Risk and Capital Management 2018

Landsbankinn hf. Pillar III risk report
31.12.2018

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 Bank 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. The Bank itself owns 1.6% of shares and other shareholders own 0.2% of shares in the Bank.

Contents

The disclosures have solely been comprised to explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks. They do not constitute any form of audited financial statement. They should not be relied upon in making judgements about the Bank. The disclosures will only be subject to external verification to the extent that they are equivalent to those made under accounting requirements.

In the interest of simplifying text, Landsbankinn Group, which consists of the parent entity, Landsbankinn, and its subsidiaries, is referred to as the 'Bank' in the disclosures. Where necessary, a distinction is made in the report between the group and the parent entity. For further information, see Note No. 91.1 – Consolidation in the Bank's Consolidated Financial Statements for 2018.

This publication, Risk and Capital Management 2018, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2018. There may be some discrepancy between this report and financial information in the Consolidated Financial Statements 2018, as the report has been prepared for the purpose of Article 18 of 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.

Additional Pillar III disclosures required under Regulation [EU] No. 575/2013 of the European Parliament and of the Council of 26 June 2013 [CRR] can be downloaded from https://corporate.landsbankinn.com/investor-relations/reports-and-financials/

1 2018 Highlights and Outlook

Landsbankinn's overall risk position decreased slightly in 2018 as measured by the risk exposure amount (REA) to total assets, despite robust growth in the loan book. All positions were within risk appetite limits of the Bank for 2018. The Bank aims to maintain a moderate risk position in 2019.

The Bank still maintains the position that current regulatory requirements and special Icelandic taxation on banks will possibly have a negative long-term effect on the Bank's lending, funding costs and ultimately financial stability. Proposed increases on e.g. equity requirements in 2019 will further reduce banks' competitiveness in lending to individuals and corporations.

Volatility in domestic financial markets increased in 2018, affecting the returns of the Bank and its customers. Liquidity in the domestic stock market is too low affecting both price discovery and volatility. The Bank believes this should be an ongoing concern for both domestic regulators and policy makers in relation to financial stability.

Capital position

The Bank's capital remained high in 2018 with a year end position of 24.9%, well above the regulatory minimum requirement of 20.5% set by the Financial Supervisory Authority of Iceland (FME) through the Supervisory Review and Evaluation Process (SREP). The Bank's capital target is to be 1.5 – 2.5% above the FME requirements and in the highest category for S&P's RAC ratio. Both capital targets were met in the year 2018.

The Bank's capital base increased by ISK 2.5 billion between 2017 and 2018. The increase was primarily due to new issuance of subordinated liabilities amounting to ISK 13 billion in 2018. The Bank measures internal capital requirements by economic capital for all material risks with regards to risk weighted assets. The internal assessment of economic capital increased slightly to ISK 100 billion at year end 2018. The ratio to REA declined by 0.7 percentage points.

Credit risk

The Bank's loan book grew substantially in 2018. The growth can be attributed to increases in both residential mortgages and corporate lending. Loans to individuals grew by 16% or ISK 57 billion, primarily in mortgages.

There was increased demand for non-indexed mortgages in the latter half of the year and over the year the non-indexed mortgage portfolio grew by ISK 44 billion. Non-bank competitors in the mortgage market signalled a reduction in risk appetite during the year by increasing requirements for down payment for mortgage to 30% from a previous level of 25%. Housing prices have soared in the domestic market in recent years, especially in certain areas. The sustainability of those price increases is increasingly uncertain. It is foreseeable that market participants in the mortgage market will re-evaluate their lending practices in the coming year, as high loan to value (LTV) ratios and long amortisation periods of mortgages can have procyclical effects on house prices, which again creates increased credit risk within the Bank's mortgage portfolio.

The Bank's corporate portfolio grew by 16% in 2018, or ISK 88 billion, including a significant increase in lending to the fisheries sector. A total of 4 exposures are classified as large exposures at year end 2018 as opposed to 3 at year end 2017. Due to the diversification of new lending and good credit of new borrowers, economic capital requirements remained similar to 2017 levels, increasing only slightly. The Bank aims to maintain a robust diversification of risk in the portfolio in 2019.

Despite a 15% growth in the loan book, economic capital for credit risk from loans only increased by 5.8% – reflecting a sustained credit quality for borrowers and a decrease in LGD, which decreased by 1.4 percentage points from 2017. The ratio of loans more than 90 days past due declined slightly over the year, amounting to 0.8% at year end 2018. However, several risk indicators reflect a tighter position of the Bank's borrowers in certain sectors, which the Bank will continue to monitor closely in 2019.

The Bank is increasingly exposed indirectly to real estate price risk as two-thirds of the Bank's collateral is now real estate, both residential and commercial.

Market risk

Market risk measured as market risk exposure amount to total REA was relatively low in 2018, in spite of increased volatility in financial markets. It was at 1.8% at year end, compared to 1.9% at year end 2017. The Bank's indexation imbalance dropped significantly in 2018, from 90.2% of capital at year end 2017 to 71.5% at year end 2018. The decrease is primarily due to CPI-linked swaps that the Bank entered into with the objective of reducing this imbalance as well as reduced demand for indexed mortgages in the latter half of 2018. The aforementioned swaps also reduced interest rate risk and inflation risk in the banking book, which remains low. Overall, market risk was well within the Bank's risk appetite in 2018.

Liquidity risk and funding

Liquidity risk continues to be significant and important to the Bank as in recent years. The

Bank's total LCR at year end was 158% and 534% in foreign currencies, well above regulatory limits and the Bank's risk appetite. The Bank's net stable funding ratio in foreign currencies is strong, 166% and total NSFR was 120% at year end.

The Bank continued to work towards diversifying its funding profile over the year 2018 especially in foreign currency. Thus, the Bank completed its inaugural Tier 2 issuance in EUR in 2018, which is a step towards further optimising the Bank's capital structure. The size of the Bank's EMTN programme is EUR 2,000 million and was increased from EUR 1,500 million in 2017. At year end 2018 EMTN bond issuance amounted to ISK 199 billion, increasing by 7 billion in 2018. The Bank was also an active issuer on the domestic bond market with issuance of covered bonds as well as bills. At year end 2018 outstanding covered bonds issuance amounted to ISK 99.6 billion, increasing by ISK 30 billion during the year 2018.

Operational risk

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. This certification becomes increasingly important as legislation of GDPR and PSD II comes to effect.

IT risk continued to be prominent in the Bank's operations in 2018 in the aftermath of the replacement of RB's core banking system. Issues that surfaced in 2017 were resolved during 2018, with only minor disruptions to customers. The Bank believes that the new core banking system will be an important part in ensuring secure services in payments to the Bank's clients and enable further product development on the deposit platform.

The Bank has maintained its focus on combating fraud and cybercrime with emphasis on programs to increase awareness of market participants, clients and staff as well as introducing measures to reduce the likelihood of customers falling prey to such criminal activity. The Bank has put in place the resources to ensure continued vigilance over the Bank's assets and its customers when it comes to cybercrime. The Bank continues to use external resources to assist with the estimation and protection against cybercrime, e.g. as a member of the Nordic Financial CERT. Weaknesses in processes or systems continue to count for most of the Bank's operational incidents in 2018. However, operational incidents due to external vendors increased during the year, most notably in the IT department.

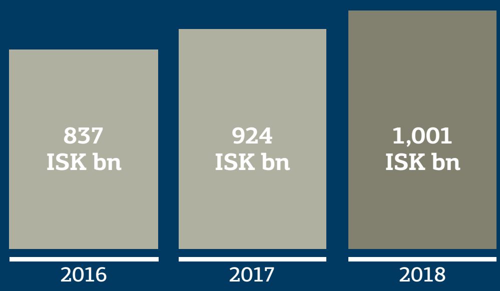
Economic outlook

Following a long period of robust growth alongside low and stable inflation, the outlook in the coming years is for a decline in economic growth and rising inflation. The economic outlook is nevertheless mostly positive, as moderate yet continuous growth is expected up to the forecast horizon of year end 2021. The Bank's Economic Research department's forecast for the next three years predicts a 2% average economic growth over the period. This is comparable to the average growth forecasted for developed economies in the coming years.

The inflation outlook has worsened somewhat since mid-2018 and inflation is expected to remain above the Central Bank's inflation target throughout the forecast period. Sharp ISK depreciation, rising import prices and increasing labour costs are the key drivers of the deteriorated inflation outlook. There is more uncertainty in the inflation forecast than often before, with the ISK exchange rate and oil price developments weighing heavily. There is also a great deal of uncertainty surrounding the outcome of collective bargaining talks which may have a considerable impact on the development of inflation in the coming years. The baseline forecast assumes that inflation will average 3.7% in 2019, 3.4% in 2020 and fall to 2.9% in 2021.

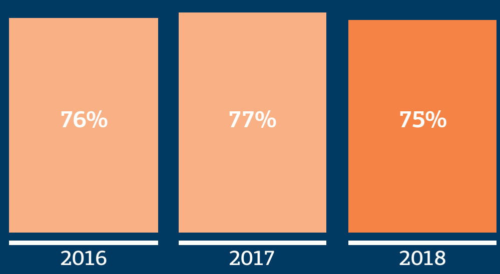
Risk metrics overview

Risk exposure amount



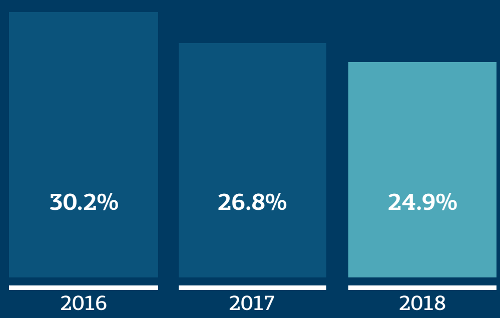
1,001 ISK bn

REA to total assets



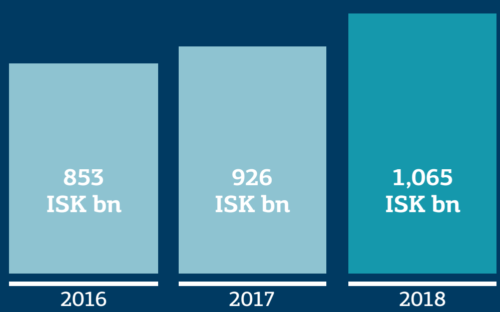
75%

Total capital ratio



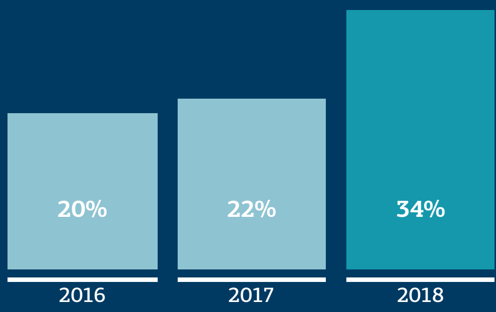
24.9%

Loans and advances to customers



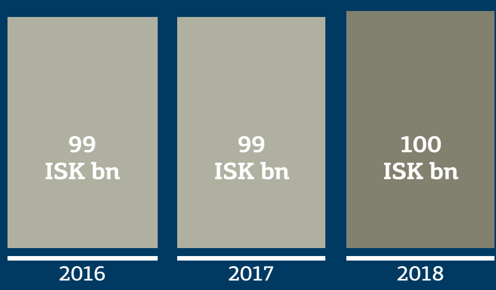
1,065 ISK bn

Large exposures to eligible capital



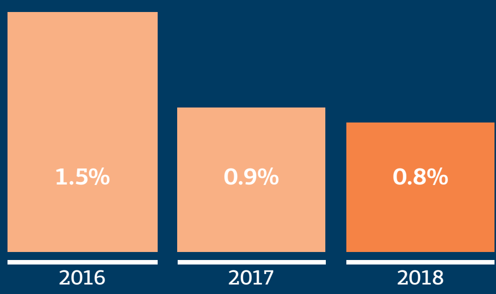
34%

Economic Capital



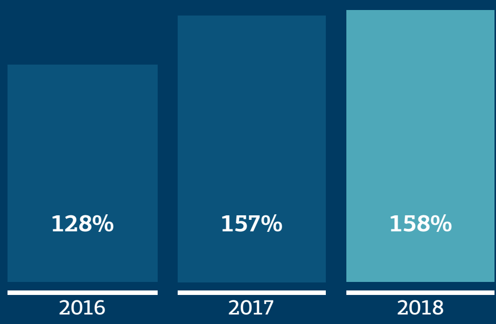
100 ISK bn

90 days past due loans



0.8%

Liquidity coverage ratio total



158%

2 Risk management

Risk Management

Risk is inherent in the Bank's activities. It 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 Bank's operations and undertakings. Risk measurement entails measuring the identified risks for management and monitoring purposes. Finally, risk controls and limits promote compliance with rules and procedures, as well as adherence with the Bank's risk appetite.

The objective of the Bank'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 endeavour that it will remain within limits and the risk appetite adopted by the Bank will comply with regulatory requirements. In order to limit and manage fluctuations that might affect the Bank's equity as well as performance, the Bank has adopted policies regarding the risk structure of its asset portfolio which are covered in more detail under each risk type.

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

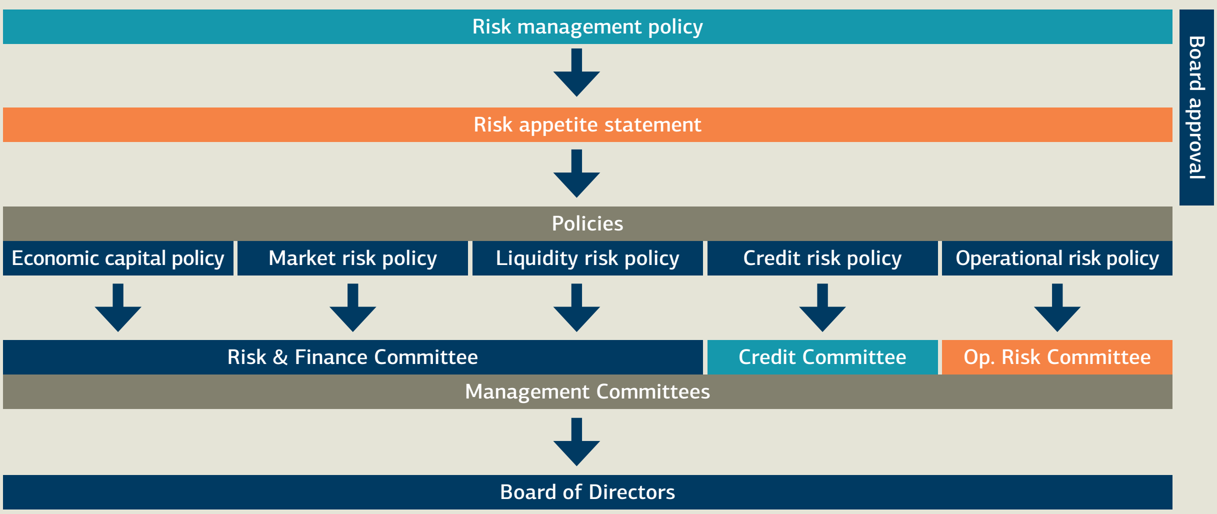
2.1 Risk appetite

The Bank's risk appetite for 2019 has been reviewed, revised and implemented. The Bank's risk policy is as follows:

The Bank's operations, risk diversification and decisions shall always be in accordance with its risk appetite, sound business practices, financing, liquidity and equity position at any given time. The Bank seeks to ensure diversified and sound financing and a sustainable risk profile. 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 operational fluctuations and is well positioned to withstand periods of increased stress.

Risk appetite defines the risk, both in terms of type and extent, which the directors are willing to take to meet the Bank's business objectives. The Bank has set itself objectives regarding financial position, asset quality, exposures and sustainable long-term profit-

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

ability. In pursuit of its goals, the Bank only takes on risks that it understands, and is able to evaluate and manage.

The Bank seeks to maintain solid business relationships, having regard for its own position as well as that of its customers at all times, and with due regard for any internal connections between customers. The Bank pursues long-term business relationships and aims to avoid reputational risk.

The Bank has set a policy on corporate social responsibility that integrates economic, social and environmental concerns in its operations. The policy aims to promote sustainability in the Icelandic society, be a dynamic force, and operate in accordance with the principles of good corporate governance.

Landsbankinn is bound to comply with relevant laws and regulations in all its operations. The main focus areas within the Bank's risk culture are adherence to rules, integrity, ethical behaviour, professionalism and management promoting good risk culture.

2.2 Risk identification

The Bank is exposed to the following material risks that 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 Bank's business units and the principal risks that they are exposed to. The risk significance is assessed within the context of the Bank as a whole and is measured based on allocation of economic capital (EC) within the Bank.

The Bank also manages other relevant risks, including, but not limited to, concentration risk, business risk, legal risk, reputational risk, conduct risk, compliance risk, data risk and modelling risk.

2.3 Risk management structure

The Bank aims to operate in line with international best practice and guidelines on risk managament. The Bank devotes substantial resources to develop and maintain its risk management systems and operations.

The Bank's risk management is based on guidelines, policies and instructions determined by the Board of Directors. The Bank 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 Bank's risk management governance structure at year end 2018 is shown in Tables 2-2 and 2-3:

Effective sub-committees provide important preparation for Board mettings. The establishment of sub-committees is designed to facilitate discussion and deeper analysis of issues for the Board's attention and its efficacy.

The Board assesses its need for sub-committees at the Board level, according to legal requirements and the size and scope of the Bank at each time, as well as the composition of the Board. The Bank's corporate governance statement is required to provide information on the establishment and appointment of sub-committees. There are currently four sub-committees of the Board of Directors.

The Audit Committee's role is to ensure the quality of the Bank'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 Bank's financial and consolidated statements and assesses the independence of the Bank'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 serves as a consulting entity to the Board of Directors in the development of the Bank's risk strategy and risk appetite. The Committee also advises the Board on the Bank's risk culture and on the organisation and effectuation of the Bank's risk policy as well as reviewing the Bank's policy as set forth in risk rules at least annually. The Committee assesses the Bank's risk management framework on an annual basis, concerning all significant risk factors and reviews reports from internal control on internal control factors concerning risk management. The Committee also reviews policies on capital management and funding, ICAAP/ILAAP reports, the results of stress tests, credit decision issues, the status of the Bank's loan portfolio, procedures for impairment calculations, the operations of Compliance and other types of risks as and where applicable.

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 IT, Compliance Officer, Senior Director of Operation, Director of Operational Risk

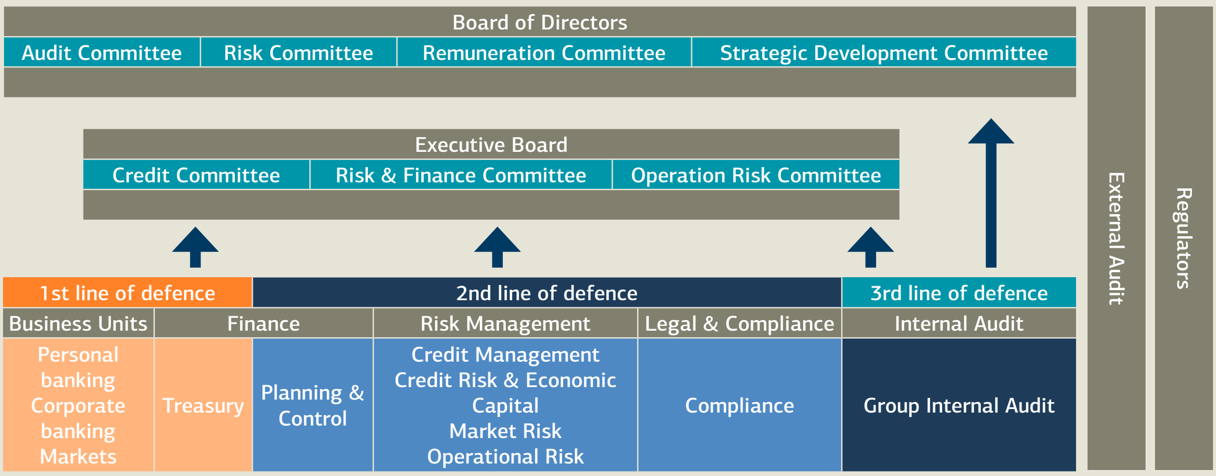
The Remuneration Committee reports annually to the Board of Directors.The Committee guides the Board of Directors and the CEO on remuneration policy and monitors the implementation of that policy after it's been approved. For further details on the Bank's remuneration policy, see Section 9.

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

The Board of Directors has overall responsibility for the establishment and oversight of the risk management framework risk appetite, and risk limit 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 primarily covers market risk, liquidity risk and legal risk. The Risk & Finance Committee monitors the Bank's overall risk position, is responsible for enforcing the Bank's risk appetite and risk limits, and reviews and approves changes to risk models before presentation 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 makes decisions on operating matters that are not under consideration in other standing committees. The Operational Risk Committee is a forum for discussion and decisions on operational risk issues and review of the effective implementation of the operational risk framework.

Figure 2-2



Governance pertaining to specific risks is discussed in the relevant sections.

2.3.2 Risk Management Division

The 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.

The Risk Management Division comprised seven departments at year end 2018:

- The Credit Management Department reviews and signs 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 Department also oversees regular updates of the Bank's rules regarding the lending process.

- The Credit Risk Department is responsible for measuring and monitoring credit risk as well as for providing the Bank with systems and processes to measure, monitor and control credit risk in credit and policy decisions. Credit Risk is further responsible for analysis and reporting on credit risk, economic capital and impairment. Credit Risk is also responsible for setting rules and procedures regarding credit risk, such as procedures for impairment measurement, credit mitigation and forbearance.

- The Market Risk Department is responsible for measuring, monitoring and reporting on market risk, liquidity risk and interest rate risk in the Bank's banking book along with limit monitoring and reporting. The Department develops and maintains the Bank's market risk models and maintains the Bank's Market Risk Policy and Liquidity Risk Policy, as well as implementing processes to measure and monitor market risk and liquidity risk within the Bank. 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 Bank.

- The Operational Risk Department is responsible for ensuring that the Bank'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 Bank's policy on operational risk as well as the rules on new products, are the responsibility of the Department. The Department is partly responsible for the security system of the online bank. The Operational Risk Department heads the work on the Bank's certification under the ISO 27001 standard for information security.

- The Risk Manager for Pension Funds is responsible for development and implementation of risk policy and risk governance, execution of risk assessment and correspondence with regulators such as the Central Bank and the FSA. The Risk Manager also makes sure that monitoring of regulatory compliance is carried out, reviews calculations and results and performs tolerance interval monitoring. The Risk Manager has direct access to the boards of the pension funds and also reports to their managing directors.

- The Internal Modelling Department is responsible for providing the Bank with IRB and EC models and related processes to estimate credit risk and link the risk to equity, as well as for providing support during the implementation of those models and processes within the Bank. The Department is also responsible for the development of models for pre-approved limits.
- The Risk Solutions Department develops and operates external solutions used by the Risk Management Division, as well as maintaining the development and reporting environments of the Risk Division. The Department is also responsible for monitoring and maintaining periodic executions of code by the Division and reporting to supervisory parties. The Department has also been responsible for the implementation of the Basel Committee on Banking Supervision for the effective risk data aggregation and risk reporting standard or BCBS 239.

2.3.3 Compliance

Compliance is an independent management unit, directly under the CEO in the Bank's organisational chart, operating in accordance with a letter of appointment from the Board of Directors. Compliance uses its independence from other units to help shape its operations.

As part of the Bank's second level control, Compliance is responsible for monitoring adherence to laws and actions against money laundering and financing of terrorist activities, laws on securities trading and data protection laws. Compliance also monitors the efficiency of the Bank's policy on abidance with laws, regulations and internal rules.

Compliance consults and instructs management on the effects of changes to the legal environment on the Bank's operations, measures to prevent conflict of interest, and any action necessary to ensure that the Bank operates in accordance with proper and sound business practices with the aim of strengthening the credibility of and confidence in financial markets.

The Data Protection Officer works independently out of Compliance, in accordance with a letter of appointment from the Board of Directors.

2.3.4 Internal Audit

Internal Audit is an independent, objective assurance and consulting activity that is a part of the Bank's organisational chart and an element of its monitoring system. The Board of Directors oversees Internal Audit and appoints the Chief Internal Auditor. The Internal Audit role is to improve and protect the Bank's value with risk-focused and objective verification, consultation and insight. Internal Audit evaluates and improves the risk management framework, control and governance processes according to systematic and disciplined practices and thus supports the Bank in accomplishing its objectives. The Chief Internal Auditor is responsible for ensuring that Internal Audit works in accordance with laws, recommendations from the Financial Supervisory Authority No. 3/2008, and standards and guidelines cited therein, including the benchmarks of the Institute of Internal Auditors (IIA).

