAC ratio as of end-June 2016 was 16.5%. S&P reports and announcements are accessible on the Landsbankinn website.

3.3 The capital base

The Group's total capital base at 31 December 2016 amounted to ISK 253 billion (2015: ISK 263 billion) and the total capital ratio, calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings, was 30.2% at 31 December 2016 (2015: 30.4%). Under the Act the minimum requirement for this ratio is 8%.

The Group's total capital ratio decreased by 0.2 percentage points in 2016. A dividend payment of ISK 1.2 pr. share or ISK 28.5 billion was made, approximately 80% of the previous year's earnings after tax. In addition, the Group purchased own shares in the amount of ISK 1.4 billion.

Change in capital ratio Figure 3-2



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 Chapter 10 of Act No. 161/2002.[1] The Group makes deductions in order to determine its core Tier 1 capital where applicable:

- Carrying amounts of intangible assets
- Deferred tax assets
- Capital holdings in other credit and financial institutions amounting to more than 10% of their capital

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 87% of total RWA.

The total amount of risk-weighted assets decreased by 3% in 2016.

1 See http://www.althingi.is/lagas/145b/2002161.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

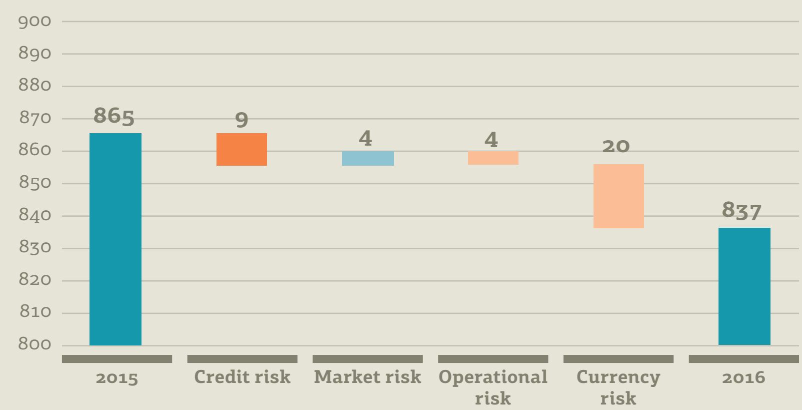
Table 3-4

Capital requirement and risk-weighted assets	31.12.2016		31.12.2015	
Credit risk breakdown	**Capital requirement**	**RWA**	**Capital requirement**	**RWA**
Central governments or central banks	422	5,277	532	6,650
Regional governments or local authorities	190	2,373	143	1,792
Institutions	584	7,299	642	8,024
Corporates	36,424	455,297	35,760	447,006
Retail	5,721	71,510	7,139	89,242
Secured by real estate property	9,778	122,230	9,931	124,136
Past due items	2,015	25,186	1,250	15,623
Items belonging to regulatory high-risk categories*	0	0	0	0
Short-term claims on institutions and corporate	0	0	0	0
Other items	3,140	39,255	3,620	45,247
Credit risk	**58,274**	**728,428**	**59,018**	**737,720**
Market risk breakdown				
Traded debt instruments	277	3,456	158	1,973
Equities	711	8,889	487	6,090
Market risk	**988**	**12,345**	**645**	**8,063**
Currency risk	**334**	**4,174**	**1,908**	**23,856**
Operational risk	**7,345**	**91,811**	**7,667**	**95,843**
Total capital requirement and RWA	**66,939**	**836,758**	**69,239**	**865,482**

Risk-weighted assets decreased by 3% from the previous year, mostly due to reduced currency risk.

Change in Risk Weighted Assets

Figure 3-3



3.5 Economic Capital

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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

Economic capital Table 3-5

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 includes EC for interest rate risk in the trading book and EC for equity price risk in the trading book. Market risk EC for interest rate risk in the trading book is calculated using the Stressed Value at Risk method according to the Basel II market risk framework, i.e. the EC equals the capital requirements for interest rate risk in the trading book of the internal models approach in the capital requirements directive. The model inputs for Stressed VaR are calibrated to historical data from the previous 5 years. Market risk EC for equity risk in the trading book is calculated using the following risk weights: • 290% for exchange traded equity exposures; • 370% for all other equity exposures, i.e. the EC for equity price risk in the trading book equals the capital requirements using the risk weights above.
Currency risk	EC for foreign exchange risk is calculated according to a modified Stressed Value at Risk model where the model inputs are calibrated to historical data from a period of significant stress relevant to the Groups' net FX position. The time horizon is one year.
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. The model calculates the EC for industry concentration using both the industry concentration in the loan portfolio and the industry concentration in Iceland[4] which is subtracted from the portfolio result to get the EC add-on for industry concentration.
Interest rate risk and inflation risk in the banking book	EC for interest rate risk and inflation risk in the banking book is equal to the loss in economic value corresponding to the 99.9th percentile of interest rate and inflation risk factor changes estimated by a Monte Carlo simulation model.
Operational risk	EC for Operational risk is calculated using the basic indicator approach, which means that it equals the Group's capital requirement.
Business risk	EC 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	EC for legal and regulatory risk is calculated by adding the potential loss of on-going disputes weighted by their status within the legal system.

4 The national sector distribution is published by the Central Bank of Iceland in their Financial Stability report.

Economic Capital	31.12.2016	31.12.2015	Difference
Credit risk - Loans to customers and credit institutions	53,835	64,239	-10,404
Credit risk - Other assets	6,769	7,719	-950
Market risk	1,396	1,531	-135
Currency risk	875	3,933	-3,058
Operational risk	7,345	7,667	-322
Single name concentration risk	4,784	6,109	-1,325
Industry concentration risk	2,600	4,665	-2,065
Interest rate risk and inflation risk in the banking book	15,889	10,575	5,314
Business risk	3,672	3,834	-162
Legal and regulatory risk	1,579	1,862	-283
Total	**98,744**	**112,134**	**-13,390**
EC/RWA	**11.8%**	**13.0%**	**-1.2%**

Table 3-6

on various levels to enable capital allocation, limit setting, pricing of products, risk adjusted performance measurement and value based management.

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

Table 3-5 summarizes how the Group calculates its EC for the risks included in the framework.

The Group made changes to its economic capital framework in 2016 as a new method was introduced for calculating economic capital due to industry concentration risk. The Group also made a few key changes which affected credit risk economic capital measurement; the Group implemented a special rating grade model for larger corporates, which is developed and based on more recent data than the previous model; and updated the LGD measurement which is calibrated according to internal historical loss data. Both of these implementations reduce to some extent the economic capital due to credit risk but other reduction is a result of decreased probability of default and overall improved quality of the loan portfolio.

Economic capital due to market risk decreased slightly in 2016 whereas economic capital held against currency risk is significantly lower at year-end compared to 2015 since the Group's net open currency positions were greatly reduced in 2016.

In Table 3-7 is a further breakdown for credit risk, probability of default by asset class as well

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Credit risk as at 31 December 2016	PD	LGD	EAD	EC
Financial institutions	0.2%	45.0%	23,040	584
Public entities	0.2%	45.0%	134,713	135
Retail*	3.5%	26.9%	383,686	12,989
Corporates	2.4%	38.4%	566,046	40,127
Total	**2.5%**	**35.4%**	**1,107,485**	**53,835**

Credit risk as at 31 December 2015	PD	LGD	EAD	EC
Financial institutions	0.1%	45.0%	22,229	646
Public entities	0.1%	45.0%	134,221	537
Retail*	4.2%	31.2%	380,548	14,960
Corporates	3.9%	42.1%	551,686	48,097
Total	**3.4%**	**38.7%**	**1,088,684**	**64,239**

*Retail exposures consist of small and medium-sized enterprises with total exposures under 75 m. ISK and meet the criteria of EU recommendation no. 2003/361/EC on SMEs and individuals.

Table 3-7

as loss given default, exposure at default and economic capital. Credit quality improved significantly in 2016, both in terms of lower Probability of Default and Loss Given Default.

3.6 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 Capital Requirements were implemented into Icelandic law in 2016. The phasing in of capital buffers is expected to be completed in the first quarter of 2017 for the three large Icelandic banks, including Landsbankinn. In the case of smaller financial firms, the phasing in is expected to be completed in January 2019. The framework does not apply to the Housing Financing Fund (HFF).

The capital buffers are:

1. Systemic Risk Buffer
2. Other Systemically Important Institution Buffer (O-SII Buffer)
3. Counter-cyclical Buffer
4. Capital Conservation Buffer

The Icelandic Financial Stability Council has recommended to the FME to impose the capital buffers according to the timeline in Table 3-8.

The Capital Buffers are expressed as a proportion of Risk Weighted

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	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Systemic Risk Buffer	3.00%	3.00%	3.00%	3.00%	3.00%
O-SII Buffer	2.00%	2.00%	2.00%	2.00%	2.00%
Counter-cyclical Buffer	0.00%	1.00%	1.00%	1.00%	1.25%
Capital Conservation Buffer	1.75%	2.50%	2.50%	2.50%	2.50%
Total	**6.75%**	**8.5%**	**8.5%**	**8.5%**	**8.75%**

Table 3-8

Assets. However, the Systemic risk buffer and the Counter-cyclical buffer only apply to domestic Risk Weighted Assets. Table 3-9 shows the proportional distribution of Risk-Weighted Assets in domestic risk and foreign risk.

Table 3-9	2016	2015
Domestic RWA	94%	90%
Foreign RWA	6%	10%
Total	100%	100%

3.7 Risk-Adjusted Return on Capital

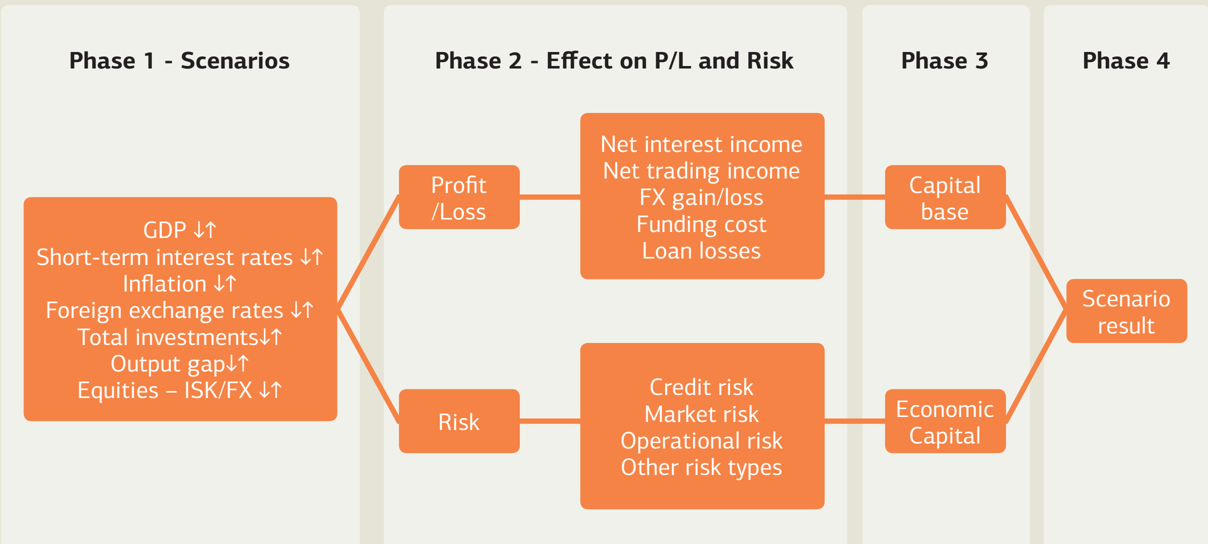
To analyse the Group's risk adjusted profit and profitability, i.e. including the cost of risk, the measures risk adjusted profit (RAP) and Risk-Adjusted Return on Capital RAROC, are reported monthly to the senior management. The objective of the measures is to measure shareholder-value creation and 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 enforced throughout the Group. By enforcing this measure, the Group can ensure that each of its departments are considering the cost of risk in the same way, and deciding how to structure and accept transactions within the same risk appetite guidelines.

3.8 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 testing process is divided into the following steps:

Figure 3-4



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

In 2016, the Group developed 4 scenarios, including a baseline 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 other material risks is also translated and calculated, resulting in changes to EC, i.e. the capital need.

In addition to the baseline scenario the Bank develops several scenarios which are to measure the effects of different events occurring simultaneously over a period of time. The results are compared with the Banks risk appetite. If the risk appetite constraints are breached, management actions are required within the scenario.

3.9 Leverage ratio

Capital Requirements Regulation (CRR) as part of Basel III framework requires banks to measure, report and monitor their leverage ratios. The ratio is defined as Tier 1 capital as a percentage of total leveraged exposure (see Table 3-10) and acts as a credible supplementary measure to the risk-based capital requirements.

A credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage, aimed at revealing hidden leverage on banks' balance sheets. The ratio reinforces the risk-based requirements with a simple, non-risk based "backstop" measure and is intended to restrict the build-up of leverage in the banking sector. The leverage ratio minimum requirement is 3%.

At 31.12.2016, the Group's leverage ratio was 20,3%, almost sevenfold the 3% minimum requirement.

Leverage ratio Table 3-10

	2016	**2015**
Tier 1 capital	248,597	262,519
Leverage exposure		
- On-balance sheet exposure (excluding derivatives)	1,110,879	1,118,371
- Derivatives instrument exposure	278	287
- Potential future exposure on derivatives	835	714
- Off-balance sheet exposure	113,267	103,456
- Regulatory adjustments to Tier 1 capital	-2,634	-2,012
Total leverage exposure	**1,222,625**	**1,220,816**
Leverage ratio	20.3%	21.5%

28 All amounts are in ISK millions Risk and Capital Management 2016

3.10 Summary of Capital Requirement and Economic Capital

At 31.12.2016 the Group estimated its EC at ISK 99 billion (11.8% of RWA) and the capital requirement to be ISK 67 billion under Pillar I.

The add-on for Pillar I risks is ISK 7 billion on credit risk and ISK 16 billion on market risk. Pillar II risks require ISK 27 billion of capital, the biggest risks being interest rate risk and inflation risk in the banking book.

Capital position as of 31.12.2016 Figure 3-5

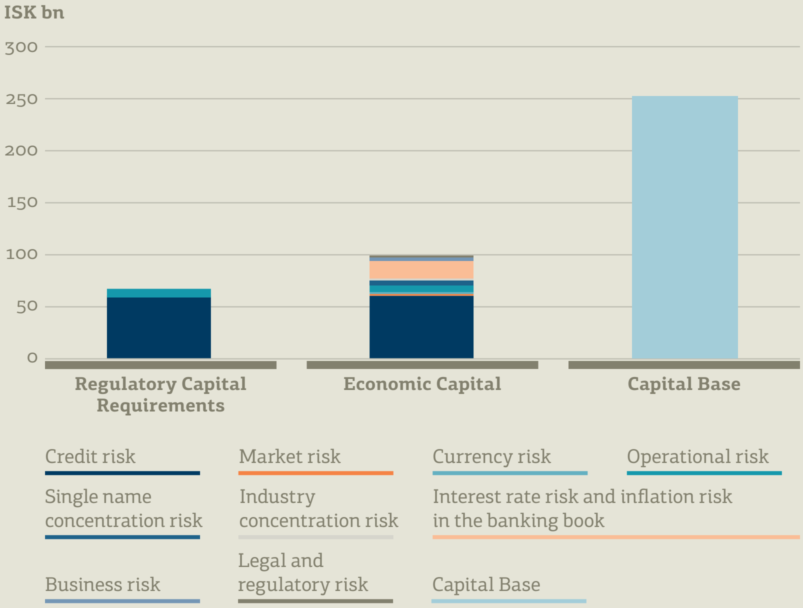


Table 3-11

Pillar 1 risks	RWA 2016	RWA 2015	CR 2016	CR 2015	EC 2016	EC 2015
Credit risk	728,428	737,720	58,274	59,018	60,604	71,958
Market risk	12,345	8,063	988	645	1,397	1,531
Currency risk	4,174	23,856	334	1,908	875	3,933
Operational risk	91,811	95,843	7,345	7,667	7,345	7,667
Total Pillar 1 risks	**836,758**	**865,482**	**66,940**	**69,239**	**70,221**	**85,089**

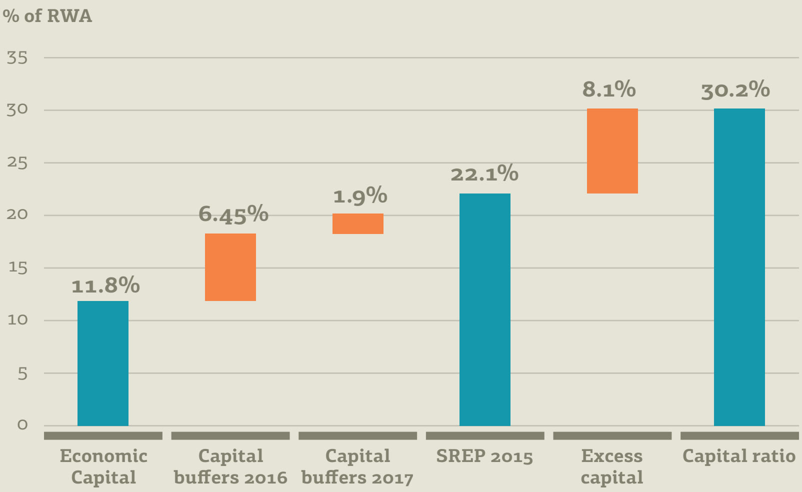
Pillar 2 risks		
Concentration risk	7,384	10,774
Interest rate risk and inflation risk in the banking book	15,889	10,575
Business risk	3,672	3,834
Legal- & regulatory risk	1,579	1,862
Total Pillar 2 risks	28,524	27,045
Total EC	98,744	112,135
Total capital base	252,806	252,806
EC/RWA	11.8%	13.0%

29 All amounts are in ISK millions Risk and Capital Management 2016

The latest SREP for Landsbankinn´s position of 31.12.2015 result can be viewed in Figure 3-6.

The Group's strategy is 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.

Economic Capital vs. Capital ratio Figure 3-6



3.11 Consolidation methods

Risk and Capital Management 2016 is based on the definition of the Landsbankinn Group used in the 2016 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.

Main subsidiaries held directly or indirectly as at 31.12.2016 are shown in Table 3-12.

Table 3-12

Company	Ownership interest	Activity
Eignarhaldsfélag Landsbankans ehf. (Iceland)	100%	Holding company
Landsbréf hf. (Iceland)	100%	Management company for mutual funds
Hömlur ehf. (Iceland)	100%	Holding company

30 All amounts are in ISK millions Risk and Capital Management 2016

Investments in associates as at 31.12.2016 are shown in Table 3-13.

