Risk and Capital Management 2012

Pillar III risk report of Landsbankinn hf.
31.12.2012

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 of the Financial Supervisory Authority of Iceland (FME) in accordance with Act No. 87/1998 on Official Supervision of Financial Activities.

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

At the end of 2012 shareholders of Landsbankinn hf. were the Icelandic State with a 81.33% share and the holding company Landskil with 18.67%. Landskil is fully owned by the Winding-up Board of LBI hf. It should be noted that the ownership of Landsbankinn hf. changed on 11 April 2013. The 18.67% share previously held by LBI hf. was transferred to the Icelandic State and Landsbankinn hf. in accordance with an agreement between the parties from December 2009. The Icelandic State now owns 98% of shares in the bank and Landsbankinn hf. 2%.

Content

1 Highlights of 2012 and outlook **6**
2 Disclosure Policy **8**
2.1 Introduction 8
2.2 Disclosure Policy 8
2.3 Frequency of Publication 9
2.4 Verification 9
2.5 Media and Location of Publication 9
3 Risk Management **10**
3.1 Risk management structure 10
3.2 Risk assessment 13
3.3 Risk appetite 14
4 Capital Management **15**
4.1 Capital management structure 15
4.2 Capital management framework 16
4.3 The capital base 16
4.4 Capital requirement 18
4.5 Economic capital 20
4.6 Stress testing 21
4.7 Summary of capital requirement and economic capital 24
4.8 Consolidation methods 24
4.9 New capital regulations 26
5 Credit Risk **28**
5.1 The Credit process 28
5.2 The credit portfolio 32
6 Market risk **49**
6.1 Market risk management and policy 49
6.2 Control and monitoring 49
6.3 Market risk exposure 50
6.4 Measuring market risk 50
6.5 Market risk VaR 54
7 Liquidity risk **56**
7.1 Identification 56
7.2 Management 56
7.3 Assessment 57
7.4 Stress test/sensitivity analysis 58
7.5 Control and monitoring 59
7.6 Requirements from supervisory authorities 59
7.7 Liquidity Contingency Plan 60
7.8 Funding and refinancing risk 60
8 Operational risk **62**
8.1 Control 62
8.2 Measurement, mitigation, processes and control 63
9 APPENDIX **66**
9.1 Further disclosures required under Pillar III 66

1 Highlights of 2012 and outlook

Landsbankinn continued to show an improving risk position and credit quality in 2012, as well as progressive capital ratios. This was reflected in an increased core tier 1 capital ratio to 25.5% and a positive overall effect from rating migrations.

The Group continued to improve its risk management framework and policies in 2012, in line with international best practices, and has defined its risk appetite. The Group aims to strengthen its risk management processes further and enhance risk culture in the coming year.

At the end of Q3 2012, Landsbankinn concluded its strategic review and defined objectives for 2015. The strategy entails a stronger focus on operational efficiency by reducing cost, strengthening management and team unity, while also pursuing responsible and profitable market initiatives. At the same time, the Bank made significant changes to its organisational structure which became effective as of 1 October 2012.

The business environment in Iceland in recent years has been characterised by instability. Domestic economic development remains uncertain and this situation extends to Iceland's major trading countries. There is also uncertainty about possible changes to laws and regulations relating to economic fundamentals, such as fisheries, financial institutions and the removal of capital controls. Economic growth has accelerated slightly in Iceland yet without stimulating investment or demand for financial services to any noticeable extent. This will have direct and indirect impact on the Group's operation and planning.

Economic development in Iceland in 2012 was favourable in many respects, especially in comparison with developments in major trading countries. While there was significant economic growth for the second consecutive year, this remained below expectations. Unemployment dropped considerably.

Weak economic growth is still expected in Iceland's major trading countries. Even though the situation has resolved somewhat, the European debt crisis remains a major factor of uncertainty and this lingering trend inevitably impacts the domestic economy. Hopes for a turnaround in the eurozone dwindled towards the end of last year and now a slight further decline is expected in 2013. The situation in Europe has not only affected exports and trade, but it could also affect Icelandic access to international capital markets.

Overall, the main characteristics describe a status quo, or a very slow recovery at best. This standstill is also reflected in the Bank's operations. The Group expects an economic growth of

just under 3% on average over the next three years. This growth will mostly be driven by capital formation and private consumption and its effects will be limited. The outlook is that inflation will remain significantly over the Icelandic Central Bank's target, particularly if the Icelandic króna (ISK) continues to weaken.

Due to restrictions on the movement of capital between Iceland and other countries, the Group's ability to mitigate risk from ISK-related currency fluctuations is limited. However, the Group has taken various measures to decrease its overall currency risk and expects future currency risk levels to be within acceptable limits.

The Bank's core operations are sound and have been improving continuously. Foundations have been laid in the form of new and revised processes to improve efficiency and customer relationship management. With solid equity and a robust liquidity base, the Group is in a strong position to take on future challenges.

Landsbankinn plans to secure funding in foreign currencies by issuing bonds on international credit markets no later than 2015. An important part of that is obtaining a credit rating from an international credit rating agency (S&P, Moody´s or Fitch) and the Bank is already working to that end.

At year-end 2012 the Bank was within all its limits on risk appetite. Defined risk appetite and risk limits have been in place for one year and have proven effective measures to reduce risk in line with the Group's strategy. The Bank's overall risk level improved significantly in 2012 which is clearly reflected in the assessment of decreased Economic Capital. In addition, the 90 days past due ratio has decreased significantly, the quality of the loan portfolio has improved and the Group has reduced its market risk. Moreover, the Bank's liquidity position remains strong and capital positions strengthened significantly. The latter is, however, an indicator of a lack of investment opportunities.

Legal uncertainty remains relatively high and has increased as a percentage of the bank's Economic Capital. This uncertainty is mainly associated with the calculation of interest on foreign exchange rate indexed loans as well as uncertainty about the legality of certain parts of the loan portfolio. The Supreme Court of Iceland is expected to hand down its ruling on some of these cases in summer 2013, resulting in clarification and lesser uncertainty.

2 Disclosure Policy

2.1 Introduction

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

The Basel II framework consists of three 'Pillars'.

- Pillar I sets out the minimum capital amount that meets the firm's credit, market and operational risk
- Pillar II requires the firm to assess whether its Pillar I capital is adequate to meet its risks (Internal Capital Adequacy Assessment Process, ICAAP) and is subject to annual review by the Financial Supervisory Authority (FME) (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 2012, reviews the Group's organisation and processes relating the identification and management of the risk types characteristic of a financial group with its type of business concept. It also describes a group's risk position on the basis of the requirements under Pillar III.

2.2 Disclosure Policy

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

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

One or more of the required disclosures may be omitted where it is believed that the information is regarded as proprietary or confi-

dential. Proprietary information is that which, if it were shared, would undermine a competitive position. Information is considered to be confidential where there are obligations binding the Group to confidentiality with customers and counterparties. If information is omitted for either of these two reasons it will be stated in the relevant section along with the reasons for this. Where appropriate, further general information on the subject of the required disclosures will be published.

2.3 Frequency of Publication

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

2.4 Verification

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

The disclosures are reviewed and approved by the Group's Board of Directors' Audit and Risk Committee.

This publication, Risk and Capital Management 2012, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2012. There may be some discrepancy between financial information in the Consolidated Financial Statement 2012 and information in the Risk and Capital Management 2012 as the report has been prepared in accordance with the Capital Requirements Directive and the Basel II capital framework, rather than in accordance with IFRS.

2.5 Media and Location of Publication

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

3 Risk Management

3.1 Risk management structure

3.1.1 Risk committees

The Bank's risk management governance structure at year-end 2012 is as follows:

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

The Credit Committee deals with credit risk – both credit limits on individual customers as well as credit risk policy issues – while the Risk & Finance Committee covers primarily market risk, liquidity risk and legal risk. The Risk & Finance Committee monitors all the Bank's risks and is responsible for enforcing the Bank's risk appetite and risk limits, and reviews and approves changes to risk models before presented to the Board of Directors. The Executive Management Committee serves as a forum for consultation and communication between the CEO and managing directors, addressing the main current issues in each division. This committee makes all major

Risk committees

Supervision by the Board of Directors	Board of Directors
	Internal Audit, Audit & Risk Committee, Governance Committee
Key risk management bodies and committees	**The CEO**
	Credit Committee Risk & Finance Committee Executive Management Committee Security Committee

Risk types	Compliance risk	Credit risk	Market risk	Operational risk	Liquidity risk

decisions not being considered in other standing committees. The Security Committee is a forum for discussions and decisions on information safety, personnel security, responsibilities in specific security areas and the Group's safety procedures.

3.1.2 Risk Management Divisions

The Bank's Risk Management Division is responsible for the Bank's risk management framework. Subsidiaries of the Bank have their own risk management functions and the Risk Management Division receives information on exposures from the subsidiaries and collates them into Group exposures.

The Risk Management Division is comprised of six departments.

- » The Credit Management Department is responsible for risk assessment and secondary voting on credit applications from customers with exposures exceeding the credit limits of individual business units and customers which have been classified yellow, orange or red. Secondary voting on decisions exceeding the authorisation of the Risk Management Division is referred to the Bank's Credit Committee.
- » The Credit Risk Monitoring Department is responsible for monitoring credit risk in the Bank's credit portfolio. This is done by operating a credit monitoring system. The Credit Risk Monitoring Department is also responsible for the portfolio valuation methodology and for the operation of the Bank's write-off process. In addition the Department works with other departments on impairment analysis.
- » The Market Risk Department is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the Bank's banking book. Market Risk is also responsible for monitoring all derivatives trading the Bank enters into, both for hedging and trading purposes. Market risk monitoring also includes FX balance monitoring for the Bank as well as providing limit monitoring for pension funds under management by the Bank. The Market Risk Department is also responsible for comprehensive risk reporting to various departments and committees.
- » The Operational Risk Department is responsible for ensuring that Bank operational risks are monitored and that the Bank implements and maintains an effective operational risk management framework.
- » The Models and Analysis Department is responsible for providing, developing and maintaining the Bank's internal models and related processes to measure risk, including the Economic Capital framework; as well as to support the implementation of such models

and processes within the Bank. In addition, the Department is responsible for credit risk, economic capital and risk appetite reporting within the Bank as well as reporting to supervisory authorities.

- The Economic Research Department is an independent unit within Risk Management and is responsible for the analysis of the external domestic and international economic environment relevant to the Bank's operations. Such analysis provides support to management in planning, risk management and decision-making. The main task of the department within the risk management context is to design and analyse macroeconomic scenarios which are applied in the stress testing process.

The Bank's Compliance Department ensures that the Bank adheres to its own rules on securities trading and insider trading and that the Bank's operations comply with Act No. 108/2007, on Securities Transactions, Act No. 67/2006 on Actions to Combat Money Laundering and Terrorist Financing, and other relevant legislation and regulations. Compliance also concentrates on Bank adherence to codes of ethics and on limiting market abuse, minimising conflicts of interest and ensuring best practice. Compliance is one of the Bank's support functions and is integral to its corporate culture.

Internal Audit is part of the Bank's risk management framework as well as being a part of the surveillance system. The purpose of Internal Audit in the risk management process is to confirm that risk management is functioning and is sufficient for the Bank. The effectiveness of the Bank's risk management and risk assessment procedures, including the Internal Capital Adequacy Assessment Process (ICAAP), is evaluated by Internal Audit and the findings are reported to the Board of Directors. The activities of Internal Audit extend to every operating unit, including the Bank's subsidiaries.

3.1.3 Risk reporting

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

The Board of Directors receives thorough risk reports every four months as well as receiving risk reporting through an integrated monthly management report. The Risk & Finance committee and the Executive Management Board receive a monthly risk report or more frequently if required. Once a year, an expanded ICAAP report is submitted for approval which is subject to a review by the FME's (Financial Supervisory Authority of Iceland) SREP process. A minor ICAAP report is also generated internally bi-annually.

Principal reporting to the Board of Directors

Annual	
ICAAP report	Evaluation of the risk profile and the solvency need. The report contains conclusions drawn from stress testing, including the effect of various scenarios on expected losses and capital needs
Minor ICAAP report	An internal update of the ICAAP report
Every four months	
Risk Management's risk report	Thorough risk report which addresses every risk type. The report covers aspects such as Economic Capital, risk appetite, credit risk, market risk, operational risk and external economic prospects
Monthly	
Risk appetite	Development in the Group's risk appetite measures. Key measurements are broken down by business units
Past due loans	Analysis of past due loans broken down by corporations and individuals, industry segments
Credit quality, probability of default	Analysis of average exposure-weighted probability of default (PD, broken down by corporations and individuals, industry segments. Default rate vs. probability of default, distribution of loan portfolio in rating categories and migration analysis
Portfolio analysis	Analysis of credit quality and concentration on industry level
Economic Capital	Analysis of Economic Capital developments and Economic Capital breakdown by risk types and business units
Large exposures	Overview of the Group's 20 largest exposures and the sum of these exposures, including the percentage of the capital base they represent
Market risk reporting	Analysis of the Group's current equity, fixed income and currency positions as well as reports on the utilisation of limits since the preceding report

3.2 Risk assessment

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

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

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

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

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

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

3.3 Risk appetite

The Bank's risk appetite has been reviewed, revised and implemented for 2013. The statement of the Bank's risk appetite is as follows:

It is the policy of the Bank to only take on risks that the Bank is able to understand, measure and manage. The Bank's strategy and long-term vision is to attain the same credit rating as comparable leading banks in the Nordic countries.

The Bank seeks to maintain solid business relationships and avoids taking part in transactions that might damage the Bank's reputation. It will take advantage of market opportunities to ensure diversified and sound financing.

Transactions entered into by the Bank aim to limit fluctuations in its operations and ensure that the Bank is always in a position to withstand shocks. Moreover, transactions shall take into account the current standing of both the Bank and its customers and has due regard for any internal connections. The profitability of the Bank shall be assessed with respect to risk taken by the Bank. The Bank's corporate culture is characterised by professionalism and processes that support its risk strategy.

Executives and employees are responsible for monitoring and managing risks taken on within their units in accordance with the Bank's rules and applicable law. Decisions are based on in-depth and professional discussions with the Bank's long-term interests in mind. Regular and thorough follow-up on decisions and risk monitoring is an integral part of the Bank's operations.

When the risk appetite is decided upon, risk limits are also set for the main types of risks associated with credit, market, liquidity and operational risk and it varies how detailed they are depending on their properties and adjustability.

Credit risk pertains to, inter alia, the quality of the loan portfolio, concentration risk and large exposures. The Bank has been successful in reducing risk in relation to all of these factors and all of the Bank's goals in this respect were achieved in 2012. Revised limits on credit risk are based on reducing the risk even further in 2013.

Measurements of market and liquidity risk have been within limits the entire year and the Bank will revise limits downwards that relate to market risk in relation to the business plan.

The Bank's liquidity position is very strong and the Bank has significant room to manoeuvre without approaching the risk limits.

4 Capital Management

4.1 Capital management structure

The Group's capital management governance structure for year-end 2012 is as follows:

Capital management structure

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

4.2 Capital management framework

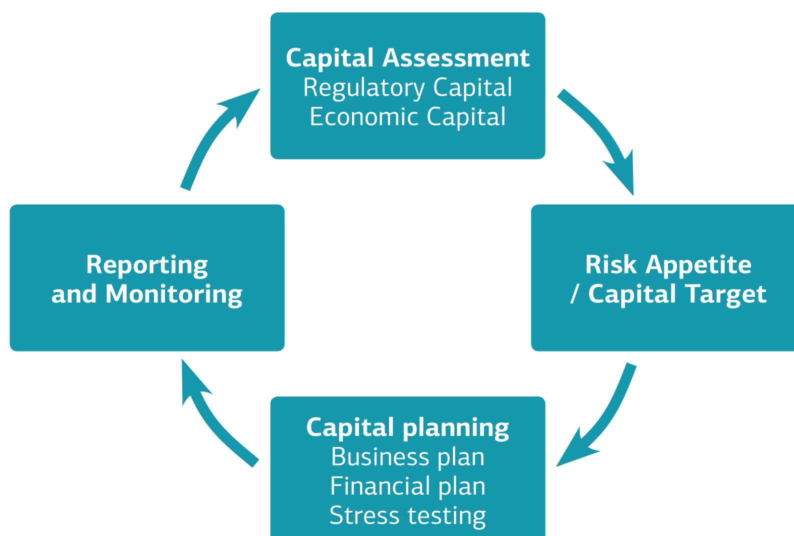
The purpose of the Group's capital management is to support the Group's strategy and ensure that it has sufficient capital to cover its risks at all times.

The capital management framework of the Bank comprises of 4 interdependent activities: Capital Assessment, Risk Appetite/Capital Target, Capital Planning, and Reporting/Monitoring.

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

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

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



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

4.3 The capital base

The Group's equity at 31 December 2012 amounted to ISK 225.2 billion (31.12.2011: ISK 200.2 billion). The Capital Adequacy Ratio, calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings, was 25.1% at 31 December 2012 (31.12.2011: 21.4%). Under the Act the minimum requirement for this ratio is 8%. The capital base consists of Tier 1 capital and the breakdown is as follows:

The Group's capital adequacy ratio rose in 2012, mainly because of its earnings of ISK 29,885 million (3.3%) before impairment. Impairment for the year 2012 was ISK 4,391 million (-0.5%) and the drop in risk-weighted assets contributes 0.5% to the capital ratio. Other positive changes include reduction in deferred tax assets and decreased holdings in financial institutions.