2.4 Risk measurement

The Bank regularly monitors and assesses its current risk profile in important business areas and for the most significant, measurable risk types. It also constantly seeks to improve the process for setting 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 Bank'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, operational risk and funding risk. Each target or limit varies in detail, as well as which metrics are used, depending on their properties, and how they are suited to facilitate risk management in an efficient manner. In addition, the Bank measures and monitors other key risk indicators which address process risk as well as additional credit, market, operational and funding risk.

Economic Capital (EC) is a key element in the management of the Bank's risk and capital structure, as well as in day-to-day financial management. EC is the estimated capital required to cover the Bank's unexpected loss over the next twelve months. One of the benefits of EC is that it presents an aggregate figure for all measurable risk types, products and business units. It thus produces a unified risk measurement expressed as a single unit of value, and the capital will at any time reflect the Bank's risk for the next year. Further details on EC are provided in Section 3.4.2.

2.4.1 Stress testing and sensitivity analysis

Stress testing and sensitivity analysis are important tools used to quantify risk in severe, unlikely but plausible, scenarios. This section provides an overview of stress testing and sensitivity analysis for different risk types within the Bank.

2.4.1.1 Capital management

Stress testing is an important part of the Bank's 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:

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

The Bank aims to develop scenarios which are dynamic, forward focused and simultaneously cover key aspects of the Bank's operations, including system-wide interactions and feedback effects.

In 2018, the Bank developed 3 scenarios, including a baseline scenario. These scenarios assume developments of key macro indicators over a three-year period. Scenarios demonstrate an alternative development of key economic variables induced by various shocks compared to the baseline macroeconomic forecast of the Bank's Economic Research Department.

When scenarios have been developed and approved by the Board, a scenario translation is applied. The Bank uses both statistical

Overview of the main risk appetite measures Table 2-4

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
Liquidity risk	Liquidity coverage ratio - Total
	Liquidity coverage ratio - FX
Operational risk	Change in REA
Funding risk	Net stable funding ratio
	Economic capital
	Equity position

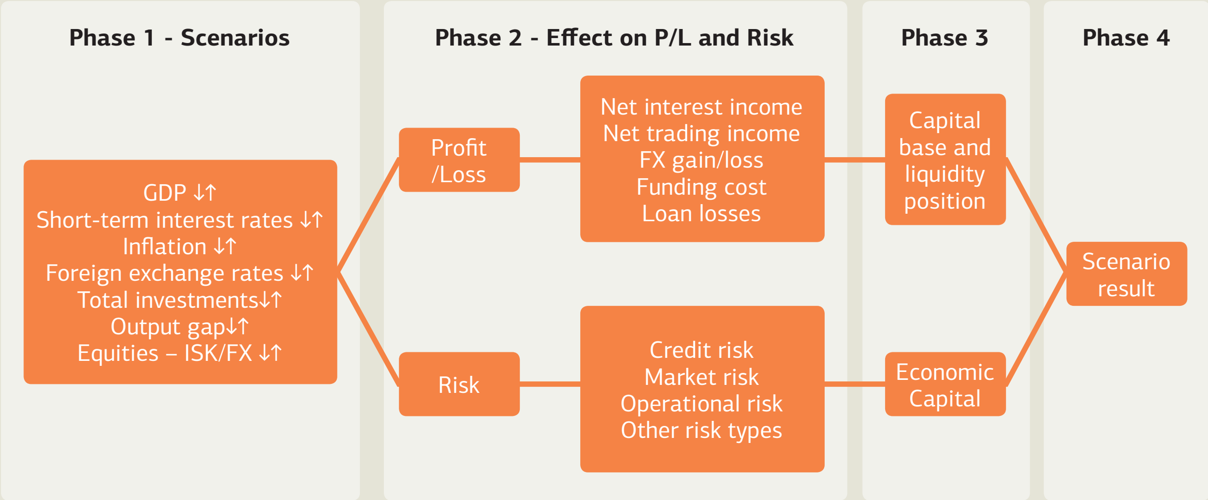


Figure 2-3

models as well as expert judgement.

The Bank 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 for a given scenario. In addition to the loan loss model results, expert judgement is applied for loan loss on selected large exposures by industries hit by the scenario shock.

Scenario results are compared with the Bank's current business plan, risk appetite, and the Bank's solvency.

The effect on financial statements is translated and calculated with a resulting impact on the capital base and liquidity position. EC for the Bank is calculated for each scenario, as well as various risk metrics within the Bank's risk appetite. If the risk appetite constraints are violated, management actions are required within the scenario.

In June 2018, Act No. 161/2002, on financial undertakings, was amended to incorporate a part of the Bank Recovery and Resolution Directive No. 2014/59/EU (also referred to as the BRRD), which was implemented within the European Union in January 2015. The amendments are the first step in implementing BRRD into Icelandic law with the incorporation of a recovery plan, early intervention and intra-bank financial support.

In response to this, the Bank has prepared a recovery plan on a group level, based on consolidated financial information as at 31 December 2017. In accordance with Article 82(a) of the act, the Bank has identified a total of 16 recovery indicators with the aim to assess the overall financial strength of the Bank, as well as relevant threshold levels indicating the need for pre-emptive measures to be taken.

2.4.1.2 Market risk

The Bank conducts stress tests and sensitivity analysis pertaining to market risk on a regular and ad-hoc basis. Comprehensive market risk stress testing is conducted as a part of the Bank's ICAAP/ILAAP once a year with a time horizon of three years. Other stress tests and sensitivity analyses of the Bank's trading and non-trading portfolios with regards to equity and interest rate risk and currency risk are made on a case-by case basis. These stress tests are subjective in nature and may pertain to specific portfolios, instruments or issuers, and usually stem from concerns regarding the Bank's operating environment, economic conditions, portfolio composition, or other reasons relevant to the Bank at the time.

The Bank uses value-at-risk (VaR) and expected shortfall (ES) 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, and the Bank calculates daily VaR at the 99% confidence interval using at least one year of historical data. Both parametric and historical VaR for the Bank's trading books in equity, fixed

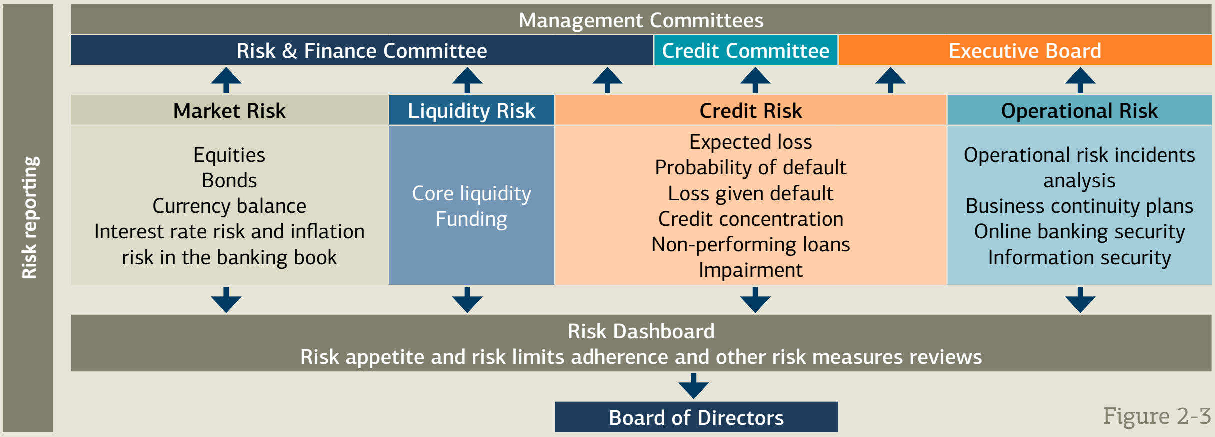


Figure 2-3

income and FX are calculated and reported to relevant parties.

Back-testing is used to evaluate the quality of the Bank's VaR model. Back-testing is done according to the Basel III 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 if end-of-day positions were to remain unchanged). A period of one year is applied as a general reference.

It is important to note that all VaR models are subject to certain assumptions and approximations that may or may not hold in real adverse market conditions and can have a major effect on model outcomes. Limitations of VaR include, for example, the use of historical data as an indicator of future events, assumptions of being able to liquidate or hedge positions fully within the relevant time horizon, and potential losses beyond the given confidence interval. Furthermore, domestic markets are relatively small and shallow. Hence, it is necessary to complement VaR calculations with subjective stress testing and sensitivity analysis to estimate possible losses due to market risk. In light of this, the Bank does not employ VaR to control market risk or set trading book limits, but rather views it as one of several indicators to better enable market risk management.

2.4.1.3 Liquidity risk

Various stress tests have been constructed to try to efficiently model how different scenarios affect the Bank's liquidity position and liquidity risk. The stress tests are based on the Bank's balance sheet mixture, as well as taking the Bank's current operating environment into account. Key liquidity metrics are also mapped onto annual internal stress tests that 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 and liquidity position of the Bank. The Bank's own subjective views, historical trends and expert opinion are key factors in constructing the stress tests. All stress tests are regularly reviewed by the Risk and Finance Committee and the stress test results are a part of the Bank's early warning indicators for liquidity risk. The Bank also performs other internal stress tests that may vary from time to time.

2.5 Risk monitoring

The Bank allocates considerable resources to ensure on-going adherence with 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.

The Bank has implemented a policy on risk data in compliance with BCBS 239 (Basel Committee on Banking Supervision's guideline 239 on effective risk data aggregation and risk reporting). The policy defines which reports should be submitted where, the frequency of those submissions, and who's responsible for them. The Board of Directors receives thorough risk reports six times a year for different risk types, as well as a comprehensive monthly risk overview. Furthermore, the Board reviews the Bank's liquidity risk on a more regular basis. 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, and a weekly report on the Bank's liquidity. Furthermore, the Bank has implemented an internal online risk dashboard for executive managers where up-to-date risk material is available. The Board and executive management are actively involved in the process of generating an expanded ICAAP/ILAAP report, which is ultimately submitted to the Board for approval once a year. The ICAAP/ILAAP report is then subject to the FME's Supervisory Review and Evaluation Process (SREP). Finally, a detailed EC report is annually submitted to the Board of Directors.

Principal reporting to the Board of Directors Table 2-5

	Annual
Risk and capital management report	Pillar III disclosures
ICAAP/ILAAP report	Evaluation of the risk profile and 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 REA and other related aspects
	Bi-annual
Credit risk report	Thorough risk report summarising the Bank's credit risk exposures and any concerns regarding credit risk
Market & liquidity risk report	Thorough risk report summarising the Bank'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 relevant to executive management and board	An aggregate report containing information on the Bank's risk appetite and material from the credit, market, liquidity and operational risk reports as well as risk-related material such as risk appetite, EC and RAROC. The report is interactive and available electronically.

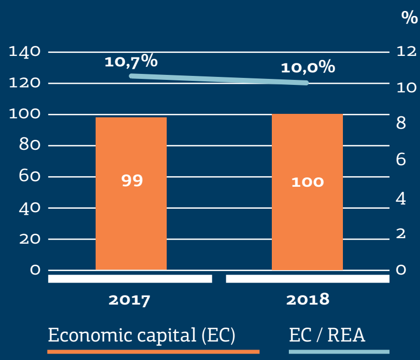
3 Capital management

Capital Management

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

- The Bank's total capital ratio decreased by 1.8 percentage points in 2018 to 24.9%
- A dividend payment of ISK 1.05 per. share in the total amount of ISK 24.8 billion was made in 2018
- The overall economic capital remained stable in 2018 while the risk exposure amount increased resulting in an EC/REA ratio of 10.0%

Economic capital



3.1 Capital management framework, roles and responsibilities

The purpose of the Bank's capital management framework is to support the Bank's strategy and ensure that it has sufficient capital to cover its risks at all times. The capital management framework of the Bank is comprised of 4 interdependent activities: capital assessment, risk appetite / capital target, capital planning, and reporting/monitoring.

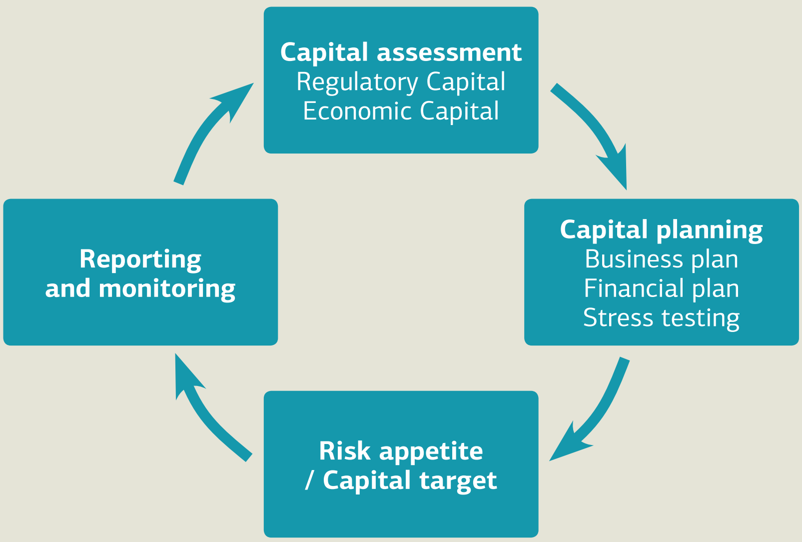
The Bank uses standardised approaches in measuring the regulatory capital requirement for Pillar I risks and economic capital (EC) for capital management purposes.

The Bank's capital management governance structure at year end 2018 is as follows:

Board of Directors

The Board of Directors of Landsbankinn is responsible for reviewing and approving the Bank's business strategy and policy on aggregate exposure and determines the Bank's risk appetite. The Board of Directors entrusts implementation of the policy to the CEO. The Board of Directors approves the Bank's

Capital management framework Figure 3-1



current issuance programme and subordinated borrowings. The Board of Directors shall be actively involved in the design and implementation of stress tests and ensure that they are based on robust and efficient governance and methodology.

CEO, Risk & Finance Committee

The CEO is responsible for implementation of the capital structure policy and manages this duty through the Bank's Risk & Finance Committee. The Committee is responsible for ensuring compliance with the policy in the development of the Bank's business and financial plans. The Risk & Finance Committee is responsible for the design and presentation of stress tests and scenarios.

Finance

The CFO is responsible for the day-to-day capital management and funding of the Bank and reports to the Risk & Finance Committee. Finance is tasked with monitoring the risk-weighted asset base, the capital base and capital position at any given time, and reporting on these matters. Reporting incorporates regular reports on developments in the capital base and equity requirements and plans, as well as the ICAAP/ILAAP report. Finance is responsible to the Risk & Finance Committee for the design and presentation of scenarios and implementation of stress testing of the Bank's capital structure. Treasury, a department within Finance, is responsible to the Risk & Finance Committee for the management of the Bank's funding, both in ISK and foreign currency.

Risk Management

The CRO is responsible for risk assessment and monitoring of risk factors and reports to the Risk & Finance Committee. Risk Management is also responsible for the economic capital framework and measurement and the Pillar III Risk report.

Managing Directors of income-generating divisions

The Managing Directors of income-generating divisions shall comply with the capital structure policy in their activities. This means inter alia that business decisions taken within these divisions shall comply with the business and financial plan, risk appetite and the Bank's current profitability target.

Internal Audit

Internal Audit shall regularly review and comment on the framework and work procedures related to the capital structure policy and, thereby, help ensure that the policy extends to and is proportional to the nature, scope and risk inherent in the Bank's operation.

3.2 Capital policy and capital targets

The Bank has a policy on capital structure, the objective of which is to ensure appropriate management, efficiency and economic utilisation of the Bank's equity, while, additionally ensuring that the Bank fulfils regulatory capital requirements at all times. With active capital management, the Bank ensures that dividend payments based on its dividend policy do not weaken its equity and liquidity positions in excess of set limits, and that the Bank can at all times meet increased risk in its operating environment.

The total capital ratio target is annually set as a part of the Bank's risk appetite. When setting the target, EC, Pillar I and II capital requirements, regulatory capital buffers, management capital buffer, risk appetite, and strategic objectives are considered. The Bank's aim is to maintain a capital ratio above the FME's total capital requirement at any given time, plus a management buffer specified in the Bank's risk appetite. 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.

The Bank aims to pay regular dividends to shareholders amounting in general to ≥50% of the previous year's profit. In line with the Bank's target capital and liquidity ratios, the aim is also to make special dividend payments to optimise the Bank's capital structure.

In determining the amount of dividend payments, the Bank's continued strong financial position shall be ensured. Risk in the Bank's internal and external environment, growth prospects and the maintenance of a long-term, robust equity and liquidity position shall be taken into account, as well as compliance with regulatory requirements of financial standing at any given time.

The Internal Capital / Liquidity Adequacy Assessment Process (ICAAP/ILAAP) under Pillar II

31.12.2018	CET1	Tier 1	Total
Pillar I	4.5%	6.0%	8.0%
Pillar II-R	2.3%	3.0%	4.0%
Minimum requirement under Pillar I and Pillar II-R	**6.8%**	**9.0%**	**12.0%**
Systemic risk buffer	2.85%	2.85%	2.85%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%
Countercyclical capital buffer	1.19%	1.19%	1.19%
Capital conservation buffer	2.50%	2.50%	2.50%
Combined buffer requirement	**8.54%**	**8.54%**	**8.54%**
Total capital requirement	**15.3%**	**17.5%**	**20.5%**

Table 3-1

is the Bank's own assessment of its capital need. It is based on EC calculations, stress testing and current results from the Supervisory Review and Evaluation Process (SREP) by the FME. ICAAP/ILAAP and SREP form the foundation for the Bank's capital planning, including the business and financial plan for the next 3 years. The Bank's most recent capital requirements, as determined by the FME, are shown in Table 3-1 (%/REA):

Based on the current regulatory capital requirement of a 20.5% capital ratio and a management buffer of 1.5-2.5%, the Bank's capital targets are shown in Table 3-2.

In July 2018, the international rating agency S&P Global Ratings announced an affirmation of the Bank's long- and short-term credit ratings (BBB+/A-2) with an unchanged stable outlook. S&P believes that the Icelandic banking market has stabilised and further improvement might not be seen in the competitive and funding landscape over the next few years. Overall, economic risks in Iceland remain stable as the economy continues to grow and signs of overheating are receding. The stable outlook on Landsbankinn reflects S&P expectations that the Bank's RAC ratio will remain above 15% over the next two years, despite high dividend payments and share-buyback programmes. The agency views the Bank's asset quality as in line with the risks in the Icelandic market, and with that of domestic peers. The stable outlook further balances a view of strong economic development in Iceland against the relatively concentrated and volatile nature of the Icelandic economy and increasing economic imbalances. S&P's reports and announcements are accessible on the Bank's website.

Table 3-2

Ratio	Goal	2018	2017	2016	Comment
Total capital ratio	≥23%	24.9%	26.7%	30.2%	Long-term goal.
Common equity Tier 1	≥18%	23.6%	26.3%	29.7%	Long-term goal.
Dividend pay-out ratio	≥50%	78%	78%	78%	Regular dividend payment as a percentage of last year's profit. In addition, special dividend payments were agreed at the AGM for 2017 and 2018. Targeted dividend pay-out ratio updated from 60 - 80% to ≥50% of previous year's profit.

24 All amounts are in ISK millions Risk and Capital Management 2018

3.3 Capital position

The Bank's equity decreased by ISK 6.5 billion in 2018 and amounted to ISK 239.6 billion (2017: ISK 246.1 billion) at 31 December 2018. The capital adequacy ratio is calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings. The Bank's total capital ratio remained strong despite decreasing by 1.8 percentage points in 2018 and was 24.9% at 31 December 2018 (2017: 26.7%).

Under the Act, the minimum capital ratio in relation to REA is 8%, with a minimum of 4.5% CET1 and 6% Tier 1 capital.

A dividend payment of ISK 1.05 per share in the total amount of ISK 24.82 billion was made in 2018. Dividends were paid in two instalments, ISK 15.36 billion for the operating year 2017, which is equivalent to 78% of the year's profit, and a special dividend to shareholders in the amount of ISK 9.46 billion. This is in line with the Bank's capital

The capital base consists of CET1 and Tier 2 capital and the breakdown is as follows:

The capital base Table 3-3

Capital base	**31.12.2018**	**31.12.2017**
Share capital	23,625	23,640
Share premium	120,630	120,764
Reserve	12,130	12,902
Retained earnings	83,225	88,751
Total equity attributable to owners of the Bank	**239,610**	**246,057**
Intangible assets	-2,622	-3,044
Deferred tax assets	-134	0
Fair value hedges	-602	0
CET1	**236,252**	**243,013**
Non-controlling interests	0	0
Tier 1 capital	**236,252**	**243,013**
Subordinated liabilities	13,340	77
General credit risk adjustment	0	4,037
Tier 2 capital	**13,340**	**4,114**
Capital base	**249,592**	**247,127**
Risk esposure amount (REA)		
Credit risk	887,372	809,492
Market risk	17,739	17,664
Operational risk	95,815	96,962
Total REA	**1,000,926**	**924,118**
CET1 ratio	23.6%	26.3%
TCR	24.9%	26.7%

25 All amounts are in ISK millions Risk and Capital Management 2018

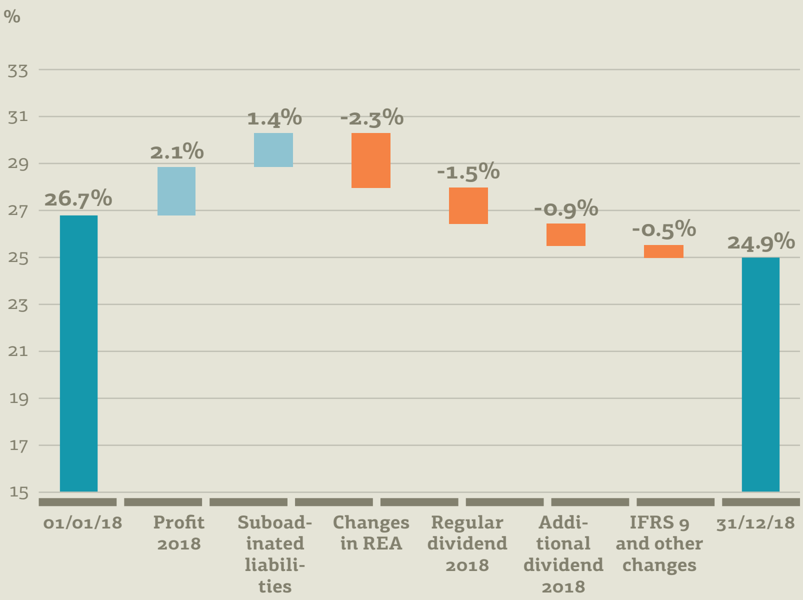
and dividend policy as well as the Bank's risk appetite. Changes in the Bank's TCR are demonstrated in Figure 3-2.

3.3.1 CET1 capital and statutory deductions

CET1 capital consists of core equity less statutory deductions according to requirements of the FME based on Article 10 of Act No. 161/2002.[1] The Bank makes deductions in order to determine its CET1 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.
- Foreseeable dividends in next year's operations

Change in capital ratio Figure 3-2



1 Article 55, see http://www.althingi.is/lagas/145b/2002161.html

Capital requirement

Table 3-4

Capital requirement and REA	31/12/18		2018 change		31/12/17	
Credit risk breakdown	**CR**	**REA**	**CR**	**REA**	**CR**	**REA**
Central governments or central banks	65	817	-91	-1,141	157	1,958
Regional governments or local authorities	150	1,869	-18	-229	168	2,097
Institutions	1,225	15,313	441	5,512	784	9,801
Corporations	45,708	571,347	4,287	53,593	41,420	517,755
Retail	9,727	121,586	3,107	38,832	6,620	82,754
Secured by real estate property	10,111	126,384	-880	-11,003	10,991	137,387
Past due items	1,823	22,784	84	1,054	1,738	21,730
Items belonging to regulatory high-risk categories*	0	0	0	0	0	0
Short-term claims on institutions and corporate	0	0	0	0	0	0
Other items	2,182	27,272	-699	-8,738	2,881	36,010
Credit risk	**70,990**	**887,372**	**6,230**	**77,880**	**64,759**	**809,492**
Market risk breakdown						
Traded debt instruments	163	2,037	-28	-351	191	2,388
Equities	706	8,823	-104	-1,294	809	10,117
CVA	37	464	-8	-101	45	565
Market risk	**906**	**11,325**	**-94**	**-1,745**	**1,000**	**13,070**
Currency risk	**513**	**6,415**	**146**	**1,821**	**368**	**4,594**
Operational risk	**7,665**	**95,815**	**-92**	**-1,147**	**7,757**	**96,962**
Total capital requirement and REA	**80,074**	**1,000,926**	**6,190**	**76,808**	**73,884**	**924,118**

3.4 Capital assessment

3.4.1 Minimum capital requirement

The regulatory minimum capital requirement (CR) under Pillar I of the Directive is 8% of risk-weighted assets for credit risk, market risk and operational risk. The Bank uses the standardised approach in measuring Pillar I capital requirements for credit risk and market risk. For operational risk, it uses the basic indicator approach.