Table 3-13

Associates	Ownership interest	31.12.2016	31.12.2015
Reiknistofa bankanna	39%	675	630
Auðkenni hf	26%	65	104
Greiðslumiðlun Íslands ehf.	48%	444	175
Total		**1,184**	**909**

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.

3.12 New regulations

The FME is currently in the process of implementing the Bank Recovery and Resolution Directive (BRRD) and determining the minimum requirement for own funds and eligible liabilities (MREL) for Icelandic banks. The directive is expected to be implemented into Icelandic law in 2017.

The BRRD in short is a three-phased preventive tool intended to minimise both the likelihood of a major crisis as well as, in the event of a crisis, the effects on the system and subsequently reducing risk to taxpayers and retail customers.

The three phases consist of:

1. Recovery plan
2. Early intervention plan
3. Resolution plan

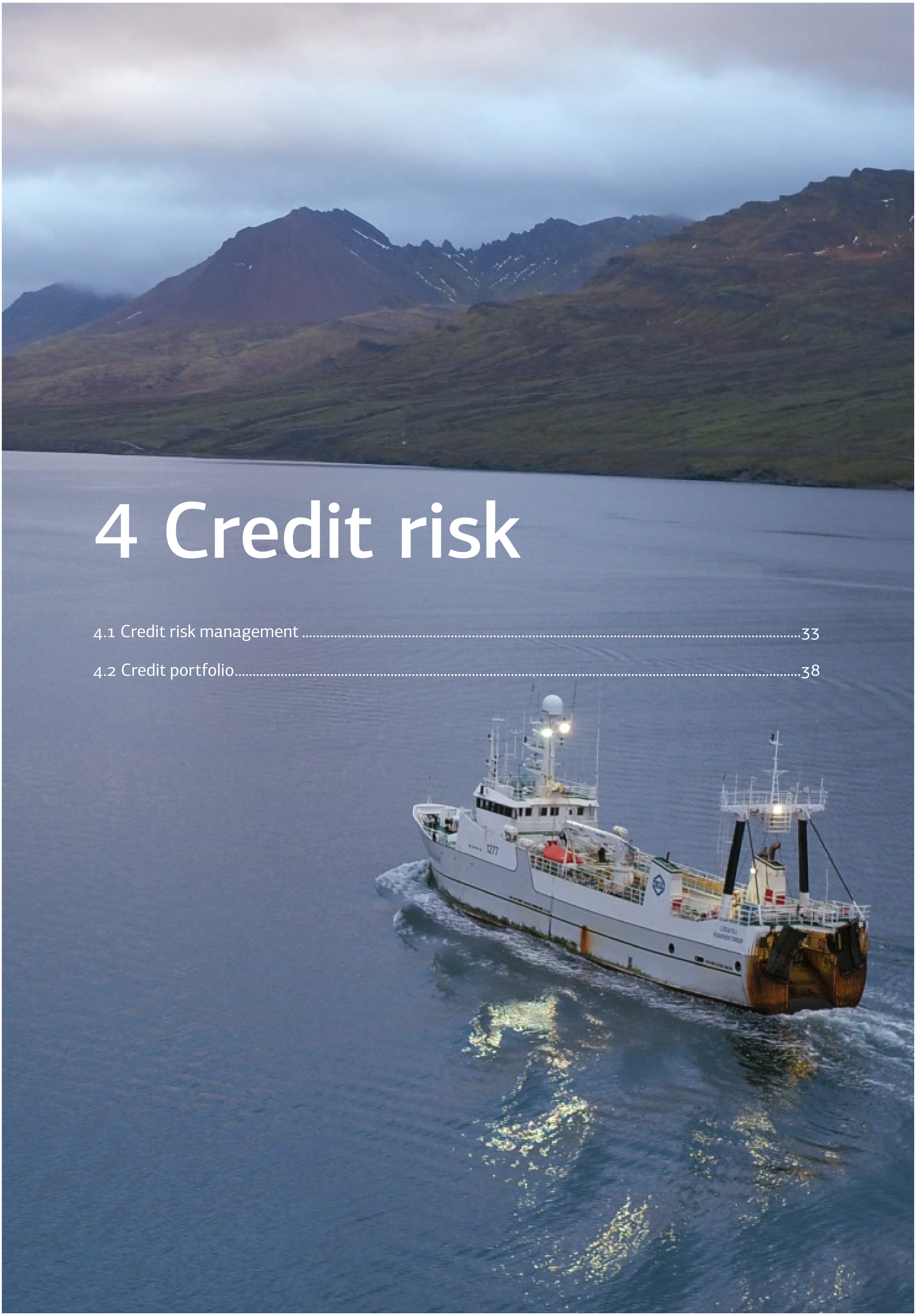
where Landsbankinn holds the responsibility for the first phase and the FME for phases two and three.

The Bank is currently working in cooperation with and under the supervision of the FME in developing a recovery plan.

The recovery plan shall as a minimum include the following:

1. Recovery plan indicators (quantitative and qualitative):
   - i. Capital, liquidity, profitability, and asset quality
   - ii. Market-based indicators and macroeconomic indicators
2. Three stress scenarios (´near-default´ situations):
   - i. System-wide event
   - ii. Idiosyncratic event
   - iii. Combination of system-wide and idiosyncratic events
3. Escalation and decision-making process in stressed conditions:
   - i. The points at which appropriate actions referred to in the plan may be taken
   - ii. Recovery options

31 All amounts are in ISK millions Risk and Capital Management 2016



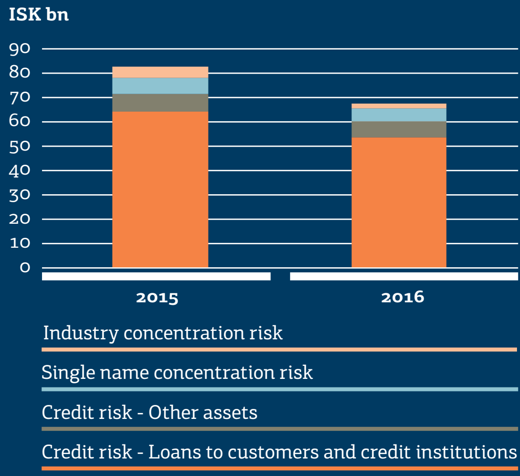
4 Credit risk

Credit risk

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

- Probability of default continued to decrease during 2016, reaching 2.5% at year-end 2016 compared to 3.4 at the end of 2015;
- Economic capital due to credit risk decreased significantly in 2016;
- A new method was introduced for calculating economic capital due to industry concentration risk;
- A special rating grade model for larger corporates was implemented.

Economic capital



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

At the end of 2016, 87% of the Group's risk-weighted assets were due to credit risk. On the same date, total loans and advances amounted to ISK 874 billion (2015: ISK 832 billion), with ISK 853 billion coming from lending activities (2015: ISK 812 billion) and ISK 20 billion from loans and advances to financial institutions (2015: ISK 21 billion).

Credit exposure from lending activities accounts for most of the Group's credit exposure and is the focus of this section.

Improving macroeconomic conditions and managerial efforts to moderate credit risk had positive effects on the credit risk profile in 2016. Overall credit quality improved, and impairment charges decreased. The credit risk profile is monitored and strengthened in accordance with the credit risk appetite, which encompasses credit quality (expected loss and its underlying risk parameters) and credit risk concentration (limits on single names and industries).

Regular risk reporting enables the ongoing monitoring of the Group's credit risk position relative to its risk appetite.

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

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 additional 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 estimated value of 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.

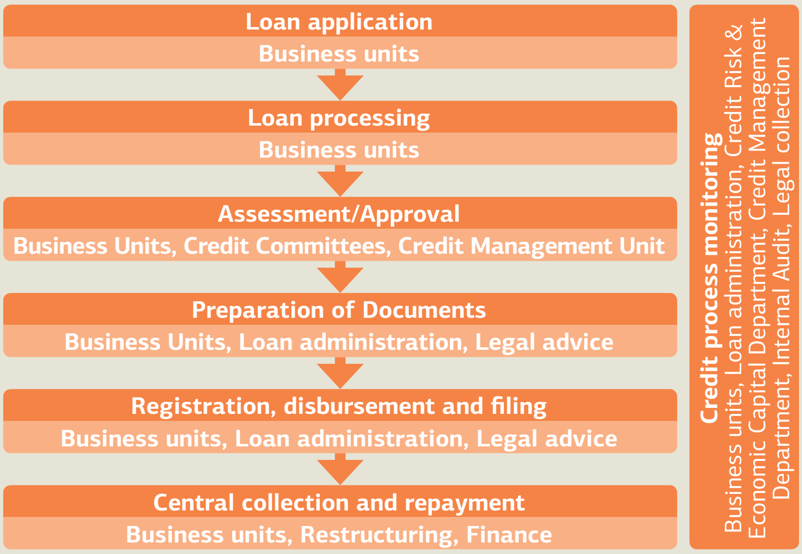


Figure 4-1

Rating category and PD band

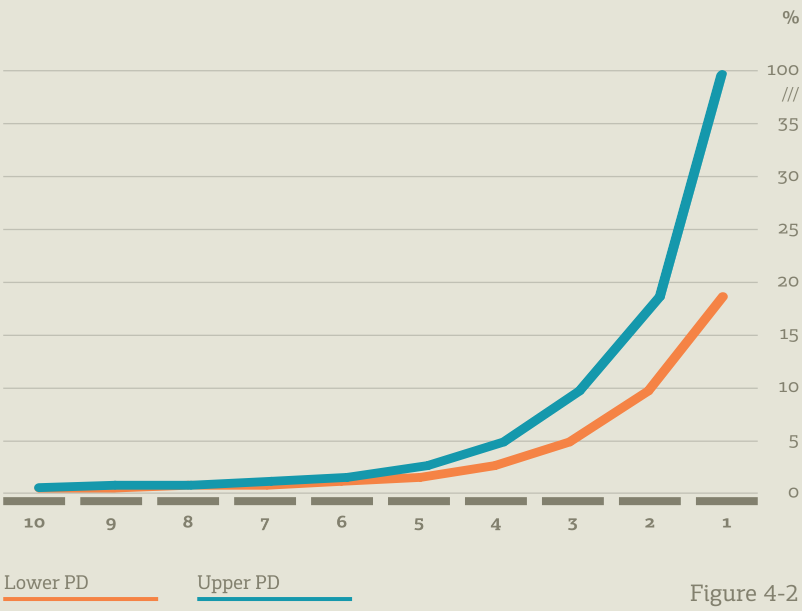


Figure 4-2

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, or 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.

The credit rating models' discriminatory power significantly exceeds the Basel II requirement of 0.5. Furthermore, the models are well calibrated, i.e. the probability of default for each rating grade is equal to the actual default rate with respect to reasonable error limits.

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%

Table 4-1

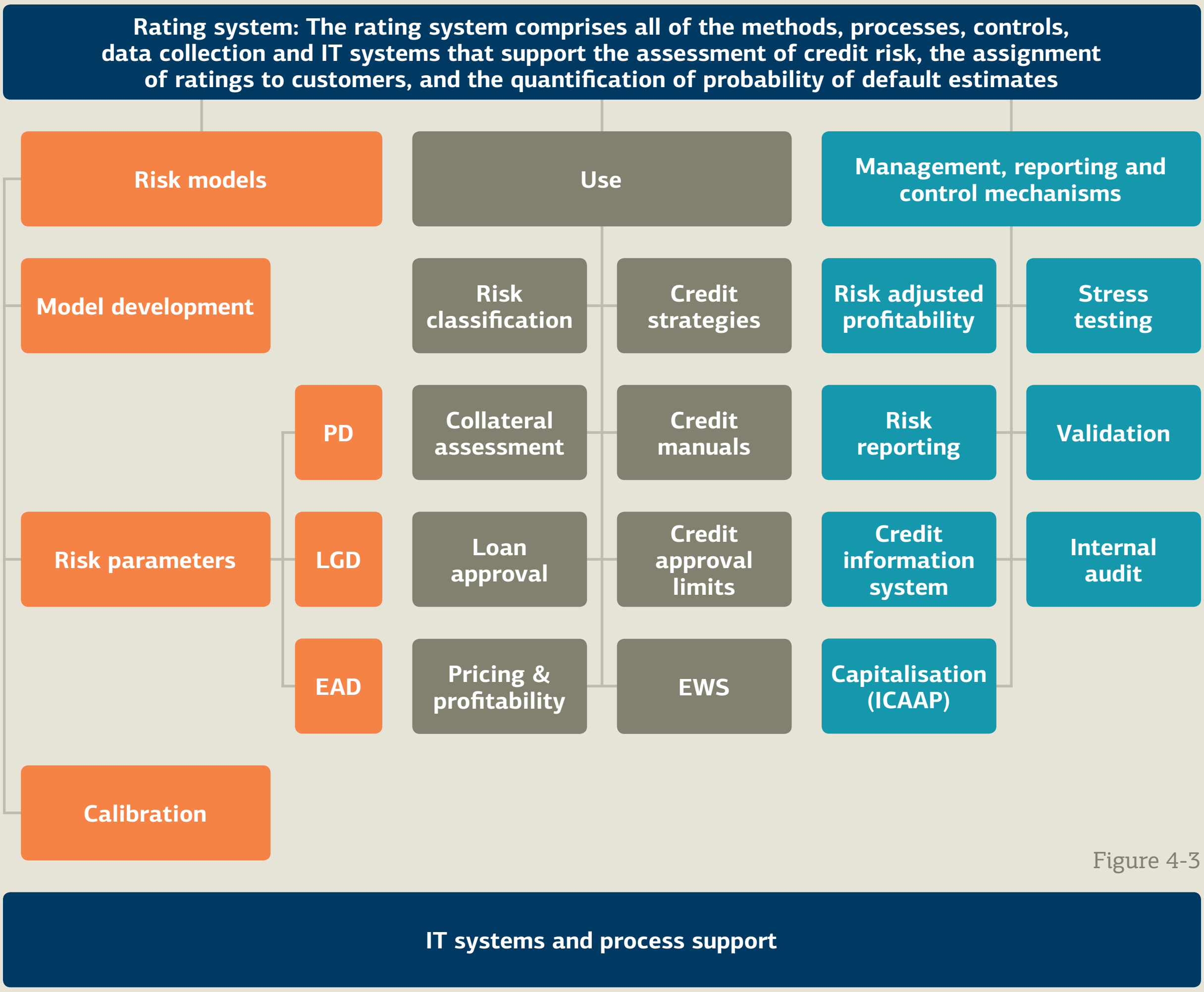


Figure 4-3

35 All amounts are in ISK millions Risk and Capital Management 2016

LGD is measured using an internal LGD model for the purpose of EC calculations. The internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the Basel model, was updated and calibrated to historical loss data in 2016.

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.

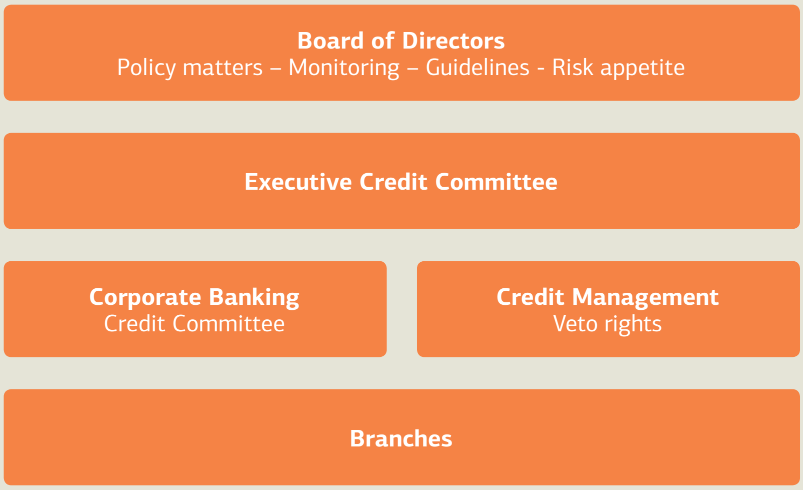


Figure 4-4

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 regulations and guidelines. The Bank's executives are responsible for the Bank'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 Bank.

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 some loan products, collateral is required by legislation, as in the mortgage finance market, or is standard market practice.

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

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the 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, 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 and similar general netting agreements with financial 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 usually 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: the customer is considered as performing without signs of repayment problems;
- Yellow: the customer shows indication of deteriorating financial strength, which could lead to financial difficulties;
- Orange: the customer is or has been in financial difficulties or default;
- Red: the customer is in default and in legal collection and/or restructuring.

The Credit Risk & Economic Capital Department within Risk Management is together with the business units responsible for the colour classification of customers.

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 Table 4-2 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.

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

Classification of the Group's financial assets

Table 4-2

As at 31 December 2016

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	30,662	-	-	-	30,662
Bonds and debt instruments	110,822	34,006	10,064	-	154,892
Equities and equity instruments	-	9,890	16,798	-	26,688
Derivatives instruments	-	278	-	-	278
Loans and advances to financial institutions	20,408	-	-	-	20,408
Loans and advances to customers	853,417	-	-	-	853,417
Other financial assets	6,528	-	-	-	6,528
Total	**1,021,837**	**44,174**	**26,862**	**0**	**1,092,873**

As at 31 December 2015

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	25,164	-	-	-	25,164
Bonds and debt instruments	125,211	69,279	9,194	-	203,684
Equities and equity instruments	-	11,385	17,807	-	29,192
Derivatives instruments	-	287	-	-	287
Loans and advances to financial institutions	20,791	-	-	-	20,791
Loans and advances to customers	811,549	-	-	-	811,549
Other financial assets	6,918	-	-	-	8,455
Total	**989,633**	**80,951**	**27,001**	**0**	**1,097,585**

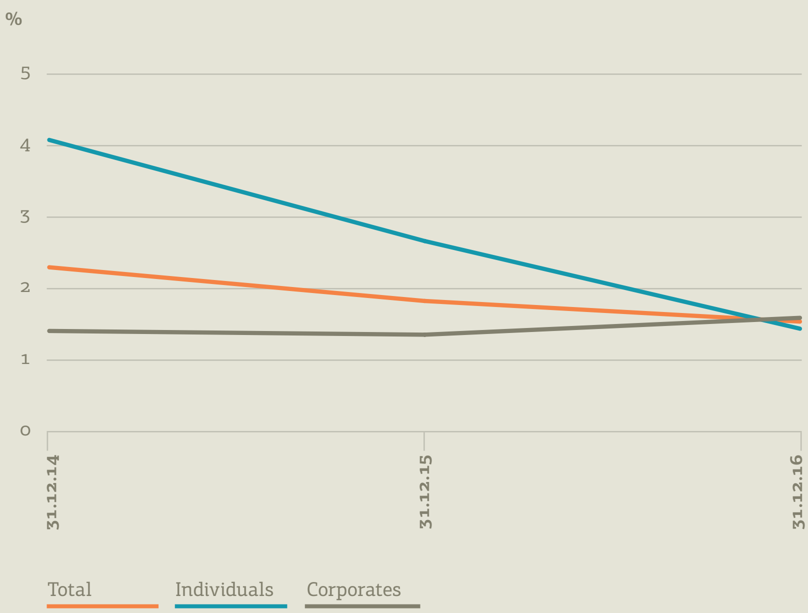
39 All amounts are in ISK millions Risk and Capital Management 2016

At the end of 2016, the total carrying amount was ISK 1,093 billion. Some ISK 853 billion are derived from lending activities, ISK 155 billion from bonds and debt instruments, and ISK 0.3 billion is derived from the carrying amount of derivatives.

