RISK BOOK
2010

Íslandsbanki

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Risk Book **2010**

Pillar 3

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1 Introduction

Iceland's economy and the Icelandic financial market have undergone substantial changes following the collapse of the banking system in 2008. The new operating environment, together with the global market turmoil, has increased the focus on risk management. The purpose of Íslandsbanki's Risk Book is to comply with the regulatory requirements for disclosure and provide market participants with information that helps facilitate a better understanding of Íslandsbanki's risk profile and capital adequacy. Risk management is at the heart of the Bank's operations and the Bank is constantly working on improvements of its risk and capital management framework.

The Risk Book provides key information on the Bank's capital structure and adequacy, material risk exposures and risk assessment processes. In addition, it provides a short summary of the economic prospects for Iceland, significant risks and an overview of pending domestic and international regulations.

Compliance with approved risk limits and regulatory requirements is an essential part of the Bank's operation. At year-end 2010, the Bank was in compliance with all regulatory requirements and internal limits. The Bank's Tier 1 capital ratio was 22.6% and its total capital ratio was 26.6%.

Regulatory Environment

The regulatory requirements for disclosure are described in the Capital Requirements Directive (CRD 2006/48&49/EC) published by the European Union (EU). The EU directive regulates the capital adequacy of banks and other financial institutions. The CRD is based on the Basel II capital framework[1] and is a set of international guidelines for banks' capital adequacy. Basel II is structured around three pillars:

- Pillar 1 – Minimum capital requirement[2]
- Pillar 2 – Supervisory review and evaluation process[3]
- Pillar 3 – Market discipline[4]

The CRD has been implemented in the European Union (EU), and is included in Icelandic financial legislation through the European Economic Area (EEA) Agreement.

National discretions for Icelandic banks and financial institutions for Pillar 3 disclosure have not yet been provided by the Icelandic Financial Supervisory Authority (FME).

Íslandsbanki operates under the Basel II capital framework. When interpreting the Pillar 3 disclosure requirements, the Bank considers the Capital Requirements Directive, without any national discretion.

Banks can choose between different methods for calculating the minimum capital requirement under Pillar 1, subject to the regulators' approval. Íslandsbanki uses the standardised approach for credit risk and market risk and the basic indicator approach for operational risk.

The Bank submitted its Internal Capital Adequacy Assessment Process (ICAAP) report under Pillar 2 in November 2010 and the Supervisory Review and Evaluation Process (SREP) with the FME is currently in progress.

Disclosure Policy

Under Pillar 3, banks are required to have a formal disclosure policy. In accordance with these requirements, Íslandsbanki discloses the relevant information annually in its Risk Book. This information is in addition to the information published under International Financial Reporting Standards (IFRS) through the risk notes in the quarterly financial statements. The Risk Book is available on the Bank's official website: www.islandsbanki.is/riskbook.

Risk and capital management disclosure aims at giving a true and fair view of the Bank's capital structure and adequacy, material risk exposures and risk assessment processes. However, Íslandsbanki may omit information it deems immaterial where such materiality is based on the criterion that omission or misstatement would be likely to change or influence the decision of a person relying on that information. Accordingly, when Íslandsbanki has considered an item to be immaterial it has not been disclosed.

In addition, if required information is deemed to be proprietary or confidential, the Bank may make the decision to exclude it from disclosure. Íslandsbanki defines proprietary information, in line with the regulation, as such information that, if shared, has the potential to undermine the Bank's competitive position. Information is considered to be confidential if the Bank is bound from disclosure by confidentiality agreements with its customers, suppliers or counterparties. If information is omitted for either of these reasons it is stated in the relevant section of the disclosure.

If material risk exposures change significantly between reporting periods, the Bank can choose to disclose this information more frequently. An excerpt of the risk and capital management information as required under IFRS is published quarterly in the financial statements.

Consolidation and Verification

This Risk Book applies to the Íslandsbanki Group, together referred to as the Bank or Íslandsbanki. Names and primary businesses of the major subsidiaries at year-end 2010 are listed in Table 1. In some cases, the disclosure is for the parent company only, in which case a special marking will be provided.

This Risk Book has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statement 2010. Where reference is made to audited information, special marking is provided.

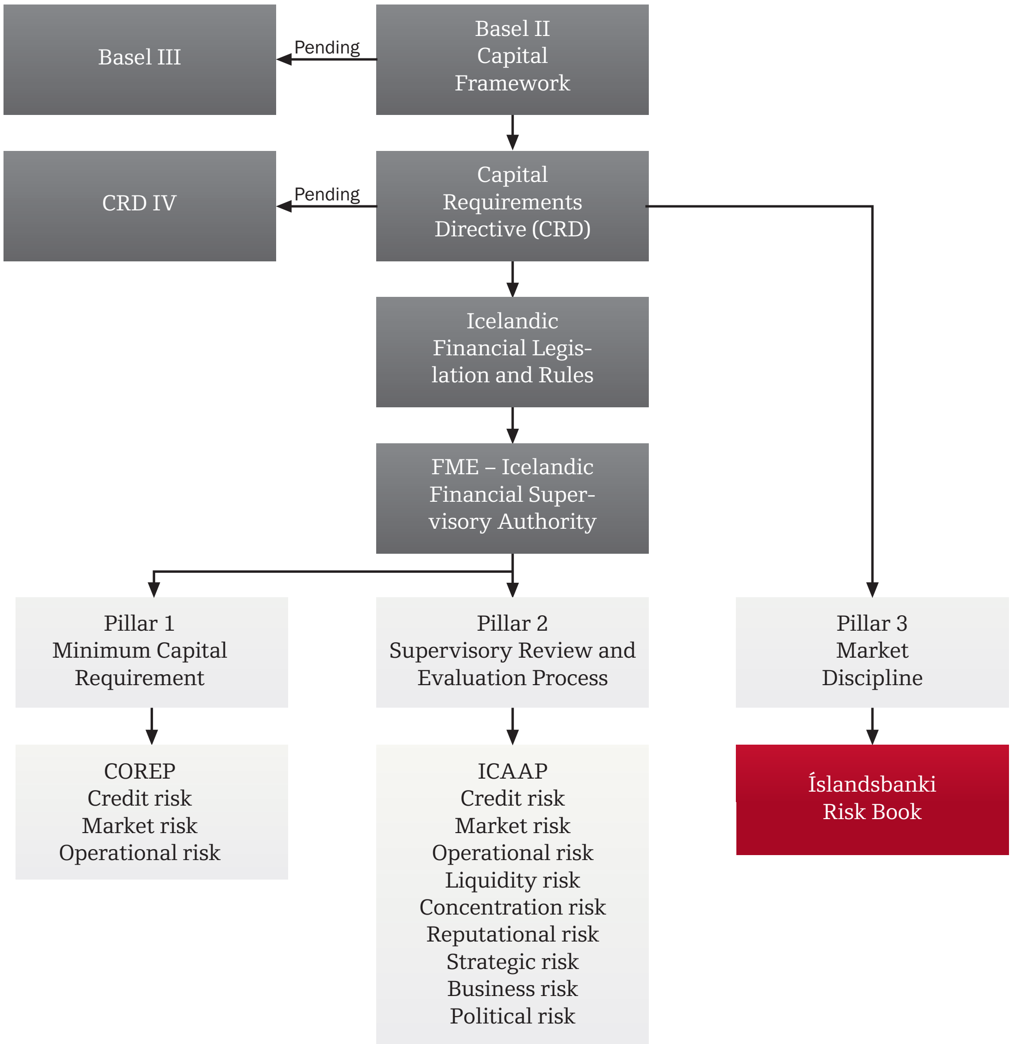

Figure 1: Regulation overview.