The Bank's risk exposure amount (REA) was ISK 1,001 billion at year end 2018 and increased by ISK 77 billion, or 8.3%, for the year. Accordingly, the minimum capital requirement for the Bank is ISK 80.1 billion. Credit risk is the single largest risk type or 89% of total REA and minimum capital requirement.

3.4.2 Economic capital

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

2 See Staðalaðferð http://www.stjornartidindi.is/Advert.aspx?ID=f051707c-8c23-4e99-a305-68dcb6f97a29

27 All amounts are in ISK millions Risk and Capital Management 2018

Table 3-5 summarises how the Bank calculates its EC for the risks included in the framework.

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 inputs 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. Each EC is calculated according to a stressed Value-at-Risk model as specified in the internal model's approach in the capital requirements directive (CRR). The model inputs are calibrated to historical data from the previous 5 years. EC for credit valuation adjustment (CVA) equals the capital requirements for CVA.
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 Bank's 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, 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 sum of: i The loss in economic value corresponding to the 99.9th percentile for ISK and the 99th percentile for significant foreign currencies of risk factor changes estimated by a Monte Carlo simulation model. ii The loss in economic value due to a +/- 200 bps shift of risk factors in other currencies (whichever results in a larger loss).
Operational risk	EC for operational risk is calculated using the basic indicator approach, which means that it equals the Bank'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.

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

Economic capital ISK million	2018	2017
Credit risk - Loans to customers and credit institutions	62,956	59,477
Credit risk - Other assets	5,144	7,001
Market risk	2,769	2,717
Currency risk	1,369	948
Operational risk	7,665	7,757
Single name concentration risk	5,401	5,048
Industry concentration risk	1,246	1,224
Interest rate and inflation risk	7,171	10,072
Business risk	3,833	3,878
Legal and political risk	2,092	482
Total	**99,646**	**98,604**
REA	1,000,926	924,118
EC/REA	**10.0%**	**10.7%**

Table 3-6

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 Bank to assess the amount of capital it requires to cover the economic effects of risk-taking activities, as well as to compare different risk types using a common "risk currency".

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

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

EC amounted to ISK 99.6 billion at 31 December 2018 and increased slightly during the year (2017: ISK 98.6 billion). The ratio of EC to REA decreased from 10.7% to 10.0% during the year. This is due to an increase in the REA which is primarily caused by an increase in lending.

Credit risk as at 31 December 2018	PD	LGD	EAD	EC
Financial institutions	0.1%	45.0%	71,606	1,146
Public entities	0.1%	45.0%	125,117	149
Retail*	2.6%	25.7%	493,358	14,129
Corporates	2.4%	35.9%	685,874	47,531
Total	**2.1%**	**33.5%**	**1,375,955**	**62,955**

Credit risk as at 31 December 2017	PD	LGD	EAD	EC
Financial institutions	0.1%	45.0%	46,818	783
Public entities	0.1%	45.0%	150,347	173
Retail*	2.9%	26.4%	415,860	12,989
Corporates	2.6%	37.3%	608,843	45,532
Total	**2.3%**	**34.9%**	**1,221,868**	**59,477**

*Retail exposure consists of small and medium-sized enterprises with total exposure under ISK 75 million and which meet the criteria of EU Directive No. 2003/361/EC on SMEs and individuals.

Table 3-7

Even though the credit quality improved in 2018 the economic capital to cover credit risk increased slightly due to increased lending.

Economic capital for market risk increased slightly in 2018, from ISK 3.7 billion at year end 2017, to ISK 4.1 billion at year end 2018 due to longer currency positions and increased volatility in the markets.

The Bank revised its methodology for estimating interest rate risk in the banking book in foreign currency at year end 2018. The risk is now calculated as the loss in economic value of assets and liabilities due to risk factor changes estimated by a Monte Carlo simulation model with a 99% confidence interval, removing the previously used 0% floor for yield curve shifts. These changes did not have a significant effect on the Bank's economic capital as at 31 December 2018.

Economic capital for interest rate risk and inflation risk in the banking book decreased significantly during 2018, from ISK 10 billion at year end 2017, to ISK 7.2 billion at year end 2018. The observed decrease is primarily due to fixed/floating CPI-linked interest rate swaps in ISK that the Bank entered into in 2018.

The Bank revised its rating grade model for smaller corporates in 2018, but the effects of the revision on EC were insignificant.

The Bank also re-calibrated its LGD model to historical loss data in 2018, but the effects of the re-calibration on EC were insignificant.

Table 3-7 shows a further breakdown for credit risk, probability of default by asset class, as well as loss given default, exposure at default and economic capital.

3.4.2.1 SME factor

Given that customers fulfil certain requirements, an SME factor can be used to decrease the risk exposure amount (REA) for credit risk from loans to customers and credit institutions. The Bank's REA for credit risk from loans to customers and credit institutions was ISK 860 billion but if the Bank was allowed to use the SME factor, the REA would decrease by ISK 13 billion and amount to ISK 847 billion. Customers must fulfil the following requirements so that the factor can be used:

1. A consolidated financial statement must be present.
2. The customer's operating income must be EUR 50 mil. or lower.
3. The customer's on-balance position must be EUR 1,5 mil. or lower.
4. The exposure must be classified as 'corporate', 'retail' or 'secured by mortgages on immovable property'.

30 All amounts are in ISK millions Risk and Capital Management 2018

Pillar 1 risks	REA 2018	REA 2017	CR 2018	CR 2017
Credit risk	887,372	809,492	70,990	64,759
Market risk	11,325	13,070	906	1,046
Currency risk	6,415	4,594	513	368
Operational risk	95,815	96,962	7,665	7,757
Total Pillar 1 risks	**1,000,926**	**924,118**	**80,074**	**73,929**
Pillar 2 risks				
Credit risk			-2,890	1,719
Market risk			1,863	1,671
Currency risk			856	580
Concentration risk			6,647	6,272
Interest rate risk and inflation risk in the banking book			7,171	10,072
Business risk			3,833	3,878
Legal & government risk			2,092	482
Total Pillar 2 risks			**19,572**	**24,674**
Total capital requirements			99,646	98,603
Total own funds (CAR)			236,110	247,127
EC / REA			**10.0%**	**10.7%**

Table 3-8

3.4.3 Pillar II

Pillar II sets forth the framework for the supervisory review process (SREP) and the framework for the Bank's internal capital/liquidity adequacy assessment process (ICAAP/ILAAP). The Bank is exposed to many risks, and they are not limited to those that are quantified under Pillar I (credit, market and operational risks). Pillar II concerns the Bank's risks in a wider sense, yet it's still specific to its operations like risk profile and business environment.

The Bank's EC equals Pillar I + Pillar II capital requirements at any given time. At 31.12.2018 the Bank's EC was ISK 99.4 billion or 10.0% of REA. ISK 80.1 million thereof is the Pillar I 8% minimum capital requirement, meaning the Bank's Pillar II requirement at 31.12.2018 is 1.9% or ISK 19.3 billion decreasing from ISK 24.7 billion, or 2.7%, at year end 2017.

3.4.4 Capital buffers

On 1 January 2014, a 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). CRD IV was incorporated into Icelandic law in 2016. The phasing in of capital buffers has been completed for the three large Icelandic banks, including Landsbankinn.

Active capital buffers at year end 2018 for the Bank as recommended by the Icelandic Financial Stability Council to the FME is 8.75% of REA.

31 All amounts are in ISK millions Risk and Capital Management 2018

Following recommendations of the FSC, the FME has decided to raise the countercyclical capital buffer to 1.75% on 15 May 2019 and 2.00% on 1 February 2020. The FME requires the Bank to maintain a capital ratio that reflects the fully phased-in capital buffers or 8.75% at year end 2018, 9.25% from mid May 2019 and 9.50% from 1 February 2020. As previously mentioned, the Bank has determined a range for a management buffer of 1.5%-2.5% in its risk appetite.

Table 3-9	1.11.2017	15.5.2019	1.2.2020
Systemic Risk Buffer	3.00%	3.00%	3.00%
O-SII Buffer	2.00%	2.00%	2.00%
Counter-cyclical Buffer	1.25%	1.75%	2.00%
Capital Conservation Buffer	2.50%	2.50%	2.50%
Total	**8.75%**	**9.25%**	**9.50%**

The capital buffers are expressed as a proportion of REA. However, the systemic risk buffer and the counter-cyclical buffer only apply to domestic REA. Proportional distribution of domestic and foreign REA at year end 2018 as compared to 2017 remained unchanged as shown in the following table:

Table 3-10	2018	2017
Domestic REA	94%	94%
Foreign REA	6%	6%
Total	100%	100%

3.4.5 Risk-adjusted return on capital

To analyse the Bank'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 senior management. The objective of the measures is to assess shareholder value creation and profitability in relation to the equity capital needed to cover the undertaken risks, i.e., the economic capital. The measures enable risk-based pricing, increase 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. These measures have been enforced throughout the Bank. By enforcing this, the Bank 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.

3.4.6 Capital allocation to business lines

The Bank makes an internal capital allocation across business divisions on the basis of each unit's contribution to the Bank's total risk as estimated by the Bank's Economic capital model. Capital exceeding the Bank's minimum capital target and the management buffer is allocated to Treasury. Allocated capital plus retained earnings per business units at year end 2018 is shown in Figure 3-3.

Capital allocation pr. business line

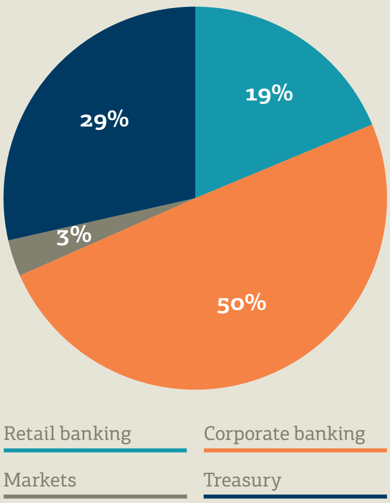


Figure 3-3

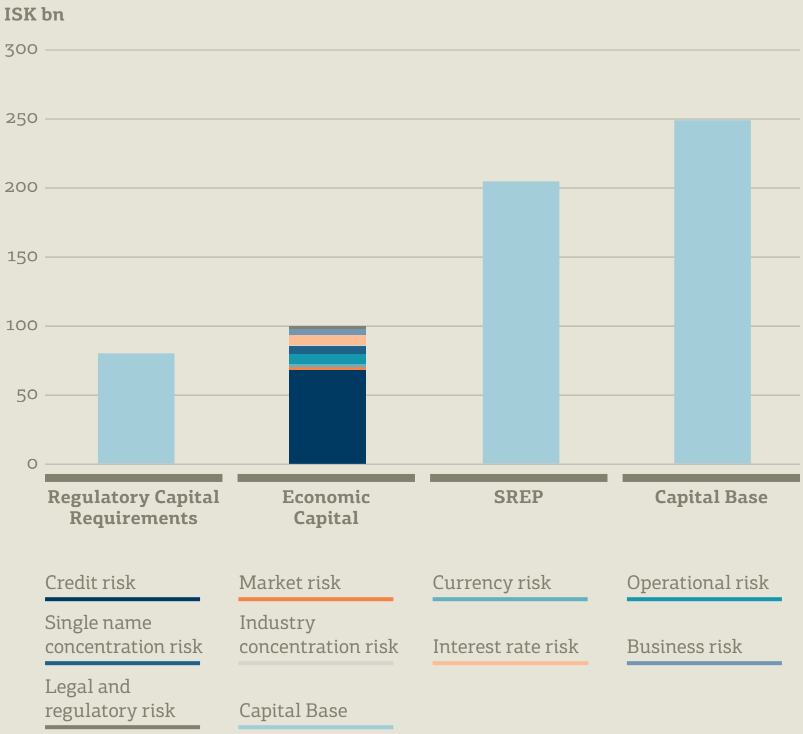
32 All amounts are in ISK millions Risk and Capital Management 2018

3.4.7 Capital assessment 31.12.2018

At 31.12.2018 the Bank estimated its EC at ISK 99.4 billion and the minimum capital requirement to be ISK 80.1 billion. Additional Pillar II capital requirements amounted to ISK 19.3 billion compared to ISK 24.7 billion at year end 2017. Pillar I and Pillar II risk amount to 10.0% of total REA. Additionally, 8.75% capital buffers and a minimum 1.5% management buffer leads to the Bank's capital assessment of TCR 20.15%.

The Bank's 24.9% capital ratio is comfortably above its strategic TCR target of ≥23% at year end 2018. Further the Bank's CET1 ratio was 23.6% which is well above the Bank's long-term target of ≥18%. Compared to the latest SREP requirement of 20.5% the Bank's excess capital from a regulatory point of view is 4.4 percentage points or ISK 44 billion.

Landsbankinn Capital position as of 31.12.2018 Figure 3-4



Leverage ratio		Table 3-11
	2018	**2017**
Tier 1 capital	236,252	243,012
Leverage exposure		
- On balance sheet exposure (excluding derivatives)	1,324,118	1,190,965
- Derivatives instrument exposure	1,923	1,905
- Potential future exposure on derivatives	1,674	1,568
- Off balance sheet exposure	147,010	141,482
- Regulatory adjustments to Tier 1 capital	-3,358	-3,044
Total leverage exposure	**1,471,367**	**1,332,875**
Leverage ratio	**16.1%**	**18.2%**

3.5 Leverage ratio

The Capital Requirements Regulation (CRR), as part of the Basel III framework, requires banks to measure, report and monitor their leverage ratios. The ratio is defined as CET1 capital as a percentage of total leverage exposure (see table 3-11) 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 31.12.2018, the Bank's leverage ratio was 16,1%, over five-fold the 3% minimum requirement. Further information about the leverage ratio can be found in the additional disclosures accompanying this document.

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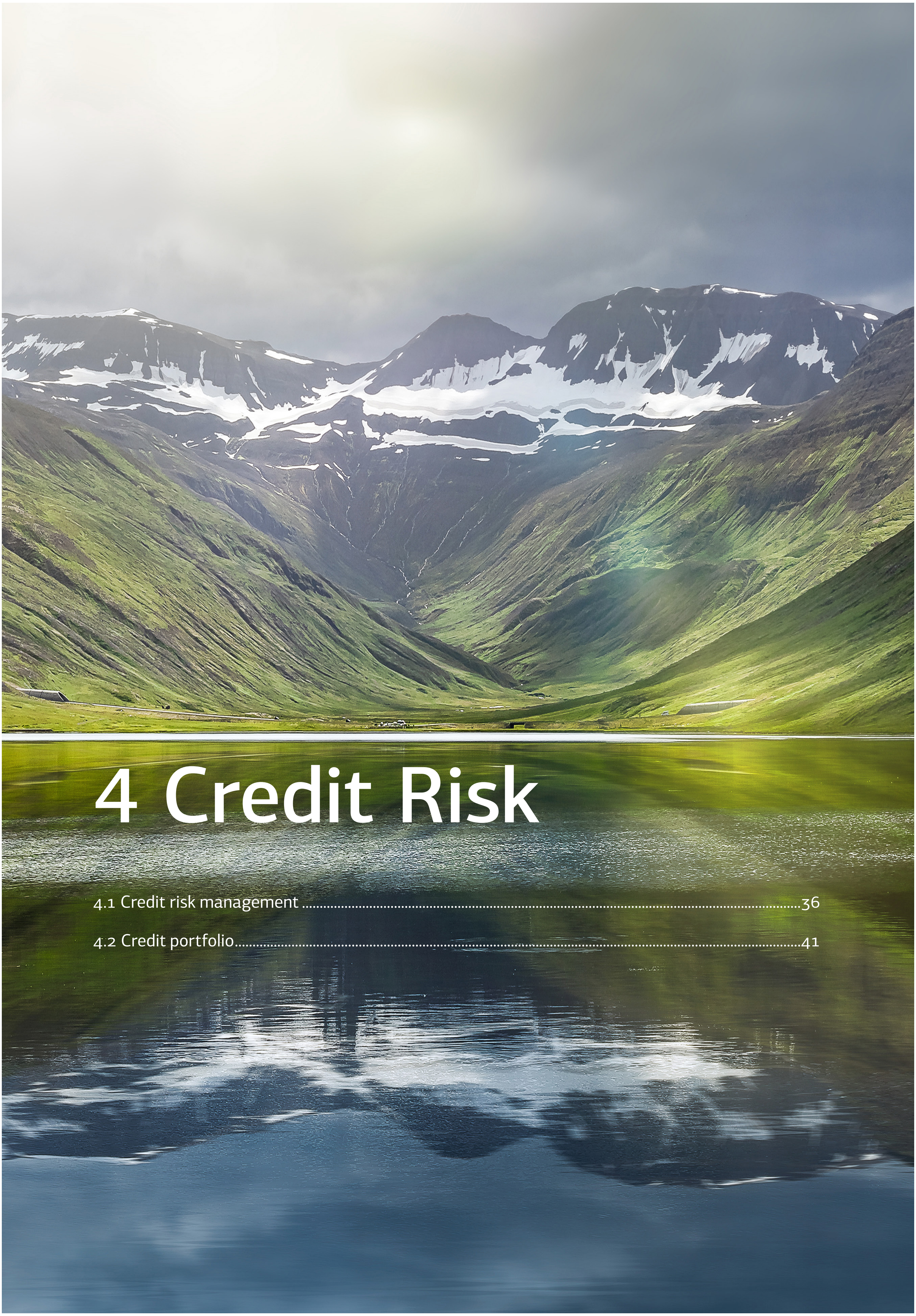


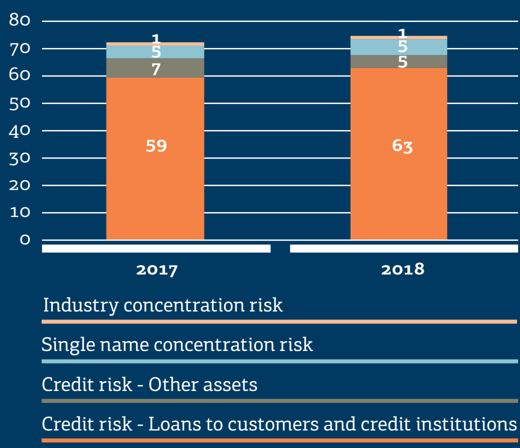
4 Credit Risk

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 decreased slightly during 2018, reaching 2.1% at year end 2018 compared to 2.3% at the end of 2017
- Economic capital due to credit risk increased slightly in 2018 due to increased lending

Economic capital



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

At year end 2018, 89% of the Bank's risk exposure amount (REA) was due to credit risk. On the same date, total loans and advances amounted to ISK 1,136 billion (2017: ISK 971 billion), with ISK 1,065 billion coming from lending activities (2017: ISK 926 billion) and ISK 71 billion from loans and advances to financial institutions (2017: ISK 45 billion).

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

Managerial efforts to moderate credit risk continued to support the Bank's credit risk profile in 2018. Overall credit quality remained stable, with 75% of total credit exposure having rating grades from 5 to 10, 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 credit risk concentration (limits on single names and industries).

Regular risk reporting enables the ongoing monitoring of the Bank'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 primarily managed through the credit process and the Bank's credit risk models which include PD, LGD and EAD modelling. The models are used for various purposes, e.g., in provisioning and management reporting.

4.1.1 Identification

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

The Bank'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 Bank and principally arises 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 the aforementioned settlement risk.

4.1.2 Assessment

Credit risk is measured in three main dimensions: probability of default (PD), loss given default (LGD) and exposure at default (EAD). For the purpose of measuring PD, the Bank 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 exclusively reflects 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', with '10' indicating the highest credit quality, and the grade '0' for defaulted obligors. The rating assignment is supported by rating

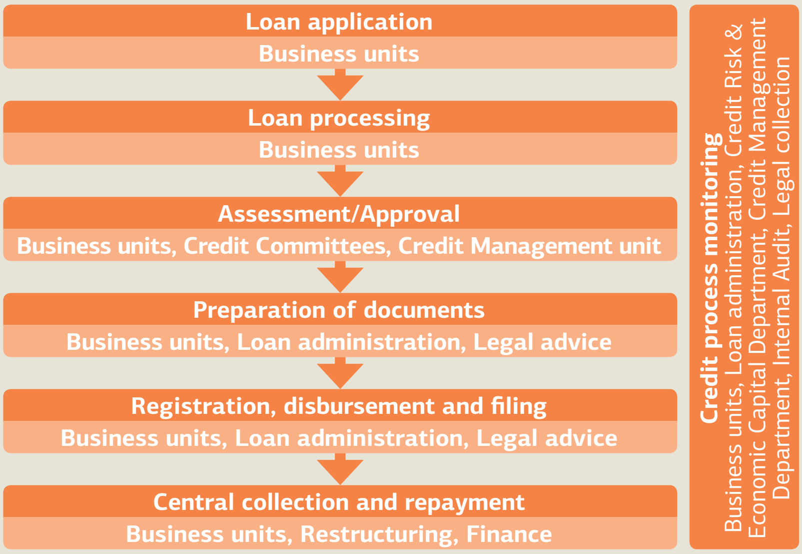


Figure 4-1

Rating category and PD band

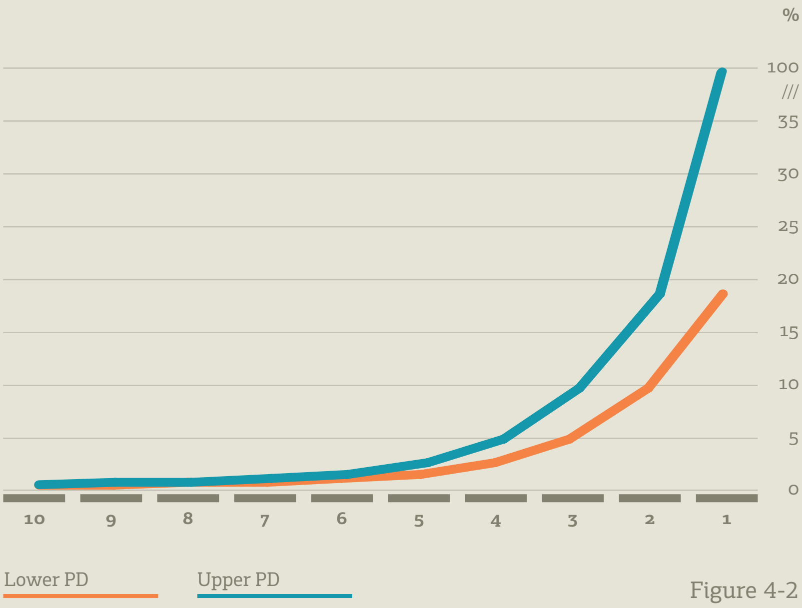


Figure 4-2

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 framework requirement of 0.5. Furthermore, the models are well calibrated, i.e., the weighted probability of default for each rating grade is equal to the

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

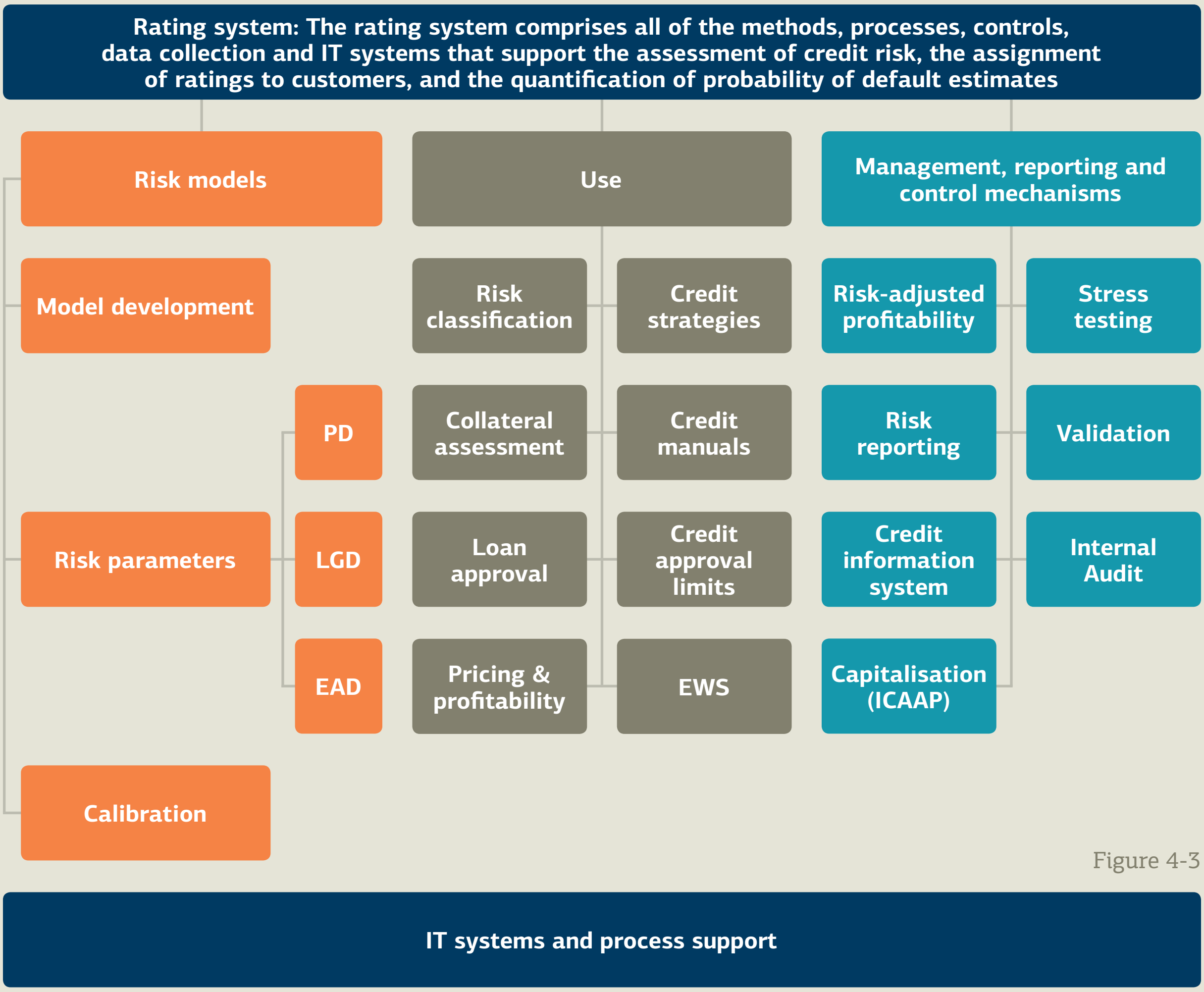


Figure 4-3

38 All amounts are in ISK millions Risk and Capital Management 2018

actual default rate with respect to reasonable error limits.