4.2.1.1 Credit exposure from lending activities

At the end of 2016, the Group's total credit exposure from lending activities amounted to ISK 853 billion, against ISK 812 billion at the end of 2015. This represents an increase of 5%. In 2016, the Group experienced increased credit demand in the corporate area, mainly in the construction and real estate sector, which resulted in a significant increase in credit exposure. Credit exposure to individuals also grew substantially, mainly due to an increase in household mortgage lending. Together with continued increased lending activities the Group continued its focus on services to existing customers and refinancing of their loans as well as restructuring clients in financial distress.

90 days past due ratio Figure 4-5



The overall 90 days past due ratio decreased further during the year, but at a slower pace than in the previous years, which witnessed more rapid decrement. The decrement was driven by the individual part of the portfolio where credit exposure in over 90 days past due reduced significantly while a slight increase was experienced in the corporate portfolio.

Since the beginning of 2016 credit exposure in over 90 days past due decreased from ISK 15 billion to ISK 13 billion resulting in 1.5% 90 days past due ratio. The decrease is mainly due to improved market conditions and, in part, also due to the Group's continued emphasis on reacting before default occurs. Customers in default represented 4% of total loans in year end 2016.

Past due loans by industry

Table 4-3

As at 31 December 2016	Loans and advances to customers	Past due loans	Loans and advances to customers past due more than 90 days
Public entities	9,783	3.2%	2.7%
Individuals	320,691	5.1%	1.4%
Corporates	522,944	4.0%	1.6%
Construction and Real estate companies	188,327	4.5%	1.3%
Holding companies	40,490	2.9%	0.4%
Fisheries	123,627	0.6%	0.3%
Manufacturing	24,167	17.8%	9.3%
Agriculture	10,135	4.7%	0.1%
Information, technology and communication	19,220	0.7%	0.1%
Retail	42,235	3.1%	1.1%
Services	74,743	5.8%	3.2%
Other	1	0.4%	0.4%
Total loans	**853,417**	**4.4%**	**1.5%**
Financial institutions	20,408	0.0%	0.0%
Total loans including financial institutions	**873,825**	**4.3%**	**1.5%**

As at 31 December 2015	Loans and advances to customers	Past due loans	Loans and advances to customers past due more than 90 days
Public entities	8,738	3.4%	0.2%
Individuals	290,962	7.1%	2.7%
Corporates	511,849	2.7%	1.4%
Construction and Real estate companies	155,334	3.1%	1.9%
Holding companies	47,612	1.1%	0.4%
Fisheries	159,515	1.2%	0.9%
Manufacturing	27,205	2.2%	0.9%
Agriculture	10,118	7.5%	1.6%
Information, technology and communication	15,502	1.3%	1.0%
Retail	36,021	3.7%	1.9%
Services	60,469	6.2%	2.0%
Other	75	0.3%	0.0%
Total loans	**811,549**	**4.3%**	**1.8%**
Financial institutions	20,791	0.0%	0.0%
Total loans including financial institutions	**832,340**	**4.2%**	**1.8%**

41 All amounts are in ISK millions Risk and Capital Management 2016

Table 4-4 shows the different types of collateral held by the Group against credit exposures. Residential property is the principal collateral held against loans to individuals. Construction projects and commercial property are the main real estate collateral held against loans to corporates. The collateral value amounts are assigned to claim value amounts. The value of each individual collateral item held cannot exceed the maximum credit exposure of the corresponding individual claim. Changes in collateral value amounts between periods result either from changes in the underlying value of collateral or changes in the credit exposure.

Table 4-4

As at 31 December 2016			**Collateral types**			
Collateral value after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other***	**Total**
Financial institutions	-	-	-	-	-	-
Public entities	1,692	-	41	-	123	1,856
Individuals	270,629	221	584	3,262	14,024	288,720
Corporates	271,474	93,714	3,835	57,720	102,542	529,285
Fisheries	12,010	91,101	152	16,205	20,948	140,416
Construction and Real estate companies	179,155	104	1,088	2,680	7,185	190,212
Holding companies	5,528	-	870	26,572	507	33,477
Retail	16,161	11	562	1,066	23,981	41,781
Services	40,368	2,443	640	1,651	28,078	73,180
Information, technology and communication	603	-	121	5,738	7,375	13,837
Manufacturing	10,104	50	384	3,808	12,023	26,369
Agriculture	7,545	5	2	-	2,332	9,884
Other	-	-	16	-	113	129
Total	**543,795**	**93,935**	**4,460**	**60,982**	**116,689**	**819,861**

As at 31 December 2015**			**Collateral types**			
Collateral value after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other***	**Total**
Financial institutions	-	-	-	-	-	-
Public entities	1,523	-	53	-	99	1,675
Individuals	230,530	261	206	3,113	7,594	241,704
Corporates	223,265	113,111	1,291	66,522	97,316	501,505
Fisheries	15,038	112,314	90	14,778	29,222	171,442
Construction and real estate companies	139,612	78	356	761	3,865	144,672
Holding companies	4,994	12	27	39,962	1,726	46,721
Retail	14,436	11	156	1,696	25,675	41,974
Services	33,445	679	225	489	14,565	49,403
Information, technology & communica-tion	551	3	81	2,635	7,440	10,710
Manufacturing	8,509	11	350	6,201	12,374	27,445
Agriculture	6,608	3	6	-	2,449	9,066
Other	72	-	-	-	-	72
Total	**455,318**	**113,372**	**1,550**	**69,635**	**105,009**	**744,884**

* The item Other includes such collateral as financial claims, invoices, liquid assets, vehicles, machines, aircraft and inventories.
** The comparative amounts have been restated. Previously the collateral value amounts reflected the value of the individual collateral held regardless of the claim amount. Amounts in this table are of an informative nature only and do not have any effect on the amounts reported by the Group in the report.

42 All amounts are in ISK millions Risk and Capital Management 2016

At the same time, the portfolio quality improved during the year, resulting in an exposure weighted average probability of default of 2.5% (discussed further in section 5.2.3).

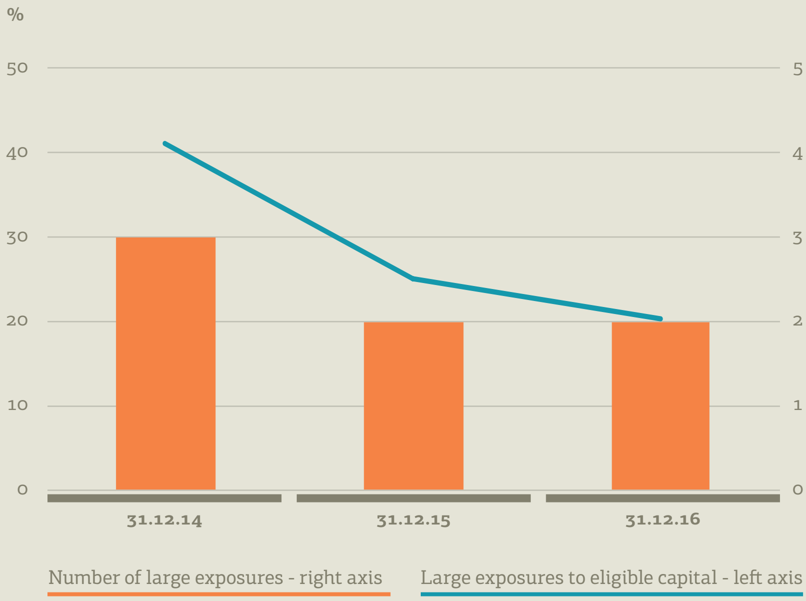
4.2.2 Risk concentration

Concentration risk includes (i) single name concentrations of large (connected) individual counterparties[5] 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.

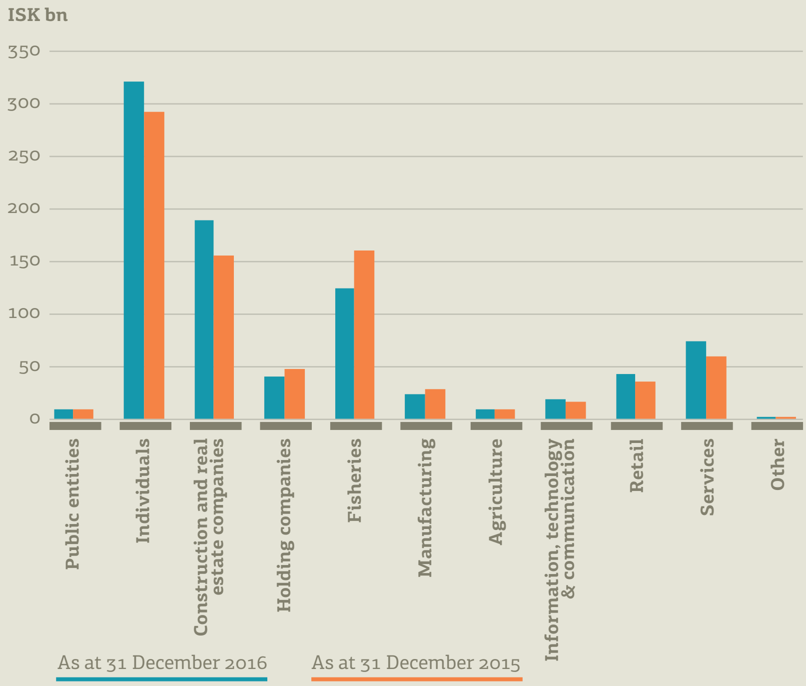
Limit management for single name and segment concentrations is set, monitored and managed through the Group's risk appetite and its limit management structure. The Group's risk profile for concentration risks is reported monthly to the Risk & Finance Committee and the Board of Directors according to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

Large exposures between 10% and 20% of the Group's eligible capital Figure 4-6



Industry segmentation of credit exposure Figure 4-7



5 Single name exposures are calculated according to the FME rules on large exposures (625/2013).

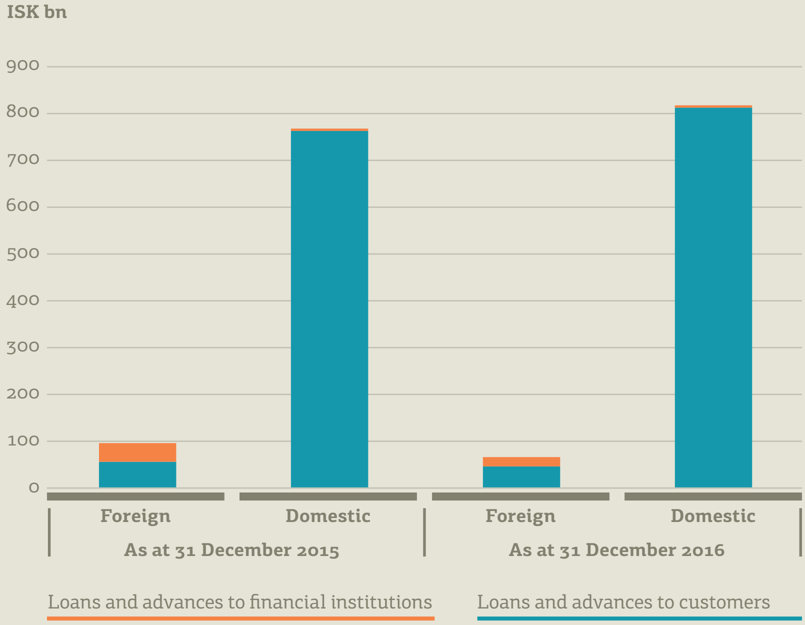
According to FME's Rules on Large Exposures Incurred by Financial Undertakings, No. 625/2013, exposures to a single customer or a group of related customers – after the deduction of particularly secure claims – may not exceed 25% of the capital base.

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 sets portfolio limits 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 2016, lending to personal customers represented 38% of the Group's total credit exposure (year-end 2015: 36%). Most of the demand from personal customers is for home financing and the Group's lending to retail customers is therefore mostly secured on real estate.

Loans and advances by geographical area Figure 4-8



The Group's credit exposures are primarily to Icelandic corporate customers. Construction & real estate companies and Fisheries companies represent the largest exposure to single industry sectors.

Customers domiciled in Iceland accounted for 94% of the Group's total credit exposure (2015: 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 2016, the average exposure-weighted PD was 2.5% (2015: 3.4%). 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 also 2.5% (2015: 3.5%).

The overall credit quality of the loan portfolio improved further in 2016, experiencing positive migration within nearly all industry sectors. Reasons for improvement include improved borrower operating performance as was seen in the Fisheries sector and the Construction and real estate sector which is the largest sector in the portfolio, debt restructurings, customers with poor credit rating leaving the Group and bankruptcy resolutions. Furthermore, new exposures to highly rated customers and improving market conditions in the construction and real estate sector, where considerable amount of companies were rated with poorer rating grades than the whole during

Probability of default (PD) Table 4-5

(%)		As at 31 December 2016	As at 31 December 2015
Financial institutions		0.2%	0.1%
Public entities		0.2%	0.2%
Individuals		3.2%	3.6%
Corporates		2,8%	4.4%
	Construction and real estate companies	3.3%	5.6%
	Holding companies	3.7%	4.3%
	Fisheries	1.7%	3.3%
	Manufacturing	2.1%	2.7%
	Agriculture	5.0%	4.4%
	Information, technology & communication	1.2%	1.6%
	Retail	1.9%	3.3%
	Services	3.4%	6.0%
	Other	4.5%	7.3%
Total		**2.5%**	**3.4%**

45 All amounts are in ISK millions Risk and Capital Management 2016

2015, have positive impact on the credit quality of the corporate portfolio. Improved credit quality in the individuals-portfolio contributes as well moderately to lower probability of default in the loan portfolio.

Figures 4-9 and 4-10 show the rating grade distribution of the loan portfolio broken down by individuals and corporates.

Figures 4.11 to 4.16 show the rating grade migration for corporates and individuals during 2016, based on existing customers at year-end 2015 and 2016.

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.

Figure 4-9

Rating grade distribution - Corporates

Figure 4-10

Rating grade distribution - Individuals

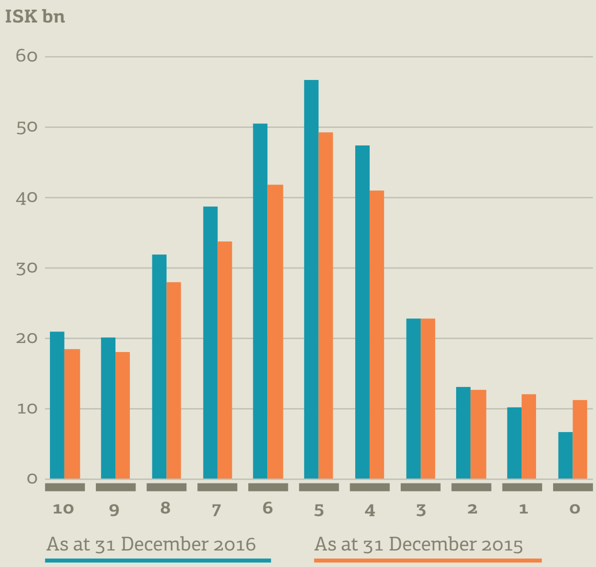


Figure 4-11

Rating migration of corporates in 2016

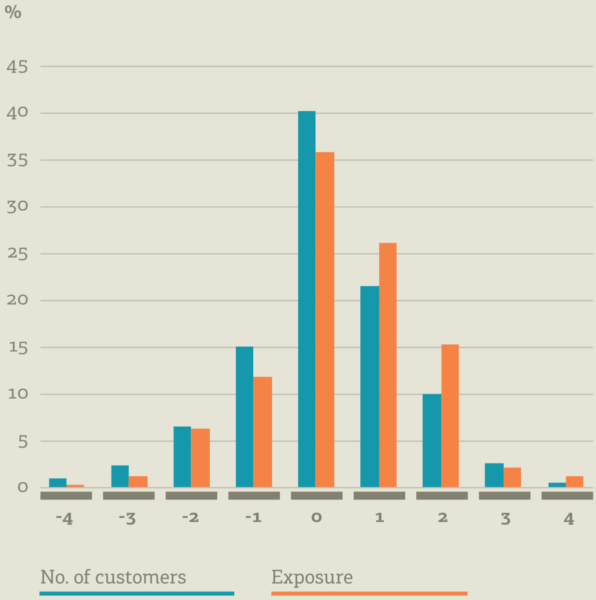


Figure 4-12

Rating migration of individuals in 2016

Rating migration of corporates in 2016 Carrying amount

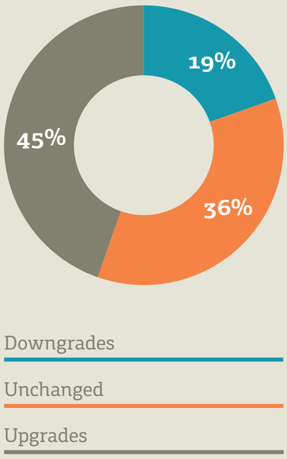


Figure 4-13

Rating migration of corporates in 2016 No. of customers

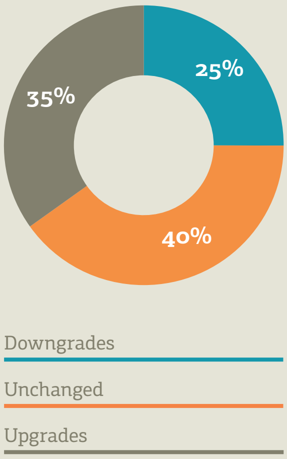


Figure 4-14

Rating migration of individuals in 2016 Carrying amount

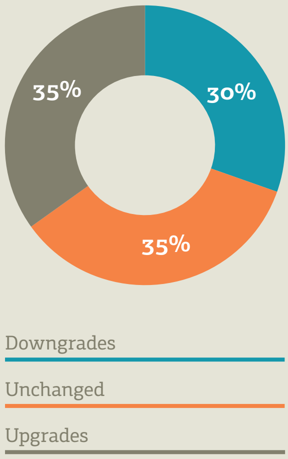


Figure 4-15

Rating migration of individuals in 2016 No. of customers

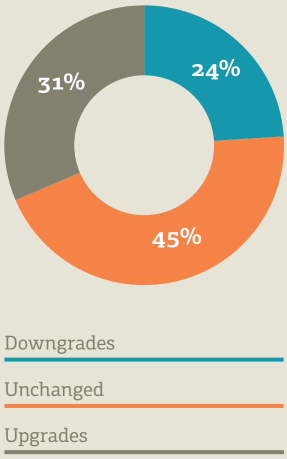


Figure 4-16

Out of the total exposure in the corporate portfolio, approximately 64% migrated up or down during 2016. This corresponds to 60% of counterparties. Upward migration was significantly higher than downward migration during 2016 with 45% of corporate exposure moving to higher rating grades.