This Risk Book has been prepared in accordance with the Basel II capital framework and the Capital Requirements Directive, rather than in accordance with IFRS. This can cause a discrepancy between financial information in the Consolidated Financial Statement 2010 and information in the Risk Book 2010. All amounts are presented in ISK million, unless otherwise mentioned.

Name	Main business	Ownership	Country
Kreditkort hf.	Creditcard issuer	55%	Iceland
Borgun hf.	Payment processing	55%	Iceland
Íslandssjóðir hf.	Fund management	100%	Iceland
Midengi ehf.	Asset management	100%	Iceland
Glitnir Asset Management AS	Asset & fund management	100%	Luxembourg
Glacier Geothermal & Seafood Corporation	Consulting	100%	US

Table 1: Names and primary business of the major subsidiaries at year-end 2010. Fully consolidated.

ECONOMIC PROSPECTS FOR ICELAND

Current status and short-term prospects

Economic indicators are now showing signs that the bottom of the downturn has been reached. Gross Domestic Product (GDP) fell by 6.8% in 2009 in real terms from the previous year, and final estimates assume a further GDP contraction of around 2–3%. Recent forecasts predict a return to moderate GDP growth in 2011, although the uncertainties in that regard are skewed to the downside.

The economic programme put together by the International Monetary Fund (IMF) and Icelandic authorities in late 2008 is proceeding relatively smoothly, despite some delays, and public finances have improved substantially in recent quarters.

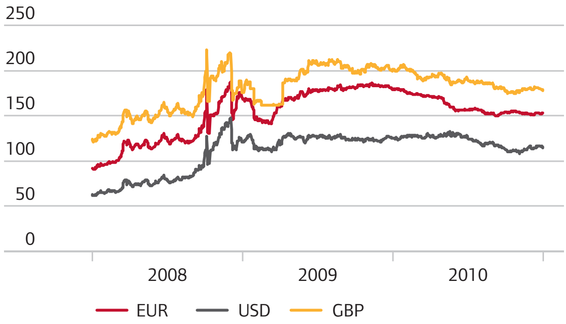

Figure 2: Value of selected currencies against ISK. Source: Central Bank of Iceland and Íslandsbanki Research.

Inflation has subsided recently, following a sharp inflation spike in the wake of the ISK's collapse in 2008. The outlook is for moderate inflation in the coming quarters, assuming that the ISK stays reasonably stable. In fact, inflation could well stay within range of the Central Bank's 2.5% target for an extended period for the first time since the target was introduced in early 2001. The main risk to inflation is a significant further depreciation of the ISK as capital controls are lifted in coming years, which could cause an inflation spike similar to the one in 2008.

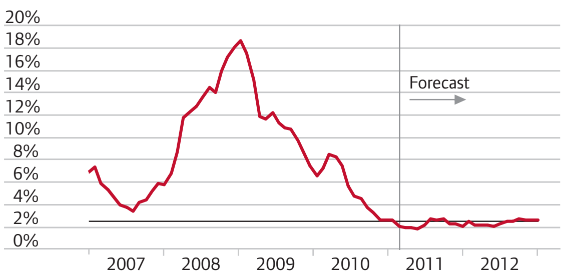

Figure 3: Consumer Price Index, YoY change. Source: Statistics Iceland and Íslandsbanki Research.

As inflation has fallen, the ISK has strengthened and economic slack has increased, the Central Bank has steadily brought down its policy rate, which peaked at 18% in late 2008 and early 2009. The Central Bank's rate cuts, coupled with limited options for domestic portfolio investments, have resulted in long-term interest rates decreasing considerably in 2010. Rates are likely to remain low in the coming quarters, with the long-term real rate near historical lows and a moderate inflation premium due to improving inflation expectations. Historically, long-term interest rates have been significantly higher on average in Iceland than in most other OECD countries, but this could change due to structural changes in the Icelandic economy and the financial sector.

Unemployment shot up after the onset of the financial crisis in 2008. Iceland had previously enjoyed an unusually low unemployment rate compared to other OECD countries, but in recent quarters unemployment has risen to record high levels for Iceland. Even so, unemployment remains in the single digit range and is expected to abate gradually throughout the coming years. However, there could be a shift to higher equilibrium unemployment, as has happened in other countries following prolonged recessions.

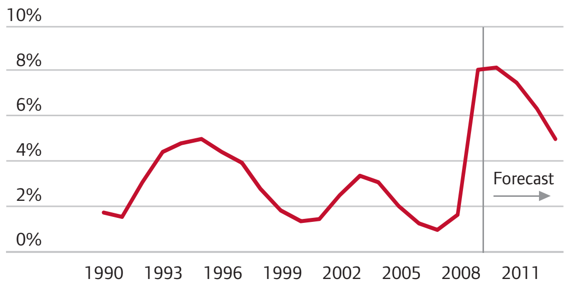

Figure 4: Unemployment as a percentage of the work force. Source: Directorate of Labour, Íslandsbanki Research.

Long-term outlook and risks

Looking further afield, the economic outlook is relatively benign. Economic growth will probably pick up as more households and companies emerge from the deleveraging phase with more robust balance sheets, while increased utilisation of Iceland's ample natural resources should provide opportunities for boosting investment and exports. However, there are also significant risks to medium-term growth prospects. In particular, there are great uncertainties about the reintegration of the Icelandic economy into the global economy. Extensive capital controls remain in place and the timing of their easing, and the extent to which the capital account will be liberalised in the medium term, is still unclear. However, the Central Bank will be publishing a plan for the removal of capital controls in March 2011 and a more detailed plan, including dates, will probably be issued in Q3 this year. Furthermore, a credible long-term monetary policy has yet to be established, although the intention is to do so before year-end. The EU accession talks are proceeding despite considerable opposition in Parliament, but the outcome is highly uncertain, as public support for EU membership has proven volatile.

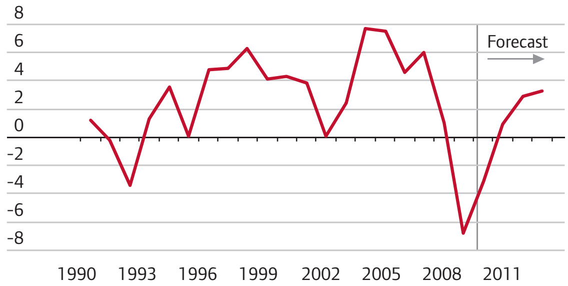

Figure 5: GDP, real change YoY. Source: Central Bank of Iceland, Statistics Iceland and Íslandsbanki Research.