The capital base

Capital base	12/31/12	12/31/11
Share capital	24,000	24,000
Share premium	123,898	123,898
Statutory reserve	5,053	3,781
Retained earnings	72,120	47,952
Non-controlling interests	95	613
Intangible assets	-541	-681
Deferred tax assets	-48	-3,003
Tier 1 capital	**225,166**	**196,561**
Deduction from original and additional own funds	-3,815	-4,531
Capital base	**220,762**	**192,031**

Risk-weighted assets		
Credit risk	679,516	696,402
Market risk	98,486	120,557
Operational risk	101,393	81,500
Total risk-weighted assets	**879,395**	**898,460**

Tier 1 capital ratio	**25.54%**	**21.88%**
Capital adequacy ratio	**25.10%**	**21.37%**

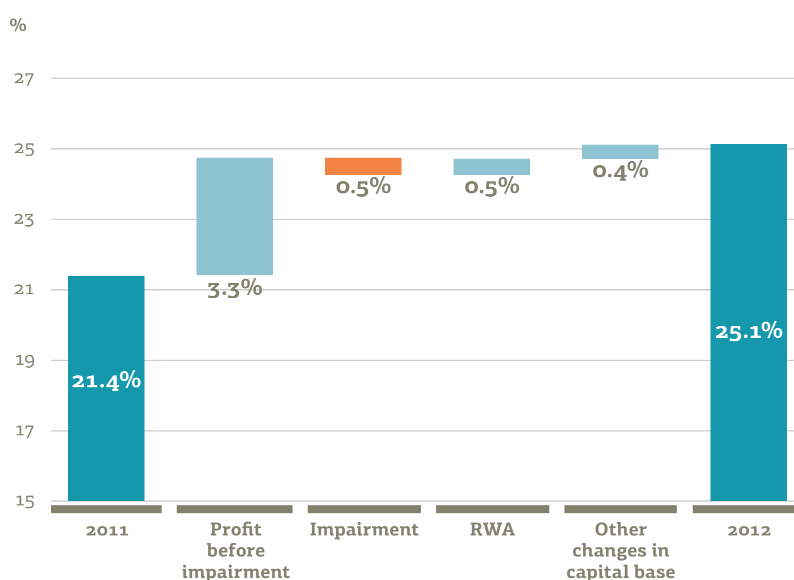
4.3.1 Tier 1 capital and statutory deductions

Tier 1 capital consists of core Tier 1 capital less statutory deductions according to requirements of the Financial Supervisory Authority (FME) based on Articled 54 and 55 of Act No. 113/1996.[1] The Group makes deductions in order to determine its core Tier 1 capital:[2]

1 Article no.55 under http://www.althingi.is/lagas/127b/1996113.html

2 Other deductions are goodwill and investments in own shares which do not apply to the Group at the year-end 2012

Change in capital ratio



» Carrying amounts of intangible assets

» Deferred tax assets

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

Capital holdings (>10%) in other credit and finance institutions are as follows:

The FME currently requires the Group to maintain a minimum core Tier 1 capital ratio of 12%.

The capital base contains no hybrid capital and no Tier 2 capital.

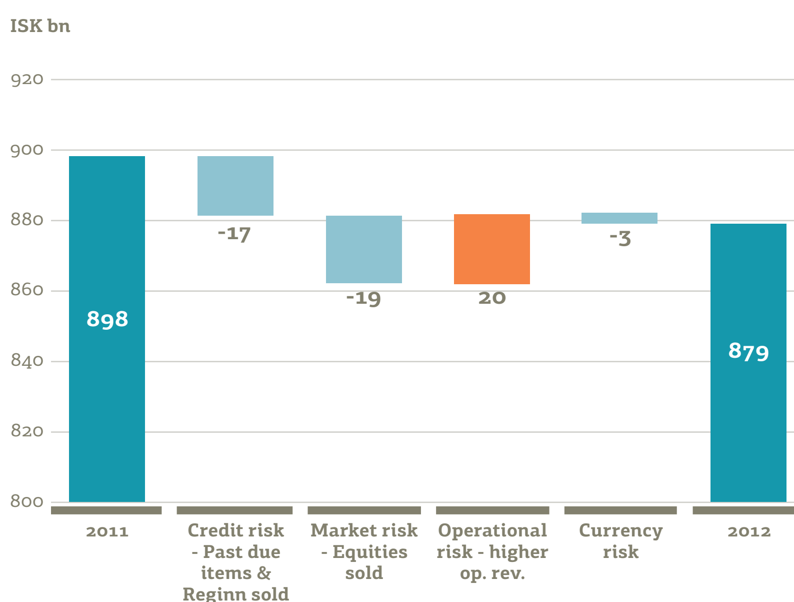
Tier 1 capital and statutory deductions

	2012	2011
Valitor	3,155	2,803
Borgun	660	455
Vörður líftryggingar		1,272
Total	**3,815**	**4,531**

4.4 Capital requirement

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

Capital requirement



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

Capital requirement

Capital requirement and risk weighted assets		12/31/12		12/31/11
Credit risk breakdown	**Capital requirement**	**RWA**	**Capital requirement**	**RWA**
Central governments or central banks	6	77	6	72
Regional governments or local authorities	353	4,416	246	3,069
Administrative bodies	6	69	1	17
Institutions	1,834	22,926	990	12,378
Corporations	30,480	381,005	28,611	357,634
Retail	9,437	117,964	7,940	99,256
Secured by real estate property	3,030	37,870	1,698	21,220
Past due items	4,174	52,175	8,106	101,321
Items belonging to regulatory high-risk categories*	974	12,170	0	0
Short-term claims on institutions and corporate	0	0	1,281	16,013
Other items	4,068	50,844	6,834	85,423
Credit risk	**54,361**	**679,516**	**55,712**	**696,402**
Market risk breakdown				
Traded debt instruments	1,439	17,991	1,875	23,431
Equities	4,426	55,321	5,524	69,055
Market risk	**5,865**	**73,312**	**7,399**	**92,487**
Currency risk	**2,014**	**25,174**	**2,246**	**28,071**
Operational risk	**8,111**	**101,393**	**6,520**	**81,500**
Total capital requirement and RWA	**70,352**	**879,395**	**71,877**	**898,460**

*One large exposure was re-classified from credit risk - other items for year 2011 without effect on risk weight.

it uses the basic indicator approach[4] in calculating capital requirement.

Risk-weighted assets (RWA) for credit risk, the single largest risk type, amounted to 77.3% of total RWA. RWA for market risk amounted to 8.3% of RWA.

Total risk-weighted assets and capital requirement decreased during 2012. The highlights of the decrease is as follows: as for credit risk, the quality of the loan portfolio has increased with lower past due items. Real estate company, Reginn[5], which was part of credit risk - other items, was sold during the year. There was also a decrease in market risk since equities were sold during the year, with the largest holding sold being in Marel; subsidiary Horn also divested part of its equity position. Operational risk increased because of higher operating revenues.

4 Capital requirements for operational risk are calculated by aggregating the operating revenues for the last three years and obtaining the arithmetic mean. If the aggregate operating revenues for any given year are negative, it is excluded in the calculations. The capital requirement for operational risk is equal to 15% of this mean.

5 The Group sold 75% of Reginn and Reginn went from being a subsidiary to an associate.

Economic capital

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

4.5 Economic capital

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

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

Economic Capital decreased slightly during 2012 mainly due to improved quality of the loan portfolio and lower assessment of Economic Capital for single name concentration risk. Credit risk is the largest source of risk confronting the Group. Legal and regulatory risk has increased as well as interest rate risk but the Group has revised its methodology for interest rate sensitivity measurements for non-trading portfolios by applying more severe interest rate shocks to the relevant yield curves, taking

Economic Capital ISK million	2012	2011
Credit risk - Loans to customers and credit institutions	68,764	69,296
Credit risk - Other assets	5,041	6,834
Market risk	5,865	7,399
Currency risk	3,676	2,443
Operational risk	8,111	6,520
Single name concentration risk	8,099	21,603
Industry concentration risk	2,710	2,466
Interest rate risk	10,688	5,055
Business risk	4,056	3,260
Legal and regulatory risk	18,913	12,800
Total	**135,923**	**137,676**
EC/RWA	**15.50%**	**15.30%**

historical interest rate volatility into account. Economic Capital is estimated at 15.5% of RWA for year-end 2012.

Below is a further breakdown for credit risk, probability of default by asset class as well as loss given default, exposure at default and EC. Probability of default for credit risk has decreased from end of year 2011 by 30% mainly because of improved quality in the corporate loan book. Numbers for 2011 in parenthesis.

4.6 Stress testing

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

Weighted average

Credit risk at 31 December 2012	Probability of default (PD)*	Loss given default (LGD)**	Exposure at default (EAD)	Economic Capital (EC)
Financial institutions	1,5% (3,1%)	45.00%	58,357	2,716
Public entities	1,2% (0,9%)	44.90%	26,277	1,687
Individuals	2,7% (2,8%)	33.20%	214,516	8,078
Corporations	6,0% (8,8%)	44.00%	527,410	56,283
Total	**4,6% (6,6%)**	**41.30%**	**826,560**	**68,764**

*Numbers in parenthesis from 31.12.2011
**Loss given default calculations are based on foundation IRB LGD, except for individuals where internal LGD's are used.

Stress testing

Baseline scenario	Based on the most recent macroeconomic forecast of Economic Research. The forecast is supported by extensive analysis of the economic environment published in a semi-annual report.
Mild recession	The scenario assumes a slight contraction in GDP growth for the first few years followed by a return to trend growth in the last years. In the scenario general business investment is hampered by a worsening economic outlook at home and abroad. Moreover, with the deteriorating outlook for economic growth in Europe, export growth will be negatively impacted. Lower investment and declining terms of trade have a negative effect on wages and employment, which results in week private consumption growth.
Severe recession	This scenario assumes a severe global recession triggered by a breakup of the eurozone. The onetime extreme shock causes a precipitous contraction in the Icelandic economy followed by five years of little or no growth.

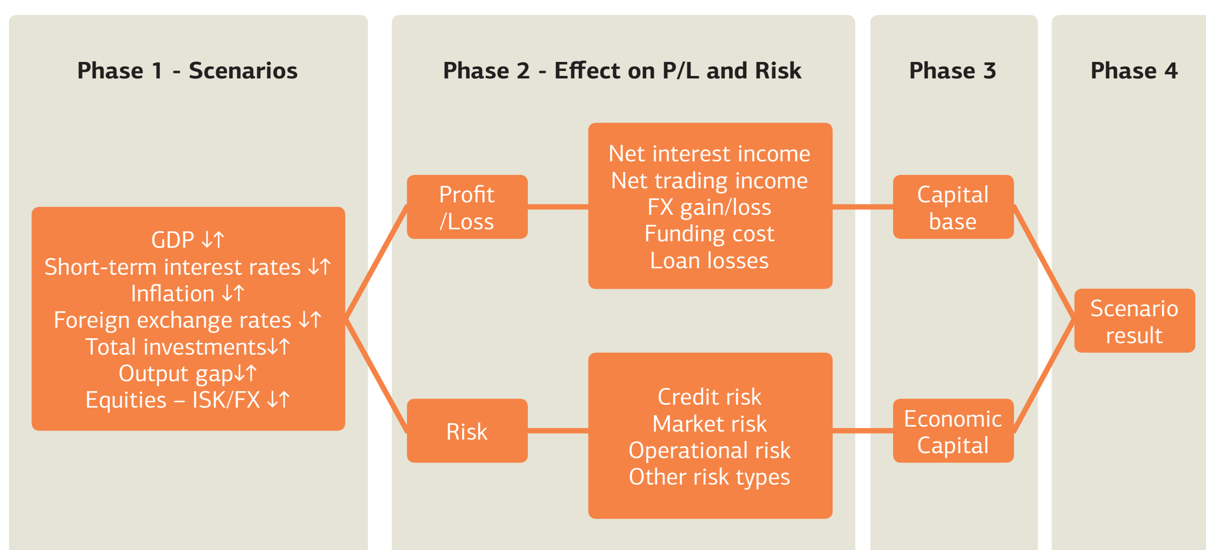
- » Scenario development and approval
- » Scenario translation
  - Translation model to determine loan loss
  - Translation method to determine the effect on financial statements
  - Translation model to determine Economic Capital
- » Calculation
- » Analysis and reporting

In 2012, the Group developed 4 scenarios, including a baseline scenario. These scenarios forecast developments of key macro indicators over a given period. Scenarios demonstrate an alternative development of key economic variables induced by various shocks compared to the baseline macroeconomic and inflation forecast of Landsbankinn Economic Research.

In general, the Group develops 3 scenarios and 1 or more scenarios which confront actual or foreseeable risk:

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

The Group uses a loan loss model which incorporates macroeconomic variables and produces probability of default (PD), default rates as well as loss given default



(LGD) which can then be translated into loan losses.

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

The purpose of a mild recession scenario is to analyse how much additional capital is needed to ensure that the Group will not have to intervene with management actions, other than not paying dividends, in the case of a mild recession. Mild recession is also important when the Group assesses the appropriateness of the risk appetite related to capital as well as to assess the size of the minimum internal buffer.[6]

The purpose of a severe recession scenario is to determine whether the capital level is satisfactory. Severe recession also requires management actions to be taken in order to increase the capital level and the internal capital buffer.

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

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

4.7 Summary of capital requirement and economic capital

At 31.12.2012 the Group estimated its Economic Capital at ISK 135.9 billion (15.5% of RWA) and the capital requirement to be ISK 70.3 billion under Pillar I.

The add-on for Pillar I risks is ISK 21 billion (2.4% of RWA), mainly due to credit risk. Pillar II risks require ISK 44.5 billion of capital (5.1% of RWA), the biggest risks being legal and regulatory.

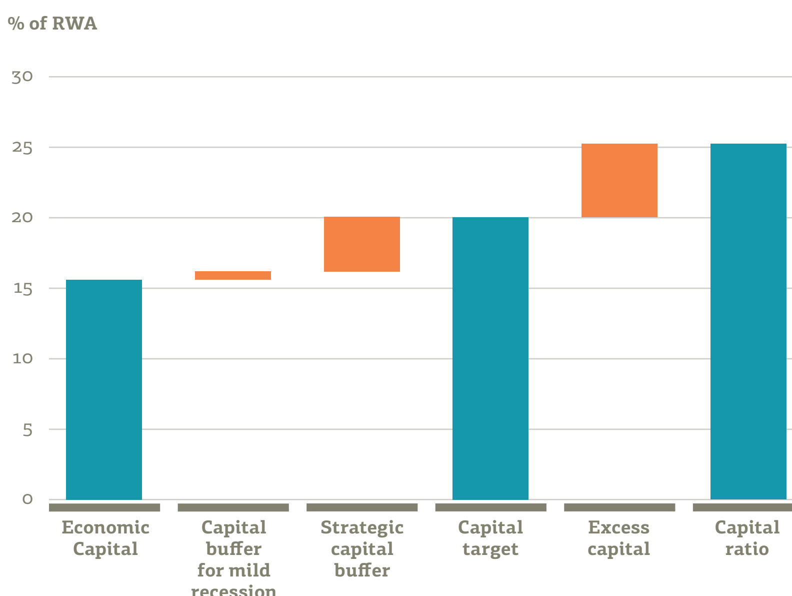
Minimum capital buffer is ISK 85 billion and supports the Group's strategy.

In the latest Supervisory Review and Evaluation Process (SREP), based on year-end 2011, the Financial Supervisory Authority (FME) required the Capital Adequacy Ratio to be at least 19.5%, mainly because of uncertainty due to pending court rulings regarding loans in foreign currency. The Group has complied with this requirement as well as taken strategic objectives into consideration into account in determining a capital target of a capital ratio above 20%.

4.8 Consolidation methods

Risk and Capital Management 2012 is based on the definition of the Landsbankinn Group used in the 2012 Annual Report and complies with IFRS. Subsidiaries are entities over which the Group has the power to govern

Summary of capital requirement and economic capital



Landsbankinn Capital position as of 31.12.2012

Consolidation methods

Company	Ownership interest	Activity
Horn fjárfestingarfélag hf. (Iceland)	100%	Investment company
Landsbréf hf. (Iceland)	100%	Management company for mutual funds
Hömlur ehf. (Iceland)	100%	Holding company*

* Manages the banks repossessed collaterals, which consists mainly of real estate assets.

financial and operating policies so as to obtain benefits from their activities, generally accompanied by a shareholding of over half of the voting rights. Subsidiaries are fully consolidated in the financial statements according to the acquisition method. In capital requirement calculations and Economic Capital the Group consolidates its subsidiaries with a full look-through approach, that is, the Group looks through the subsidiary and down at each individual asset.

The main subsidiaries held directly or indirectly at 31.12.2012 were as follows:[7]

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

Investments in associates at 31.12.2012 are as follows:

Associates	Ownership interest	Carrying amount
Valitor Holding hf.	38%	3,155
Framtakssjóður Íslands hf.	28%	8,113
Reginn hf.	25%	2,798
Borgun hf.	31%	660
Reiknistofa bankanna hf.	37%	629
Motus ehf.	40%	125
Auðkenni hf.	20%	38
Other	-	10
Total		**15,529**

7 Other subsidiaries are Eignarhaldsfélag Landsbankans ehf., Landsvaki ehf., Blámi-fjárfestingafélag ehf., Landsbanki Vatnsafl ehf., Span ehf. and Landsbanki Holdings UK plc., all in 100% ownership.

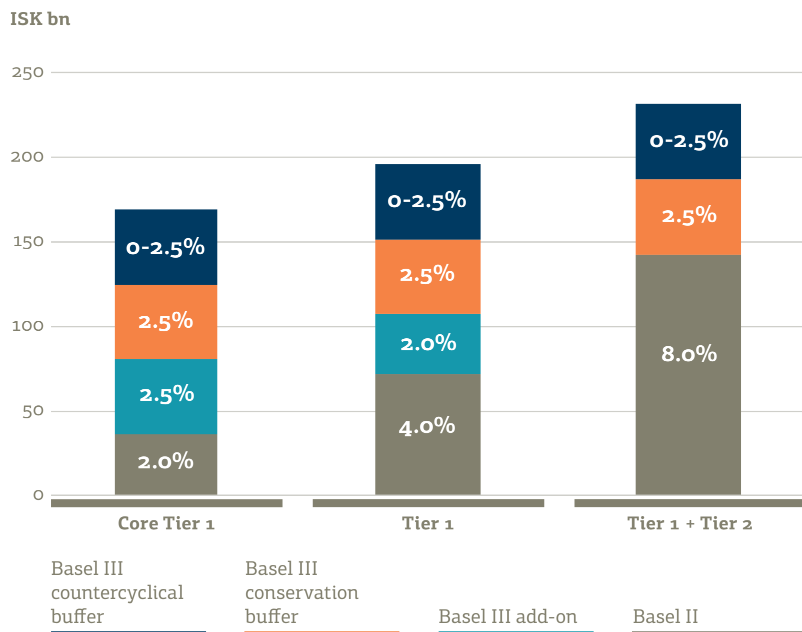
4.9 New capital regulations

The Basel III framework was finalized in December 2010 with a revised version in June 2011. On 16 April 2013 the European Parliament announced the adoption of the legislative package known as CRD IV, which will implement Basel III within the European Union. Implementation will either be from 1 January 2014 or from 1 July 2014.