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 model defined in the Basel framework, was updated and calibrated to historical loss data in 2018.

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. The Bank uses the standard approach for estimating economic capital, but the internal models for provisioning.

4.1.3 Management and policy

The Bank's credit risk management objective is to ensure compliance with the Bank's credit policy, which entails that the only risk taken is one that the Bank understands, can measure and manage.

The Bank'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 Bank manages credit risk according to its risk appetite statement and credit policy approved by the Board of Directors, as well as detailed credit policies 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 exposure to certain industries. The CEO ensures that the risk policy is reflected in the Bank's internal framework of regulations and guidelines. The Bank's executives are responsible for ensuring that the Bank's business units execute the risk policy appropriately as the CEO is responsible for the oversight of the process as a whole.

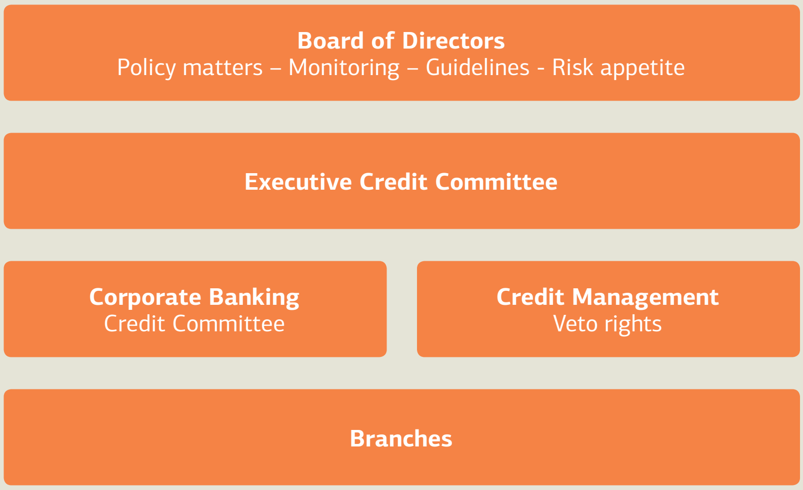


Figure 4-4

Incremental credit authorisation levels are defined based on size of units, types of customers and the lending experience of credit officers. The Bank has also implemented industry policies to the credit decision process. Credit decisions exceeding authorisation levels of business units are subject to confirmation by Credit Management, a department within Risk Management. The Corporate Banking Credit Committee has authorisation levels exceeding that of individual business unit managers and meets regularly to make credit decisions. Credit Management has veto powers over the decisions of the Corporate Banking Credit Committee. Credit decisions exceeding the signing limits of the Corporate Banking Credit Committee are subject to approval by the Bank'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 Bank's credit policy, as well as 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 majority of collateral types 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 Bank's credit policy. Credit extended by the Bank may be secured on residential or commercial properties, land, securities, transport vessels, fishing vessels together with their non-transferable fishing quotas, etc. The Bank 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 Bank regularly assesses the market value of received collateral. The Bank has developed models to estimate the value of the most frequent types of collateral. For collateral where no valuation model exists, the Bank 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 Bank monitors the market value of mark-to-market collateral and may require additional collateral in accordance with the underlying loan agreements.

In order to further limit the credit risk arising from financial instruments, the Bank enters into netting agreements, under which the Bank 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 Bank 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 Bank 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 price volatility and the expected costs of repossession and sale of the pledge into account.

4.1.4.1 Derivative financial instruments

In order to mitigate credit risk arising from derivatives, the Bank chooses the counterparties for derivatives trading based on stringent requirements, according to which clients must meet certain conditions set by the Bank. The Bank 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 Bank enters into. Collateral management and monitoring is performed daily, and derivative contracts with clients are usually fully hedged.

The Bank'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 Bank are offset when the Bank 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 Bank uses fair value estimates based on available information and the Bank's own estimates.

4.1.5 Control and monitoring

The Bank monitors exposures to identify signs of weakness in customer earnings and liquidity as soon as possible. To monitor customers, the Bank 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 as follows:

- 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 Department within Risk Management is together with the business units responsible for the colour classification of customers.

4.1.6 Impairment process

As at 1 January 2018, the Bank implemented the three-stage expected credit loss model under IFRS 9. Allowance is calculated as the 12-month expected credit loss (ECL) or the lifetime expected credit loss.

The Bank recognises loss allowances for ECL on the following financial instruments that are not measured at fair value through profit or loss:

- Cash and balances with Central Bank
- Bonds and debt instruments
- Loans and advances to financial institutions
- Loans and advances to customers

Off-balance sheet exposures:

- Financial guarantees and underwriting commitments
- Undrawn loan commitments
- Undrawn overdraft/credit card facilities

When measuring ECL the Bank uses a forward-focused model in compliance with IFRS 9. This requires considerable judgement over how changes in economic factors affect ECL. ECL reflects the present value of cash shortfalls due to possible default events either over the following twelve months or over the expected life of a financial instrument, depending on credit deterioration from inception.

The Credit Risk Department is responsible for assessing impairment on loans and receivables and a Valuation Team, comprised of the CEO, the Managing Directors of Finance, Risk Management, Corporate Banking and Personal Banking, reviews and approves the assessment.

4.2 Credit portfolio

4.2.1 Credit exposure

The Bank'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 ECL. Most of the exposure derives from lending activities in the form of loans with and without collateral.

At year end 2018, the total carrying amount was ISK 1,314 billion. ISK 1,065 billion is derived from lending activities, ISK 77 billion from bonds and debt instruments, and ISK 1.9 billion is derived from the carrying amount of derivatives.

Table 4.2 shows the classification of the Bank's financial assets. With the implementation of the IFRS 9 standard, the classification of the financial assets changed slightly, as seen in the table column names.

Classification of the Bank's financial assets

Table 4-2

As at 31 December 2018

Financial assets	Amortised cost	Mandatorily at fair value	Designated at fair value	Total carrying amount
Cash and balances with Central Bank	70,854	-	-	70,854
Bonds and debt instruments	3,776	63,386	9,896	77,058
Equities and equity instruments	-	23,547	-	23,547
Derivative instruments	-	1,923	-	1,923
Loans and advances to financial institutions	71,385	-	-	71,385
Loans and advances to customers	1,054,862	9,670	-	1,064,532
Other financial assets	4,864	-	-	4,864
Total	**1,205,741**	**98,526**	**9,896**	**1,314,163**

As at 31 December 2017

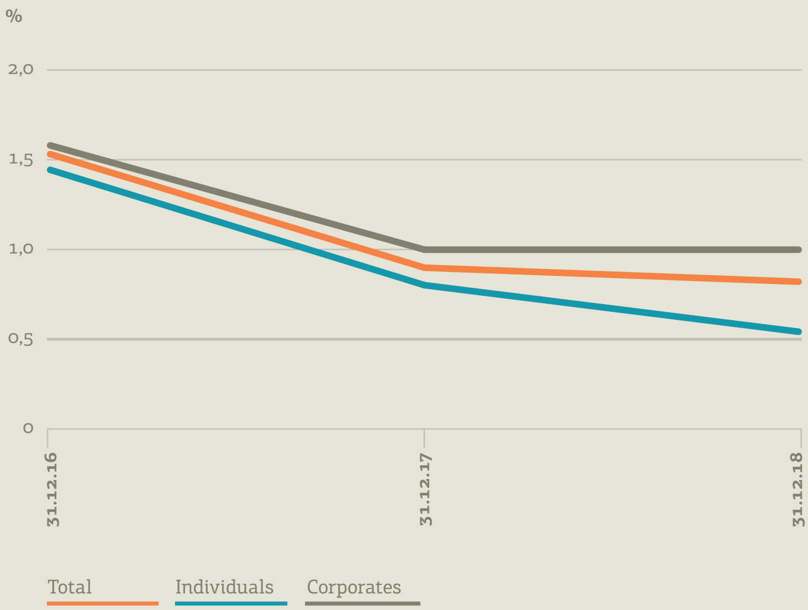
Financial assets	Loans and receivables	Held for trading	Designated at fair value	Total carrying amount
Cash and balances with Central Bank	55,192	-	-	55,192
Bonds and debt instruments	49,421	57,176	10,713	117,310
Equities and equity instruments	-	9,298	18,682	27,980
Derivative instruments	-	1,905	-	1,905
Loans and advances to financial institutions	44,866	-	-	44,866
Loans and advances to customers	925,636	-	-	925,636
Other financial assets	5,457	-	-	5,457
Total	**1,080,572**	**68,379**	**29,395**	**1,178,346**

42 All amounts are in ISK millions Risk and Capital Management 2018

4.2.1.1 Credit exposure from lending activities

At year end 2018, the Bank's total credit exposure from lending activities amounted to ISK 1,065 billion, compared to ISK 926 billion at year end 2017. This represents an increase of 15%. In 2018, there was increased credit demand in the corporate sector, primarily in fisheries, service and real estate, that resulted in a significant increase in credit exposure. Credit exposure to individuals also grew substantially, primarily due to an increase in mortgage lending. Together with continued increased lending activities, the Bank continued its focus on services to existing customers and loan refinancing as well as restructuring loans for clients in financial distress.

90 days past due ratio Figure 4-5



The overall 90 days past due ratio decreased slightly during 2018, albeit not as significantly as in the previous year. The overall ratio was 0.8% at year end 2018. This slight decrease was driven by a decrease in the 90 days past due ratio for individuals, which decreased from 0.8% at the start of 2018 to 0.5% at year end 2018. The 90 days past due ratio for corporates remains unchanged at 1.0% at year end 2018. It declined slightly during the first 9 months of the year before increasing again during the final 3 months of the year.

Overall credit exposure over 90 days past due increased slightly during the year from ISK 8 billion to ISK 9 billion. However, as the portfolio grew during the year, this results in a decrease in the overall 90 days past due ratio. The decrease is primarily due to the improved financial position of the Bank's individual borrowers and, in part, also due to the Bank's continued emphasis on reacting before default occurs. However, the increase in the 90 days past due ratio for corporates during the last quarter of the year does raise a slight concern and is a cause for careful monitoring going forward. Customers in default represented 1.9% of the total portfolio at year end 2018 measured by carrying amount, having represented 2.2% of the total portfolio at year end 2017. Although a net decrease was observed in this ratio over the year, it actually reached a low-point of 1.7% in September and has been climbing since.

The overall portfolio quality improved slightly during 2018, resulting in an exposure-weighted average probability of default of 2,1% (discussed further in Section 4.2.3). Note that the probability of default is calculated based on exposure at default.

Table 4-4 shows the different types of collateral held by the Bank 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

Past due loans by industry

Table 4-3

As at 31 December 2018	Loans and advances to customers	Loans and advances to customers past due 6-90 days	Loans and advances to customers past due more than 90 days
Public entities	4,719	0.3%	0.0%
Individuals	413,699	1.9%	0.5%
Corporates	646,113	1.2%	1.0%
Real estate companies	137,347	1.8%	0.7%
Construction companies	87,514	1.2%	2.5%
Holding companies	30,973	0.4%	0.0%
Fisheries	146,896	0.0%	0.3%
Manufacturing	21,937	0.8%	0.9%
Agriculture	8,559	2.6%	1.5%
Information, technology and communication	29,798	0.0%	0.1%
Retail	63,645	1.1%	0.7%
Services	119,426	2.3%	1.8%
Other	0	0.0%	0.2%
Total loans	**1,064,532**	**1.5%**	**0.8%**
Financial institutions	**71,385**	0.0%	0.0%
Total loans including financial institutions	**1,135,917**	**1.4%**	**0.8%**

As at 31 December 2017	Loans and advances to customers	Loans and advances to customers past due 6-90 days	Loans and advances to customers past due more than 90 days
Public entities	11,243	0.4%	0.0%
Individuals	356,940	2.3%	0.8%
Corporates	558,156	1.6%	1.0%
Real estate companies	123,245	1.9%	1.4%
Construction companies	79,906	0.7%	0.9%
Holding companies	25,894	0.0%	0.1%
Fisheries	114,136	0.3%	1.0%
Manufacturing	17,152	3.0%	0.4%
Agriculture	8,710	1.5%	0.6%
Information, technology and communication	31,563	0.3%	0.0%
Retail	54,034	2.2%	0.9%
Services	103,517	3.6%	1.4%
Other	1	0.0%	0.0%
Total loans	**925,636**	**1.9%**	**0.9%**
Financial institutions	44,866	0.0%	0.0%
Total loans including financial institutions	**970,502**	**1.8%**	**0.9%**

44 All amounts are in ISK millions Risk and Capital Management 2018

held against loans to corporates. The principal collateral held against loans to customers in the fisheries sector is transport and fishing vessels together with their non-transferable fishing quotas. The collateral value amounts are assigned to claim value amounts. The value of each held individual collateral item cannot exceed the gross carrying amount of the corresponding individual claim. Changes in collateral value amounts between periods result either from

Table 4-4

As at 31 December 2018			**Collateral types**			
Collateral value after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other***	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	209	0	2	0	49	260
Individuals	364,073	96	167	2,748	17,183	384,267
Individuals – mortgage	331,631	16	91	31	4,170	335,939
Individuals – other	32,442	80	76	2,717	13,013	48,328
Corporates	322,111	108,996	4,910	68,737	90,717	595,471
Fisheries	9,530	107,296	386	15,257	12,639	145,108
Construction companies	73,430	46	1,557	77	5,405	80,515
Real estate companies	127,043	38	555	1,221	622	129,479
Holding companies	3,093	0	146	26,251	13	29,503
Retail	22,901	3	106	12,349	23,599	58,958
Services	69,033	1,613	327	3,811	31,211	105,995
Information, technology and communication	1,293	0	30	9,507	8,451	19,281
Manufacturing	9,723	0	1,800	264	7,003	18,790
Agriculture	6,065	0	3	0	1,774	7,842
Other	0	0	0	0	0	0
Total	**686,393**	**109,092**	**5,079**	**71,485**	**107,949**	**979,998**

As at 31 December 2017			**Collateral types**			
Collateral value after haircut	**Real estate**	**Vessels**	**Deposits**	**Securities**	**Other***	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	1,218	0	41	0	348	1,608
Individuals	307,811	87	118	2,852	15,773	326,641
Individuals – mortgage	275,785	13	35	80	3,396	279,310
Individuals – other	32,025	74	83	2,772	12,377	47,331
Corporates	278,009	81,586	2,454	52,372	89,125	503,545
Fisheries	8,711	79,959	257	11,241	13,230	113,398
Construction companies	65,727	62	1,067	7	6,077	72,939
Real estate companies	110,733	25	339	1,876	797	113,770
Holding companies	1,600	0	20	22,181	11	23,812
Retail	19,482	1	156	3,584	23,823	47,046
Services	57,416	1,486	261	3,906	29,831	92,900
Information, technology and communication	517	0	31	8,431	4,459	13,438
Manufacturing	7,866	46	319	1,146	8,328	17,705
Agriculture	5,958	7	4	0	2,569	8,538
Other	0	0	0	0	0	0
Total	**587,038**	**81,673**	**2,614**	**55,224**	**105,246**	**831,795**

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

45 All amounts are in ISK millions Risk and Capital Management 2018

changes in the underlying value of collateral or changes in the credit exposure.

4.2.2 Risk concentration

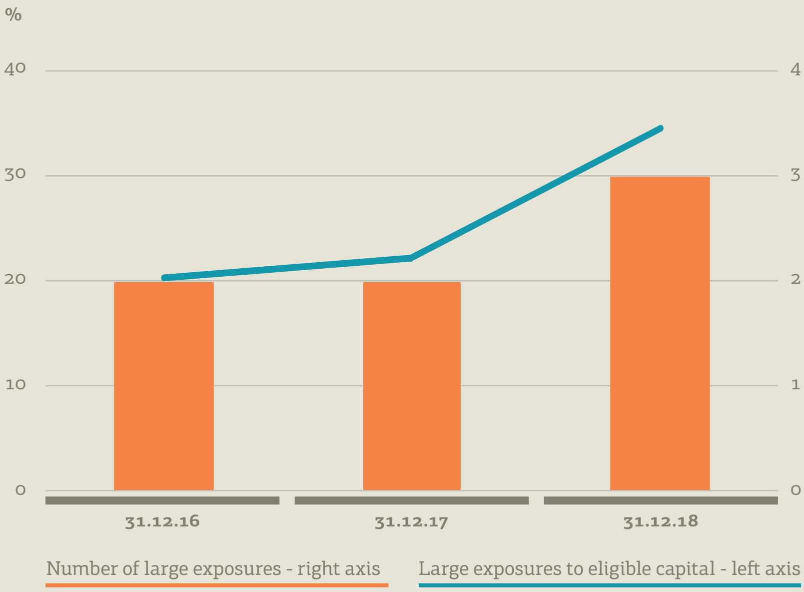
Concentration risk includes (i) single name concentrations of large (connected) individual counterparties and (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g., sector, economy, geographical location, instrument type, or other.

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

The Bank 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 Bank's business strategy. Concentration risk is credit risk related to the degree of diversification in the credit portfolio and includes both single name concentration risk and segment concentration risk.

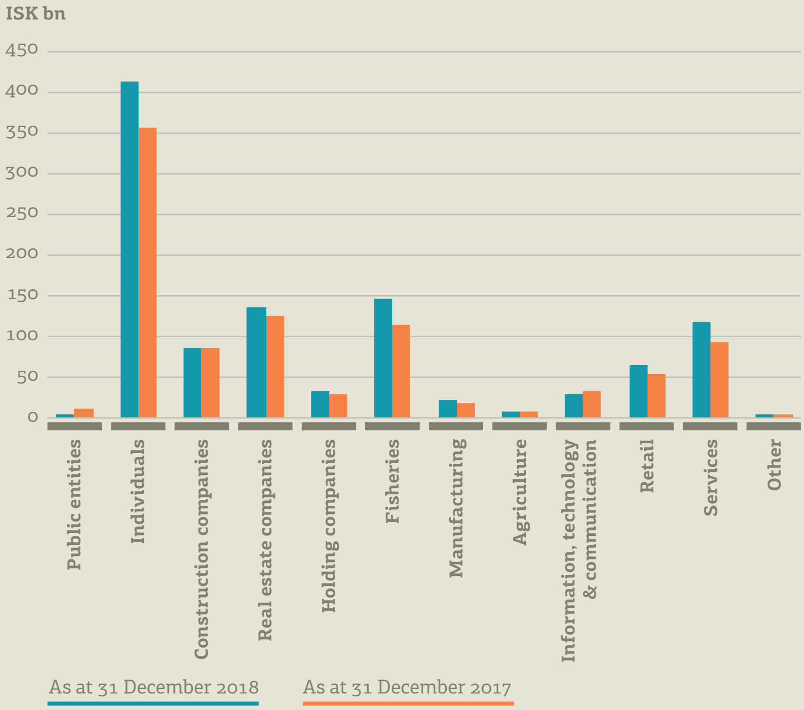
According to FME Regulation No. 233/2017 on prudential requirements for credit institutions and investments firms, exposures to a single customer or a group of related customers – after the deduction of particularly secure

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



* Large exposures after credit risk mitigation.

Industry segmentation of credit exposure Figure 4-7



claims – may not exceed 25% of the capital base. No exposure to a single customer or a group of related customers exceeded 25% in the year 2018, and at year end the largest single-customer exposure amounted to 12.9% of the capital base.

The Bank's risk profile for large exposures is reported monthly to management and the Board of Directors according to internal guidelines.

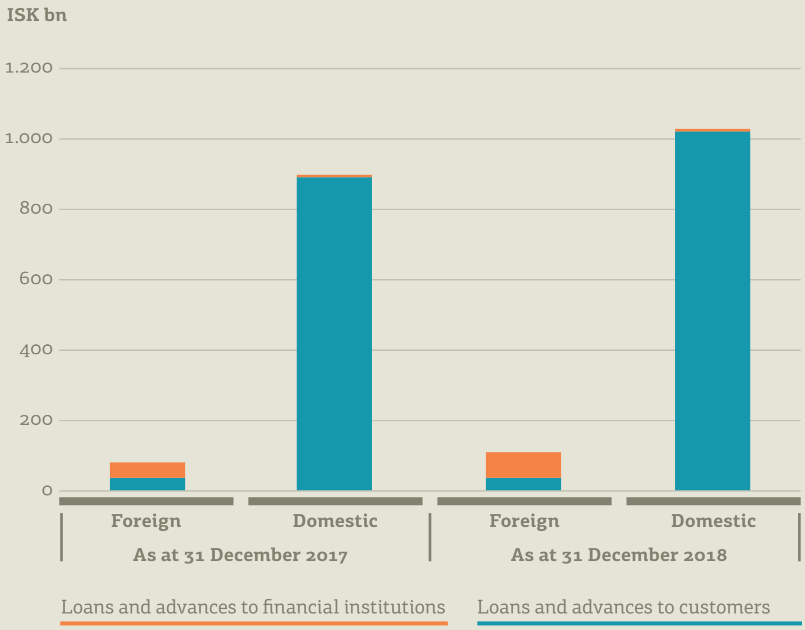
As for single name concentration the Bank's Board of Directors sets portfolio limits for segment concentration in the Bank's risk appetite.

It is a logical consequence of the Bank's business model that credit exposure from lending activities is concentrated to some industries. At year end 2018, lending to individuals represented 39% of the Bank's total credit exposure (year end 2017: 38%). Most of the demand from individuals is for property financing, and the Bank's lending to retail customers is therefore mostly secured by real estate.

The Bank's credit exposures are primarily to Icelandic corporate customers. Companies in the real estate, fisheries and service sectors represent the largest exposure to single industry sectors.

Customers domiciled in Iceland accounted for 96% of the Bank's total credit exposure in 2018 (2017: 96%). Exposure to foreign counterparties primarily relates to the management of the Bank's foreign liquidity reserves.

Loans and advances by geographical area Figure 4-8



4.2.3 Migration analysis

Migration analysis in this section is based on the Bank's rating scale and PD estimates. At the end of 2018, the average exposure-weighted PD was 2.1% (2017: 2.3%). Excluding loans to financial institutions, which as mentioned above relates to the management of the Bank's foreign liquidity reserves, the exposure-weighted PD was 2.3% (2017: 2.4%).