The government is facing some challenging tasks. It has made substantial changes to the domestic tax regime and further changes in the direction of increased taxes on individuals and businesses cannot be ruled out. The government has also been conservative with respect to allowing foreign direct investments (FDI) related to further energy utilisation. The Icesave[5] issue remains unresolved, although a new, more favourable agreement has been approved by Parliament. However, Iceland's president has decided to put the bill to a public referendum in April 2011. A permanent political agreement on the framework for fisheries management has yet to be reached, and this creates uncertainty for the fisheries sector with regard to fishing rights. A more detailed discussion on political risk can be found under Chapter 9.

Also, there are risks to the revival of private consumption, the single largest component of GDP. Icelandic households are still heavily indebted on average, and it remains unclear how successful current measures by the government and financial institutions in order to facilitate orderly household deleveraging will be. Experience from other countries suggests that private consumption tends to remain subdued for an extended period following a credit bubble and subsequent financial crisis.

1) Basel Committee on Banking Supervision – International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version. www.bis.org/publ/bcbs128.pdf.

Enhancements to the Basel II framework July 2009. http://www.bis.org/publ/bcbs157.pdf.

2) Pillar 1 sets rules for calculation of the total minimum capital requirements for credit, market and operational risk.

3) Pillar 2 sets forth the framework for the Supervisory Review and Evaluation Process (SREP) and the framework for banks' Internal Capital Adequacy Assessment Process (ICAAP).

4) Pillar 3 sets disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment process, and hence the capital adequacy of the institution.

5) See glossary for further description of the Icesave issue.

2 Risk Management in Íslandsbanki

Risk assessment and the prudent evaluation and pricing of risk are key elements in the Bank's operations. In turn, an efficient risk assessment framework forms the foundations of the Bank's risk management strategy.

Risk Management in Íslandsbanki has a staff of 19 employees. All of them have completed university degrees and about half of them have completed certification as Financial Risk Managers (FRM) from Global Association of Risk Professionals (GARP).

ORGANISATIONAL STRUCTURE

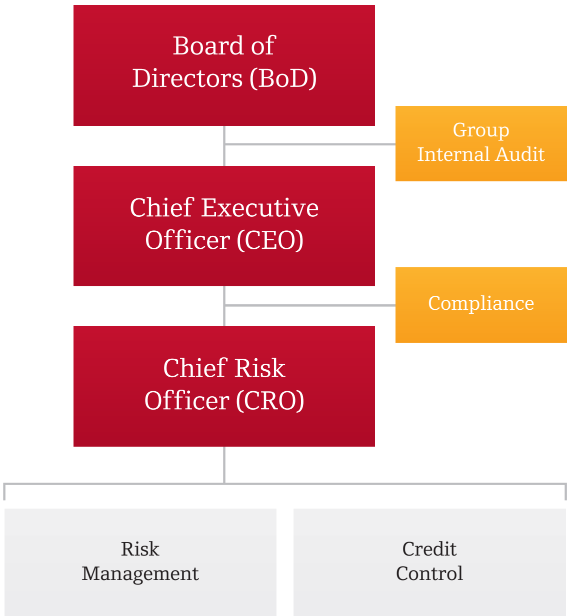

Figure 6: Organisational structure of Risk Management and Internal Control.

The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies.

Group Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

The compliance function is responsible for ensuring that the processes and the business conducted within the Bank are in accordance with external laws and regulations and internal directives and instructions.

The Risk Management department is an organisationally independent unit but provides strategic support aligned with the objectives of each business unit. The existence of an independent risk management department does not absolve management from its responsibility to manage all risks arising in their business and function. Decision-making that involves risk is based on a committee structure (see "Risk Management Committee Structure"). In addition to the oversight provided by the risk committees, Risk Management monitors risk within the business units on a company-wide basis.

Risk Management reports on risk and compliance against limits to internal and external stakeholders and ensures an appropriate escalation of limit breaches. Risk Management advises on risk and risk assessment; develops, maintains and tests risk models; and provides other forms of support within its expertise. Risk Management also manages the capital adequacy assessment process (ICAAP).

Risk Management at Íslandsbanki has a staff of 19 employees. All of them have completed university degrees and about half of them have completed certification as FRM from GARP.

Credit Control is accountable for the execution and monitoring of the credit process in accordance with credit rules and credit policies. This entails administering the credit committees and providing support and guidance to business units on credit and credit processing. Credit Control interacts with the business units on a daily basis on all issues regarding credit and focuses on sharing experiences and best practices.

Credit Control is accountable for monitoring defaults, credit watch lists, assessment for specific impairments and final write-offs.

RISK POLICIES AND MATERIAL RISKS

The governing principles for risk management and internal control within Íslandsbanki are described in the Bank's *Risk Management and Internal Control Policy.*

Each year the Board decides on material risks within Íslandsbanki and accordingly defines the risk appetite for all material risks. Risk disclosure is made with emphasis on material risk types. In 2010, the following risks were viewed as material within Íslandsbanki:

- Credit risk
- Market risk, including interest rate risk and inflation risk in the banking book
- Liquidity risk
- Operational risk, including legal risk
- Concentration risk

Other risk factors that are considered significant, but not material, and are currently not covered in separate risk policies are:

- Business and strategic risk
- Reputational risk

- Settlement risk
- Political risk

Figure 7 outlines the Bank's key risk management and internal control documents. All the risk policies have been approved by the Board and the Bank has a separate policy for each material risk, except concentration risk, which is addressed in the policies for credit, market and liquidity risk.

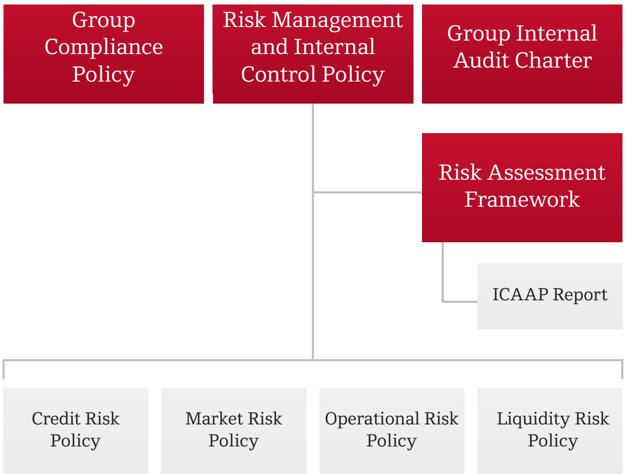

Figure 7: Overview of key risk management and internal control documents.

MATERIAL RISK ACROSS BUSINESS LINES

Íslandsbanki offers comprehensive financial services to individuals, households, corporations and professional investors in Iceland. The risk inherent in each business unit differs depending on the products and services offered. Table 2 shows the material risk factors identified in each business unit.

Retail Banking

Retail Banking provides banking services to individuals, households and small to medium-sized companies (SMEs). The unit comprises Íslandsbanki's branch network, Asset-Based Financing and its two independently operated subsidiaries: Kreditkort, a credit card issuer and Borgun, a payment processing company.

Retail Banking's main activity is lending and credit risk is the main risk factor. Operational risk is inherently a part of the operations but is not considered high in relative terms. Concentration risk arises both through the lending activity of Retail Banking and through deposit taking.