The adoption period for Basel III will take place in the years 2013-2019 and will affect two main areas, regulatory capital and asset and liability management. New definition of capital is introduced to increase the quality, consistency and transparency of the capital base.

The main changes on regulatory capital are as follows:

Basel III add on and buffers



- Core Tier 1 (CET1) rises from 2% to 4.5%
- Tier 1 capital ratio increases from 4% to 6%
- New capital conservation buffer of 2.5% bringing CET1 to 7% (vs. 2% in Basel II) and Tier 1 capital to 8.5% (vs. 4% in Basel II)
- Countercyclical buffer within a range of 0% to 2.5% of common equity or other fully loss absorbing capital.[8]
- Elimination of Tier 3 capital

Additional capital surcharges to CET1 between 1% and 2.5% for systemically important financial institutions (SIFIs) depending on the systemic importance of the institution are currently in discussion.

Tier 1 capital requirements will be implemented gradually between 2013 and 2015 and the capital buffers between 2016 and 2019. The CET1 was set at 3.5% as of 1 January this year and Tier 1 was set at 4.5%. Tier 1 (going-concern capital) should allow an institution to continue its activities and help prevent insolvency while Tier 2 (gone-concern capital) would help ensure that depositors and senior creditors can be repaid if the institution fails.

Basel III also introduces an increase of risk-weighted assets (RWA) from trading activities like stress tests on value-at-risk and securitisations. For counterparty credit risk, risk weights will be increased on exposures to large financial institutions in the IRB formula. Overall the rules will result in less available capital to cover higher RWA requirements.

New rules were introduced by the Icelandic Financial Supervisory Authority (FME) in December 2012.[9] These state that contingent convertible capital can be at most 10% of Tier 1 capital and non-innovative hybrid capital can be at most 5% of Tier 1 capital. This means that the CET1 has to reach 90% of Tier 1 capital while in Basel III this ratio is 75% (82.4% inclusive of capital conservation buffer).

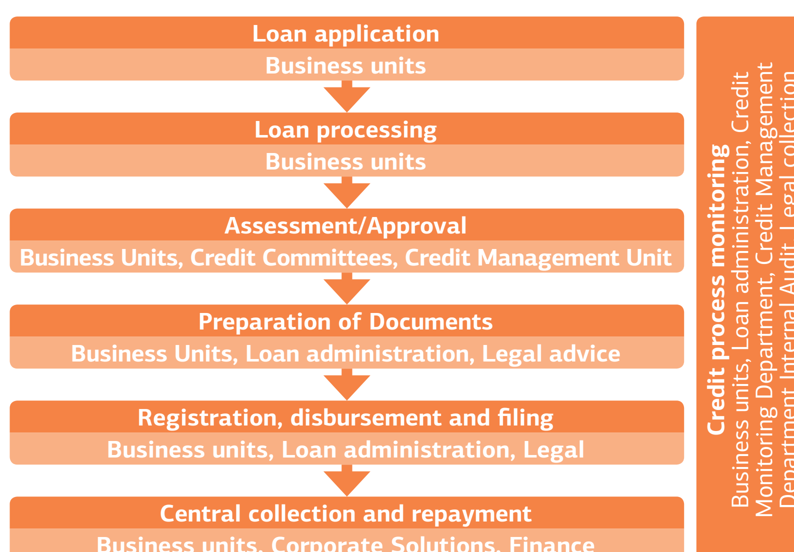
As for Landsbankinn's composition of Tier 1 this will have no effect since Tier 1 is all CET1.

8 Percentage determined by national supervisors.
9 http://www.stjornartidindi.is/Advert.aspx?ID=49ab7439-7fc2-427f-8004-b68d6d98132f

5 Credit Risk

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

At the end of 2012, 77% of the Group's risk-weighted assets were due to credit risk. On the same date, total loans and advances to customers amounted to ISK 730.436 million (2011: ISK 739.263 million), with ISK 666.087 million coming from lending activities (2011: ISK 639.130 million) and ISK 64.349 million from loans and advances to financial institutions (2011: ISK 100.133 million).



5.1 The Credit process

5.1.1 Identification

Credit risk is defined as the risk of loss if counterparties fail to fulfil their obligations and pledged collaterals do not cover the existing claims.

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

5.1.2 Assessment

Credit risk is measured in three main dimensions: the probability of default (PD), the loss given default (LGD) and the exposure. 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 play an essential role in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an obligor 'rating scale' which reflects exclusively quantification of the risk of obligor default, i.e. credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors going from '1' to '10', '10' indicating the highest credit quality, and the grade '0' for defaulted obligors. The rating assignment is supported by rating models, which takes 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.

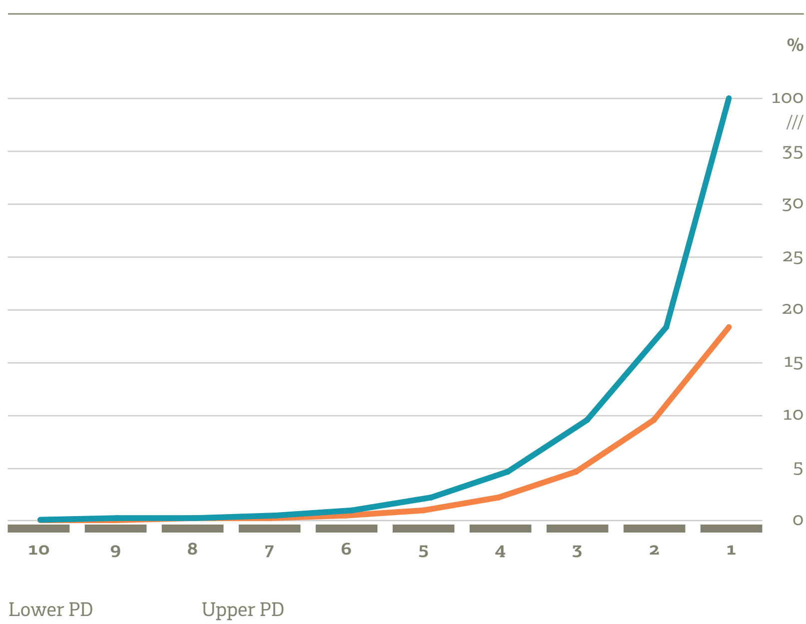
LGD is measured using the models defined in the Basel framework for the purpose of Economic Capital calculations. In addition, during 2012 the Bank implemented in the business processes an internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the aforementioned Basel model.

Exposure is calculated using the credit conversion factors of the Basel framework.

5.1.3 Management and policy

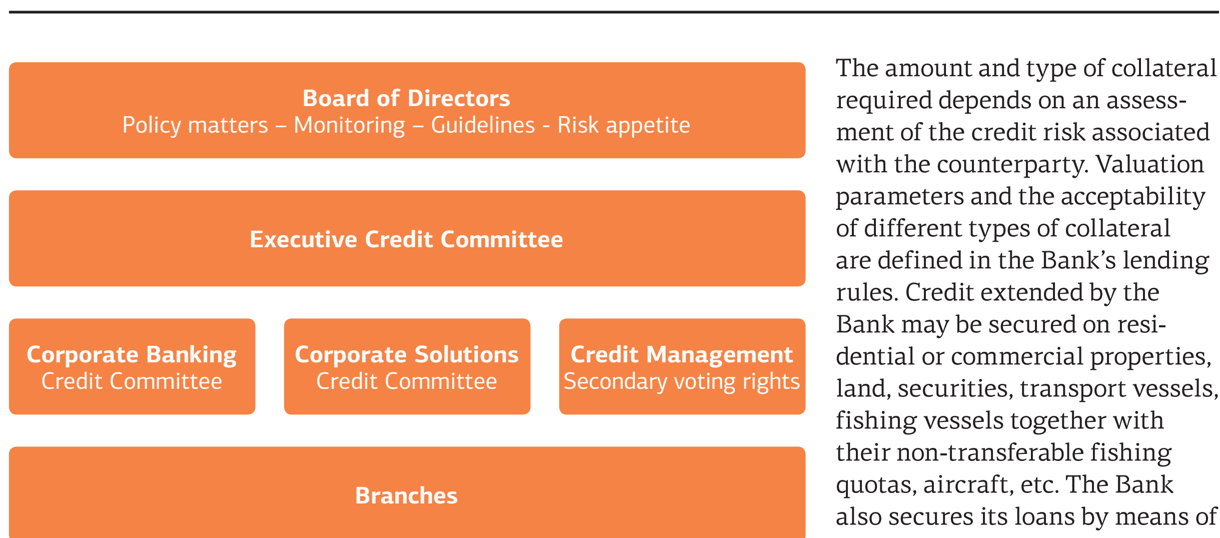
The Bank's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk & Finance Committee, the Credit Committee, the credit departments within the Risk Management Division and the business units. The Bank manages credit risk according to its risk appetite statement and credit policy approved by the Board of Directors as well as detailed lending rules approved by the CEO. The risk appetite statement and credit policy include limits on large exposures

Rating category and PD band



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

Internal rating grade	S&P
10	AAA/AA+/AA/AA-
9	A+/A/A-
8	BBB+
7	BBB/BBB-
6	BB+/BB
5	BB-
4	B+
3	B
2	B-
1	CCC/C



to individual borrowers or groups of borrowers, concentration of risk and exposures to certain industries. The CEO ensures that the risk policy is reflected in the Bank's internal framework of regulation and guidelines. Together with the Bank's executives, the CEO monitors that the Bank's business units execute the risk policy appropriately.

Incremental credit authorization levels are defined based on size of units, types of customers and lending experience of credit officers. Credit decisions exceeding authorization levels of business units are subject to confirmation by Credit Management, a department within Risk Management. Credit decisions exceeding the limits of Credit Management are subject to approval by the 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 authorization within the Bank.

5.1.4 Mitigation

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

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

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the Bank's lending rules. 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, aircraft, etc. The Bank also secures its loans by means of receivables 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 collateral received. The Bank has developed models to estimate the value of the most frequent types of collateral. For collateral for which no valuation model exists, the Bank estimates the value manually. It calculates 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.

The Bank is finalising the implementation of a new collateral system, which is developed internally and allows the Bank to analyse the quality and value of the collateral held to secure the loan portfolio.

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

5.1.4.1 Derivative financial instruments

In order to mitigate credit risk arising from derivatives the Bank chooses the counterparties for derivatives trading based on stringent rules, according to which clients must qualify as professional clients but only if certain conditions are met. The Bank also enters into standard International Swaps and Derivatives Association (ISDA) master netting agreements with foreign counterparties and similar general netting agreements with domestic counterparties.

Rich 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 fully hedged.

The Bank's supervision system monitors derivatives exposure and collateral value intraday, it issues margin calls and manages netting agreements.

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

The Bank measures the credit risk of derivatives by calculating a credit equivalent value for each derivative. The credit equivalent value is the market value of a contract plus a percentage of the nominal amount of the derivative which depends on the type of derivative. The percentage is twice that of the 99% Value at Risk (VaR), calculated for each underlying security or currency based on historical volatility, for a holding period of five days.

5.1.5 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 – a credit monitoring classification of four credit risk groups (green, yellow, orange and red). The colour classification is the following:

- Green customers are considered as performing without difficulties.
- Yellow customers are on Watch list 1, they have temporary difficulties and may need some instalments postponed or modification of terms or loan covenants.
- Orange customers are on Watch list 2. They are still under the supervision of the relevant business unit but are likely to go through debt restructuring or postponement of instalments.
- Red customers are under supervision by Corporate Solutions and need restructuring, are in legal collection, write-offs or debt-to-equity conversion. Management of the customer's operations will possibly be taken over by the Bank. In some cases, collateral or guarantees will be collected and/or the operations sold.

The Credit Risk Monitoring Department within Risk Management is together with the business units responsible for the verification of colour for the customer and transfer of customers from the business units to Corporate Solutions if necessary.

5.1.6 Impairment process

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

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

The Group has significantly reduced granting loans in foreign currency unless the customer's income is in the same currency or a comparable currency.

The Bank acquired loans and advances at deep discount that reflected credit losses which were already incurred at acquisition date. The deep discount was included in the fair value of these loans and advances estimated at initial recognition. When loans acquired at deep discount have gone through restructuring they have no allowance. Restructured loans are subject to impairment which results in increased collective, and potentially, individual allowances.

5.2 The credit portfolio

5.2.1 Credit exposure

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

The Credit portfolio

At 31 December 2012

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	25,898	-	-	-	-	25,898
Bonds and debt instruments	113,203	100,950	14,055	-	-	228,208
Equities and equity instruments	-	1,107	35,774	-	-	36,881
Derivatives instruments	-	1,043	-	-	-	1,043
Loans and advances to financial institutions	64,349	-	-	-	-	64,349
Loans and advances to customers	666,087	-	-	-	-	666,087
Other financial assets	10,481	-	-	-	-	10,481
Total	880,018	103,100	49,829	-	-	1,032,947

At 31 December 2011

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	8,823	-	-	-	-	8,823
Bonds and debt instruments	112,547	93,063	16,238	-	-	221,848
Equities and equity instruments	-	1,224	44,813	-	-	46,037
Derivatives instruments	-	159	-	-	-	159
Loans and advances to financial institutions	100,133	-	-	-	-	100,133
Loans and advances to customers	639,130	-	-	-	-	639,130
Other financial assets	4,321	-	-	-	-	4,321
Total	864,954	94,446	61,051	-	-	1,020,451

At the end of 2012, the total carrying amount was ISK 1.033 billion. Some ISK 666 billion are derived from lending activities, ISK 228 billion from bonds and debt instruments but only ISK 1 billion is derived from the carrying amount of derivatives. The following table shows the classification of the Group's financial assets.

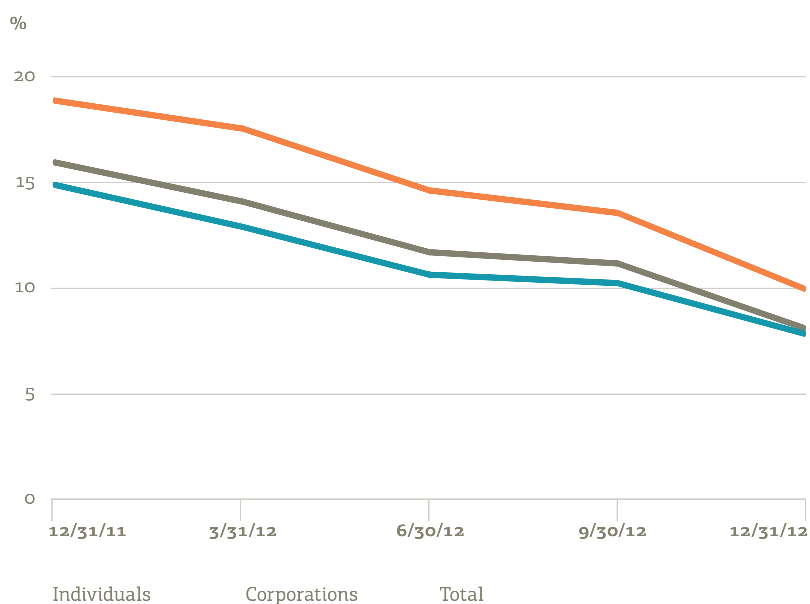
5.2.1.1 Credit exposure from lending activities

At the end of 2012, the Group's total credit exposure from lending activities amounted to ISK 666,087 million, against ISK 639,130 million at the end of 2011. This represents an increase of 4.2%. In 2012, credit demand remained low and did not result in a significant increase in credit exposure. The low demand related to both personal and corporate customers.

Lending capacity in the Icelandic banking system, as well as credit supply, has exceeded demand in recent semesters. Lending operations have thus extensively focused on services to existing customers and refinancing their loans as well as restructuring clients in financial distress. The impact of financial restructuring to a number of clients, both individuals and corporations, and recalculation of foreign debt reduced the 90 days past due ratio from 14% to 8%. Since the beginning of 2012 credit exposure in over 90 days past due decreased from ISK 92 billion to ISK 55 billion. The decrease is mainly due to the fact that corporate loans were restructured, returned to performing standing or written off in part or whole. New past due loans reduced significantly the last few months of 2012 and if that trend continues, along with the restructuring, the 90 days past due will continue to decline. Partially this is also due to more accurate analysis and increased monitoring of new defaults, where emphasis is put on reacting as soon as possible when default arises.

At the same time, the portfolio quality has improved considerably as the average probability of default decreased from 6.6% to 4.6% (discussed further in section 5.2.4). Usually some time passes after restructuring is completed until its effects are seen in the loan portfolio. Therefore it can

90 days past due ratio



Credit exposure from lending activities

2012	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	293,285	380,408	56,740	730,433
Loans and advances to customers	292,480	373,607	0	666,087
Past due loans	22%	5%	0%	27%
Impaired	10%	20%	0%	30%
Loans and advances to customers past due more than 90 days	14%	4%	0%	8%

2011	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	301,510	344,318	93,435	739,263
Loans and advances to customers	287,419	351,703	8	639,130
Past due loans	40%	12%	4%	56%
Impaired	34%	27%	0%	61%
Loans and advances to customers past due more than 90 days	27%	7%	4%	14%

be assumed that the impact of restructuring already completed has not fully emerged.

Developments of the quality of the Group's credit portfolio have been positive since taking over part of the domestic operations of LBI hf. on the Bank's foundation in 2008. In the majority of segments, there was an improvement in credit quality in the year 2012.

At the end of the year, the impairment ratio was 4.3% (end 2011: 3.1%). The increment is due to loans acquired at deep discount and customers whose loans have gone through restructuring.