The overall credit quality of the loan portfolio increased slightly in 2018. However, the portfolio experienced both positive and negative migration within different industry sectors in 2018. Amongst notable credit quality changes during the year is the decrease in the average probability of default in the fisheries sector. This decrease is largely due to new exposures to customers with good credit quality in the sector. In sectors where an increase in the average probability of default was observed, such as for construction companies, a slight decrease in credit quality for some of the more significant exposures was a contributing factor. In general, where improved

Probability of default (PD) Table 4-5

(%)		As at 31 December 2018	As at 31 December 2017
Financial institutions		**0.1%**	**0.1%**
Public entities		**0.1%**	**0.1%**
Individuals		**2.3%**	**2.6%**
Corporates		**2.6%**	**3.0%**
	Construction companies	3.9%	3.3%
	Real estate companies	3.2%	2.8%
	Holding companies	2.6%	2.9%
	Fisheries	1.4%	2.4%
	Manufacturing	1.5%	3.1%
	Agriculture	2.6%	2.2%
	Information, technology & communication	1.1%	2.3%
	Retail	1.8%	2.6%
	Services	3.3%	3.8%
	Other	0.1%	3.0%
Total		**2.1%**	**2.3%**

48 All amounts are in ISK millions Risk and Capital Management 2018

credit quality is observed, underlying drivers include improved borrower operating performance, debt restructurings, customers with poor credit rating leaving the portfolio and bankruptcy resolutions. Furthermore, new exposures to customers with lower probabilities of default have a positive impact on the credit quality of the portfolio as a whole.

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

Figures 4.11 to 4.16 show the rating grade migration for corporates and individuals during 2018, based on existing customers at year end 2017 and 2018.

Migration is shown both in terms of number of customers and exposure. Migration analysis does not cover customers in default, i.e., customers with a credit rating of 0.

Figure 4-9

Rating grade distribution - Corporates

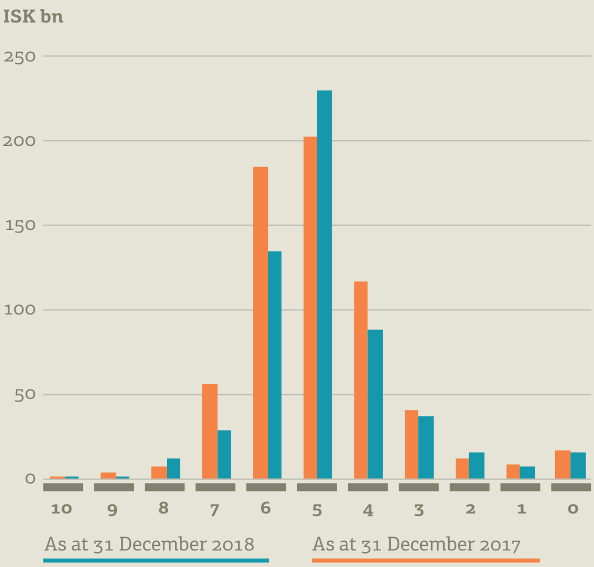


Figure 4-10

Rating grade distribution - Individuals

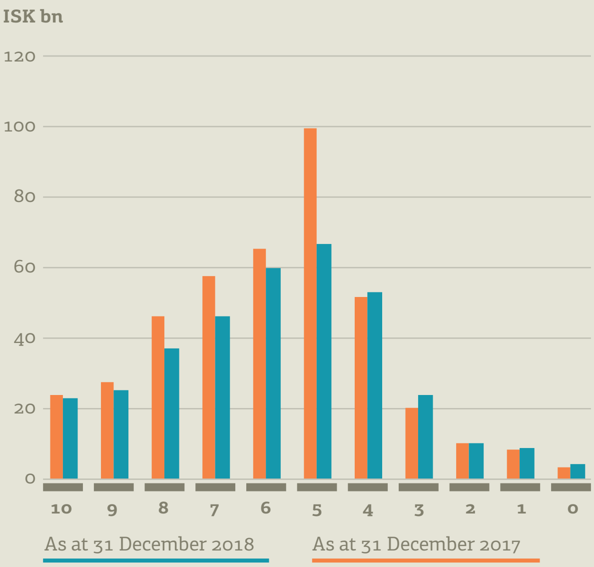


Figure 4-11

Rating migration of corporates in 2018

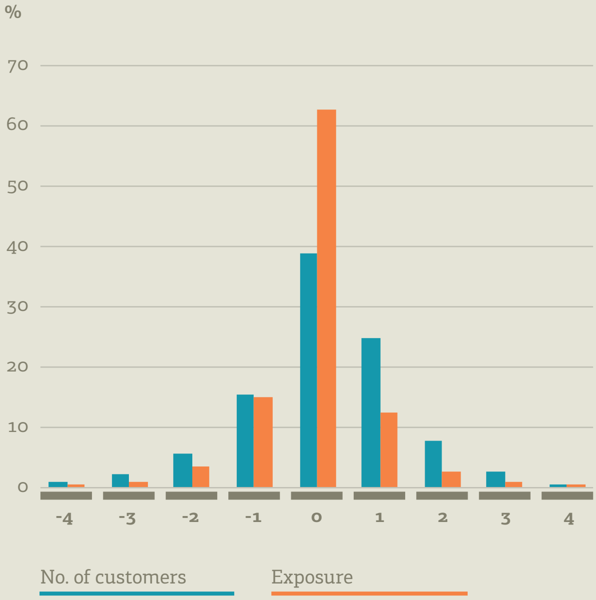
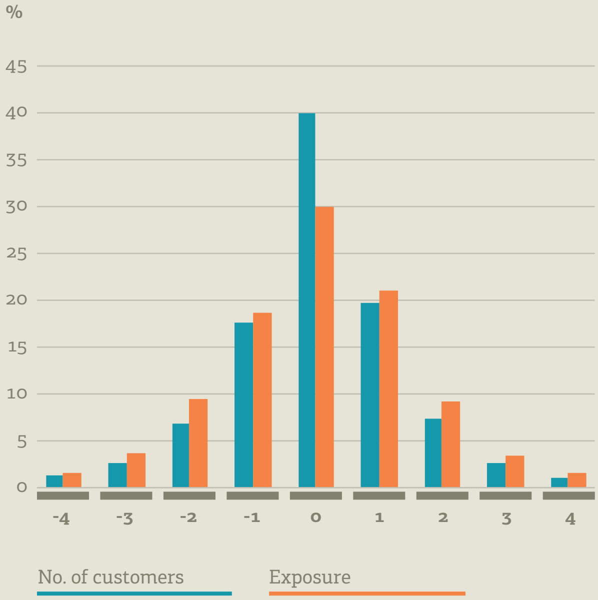


Figure 4-12

Rating migration of individuals in 2018



Rating migration of corporates in 2018 Carrying amount

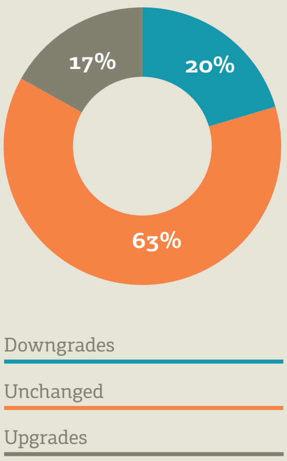


Figure 4-13

Rating migration of corporates in 2018 No. of customers

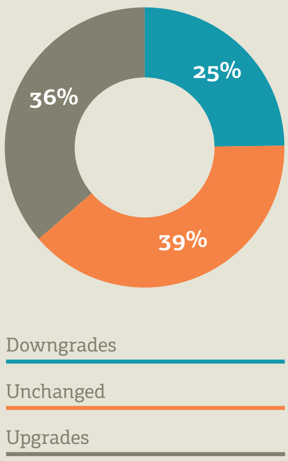


Figure 4-14

Rating migration of individuals in 2018 Carrying amount

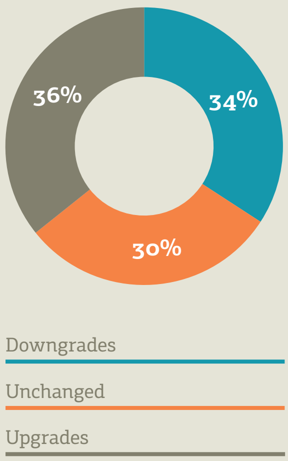


Figure 4-15

Rating migration of individuals in 2018 No. of customers

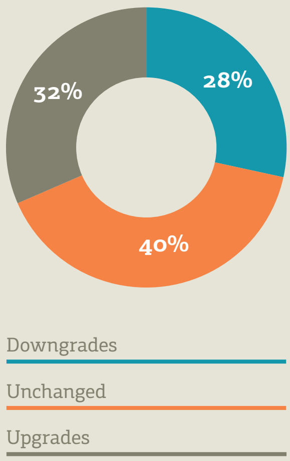


Figure 4-16

The rating and risk grade distribution primarily changes 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 Bank, compared to the rating grade distribution of existing customers during the comparison period; and, increased or decreased exposure per rating grade to existing customers.

The percentage of upgrades was higher than the percentage of downgrades both in terms of carrying amount and number of customers for individuals, and in terms of number of customers for corporates. However, the percentage for downgrades was slightly higher than the percentage of upgrades in terms of carrying amount for corporates. At year end 2018, the average exposure-weighted PD for corporate customers was 2.6% (2017: 3.0%). For individuals, the average exposure-weighted PD was 2.3% (2017: 2.6%).

The default rate, which is measured by number of customers and not exposure, for corporate customers for 2018, was 2.9% as compared to the predicted 4.5%. No corporate customers in rating grades 7, 8, 9 and 10 defaulted. The default rate of individuals for 2018 was 1.3% as compared to the predicted 2.0%. For individual rating grades, the default rate was in coherence with what was expected, for all rating grades. Predicted default rate values are based on the average through-the-cycle (TTC) PD values for each rating category at the start of the year. The fact that actual default rate values are lower than the predicted ones in 2018 is to be expected since actual default rate values are point-in-time measurements and the Icelandic economy is currently close to the peak of its cycle. In years when the economy is closer to the bottom of its cycle, the actual default rate would be expected to be higher than the corresponding predicted values.

4.2.4 Loan impairment

Total ECL amounted to ISK 13 billion at year end 2018, as compared to ISK 17 billion at the start of the year. The decrease in ECL during the year 2018 is primarily due to reversals resulting from financial assets that have been derecognised and provisions used to cover write-offs, as shown in Table 4-6.

Figure 4-17

12 month default rate vs. probability of default band - Corporates 2018

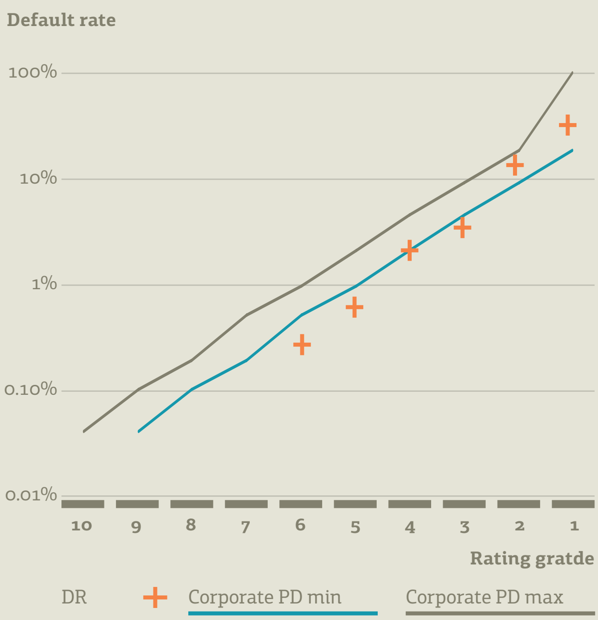
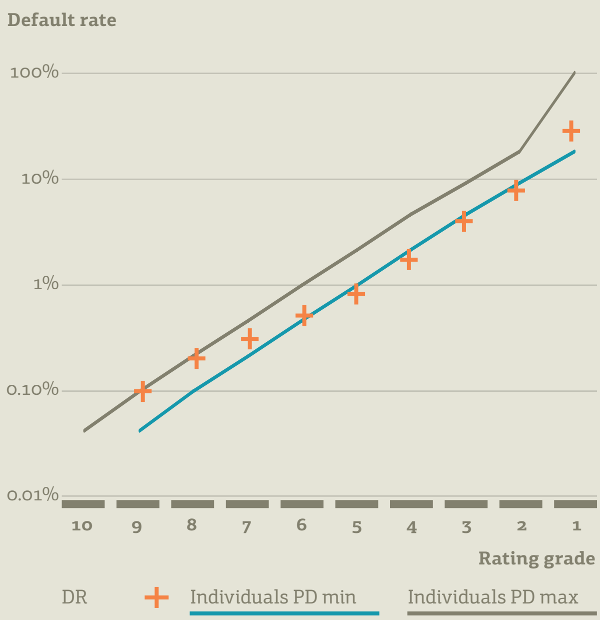


Figure 4-18

12 month default rate vs. probability of default band - Individuals 2018



Loan impairment	12-month ECL Stage 1	Lifetime ECL Stage 2	Lifetime ECL Stage 3	Total
Balance at 1 January 2018 - Financial institutions	**-3**	**0**	**0**	**-3**
New financial assets originated	0	-1	0	-2
Transfer to Stage 2 - Lifetime ECL	4	-4	0	0
Changes in models/risk parameters	-3	0	0	-3
Balance at 31 December 2018 - Financial institutions	**-2**	**-5**	**0**	**-7**
- of which classified as deduction from gross carrying amounts	-2	0	0	-2
- of which classified as liabilities	0	-5	0	-5

	12-month ECL Stage 1	Lifetime ECL Stage 2	Lifetime ECL Stage 3	Total
Balance at 1 January 2018 – Loans and advances to customers	**-2,671**	**-1,048**	**-13,075**	**-16,794**
New financial assets originated	-1,359	-350	-494	-2,203
Reversals due to financial assets that have been derecognised	976	207	1,079	2,262
Changes due to reclassification of financial assets	80	0	0	80
Transfer to Stage 1 - 12-month ECL	-103	84	19	0
Transfer to Stage 2 - Lifetime ECL	452	-483	31	0
Transfer to Stage 3 - Lifetime ECL	990	470	-1,460	0
Changes in models/risk parameters	-949	-120	1,050	-19
Provisions used to cover write-offs	31	10	3,505	3,546
Balance at 31 December 2018 - Loans and advances to customers	**-2,553**	**-1,230**	**-9,345**	**-13,128**
- of which classified as deduction from gross carrying amounts	-2,283	-1,207	-9,315	-12,805
- of which classified as liabilities	-270	-23	-29	-323

Table 4-6

Table 4-8 shows ECL by stages for loans split by industry sectors. Total loans gross increased across most sectors in 2018. Total stage 1 ECL decreased slightly in 2018, however, in sectors where a decrease in credit quality was observed, such as for real estate and construction companies, the stage 1 ECL increased slightly. Total stage 2 ECL increased slightly during the year, but total

52 All amounts are in ISK millions Risk and Capital Management 2018

	1.1.2018 - 31.12.2018				
	Financial institutions	**Public entities**	**Individuals**	**Corporates**	**Total**
New financial assets originated	-2	-1	-360	-1.843	-2.205
Reversals due to financial assets that have been derecognised	0	124	507	1.632	2.263
Changes due to reclassification of financial assets	0	0	0	80	80
Changes due to financial assets recognised in the opening balance	-3	14	173	-206	-22
Write-offs	0	0	-946	-3.714	-4.660
Provisions used to cover write-offs	0	0	654	2.892	3.546
Recoveries	0	0	509	328	837
Translation difference	0	0	1	458	459
Net impairment loss for the period	**-4**	**138**	**539**	**-372**	**299**

Table 4-7

stage 3 ECL decreased significantly during the year, mostly due to provisions used to cover write-offs. The average loss given default decreased across most sectors in 2018, most notably for the information, technology and communication sector, where a 10.2 percentage-point decrease was observed.

4.2.5 Forbearance

The Bank adopts forbearance plans to assist customers in financial difficulty. Concessions granted to customers include interest-reduction schedules, interest-only schedules, temporary payment holidays, term extensions, cancelation of outstanding fees and settlements.

Forbearance plans must comply with the Bank's Credit Policy. They are used as an instrument to maintain long-term customer relationships during economic downturns if there is a realistic possibility that the customer will be able to meet obligations again, and are used for minimising loss in the event of default.

53 All amounts are in ISK millions Risk and Capital Management 2018

ECL by stages for loans split by industry sectors

Table 4-8

As at 31 December 2018	Total loans	Off-balance	Gross carrying amount	12-month ECL – Stage 1	Lifetime ECL – Stage 2	Lifetime ECL – Stage 3	Carrying amount	Average lifetime probability of default	Average loss given default
Financial institutions	75,146	3,760	71,387	-2	0	0	71,385	0.04%	55.1%
Public entities	7,800	2,936	4,865	-8	-137	0	4,720	8.84%	55.5%
Individuals	447,158	31,099	416,040	-561	-602	-1,178	413,699	17.91%	13.3%
Mortgages	336,701	0	336,685	-240	-343	-303	335,799	20.72%	7.3%
Other	110,456	31,099	79,355	-321	-259	-875	77,900	9.31%	31.4%
Corporates	821,961	165,547	656,432	-1,714	-468	-8,137	646,113	7.68%	21.2%
Real estate companies	161,012	22,057	138,951	-569	-82	-957	137,343	13.81%	19.2%
Fisheries	160,213	12,934	147,295	-83	-42	-258	146,912	3.30%	10.3%
Services	143,881	21,511	122,383	-169	-159	-2,616	119,426	8.75%	23.2%
Construction companies	146,200	56,891	89,305	-620	-110	-1,065	87,510	6.29%	26.9%
Retail	83,960	19,502	64,457	-88	-28	-697	63,644	6.93%	22.1%
Holding companies	33,050	1,884	31,165	-84	-4	-106	30,971	6.01%	15.5%
Information, technology and communication	35,580	5,659	29,922	-61	-1	-61	29,799	6.76%	33.8%
Manufacturing	48,215	23,995	24,220	-32	-18	-2,234	21,936	5.32%	33.6%
Agriculture	9,818	1,083	8,734	-8	-24	-143	8,559	10.80%	19.6%
Other	31	31	0	0	0	0	0	0.86%	55.1%
Total	**1,352,065**	**203,341**	**1,148,724**	**-2,285**	**-1,207**	**-9,315**	**1,135,917**	**10.65%**	**20.6%**
- of which loans and advances to customers	1,276,919	199,582	1,077,337	-2,283	-1,207	-9,315	1,064,532	11.27%	18.6%
- of which loans and advances to financial institutions	75,146	3,760	71,387	-2	0	0	71,385	0.04%	55.1%

As at 31 December 2017	Gross carrying amount	Carrying amount	Impaired loans before allowances	Impaired loans in % of loans	Collective allowance	Individual allowance	Total provisioning ratio
Financial institutions	44,866	44,866	-	0.0%	-	-	-
Public entities	11,345	11,243	135	1.2%	- 56	- 46	75.6%
Individuals	359,917	356,940	4,965	1.4%	- 1,076	- 1,901	60.0%
Corporates	570,564	557,453	22,741	4.0%	- 2,905	- 10,206	57.7%
Fisheries	115,045	114,354	783	0.7%	- 357	- 334	88.2%
Construction companies	81,954	80,067	2,025	2.5%	- 643	- 1,243	93.1%
Real estate companies	124,986	123,483	3,751	3.0%	- 548	- 954	40.1%
Holding companies	26,179	25,943	138	0.5%	- 142	- 94	171.6%
Retail	53,078	52,363	1,537	2.9%	- 225	- 490	46.5%
Services	106,381	103,706	5,760	5.4%	- 522	- 2,153	46.4%
Information, technology and communication	32,066	31,624	82	0.3%	- 374	- 69	539.0%
Manufacturing	22,024	17,185	8,209	37.3%	- 73	- 4,766	59.0%
Agriculture	8,849	8,726	456	5.2%	- 20	- 103	27.0%
Other	1	1	-	0.0%	-0	-	-
Total	**986,692**	**970,502**	**27,840**	**2.8%**	**- 4,037**	**- 12,153**	**58.2%**

54 All amounts are in ISK millions Risk and Capital Management 2018

The Bank has implemented the European Banking Authority's (EBA's) definition of loans subject to forbearance measures. 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.

Total exposures subject to forbearance measures decrease from ISK 56 billion (5.7% of the total portfolio) at year end 2017 to ISK 34 billion (2.9% of the total portfolio) at year end 2018. The main reason for this decrease is large exposures to certain customers no longer being subject to forbearance measures.

4.2.6 Credit risk analysis by industry sectors

This section describes developments in credit quality for the three largest corporate sectors in the Bank's lending portfolio in the year 2018.

4.2.6.1 Fisheries

Loans and advances to customers in the fisheries industry

Exposures subject to forbearance measures Table 4-9

	31.12.2018		31.12.2017	
(ISK millions)	Performing	Non-performing	Performing	Non-performing
Modification	15,249	16,079	13,168	13,702
Refinancing	1,026	1,223	22,464	6,590
- of which: Under probation	2,616	0	451	0
Total	**16,275**	**17,301**	**35,632**	**20,292**

amounted to ISK 147 billion as at 31 December 2018 (2017: ISK 114 billion). Credit exposure to the sector represented 13% of the Bank's loan portfolio.

Total ECL for the fisheries sector amounts to ISK 386 million, with ISK 86 million for stage 1 loans, ISK 42 million for stage 2 loans, and ISK 258 million for defaulted stage 3 loans.

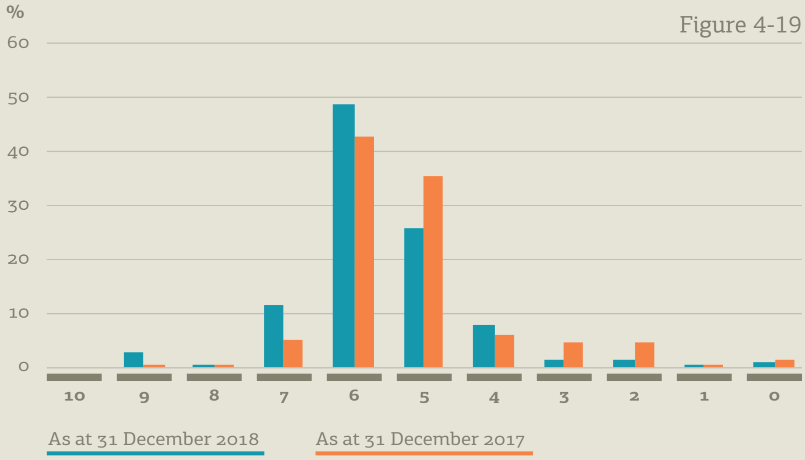
At year end 2018, loans and advances to customers having rating grades of 4 and higher represented 99% of the total fisheries portfolio compared to 89% in 2017.

The sector's average exposure-weighted PD was 1.4% as at 31 December 2018 and decreased significantly from the 2017 value of 2.4%. This decrease is in part thanks to large new exposures to customers with good credit quality.

Credit extended by the Bank to the fisheries industry is primarily secured by transport and fishing vessels together with their

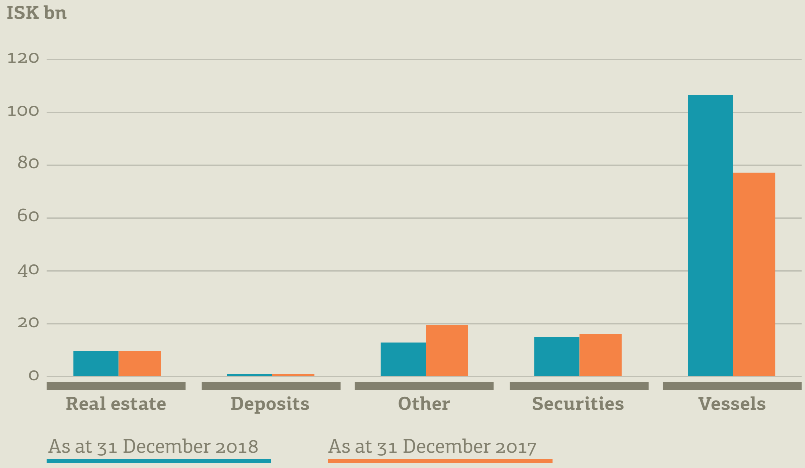
Loans and advances to fisheries sector per rating grade

Figure 4-19



Fisheries - Collateral types

Figure 4-20



non-transferable fishing quotas, or 74% of the sector's total collateral.