Business unit	Credit risk	Market risk	Operational risk	Liquidity risk	Concentration risk
Retail Banking	X		X		X
Corporate Banking	X	X	X		X
Markets	X	X	X		X
Wealth Management	X		X		
Finance & Treasury	X	X	X	X	X

Table 2: The material risk factors indentified within each business unit.

Any market risk due to mismatches between assets and liabilities in Retail Banking is transferred to the Treasury department, which manages the risk through internal pricing and lending quotas where applicable.

Corporate Banking

Corporate Banking offers a broad range of credit services and advisory services to medium-sized and large corporations and investors. Credit risk and credit concentration risk are the main risk factors in Corporate Banking. Operational risk is also a material risk factor for the Corporate Banking unit and some market risk is inherent in the operations in relation to bonds or shares in the banking book. As with Retail Banking, any market risk due to mismatches between assets and liabilities in Corporate Banking is transferred to the Treasury department, which manages the risk through internal pricing and lending quotas where applicable.

Markets

Markets provide the Bank's clients with financial advice and solutions as well as execution and access to capital markets products. Operational risk is a material risk factor since the volume of transactions performed is fairly high. Credit and market risk is mainly originated within proprietary and interbank trading activities, including management of the liquidity portfolio, which are subject to strict limits. Collateral positions are valued and monitored intraday and margin calls are performed when required according to a strict framework approved by the Risk Committee.

Wealth Management

Wealth Management offers comprehensive solutions in asset management and private banking for private investors and institutional clients. In addition, Wealth Management provides advisory, investment and pension services for retail investors as well as portfolio management services for affluent private investors.

Operational risk is the main material risk factor within Wealth Management but some credit risk is inherent due to acquired loan portfolios that are being run down.

Treasury

Treasury is a part of the Finance and Treasury department. Treasury is responsible for optimising the Bank's balance sheet in strict adherence to the risk limits approved by the Board of Directors. One of the main responsibilities includes managing the Bank's funding and liquidity risk. Market risk is also an integral part of Treasury's operations, since all mismatches between the Bank's assets and liabilities are managed by Treasury. Operational risk is a material risk factor but is not considered high in relative terms. Concentration risk is a material risk factor, mainly on the liability side in relation to single large depositors or groups of depositors.

RISK MANAGEMENT COMMITTEE STRUCTURE

The organisational structure for the committees governing the Bank's risks is shown in Figure 8:

Figure 8: Organisational structure of Risk Management committees.

The implementation of the risk management framework, limit-setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee and the Executive Board. The Board of Directors has granted authority to these committees to issue specific guidelines and targets regarding acceptable risk limits and decide on individual positions, depending on size and risk level. The members of these committees are appointed by the CEO.

Risk Committee

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks on a consolidated level. The Risk Committee governs the Bank's *Credit Risk Policy* and other credit rules and procedures. The Risk Committee can delegate authorisation power to subcommittees and decides on credit authorisation limits to individuals.

The Risk Committee is also responsible for approving products and services according to a formal approval process within the Bank.

The Risk Committee and each of its subcommittees have the authority to decide on credit proposals, credit risk and counterparty credit risk within defined limits. Decisions on exposures that exceed committee limits shall be reverted to a senior committee. In particular, credit decisions exceeding the limits of the Risk Committee need to be referred to the Board for confirmation.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) supervises other financial risks, including market risk, liquidity risk and interest rate risk in the banking book (non-trading portfolio). ALCO decides on and sets limits for these risks and governs the Bank's *Market Risk Policy* and *Liquidity Risk Policy*. ALCO also oversees the Bank's capital allocation framework and transfer pricing mechanism.

Executive Management Board

The Executive Management Board is responsible for the operational risk framework on a consolidated level. The operational risk framework covers how operational risk is identified, assessed, measured, monitored, controlled and mitigated at the Bank. In addition, the Executive Management Board supervises reputational risk, business risk and strategic risk. The Executive Management Board governs the Bank's *Operational Risk Policy*.

Reporting

Íslandsbanki aims to have clearly defined and efficient reporting lines to ensure compliance with the approved risk limits and targets.

Reporting on the material risks is an essential part of the risk management and internal control reporting system and the Bank is continually working on improvements on the technological platform to better support risk management. Since the Bank's establishment, several initiatives have been taken to strengthen the risk governance by putting in place systems and work procedures required to proactively manage and mitigate risk.

Each month, the Board receives a Risk Dashboard summarising the main risk positions as compared to internal and regulatory limits.

Risk Management produces several other internal and external reports. The main recipients of internal reports are; the Board of Directors, the Risk Committee, the Asset and Liability Committee, the Executive Board and, when applicable, Internal Audit. The Compliance function has access to all reports to regulators.

The main official information that the Bank publishes are the Annual Report, Financial Statements, the Risk Book and investors' presentations. All of these are available on the website: www.islandsbanki.is.

All of the Bank's financial accounts are prepared in accordance with International Financial Reporting Standards (IFRS). Regulatory reports are prepared based on Basel II requirements along with discretionary rules and requirements made by the Central Bank (CB) and the Financial Supervisory Authority (FME). At the time of preparation of this document the Bank is not regulated by the Nasdaq OMX Iceland[6] since Íslandsbanki is not an issuer of listed securities and bonds. However, internal standards assume that the Bank is compliant with and works according to the guidelines issued by Nasdaq OMX Iceland for listed companies.

6) The Icelandic stock exchange is a part of the Nasdaq OMX Nordic.

3 Capital Management

Íslandsbanki's capital ratios have been increasing despite difficult market environment. At 31 December 2010, the Bank's Tier 1 capital was ISK 121 billion or 22.6% of risk weighted assets. At the same time, the total capital ratio, including Tier 2 subordinated debt, was 26.6%.

The current capitalisation levels are well above both internal and regulatory requirements, supporting either further growth of the Bank or dividend payments to shareholders. When considering future dividend payments, the Bank will take into account the results from its ICAAP and conditions from the regulator.

Íslandsbanki submitted its 2010 ICAAP report to the FME in November 2010. The SREP process with the FME is currently in progress.

CAPITAL MANAGEMENT FRAMEWORK

The Bank's capital management framework aims to ensure that the Bank has sufficient capital to cover the underlying risks of its business activities. The framework has been developed based on regulatory requirements and international best practices. The Bank's capital management is framed in by the Internal Capital Adequacy Assessment Process (ICAAP).

CAPITAL BASE

Íslandsbanki's total capital base is composed of two parts:

- Tier 1 capital: Consists of common share capital, additional paid-in capital and retained earnings. Intangible assets and tax assets are deducted from Tier 1 capital.
- Tier 2 capital: Consists of long-term subordinated debt. The subordinated Tier 2 loan is denominated in Euros. Its eligibility as Tier 2 capital will decrease by 20% in 2015 since the remaining term is at that point in time only five years. After that, there is an annual linear decrease by 20% until maturity.

According to regulatory requirements Tier 2 capital cannot exceed one-third of the total capital base.

The Bank's total capital base is shown in Table 3.