In the individuals portfolio, approximately 65% migrated either up or down in 2016 with respect to exposure and 55% in terms of customer numbers.

On an overall level, migration had a positive impact on credit risk economic capital during 2016 and reduced credit risk economic capital for corporates.

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.

Overall, the percentage of upgrades was higher than the percentage of downgrades both in the corporate and individual segment. At the end of 2016, the average exposure-weighted PD for corporate customers was 2.8% (2015: 4.4%). For individuals, the average exposure-weighted PD was 3.2% (2015: 3.6%). As mentioned before positive developments in the fisheries, construction and real estate and individual sectors have the largest impact of decrease to the measurement value.

The default rate, which is weighted by the number of customers and not exposure, for corporate customers for 2016 was 3.8% as compared to the predicted 5.6%. No corporate customers in rating grades 8, 9, and 10, defaulted. The default rate of individuals for 2016 was 2.0% as compared to the predicted 2.6%, and the default rate of each rating grade was in coherence with what was expected, except for grade 8.

Figure 4-17

12 month default rate vs. probability of default band - Corporates 2016

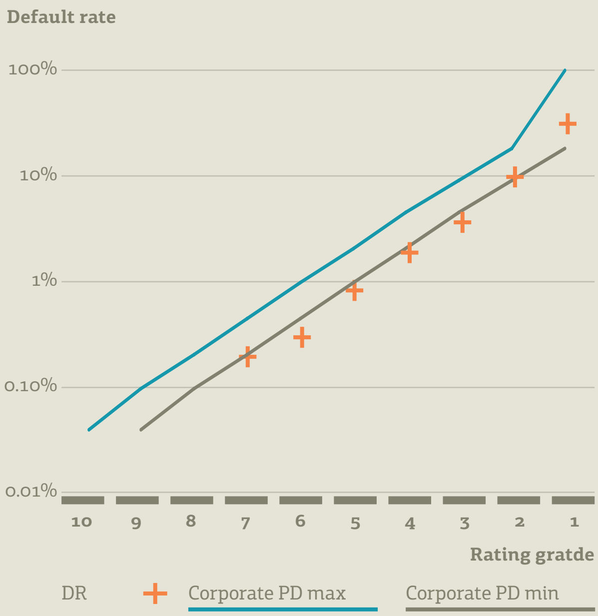
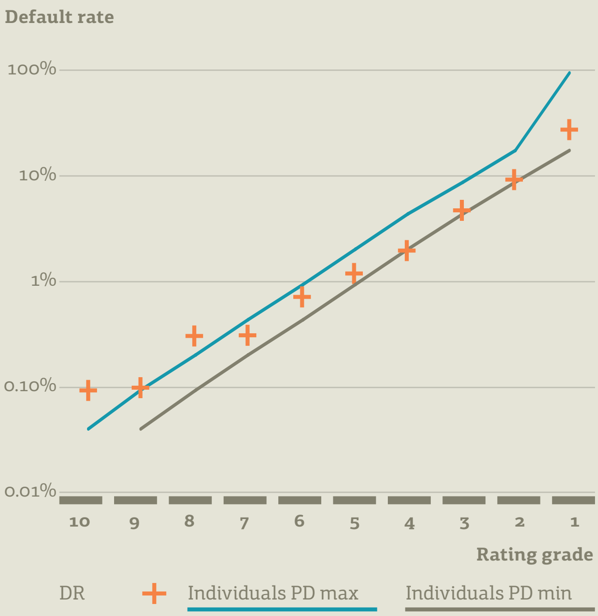


Figure 4-18

12 month default rate vs. probability of default band - Individuals 2016



4.2.4 Loan impairment

Total allowance for impairment totalled ISK 21 billion in 2016, as compared to ISK 34 billion in 2015. Allowances decreased in nearly all industry sectors during 2016 while the overall carrying amount increased. The decrease in allowances is mainly due to written-off loans, lower probability of default, improved collaterals and lower past due rate.

At the end of 2016, 93% of the portfolio consisted of claims that were neither past due nor impaired. The accumulated impairment amounted to ISK 5 billion.

Loan impairment Table 4-6

	Individual allowance	Collective allowance	Total
Open 1.1.2016	-28,200	-5,457	-33,657
New provisions	-4,676	-	-4,676
New provisions due to merger	-	-	0
Reversals	8,469	1,434	9,903
Provisions used to cover write-offs	7,479	-	7,479
Translation difference	-	-	0
Closing 31.12.2016	-16,928	-4,023	-20,951

	Individual allowance	Collective allowance	Total
Open 1.1.2015	-33,731	-7,716	-41,447
New provisions	-10,646	-	-10,645
New provisions due to merger	-2,863	-491	-3,354
Reversals	12,821	2,565	15,386
Provisions used to cover write-offs	6,570	-	6,570
Translation difference	-351	185	-166
Closing 31.12.2015	-28,200	-5,457	-33,657

49 All amounts are in ISK millions Risk and Capital Management 2016

Table 4-7

		1.1.-31.12.2016	
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-4,676	-	-4,676
Write-offs	-9,663	-	-9,663
Provisions used to cover write-offs	7,479	-	7,479
Reversals	9,903	-	9,903
Recoveries	2,207	-	2,207
Translation difference	-	-	0
Impairment loss for the period	5,250	-	5,253
Impairment of financial institutions and other	-	-452	-452
Net impairment loss for the period	5,253	-452	4,798

		1.1.-31.12.2015	
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-10,646	-645	-11,290
Write-offs	-7,601	-	-7,602
Provisions used to cover write-offs	6,570	-	6,570
Reversals	15,386	-	15,386
Recoveries	2,146	-	2,146
Translation difference	-166	-	-166
Impairment loss for the period	5,689	-645	5,044
Impairment of financial institutions and other	-	-	0
Net impairment loss for the period	5,689	-645	5,044

Impaired loans gross decreased by 40% during the year to reach ISK 34 billion. This corresponds to 3.9% of total loans excluding financial institutions (2015: 6.7%). The decrease in impaired loans was mainly related to improved economic conditions in general which benefit the household sector which saw a decrease of ISK 10 billion and decreases of ISK 5 billion were seen in the Construction & real estate companies sector, as well. Impaired loans gross in the in the fisheries sector also decreased by ISK 4 billion.

Impaired loans net, after allowances for individually assessed impaired loans, decreased to ISK 17 billion, corresponding to 2.0% of total loans. Allowances for individually assessed loans decreased by ISK 11 billion, to ISK 17 billion, and collectively assessed loans reduced to ISK 4 billion. The ratio of individual allowances for impaired loans remained 50% (2015: 50%) and total allowances in relation to impaired loans increased as well to 62% (2015: 59%).

IFRS 9 will replace the earlier accounting standard for financial instruments, IAS 39, when it becomes effective in 2018. IFRS 9 is a mandatory regulatory change which addresses the accounting for financial instruments and contains three main topics: classification and measurement of financial instruments, impairment of financial assets and hedge accounting. It creates significant challenges for banks due to its material financial impact and very high complexity of implementation. The effective date has been set at 1st January 2018. The Group is prepared for the regulatory change and has developed models and calculations which

50 All amounts are in ISK millions Risk and Capital Management 2016

Table 4-8 shows impaired loans split by industry sectors.

As at 31 December 2016	Gross carrying amount	Carrying amount	Impaired loans before allowances	Impaired loans in % of loans	Collective allowance	Individual allowance	Total provisioning ratio
Financial institutions	20,408	20,408	-	0.0%	-	-	-
Public entities	10,028	9,783	464	4.6%	-48	-198	52.9%
Individuals	326,844	320,691	9,229	2.8%	-1,500	- 4,654	66.7%
Corporates	537,495	522,943	24,356	4.5%	-2,476	-12,076	59.7%
Construction and Real estate companies	192,818	188,327	6,290	3.3%	- 1,205	-3,286	71.4%
Holding companies	41,148	40,490	644	1.6%	-251	-408	102.2%
Fisheries	124,094	123,627	779	0.6%	-145	-322	60.0%
Manufacturing	25,535	24,167	5,606	22.0%	-91	-1,277	24.4%
Agriculture	10,247	10,135	83	0.8%	-45	-68	135.4%
Information, technology and communication	19,383	19,220	77	0.4%	-115	-49	213.0%
Retail	43,436	42,235	1,806	4.2%	-224	-977	66.5%
Services	80,833	74,743	9,072	11.2%	-401	-5,690	67.1%
Other	1	1	-	0.0%	-0	-	-
Total	**894,776**	**873,825**	**34,050**	**3.8%**	**-4,024**	**- 16,927**	**61.5%**

As at 31 December 2015	Gross carrying amount	Carrying amount	Impaired loans before allowances	Impaired loans in % of loans	Collective allowance	Individual allowance	Total provisioning ratio
Financial institutions	20,791	20,791	-	0.0%	-	-	-
Public entities	8,969	8,738	462	5.1%	-8	-222	49.9%
Individuals	303,349	290,962	19,714	6.5%	-1,967	-10,420	62.8%
Corporates	532,888	511,849	36,624	6.9%	-3,482	-17,556	57.4%
Construction and Real estate companies	162,090	155,334	11,382	7.0%	-1,431	-5,326	59.4%
Holding companies	48,649	47,612	978	2.0%	-343	-694	106.1%
Fisheries	162,160	159,515	4,615	2.8%	-224	-2,420	57.3%
Manufacturing	29,384	27,205	7,333	25.0%	-231	-1,949	29.7%
Agriculture	10,440	10,118	808	7.7%	-71	-251	39.8%
Information, technology and communication	15,787	15,502	261	1.7%	-137	-148	109.3%
Retail	38,069	36,021	2,871	7.5%	-325	-1,723	71.4%
Services	66,233	60,469	8,376	12.6%	-719	-5,045	68.8%
Other	76	75	-	0.0%	-1	-	-
Total	**865,997**	**832,340**	**56,800**	**6.6%**	**-5,458**	**-28,198**	**59.3%**

51 All amounts are in ISK millions Risk and Capital Management 2016

should be fully compliant with the IFRS 9 accounting requirements and related prudential regulation. A parallel run is scheduled within the Group in Q1 2017 and throughout 2017. For further details on the IFRS 9 implementation, see the Group's 2016 Consolidated Financial Statements, note 93.41.

4.2.5 Forbearance

Forborne exposures are debt contracts in respect of which forbearance measures have been extended. Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments. A concession is either a modification of the previous terms and conditions of a contract the debtor is considered unable to comply with due to its financial difficulties; or a refinancing of a troubled debt contract, that would not have been granted had the debtor not been in financial difficulties. A concession may entail a loss for the Bank.

Forbearance plans must comply with the Group's Credit Policy. They can be used as an instrument to temporarily assist a customer who experiences short term financial difficulties if there is likely that the customer will be able to meet obligations again and are used for minimising the loss for the Bank.

The Group implemented the European Banking Authority's (the EBA's) definition of loans subject to forbearance measures at the end of 2016. Table 4.9 is based on the EBA's definition, which states that a minimum two-year probation period must pass from the date forborne exposures are considered to be performing again. Such exposures are included in the Under Probation category. Exposures with forbearance measures are divided into performing and non-performing loans.

4.2.6 Credit risk analysis by industry sectors

This section describes developments in credit quality in selected segments of the Group's lending portfolio in the year 2016.

Exposures subject to forbearance measures Table 4-9

	31.12.2016		31.12.2015	
(ISK millions)	Performing	Non-performing	Performing	Non-performing
Modification	11,718	15,592	37,941	21,769
Refinancing	16,546	861	3,279	3,374
Under probation	4,612	0	8,517	0
Total	**32,877**	**16,452**	**49,737**	**25,143**

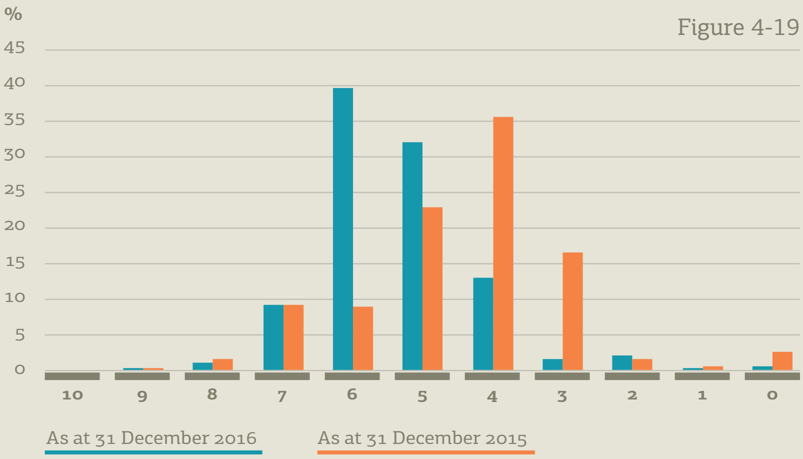
4.2.6.1 Fisheries

The fisheries and seafood industry experienced difficulties last year due mostly to the much stronger ISK. The ISK exchange rate index increased by 11.9% in 2015 which is the highest relative increase since the Central Bank began recording the exchange rate index in 1991. The closest the ISK has come to this appreciation rate before was in 2005, when it gained 11.2%.

Export figures by country from the fisheries and seafood industry show that the ISK exchange rate strengthened more than the index, or by 13.8%. A stronger ISK hit the fisheries and seafood industry harder than the travel industry - the ISK only gained 11.3% against the buyers of Icelandic travel services. That being said, the Icelandic fisheries and seafood industry pays a good deal of its salary costs in foreign currency and is financed nearly entirely on international credit markets. In addition, world oil prices remain fairly low, as compared with previous years. Oil prices sank to a temporary low around the turn of the year 2015/2016 and have risen since. In 2016, the average price was USD 43.4 per barrel, which is 17% lower than the average price in 2015.

Loans and advances to fisheries sector per rating grade

Figure 4-19



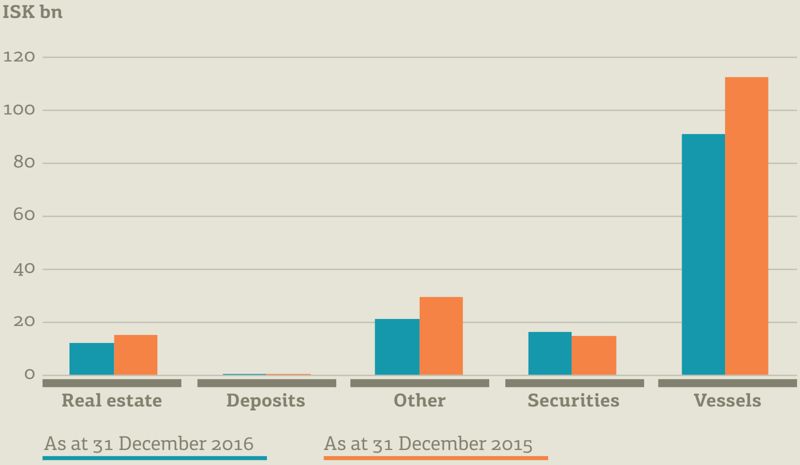
The fact that the seafood product purchase price index in foreign currency was a 4.4% higher in 2016 than in 2015 counterbalanced appreciation of the ISK somewhat. Prices changed but little in the beginning of 2016. They began rising shortly after mid-year and were higher in the last few months of the year than previously recorded. Statistics Iceland has maintained the seafood product purchase price index since 2006. The price for demersal fish was 3.7% higher last year than in 2015 and the price of pelagics 12% higher. World prices for meat for human consumption have fallen considerably over the past two years. Historically, the price of Icelandic demersal fish has developed in line with meat prices, though lagging behind by several months. This has not been the case in the past two years as Icelandic demersal prices have increased considerably.

The outlook for this year's capelin season is dim, with the Marine Research Institute recommending a blanket ban on fishing capelin. A final effort to locate fishable amounts of capelin has yet to be made so some hope still remains. In 2009, only 14,000 tonnes of capelin were caught - this season could turn out even worse.

Loans and advances to customers in the fisheries industry amounted to ISK 124 billion as at 31 December 2016 (2015: ISK 160 billion). Credit exposure to the sector represented 15% of the Group’s loan portfolio.

Fisheries - Collateral types

Figure 4-20



Impaired exposure in the sector amounts to ISK 0.8 billion and the amount of not individually impaired loans is ISK 123 billion. The collective allowance is ISK 0.1 billion.

At the end of 2016, the loans and advances to fisheries customers in rating grades 4 and higher represented 95% of the total compared to 79% in 2015.

The sector's average exposure-weighted PD was 1.7% as at 31 December 2016 and decreased significantly during the year. The decrease is to some extent due to general positive rating migration. 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 65% of the total sector's collateral.

4.2.6.2 Construction and real estate companies

In 2016 construction and real estate companies witnessed continued favourable developments in respective market conditions, both in terms of housing prices and hotel operations.

Real estate prices in the capital area increased by 9.4% between 2014 and 2015. Price developments have continued to increase significantly, with a total increase in housing prices reaching 15% in 2016.

Most indicators suggest that real estate prices will continue to rise. For one thing, it appears clear that housing supply, especially the supply of new housing, fails to meet current demand which puts an upward pressure on prices. An additional influencing factor is that there has recently been increased competition on the housing loan market. The pension funds have become more active in the market. They have lowered interest in line with lower yields on the bond market. Access to credit has become easier and this again puts upward pressure on prices.