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

Credit exposure from lending activities

At 31 December 2012	Personal Banking	Corporate Banking	Treasury	Total
Financial institutions	142	7,467	56,740	64,349
Public entities	1,552	10,024	-	11,576
Individuals	192,963	2,084	-	195,047
Corporations	98,628	360,833	-	459,461
Fisheries	9,313	133,639	-	142,952
Construction and real estate companies	29,106	75,822	-	104,928
Holding companies	5,241	54,768	-	60,009
Retail	15,034	26,985	-	42,019
Services	25,613	27,087	-	52,700
ITC	2,096	17,317	-	19,413
Manufacturing	7,583	18,082	-	25,665
Agriculture	4,137	6,062	-	10,199
Other	505	1,071	-	1,576
Total	**293,285**	**380,408**	**56,740**	**730,433**

At 31 December 2011	Personal Banking	Corporate Banking	Treasury	Total
Financial institutions	2,746	3,961	93,426	100,133
Public entities	2,362	9,777	-	12,139
Individuals	170,748	2,466	8	173,222
Corporations	125,656	328,113	-	453,769
Fisheries	11,286	124,111	-	135,397
Construction and real estate companies	32,600	69,358	-	101,958
Holding companies	6,560	42,062	-	48,622
Retail	17,203	25,198	-	42,401
Services	36,638	29,482	-	66,120
ITC	2,038	18,130	-	20,168
Manufacturing	15,638	12,370	-	28,008
Agriculture	3,562	4,944	-	8,506
Other	131	2,458	-	2,589
Total	**301,510**	**344,318**	**93,435**	**739,263**

Credit exposure from lending activities

12/31/12	Collateral types					
Collaterals after haircut	**Real estate**	**Ships**	**Deposits**	**Securities**	**Other**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	1,575	0	32	0	38	1,645
Individuals	152,374	23	2,339	2,438	88	157,262
Corporations	141,391	113,070	3,108	40,765	31,534	329,868
Fisheries	5,395	112,632	136	2,564	5,455	126,182
Construction and real estate companies	77,958	0	1,162	340	1,559	81,020
Holding companies	4,751	0	210	27,304	3,627	35,892
Retail	11,515	0	219	627	10,514	22,875
Services	30,372	430	866	2,678	1,982	36,328
ITC	756	8	125	1,843	4,357	7,089
Manufacturing	7,179	0	385	5,409	1,370	14,343
Agriculture	3,203	0	4	0	2,670	5,876
Other	262	0	1	0	0	263
Total	**295,339**	**113,093**	**5,480**	**43,202**	**31,661**	**488,774**

12/31/11	Collateral types					
Collaterals after haircut	**Real estate**	**Ships**	**Deposits**	**Securities**	**Other**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	1,627	0	271	0	38	1,937
Individuals	141,471	0	2,503	1,001	60	145,035
Corporations	153,134	99,087	9,785	20,722	22,494	305,221
Fisheries	5,877	98,933	1,386	3,514	5,179	114,890
Construction and real estate companies	92,070	91	1,780	231	1,432	95,604
Holding companies	7,028	0	3,469	15,263	2,312	28,072
Retail	12,440	0	1,536	56	7,689	21,720
Services	22,995	63	1,134	810	1,311	26,313
ITC	715	0	144	1	2,368	3,227
Manufacturing	7,263	0	282	608	944	9,097
Agriculture	4,015	0	23	0	27	4,065
Other	731	0	31	239	1,232	2,233
Total	**296,233**	**99,087**	**12,559**	**21,723**	**22,592**	**452,194**

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

Property values remained fairly stable in 2012. The Group is finalising the implementation of a new collateral system, which is developed internally and allows the Group to analyse the quality and value of the collateral held to secure the loan portfolio.

5.2.2 Risk concentration

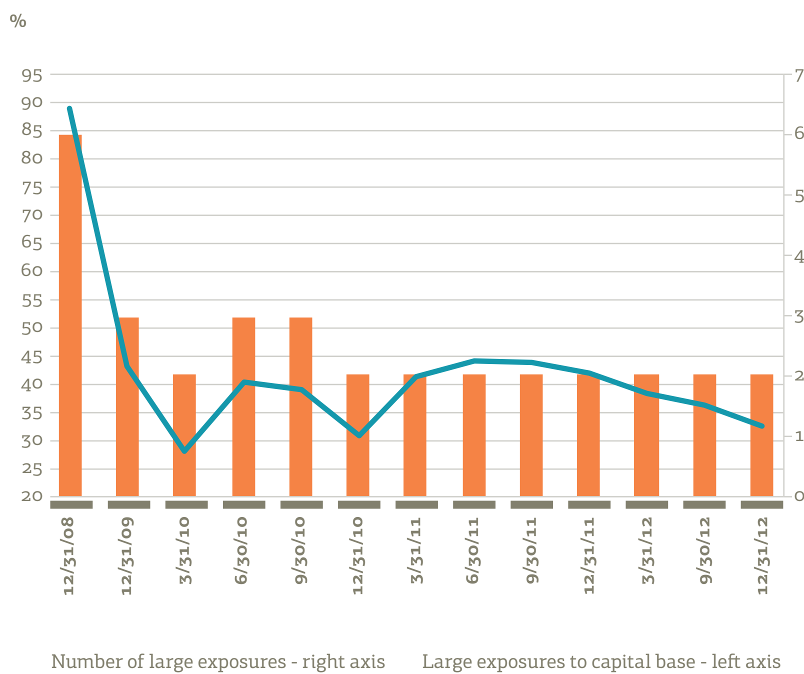
Concentration risk includes (i) single name concentrations of large (connected) individual counterparties[10] and (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location, instrument type or other.

Limit management for single name and segment concentrations are set, monitored and managed through the Bank's risk appetite as well as limit management system. 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.

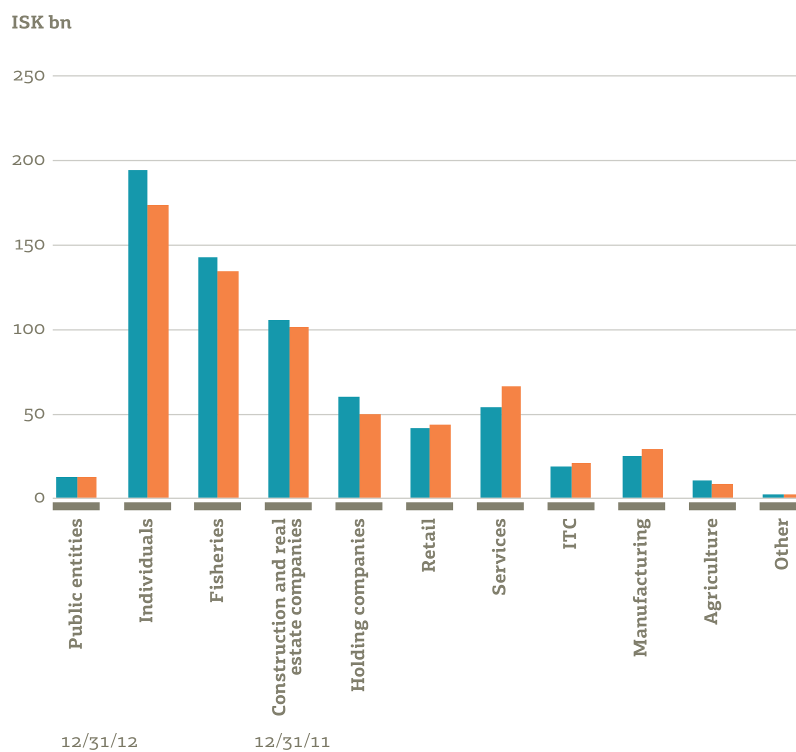
The Group uses the identification of risk concentrations in the credit portfolio as a credit risk management parameter. Risk concentrations arise in the credit portfolio as an inevitable consequence of the Group's business strategy. Concentration risk is credit risk related to the degree of diversification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

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

Large exposures



Industry segmentation of credit exposure



segment concentration risk.

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

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

Risk concentration

As on single name concentration the Bank's Board of Directors has introduced portfolio limits for the year 2013 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 the end of 2012, lending to retail customers represented 29% of the Bank's total credit exposure (year-end 2011: 27%). Most of the demand from retail customers is for home financing and the Bank's lending to retail customers is therefore mostly secured on real property.

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

Customers domiciled in Iceland accounted for 94% of the Group's total credit exposure (2011: 92%). Exposure to foreign countries relates mainly to the management of the Group's foreign liquidity reserves.

Probability of default (PD)

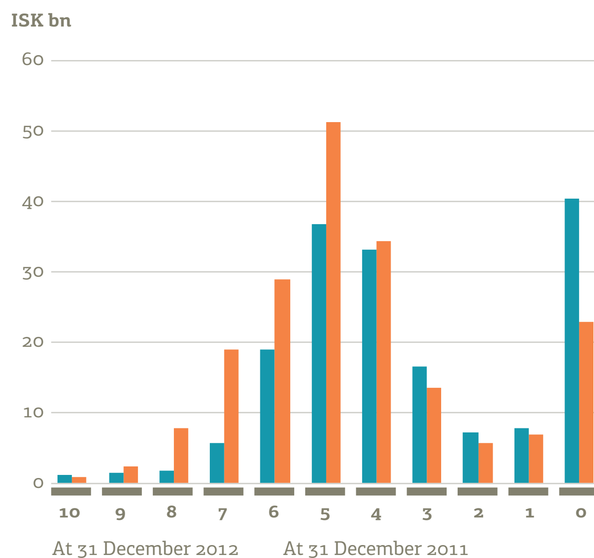
(%)		31.12.2012	31.12.2011
Financial institutions		1.5%	3.1%
Public entities		1.2%	0.9%
Individuals		2.7%	2.8%
Corporations		6.0%	8.8%
	Construction and real estate companies	7.6%	10.6%
	Holding companies	8.5%	12.3%
	Fisheries	4.3%	8.7%
	Industry	4.3%	6.5%
	Agriculture	3.9%	5.0%
	ITC	4.5%	1.7%
	Retail	7.8%	9.5%
	Other	14.8%	12.9%
	Services	4.4%	6.7%
Total		**4.6%**	**6.6%**

5.2.3 Migration analysis

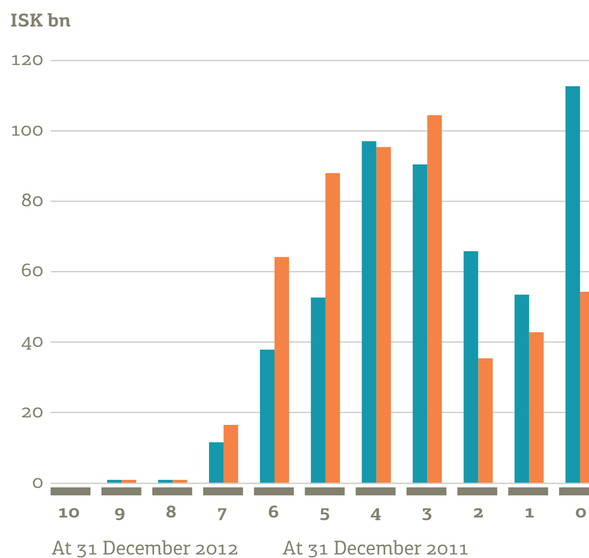
Migration analysis in this section is based on the Group's rating scale and PD estimates. At the end of 2012, the average exposure-weighted PD was 4.6% (2011: 6.6%). The PD for corporations was 6.0% (2011: 8.8%).

The following charts show the rating grade distribution of the loan portfolio broken down by individuals and corporations. Exposure in rating grades 4, 5, 6 and 7 increased on an overall level by 61%, 81%, 13% and 18% respectively.

Rating grade distribution - Individuals



Rating grade distribution - Corporations

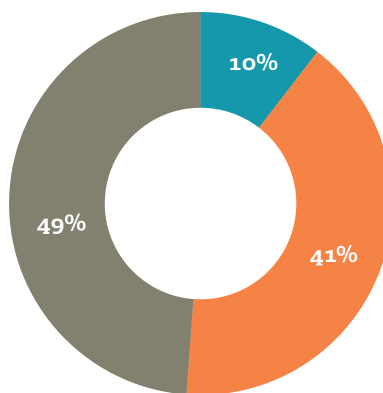


The figures show the rating grade migration for corporations and individuals during 2012, based on existing customers at year-end 2011 and 2012. Migration is shown both in terms of number of customers and exposure. Migration analysis does not cover customers with evidence of default, that is, customers in rating category 0.

Out of the total exposure in the corporate portfolio, approximately 59% migrated up or down during 2012. This corresponds to 52% of counterparties. Compared to 2011, the Group experienced more positive migration during 2012 and upward migration was significantly higher than downward migration during 2012.

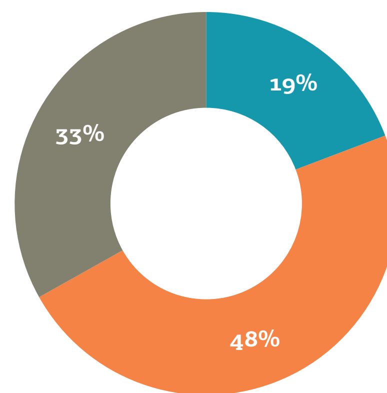
In the retail customer portfolio, approximately 63% migrated either up or down in 2012 with respect to exposure and 62% in terms customer numbers. On an overall level, migration had a positive impact on credit risk economic capital during 2012 and reduced IRB credit risk economic capital by approximately 6%. This calculation does not take into account the changes in exposure distribution nor rating distribution of lost and new customers or customers who defaulted during the year.

Rating migration of corporations in 2012 Carrying amount



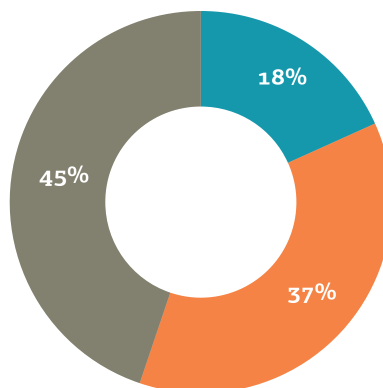
Downgrades Unchanged Upgrades

Rating migration of corporations in 2012 No. of customers



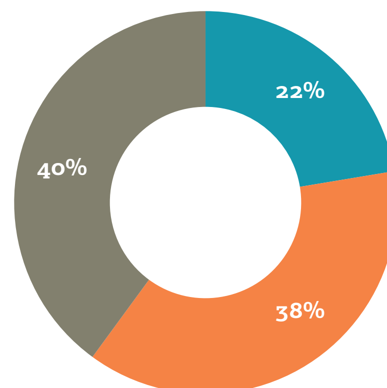
Downgrades Unchanged Upgrades

Rating migration of individuals in 2012 Carrying amount



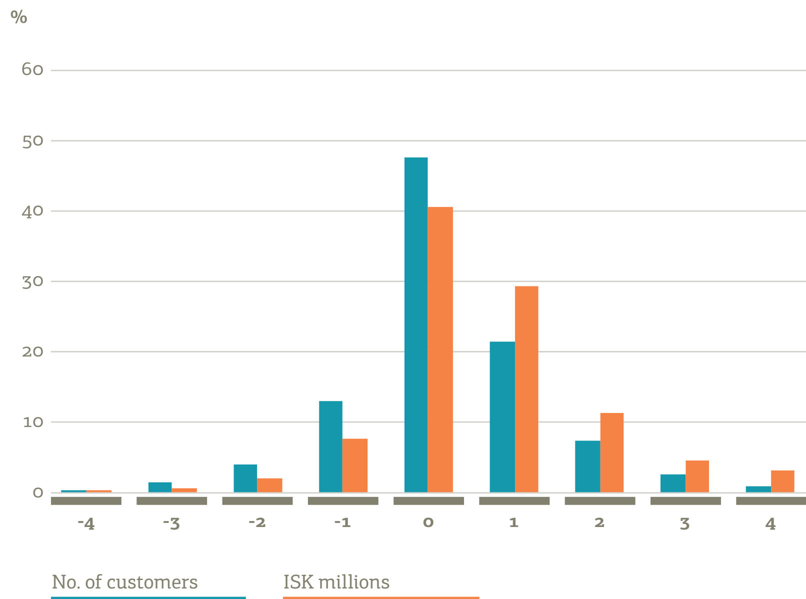
Downgrades Unchanged Upgrades

Rating migration of individuals in 2012 No. of customers

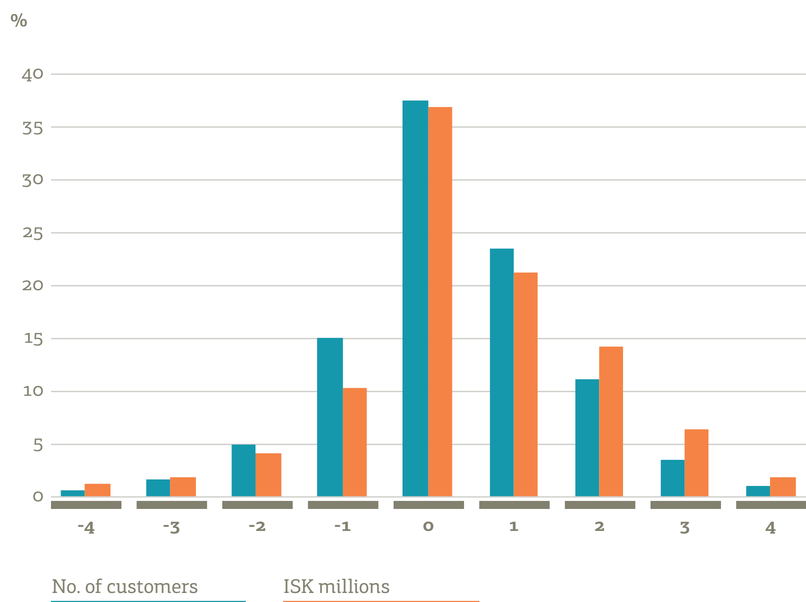


Downgrades Unchanged Upgrades

Rating migration of corporations in 2012



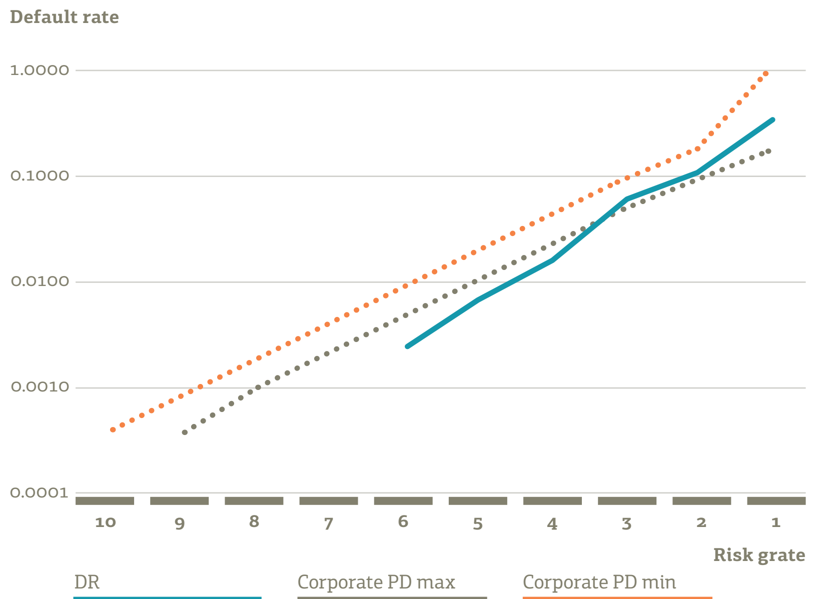
Rating migration of individuals in 2012



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

Altogether, the percentage of upgrades was higher than the percentage of downgrades mainly because of the corporate segment. At the end of 2012, the average exposure-weighted PD