4.2.6.2 Real estate companies

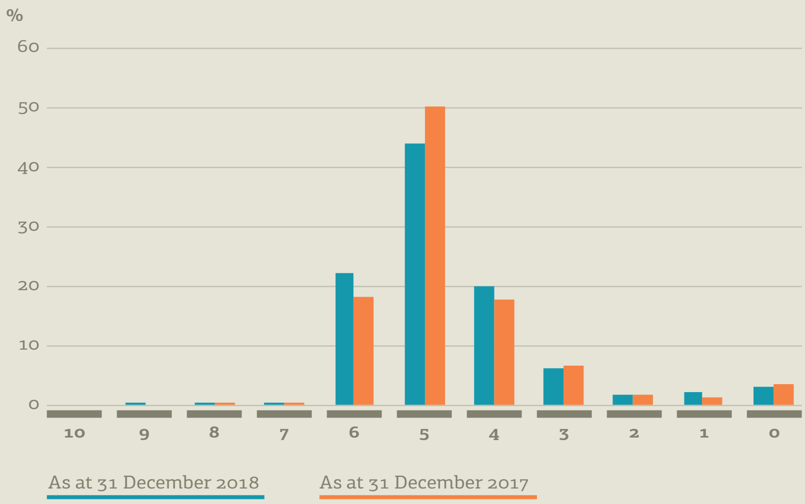
Loans and advances to customers in the real estate industry amounted to ISK 137 billion as at 31 December 2018 (2017: ISK 126 billion). Credit exposure to the sector represented 12% of the Bank's loan portfolio.

Total ECL for the real estate sector amounts to ISK 1.7 billion, with ISK 610 million for stage 1 loans, ISK 83 million for stage 2 loans and ISK 962 million for defaulted stage 3 loans.

The sector's average exposure-weighted PD was 3.3% as at 31 December 2018 compared to 2.8% as at 31 December 2017. This decrease in credit quality can primarily be attributed to an increase in loans having credit rating 1 between 2017 and 2018.

Credit extended by the Bank to real estate companies is secured, primarily on real estate, or 98% of the sector's total collateral.

Loans and advances to the Real estate sector per rating grade Figure 4-21



Construction and real estate sector - Collateral types

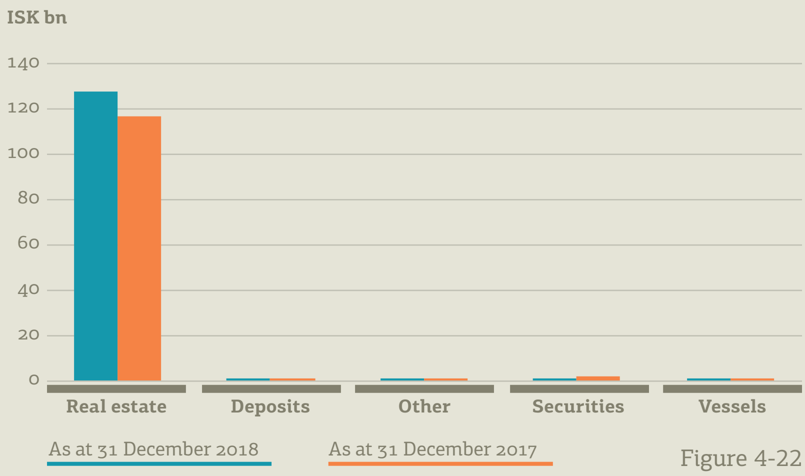


Figure 4-22

4.2.6.3 Services

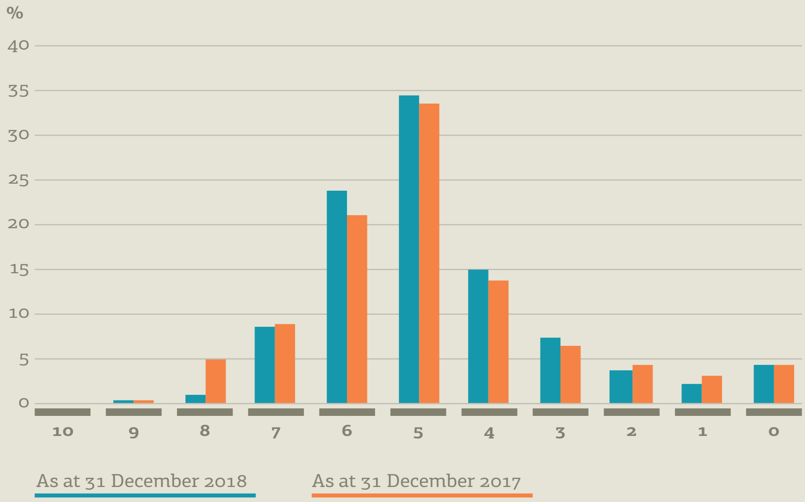
Loans and advances to customers in the services industry amounted to ISK 119 billion as at 31 December 2018 (2017: ISK 90 billion). Credit exposure to the sector represented 11% of the Bank's loan portfolio.

Total ECL for the services sector amounts to ISK 3 billion, with ISK 197 million for stage 1 loans, ISK 165 million for stage 2 loans and ISK 2.6 billion for defaulted stage 3 loans.

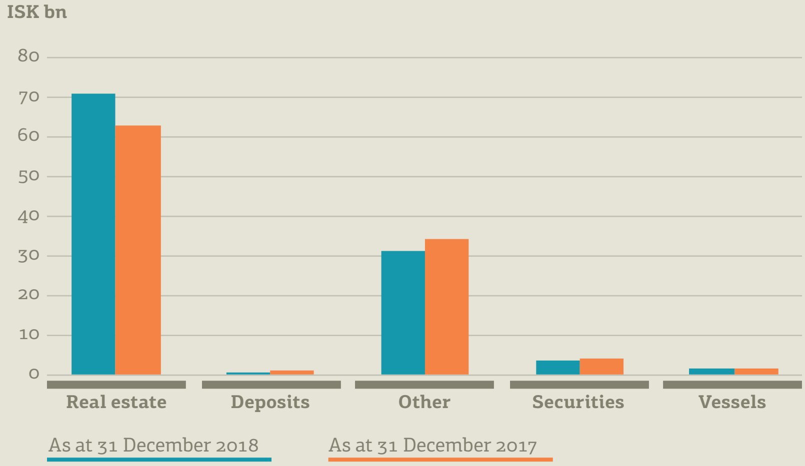
The sector's average exposure-weighted PD was 3.3% as at 31 December 2018 compared to 3,8% as at 31 December 2017. Contributing factors to the decrease in the PD value include a decreased exposure with rating grades 1 and 2 and new loans with rating grades of 5 and higher.

Credit extended by the Bank to companies in the services sector is primarily secured by real estate, or 65% of the sector's total collateral.

Loans and advances to services sector per rating grade Figure 4-23



Services - Collateral types Figure 4-24

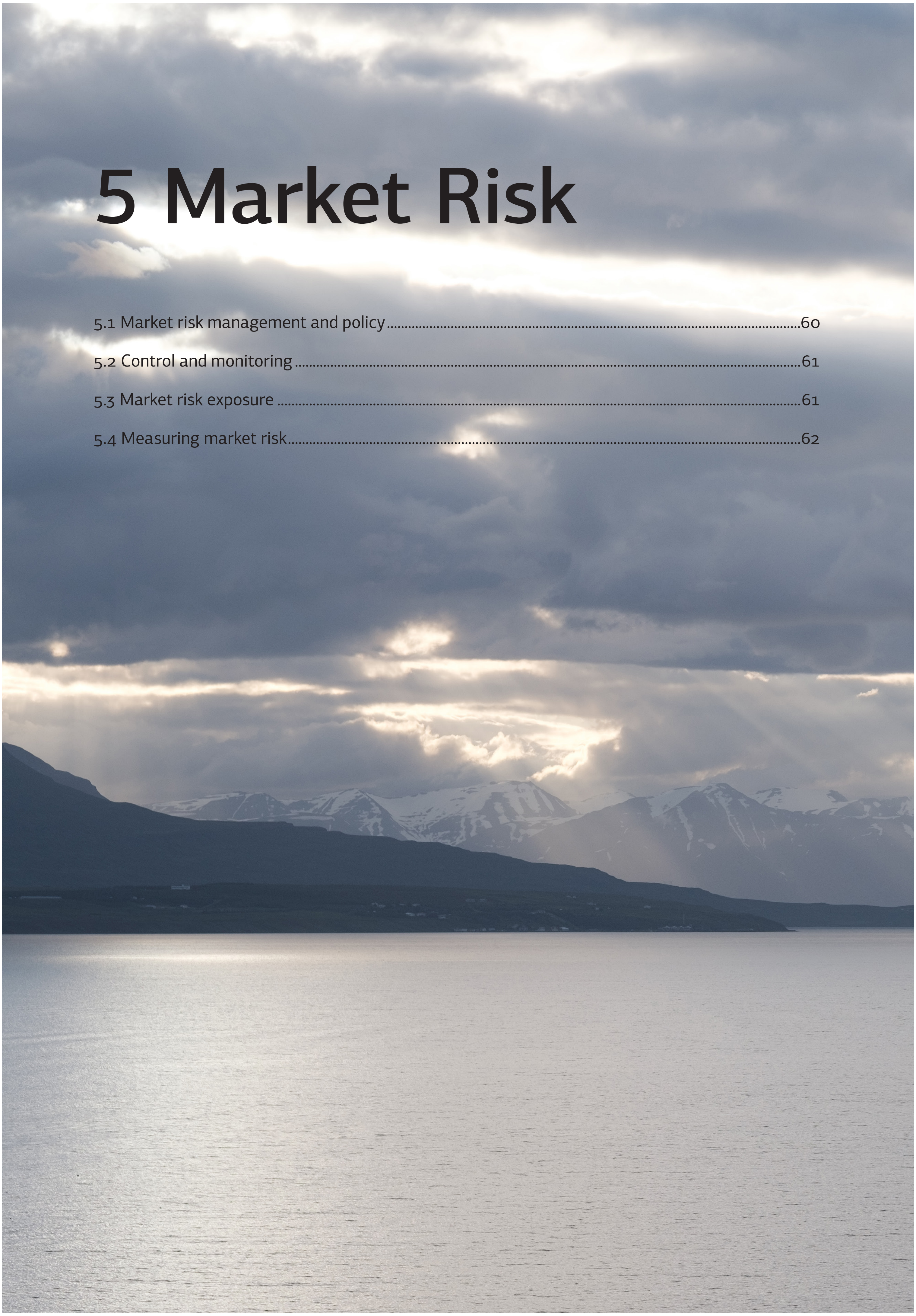


Tourism

Loans to the tourism industry account for ISK 81 billion of the service sector (2017: ISK 75 billion). Credit exposure to the tourism sector represented 8% of the Bank's loan portfolio at year end 2018.

Total ECL for the tourism sector amounts to ISK 1 billion, with ISK 115 million for stage 1 loans, ISK 140 million for stage 2 loans and ISK 832 million for defaulted stage 3 loans.

The sector's average exposure-weighted PD was 3.9% as at 31 December 2018 compared to 3.8% as at 31 December 2017.



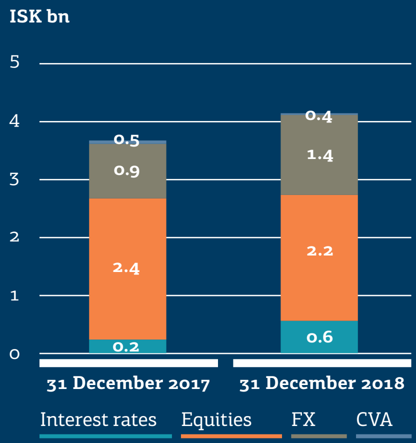
5 Market Risk

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.

- The Bank's market risk increased slightly in 2018, primarily due to increasing volatility in the domestic markets;
- Total market risk in the Bank's trading book together with foreign exchange risk and CVA risk, as measured by economic capital, was ISK 4.1 billion at year-end 2018 compared to ISK 3.7 billion at the end of 2017;
- The majority of the Bank's exposures that entail market risk consists of equities and equity derivatives, bonds and fixed income products and open currency positions.

Economic capital



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.

The majority of the Bank's exposures that entail market risk consists of equities and equity derivatives, bonds and fixed income products, and open currency positions.

The Bank's market risk increased slightly in 2018, primarily due to increasing volatility in domestic markets. Total market risk in the Bank's trading book together with foreign exchange risk, as measured by economic capital, was ISK 4.1 billion at year end 2018 compared to ISK 3.7 billion at the end of 2017. The Bank's market risk is still considered relatively low and well within the Bank's risk appetite

5.1 Market risk management and policy

The Board of Directors is responsible for determining the Bank's market risk appetite, and the Risk & Finance Committee

Total net exposure subject to market risk Table 5-1

	Net position at year-end	
	2018	**2017**
Equities and equity instruments in the trading book	4,284	4,927
Bonds and debt instruments in the trading book	-256	6,129
FX balance	5,420	3,986

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, in accordance with the Bank's policies, limits and risk appetite. 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 for market risk management within the Bank in accordance with the Bank's three lines of defence principle.

The Bank 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 Bank'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, which entails exposure to market risk.

Market risk mitigation reflects the Bank's overall risk appetite by identifying the target level for market risk factors and to limit exposure. Other market risk mitigation plans are made on a case-by-case basis involving hedging strategies and risk reduction through diversification.

5.2 Control and monitoring

The aim of the market risk management process is to ensure that market risk levels are within the Bank's risk appetite and mitigating the risk of losses while maintaining acceptable profitability. This entails quickly detecting and correcting deficiencies in compliance to policies, processes and procedures along with limit monitoring, handling limit breaches, risk modelling and reporting. The Bank monitors various 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. Risk reports show the Bank's total risk in addition to summarising risk concentration in different business units and asset classes, as well as across other attributes, as appropriate, pursuant to the Bank's activities.

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, summarised 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 summarises the Bank's exposure to market risk at year end 2018.

The Bank 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

61 All amounts are in ISK millions Risk and Capital Management 2018

Total market risk (REA measure) at year-end

Table 5-2

	2018		2017	
	REA	**Ratio to REA**	**REA**	**Ratio to REA**
Equity price risk in the trading book	8,823	0.9%	10,117	1.1%
Interest rate risk in the trading book	2,037	0.2%	2,388	0.3%
Foreign exchange risk	6,415	0.6%	4,594	0.5%
CVA risk	464	0.0%	565	0.1%
Total	**17,739**	**1.8%**	**17,664**	**1.9%**

and is mitigated through strict collateral requirements and limits. Further information about the Bank's exposure to counterparty credit risk can be found in the additional disclosures accompanying this document (see also 4.1.4.1).

5.3.1 Banking book exposures

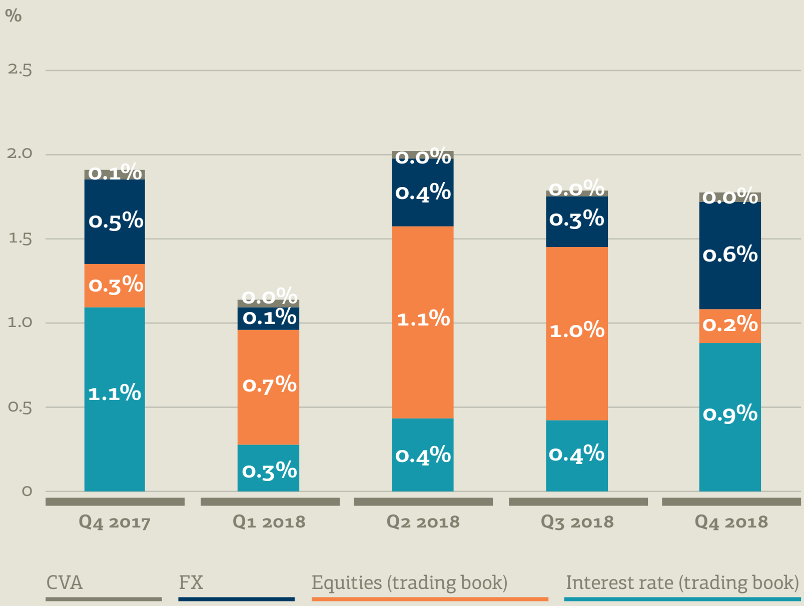
The banking book exposures of the Bank pertaining to market risk are exposures in equities and bonds. The vast majority of the equities are unlisted and are, for the most part, legacy positions obtained through corporate restructuring, or acquired when the Bank was established in 2008. The bond holdings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

5.4 Measuring market risk

The Bank uses risk exposure amounts (REA) and economic capital (EC) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. Risk exposure amounts are determined by applying specific risk weights to the Bank's assets, according to 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 analyses as appropriate, taking the Bank's balance sheet composition and operating environment into account.

Total market risk (Ratio to total REA)

Figure 5-1



Total market risk, measured as the ratio of risk exposure amounts to total REA, remains modest, amounting to 1.8% at year end 2018 (compared to 1.9% at year end 2017), well within the Bank's market risk appetite.

5.4.1 Equity price risk in the trading book

62 All amounts are in ISK millions Risk and Capital Management 2018

Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments. The Bank'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 Bank'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 derivative 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 Bank'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 mismatch of assets and liabili-

Assets and liabilities in the banking book by interest rate fixing period Table 5-3

	Net position at year end 2018				
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	1,050,239	75,301	106,190	58,886	1,290,616
Total liabilities	774,638	22,522	192,386	78,517	1,068,064
Net on-balance sheet position	275,601	52,779	-86,196	-19,631	222,552
Effect of derivatives held for risk management	-83,861	0	83,861	0	0
Net off-balance sheet position	16,957	56	-14,711	-2,303	0
Total interest repricing gap	**208,697**	**52,835**	**-17,046**	**-21,934**	**222,552**

	Net position at year end 2017				
	Up to 3 M	**3-12 M**	**1-5 Y**	**Over 5 Y**	**Total**
Total assets	941,499	72,519	68,081	68,267	1,150,366
Total liabilities	-666,949	-24,776	-162,400	-74,119	-928,244
Net on-balance sheet position	274,550	47,743	-94,319	-5,852	222,122
Effect of derivatives held for risk management	-41,066	-37,275	41,066	37,275	0
Net off-balance sheet position	0	0	0	0	0
Total interest repricing gap	**233,484**	**10,468**	**-53,253**	**31,423**	**222,122**

63 All amounts are in ISK millions Risk and Capital Management 2018

Interest rate risk (fair value sensitivity) in the banking book at year end				Table 5-4
	2018		**2017**	
	+100 bps	**-100 bps**	**+100 bps**	**-100 bps**
ISK non-indexed	-916	962	125	-129
ISK indexed	426	170	-4,081	5,137
EUR	2,283	-2,413	2,004	-2,061
SEK	226	-229	307	-314
USD	-157	164	-64	65
Other	-40	42	5	-6
Total	**1,822**	**-1,304**	**-1,705**	**2,692**

ties. Net positions of assets and liabilities in the banking book by the interest rate fixing period, at year- end 2018 and 2017, are shown in Table 5 3:

The Bank 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 summarises the sensitivity of the Bank's banking book fair value resulting from a flat 100 bps upward and downward shift of all yield curves at year end:

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,

Net FX balance		Table 5-5
	Net position at year-end	
	2018	**2017**
CHF	128	111
EUR	3,842	2,335
GBP	-123	237
JPY	92	376
USD	1,085	502
Other	396	427
Total	**5,420**	**3,988**

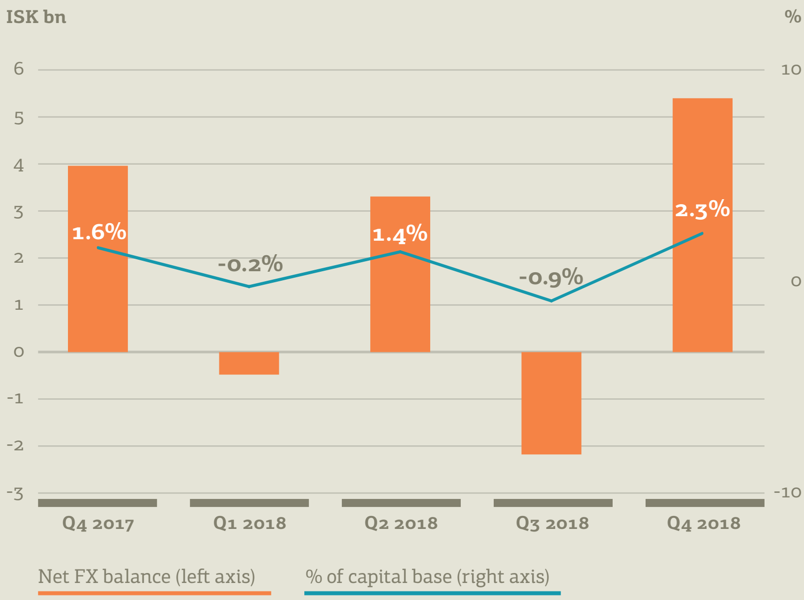
64 All amounts are in ISK millions Risk and Capital Management 2018

currency swaps or other currency contracts that are not matched with an offsetting contract. The net FX balance at year end 2018 and 2017 can be seen in Table 5 5:

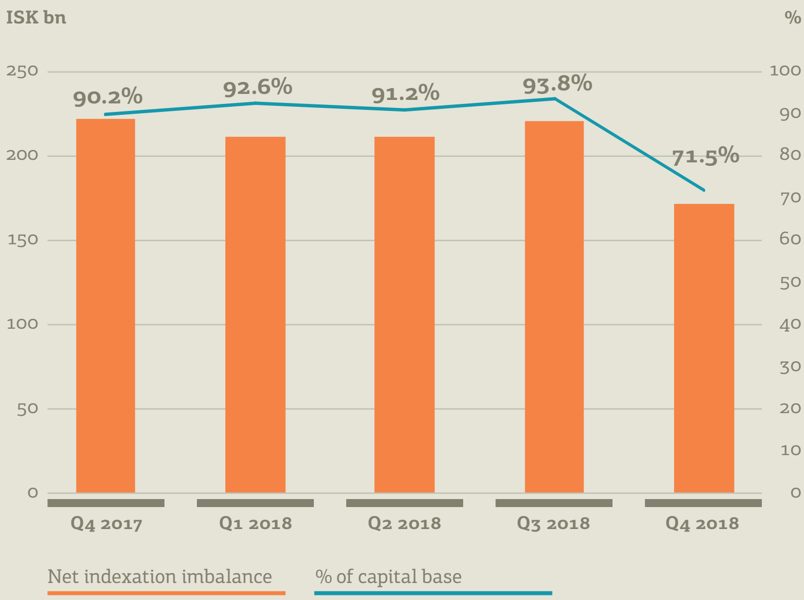
5.4.5 Other market risk

Other market risk within the Bank is comprised of inflation risk and risk due to credit valuation adjustment (CVA).
CVA is an adjustment to the fair value (or price) of derivative instruments to account for counterparty credit risk. The derivative contracts the Bank enters into that entail CVA risk are well collateralised, reducing CVA risk. Hence, the Bank's CVA risk is low and considered immaterial.
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. Mismatched CPI-linked assets and liabilities exposes the Bank to inflation risk. The Bank's total CPI indexation balance decreased significantly in 2018, amounting to ISK 171 billion at year end 2018 as compared to ISK 222 billion at year end 2017. The drop in the mismatch is in accordance with the Bank's risk appetite and is first and foremost due to CPI-linked swaps that the Bank entered into, as well as reduced demand for indexed mortgages and increased refinancing from indexed to non-indexed mortgages in late 2018.

Net FX balance Figure 5-2



Indexation imbalance Figure 5-3



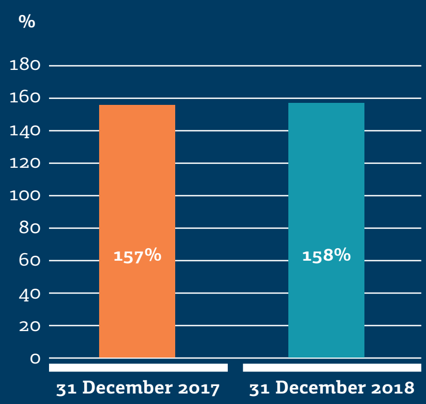
6 Liquidity Risk

Liquidity Risk

Liquidity risk is the risk that the Bank 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 Bank's key risk factors and great emphasis is placed on liquidity risk management within the Bank, which is reflected in both its risk appetite as well as in internal liquidity management policies and rules. The Bank's policy remains to sustain a strong liquidity position in the near- and longer-term as is reflected in the Bank's business plan;
- The Bank's liquidity position is well above regulatory requirements and the Bank's risk appetite. Total liquidity coverage ratio was 158% at year end 2018 (year end 2017: 157%) and the Bank's LCR in foreign currencies was 534% at year end 2018 (year end 2017: 931%).