Significant wage increases and positive developments in purchasing power contribute to pressure in the housing market. Household finances have improved greatly recently. Debt has decreased, equity position has improved and LTV ratios are lower than previously. Households have more capacity to service higher debt under the current expansion conditions. All of these factors put upwards pressure on real estate prices going forward. There are other contributing factors, such as the need to import labour in coming years which will raise the demand for housing. Continued growth in tourist numbers will likely increase rental of housing to that group, reducing supply even further.

Transactions in the housing market are increasing at a slower pace than before and in lieu of

Table 4-10

Fisheries ISK m	As at 31 December 2016	As at 31 December 2015
Gross carrying amount	124,094	162,160
Performing - Individual allowance	-71	-901
Non-performing - Individual allowance	-250	-1,519
Collective allowance	-145	-224
Carrying amount	123,627	159,515

new apartments for rent, this will only contribute to price hikes. Analysts agree that too few new apartments have been constructed in the past couple of years and numerous apartments have been rented out to tourists. Real estate companies have purchased a significant number of apartments to rent. As a result, the supply on the traditional sale and purchase market has dwindled considerably.

The on-going increase in real estate prices has been more or less the only factor driving inflation in Iceland over an extended period. In the last couple of years, the housing component has accounted for the lion's share of inflation and, less housing price increases, Iceland would currently be experiencing deflation. Strengthening of the ISK and lower price levels on import markets serve as counterweights.

Economic developments have been very positive in recent years. Growth has been robust and the same can be said for private consumption and the purchasing power of disposable income. As a rule, real estate prices follow the development of other economic indicators and as a result, continuing trend in housing prices is expected.

Substantial investment in hotel operations is in the pipeline, and the Group has been involved to some extent in its funding. In the capital region, which is by far the largest market, the Bank has a 20% market share of long-term funding of hotels (percentage of hotel rooms). The decrease in the market share of long-term hotel funding is due to the strong growth of real estate companies and real estate funds of securities firms.

The Group provides project financing for around 19% of the total number of hotel rooms under construction or in preparation.

Loans and advances to construction and real estate companies amounted to ISK 188 billion as at 31 December 2016 (2015: ISK 155 billion). Credit exposure to the sector represented 20% of the Group's loan portfolio. 8% of total credit exposure to construction and real estate companies is to hotel operations, 87% of which is to real estate companies and 13% to construction companies. 46% of the total loans to the sector is due to residential property, 57% of which is to construction companies. Loans due to commercial buildings, other than for hotel operations, represent 35% of credit exposure to the sector, 78% of which is to real estate companies.

Construction & real estate companies split by operations

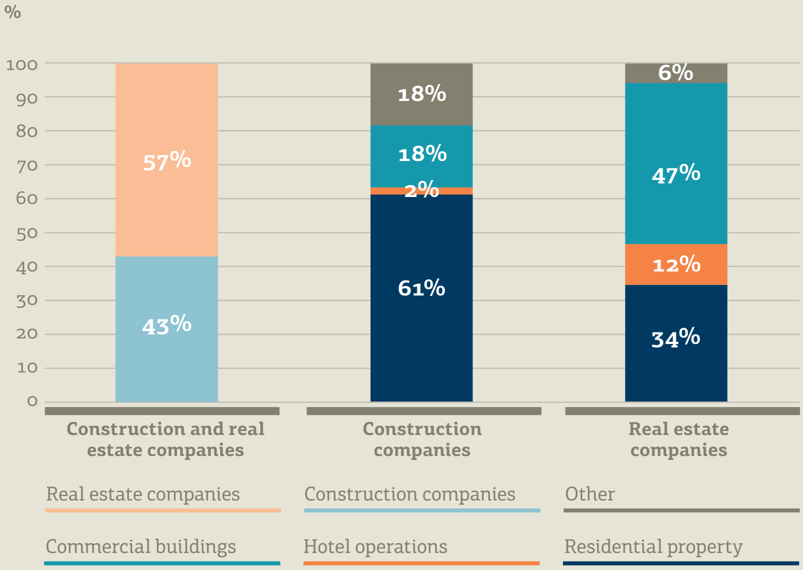


Figure 4-21

Table 4-11

Construction and real estate companies	As at 31 December 2016	As at 31 December 2015
Gross carrying amount	192,818	162,090
Performing - Individual allowance	-1,346	-2,618
Non-performing - Individual allowance	-1,940	-2,708
Collective allowance	-1,205	-1,431
Carrying amount	188,327	155,334

55 All amounts are in ISK millions Risk and Capital Management 2016

Impaired exposure in the sector amounts to ISK 6 billion and the amount of not individually impaired loans is ISK 187 billion. The collective allowance is ISK 1.2 billion.

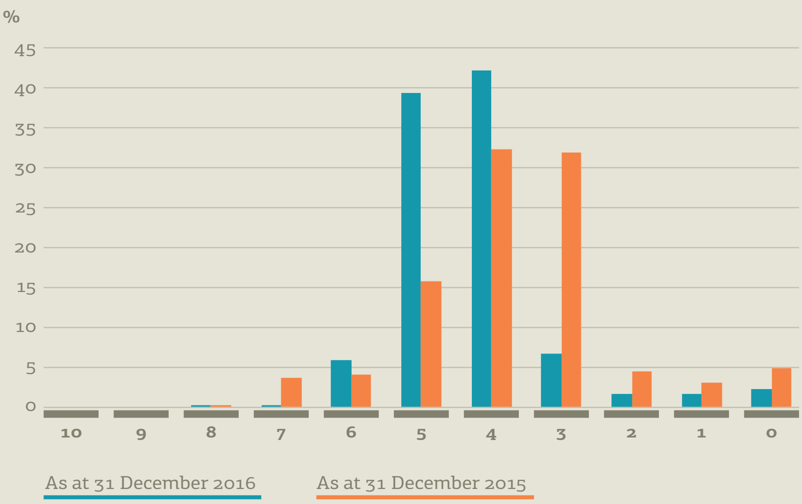
Positive developments and improvement in the sector's credit quality can both be seen in a significant migration from the lowest rating grades, 1, 2, and 3 to higher ones as well as increased exposure in rating grades 5 and 6.

The sector's average exposure-weighted PD was 3.3% as at 31 December 2016 and improved during the year.

Credit extended by the Group to construction and real estate companies is well secured, mainly on real estate or 94% of the total sector's collateral.

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

Figure 4-22



Construction and real estate sector - Collateral types

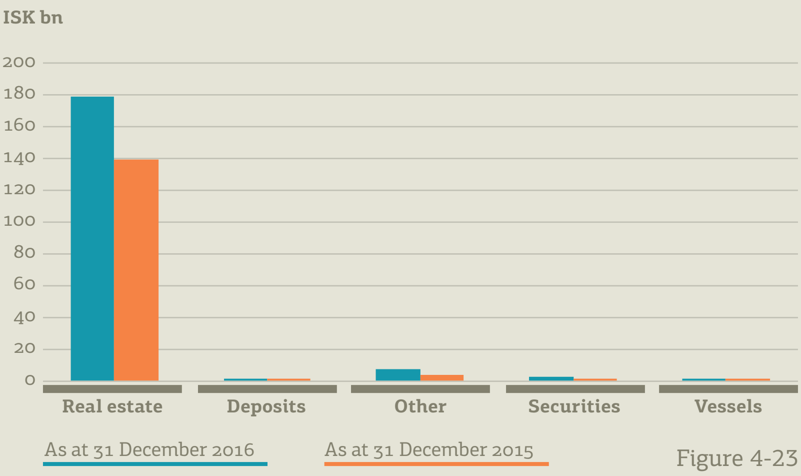


Figure 4-23

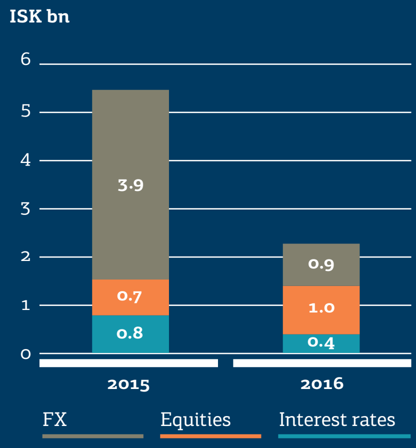
5 Market risk

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, inflation, foreign exchange rates and equity prices.

- Total market risk in the Bank's trading book together with foreign exchange risk, as measured by economic capital, was ISK 2.3 billion at year-end 2016 compared to ISK 5.5 billion at the end of 2015;
- Total market risk decreased slighlty in 2016 but foreign exchange risk decresead significantly due to lower net currency position;
- The majority of the Group's exposures that entail market risk consists of equities and equity derivatives, bonds and fixed income products and open currency positions.

Economic capital



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 Group in accordance with the Group's three lines of defence principle.

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, proprietary position-taking as part of asset and liability management and funding transactions, managed by Treasury. Treasury is also responsible for daily liquidity management.

Market risk mitigation is reflected in the Group's overall risk appetite by identifying the target level and strategy of market risk factors. Other market risk mitigation plans are made on a case-by-case basis involving hedging strategies and risk reduction through diversification.

The Group continued to strengthen market risk controls and processes relating to market risk management in 2016.

Total net exposure subject to market risk

Table 5-1

	Net position at year-end	
	2016	2015
Equities and equity instruments in the trading book	4,420	2,144
Bonds and debt instruments in the trading book	8,569	34,997
Net FX position	3,480	23,795

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 Group 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, pursuant to the Group's activites

Market risk arising from trading and non-trading activities is measured, monitored and reported on a daily, weekly and monthly basis. The market risk limits set by the Risk & Finance Committee are monitored by Market Risk and all exceptions and breaches of limits are reported on a regular basis to the Risk & Finance Committee and other relevant parties as necessary. Furthermore, summarized reports highlighting market risk, risk appetite measurements and any concerns regarding market risk are sent to the Board of Directors on a regular basis.

5.3 Market risk exposure

Table 5 1 summarizes the Group's exposure to market risk at year-end 2016:

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

Total market risk (RWA measure) at year-end

Table 5-2

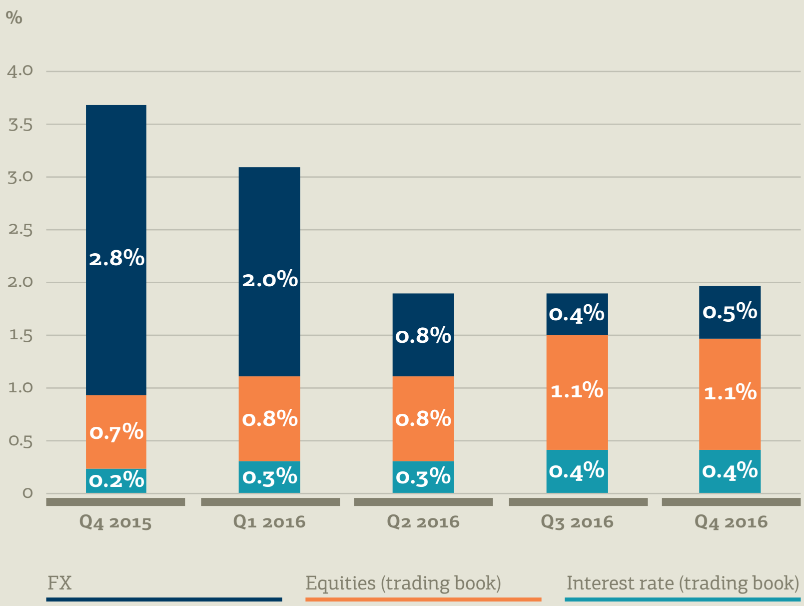
	2016		2015	
	RWA	Ratio to RWA	RWA	Ratio to RWA
Equity price risk in the trading book	8,889	1.1%	6,090	0.7%
Interest rate risk in the trading book	3,456	0.4%	1,973	0.2%
Foreign exchange risk	4,174	0.5%	23,856	2.8%
Total	**16,519**	**2.0%**	**31,919**	**3.7%**

59 All amounts are in ISK millions Risk and Capital Management 2016

5.3.1 Banking book exposures

The banking book exposures of the Group pertaining to market risk are exposures in equities and bonds. The vast majority of the equities are unlisted and are, for the most part, legacy positions obtained through corporate restructuring or were acquired when the Bank was established in 2008. The bond holdings in the banking book are comprised of strategic investments and liquidity management instruments. Capital reserved against these exposures is classified as credit risk.

Total market risk (Ratio to total RWA) Figure 5-1



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 Value-at-Risk (VaR), daily profits and losses, delta positions and net positions across different attributes such as the currency and issuer. These risk measurements are supplemented by specific stress tests and scenario analysis as appropriate, taking the Bank's balance sheet mixture and operating environment into account.

Total market risk, measured as ratio of risk-weighted assets to total RWA, is considered modest, amounting to 2.0% at year-end 2016 (compared to 3.7% at year-end 2015), well within the Group's market risk appetite.

5.4.1 Equity price risk in the trading book

Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments. The Group's equity trading portfolio is comprised of proprietary trading positions and exposures due to market making, including equity derivatives and hedging positions. All equity-based derivative contracts are usually fully hedged with regards to market risk and are subject to various limit requirements.

5.4.2 Interest rate risk in the trading book

Interest rate risk is the risk of loss arising from the impact of adverse changes in market interest rates. The Group's trading portfolios contain exposures due to market making and proprietary trading, highly concentrated on government-guaranteed bills/bonds as well as covered bonds and fixed income derivatives. As with equity-based derivatives, all fixed income derivatie contracts are usually fully hedged with regards to market risk and are subject to strict limit requirements.

5.4.3 Interest rate risk in the banking book

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

Assets and liabilities in the banking book by interest rate fixing period

Table 5-3

	Net position at year-end 2016				
	Up to 3 M	3-12 M	1-5 Y	Over 5 Y	Total
Total assets	813,323	104,901	88,204	59,757	1,066,185
Total liabilities	-691,128	-19,198	-111,376	-21,383	-843,085
Net on-balance sheet position	122,195	85,703	-23,172	38,374	223,100
Net off-balance sheet position	153	-153	0	0	0
Total interest repricing gap	**122,348**	**85,550**	**-23,172**	**38,374**	**223,100**

	Net position at year-end 2015				
	Up to 3 M	3-12 M	1-5 Y	Over 5 Y	Total
Total assets	802,657	114,138	100,448	51,150	1,068,393
Total liabilities	-739,720	-28,643	-54,289	-11,880	-834,532
Net on-balance sheet position	62,937	85,495	46,159	39,270	233,861
Net off-balance sheet position	359	-176	-183	0	0
Total interest repricing gap	**63,296**	**85,319**	**45,976**	**39,270**	**233,861**

mismatch of assets and liabilities. Net positions of assets and liabilities in the banking book by interest rate fixing period, at year-end 2016 and 2015, are shown in Table 5 3:

The Group employs a monthly stress test of the interest rate risk in the banking book by measuring the impact of shifting the relevant interest rates for every currency on the fair value of all interest-rate sensitive assets and liabilities in the banking book. Table 5 4 summarizes the sensitivity of the Group's banking book fair value resulting from a flat 100 bp upward shift of all yield curves at year-end:

61 All amounts are in ISK millions Risk and Capital Management 2016

Interest rate risk (fair value sensitivity) in the banking book at year-end Table 5-4

	2016		2015	
	+100 bps	-100 bps	+100 bps	-100 bps
ISK non-indexed	102	-112	-343	351
ISK indexed	-5,235	6,189	-6,060	7,110
EUR	2,771	-2,881	872	-901
USD	-146	147	-523	541
GBP	1	-1	-9	9
JPY	-6	6	-7	7
CHF	-6	6	-8	8
Other	367	-380	-2	2
Total	**-2,152**	**2,974**	**-6,080**	**7,127**

5.4.4 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 2016 can be seen in Table 5 5:

5.4.5 Other market risk

Other market risk within the Group 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 Group to inflation risk. The Group's total CPI indexation balance at year-end 2016 amounted to ISK 207 billion as compared to ISK 169 billion at year-end 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.

Net FX balance Table 5-5

	Net position at year-end	
	2016	2015
CHF	117	657
EUR	2,830	11,869
GBP	43	1,884
JPY	59	401
USD	309	4,628
Other	123	4,356
Total	**3,480**	**23,795**

62 All amounts are in ISK millions Risk and Capital Management 2016

5.5 Market risk VaR

Landsbankinn uses value-at-risk (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 and estimation of economic capital.

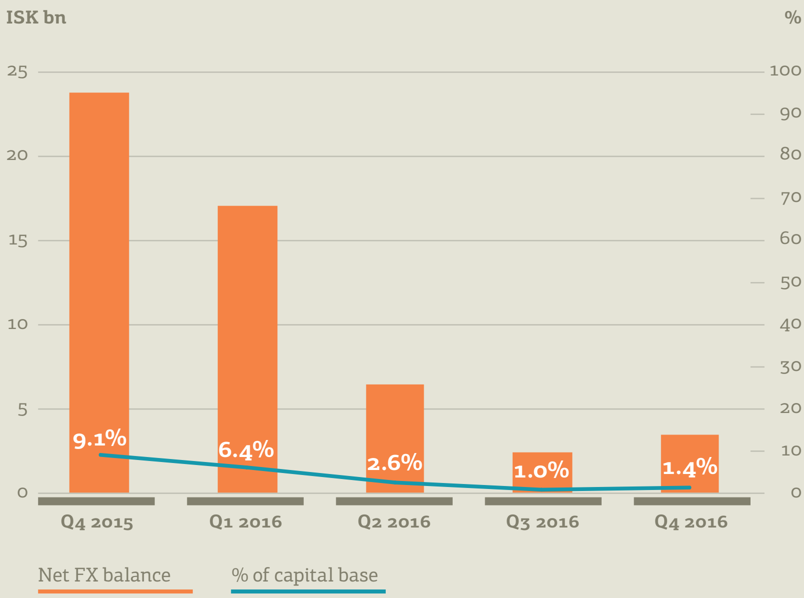
The Group calculates daily VaR at the 99% confidence interval using at least one year of historical data. Both parametric and historical VaR for the Group's trading books in equity, fixed income and FX are calculated and reported to relevant parties.

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 comparing 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.