12 month default rate vs. probability of default band - Corporations 2012



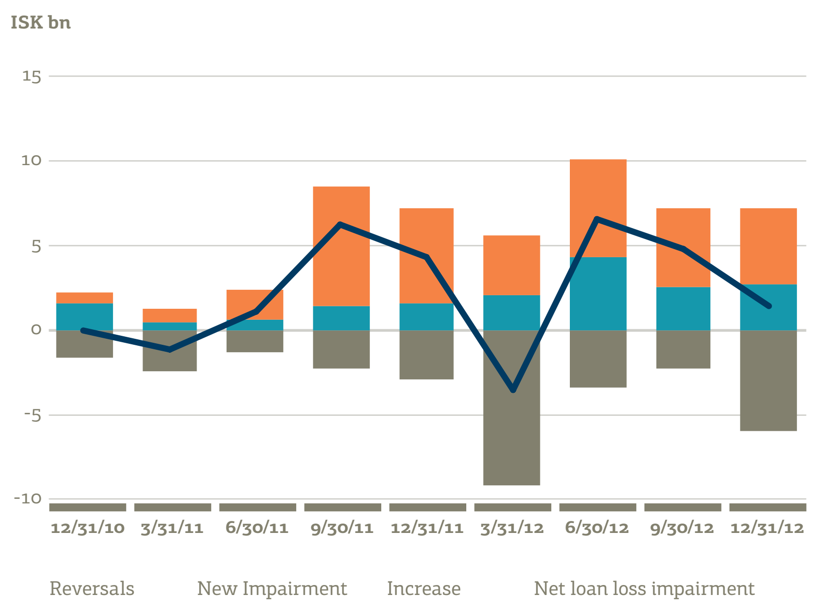
for corporate customers was 6.0% (2011: 8.8%). For individuals, the average exposure-weighted PD was 2.7% (2011: 2.8%).

The default rate for corporate customers for 2012 was 11.1% compared to the predicted 11.2%.

5.2.4 Loan impairment

Total allowance for impairment totalled to ISK 44 billion in 2012, compared to ISK 28 billion in 2011. Allowances increased in nearly all industry sectors during 2012 while the overall carrying amount decreased slightly. The increase in allowances is mainly due to loans acquired at deep

Individual Loan Impairment



Allowance for impairment on loans and advances to financial institutions and customers and other financial assets

	1.1.-31.12.2012			1.1.-31.12.2011		
	Customers	Other financial assets	Total	Customers	Financial assets	Total
Balance at the beginning of the year	28,420	-	28,420	21,122	2,178	23,300
Impairment loss for the period	15,960	-	15,960	9,212	-2,178	7,034
Collected previously written-off loans	811	-	811	98	-	98
Loans written-off	-1,161	-	-1,161	-2,012	-	-2,012
Balance at the end of the period	**44,030**	**0**	**44,030**	**28,420**	**0**	**28,420**
Individual allowance	28,523	-	28,523	19,696	-	19,696
Collective allowance	15,507	-	15,507	8,724	-	8,724
Total	**44,030**	**0**	**44,030**	**28,420**	**0**	**28,420**
Net impairment loss						
Impairment loss for the period	15,960	-	15,960	9,310	-2,178	7,132
Impairment of claims reversed	-	-3,700	-3,700	-98	-	-98
Net impairment loss for the period	**15,960**	**-3,700**	**12,260**	**9,212**	**-2,178**	**7,034**

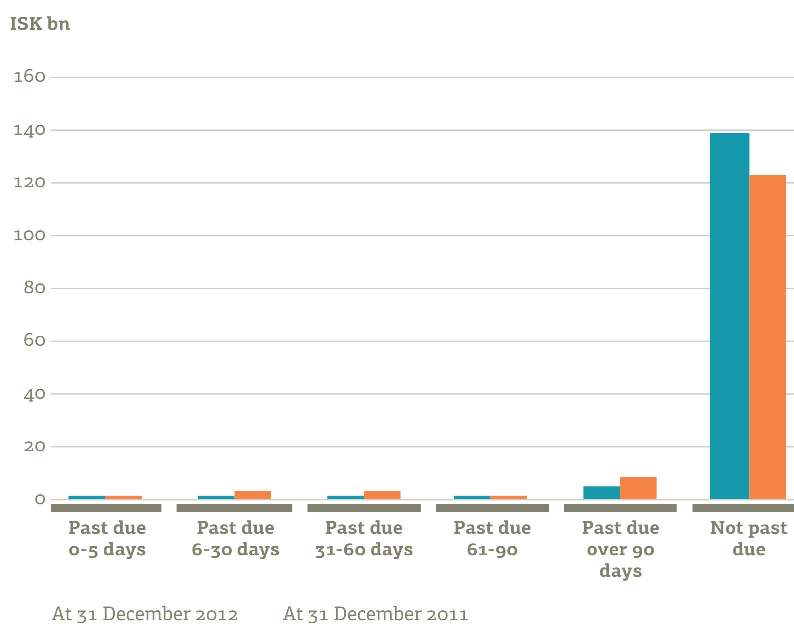
discount which now have been restructured.

At the end of 2012, 77% of the portfolio consisted of claims that were neither past due nor impaired. The accumulated impairment loss amounted to ISK 16 billion.

5.2.5 Credit risk analysis by industry sectors

This section describes developments in credit quality in selected segments of the Group's lending portfolio in the years 2012 and 2011.

Gross carrying amount - Past due Fisheries

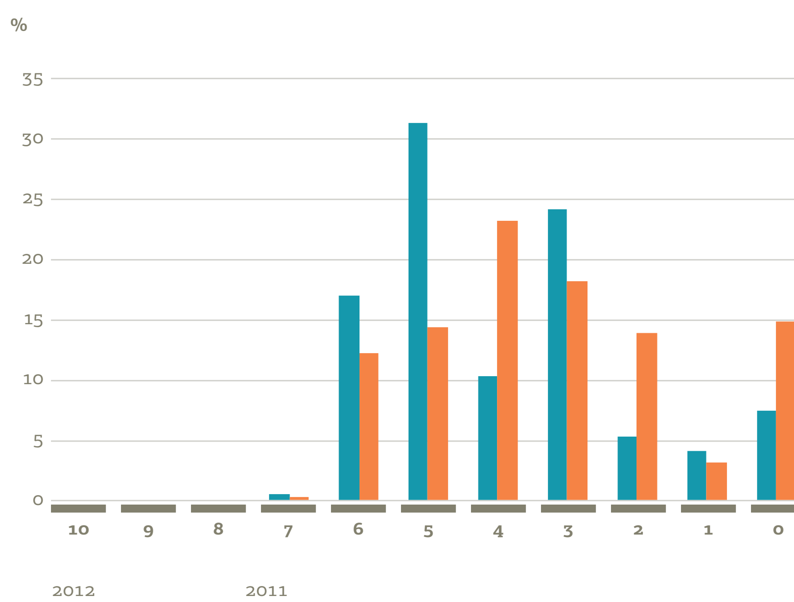


Fisheries

	2012	2011
Gross carrying amount	149,477	137,878
Performing - Individual allowance	-2,448	-1,876
Non-performing - Individual allowance	-1,496	-821
Collective allowance	-2,582	-2,278
Carrying amount	142,952	132,903

5.2.5.1 Fisheries

Loans and advances to fishery customers per rating grade



The fishing industry portfolio represents 21% of the Group's total credit exposure and is the largest single industry in the Group's loan portfolio. In 2012, product prices abroad decreased and a considerable increase in natural resource tax or fishing fee was legislated. This had a negative impact on cash flow and return on capital in the industry and its effects will continue to be felt in the future. Despite these setbacks in 2012 the fishing industry may still be considered successful, as the exchange rate of the Icelandic króna is favourable to the export industry. Investment in the fishing industry has, however, been negligible in recent years, which is partly due to the uncertainty regarding changes in the fishing quota legislation. One may expect that investment in fisheries will increase with the elimination of this uncertainty and improved cash flow, as significant investment need has accumulated in the sector.

Loans and advances to customers in the fisheries industry amounted to ISK 142,952 million at 31 December 2012 (2011: 132,903).

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

The impaired exposure in the sector amounts to ISK 60 billion and the amount of not individually impaired loans is ISK 87 billion. The collective allowance is ISK 2.6 billion.

At the end of 2012, the loans and advances to fisheries customers in rating grades 4-6 represented 59% of the total.

The sector's average exposure-weighted PD was 4.3% at 31 December and had dropped from 8.7% during the year. Credit extended by the Group to the fisheries industry is mainly secured by transport and fishing vessels together with their non-transferable fishing quotas, or 89% of the total sector's collateral.

Loans and advances to customers in the fisheries industry, broken down by colour classification, migrated positively during 2012. As at 31 December 2012, loans classified as green were 72% of

the sector's portfolio compared to 58% at year-end 2011.

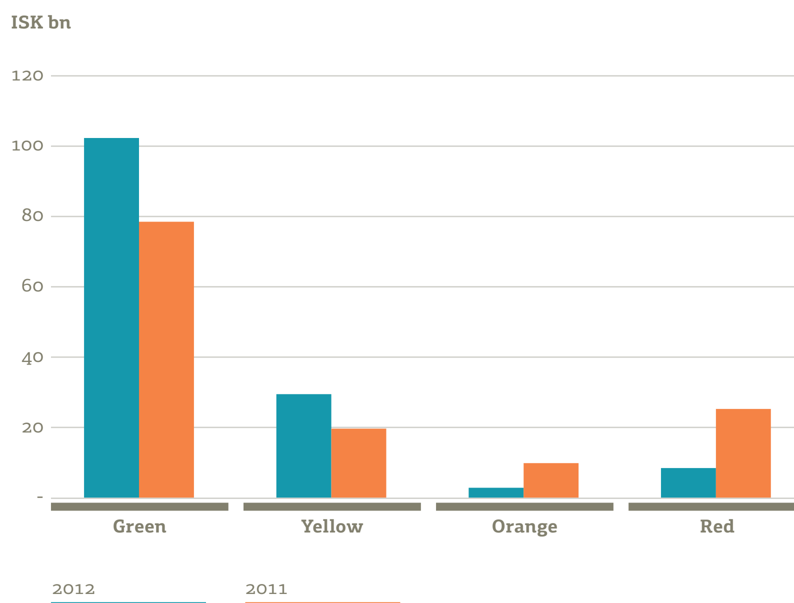
In addition, loans classified as red reduced from 19% to 6% of the sector's loan portfolio during the period.

5.2.5.2 Construction and real estate companies

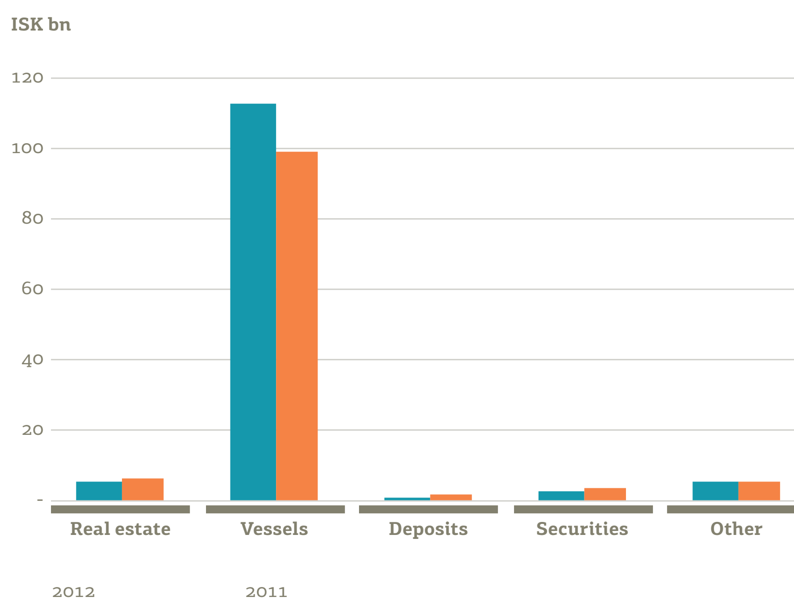
Iceland's asset markets have gradually recovered since a major setback following the economic crises in 2008. The stock market has been recovering and developing rapidly and real estate markets have been rising. Construction is still low, but it is clear that an increase in residential construction is needed in the coming years to meet demand. The market for commercial real estate has also strengthened in accordance with the restructuring of the economy, but an oversupply of commercial real estate is still considerable. In mid-2012, the real estate company Reginn hf. was listed. The listing exceeded expectations as well as its ongoing development. It is expected that another real estate company, Reitir, will also be listed in 2013. Therefore, it can be expected that the formal commercial rental market will strengthen in the coming years along with general restructuring of companies.

Loans and advances to construction and real estate companies amounted to ISK 104,928 million at 31 December 2012 (2011: ISK

Fisheries - Colour classification



Fisheries - Collateral types



Construction and real estate companies

	2012	2011
Gross carrying amount	112,558	107,013
Performing - Individual allowance	-1,926	-1,090
Non-performing - Individual allowance	-1,869	-1,888
Collective allowance	-3,835	-2,977
Carrying amount	104,928	101,058

101,058 million). Credit exposure to the sector represented 16% of the Group's loan portfolio.

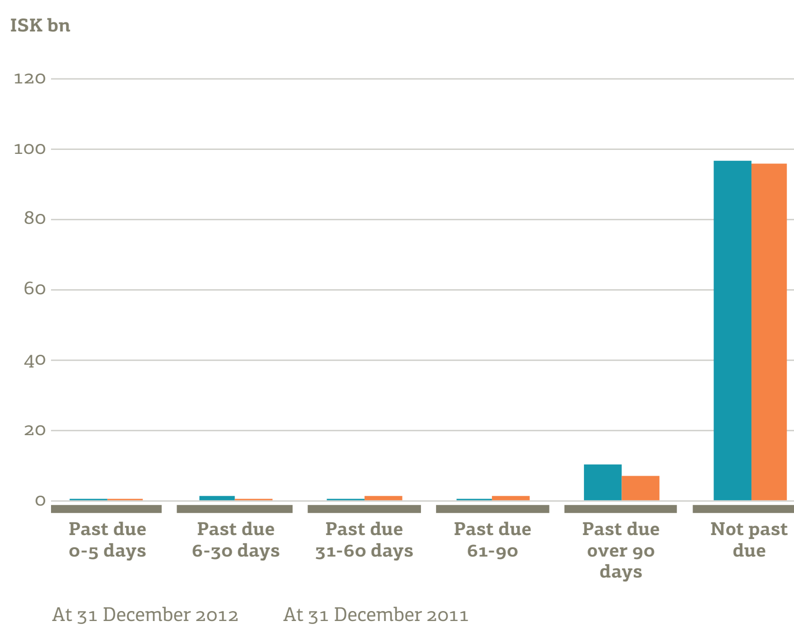
The chart shows the gross carrying amount of loans and advances to construction and real estate companies that have failed to make payments which had become contractually overdue by one or more days.

The impaired exposure in the sector amounts to ISK 30 billion and the amount of not individually impaired loans is ISK 78 billion. The collective allowance is ISK 3.8 billion.

At the end of 2012, loans and advances to construction and real estate customers in rating grades 4-6 represented 37% of the total. Thus, the majority is in lower rating grades, indicating that the sector's situation as a whole is still fairly poor despite positive developments in the previous years. Credit extended by the Group to construction and real estate companies is however well secured, mainly by real estate.

The sector's average exposure-weighted PD was 7.6% at 31 December and had fallen from 10.6% during the year.