Tier 1 capital	31.12.2010	31.12.2009
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,498	2,059
Retained earnings	53,174	24,204
Minority interest	791	840
Tax assets	-283	0
Intangible assets	-187	-107
Total Tier 1 capital	**120,993**	**91,996**
Tier 2 capital		
Qualifying subordinated liabilities	21,241	24,843
Total regulatory capital	**142,234**	**116,839**

Table 3: The Bank's total capital base (ISK m). Consolidated, audited.

CAPITAL REQUIREMENTS AND CAPITAL RATIOS

The Icelandic capital adequacy rules are based on the EU capital requirements directives (CRD). The capital adequacy rules require an absolute minimum capital level of 8% of risk weighted assets as calculated under Pillar 1. Additional capital requirements for Pillar 1 risks and other risk factors are determined under Pillar 2.

Currently, Íslandsbanki is operating under discretionary capital requirements made by the Icelandic regulator, the FME, requiring a minimum Tier 1 ratio of 12% of risk weighted assets and a Total Capital ratio allowing for subordinated Tier 2 debt of 16%. Table 4 shows Íslandsbanki's capital ratios at the end of 2009 and 2010.

Íslandsbanki's capital ratios	31.12.2010	31.12.2009
Total RWA	534,431	589,820
Total capital base	**142,234**	**116,839**
Total Tier 1capital	**120,993**	**91,996**
Total capital ratio	**26.6%**	**19.8%**
Tier 1 ratio	**22.6%**	**15.6%**

Table 4: Íslandsbanki's capital and capital ratios (ISK m). Consolidated, audited.

As this report is being published, the Bank is engaged in a dialogue with the FME under the SREP process, which includes a review of the Bank's ICAAP report for 2010. In the coming years, the Bank expects that the results from the ICAAP and FME's SREP will define the Bank's capital requirements and replace the current discretionary requirements of 12% and 16% as described above.

Pillar 1

The Basel II rules allow for the use of a different method to assess the Pillar 1 capital requirements for credit, market and operational risk. The Bank has adapted the standardised approach for credit risk and market risk under Pillar 1 and the basic indicator approach for operational risk. Íslandsbanki aims to have its internal risk models and data bases support more advanced methods for capital requirement calculations in the future.

Credit Risk

The capital requirements under Pillar 1 form the basis for calculating the Bank's capital ratios. The minimum capital requirement for credit risk is calculated as 8% of the risk weighted assets (RWA) for credit risk. The RWA for credit risk are derived by assigning a risk weight, in the range of 0%–150%, to the Bank's assets depending on the creditworthiness of the counterparty, the underlying collateral and the type and term of the exposure.

Market Risk

The RWA for equities and bonds are calculated by dividing the capital requirements by 8% while the RWA for currency risk are calculated as the maximum of the Bank's total long and total short positions

Operational Risk

Under the Basic Indicator Approach for operational risk capital calculations, the RWA are derived from the minimum capital requirement divided by 8%. Under the basic indicator approach the capital requirement for operational risk is equal to 15% of the indicator. The indicator is the average over three years of the sum of net interest income and net non-interest income. Given the short operating history of Íslandsbanki, figures from 2009 and 2010 are currently used for calculating the minimum capital held for operational risk in 2010.

The changes in Íslandsbanki's RWA in 2010 are displayed in Figure 9. There are two main factors that contributed to the decrease in RWA: the volume of the loan portfolio has decreased and the currency imbalance has been reduced significantly. The reduction in the loan portfolio is both due to appreciation of the ISK as well as to customers' repayment of debt.

Other factors contribute to the changes in RWA between years. A decrease in operational income included in the relevant indicator results in lower RWA for operational risk, whereas some reclassification of exposures increases the capital requirement due to credit risk.

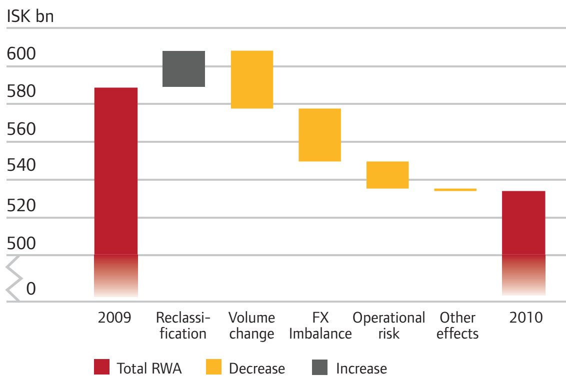

Figure 9: Changes in Risk Weighted Assets from 2009 to 2010 (ISK bn).

Íslandsbanki's Capital Requirements and RWA	31.12.2010		31.12.2009	
	Minimum Capital Requirements	RWA	Minimum Capital Requirements	RWA
CREDIT RISK	**35,247**	**440,586**	**36,382**	**454,773**
Central governments or central banks	123	1,535	10	121
Regional governments or local authorities	83	1,031	104	1,302
Administrative bodies and non-commercial undertakings	126	1,569	379	4,738
Institutions	512	6,398	1,722	21,526
Corporates	17,163	214,543	19,590	244,875
Retail	7,092	88,649	5,856	73,205
Secured by real estate property	1,973	24,664	3,613	45,161
Past due items	5,064	63,296	2,365	29,559
Other items	3,112	38,901	2,743	34,287
MARKET RISK	**1,181**	**14,766**	**3,369**	**42,117**
Traded debt instruments	274	3,429	234	2,924
Equity	92	1,154	22	271
Foreign Exchange	815	10,183	3,114	38,922
OPERATIONAL RISK	**6,326**	**79,079**	**7,434**	**92,929**
Total	**42,755**	**534,431**	**47,186**	**589,819**

Table 5: Capital requirements and RWA under Pillar 1 (ISK m). Consolidated, unaudited.

CAPITAL ALLOCATION

Allocation of economic capital, across business units and individual positions, is a key element in the Bank's capital management, pricing and performance measurement.

Capital is allocated to all business units, down to branch or department level, based on each unit's risk exposure and the current minimum requirement of 12% core Tier 1 capital. Return on allocated capital is then calculated for each unit as a risk-adjusted performance measure.

ICAAP

Pillar 2 defines guidelines for supervisory review of a bank's capital adequacy and internal capital adequacy assessment process (ICAAP). The ICAAP requires assessment of all material risks to which the Bank is exposed, not covered or not fully covered under Pillar 1. The Pillar 2 risks defined for Íslandsbanki are liquidity risk, concentration risk, reputational risk, strategic risk, business risk, legal risk and political risk.

In addition to the Pillar 1 risks Íslandsbanki's internal capital assessment is divided into three components:

1. Minimum capital requirements under Pillar 1, as defined above
2. Additional capital requirements for Pillar 2, risk factors and other risk factors not fully covered under Pillar 1
3. Reduction in available capital due to stress testing

The assessment of capital under stress starts with the available baseline capital from Íslandsbanki's business plan (the column farthest to the right in Figure 10) and shows how losses from the stressed scenario are deducted from the available capital.

The available capital after stress testing should exceed the minimum Pillar 1 and Pillar 2 capital requirements at all times.