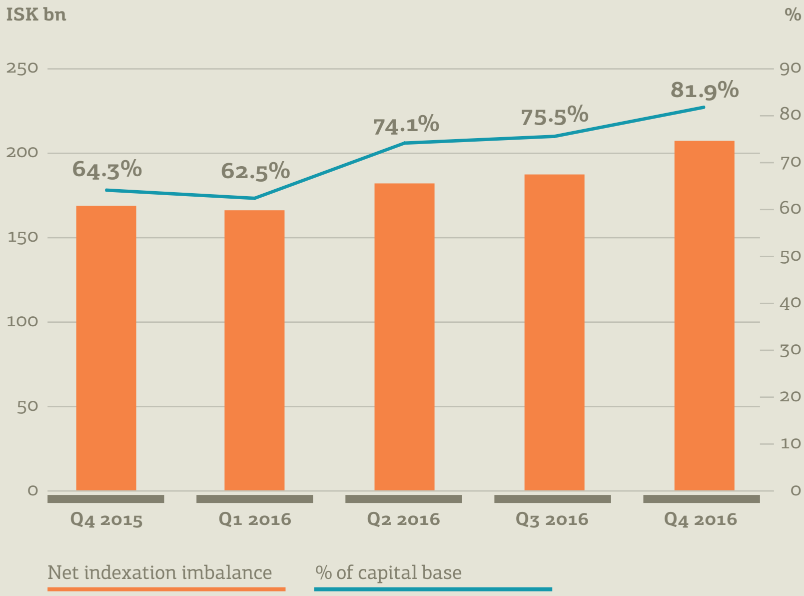
5.5.1 Stress test / sensitivity analysis

The Group conducts quarterly sensitivity analysis of 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.

Net FX balance Figure 5-2



Indexation imbalance Figure 5-3



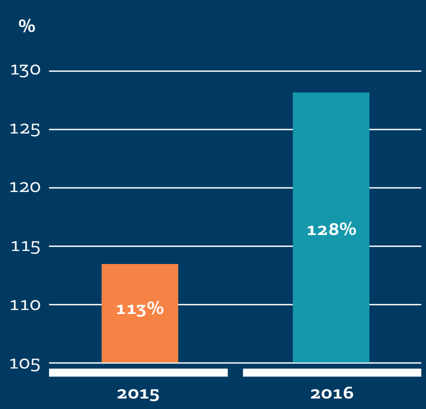
6 Liquidity risk and funding

Liquidity risk and funding

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;
- Great focus has been put on securing and maintaining a strong liquidity position for the past few years, e.g. by managing lending growth and increasing debt issuance in the form of borrowing;
- The Bank's liquidity position is strong at year-end and the Bank remains well prepared for future challanges, such as further steps towards lifting capital controls and other changes in it's operating environment.

Total Liquidity Coverage Ratio



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 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. An integral part of the management process is conducting forward-looking analysis to estimate future liquidity position, taking the Bank's commitments into account.

The liquidity management policy is largely built on the liquidity risk measurement framework defined in Basel III, as well as taking the Bank's current operating environment into account.

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

Figure 6-1

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 Group complies with the liquidity and funding rules set by the Central Bank of Iceland No. 1031/2014 and No. 1032/2014. 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 implementation schedule in Table 6-1 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.

LCR and NSFR regulatory implementation schedule Table 6-1

	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

66 All amounts are in ISK millions Risk and Capital Management 2016

Liquidity Coverage Ratio

Table 6-2

	Total		Foreign currencies	
As at 31 December 2016	**Unweighted**	**Weighted**	**Unweighted**	**Weighted**
Level 1 liquid assets	143,977	143,977	26,221	26,221
Level 2 liquid assets and information items	28,749	5,589	11,177	5,589
A. Total liquid assets	**172,726**	**149,566**	**37,398**	**31,810**
Deposits	391,508	123,148	36,126	14,123
Borrowing	2,787	2,787	447	447
Other outflows	173,532	31,002	29,879	2,561
B. Total outflows (0-30 days)	**567,827**	**156,937**	**66,452**	**17,131**
Loans and advances to financial institutions	18,707	16,732	18,680	16,704
Other inflows	54,673	23,547	28,642	14,317
Limit on inflows	0	0	0	-18,173
C. Total inflows (0-30 days)	**73,380**	**40,279**	**47,322**	**12,848**
Liquidity Coverage Ratio: A/(B-C)		**128%**		**743%**

	Total		Foreign currencies	
As at 31 December 2015	**Unweighted**	**Weighted**	**Unweighted**	**Weighted**
Level 1 liquid assets	192,467	192,467	42,722	42,722
Level 2 liquid assets and information items	16,631	0	42	0
A. Total liquid assets	**209,098**	**192,467**	**42,764**	**42,722**
Deposits	408,785	148,337	61,340	27,645
Borrowing	1,014	1,014	1,014	1,014
Other outflows	185,594	54,110	30,721	3,557
B. Total outflows (0-30 days)	**595,393**	**203,461**	**93,075**	**32,216**
Loans and advances to financial institutions	17,581	16,376	17,581	16,376
Other inflows	48,369	17,440	8,155	3,963
Limit on inflows	0	0	0	0
C. Total inflows (0-30 days)	**65,950**	**33,816**	**25,736**	**20,339**
Liquidity Coverage Ratio: A/(B-C)		**113%**		**360%**

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 Group has sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The calculations for the ratio at year-end 2016 and 2015 are shown in Table 6-2.

67 All amounts are in ISK millions Risk and Capital Management 2016

Total deposits* by groups

Table 6-3

As at 31 December 2016 — **0-30 days deposits balance by groups**

Groups	Less stable deposits	Applied run-off rate	Stable deposits	Applied run-off rate	Term deposits	Total deposits
1. Individuals	113,198	10%	56,038	5%	98,305	267,541
2. Small and medium size corporates	48,619	10%	9,291	5%	4,832	62,742
3. Operational deposits	0	25%	0	5%	0	0
4. Large corporates	67,833	40%	0	20%	13,038	80,871
5. Government, municipalities and Central Bank	30,565	40%	259	20%	651	31,475
6. Financial institutions in resolution process	10,361	100%	0	-	28,330	38,691
7. Financial institutions	39,266	100%	0	-	61,968	101,234
8. Other foreign counterparties	14,226	100%	2,100	25%	4,370	20,696
9. Pledged accounts	0	-	6,569	-	0	6,569
Total deposits	**324,068**		**74,257**		**211,494**	**609,819**

*Deposits and other liabilities due to financial institutions and Central Bank

As at 31 December 2015 — **0-30 days deposits balance by groups**

Groups	Less stable deposits	Applied run-off rate	Stable deposits	Applied run-off rate	Term deposits	Total deposits
1. Individuals	89,491	10%	70,745	5%	86,602	246,838
2. Small and medium size corporates	46,315	10%	10,187	5%	4,609	61,111
3. Operational deposits	7.069	25%	169	5%	229	7,467
4. Large corporates	61,185	40%	367	20%	25,645	87,197
5. Government, municipalities and Central Bank	29,124	40%	0	20%	642	29,766
6. Financial institutions in resolution process	19,273	100%	0	-	48,321	67,594
7. Financial institutions*	63,417	100%	0	-	38,566	101,983
8. Other foreign counterparties	9,581	100%	1,862	25%	2,383	13,826
Total deposits	**325,455**		**83,330**		**206,997**	**615,782**

*Deposits and other liabilities due to financial institutions and Central Bank

Estimated inflow and outflow weights, according to liquidity regulation No. 1031/2014, are applied to the total balance amount for each group, reflecting the next 30 calendar days. Run off rates for deposits are shown Table 6-3.

68 All amounts are in ISK millions Risk and Capital Management 2016

6.3.2 Net Stable Funding Ratio (NSFR)

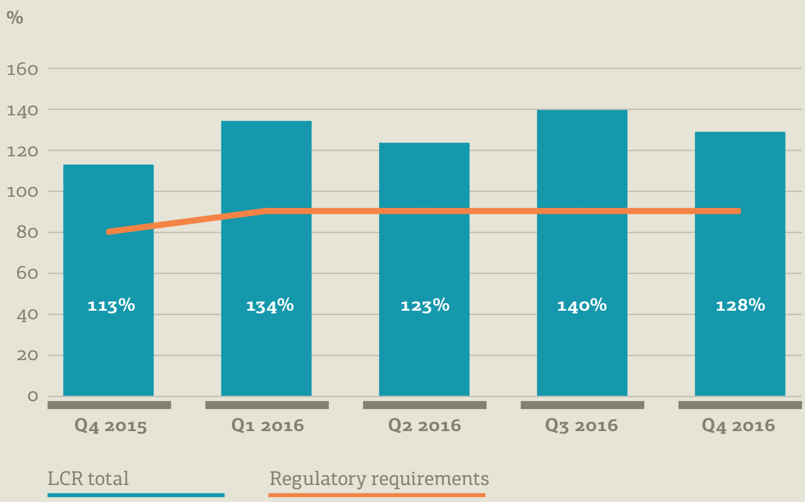
The Net Stable Funding Ratio has a longer time horizon and its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities. The aim of NSFR is to promote more medium and long term funding. It establishes a minimum acceptable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

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

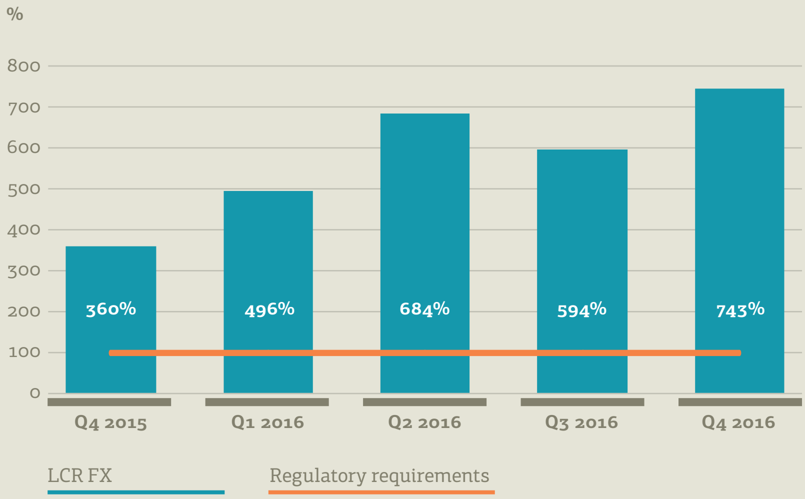
$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

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 the institution as well as those of its off-balance sheet (OBS) exposures. The Group's NSFR in foreign currencies as at 31 December 2016 was 154%.

Liquidity Coverage Ratio (total) Figure 6-2



Liquidity Coverage Ratio (FX) Figure 6-3



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.

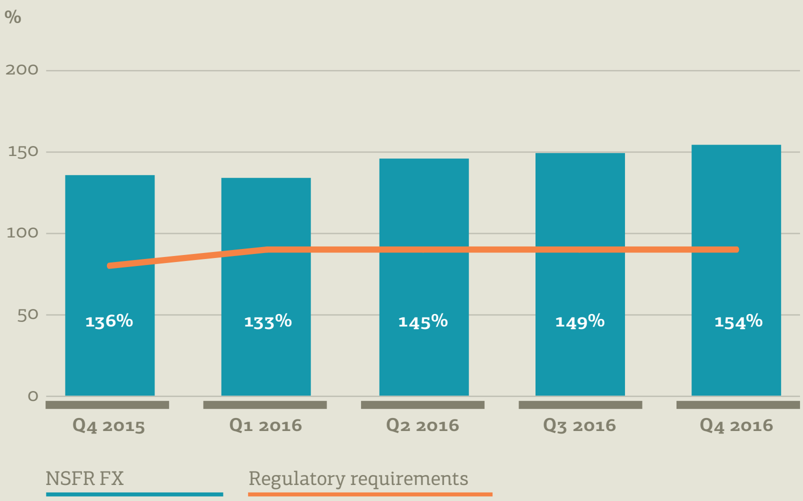
The Risk Management Division of the Bank regularly evaluates the Group's liquidity position and monitors internal and external events and factors that may affect the liquidity position.

6.4.1 Liquidity Contingency Plan

The Bank has in place a contingency 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:

Net Stable Funding Ratio (FX) Figure 6-4



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

The contingency plan is supplemented by 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 based on the Group's balance sheet mixture as well as taking the Group's current operating environment into account. The Group also performs other internal stress tests which may vary from time to time.

6.5 Funding and financing

The Bank continued to work towards diversifying its funding profile over the year 2016 in particular in foreign currency. the Bank completed a EUR 500 million issuance in September 2016 and a SEK 1 billion issuance in November 2016 under the Bank's EMTN programme and the proceeds were primarily used to repay maturities on secured bonds issued to LBI hf. The Bank was also an acitve issuer on the domestic bond market with issuance of covered bonds as well as with issuance of bills.

The Bank has a credit rating from Standard and Poor's, BBB / A-2 with a positive outlook. The last rating action taken by S&P was in October 2016 when the Bank received an upgrade from BBB- to its current rating grade.

6.5.1 Funding

The Bank's funding is primarily divided into three parts. Deposits from customers are the Bank's primary funding source but it also funds itself through borrowing in the form of bond issuance, both in the international markets in foreign currencies as well as in the domestic market in Icelandic kronur. Last but not least the Bank finances itself with contributions from owners in the form of equity. Figure 6-6 shows the Bank's funding structure as of year-end 2016 and 2015.

6.5.2 Borrowing

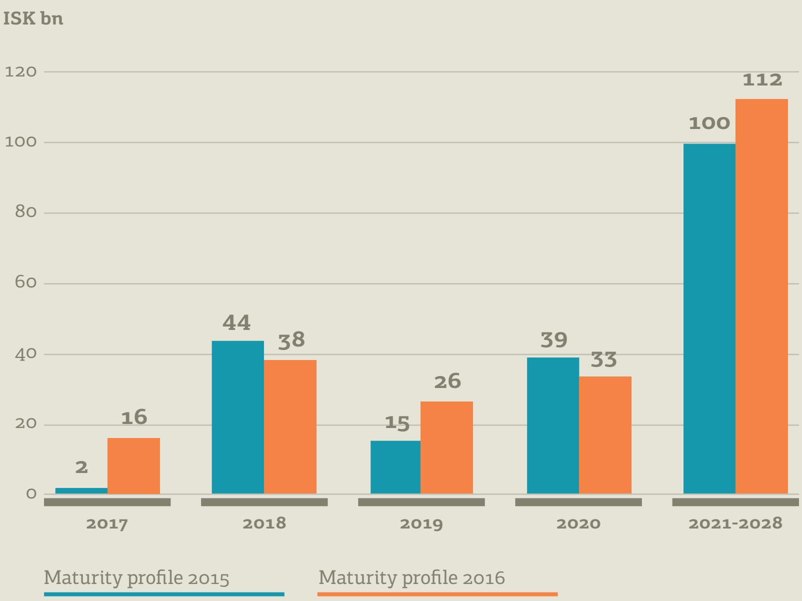
6.5.2.1 EMTN Programme

The Bank has set up an EMTN programme to the amount of EUR 1,500 million and completed a new EUR 500 million issuance in September 2016 and a SEK 1 billion issuance in November 2016 under the EMTN programme. Furthermore, the Bank tapped into existing NOK and SEK issues in April last year to the amount of SEK 100 million and NOK 250 million.

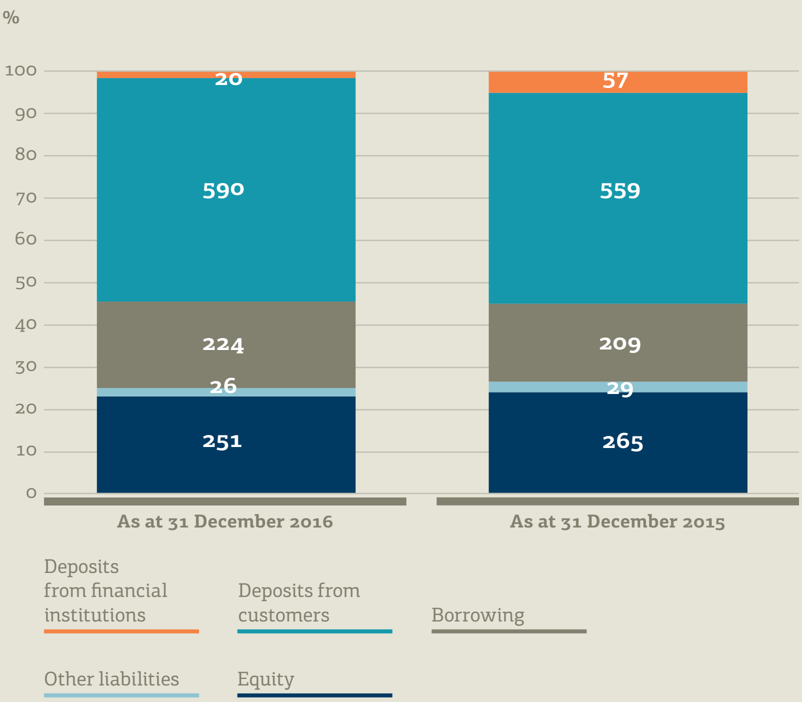
6.5.2.2 Secured bonds

The Bank issued foreign currency denominated bonds to LBI hf. in December 2009 as part of settlement when assets and liabilities of LBI hf. were transferred to the Bank. An amendment to the bonds was agreed upon and came into force in December 2014. The outstanding amount was to be paid in ten bonds denominated

Funding and financing Figure 6-5



Funding profile Figure 6-6



EMTN Programme

Table 6-4

As at 31 December 2016	Currency	Final maturity	Remaining principal	Contractual interest rate
Senior Unsecured	EUR	19.10.18	300	3.00% fixed rate
Senior Unsecured	EUR	15.03.21	500	1.625% fixed rate
Senior Unsecured	NOK	11.06.19	500	NIBOR + 2.6%
Senior Unsecured	SEK	10.06.19	350	STIBOR + 2.6%
Senior Unsecured	SEK	24.11.20	250	STIBOR + 1.5%
Senior Unsecured	SEK	24.11.20	750	1.375% fixed rate

in EUR and USD and maturing every second year. Interest rates wil 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 Bank used the proceeds from EMTN issuance in 2016 to prepay in full Bonds E and G that were denominated in EUR and scheduled to mature in 2022 and 2026. The Bank also partially prepaid Bond D that is denominated in USD and will mature in 2020.

6.5.2.3 Covered bonds

The Bank has set up a ISK 100 billion 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. The Bank issued two new series of bonds in 2016, LBANK CBI 28, a twelve year CPI-linked fixed rate bond and LBANK CB 21, a five year fixed rate bond, as well as tap issues to pre-existing issued bond series. At year-end the total nominal value of covered bonds outstanding amounted to 37,560 million ISK, up from 22,080 million ISK at year-end 2015.