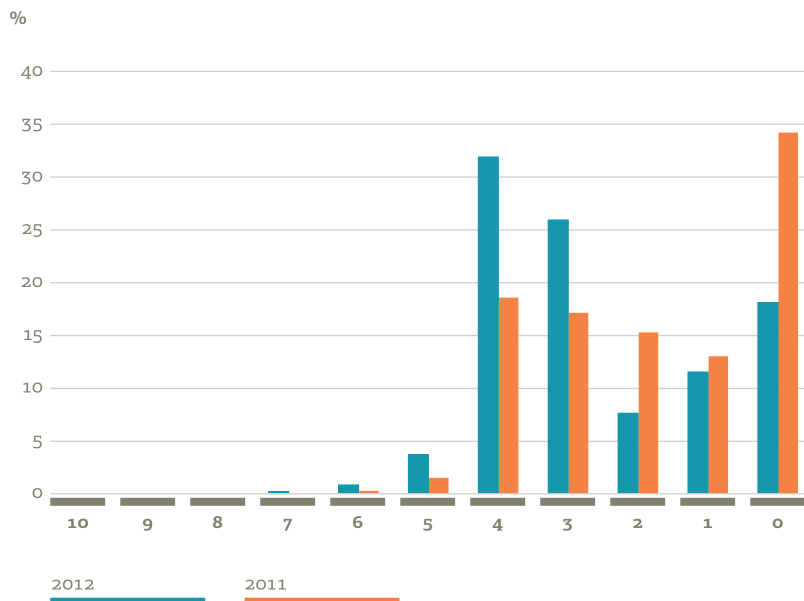
Gross carrying amount - Past due Construction and real estate companies



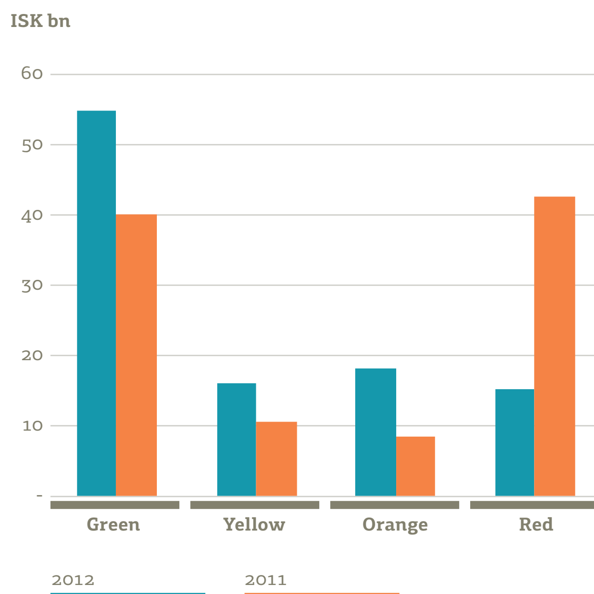
Loans and advances to customers in the construction and real estate sector, broken down by colour classification, migrated positively during 2012. Loans classified as green were at 31 December 2012 52% of the sector's portfolio compared to 39% at year-end 2011.

In addition, loans classified as red were reduced from 42% to 15% of the sector's loan portfolio during the period.

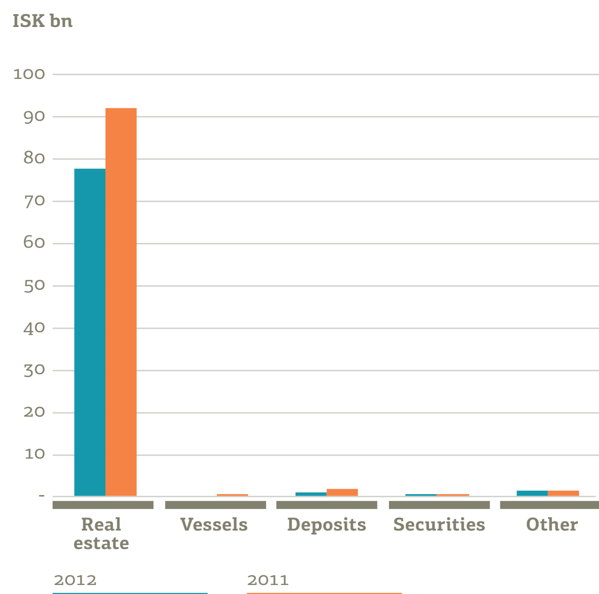
Loans and advances to Construction and real estate customers per rating grade



Construction and real estate companies - Color classification



Construction and real estate companies - Collateral types



6 Market risk

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

Since capital controls are in effect in Iceland, local markets have been fairly inactive for the past few years. The domestic equity market did, however, grow in 2012 showing increased turnover and listing of three new companies with a few more new listings expected in 2013. The Icelandic króna has been fairly volatile in the past year whereas the domestic bond market has been steady and continues to be comprised mainly of government bonds and housing bonds.

6.1 Market risk management and policy

The Board of Directors is responsible for determining the Group's overall risk appetite for market risk. The CEO of the Group appoints the Risk & Finance Committee, which is responsible for developing detailed market risk management policies and setting market risk limits. Treasury within Finance and the Market Making Department within Markets are responsible for managing market-related positions under the supervision of the Market Risk Department within Risk Management. The objective of market risk management is to identify, locate and monitor market risk exposures and analyse and report to appropriate parties. Together, the risk appetite of the Bank and the market risk rules set the overall limits that govern market risk management within the Bank.

The Group separates its exposure to market risk into trading and non-trading portfolios, managing each separately. Trading portfolios include positions arising from market-making and proprietary position-taking managed by Treasury. Non-trading portfolios include positions arising from the Group's retail and commercial banking operations and proprietary position-taking as part of Asset and Liability Management (ALM) within Treasury. ALM is also responsible for daily liquidity management, creating exposure to market risk.

Market risk mitigation is reflected in the Group's overall risk appetite by identifying the target level and strategy of market risk factors. The main focus has been on reducing foreign exchange imbalance as well as reducing equity risk, primarily by selling unlisted assets acquired through corporate restructuring.

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

6.2 Control and monitoring

Market risk monitoring and reporting is managed by the Risk & Finance Committee and implemented by the Market Risk Department.

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

Total exposure subject to market risk

	Net position at year-end	
	2012	2011
Equities and equity instruments	**36,881**	**46,037**
Listed	2,666	14,004
Unlisted	34,215	32,033
Bonds and debt instruments	219,291	215,661
Total FX position	-20,039	20.034

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

6.3 Market risk exposure

The table above summarizes the Group's exposure to market risk at year-end 2012:

The Group has lowered its exposure to listed equities over the past year by selling assets. The Group's net FX exposure has gone from ISK 20 bn long to ISK 20 bn short at year-end since the contingent bond to LBI hf. was realized in foreign currency at 31 December 2012.

The source of the majority of the Group's equity exposure is in unlisted equities that are, for the most part, legacy positions obtained through corporate restructuring or were acquired when the bank was established in 2008. The Group will continue to mitigate the risk associated with this exposure in 2013.

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

6.4 Measuring market risk

The Bank uses risk-weighted assets (RWA) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. Risk-weighted assets are determined by applying specific risk weights to the Group's assets, following methodology developed by the Basel Committee on Banking Supervision. Several other indicators are used as measures of market risk as well, including daily profit and loss, net positions across different att-

Total market risk (RWA measure) at year-end

	2012		2011	
	RWA	Ratio to RWA	RWA	Ratio to RWA
Equity price risk	55,321	6.30%	69,055	7.70%
Interest rate risk (trading book)	17,991	2.00%	23,431	2.60%
Foreign exchange risk	25,174	2.90%	28,071	3.10%
Total	**98,486**	**11.20%**	**120,557**	**13.40%**

ributes such as the currency and issuer, Value at Risk (VaR) and Economic Capital.

6.4.1 Equity price risk

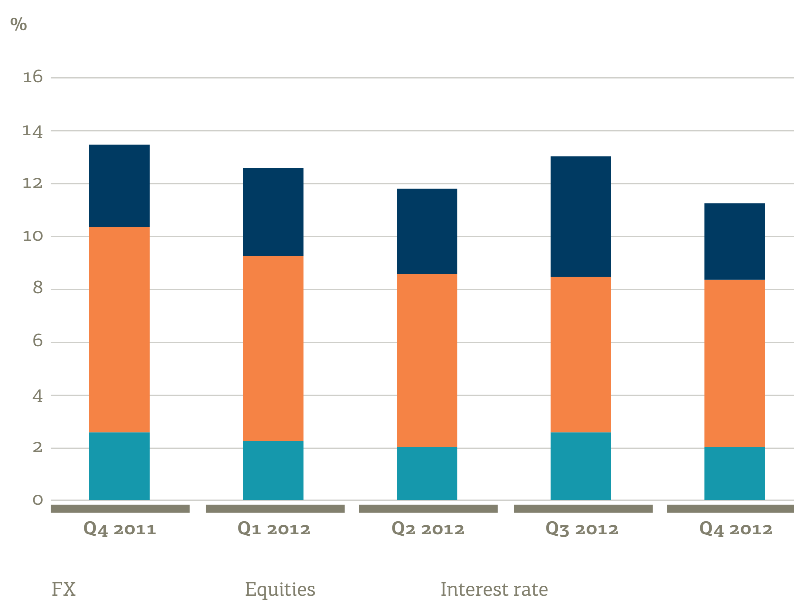
Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments.

The Group separates its equity exposure into trading and non-trading (proprietary) portfolios, managing each of them separately. Part of the Group's non-trading equity portfolio is managed by its subsidiary, Horn Invest. However, all of Horn's operations were consolidated in 2012 within another subsidiary of the Group, Landsbréf.

6.4.2 Interest rate risk

Interest rate risk is the risk of loss arising from the impact of changes in market prices related to interest rate linked instruments. The Group has two main fixed income portfolios which are subject to interest risk. Firstly, a trading portfolio strictly focused on government-guaranteed bills/bonds as part of market making and, secondly, a proprietary bond portfolio containing corporate

Total market risk (ratio to total RWA)



Total equity exposure

	Net position at year-end	
	2012	**2011**
Trading	2,666	6,519
Non-trading	34,215	39,518
Total	**36,881**	**46,037**

issuances, as well as government-guaranteed bonds. Furthermore, the Group has a liquidity management portfolio containing foreign government bills and a hedge portfolio for TRS contracts, which also contains government-guaranteed bills/bonds.

Overall, the Group's interest rate risk is low, mainly consisting of government bonds with low average duration.

6.4.2.1 Interest rate risk in the banking book

Interest rate risk in the banking book is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. Changes in interest rate on the Group's assets and liabilities, other than those in its trading book, 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 liabilities.

The Bank employs a quarterly stress test of the interest rate risk in the Group's banking book by measuring the impact of shifting the relevant interest rate curves for every currency. The table on the next page summarizes the impact of parallel interest rate shifts on the Group's equity at year-end.

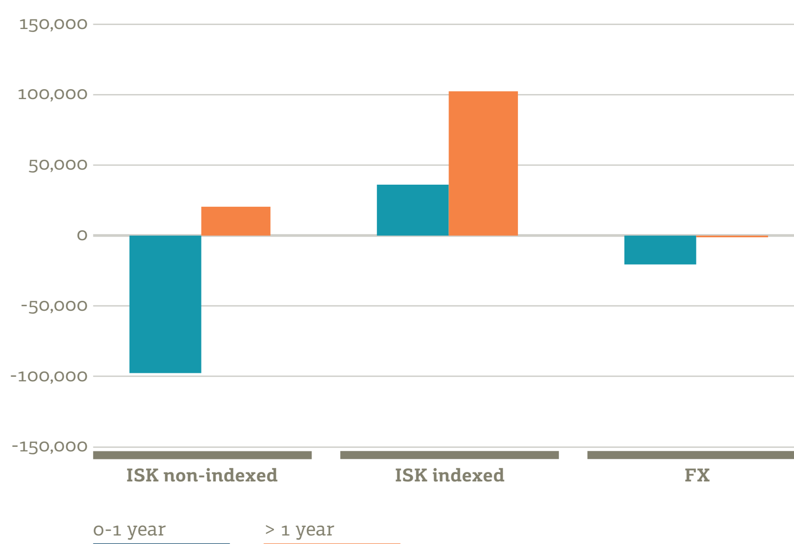
The changes in asset and liability mismatch can be summarized by increase in non-indexed housing and car loans with fixed rates and transfers from shorter to longer repricing periods in indexed loans over the past year. Furthermore, pre-payment of the secured FX bond to LBI hf. (see 7.3) reduced the FX asset/liability mismatch.

The Bank aims to reduce interest rate risk in the banking book in 2013. A step in that direction will be to ensure funding for its non-

Total interest rate exposure

	Net position at year-end	
	2012	**2011**
Trading	91,866	89,965
Non-trading	127,424	125,696
Total	**219,291**	**215,661**

Asset and liability mismatch at year-end 2012



Interest rate in the banking book at year-end

		2012		2011	
	Shift (bps)	Ec. value	% of equity	Ec. value	% of equity
ISK non-indexed	400	-2,686	-1.2%	-696	-0.4%
ISK indexed	240	-7,525	-3.4%	-5,304	-2.8%
EUR	200	-338	-0.2%	-360	-0.2%
USD	200	-107	0.0%	-176	-0.1%
GBP	200	14	0.0%	-25	0.0%
JPY	200	-13	0.0%	-48	0.0%
CHF	200	-13	0.0%	-77	0.0%
Other	200	-20	0.0%	1	0.0%
Total		**-10,688**	**-4.8%**	**-6,685**	**-3.5%**

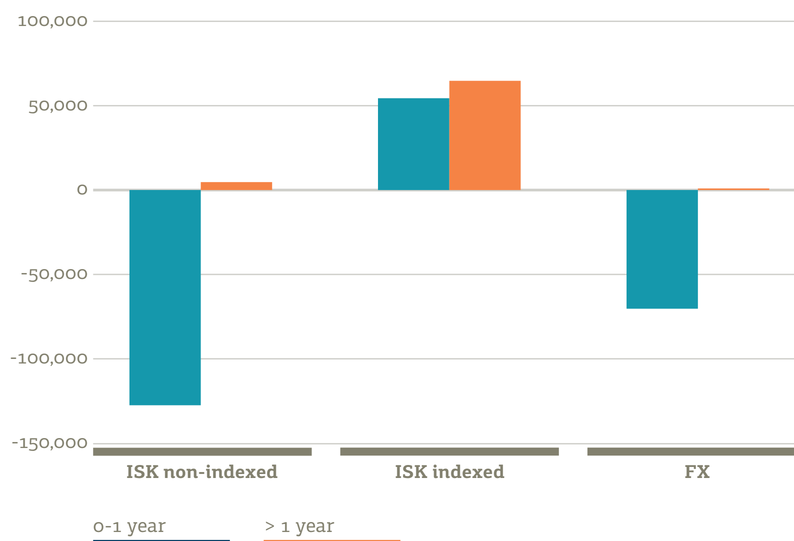
indexed loan portfolio by issuing covered bonds.

6.4.3 Foreign exchange risk

Foreign exchange risk (FX risk) is the risk of adverse movements due to exchange rate fluctuations. The Group's net open positions in currencies at year-end 2012 are summarized in the table on the next page.

In 2012, significant focus was devoted to foreign exchange risk within the Group due to imbalances in its FX assets and liabilities. The primary reason for these imbalances is due to a contingent

Asset and liability mismatch at year-end 2011



bond issuance to LBI (formerly Landsbanki Islands hf.) at year-end, but was accounted for in ISK during 2012. Hence, the Group was long in FX until 31.12.2012 when the carrying amount of the contingent bond (ISK 87.5 billion) was realized in EUR. The nominal value of the contingent bond is subject to an ISK 92 billion cap and was issued in April 2013 in EUR, USD and GBP.

6.4.4 Other market risk

Other market risk is comprised only of inflation risk. Inflation risk is the risk that the fair value or future cash flows of CPI-indexed financial instruments may fluctuate due to changes in the Icelandic CPI index. The Bank's total CPI indexation balance at year-end amounted to ISK 145,784 m.

Historical observations suggest that the likelihood of deflation resulting in material losses are well within the first percentile (equivalent to around 3.9% deflation), and hence, inflation risk is considered immaterial.

Net FX balance

	Net position at year-end	
	2012	**2011**
AUD	66	-
CAD	277	-
CHF	1,432	5,281
DKK	1,104	-
EUR	-24,584	14,137
GBP	763	-7,748
JPY	1,108	3,816
SEK	23	-
USD	-590	1,885
Other	362	2,663
Total	**-20,039**	**20,034**

6.5 Market risk VaR

A value at risk (VaR) model is used to compute Economic Capital for FX risk. Landsbankinn uses VaR as a common ground for measuring market risk in different products. An internal VaR model is in place for the quantification of market risk, including FX risk. The basic building blocks of the model, key assumptions and parameters, as well as its limitations, are explained below.

The three main parameters of VaR are:

- a collection of assets for which VaR is to be calculated
- a confidence level
- a time horizon (i.e. holding period of assets)

The model utilizes a parametric method based on variance and covariance between changes in market prices. It is based on the key assumption that changes in market parameters are normally distributed. Furthermore, it assumes a static portfolio, i.e. that there are no movements of assets over the given holding period. The main advantage of the variance-covariance approach is simplicity; VaR is relatively easy to compute when normality is assumed and both different confidence intervals and holding periods can easily be varied. It is especially useful for computing VaR for a collection of FX positions since they can be regarded as linear and the exchange rate datasets are of high quality.

The foundation for the model is a covariance matrix of risk factors (which assets are mapped to) that is generated on a daily basis. Historical volatility of the underlying assets is calculated using an Exponentially Weighted Moving Average (EWMA) which uses a smoothing parameter to weight returns so that more recent returns have greater weight on the variance.

The Group calculates VaR at the 99% confidence interval with a time horizon of one day. As mentioned above, these parameters can easily be modified. In practice, VaR for longer holding periods (e.g. 10 days) are obtained by scaling the one day VaR. Since FX positions are regarded as highly liquid instruments, choosing the time horizon to be one day is convenient. The decaying factor of the EWMA volatility in covariance calculations is chosen to be 0.94 in accordance with best practices (RiskMetrics λ) as well as the length of data series, which is one year. Data quality of exchange rates and exposure is good and readily available.

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

Backtests conducted showed that the model works well, having less than four outliers on an annual basis, which is equal to the expected number of outliers given the confidence level.

6.5.1 Stress test / sensitivity analysis

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

7 Liquidity risk

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

7.1 Identification

Landsbankinn has set a liquidity risk management policy for Landsbankinn hf. and its subsidiaries. They are set to ensure effective liquidity risk management. Liquidity risk management refers to the internal policies and procedures containing quantitative and qualitative objectives, limits and reporting put in place. Furthermore the objective of the liquidity management policy is to describe the manner in which the Group identifies, evaluates, measures, monitors, manages and reports its liquidity. The policy clearly outlines the structure, responsibilities and controls for managing liquidity risk and overseeing the liquidity positions of all legal entities, branches and subsidiaries. The Group's liquidity risk management policy includes a contingency liquidity plan, along with a communication strategy. The contingency planning policy provides a framework for detecting an upcoming liquidity event with predefined early warnings and actions for preventing temporary or longer term liquidity disruptions.