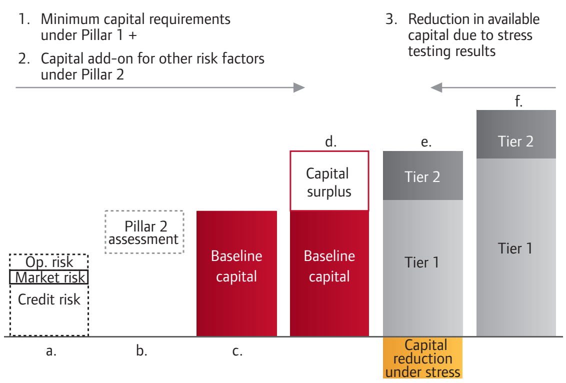

Figure 10: Íslandsbanki's ICAAP methodology.

a. Minimum capital requirements under Pillar 1

b. Capital add-on under Pillar 2

c. Baseline capital requirements under Pillar 1 & 2

d. Capital surplus after stress test

e. Available capital after stress test

f. Available capital before stress test

Table 6 shows a classification of how different risk types contribute to the Pillar 2 capital requirements described above. The former (1) is the need for additional baseline capital and the latter (2) is the reduction in available capital due to stress test results.

Risk type	Additional capital requirements	Reduction in capital under stressed conditions
Credit risk	x	x
Credit concentration risk	x	x
Market risk in the banking and trading book	x	x
Liquidity risk		x
Business risk		x
Legal & political risk	x	

Table 6: Risk types under Pillar 2.

Stress Testing

Íslandsbanki's business plan, and the strategy it is built on, is formulated with a bottom-up approach with the participation of all units in the Bank. Each business prepares their individual business plan and the consolidated business plan, approved by the Board, is then used as a basis for stress testing.

The next step in the stress testing process is the definition of the relevant input parameters and economic assumptions for scenarios. A stress testing team within Risk Management developed a set of parameters that are either statistically significant or relevant by expert judgement to the underlying risk factors.

Íslandsbanki's economic research unit has provided a baseline economic scenario that is used as a basis in the Bank's business model and an adverse scenario that is used for stress testing purposes. The parameters are then linked to portfolio specific risk factors. Finally, the scenarios are translated into factors that drive the Bank's profit and balance sheet to assess the financial impact of the stressed scenarios.

The impact assessment for different risk factors and the key drivers of the Bank's operations are based both on statistical models and expert judgement. The impact assessment should thus provide a good basis for planning, comparing the results with the Bank's risk appetite and taking action where necessary.

Further development of the Bank's stress testing methodology and framework is one of the key objectives for Risk Management in the next couple of years.

4 Credit Risk

Credit risk is the primary risk factor in the Bank's operations and taking on credit risk is a core activity of the Bank.

The Bank has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Bank's financial performance.

The loan portfolio acquired from Glitnir banki hf. (Glitnir) comprises the largest part of the Bank's credit exposure. Due to the fact that the loan portfolio was acquired at a deep discount and is currently being restructured, conventional measures of credit exposure are perhaps not fully descriptive.

This chapter explains the sources of credit risk within the Bank and how credit risk is measured, monitored and mitigated.

DEFINITION OF CREDIT RISK

Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or otherwise fail to perform as agreed.

This risk comprises default risk, recovery risk, credit concentration risk, country risk and settlement risk.

STRATEGY, ORGANISATION AND RESPONSIBILITY

Íslandsbanki's strategy is to maintain a modest credit risk profile. This entails in particular that at consolidated level the Bank aims to have long-term average annual credit losses less than 0.9% of the loan portfolio.

This risk appetite is reflected in the credit risk limit structure and guided through the use of credit risk assessment models that separately assess the probability of default (PD) and loss given default (LGD) for most transactions.

Credit risk activities are controlled through exposure limits applied to counterparties, sectors and with limits specific for different products. Exposure is measured according to the accounting principles adapted by the Bank. The Risk Committee is accountable for supervising and monitoring the Bank's credit and credit concentration risks on a consolidated basis.

Risk Management is responsible for the monitoring and reporting of credit risk. Its main activities with respect to credit risk are to monitor the Bank's credit risk against the limits set in the *Credit Risk Policy*, report on credit risk, develop, maintain and enhance credit risk management models used at Íslandsbanki, monitor risk model performance, and calculate the latent impairment for the loan portfolio. Risk Management does not take part in individual credit decisions.

Credit Control is responsible for monitoring and supervising the credit process, governing credit committees, assisting in credit workout cases, monitoring past due loans and defaults, carrying out the specific impairment process and proposing loan write-offs. The department is responsible for the implementation of credit processes in the Bank and for ensuring that rules regarding credit analyses and procedures are fully met.

APPROVAL PROCESS

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows, as well as the borrower's general ability to repay the obligations, forms the basis for all credit decisions.

Credit cases are prepared by business units and approved by a body with sufficient authorisation limit. For smaller amounts the approval can be carried out in the branches, but for higher amounts the decision is made in a central credit committee. All credit authorisations require at least two employees. The risk at hand must be within the authorisation limit of at least one of the two employees. The Bank's business units are ultimately responsible for their credit risk.

DEEP DISCOUNT AND THE DIFFERENCE BETWEEN CLAIM VALUE AND CARRYING AMOUNT

Before discussing measurements of credit risk, it is helpful to understand the background of the deep discount of the acquired portfolio and the difference between claim value and carrying amount.

A loan is defined as having been acquired at a deep discount when the fair value purchase price is considerably lower than the claim value, according to the terms of the loan. A large part of the Bank's assets were acquired at a deep discount. The deep discount was intended to meet both incurred credit losses at the acquisition date and expected future losses for the next three to five years, depending on the loan portfolio. The inclusion of expected future losses means that, on average, there should be no credit losses from the acquired portfolio in the next three to five years.

Because of the deep discount difference between the claim value and the carrying amount, the Bank believes that the loan portfolio can on average be restructured into a performing loan portfolio without a further reduction of the carrying amount. There can be some variability, however, which means that for some counterparties the deep discount will not suffice while for others the restructuring will result in a financial gain for the Bank.

The difference between claim value and carrying amount was initially divided into two parts: initial impairment, which is intended to absorb credit losses, and discount, which is intended to cover the difference between contractual interest rates and the required return, taking into account the Bank's funding cost and risk premium. The initial impairment and the discount are not shown on the Bank's balance sheet. The carrying amount is stated as the claim value less the initial impairment and the discount. The initial difference between claim value and the deep discount carrying amount are shown in the Bank's consolidated financial statements for 2008.

The acquired loans are accounted for at amortised cost using the effective interest rate method. This means that the discount is amortised over a fixed period of time and thus added to the carrying amount. Other adjustments in the carrying amount are reflected by three ledgers that are, unlike the initial impairment and the remaining discount, visible on the balance sheet. These ledgers are FX impairment, added impairment, and added recovery.

The FX impairment is used to offset currency movements for loans that the Bank treats as ISK assets. The Bank splits its foreign currency denominated loans into two parts:

FX/FX loans: Foreign currency denominated loans to customers with revenues or collateral in foreign currency. The counterparties to these loans are the ones to whom the Bank would consider granting a loan in foreign currency today.

FX/ISK loans: Foreign currency denominated loans to customers with revenues and collateral in ISK. The Bank's aim is to convert all these loans to ISK loans.