Secured bonds

Table 6-5

As at 31 December 2016	Currency	Final maturity	Remaining principal	Contractual interest rate (Base rate + initial margin / Step-up margin)
Bond D	USD	9.10.2020	170	LIBOR + 2.90% / 3.50%
Bond F	USD	9.10.2024	271	LIBOR + 2.90% / 3.90%

Covered bonds

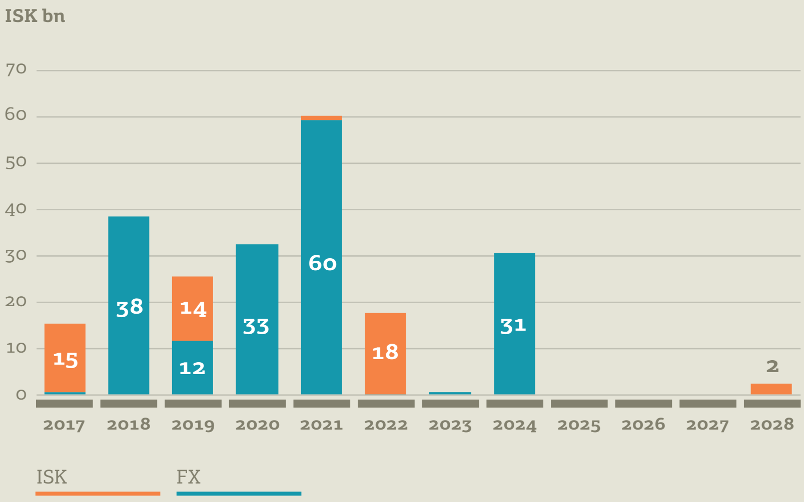
Table 6-6

As at 31 December 2016	Currency	Final maturity	Remaining principal	Fixed contractual interest rate
LBANK CB 17	ISK	23.10.2017	3,160	6.00%
LBANK CB 19	ISK	17.9.2019	13,540	6.80%
LBANK CBI 21	ISK	30.11.2021	700	5.50%
LBANK CBI 22	ISK	28.4.2022	17,780	3.00%
LBANK CBI 28	ISK	4.10.2028	2,380	3.00%

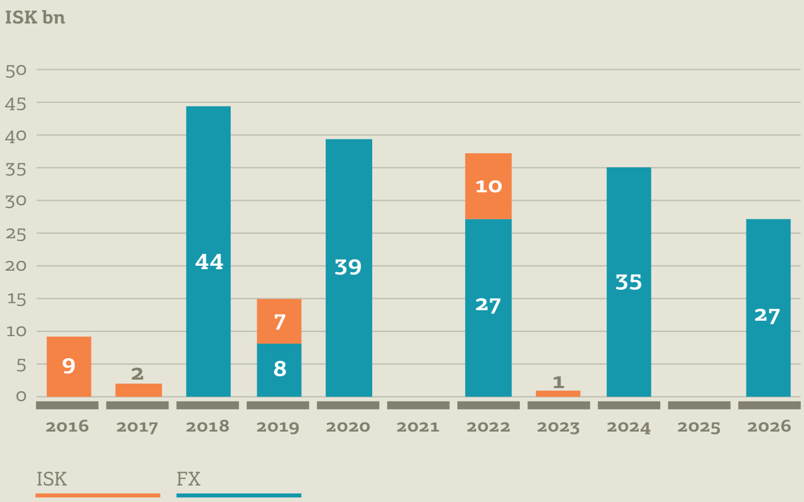
72 All amounts are in ISK millions Risk and Capital Management 2016

Maturity profile as at 31 December 2016

Figure 6-7



Maturity profile as at 31 December 2015



6.5.2.4 Bills

The Bank has set up a ISK 30 billion Debt issuance programme. The Bank will primarily issue bills under the programme for general funding purposes.

Bills Table 6-7

As at 31 December 2016	Currency	Final maturity	Remaining principal
LBANK 17 0110	ISK	10.1.2017	2,340
LBANK 17 0210	ISK	10.2.2017	1,020
LBANK 17 0310	ISK	10.3.2017	1,040
LBANK 17 0410	ISK	10.4.2017	2,820
LBANK 17 0510	ISK	10.5.2017	2,780
LBANK 17 0612	ISK	12.6.2017	1,720

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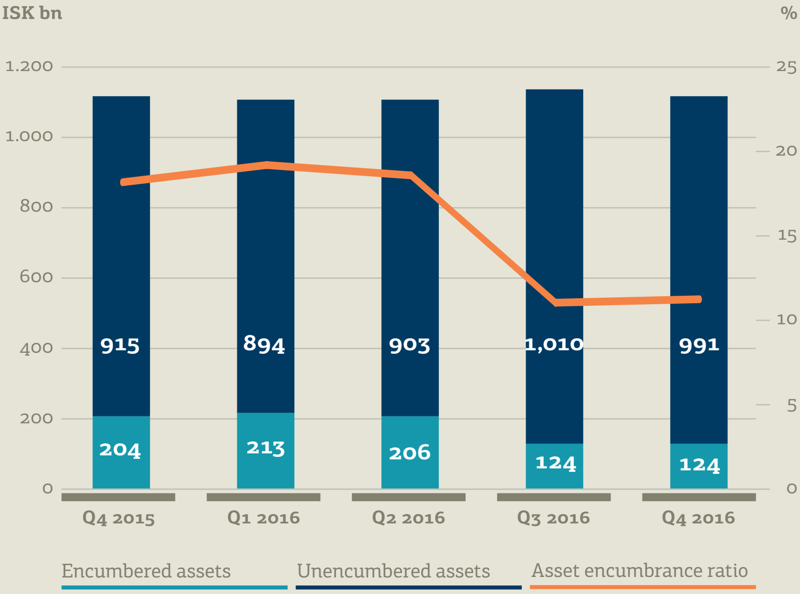
6.5.3 Asset encumbrance ratio

The Group's liquidity and funding risk framework includes measures of encumbered assets as a ratio to total assets. Encumbered assets are mainly comprised of loans and advances which are pledged against covered bonds and secured bonds issued by the Bank. Other encumbered assets are pledged as collateral to the Central Bank, pledged as collateral to secure trading lines and credit support for GMRA/ISDA master agreements and other pledges of similar nature.

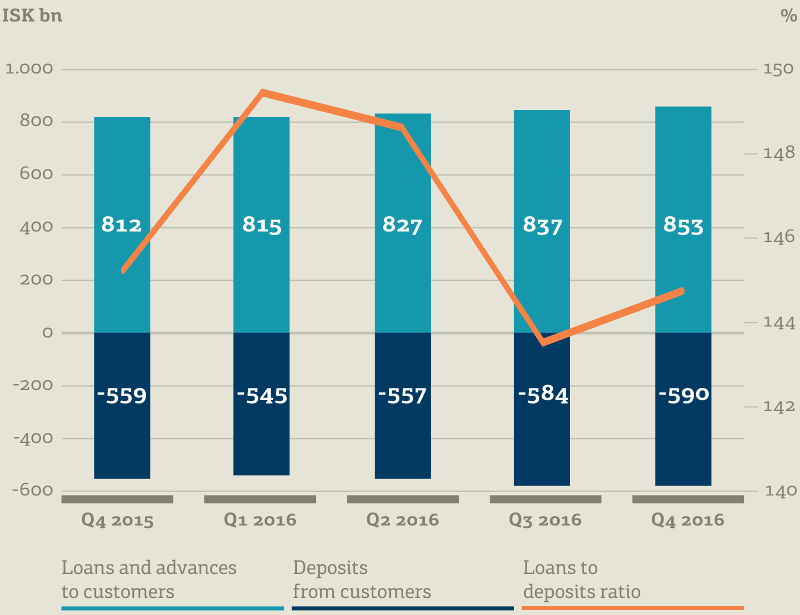
The asset encumbrance ratio was significantly reduced in Q3 following a prepayment of secured bonds issued to LBI hf.

The ratio of loans to deposits is another indicator monitored within the Group's funding risk framework. Figure 6-9 shows the Group's LTD ratio in 2016.

Asset encumbrance ratio Figure 6-8



Loans to deposits ratio Figure 6-9



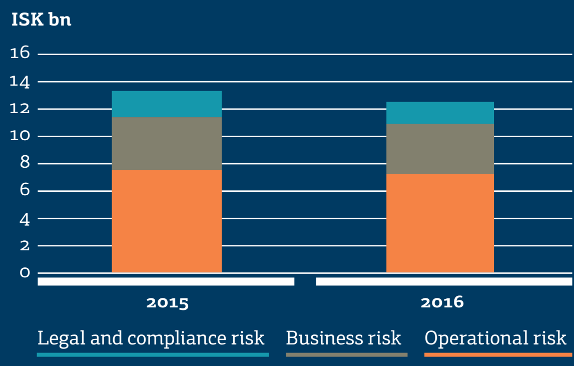
7 Operational risk

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

- Weakness in processes or systems continued to be the source of most operational incidents;
- Continued ISO 27001 certification for 10 years;
- The Operational Risk Committee is responsible for all risks relating to operational risk

Economic capital



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.

IT risk is especially relevant to the Bank in 2017 as RB the IT service centre for the Icelandic financial market is in the final stages of a core banking replacement project. To get ready for this the Bank is making changes to many internal IT systems. It is extremely important to the Bank that the rollout of the new core banking system goes according to plan.

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 policies 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. Part of this framework is the business continuity plans of the Bank as well as the security system for the online bank. The Department is also responsible for the ISO 27001 certification of the bank.

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 some time now, "Execution, delivery and process management" has had by far the largest number of events, 49 in 2014 and 34 in 2105 and 41 in 2016.

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

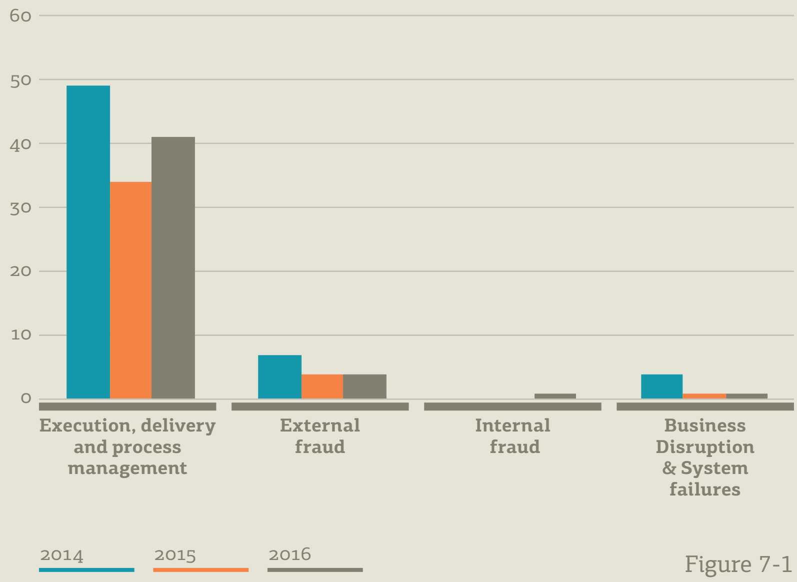


Figure 7-1

7.2.2 Control and monitoring

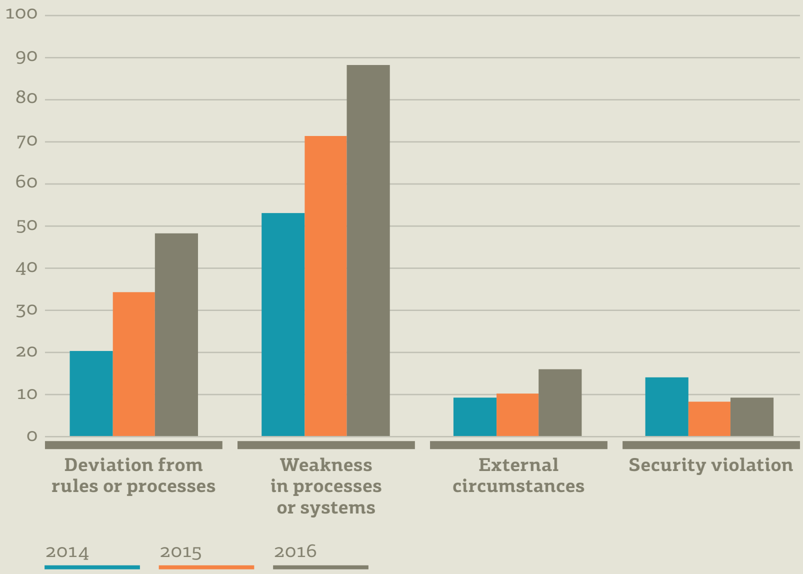
The Board and the CEO set detailed rules on operational risk governance and responsibilities. Day-to-day management of operational risk is a part of all managers' responsibilities and they are also responsible for monitoring and controlling the operational risk in their departments. Managers evaluate 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.

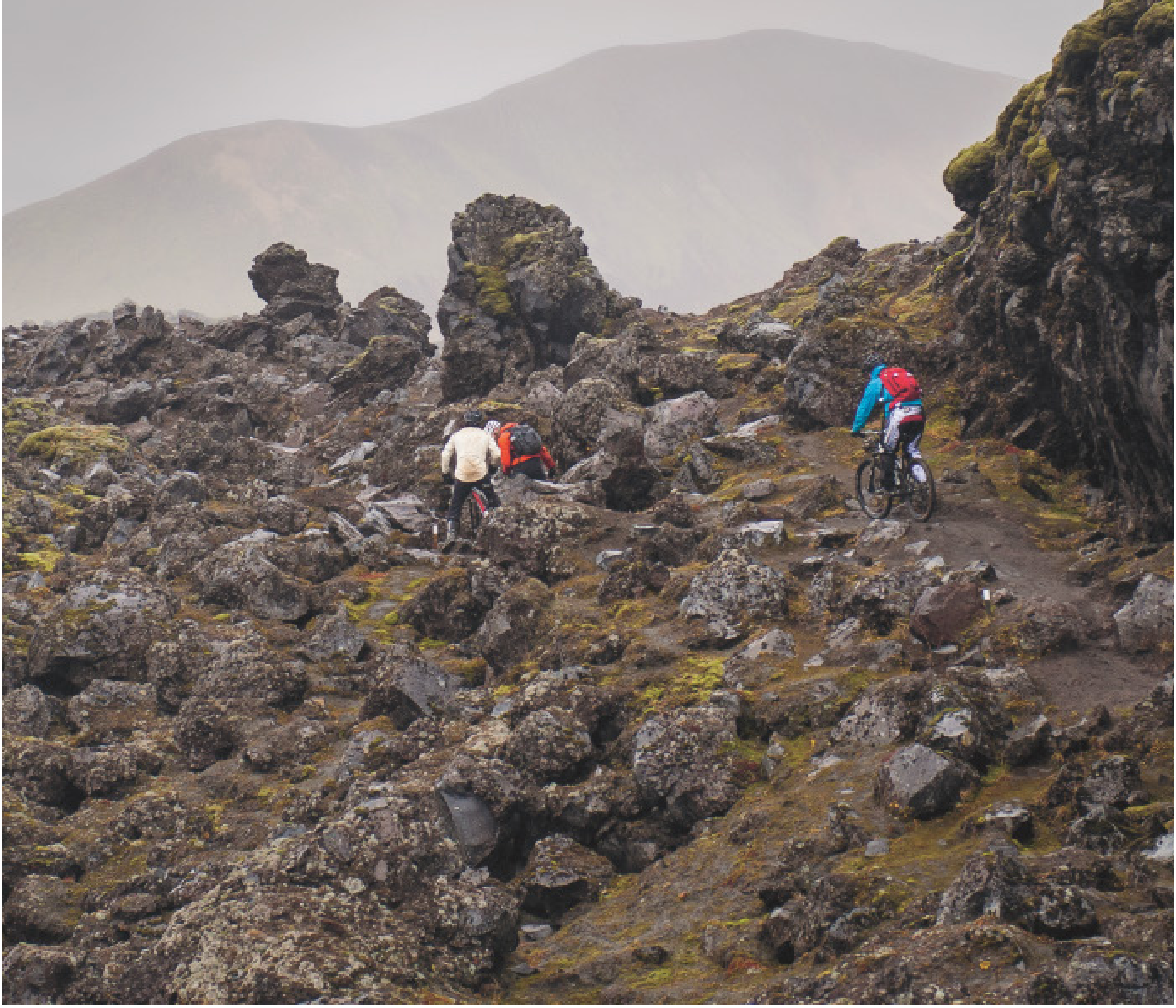
Incident reporting, auditing and follow-up is an important part of operational risk management as the identification and remedial action helps to limit losses resulting from inadequate and failed processes. The Operational Risk Department is responsible for business continuity management and for maintaining 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 Figure 7-2



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 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 2016, 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 for the purpose of Article 18 of the Act No. 161/2002 on Financial Undertakings, cf. Article 11 of Act No. 96/2016. 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 2016, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2016. There may be some discrepancy between financial information in the Consolidated Financial Statement 2016 and information in the Risk and Capital Management 2016 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 2016 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 Annual General Meeting 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 advice 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.

In the year 2016 the Remuneration committee members are Tryggvi Pálsson (Chairman), Helga Björk Eiríksdóttir and Jóhann Hjartarson until the AGM 22 April. After the AGM the Remuneration committee members are Helga Björk Eiríksdóttir (Chairman), Magnús Pálsson and Berglind Svavarsdóttir.

9.1.3 Remuneration policies for Landsbankinn Board of Directors and CEO

Board members shall receive set monthly remuneration in accordance with the decision of the AGM each year as provided for in Article 79 of Act No. 2/1995, on Public Limited Companies. In determining the remuneration amount, consideration shall be taken to the hours spent on the job, the responsibilities borne by the board members and the company's performance. The Remuneration Committee presents the Board of Directors with a substantiated proposal for remuneration to Board members 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. Board members may not conclude severance agreements with the Bank.

The Board of Directors appoints the Bank's CEO. According to the Act on the Senior Civil Servant's Board No. 47/2006 the Senior Civil Servant's Salary Board determines the remuneration of the Bank's CEO. The Senior Civil Servant's Salary Board is an independent board which is entrusted with the task of deciding salaries and remuneration of senior state officials. In December 2016, Parliament passed a new Act on the Senior Civil Servant's Board. The new Act No. 130/2016 enters into force on 1 July 2017 and repeals and replaces Act No. 47/2006. The new Act stipulates that the Board of Directors determines the remuneration of the Bank's CEO.

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.