7.2 Management

The objective of the liquidity management policy, formulated by the Risk & Finance Committee, 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 in times of stress.

This policy aims to ensure that the Group does that by maintaining an adequate level of unencumbered, high-quality liquid assets that can be converted into cash, even in times of stress. The Group has also implemented stringent stress tests that have a realistic basis in the Group's operating environment to further measure the Group's ability to withstand different and adverse scenarios of stressed operating environments.

In its liquidity management policy the Group also uses measurements that have been developed within the Bank and best suit the operating environment of the Group.

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

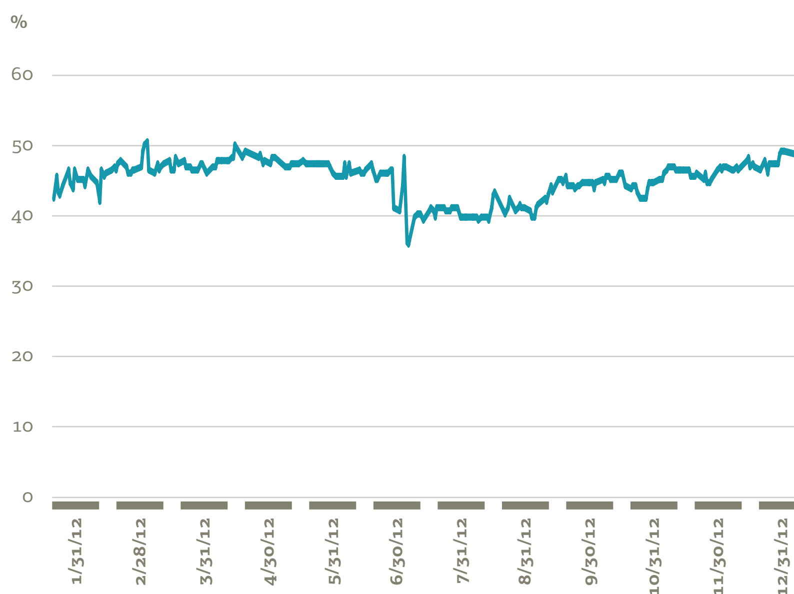
The Group monitors intraday liquidity risk, short-term liquidity

risk, and risk arising from mismatches of longer term assets and liabilities. Short-term liquidity risk is defined as under 12 months.

The Group's liquidity management process includes: projecting expected cash flows in a maturity profile rather than relying merely on contractual maturities; monitoring balance sheet liquidity; monitoring and managing the maturity profile of liabilities and off-balance sheet commitments; monitoring the concentration of liquidity risk in order to avoid undue reliance on large financing counterparties projecting cash flows arising from future business; and, maintaining liquidity and contingency plans which outline measures to take in the event of difficulties arising from liquidity crisis.

In its liquidity management policy the Group is implementing the Basel III standards "Basel III: International framework for liquidity risk measurement, standards and monitoring".

Core liquidity ratio 2012



7.3 Assessment

The Group's liquidity position is measured with a liquidity benchmark. The benchmark is expressed as the ratio between liquid assets and total deposits, the core liquidity ratio. Liquid assets are assets that can be readily converted into cash. The ratio is calculated for both deposits in domestic currency and foreign currencies. The outcome indicates the percentage of deposit withdrawals the Group can sustain using only liquid assets.

The definition of the liquidity benchmark measurement is as follows:

$$\frac{\text{Liquid assets}}{\text{Total deposits}}$$

Core liquid assets of the Group as of 31 December 2012 amounted to ISK 251 billion and the Group could withstand 48% withdrawal of all deposits.

In June 2012, the Group took advantage of its strong liquidity position to make an optional prepayment of ISK 72 billion of the secured FX bonds issued to LBI hf. in 2010.

7.3.1 Basel III ratios

In its liquidity management policy the Group also uses measurements that have been developed by the Basel Committee on Banking Supervision and are a part of the Basel III framework. Two main measurements in this framework are the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The objective of the Liquidity Coverage Ratio (LCR) is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The Net Stable Funding Ratio (NSFR) has a time horizon of one year and its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities.

It is the intent of the Group to implement the framework published by the Basel Committee on Banking Supervision, e.g. the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), to further ensure the Group's ability to measure and withstand liquidity needs in the short term (LCR) as well as to promote more medium and long-term funding of the assets and activities of the Group (NSFR). Implementation on these measurements is in progress within the Bank and a further analysis on these liquidity risk measurements is on-going parallel to the work of the Central Bank of Iceland and the Icelandic Financial Supervisory Authority (FME). The Bank reported impact surveys to the Icelandic regulators in the year 2012 and has co-operated with them on implementation. The Bank will continue to work closely with the Icelandic regulators in the year 2013 as well as follow the development of these measurements in Europe. Icelandic regulators have set forth a reporting plan for these liquidity ratios for the year 2013 but no public announcements have been made regarding minimum requirements. LCR and NSFR are currently measured on a monthly basis but the results of these measurements will not be made public until the requirements have been fully defined and approved by the regulators.

7.4 Stress test / sensitivity analysis

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

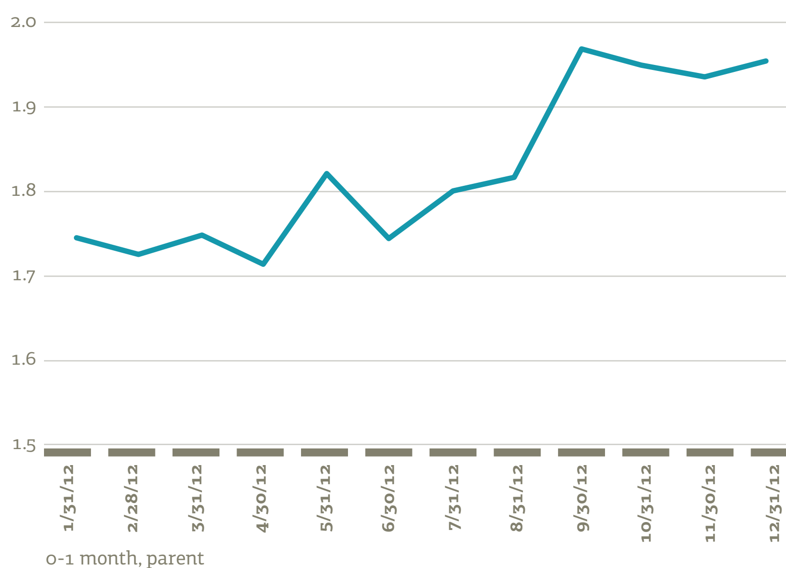
7.5 Control and monitoring

RAFC sets limits regarding liquidity risk tolerance and risk appetite through the liquidity management police by determining an acceptable level of liquidity position under normal and stressed business conditions. RAFC is responsible for deciding on strategies, policies and practices on liquidity risk in accordance with the risk tolerance while taking into account key business lines, products, legal structures and regulatory requirements.

The Bank's Treasury Department is responsible for the on-going management of its liquidity position and that entails closely monitoring current trends and potential market developments that may present significant and complex challenges for the Bank's liquidity strategy. The stock of high-liquid assets is under the control of Treasury and Treasury must manage the assets in accordance with the Bank's liquidity management policy.

The Risk Management Division of the Bank regularly evaluates the Group's liquidity position and monitors internal and external events and factors that may affect the liquidity position. Risk Management ensures compliance with the Bank's liquidity management policy and that its liquidity requirements are met.

Liquidity ratio set by the Central Bank of Iceland



7.6 Requirements from supervisory authorities

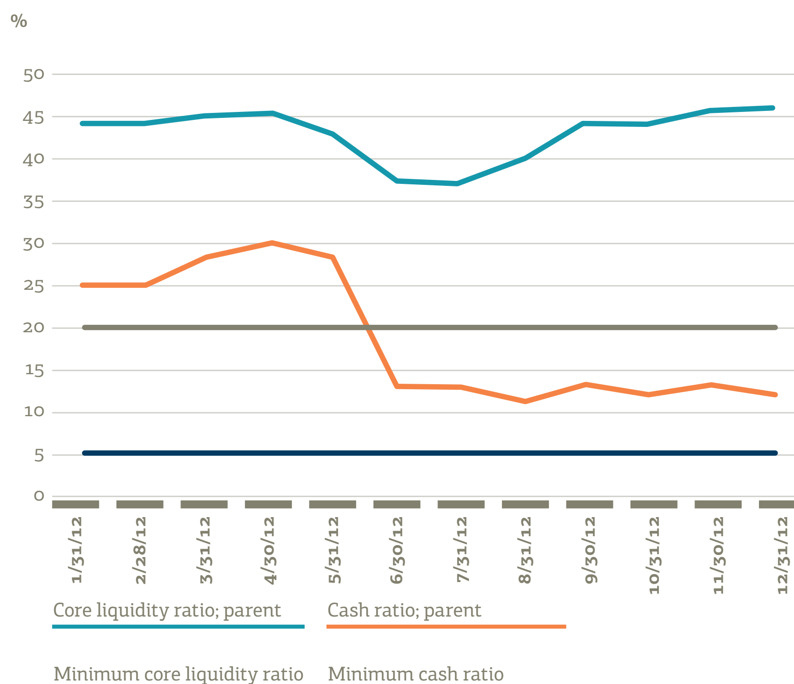
The Bank follows liquidity rules set by the Central Bank of Iceland to govern the ratio of weighted liquid assets and liabilities as well as following guidelines No. 1/2008 from the Icelandic Financial Supervisory Authority (FME) on best practices for managing liquidity in banking organisation.

The rules set by the Central Bank require the ratio of weighted assets to weighted liabilities to stay above 1 for the next three months, and involve a stress test,

weighting assets and liabilities with specific coefficients and reflecting how accessible each asset would be in a liquidity crisis and how great the need would be to repay the liability in question when due. The Bank was well above 1 in all time bands in the year 2012.

The guidelines set by the Financial Supervisory Authority require the ratio of core liquid assets to deposits to stay above 20% and the ratio of cash and cash equivalents to on-demand deposits to stay above 5%. The Bank submits monthly reports on its liquidity position to the Central Bank and the Financial Supervisory Authority.

Liquidity ratios set by the FME



7.7 Liquidity Contingency Plan

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

The Liquidity Contingency Plan stipulates the actions which shall be taken to monitor if the occurrence of a Liquidity Event or a confidence crisis is likely or imminent. It also includes a detailed action plan and procedures for the managing of a Liquidity Event. The Liquidity Contingency Plan includes the following items:

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

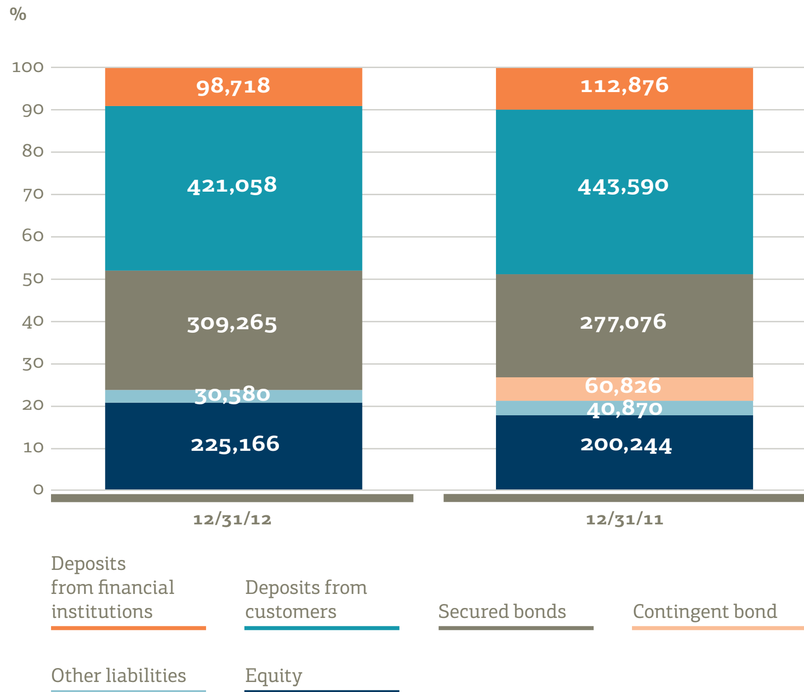
7.8 Funding and refinancing risk

Landsbankinn´s funding is divided into four parts. Deposits from customers is the bank´s primary funding but the bank also funds itself through borrowing in the form of bond issues as well as deposits from financial institutions. Last but not least the bank finances itself with contributions from owners in the form of equity.

Landsbankinn issued bonds (Bond A and contingent Bond A) in foreign currency to LBI as a means of payment for the transfer of assets and liabilities from LBI to Landsbankinn. The bonds amount to 309 billion ISK and have final maturity in 2018 with annual installments that can be seen in the image below. Landsbankinn has put an emphasis on extending the current long term debt of the Bank either by re-negotitating the outstanding bond issuance to LBI or refinancing the debt by issuing bonds on the international credit markets.

Landsbankinn has a strong liqui-

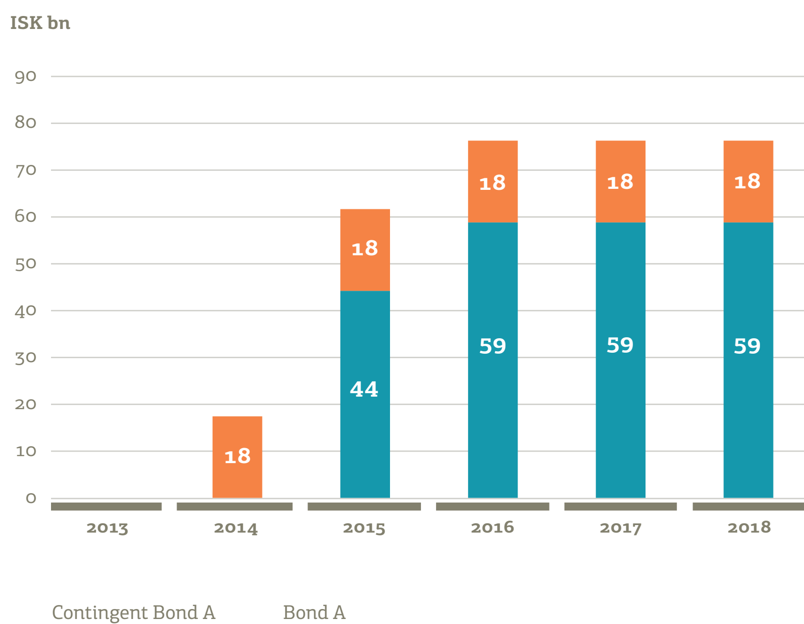
Funding profile



dity position, both in ISK as well as in foreign currencies, which is an important factor whilst the Bank works on extending it´s long term funding.

Landsbankinn plans to secure funding in foreign currencies by issuing bonds on international credit markets no later than 2015. An important part of that is obtaining a credit rating from an international credit rating agency (S&P, Moody´s or Fitch) and the Bank is already working to that end.

Annual installments of secured bonds



8 Operational risk

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

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

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

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

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

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

8.1 Control

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

The Security Committee is responsible for IT risk and physical security. All rules and work procedures connected to the remit of the Security Committee are approved by it.

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

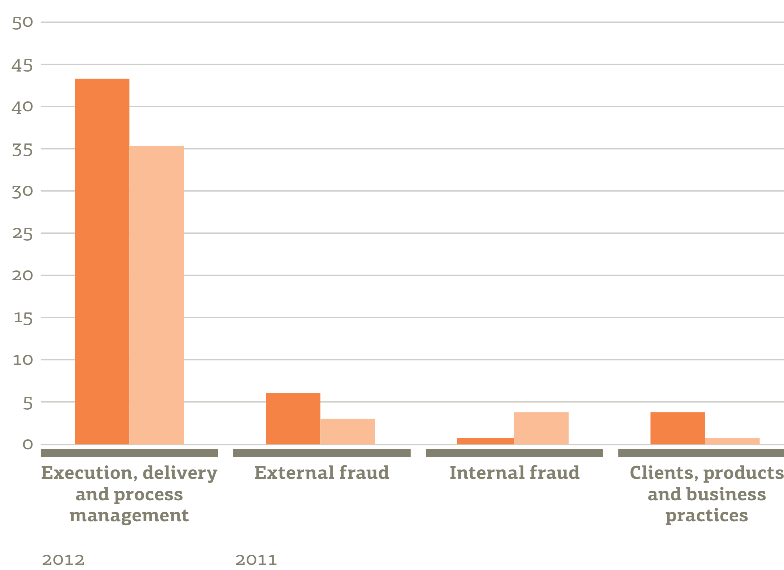
Internal Audit is responsible for auditing the effectiveness of the operational risk framework and the work of the Operational Risk Department.

Operational risk measurements are reported to the Board in a comprehensive manner as a part of the regular reporting done by Risk Management, three times a year. Managing Directors get semi-annual reports on the key risk indicators relevant to operations under their control.

8.2 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.

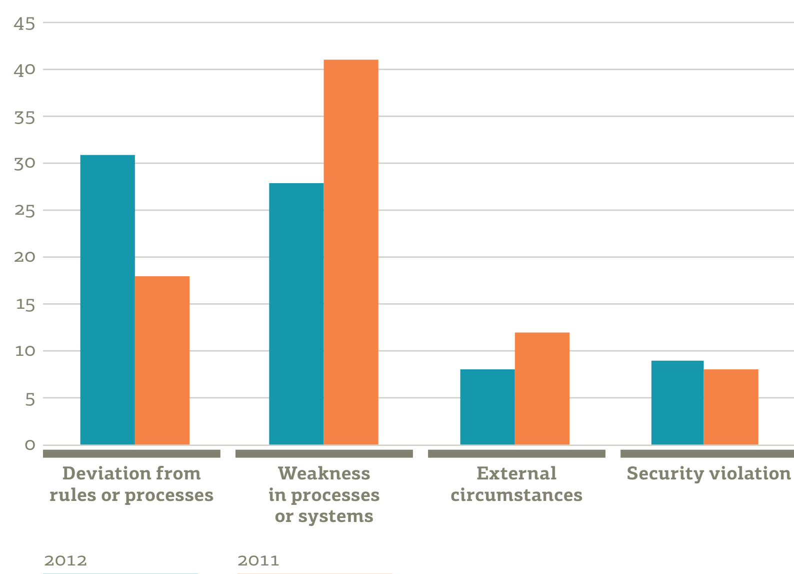
Number of loss incidents based on Basel II classification



- Self-assessment. The Bank assesses its operations and activities against a menu of potential risk vulnerabilities. As a part of this internally driven procedure, the Bank has set up a well-documented process to identify strengths and weaknesses in the operational risk environment. The self-assessment is done by senior directors for operations under their control and then reported up to managing directors. This is done on a two year cycle and more often if there are material changes in the operational risk environment of departments. The self-assessment identifies control gaps, enabling appropriate corrective action to be taken.