Total Liquidity Coverage Ratio



Liquidity risk is the risk that the Bank will encounter difficulty in meeting its financial liabilities obligations 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.

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The Bank's liquidity position was at year end 2018 well above regulatory requirements and the Bank's risk appetite. The total liquidity coverage ratio was 158% at year end 2018 (year end 2017: 157%) and the Bank's LCR in foreign currencies was 534% at year end 2018 (year end 2017: 931%).

6.1 Identification

The Board has set a liquidity risk management policy for the Bank. Liquidity risk management refers to the internal policies and procedures containing quantitative and qualitative objectives, limits and reporting put in place. The policy describes how the Bank identifies, evaluates, measures, monitors, manages and reports its liquidity. The policy clearly outlines the structure, responsibilities and controls for managing liquidity risk within the Bank and includes a liquidity contingency plan. 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 Bank does this by maintaining an adequate level of unencumbered, high-quality liquid assets that can readily be converted into cash. The Bank has also implemented stringent stress tests that have a realistic basis in the Bank's operating environment to further measure the Bank's ability to withstand different and adverse scenarios of stressed operating environments. The Bank'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 Bank. The Risk & Finance Committee monitors the Bank's liquidity risk, while the Bank's Internal Audit function assesses whether the liquidity management process is designed properly and operating effectively.

Short-term liquidity risk

» Intra-day
» 30 days (LCR)
» Stress testing and scenario analysis

Longer-term liquidity risk

» Medium to long-term (NSFR)
» Cash flow projections
» Stress testing and scenario analysis

Structural issues

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

Figure 6-1

The Bank'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-focused analysis to estimate the future liquidity position, taking the Bank's commitments into account.

The liquidity management policy is largely built on the European regulation, Capital Requirements Regulation (CRR), defined within the European Banking Authority (EBA), as well as taking the Bank's current operating environment into account.

6.3 Assessment

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

The Bank complies with the liquidity rules set by the Central Bank of Iceland No. 266/2017. The liquidity rules are based on the liquidity requirements set forth in the CRD IV/CRR framework, which was fully implemented in Iceland in 2017 (Regulation No. 233/2017).

The Bank also follows Regulation No. 1032/2014, on funding, set by the Central Bank of Iceland as well as following Guidelines No. 2/2010 from the Icelandic Financial Supervisory Authority on best practice 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 regular reports on its liquidity position to the Central Bank and the FME.

Table 6-1

		Total unweighted value*	Total weighted value*
		31.12.2018	31.12.2018
Number of data points used in the calculation of averages		**12**	**12**
HIGH-QUALITY LIQUID ASSETS			
1	Total high-quality liquid assets (HQLA)		100,333
CASH-OUTFLOWS			
2	Retail deposits and deposits from small business customers, of which:	307,674	26,291
3	*Stable deposits*	126,284	6,314
4	*Less stable deposits*	181,390	19,977
5	Unsecured wholesale funding	177,998	98,289
6	*Operational deposits (all counterparties) and deposits in networks of cooperative banks*	0	0
7	*Non-operational deposits (all counterparties)*	174,437	94,728
8	*Unsecured debt*	3,561	3,561
9	Secured wholesale funding		0
10	Additional requirements-	126,878	12,977
11	*Outflows related to derivative exposures and other collateral requirements*	1,792	1,792
12	*Outflows related to loss of funding on debt products*	240	240
13	*Credit and liquidity facilities*	124,846	10,945
14	Other contractual funding obligations	3,845	1,070
15	Other contingent funding obligations	21,286	5,104
16	**TOTAL CASH OUTFLOWS**		143,730
CASH-INFLOWS			
17	Secured lending (e.g. reverse repos)	0	0
18	Inflows from fully performing exposures	110,032	79,473
19	Other cash inflows	11,123	2,844
EU-19a	(Difference between total weighted inflows and total weighted outflows arising from transactions in third countries where there are transfer restrictions or which are denominated in non-convertible currencies)		0
EU-19b	(Excess inflows from a related specialised credit institution)		0
20	**TOTAL CASH INFLOWS**	121,155	82,317
EU-20a	***Fully exempt inflows***	0	0
EU-20b	***Inflows Subject to 90% Cap***	0	0
EU-20c	***Inflows Subject to 75% Cap***	121,158	82,320
			TOTAL ADJUSTED VALUE
21	**LIQUIDITY BUFFER**		**100,333**
22	**TOTAL NET CASH OUTFLOWS**		**61,690**
23	**LIQUIDITY COVERAGE RATIO (%)**		**164%**

*EU LIQ1 template; values are a simple arithmetic average of end of month data for each month preceding 31 December 2018.

69 All amounts are in ISK millions Risk and Capital Management 2018

Total deposits by groups

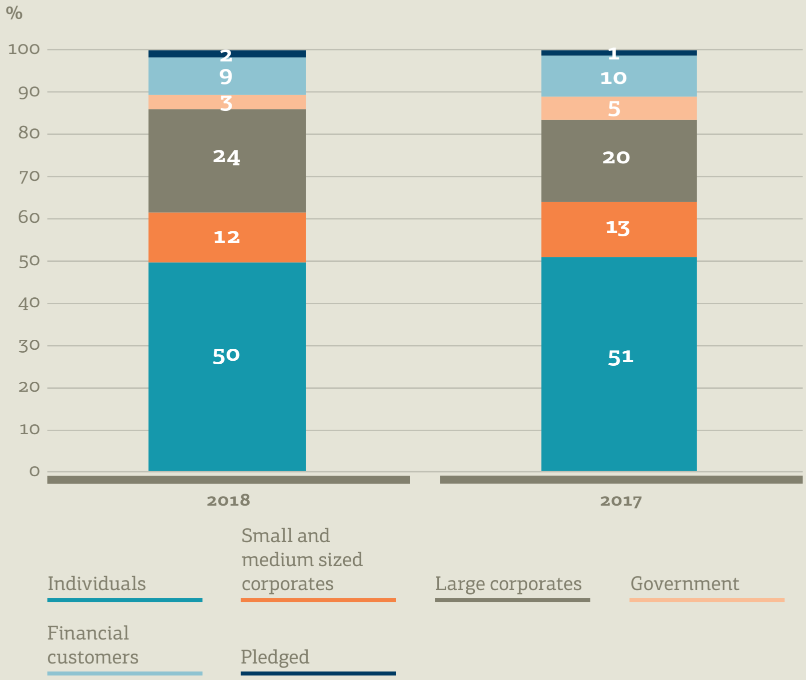
Table 6-2

As at 31. December 2018	Run off rate	0-30 days	Over 30 days	Total
Retail deposits				
Individuals	5% - 100%	262,276	94,858	357,134
Small and Medium Sized Corporates	5% - 100%	61,461	5,999	67,461
Operational deposits	5% - 25%	0	0	0
Non-operational deposits		0	0	0
Large Corporates	20% - 40%	128,063	31,147	159,211
Government	20% - 40%	17,986	7,706	25,692
Financial customers	100%	47,641	61,735	109,376
Other*		8,263	515	8,778
Total deposits		**525,691**	**201,961**	**727,652**

*Include pledged deposits not included in the Bank's LCR but are included in the Bank's consolidated financial statement.

0-30 days maturity deposits by groups

Figure 6-2



Total deposits by maturity

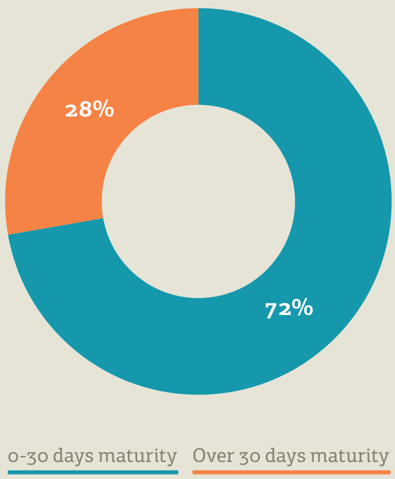


Figure 6-3

6.3.1 Liquidity Coverage Ratio (LCR)

The Bank measures the Liquidity Coverage Ratio (LCR) as a key indicator for short-term liquidity. The objective of the ratio is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to withstand a significant stress scenario lasting 30 calendar days. Quantitative information on the Bank's LCR at year end 2018 is shown in Table 6 1. Further information can be found in the additional disclosures accompanying this document.

Table 6-2 shows the Bank's deposit base at year end 2018. Run off rates are used to estimate deposit outflows under stressed conditions for the next 30 calendar days according to liquidity rules No. 266/2017. Figures 6.2 and 6.3 show further breakdown of the Bank's deposit base.

70 All amounts are in ISK millions Risk and Capital Management 2018

6.3.2 Net Stable Funding Ratio (NSFR)

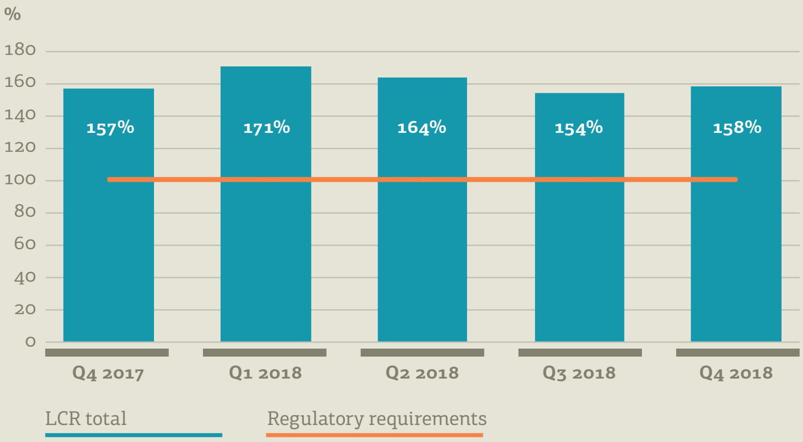
The Net Stable Funding Ratio has a longer time horizon. Its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities. The aim of NSFR is to promote more medium- and long-term funding. It establishes a minimum acceptable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

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

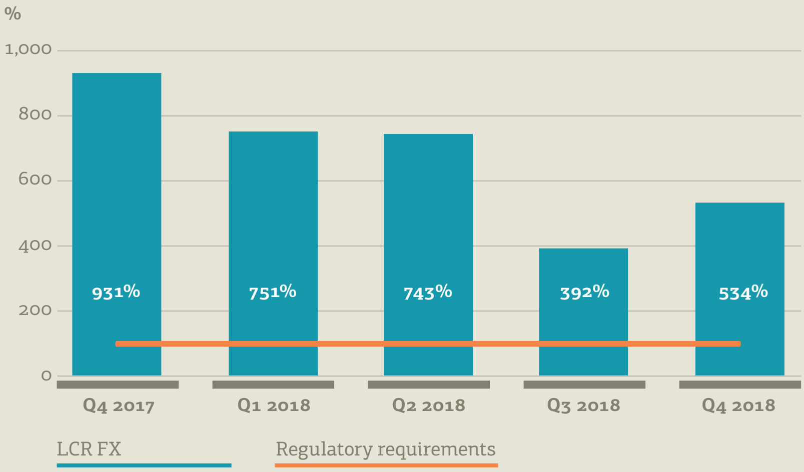
$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

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 Bank's total NSFR was 120% at year end, and the NSFR in foreign currencies was 166%.

Liquidity Coverage Ratio (total) Figure 6-4



Liquidity Coverage Ratio (FX) Figure 6-5



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.

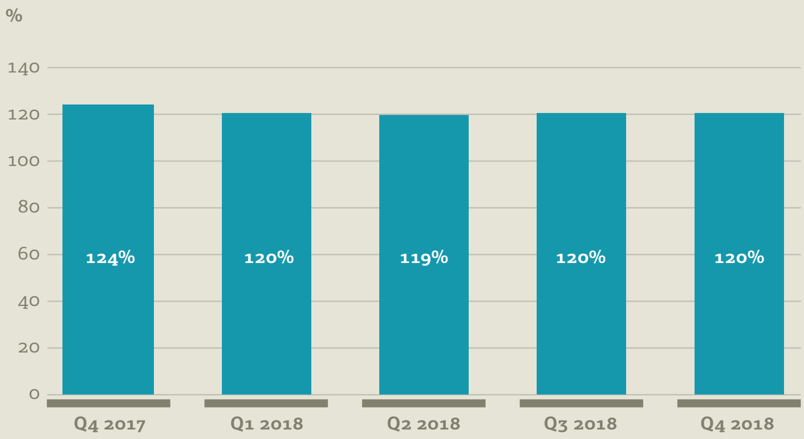
Liquidity risk is primarily controlled through tolerance limits set in the Bank's risk appetite. Limit management is supplemented by regular monitoring and reporting of liquidity position under normal and stressed business conditions.

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

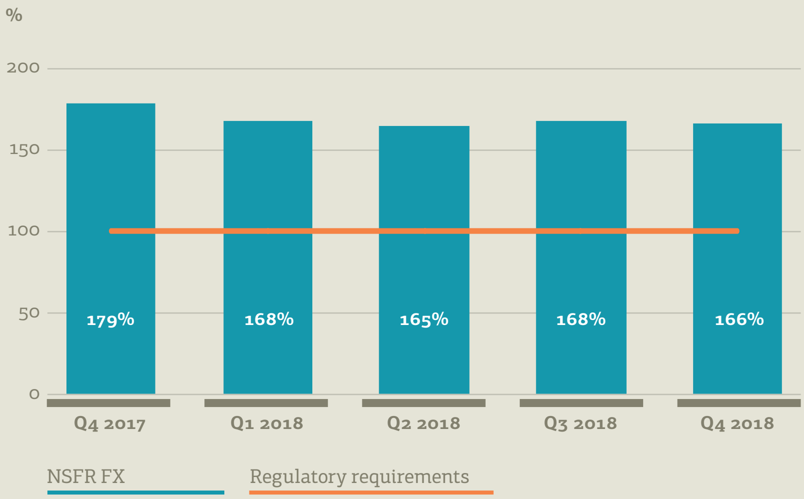
6.4.1 Liquidity Contingency Plan

The Bank has a contingency plan in place, which is set to provide a framework for detecting an upcoming liquidity event with predefined early warning indicators and actions for preventing

Net Stable Funding Ratio (Total) Figure 6-6



Net Stable Funding Ratio (FX) Figure 6-7



temporary or longer term liquidity disruptions.

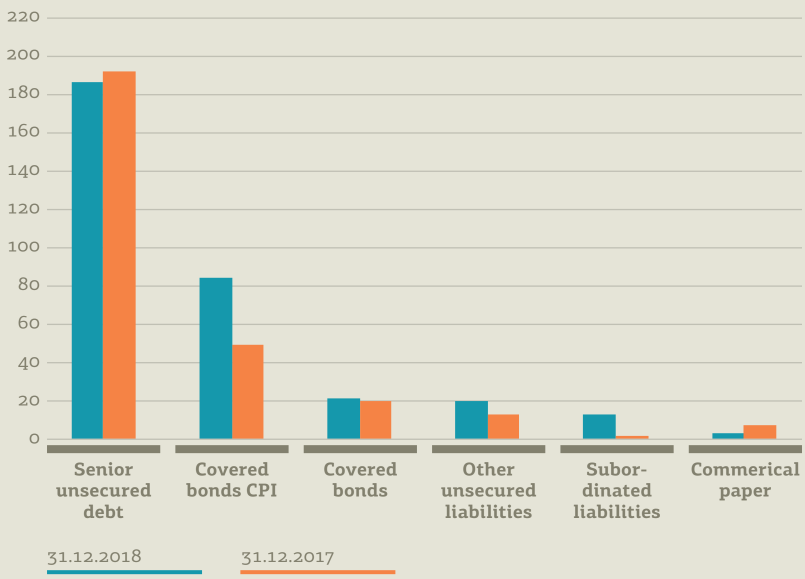
The Liquidity Contingency Plan stipulates the actions that shall be taken to monitor the likelihood or imminence of the occurrence of a liquidity event or a confidence crisis. It also includes a detailed action plan and procedures for managing a liquidity event. The Contingency Plan includes the following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

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

The contingency plan is supplemented by the monitoring of early warning indicators along with their defined warning and trigger levels to detect potential liquidity problems. These early warning indicators are either internal, such as changes in the Bank's balance sheet composition, decreasing liquidity ratios, deposit outflows or a downward trend in financial ratios, or external, such as rating downgrades, third party evaluations or market price fluctuations. The Bank determines four levels of stress for each early warning indicator. These four levels of stress are risk alert levels and each level further indicates the increasing likelihood of funds leaving and increased likelihood

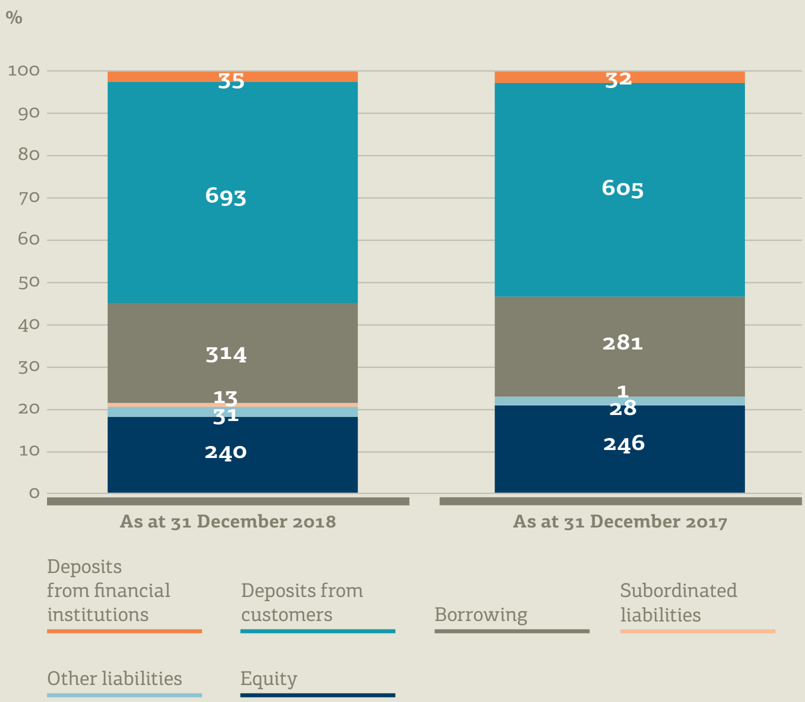
Borrowings and Subordinated Liabilities

Figure 6-8



Funding profile - ISK billions

Figure 6-9



EMTN Programme Table 6-3

As at 31 December 2018	Currency	Final maturity	Outstanding principal	Contractual interest rate
Senior unsecured				
LBANK FLOAT 06/19 - SEK	SEK	10.06.2019	350	STIBOR + 2.60%
LBANK FLOAT 06/19 - NOK	NOK	11.06.2019	500	NIBOR + 2.60%
LBANK FLOAT 06/20	SEK	22.06.2020	700	STIBOR + 1%
LBANK 0.75 06/20	SEK	22.06.2020	300	FIXED 0.75%
LBANK FLOAT 11/20	SEK	24.11.2020	250	STIBOR + 1.50%
LBANK 1.375 11/20	SEK	24.11.2020	750	FIXED 1.375%
LBANK 1.625 03/21	EUR	15.03.2021	500	FIXED 1.625%
LBANK 1.375 03/22	EUR	14.03.2022	300	FIXED 1.375%
LBANK 1 05/23	EUR	30.05.2023	300	FIXED 1%
Subordinated				
LBANK 3.125 28NC23 T2	EUR	06.09.2028	100	FIXED 3.125%

of a liquidity event. The indicators are monitored weekly by the Risk and Finance Committee and reviewed at least annually by the Board of Directors.

6.5 Funding

The Bank continued to work towards diversifying the Bank's funding profile over the year 2018, particularly in foreign currency. The Bank completed its inaugural Tier 2 issuance in EUR. The issuance is a step towards further otpimising the Bank's capital structure.

The Bank was also an active issuer on the domestic bond market with issuance of covered bonds as well as with issuance of commercial paper.

The Bank has a credit rating from S&P Global Ratings (S&P) which at year end 2018 was BBB+ / A-2 with a stable outlook. The last rating action taken by S&P was in October 2017 when the Bank received an upgrade from BBB to its current rating.

6.5.1 Funding

The Bank's funding rests on three pillars. Deposits from customers

Covered bonds Table 6-4

As at 31 December 2018	Currency	Final maturity	Outstanding principal	Fixed contractual interest rate
LBANK CB 19	ISK	17.09.2019	16,120	6.80%
LBANK CB 21	ISK	30.11.2021	3,720	5.50%
LBANK CB 23	ISK	23.11.2023	1,540	5.00%
LBANK CBI 22	ISK	28.04.2022	19,540	3.00%
LBANK CBI 24	ISK	15.11.2024	27,740	3.00%
LBANK CBI 28	ISK	04.10.2028	30,700	3.00%

74 All amounts are in ISK millions Risk and Capital Management 2018

Commercial Paper

Table 6-5

As at 31 December 2018	Currency	Final maturity	Outstanding principal
LBANK 190110	ISK	10.1.2019	560
LBANK 190410	ISK	10.4.2019	420
LBANK 190510	ISK	10.5.2019	1,760

are the Bank's primary funding source but the Bank is also funded through borrowing in the form of bond issuance, both in the international markets in foreign currencies as well as in the domestic market in ISK. Furthermore, the Bank is funded with contributions from owners in the form of equity. Figure 6-6 shows the breakdown of the Bank's borrowings while Figure 6-7 shows the Bank's funding structure as of year end 2018 and 2017.

6.5.2 Borrowings

6.5.2.1 EMTN Programme

The size of the Bank´s EMTN programme is EUR 2,000 million, increasing from EUR 1,500 million in 2017. The inaugural issuance under the programme was made in autumn 2015, with continued issuance on a regular basis to date. In 2018 the Bank reached a milestone with its inaugural Tier 2 market funding.

In September 2018 the Bank issued its inaugural Tier 2 issuance of EUR 100 million with a 10NC5 structure. The bonds have a final maturity in September 2028, but are callable in September 2023. They were priced at a spread of 285 basis points above the EUR mid-swap rate, with a fixed coupon of 3.125%. The issuance is rated BBB- by S&P Global Ratings.

The Bank's first bond issuance under the EMTN programme matured in October 2018. In November 2017, the Bank pre-paid EUR 150 million representing half of the outstanding bond series. The remainder of the bond was paid in full in October 2018.

At year end 2018 EMTN bond issuance amounted to ISK 199 billion, increasing by 7 billion in 2018.

6.5.2.2 Covered bonds

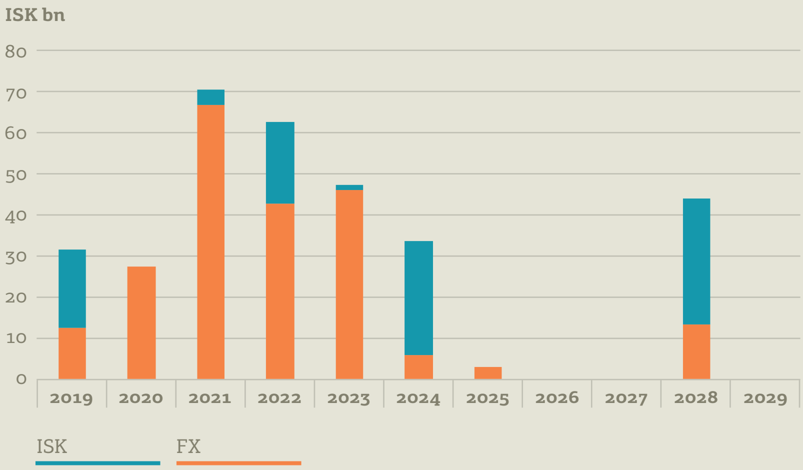
The Bank has set up an ISK 120 billion covered bond programme, increasing from ISK 100 billion in 2017.

The covered bond issuance is primarily intended to fund the Bank's mortgage portfolio and to mitigate interest rate risk. Regular auctions of covered bonds were held in 2018, where previously issued bonds were tapped. No covered bond series matured during the year 2018.