For the FX/ISK loans, all changes in claim value due to changes in the underlying currencies against the ISK are fully offset with an additional impairment charge called FX impairment, leaving the carrying amount of the loans unaffected by currency fluctuations. This applies both in the case of appreciation and depreciation of the ISK. When the ISK appreciates then the FX impairment is reversed.

Since the FX impairment is always accompanied by a financial gain of equal amount in the income statement, this impairment does not indicate a loss from the initial transfer price. This effect is shown schematically in Figure 11. The first column shows how the claim value of a foreign currency denominated loan is divided into carrying amount, initial impairment and discount as measured in ISK. The second two columns show the same split after a strengthening of the foreign currency by 50%, for an FX/FX loan and an FX/ISK loan, respectively. For an FX/FX loan, the claim value, carrying amount, initial impairment and discount all increase by 50%. For an FX/ISK loan, on the other hand, only the claim value and the initial impairment increase by 50%. The carrying amount and the discount are thus kept constant in ISK by the FX impairment.

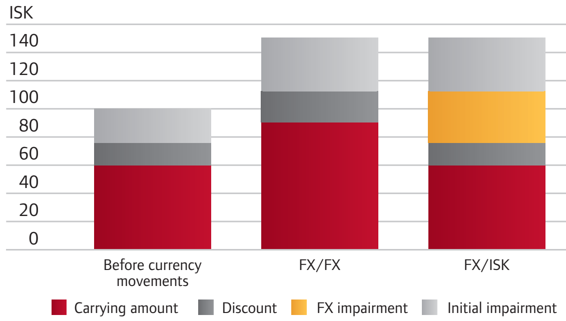

Figure 11: Illustrative relationship between claim value, initial impairment, discount, carrying amount and FX impairment.

Added impairment and added recovery are used when a specific assessment indicates that the expected recovery of a loan will be different from the initial assumption. Added impairment indicates that expected recovery is lower than initially estimated. Added recovery, however, indicates that the expected recovery has surpassed the initial expectation.

MEASUREMENT AND MONITORING

Credit risk is measured on the basis of possible losses from the credit portfolio. Potential losses can be divided into expected and unexpected losses.

Expected losses are derived from the borrower's probability of default (PD), the predicted exposure at default (EAD) and the loss given default (LGD). The LGD is based on all expected cash flows, including the ones from realisation of collateral, and properly adjusted for the cost of collection. The expected losses are covered by the business margin. Unexpected losses, on the other hand, need to be covered by the Bank's capital.

RISK CLASSES

Íslandsbanki uses internal rating models to assess the default probability of corporate and retail customers. While these ratings have been used for pricing and internal capital allocation in the past, the current situation where the claim value of an obligor's debt can differ substantially from the corresponding carrying amount renders the application of these ratings less straightforward.

The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its industry sector, market position and management. The corporate rating model assigns each obligor to one of ten risk classes (one risk class for default, and nine risk classes for performing obligors).

For retail customers, both individuals and very small entities (VSE) which are companies with a total exposure to the Bank of less than ISK 150 million, the Bank uses statistical rating models. These PD models are behavioural models, i.e. they require input about a customer's historic payment behaviour. These models rank obligors according to their repayment capacity and, consequently, assign a long-term average default rate to each rank.

Figure 12 shows the distribution of carrying amount (excluding credits in default) into PD ranges for the individuals, VSE and corporate portfolios, respectively. The PD corresponds to the observed long-term average default rate, where a 90-day past due or specific impairment was used as the default criterion.

For the corporate portfolio, default data for the period 30 June 2002 to 30 June 2008 was used, i.e. the periods in the aftermath of the Icelandic banking crisis were excluded from the long-term average. The reason for this exclusion is that the PD rating is based on amounts from financial statements that are not descriptive of the company in the changed environment anymore.

For the individuals and VSE portfolios, the full available period from 30 June 2004 to 30 June 2010 was used. This is possible for these models since the assigned risk class is based on the ranking of obligors in the portfolio, which was less affected by the banking crisis than the corporate rating.

It is important to keep in mind that the risk classes for both the corporate and retail PD models are based on the claim value of an obligor's debt. If there are significant differences between the claim value of an obligor's debt and the carrying amount, the risk classes will underestimate the obligor's repayment capacity with respect to the carrying amount, often significantly. The PDs shown in the figure are, therefore, upward biased. For the pricing of restructured loans, Íslandsbanki therefore currently applies a forward looking approach using pro forma financial statements for the company under regular economic conditions.

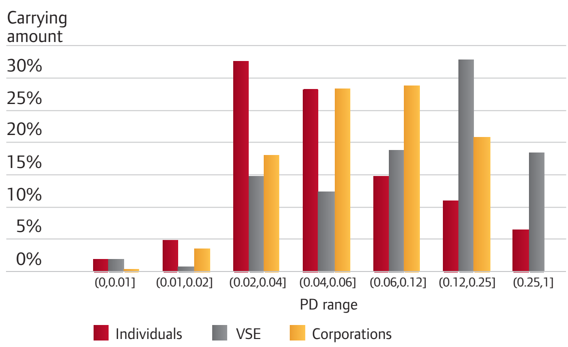

Figure 12: Distribution of carrying amount by PD ranges at year-end 2010 (excluding credits in default).

Collateral and Guarantees

Since collateral is not generally used until a borrower faces serious repayment difficulties, the valuation of collateral focuses on its expected value in case of insolvency. The Risk Committee has appointed a Collateral Board that reviews and proposes guidelines for the valuation of collateral and pledged assets; a specially assigned Quota Board does the same for credit mitigants in the fisheries sector, including fishing quota. The objective is to ensure that the valuation of collateral is co-ordinated throughout the Bank.

The potential correlation between collateral value and the obligor's financial condition is taken into consideration. Collaterals without a formal reference value are not included in loan-to-value calculations. However, the Bank accepts all collateral that improves the Bank's position.

The main types of collateral accepted by the Bank are commercial and residential real estate, fishing vessels including the fishing quota assigned to the vessel, and financial collateral.

The Bank has one significant exposure to a former financial institution. This exposure is guaranteed by the Icelandic government as it was assumed as part of a transfer of deposits to the Bank. The Bank also has an exposure to a company that is owned and guaranteed by the government. These are currently the only two guarantees that the Bank uses for reduction of capital requirement.

Borrower Concentration

The Bank seeks to actively limit large exposures. A large exposure is defined as an exposure to a group of connected clients that exceeds 10% of the Bank's capital base. The exposure is evaluated net of credit risk mitigating effects eligible according to FME rules no. 216/2007.

When assessing the exposure, both on-balance sheet items and off-balance sheet items, from all types of financial instruments are included as defined in the FME rules. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article 1.a in Act no. 161/2002 on Financial Undertakings where groups of connected clients are defined.

At 31 December 2010, the Bank had one large exposure to a group of connected clients that summed up to less than 16% of the Bank's capital base on the consolidated level. In particular, no large exposure exceeds the maximum 25% set by law.

The Bank also seeks to minimise borrower concentration risk and has an internal limit on the aggregated exposures to the 20 largest groups of connected clients. This limit is reported internally on a monthly basis.