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

Credit exposure (EAD)	2015	2016	
ISK million	At 31 December	Average	At 31 December
Standardised approach for credit risk			
Central governments and central banks	167,524	172,588	167,830
Public sector entities	0	14	23
Corporate customers	451,128	465,559	474,374
Institutions	22,243	21,033	23,460
Regional governments and local authorities	8,575	11,781	11,581
Retail customers	129,776	118,565	111,735
Exposures secured by real property	265,208	281,351	292,809
Standardised approach for credit risk, total	**1,044,455**	**1,070,891**	**1,081,813**

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 2016, 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 2016 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manufacturing	Agriculture	Other	Total
Standardised approach for credit risk													
Central governments and central banks	-	167,830	-	-	-	-	-	-	-	-	-	-	167,830
Public sector entities	-	-	-	-	-	-	0	10	-	10	3	-	23
Corporate	-	4,870	5,091	123,442	166,599	22,617	39,017	66,715	19,326	19,737	6,790	171	474,374
Institutions	23,460	-	-	-	-	-	-	-	-	-	-	-	23,460
Regional governments and local authorities	-	7,860	14	-	3,648	-	-	14	45	-	-	-	11,581
Retail	-	294	61,473	3,733	14,502	1,976	6,356	15,896	1,112	3,669	2,716	8	111,735
Retail exposures secured by real property	-	88	256,075	866	24,809	323	3,588	4,109	172	2,034	744	-	292,809
Standardised approach for credit risk total	**23,460**	**180,942**	**322,652**	**128,041**	**209,558**	**24,916**	**48,961**	**86,745**	**20,655**	**25,451**	**10,253**	**179**	**1,081,813**

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

Credit exposure (EAD) broken down by industry

At 31 December 2015 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agriculture	Other	**Total**
Standardised approach for credit risk													
Central governments and central banks	-	167,524	-	-	-	-	-	-	-	-	-	-	**167,524**
Public sector entities	-	-	-	-	-	-	-	-	-	-	-	-	**-**
Corporate	-	15,948	3,219	157,142	128,217	24,592	29,383	49,105	15,515	22,105	5,857	45	**451,128**
Institutions	22,243	-	-	-	-	-	-	-	-	-	-	-	**22,243**
Regional governments and local authorities	-	8,399	18	-	-	-	-	115	43	-	-	-	**8,575**
Retail	-	151	81,911	3,512	12,725	2,225	6,839	14,838	1,093	2,935	3,499	50	**129,776**
Retail exposures secured by real property	-	163	209,513	3,032	32,807	1,253	4,499	9,304	149	3,608	852	28	**265,208**
Standardised approach for credit risk total	**22,243**	**192,186**	**294,660**	**163,686**	**173,749**	**28,070**	**40,721**	**73,361**	**16,800**	**28,648**	**10,208**	**123**	**1,044,455**

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

Credit exposure (EAD) broken down by maturity

At 31 December 2016 (ISK million)		≥ 1 year	≥ 2 years	≥ 3 years	≥ 4 years		**Total**
	< 1 year	< 2 years	< 3 years	< 4 years	< 5 years	≥ 5 years	
Standardised approach for credit risk							
Central governments and central banks	55,963	107,396	12	24	3,479	957	**167,830**
Public sector entities	1	1	8	1	12	0	**23**
Corporate	167,232	50,874	34,815	53,522	40,775	127,157	**474,374**
Institutions	18,176	3,086	39	48	2	2,109	**23,460**
Regional governments and local authorities	534	126	285	2,036	45	8,553	**11,581**
Retail	26,824	6,839	9,428	9,833	8,470	50,341	**111,735**
Retail exposures secured by real property	8,785	2,867	1,405	2,421	2,241	275,091	**292,809**
Standardised approach for credit risk, total	**277,515**	**171,189**	**45,992**	**67,884**	**55,024**	**464,208**	**1,081,813**

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

Credit exposure (EAD) broken down by maturity

At 31 December 2015 (ISK million)		≥ 1 year	≥ 2 years	≥ 3 years	≥ 4 years		**Total**
	< 1 year	< 2 years	< 3 years	< 4 years	< 5 years	≥ 5 years	
Standardised approach for credit risk							
Central governments and central banks	60,418	40	106,887	20	19	140	**167,524**
Public sector entities	-	-	-	-	-	-	**-**
Corporate	133,769	47,350	48,401	43,872	57,249	120,487	**451,128**
Institutions	22,104	3	40	6	56	34	**22,243**
Regional governments and local authorities	688	44	131	236	2,044	5,431	**8,575**
Retail	40,863	4,665	6,050	8,172	7,851	62,175	**129,776**
Retail exposures secured by real property	9,383	1,879	3,564	4,900	2,882	242,601	**265,208**
Standardised approach for credit risk, total	**267,227**	**53,981**	**165,072**	**57,206**	**70,101**	**430,868**	**1,044,455**

Loans and advances by industry sectors

31.12.2016	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	20,408	20,408	0	0	0	0	0	20,408
Public entities	10,028	9,564	-48	0	0	464	-198	9,783
Individuals	326,844	317,615	-1,500	2,170	-738	7,059	-3,915	320,691
Corporates	537,495	513,139	-2,476	9,952	-4,446	14,404	-7,630	522,943
Fisheries	124,094	123,315	-145	326	-71	452	-250	123,627
Construction and real estate companies	192,818	186,528	-1,205	2,352	-1,346	3,938	-1,940	188,327
Holding companies	41,148	40,504	-251	156	-35	489	-372	40,490
Retail	43,436	41,630	-224	756	-291	1,050	-685	42,235
Services	80,833	71,761	-401	3,601	-2,029	5,471	-3,661	74,743
ITC	19,383	19,307	-115	27	-6	49	-43	19,220
Manufacturing	25,535	19,929	-91	2,694	-632	2,912	-646	24,167
Agriculture	10,247	10,164	-45	39	-35	43	-32	10,135
Other	1	1	0	0	0	0	0	1
Total	**894,776**	**860,726**	**-4,024**	**12,122**	**-5,184**	**21,928**	**-11,743**	**873,825**

*Non-performing past due more than 90 days

91 All amounts are in ISK millions

Loans and advances by industry sectors

				Individually impaired				
				Of which performing		Of which non-performing*		
31.12.2015	Gross carrying amount	Gross not individually impaired	Collective allowance	Gross carrying amount	Individual allowance	Gross carrying amount	Individual allowance	Carrying amount
Financial institutions	20,791	20,791	0	0	0	0	0	20,791
Public entities	8,969	8,507	-8	429	-204	32	-18	8,738
Individuals	303,349	283,635	-1,967	4,937	-2,273	14,777	-8,147	290,962
Corporates	532,888	496,264	-3,482	23,167	-9,813	13,458	-7,745	511,849
Fisheries	162,160	157,545	-224	1,762	-901	2,853	-1,519	159,515
Construction and real estate companies	162,090	150,708	-1,431	6,468	-2,618	4,914	-2,708	155,334
Holding companies	48,649	47,671	-343	266	-155	713	-540	47,612
Retail	38,069	35,198	-325	1,489	-923	1,382	-800	36,021
Services	66,233	57,857	-719	6,133	-3,712	2,243	-1,333	60,469
ITC	15,787	15,526	-137	12	-3	249	-145	15,502
Manufacturing	29,384	22,052	-231	6,466	-1,335	867	-615	27,205
Agriculture	10,440	9,631	-71	571	-166	237	-85	10,118
Other	76	76	-1	0	0	0	0	75
Total	**865,997**	**809,197**	**-5,457**	**28,533**	**-12,290**	**28,267**	**-15,910**	**832,340**

*Non-performing past due more than 90 days

92 All amounts are in ISK millions Risk and Capital Management 2016

The tables below show the Group's maximum credit risk exposure at 31 December 2016 and 2015. 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 2016	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	-	30,662	-	-	-	-	-	-	-	-	-	-	30,662
Bonds and debt instruments	2,031	142,956	-	-	8294	-	-	80	-	-	-	1531	154,892
Derivative instruments	220	14	-	-	-	-	-	24	-	-	-	20	278
Loans and advances to financial institutions	20,408	-	-	-	-	-	-	-	-	-	-	-	20,408
Loans and advances to customers	-	9,783	320,691	123,626	188,327	74,743	42,235	40,490	24,167	10,135	19,220	1	853,416
Other financial assets	3,246	282	301		1329	1008	5	61	290	3	2	1	6,528
Total on-balance sheet exposure	**25,905**	**183,697**	**320,991**	**123,626**	**197,950**	**75,751**	**42,240**	**40,655**	**24,457**	**10,138**	**19,222**	**1,553**	**1,066,184**
Off-balance sheet exposure	**5,640**	**16,385**	**29,109**	**17,421**	**49,953**	**15,999**	**18,704**	**2,392**	**9,996**	**1,149**	**4,159**	**382**	**171,289**
Financial guarantees and underwriting commitments	2,022	634	819	6,345	3,648	2,179	2,959	64	525	10	895	365	20,464
Undrawn loan commitments	0	9,080	0	7,295	42,301	6,052	10,724	1,392	7,246	249	2,017	-	86,357
Undrawn overdraft/Credit card facilities	3,618	6,671	28,291	3,781	4,004	7,768	5,021	936	2,225	890	1,247	17	64,469
Maximum exposure to credit risk	**31,545**	**200,082**	**350,100**	**141,047**	**247,903**	**91,750**	**60,944**	**43,047**	**34,453**	**11,287**	**23,381**	**1,935**	**1,237,474**
Percentage of carrying amount	2.5%	16.2%	28.3%	11.4%	20.0%	7.4%	4.9%	3.5%	2.8%	0.9%	1.9%	0.2%	100.0%

*Public entities consist of central government, state-owned enterprises, central banks and municipalities
**ITC consists of corporates in the information, technology and communication industry sectors

93 All amounts are in ISK millions Risk and Capital Management 2016

At 31 December 2015	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	-	25,164	-	-	-	-	-	-	-	-	-	-	25,164
Bonds and debt instruments	1,356	192,275	-	-	8516	-	-	123	-	-	-	1414	203,684
Derivative instruments	47	2	1	90	108	-	-	-	-	-	-	39	287
Loans and advances to financial institutions	20,791	-	-	-	-	-	-	-	-	-	-	-	20,791
Loans and advances to customers	-	8,738	290,961	159,514	155,334	60,469	36,021	47,612	27,205	10,118	15,502	75	811,549
Other financial assets	4,178	582	438	8	866	452	119	31	230	1	1	12	6,918
Total on-balance sheet exposure	**26,372**	**226,761**	**291,400**	**159,612**	**164,824**	**60,921**	**36,140**	**47,766**	**27,435**	**10,119**	**15,503**	**1,540**	**1,068,393**
Off-balance sheet exposure	**689**	**16,940**	**25,095**	**23,018**	**43,835**	**15,537**	**15,615**	**1,158**	**9,597**	**620**	**3,797**	**154**	**156,055**
Financial guarantees and underwriting commitments	26	1,422	777	7,210	2,022	1,993	2,278	60	653	27	1,070	99	17,637
Undrawn loan commitments	-	8,111	100	11,511	37,647	6,726	6,888	723	6,518	167	1,584	-	79,975
Undrawn overdraft/Credit card facilities	663	7,407	24,218	4,297	4,166	6,818	6,449	375	2,426	426	1,143	55	58,443
Maximum exposure to credit risk	**27,061**	**243,701**	**316,495**	**182,630**	**208,659**	**76,458**	**51,755**	**48,924**	**37,032**	**10,739**	**19,300**	**1,694**	**1,224,448**
Percentage of carrying amount	2.2%	19.9%	25.8%	14.9%	17.0%	6.2%	4.2%	4.0%	3.0%	0.9%	1.6%	0.1%	100.0%

*Public entities consist of central government, state-owned enterprises, central banks and municipalities
**ITC consists of corporates in the information, technology and communication industry sectors

94 All amounts are in ISK millions Risk and Capital Management 2016

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 value of collateral. Loan-to-value is one of the key risk factors assessed when qualifying borrowers 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 are smaller buffers to protect against price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance.

As at 31 December 2016	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	-	-	-	-	-	-	-	26,047	-	26,047
Public entities	42	263	758	255	1,318	1,174	544	23,922	-246	26,168
Individuals	20,188	60,457	145,319	52,366	278,330	16,035	9,374	61,589	-6,154	349,800
Corporates	21,535	81,606	191,261	143,241	437,643	166,424	94,963	53,583	-14,551	643,099
Fisheries	8,657	32,701	68,975	21,827	132,161	8,125	5,207	1,231	-467	141,049
Construction and Real estate companies	2,006	10,258	47,886	79,549	139,699	87,348	54,130	15,724	-4,490	238,281
Holding companies	6,336	4,723	17,310	1,857	30,226	5,382	2,353	7,933	-659	42,882
Retail	865	6,939	9,787	18,212	35,803	21,067	5,663	5,272	-1,201	60,941
Services	2,218	16,392	23,697	14,005	56,312	26,516	14,583	14,003	-6,090	90,741
Information, technology and communication	56	659	5,006	91	5,812	11,733	8,054	5,997	-164	23,378
Manufacturing	360	9,078	17,079	5,533	32,050	796	492	2,683	-1,368	34,161
Agriculture	1,037	743	1,521	2,160	5,461	5,392	4,472	542	-112	11,283
Other	-	113	-	7	120	65	9	198	-	383
Total	41,765	142,326	337,338	195,862	717,291	183,633	104,881	165,141	-20,951	1,045,114

95 All amounts are in ISK millions Risk and Capital Management 2016

As at 31 December 2015**	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	-	-	-	-	-	-	-	21,481	-	-21,481
Public entities	18	342	805	521	1,686	508	221	22,915	-230	24,879
Individuals	18,251	47,954	115,324	47,331	228,861	18,679	12,188	80,905	-12,389	316,056
Corporates	13,630	89,559	165,125	135,410	403,724	177,066	104,552	66,226	-21,038	625,979
Fisheries	5,993	43,208	64,924	46,250	160,375	19,725	12,332	5,077	-2,644	182,534
Construction and Real estate companies	1,527	7,436	31,330	45,447	85,740	99,599	56,834	20,616	-6,756	199,199
Holding companies	3,098	8,044	31,107	3,054	45,303	1,930	1,132	2,549	-1,037	48,745
Retail	551	1,672	11,569	21,016	34,807	14,153	8,102	4,725	-2,049	51,636
Services	1,312	11,799	11,547	9,191	33,848	26,817	16,297	21,153	-5,764	76,054
Information, technology and communication	125	143	5,750	456	6,474	6,375	4,235	7,536	-285	20,100
Manufacturing	403	16,223	7,398	5,615	29,640	5,723	4,112	3,618	-2,180	36,801
Agriculture	621	1,034	1,428	4,381	7,465	2,744	1,508	845	-322	10,732
Other	-	-	72	-	72	-	-	107	-1	178
Total	**31,899**	**137,855**	**281,254**	**183,262**	**634,271**	**196,253**	**116,961**	**191,527**	**-33,657**	**988,395**

*If LTV is less than 100% the loan is considered fully secured. If LTV is greater than 100% the loan is partially collateralised and the respective collateral value is shown in the table.
**The comparative amounts have been restated due to changes in LTV calculation since year-end 2015. In previous calculations of LTV, a haircut was applied to the value of collateral.

96 All amounts are in ISK millions Risk and Capital Management 2016

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 2016

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	**Total**
Bonds and debt instruments	35,555	8,337	178	**44,070**
Equities and equity instruments	10,808	0	15,880	**26,688**
Derivative instruments	0	278	0	**278**
Total	**46,363**	**8,615**	**16,058**	**71,036**

Financial liabilities	**Quoted prices (unadjusted)**	**Observable inputs**	**Unobservable inputs**	**Total**
Derivative instruments	0	1,183	0	**1,183**
Short positions	546	0	0	**546**
Total	**546**	**1,183**	**0**	**1,729**

At 31 December 2015

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	**Total**
Bonds and debt instruments	69,477	8,553	443	**78,473**
Equities and equity instruments	11,069	0	18,123	**29,192**
Derivative instruments	0	287	0	**287**
Total	**80,546**	**8,840**	**18,566**	**107,952**

Financial liabilities	**Quoted prices (unadjusted)**	**Observable inputs**	**Unobservable inputs**	**Total**
Derivative instruments	0	702	0	**702**
Short positions	2,698	0	0	**2,698**
Total	**2,698**	**702**	**0**	**3,400**

97 All amounts are in ISK millions

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

2016	
Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2016	18,123
Total gains (losses) recognised in income statement	732
Purchases	992
Sales	-2,894
Settlements	0
Dividend received	-1,073
Carrying amount at 31 December 2016	**15,880**

2015	
Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2015	21,908
Total gains (losses) recognised in income statement	7,631
Purchases	372
Sales	-688
Acquired financial assets in business combinations	265
Settlements	0
Dividend received	-3,911
Transfers into Level 3	1,114
Transfers from Level 3 to Level 1	-8,568
Carrying amount at 31 December 2015	**18,123**

98 All amounts are in ISK millions Risk and Capital Management 2016

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 2016	At 31 December 2015	At 31 December 2016	At 31 December 2015	At 31 December 2016	At 31 December 2015
IRB-F approach						
10	0	959	0	45	0	15
9	650	1,310	45	44	26	26
8	11,926	10,476	44	33	38	39
7	32,821	52,425	44	42	60	59
6	117,940	39,033	43	44	85	85
5	170,074	105,731	42	44	112	112
4	139,998	159,573	39	39	140	140
3	23,565	95,936	43	43	190	184
2	6,629	10,033	45	43	242	235
1	2,836	7,941	40	44	258	258
0	23,634	29,442	47	47	0	0

99 All amounts are in ISK millions Risk and Capital Management 2016

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 2016	At 31 December 2015	At 31 December 2016	At 31 December 2015	At 31 December 2016	At 31 December 2015
IRB-F approach						
10	0	46	0	49	0	0
9	645	3	49	20	0	0
8	4,589	886	40	49	0	0
7	5,964	5,924	39	49	0	0
6	10,069	6,608	40	49	0	0
5	12,655	7,838	44	48	2,532	0
4	10,485	10,728	43	51	6,297	1,050
3	1,735	8,712	47	50	2,250	0
2	157	308	49	49	3	19
1	98	232	46	50	0	0
0	382	328	47	49	0	0

100 All amounts are in ISK millions

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

At 31 December 2016

Approach		Guarantees	Credit derivatives	Eligible financial collateral	Real property	Other eligible collateral	Total
IRB-F	Corporate customers	11,083	-	23,885	86,900	-	121,868
	IRB approach, total	11,083	-	23,885	86,900	-	121,868

At 31 December 2015

Approach		Guarantees	Credit derivatives	Eligible financial collateral	Real property	Other eligible collateral	Total
IRB-F	Corporate customers	1,068	-	25,940	73,891	-	100,899
	IRB approach, total	1,068	-	25,940	73,891	-	100,899

101 All amounts are in ISK millions Risk and Capital Management 2016

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