75 All amounts are in ISK millions Risk and Capital Management 2018

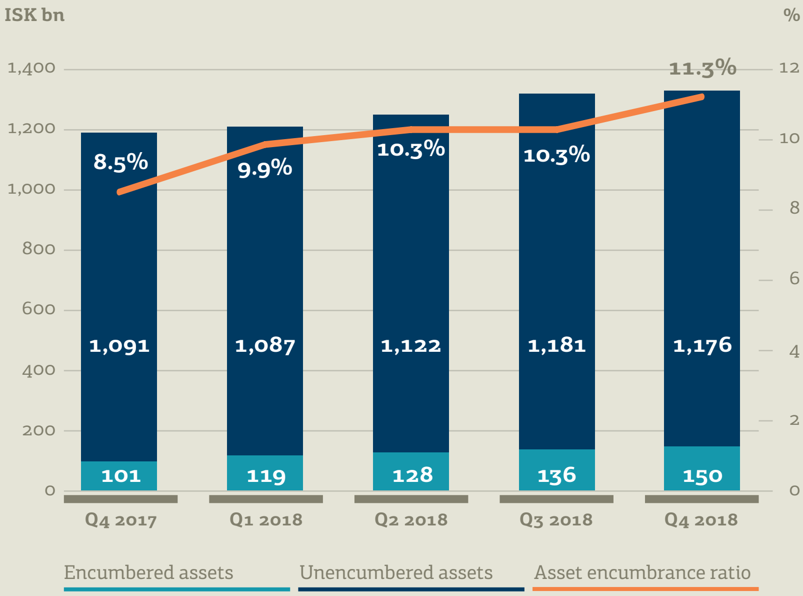
Maturity Profile

Figure 6-10



Asset encumbrance ratio

Figure 6-11



Agreements with market makers in the secondary market for covered bonds were renewed in 2018. At year end 2018, outstanding covered bonds issuance amounted to ISK 99.6 billion, increasing by ISK 30 billion during the year 2018.

6.5.2.3 Commercial Paper

The Bank continued regular issuance of commercial paper in 2018 under the ISK 50 billion debt issuance programme. Outstanding issuance of commercial paper amounted to ISK 2.7 billion at year end 2018, compared to ISK 7.4 billon at the end of 2017.

6.5.3 Asset encumbrance ratio

The Bank's liquidity and funding risk framework includes measures of encumbered assets as a ratio to total assets. Encumbered assets are primarily 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 Bank's asset encumbrance ratio remains low.

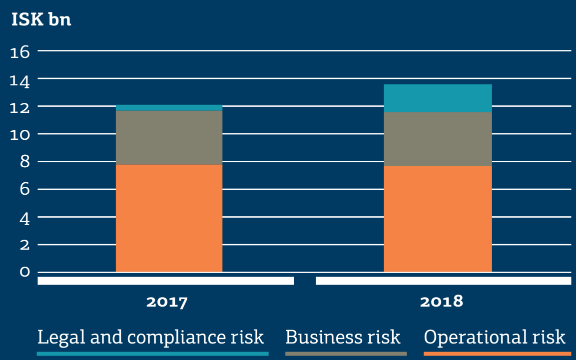
7 Operational Risk

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.

- Cybercrime is increasing and the Bank is trying to raise awareness among customers
- The bank saw an increased number of registered incidents in 2018, partly due to emphasis on compliance with GDPR

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 political risk and IT risk.

Legal and political 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 IT systems failure. Both factors are relevant in the Bank's current environment.

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

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

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

- Risk culture, human resource management practices, organisational 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. The operational risk rules set out the policy regarding operational risk, the roles and responsibilities of stakeholders in the Bank and the operational risk tolerance in terms of limits.

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

The Operational Risk Department, which is responsible for developing and maintaining the framework for managing operational risk and supporting the organization in the implementation of the framework, is a part of the Risk Management Division. 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 part of the regular reporting done by Risk Management. 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 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 prioritising subsequent management action;
- Risk assessments on important IT systems;
- 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 accordance with 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 by far had the largest number of events, 41 in 2016, 46 in 2017 and 37 in 2018.

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

7.2.1 Mitigation

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

Number of loss incidents based on Basel II classification

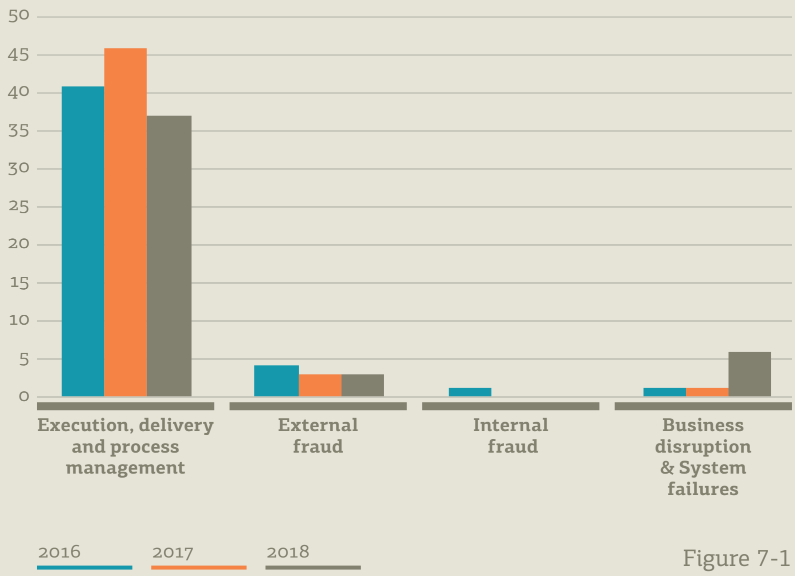


Figure 7-1

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 if one data centre (for instance the primary data centre) becomes unusable. In the event of a failure, core systems will automatically switch 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.

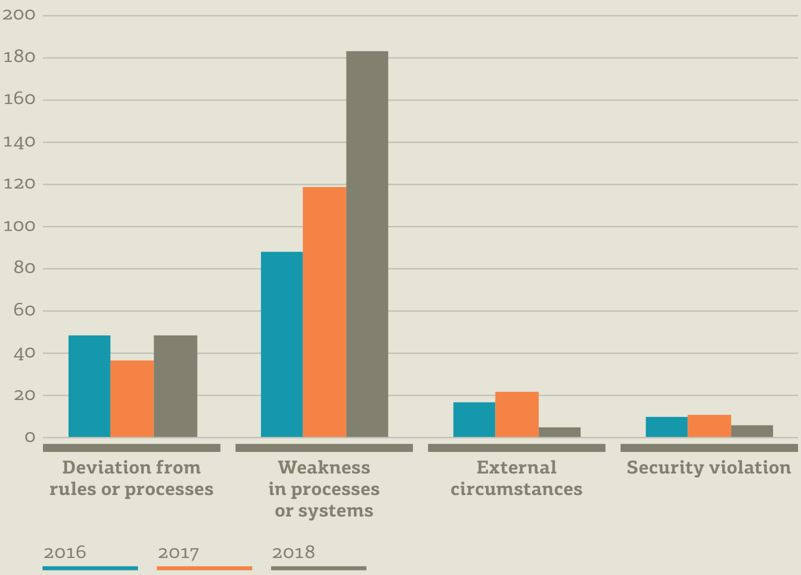
7.2.2 Control and monitoring

The Board and CEO set detailed rules on operational risk governance and responsibilities. Day-to-day management of operational risk is a part of every manager's responsibility, who are further 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 that the Bank has established to monitor and control operational risk. The Bank has a programme in place to ensure full compliance with GDPR from when it took effect in Iceland in July 2018. This programme has been led by a designated Data Protection Officer (DPO) within the Bank.

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. These 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



7.3 Cybersecurity risk

For the past seven years, the Bank has built a cyber-response team, a network with peers in the Financial sector, and made major investments into IT Security in order to increase resilience for cybersecurity threats and cybercrime. The government and Central Bank of Iceland enforced capital restrictions after the collapse in 2008. These restrictions helped in preventing cybercrime, but since they were lifted an increase in fraud related cases in Iceland has been recorded. As the banking sector becomes more digitalised, so does financial crime. This is something that the Bank is aware of, and actively trying to increase awareness amongst its customers.

This can be divided into five categories:

- **Know** – Gaining the institutional understanding to identify what systems need to be protected, assess priority in light of organisational mission, and manage processes to achieve cost effective risk management goals, and to aim to know vulnerability;

- **Prevent** – Categories of management, technical, and operational activities that enable the organisation to decide on the appropriate outcome-based actions to ensure adequate protection against threats to business systems that support critical infrastructure components;

- **Detect** – Activities that identify (through ongoing monitoring or other means of observation) the presence of undesirable cyber risk events, and the processes to assess the potential impact of those events;

- **Respond** – Specific risk management decisions and activities enacted based upon previously implemented planning (from the Prevent function) relative to estimated impact;

- **Recover** – Categories of management, technical, and operational activities that restore services that have previously been impaired through an undesirable cybersecurity risk event.

In relation to detection and knowing, the Bank has established an incident response team with members from both the IT and Risk departments. This team uses NIST (National Institute of Standards and Technology) as a template for the Bank to build its cyber resilience with the five bullet points mentioned above. The Bank also uses several external vendors for sharing intelligence, as it has been shown that there is limited overlap between them. The newest contributor is the Nordic Financial CERT, where the Bank also sees itself participating in sharing IOC (Indicators of Compromise) to the Nordic society that will help all participants in preventing fraud.

The focus on prevention and response is both external and internal. For external prevention, the Bank has created a website dedicated to cybercrime prevention (https://umraedan.landsbankinn.is/umraedan/samfelagid/verum-vakandi). The aim is to limit cybercrime incidents by sharing information to make customers more risk aware. The security team has also visited companies and attended conferences to give presentations about cybercrime and best practices to avoid fraud. This is also seen by the Bank as a part of its social responsibility within the Icelandic society. The Bank additionally produced a commercial for TV and Cinema to educate viewers on fraudulent activity.

For the past few years, the Bank has worked towards creating a layered security approach. The focus has been on secure coding for in-house solutions, policies and procedures have been implemented to improve security at different levels based on ISO27001:2013, and the Bank has used 3rd party pen-testers on a 24/7 basis to better understand any security gaps. In practice, this approach has shown, the importance of using external vendors to review the Bank's IT systems. The Bank also has procedures in place for responding to incidents such as BEC fraud, DDOS attacks, External Breach, Data theft and Ransomware.

The Bank reviews its procedures every year. For the recovery part, a categorisation is in place for the Bank's systems. Category A systems have a fault tolerance setup in place. In general, the approach is ever evolving in response to improvements in technology.

8 Regulatory Developments

Regulatory Developments

Landsbankinn monitors regulatory developments to ensure that its operations comply with laws, regulations and rules applicable at any time. This section provides an overview of regulatory developments considered by the Bank to be of significant relevance for its operations. The section initially summarises new regulatory requirements that came into effect in 2018, and then explores expected regulatory requirements in 2019 and beyond.

8.1 New regulatory requirements

Amendments to the Act on Financial Undertakings

With Act No. 34/2018, amendments were made to Act No. 161/2002 on Financial Undertakings based on Directive 2001/24/EU on the reorganisation and winding-up of credit institutions. The Act was implemented following indications from the EFTA Surveillance Authority, which found Iceland to have improperly transposed certain provisions of the Directive. The Act more specifically clarifies the legal provisions on netting and clearance agreements in financial restructuring and dissolution of financial undertakings, as well as choice-of-law rules following annulment and rescission of legal acts.

Act No. 54/2018, amending Act No. 161/2002, on Financial Undertakings, firstly incorporates part of the Bank Recovery and Resolution Directive 2014/59/EU (BRRD), and secondly a few provisions of the Capital Requirements Directive 2013/36/EU (CRD IV) and the Capital Requirements Regulation (EU) No. 575/2013 (CRR) are implemented into the Act. The law is the first phase of incorporating the material rules of the BRRD into Icelandic legislation. More precisely, in this first phase changes were made to the Act on Financial Undertakings implementing the content of the Directive addressing recovery plans, early intervention of the Financial Supervisory Authority, and intra-group financial support. According to the Act, financial undertakings are now required to adopt a Recovery Plan which meets the BRRD standards and requirements. Changes to the Act on account of CRD IV and CRR concern group-oriented surveillance and are linked to substantive provisions of the BRRD on groups. The main amendments concern the cooperation between surveillance bodies on a group-basis, prudential requirements on a group-basis, regulatory authority for important risk commitments and legal reference for CRR.

Act on Derivative Trading, Central Counterparties and Derivatives Trade Repositories

Act No. 15/2018 on Derivative Trading, Central Counterparties and Derivatives Trade Repositories implements Regulation (EU)

No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) into Icelandic law. The Act aims at enhancing the transparency of OTC derivative trading and reducing counterparty and operational risk, as well as increasing the activity of the derivative market via more effective procedures.

Act on the Protection of Privacy and Processing of Personal Information

The new comprehensive Act on the Protection of Privacy and Processing of Personal Information No. 90/2018 incorporates the General Data Protection Regulation (EU) 2016/679 (GDPR) into Icelandic legislation. The Regulation strengthens the fundamental rights of individuals in a digital world, and further facilitates the development of the inner digital market by simplifying rules for companies. The regulation entails extensive amendments in the field of privacy. Among other things they address a changed and increased role of domestic data protection authorities, increased individual rights, new security certifications and authorisations to impose fines. The regulation also applies to organisations based outside the EEA, should they process personal data of EEA residents.

Act on Measures Against Money Laundering and Terrorist Financing

With Act No. 140/2018 on Measures Against Money Laundering and Terrorist Financing, the 4th Anti-Money Laundering Directive 2015/849/EU (AML IV) has been implemented into Icelandic legislation, as well as selected provisions from the 5th Anti-Money Laundering Directive 2018/843/EU (AML V), amending a few provisions in the 4th Directive. This was a necessary comprehensive review of the previously applicable Act in order to meet the minimum international requirements. The implementation of risk-oriented surveillance according to the 4th Anti-Money Laundering Directive entails a different approach to due diligence of customers of financial institutions and other obliged entities, and subsequently the surveillance of obliged entities of customers and contractual relationships is modified. All obliged entities are now requested to carry out a risk assessment of their operations and periodically update this assessment. Obliged entities are subject to increased reporting obligations to independently confirm the information they collect from customers in relation to due diligence.

8.2 Expected regulatory requirements

Participation of board members and executive directors in management of other companies

A bill submitted to Parliament in November 2018 proposed amendments to certain provisions of Act No. 161/2002, on Financial Undertakings, regarding limitations to the participation of board members and executive directors of financial undertakings of systemic key importance in the management of other companies. The amendments are based on the CRD IV Directive 2013/36/EU. The bill also proposes amendments regarding auditing of financial undertakings, on one hand amending the provision on auditors' mandatory disclosure to the Financial Supervisory Authority in accordance with the rules of European law, and on the other hand extension of the authorised term of auditors from five to ten years, as this amendment is based on Regulation (EU) No. 537/2014 on specific requirements regarding statutory audit of public-interest entities.

Operations across borders and group-oriented surveillance

Another bill to amend the Act on Financial Undertakings in the pipeline for spring 2019, which specifically proposes amendments to Article V, on financial undertakings' operations across borders, and to Article XIII, on group-oriented surveillance. The bill is based on CRD IV and will propose amendments to legal rules on operations and surveillance of branches and service operations of financial undertakings within the EEA, operations and surveillance of financial undertakings' branches outside the EEA in Iceland, group-oriented surveillance, and surveillance bodies' information exchange.

Capital buffer for global systemically important financial institutions

Another bill amending the Act on Financial Undertakings, which will entail amendments to provisions on capital buffers, is expected. This bill will on the one hand propose a new capital buffer, that is a capital buffer for global systemically important financial institutions, while on the other hand the Financial Supervisory Authority will publish a regulatory act on the value of capital buffers based on the provisions of the Act instead of relying on administrative decisions thereon. The bill will also entail a few additional amendments to the legal provisions on capital buffers in order for the provisions on capital buffers to be in full accordance with CRD IV.

Treatment of ISK-denominated assets subject to certain restrictions

A bill amending Act No. 37/2016 on the Treatment of ISK-Denominated Assets Subject to Certain Restrictions and the Foreign Exchange Act was submitted to Parliament in December 2018. This is one of the last steps taken by authorities to lift capital controls that were put in place in the wake of the fall of the Icelandic financial system in 2008. The bill proposes changes to the Act on the Treatment of ISK-Denominated Assets Subject to Certain Restrictions, which is aimed at considerably extending exemptions from restriction on the executive rights for assets covered by the Act. The bill thus proposes that authorisations for withdrawals from accounts subject to certain restrictions be amended, enabling all off-shore ISK-denominated asset owners to release their off-shore assets. The bill furthermore proposes to amend preliminary provision III of Foreign Exchange Act No. 87/1992 stipulating the authorisation of the Central Bank of Iceland to resort to minimum reserves for capital inflow. This authorisation was legalised in 2016 and was a component of the Government's lifting of capital controls. The proposed change entails an authorisation to meet minimum reserve requirement with Central Bank repurchase agreements.

Special tax on financial undertakings

A bill amending Act No. 155/2010, on a Special Tax on Financial Undertakings, is expected to be submitted to Parliament during the 2019 spring session. The bill is expected to propose a reduction of the banking tax rate in four increments, from 0.376% to 0.145% in the 2020-2023 period.

Securities settlement and securities depositories

A bill on securities settlement and securities depositories is expected to be submitted to Parliament in early 2019. The bill will entail the implementation of Regulation (EU) No. 909/2014, on improving securities settlement in the European Union and on central securities depositories (CSDR), aimed at improving securities settlement in the EEA and harmonising requirements for securities depositories operating a securities settlement system. Various rules have hitherto applied to settlement in EU member states, providing for different clearing and settlement times, as well as varying operating conditions and authorisations. The bill will furthermore entail necessary amendments to Act No. 131/1997, on Electronic Registration of Title to Securities.

Managers of specialised funds

A bill on managers of specialised funds is expected to be submitted to Parliament in early 2019. The bill will entail the implementation of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD). The Directive introduces a legal framework for the authorisation, supervision and oversight of managers of a range of alternative investment funds (AIFM), including hedge funds and private equity funds located and/or operated in EU countries requiring fund managers to obtain authorisation from the competent authority as well as making them subject to supervision. Furthermore, the bill will repeal provisions of the Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Institutional Investor Funds regarding investment funds (No. 128/2011).

UCITS, Investment Funds and Institutional Investor Funds

Submission to Parliament of a bill amending Act No. 128/2011 on UCITS, Investment Funds and Institutional Investor Funds is expected in the first part of 2019 due to implementation of the UCITS V Directive 2014/91/EU.

Markets for financial instruments

Submission to Parliament of a bill on a new comprehensive legislation on markets for financial instruments, which entails the implementation of the MiFID II Directive 2014/65/EU and the accompanying MiFIR Regulation 600/2014 into Icelandic legislation, is expected in 2019. This represents a considerable modification of the current legislation, calling for amendments to Act No. 161/2002, on Financial Undertakings, Act No. 108/2007, on Securities Transactions, and Act No. 110/2007, on Stock Exchanges. The MiFID II Directive and the MiFIR Regulation represent a review and update to the MiFID I Directive 2004/39/EC, passed into law in Iceland in 2007. The modifications pursuant to MiFID II will increase the efficiency and transparency of financial markets and create investor protection.

Interchange fees

A bill on interchange fees is expected to be submitted to Parliament in early 2019. The bill will entail the implementation of Regulation (EU) No. 751/2015, on interchange fees for card-based payment transactions (IFR). The bill will among other things stipulate a maximum interchange fee for debit and credit card use, and its purpose is to reduce costs for sellers and consumers, improve transparency and competition in the payment card market, and promote integration of payment card markets across borders within Europe.

Payment services

A bill on payment services is expected to be submitted to Parliament in early 2019. The bill will entail the implementation of Directive 2015/2366/EU, on Payment Services (PSD2), regarding payment services in the single market, and calls for a revision of Act No. 120/2011, on Payment Services. The Directive seeks to improve the existing EU rules for electronic payments and takes emerging and innovative payment services, such as internet and mobile payments into account. The Directive sets out strict security requirements for electronic payments and the protection of consumers' financial data, guaranteeing safe authentication and reducing the risk of fraud; increases the transparency of conditions and information requirements for payment services; and sets out rules concerning the rights and obligations of users and providers of payment services. Furthermore, the Directive seeks to open up payment markets to new entrants leading to more competition, greater choice and better prices for consumers.

Bank recovery and resolution of financial undertakings

A bill on a new comprehensive legislation on Bank Recovery and Resolution of Financial Undertakings is expected to be submitted to Parliament in early 2019. The bill will entail the implementation of the second part of the Bank Recovery and Resolution Directive 2014/59/EU (BRRD). The bill stipulates the rules regarding preparation and execution of resolution, and other points concerning recovery and resolution of financial undertakings. The bill will designate the new authorities or administrative units, resolution authority and resolution fund, to provide public administration in resolution procedures and financing of resolution procedures.

Reduction of common contributions to the Depositors' and Investors' Guarantee Fund

The Ministry of Finance and Economic Affairs has published and called for opinions on its scheme for the reductions of common contributions to the Depositors' and Investors' Guarantee Fund. The bill proposes a general reduction of premiums from 0.225% of the contribution annual basis to 0.16%. The proposed amendment will reduce contributions from credit institutions to the Depositors' and Investors' Guarantee Fund, which will increase their possibility of reducing the interest rate difference of deposits and loans to the advantage of consumers and undertakings in Iceland.

9 Remuneration report

Remuneration report

9.1 Remuneration report

9.1.1 Introduction

Landsbankinn hf. emphasises hiring and employing exceptional personnel. The aim of the remuneration policy is to make the Bank 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 the market leader. In determining terms of employment, responsibility and performance shall be taken into account, as well as equal rights perspectives. The remuneration policy applies to the Board of Directors, the Executive Board of Landsbankinn, and all Landsbankinn employees. The subsidiary of Landsbréf has its own remuneration policy and Remuneration Committee.

9.1.2 Governance

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

At the start of 2018 the Remuneration Committee members were Chairman of the board, Helga Björk Eiríksdóttir (Chairman of the Remuneration Committee), Magnús Pétursson and Berglind Svavarsdóttir. After the Bank's annual meeting in March, Magnús was replaced by Samúel Guðmundsson, a member of the Board of Directors. Samúel resigned from the Board, and therefore from the Committee as well, in November. In addition, the CEO of the Bank, Head of HR and Head of Legal regularly attend certain parts of Remuneration Committee meetings.

In the year 2018, the Committee reviewed the remuneration policy prior to the annual meeting and made no changes to the policy. During 2018 the Committee held 4 meetings, 1 before the annual meeting, 2 before Samúel's resignation, and 1 thereafter.

9.1.3 Remuneration policies for the Bank's 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 No. 47/2006, on the Senior Civil Servant's Board, the Senior Civil Servant's Salary Board determined the remuneration of the Bank's CEO until 1 July 2017. 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. Act No. 130/2016 newly entered into force on 1 July 2017 and repealed and replaced 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. The Bank publicly publishes the terms of employment of Directors and key executives in its annual report.

All employees in the Bank receive a fixed salary, according to position and function. The salary level is evaluated on an annual basis. Employee benefits are offered to all employees. All employees have mandatory pension contributions and paid holidays on market aligned terms.

The Bank does not offer variable remuneration, and has no plan to implement variable remuneration. Any decision to implement variable remuneration has to be presented to a shareholders' meeting for approval.

The Remuneration Committee performs an annual comparison with market data on remuneration to ensure remuneration is competitive, but not leading for various groups, such as the Executive board, Managers, Branch managers and Control functions.

10 Disclosure Policy

Disclosure Policy

10.1 Introduction

The Basel III Accord, implemented in the European Union through the Capital Requirements Directive (CRD 2013/36/EU (the 'Directive')) establishes a revised regulatory capital framework across Europe, governing the amount and nature of capital that must be maintained by credit institutions. Parts of the Directive have been implemented into Icelandic law by amendments to the Act on Financial Undertakings (Act. No. 57/2015 and Act No. 69/2016, amending Act No. 161/2002 on Financial Undertakings). The amendments to Icelandic law incorporate, among other things, the CRD IV capital buffer requirements, disclosure requirements, minimum leverage ratio, supervisory review and evaluation process and capital definitions.

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 / Liquidity Adequacy Assessment Process, ICAAP/ILAAP) 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 2018, reviews the Bank'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 Bank's risk position on the basis of the requirements under Pillar III.

10.2 Disclosure policy

In accordance with the Directive, the Bank 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 Bank 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.

10.3 Frequency of publication

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

10.4 Verification

The disclosures have been put together to solely explain the basis of preparation and disclosure of certain capital requirements and provide information about the management of certain risks. They do not constitute any form of audited financial statement and have been produced solely for the purpose of Pillar III. They should not be relied upon in making judgements about the Bank. 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 Bank's Board of Directors and Risk & Finance Committee.

This publication, Risk and Capital Management 2018, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2018. There may be some discrepancy between financial information in the Consolidated Financial Statement 2018 and information in the Risk and Capital Management 2018, as the report has been prepared in accordance with the Capital Requirements Directive and the Basel III capital framework, rather than in accordance with IFRS.

10.5 Media and location of publication

The disclosures will be published on the Bank's website.

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