- Risk Mapping. This process involves mapping all reported incidents by risk type and to business units. This exercise reveals areas of weakness, leads to corrective action and assists in prioritizing subsequent management action.
- Key Risk Indicators (KRIs) are statistics and/or metrics, often financial, which can provide insight into the Bank's risk position. These indicators are reviewed periodically to alert the Bank of changes that indicate risk concerns. The Bank is still in the early stages of developing and adapting the use of KRIs in its risk reporting.
- The Bank is certified in adherence to ISO 27001, the international standard on Information Security. This standard helps the Bank in assessing and monitoring operational risk in the certified areas.

Operational incidents



When measured by number of events, "Execution, delivery and process management" has by far the largest number of events, or 43 in 2012 out of less than 60 incidents in total.

The Bank categorizes operational incidents into deviation from rules or processes, weakness in processes or systems, external circumstances or security violations. The largest number of incidents is in the first two groups, or over 70%.

8.2.1 Mitigation

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

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

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

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

8.2.2 Control and monitoring

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

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

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

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

9 APPENDIX

9.1 Further disclosures required under Pillar III

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

9.1.1 Credit risk

In this section the Group in some cases reports exposure values as Exposure at Default (EAD). This is addressed specifically where applicable. Risk and Capital Management 2012, section 5, on the other hand, is based on accounting data.

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

Credit exposure (EAD)	2012		2011
ISK billion	At 31 December	Average	At 31 December
Standardised approach for credit risk			
Central governments and central banks	41	74	113
Corporate customers	742,287	840,380	682,932
Institutions	94,706	89,490	56,138
Regional governments and local authorities	7,216	7,817	8,786
Retail customers	240,509	245,165	269,338
Retail exposures secured by real property	78,746	83,178	86,080
Standardised approach for credit risk, total	1,163,505	1,266,103	1,103,388
Total credit exposure (EAD)	1,163,505	1,266,103	1,103,388

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

Credit exposure (EAD) broken down by industry

At 31 December 2012 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agri-culture	Other
Standardised approach for credit risk												
Central governments and central banks	0	109	0	0	0	0	0	0	0	0	0	4
Corporate customers	0	9,676	0	182,936	159,397	156,099	44,770	53,650	19,991	29,157	9,047	18,209
Institutions	56,138	0	0	0	0	684	0	0	0	0	0	0
Regional governments and local authorities	0	8,356	0	0	12	0	0	419	0	0	0	0
Retail customers	0	709	170,225	6,442	32,830	6,416	15,607	22,562	2,469	8,251	3,680	148
Retail exposures secured by real property	0	0	85,950	0	105	0	12	13	0	0	0	0
Standardised approach for credit risk total	56,138	18,850	256,174	189,378	192,343	163,200	60,389	76,644	22,460	37,408	12,727	18,360
Total credit exposure (EAD)	56,138	18,850	256,174	189,378	192,343	163,200	60,389	76,644	22,460	37,408	12,727	18,360

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

Credit exposure (EAD) broken down by industry

At 31 December 2011 (ISK million)		Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agri-culture	Other
Standardised approach for credit risk													
STD	Central governments and central banks	0	36	0	0	0	0	0	0	0	0	0	5
STD	Corporate customers	0	9,149	0	185,968	179,393	159,888	56,159	70,527	22,749	29,315	8,126	21,014
STD	Institutions	94,706	0	0	0	0	0	0	0	0	0	0	0
STD	Regional governments and local authorities	0	6,704	0	0	14	0	0	495	0	0	3	0
STD	Retail customers	0	642	146,094	6,118	32,273	7,150	14,547	20,196	1,939	7,626	3,690	234
STD	Retail exposures secured by real property	0	0	78,332	1	331	0	19	64	0	0	0	0
Standardised approach for credit risk total		94,706	16,531	224,426	192,088	212,010	167,039	70,725	91,281	24,687	36,941	11,818	21,253
Total credit exposure (EAD)		94,706	16,531	224,426	192,088	212,010	167,039	70,725	91,281	24,687	36,941	11,818	21,253

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

Credit exposure (EAD) broken down by maturity

At 31 December 2012 (ISK million)		≥ 1 year	≥ 2 years	≥ 3 years	≥ 4 years	
	< 1 year	< 2 years	< 3 years	< 4 years	< 5 years	≥ 5 years
Standardised approach for credit risk						
Central governments and central banks	54	13	25	9	5	7
Corporate customers	269,250	62,556	74,030	56,573	38,857	181,665
Institutions	55,453	16	17	7	3	642
Regional governments and local authorities	1,867	1,810	2,041	466	114	2,488
Retail customers	86,246	14,849	16,410	13,405	9,437	128,992
Retail exposures secured by real property	249	177	102	55	208	85,288
Standardised approach for credit risk, total	413,121	79,421	92,625	70,514	48,625	399,082
Total credit exposure (EAD)	413,121	79,421	92,625	70,514	48,625	399,082

At 31 December 2011 (ISK million)		≥ 1 year	≥ 2 years	≥ 3 years	≥ 4 years	
Standardised approach for credit risk	< 1 year	< 2 years	< 3 years	< 4 years	< 5 years	≥ 5 years
Central governments and central banks	9	2	10	15	0	5
Corporate customers	336,887	59,518	53,571	62,059	55,522	174,730
Institutions	94,057	37	9	17	0	586
Regional governments and local authorities	1,755	1,244	45	1,039	523	2,609
Retail customers	79,061	17,050	11,527	10,919	7,074	114,877
Retail exposures secured by real property	241	219	144	74	82	77,987
Standardised approach for credit risk, total	512,010	78,071	65,306	74,123	63,201	370,795
Total credit exposure (EAD)	512,010	78,071	65,306	74,123	63,201	370,795

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

Loans and advances by industry sectors

			Individually impaired					
12/31/12	Gross carrying amount	Not individually impaired	Of which performing	Individual allowance	Of which non-performing*	Individual allowance	Collective allowance	Carrying amount
Financial institutions	64,349	64,349	0	0	0	0	0	64,349
Public entities	11,682	7,794	3,717	51	108	11	44	11,576
Individuals	207,608	167,667	22,436	3,549	7,577	6,379	2,632	195,047
Corporations		0						
Fisheries	149,477	89,405	54,380	2,448	1,749	1,496	2,582	142,952
Construction and real estate companies	112,558	82,272	22,988	1,926	3,503	1,869	3,835	104,928
Holding companies	66,235	40,464	22,050	564	582	2,575	3,087	60,009
Retail	47,549	33,737	8,763	2,376	1,039	1,634	1,520	42,019
Services	55,917	45,944	6,713	1,323	1,028	908	986	52,700
ITC	19,770	14,202	5,287	186	50	46	126	19,413
Manufacturing	26,802	22,807	2,889	458	315	334	346	25,665
Agriculture	10,747	5,098	5,093	127	256	173	248	10,199
Other	1,772	1,573	0	0	110	90	102	1,581
Total	**774,467**	**575,313**	**154,315**	**13,007**	**16,317**	**15,515**	**15,508**	**730,437**

*Non-performing past due more than 90 days

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

Loans and advances by industry sectors

12/31/11	Gross carrying amount	Not individually impaired	Individually impaired				Collective allowance	Carrying amount
			Of which performing	Individual allowance	Of which non-performing*	Individual allowance		
Financial institutions	100,133	100,133	0	0	0	0	0	100,133
Public entities	12,143	8,662	3,457	24	0	0	50	12,139
Individuals	186,033	149,003	21,612	3,354	8,039	4,025	353	173,223
Corporations		0						
Fisheries	137,878	120,085	12,729	1,876	2,367	821	2,278	135,397
Construction and real estate companies	107,013	82,595	19,358	1,090	2,082	1,888	2,977	101,958
Holding companies	51,112	43,683	4,317	1,160	355	1,598	786	48,622
Retail	44,443	37,261	3,882	295	1,972	1,032	950	42,401
Services	68,301	61,148	4,450	305	1,300	1,097	744	66,121
ITC	20,261	18,349	1,770	3	79	61	94	20,168
Manufacturing	28,709	26,909	1,201	137	210	253	36	28,008
Agriculture	8,834	6,798	1,470	477	48	41	439	8,505
Other	2,824	2,470	0	0	195	159	18	2,588
Total	**767,683**	**657,097**	**74,246**	**8,721**	**16,646**	**10,975**	**8,725**	**739,263**

*Non-performing past due more than 90 days

The tables below show the Group's maximum credit risk exposure at 31 December 2012 and 2011. For on-balance sheet assets, the exposures set out below are based on net carrying amounts as reported in the statement of financial position. Off-balance sheet amounts in the tables below are the maximum amounts the Group might have to pay for guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities.

				Corporations									
At 31 December 2012	**Financial institutions**	**Public entities***	**Individuals**	**Fisheries**	**Construction and real estate companies**	**Services**	**Retail**	**Holding companies**	**Manufacturing**	**Agriculture**	**ITC****	**Other**	**Carrying amount**
Cash and balances with Central Bank		25,898											25,898
Bonds and debt instruments	9,528	216,935			3			397	352			993	228,208
Derivative instruments	1,039											4	1,043
Loans and advances to financial institutions	64,349												64,349
Loans and advances to customers		11,576	195,047	142,952	104,928	52,700	42,019	60,009	25,665	10,199	19,413	1,579	666,087
Other financial assets	8,106	276	600	11	300	587			253		2	346	10,481
Total on-balance sheet exposure	**83,022**	**254,685**	**195,647**	**142,963**	**105,231**	**53,287**	**42,019**	**60,406**	**26,270**	**10,199**	**19,415**	**2,922**	**996,066**
Off-balance sheet exposure	**4,054**	**14,215**	**28,146**	**14,374**	**30,798**	**11,465**	**8,612**	**1,147**	**2,361**	**1,049**	**2,495**	**46**	**118,763**
Financial guarantees	0	95	463	1,731	23,149	2,123	1,685	208	584	39	552	35	30,664
Undrawn loan commitments	1,500	9,022	22	10,592	5,628	2,122	1,948	278	194	701	901	0	32,908
Undrawn overdraft/ Credit card facilities	2,554	5,098	27,661	2,051	2,020	7,220	4,979	661	1,583	309	1,043	11	55,190
Maximum exposure to credit risk	**87,076**	**268,900**	**223,793**	**157,337**	**136,028**	**64,752**	**50,631**	**61,553**	**28,631**	**11,248**	**21,911**	**2,968**	**1,114,828**
Percentage of carrying amount	7.80%	24.10%	20.10%	14.10%	12.20%	5.80%	4.50%	5.50%	2.60%	1.00%	2.00%	0.30%	100.00%

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

**ITC consists of corporations in the information, technology and communication industry sectors

				Corporations									
At 31 December 2011	**Financial institutions**	**Public entities***	**Individuals**	**Fisheries**	**Construction and real estate companies**	**Services**	**Retail**	**Holding companies**	**Manufacturing**	**Agriculture**	**ITC****	**Other**	**Carrying amount**
Cash and balances with Central Bank		8,823											8,823
Bonds and debt instruments	10,118	208,802			2			2,249	306			371	221,848
Derivative instruments	100			43								16	159
Loans and advances to financial institutions	100,133												100,133
Loans and advances to customers		12,139	173,222	135,397	101,958	66,120	42,401	48,622	28,008	8,506	20,168	2,589	639,130
Other financial assets	3,089	42		11		562		600	2		4	11	4,321
Total on-balance sheet exposure	**113,440**	**229,806**	**173,222**	**135,451**	**101,960**	**66,682**	**42,401**	**51,471**	**28,316**	**8,506**	**20,172**	**2,987**	**974,414**
Off-balance sheet exposure:	**0**	**7,583**	**31,658**	**11,272**	**8,192**	**8,586**	**11,348**	**6,466**	**2,876**	**2,150**	**2,626**	**1,156**	**93,913**
Financial guarantees	0	28	512	1,232	3,949	2,529	1,723	275	690	170	1,195	32	12,335
Undrawn loan commitments	0	4,130	22	7,875	2,380	254	4,851	5,507	369	1,655	371	327	27,741
Undrawn overdraft/ Credit card facilities	0	3,425	31,124	2,165	1,863	5,803	4,774	684	1,817	325	1,060	797	53,837
Maximum exposure to credit risk	**113,440**	**237,389**	**204,880**	**146,723**	**110,152**	**75,268**	**53,749**	**57,937**	**31,192**	**10,656**	**22,798**	**4,143**	**1,068,327**
Percentage of carrying amount	10.60%	22.20%	19.20%	13.70%	10.30%	7.00%	5.00%	5.40%	2.90%	1.00%	2.10%	0.40%	100.00%

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

**ITC consists of corporations in the information, technology and communication industry sectors

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

12/31/12	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised					
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	No collateral	Individual allowance	Collective allowance	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	68,404	0	0	68,404
Public entities	25	43	172	104	344	6,002	1,142	19,552	62	44	25,791
Individuals	6,621	11,206	14,577	18,473	50,878	100,197	64,967	84,679	9,928	2,632	223,193
Corporations											
Fisheries	1,091	4,765	24,202	20,277	50,335	90,952	58,291	22,564	3,943	2,582	157,326
Construction and real estate companies	320	1,833	3,167	9,321	14,641	121,949	49,980	6,765	3,795	3,835	135,725
Holding companies	402	163	1,043	1,950	3,558	49,780	32,115	14,044	3,139	3,087	61,156
Retail	159	641	1,281	1,065	3,146	42,039	17,042	10,977	4,010	1,520	50,631
Services	803	811	10,719	1,581	13,915	34,793	14,160	18,673	2,231	986	64,164
ITC	25	35	65	29	155	20,727	6,396	1,383	231	126	21,907
Manufacturing	72	278	729	1,010	2,088	19,283	10,786	7,792	792	346	28,026
Agriculture	176	119	262	64	621	10,205	3,910	970	299	248	11,249
Other	3	0	76	0	79	41	26	1,696	90	102	1,624
Total	**9,697**	**19,895**	**56,294**	**53,874**	**139,761**	**495,967**	**258,815**	**257,499**	**28,522**	**15,508**	**849,197**

*Credit card loans and overdraft on debit cards are assumed to be without collateral. If LTV is less than 100% the loan is considered fully secured. If LTV is greater than 100% the loan is partially collateralised and the respective collateral value is shown in the table

12/31/11	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised					
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	No collateral	Individual allowance	Collective allowance	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	100,133	0	0	100,133
Public entities	29	43	105	214	391	2,135	1,041	17,270	24	50	19,722
Individuals	9,466	13,732	25,297	21,487	69,981	46,169	26,231	96,463	7,379	353	204,881
Corporations											
Fisheries	919	10,067	34,247	16,160	61,393	73,407	26,500	16,843	2,697	2,278	146,668
Construction and real estate companies	920	1,008	3,421	9,302	14,651	93,926	49,199	7,526	2,978	2,977	110,147
Holding companies	38	167	278	129	611	51,469	13,682	6,550	2,757	786	55,087
Retail	1,270	889	1,760	1,908	5,827	46,687	13,270	3,512	1,327	950	53,749
Services	571	1,476	1,856	1,174	5,077	32,967	12,202	38,809	1,402	744	74,707
ITC	120	70	16	29	235	19,646	3,961	3,071	64	94	22,794
Manufacturing	60	751	592	2,209	3,613	12,572	4,554	15,092	390	36	30,851
Agriculture	100	302	205	227	834	8,942	2,322	1,835	518	439	10,654
Other	1	0	0	70	71	27	18	3,823	159	18	3,744
Total	**13,494**	**28,505**	**67,776**	**52,908**	**162,684**	**387,946**	**152,980**	**310,928**	**19,696**	**8,725**	**833,137**

*Credit card loans and overdraft on debit cards are assumed to be without collateral. If LTV is less than 100% the loan is considered fully secured. If LTV is greater than 100% the loan is partially collateralised and the respective collateral value is shown in the table

9.1.2 Market risk

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

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

At 31 December 2012

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Bonds and debt instruments	63,751	40,643	10,611	**115,005**
Equities and equity instruments	4,212	2,792	29,877	**36,881**
Derivative instruments		1,043		**1,043**
Total	**67,963**	**44,478**	**40,488**	**152,929**

Financial liabilities	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Derivative instruments		519		**519**
Short positions	8,919			**8,919**
Contingent bond			87,474	**87,474**
Total	**8,919**	**519**	**87,474**	**96,912**

Year-end 2011

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Bonds and debt instruments	69,543	28,155	11,603	**109,301**
Equities and equity instruments	14,290	3,488	28,259	**46,037**
Derivative instruments		159		**159**
Total	**83,833**	**31,802**	**39,862**	**155,497**

Financial liabilities	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Derivative instruments		1,729		**1,729**
Short positions	6,187			**6,187**
Contingent bond			60,826	**60,826**
Total	**6,187**	**1,729**	**60,826**	**68,742**

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

Equities outside the trading book are valued at fair value, with value adjustment in the income statement. For information on separation of equity exposure into trading/non-trading portfolios, see Section 6.4.1.

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

2012

Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2012	28,259
Total gains (losses) recognised in income statement	5,061
Purchases	2,629
Sales	-6,281
Settlements	209
Carrying amount at 31 December 2012	**29,877**

2011

Equities and equity instruments	Unobservable inputs
Carrying amount at 1 January 2011	10,477
Total (losses) gains recognised in income statement	13,097
Purchases	4,585
Sales	-7,418
Acquisitions through business combination	192
Settlements	2,936
Reclassification from assets held for sale	4,390
Carrying amount at 31 December 2011	**28,259**