Industry Sector Concentration

The Bank has limits on both the exposure to any single economic industry sector as well as the aggregated exposure to the three largest economic industry sectors as a percentage of the Bank's total credit exposure. Exposure to retail individuals, as a separate economic industry sector, is also considered separately. These limits are reported on a monthly basis.

CREDIT PORTFOLIO EXPOSURES

Table 7 shows the main sources for credit risk at Íslandsbanki.

Sources of credit risk	31.12.2010	31.12.2009	Level
Loans to customers	515,161	537,489	C
Loans to financial instit. and central banks	63,068	77,603	C
Debt instruments	68,024	66,701	C
Unsettled transactions	1,085	3,287	C
Guarantees and undrawn commitments	20,270	17,632	P
Derivatives	70	0	C

Table 7: Sources of credit risk (exposure in ISK m). Unaudited. Because credit conversion factors are used to measure credit exposure for guarantees and undrawn commitments the exposure does not match the amounts in the Consolidated Financial Statements 2010. C: Consolidated. P: Parent.

In addition see "Settlement risk" in Chapter 9. The Bank furthermore considers indirect exposure, i.e. exposure that is not direct but becomes direct at the event of a default of a third party as one source of credit risk. The Bank currently has no credit exposure to securitisation.

Loans to Customers

Loans to customers represent the largest portion of the Bank's credit risk exposure. At year-end 2010 the loan portfolio amounted to ISK 515,161 million. This portfolio is divided into loans to individuals, companies, municipalities and government-guaranteed borrowers.

Loans to individuals

Loans to individuals derive from lending activities to individuals residing in Iceland and are an important part of the credit profile of the Bank. Table 8 shows a breakdown of loans to individuals by product type.

Product type	31.12.2010	31.12.2009
Mortgages	105,637	106,267
Term loans	33,148	36,079
Leasing	11,678	7,262
Overdrafts	7,943	8,199
Credit cards	14,307	17,154
Total	**172,713**	**174,960**

Table 8: Loans to individuals by product type (carrying amount, ISK m). Parent, unaudited.

Mortgages

The largest part of loans to individuals is in the form of residential real estate mortgages.

For capital requirement reduction purposes, the Bank uses only loans that are a part of the standard mortgage product. In addition, there are loans to individuals with charges on residential real estate that for some reason do not fulfil the requirements for the standard mortgage product. This can include loans on a second lien, loans where the purpose of the loan was not to acquire the underlying property, and loans with non-standard term structure or non-standard currency composition. Loans that do not fit the standard mortgage product are classified here as term loans.

Figure 13 shows how the mortgage portfolio is distributed in loan-to-value (LTV) bands. Only loans with direct pledge are included in the graph. In the breakdown, every ISK lent is categorised according to its seniority in the total debt on the property. The first column represents the part of the portfolio that falls in the 0–10% LTV band, and so on. The red colour indentifies loans that are more than 90 days past due.

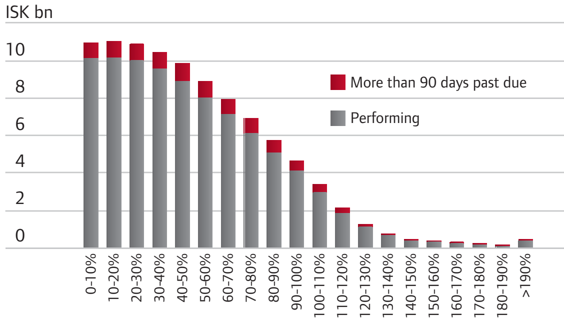

Figure 13: The loan-to-value distribution of the retail mortgage portfolio, year-end 2010. Parent, unaudited.

For capital requirement purposes, residential real estate mortgages to individuals are partitioned into two segments, the part that is covered up to 80% loan-to-value and the amount that exceeds 80% loan-to-value. The value of the property is obtained from the Iceland Property Registry (FMR) which is updated once per year. Mortgages secured with a universal pledge do not have a well defined LTV.

Mortgages	Performing	Past due	Total
Amount below 80% LTV	70,469	6,512	76,982
Amount above 80% LTV	17,581	2,533	20,114
Universal pledge	7,830	711	8,542
Total	**95,881**	**9,756**	**105,637**

Table 9: Breakdown of the mortgage portfolio by LTV bands, year-end 2010 (carrying amount, ISK m). Parent, unaudited.

Loans to Companies

Loans to companies include loans to large corporate entities, SMEs, VSEs, municipalities, public sector entities and government guaranteed borrowers. These loans comprise a significant part of the Bank's balance sheet and operation.

The industry breakdown in Table 10 shows the Bank's credit exposure by industry and customer segment. The breakdown follows an internal industry classification that is based on the Icelandic ISAT 2008 that derives from the European NACE Rev. 2. The main differences to ISAT 2008 are: seafood is considered to be a separate sector, consisting of both the fishing and processing of seafood; individuals are a single segment independent of their activity; and investment companies are singled out as a sector rather than being included in services.

Loans to companies by sector	31.12.2010		31.12.2009	
Real estate	78,772	23%	77,630	21%
Seafood	67,934	20%	72,120	20%
Government secured customer loan	52,182	15%	47,879	13%
Investment companies	42,124	12%	53,413	15%
Commerce	29,949	9%	29,911	8%
Services	20,951	6%	20,151	6%
Industry	16,100	5%	21,726	6%
Construction	17,088	5%	20,034	6%
Loans to municipalities	4,909	1%	3,738	1%
Other	4,877	1%	6,813	2%
Transportation	4,723	1%	5,134	1%
Loans to central government and state-owned enterprises	2,839	1%	3,982	1%
Total	**342,448**	**100%**	**362,529**	**100%**

Table 10: Loans to companies by sector (carrying amount, ISK m). Consolidated, unaudited.

The government secured customer loan, discussed under Note 60 in the Consolidated Financial Statements 2010, is also indicated separately since it would otherwise skew the industry breakdown.

Balances with the Central Bank and Loans to Financial Institutions

Cash and balances with the Central Bank totalled ISK 30,799 million at end of 2010 compared to ISK 38,742 million at end of 2009. This includes certificates of deposits, mandatory reserve deposits and other balances with the Central Bank.

Icelandic financial institutions are defined based on Act no. 161/2002 on Financial Undertakings. The Bank also has exposures to foreign financial institutions, mostly in the form of money-market deposits. The following table shows a breakdown of loans to financial institutions by country of domicile.

Country	31.12.2010	31.12.2009
Germany	8,978	2,618
Iceland	7,126	10,286
United States	5,602	1,981
Denmark	5,011	291
Sweden	2,891	6,737
Luxembourg	1,986	60
Norway	1,815	6,296
Japan	194	109
Canada	183	1,529
Australia	90	743
Belgium	57	320
Switzerland	17	1,710
Total	**33,951**	**32,681**

Table 11: Loans to financial institutions by country of domicile (carrying amount, ISK m). Parent, unaudited.

Debt Instruments

The Bank is exposed to credit risk as a result of trading and investing in debt instruments, e.g. as part of the Bank's liquidity management, and as a result of restructuring activities. Table 12 presents the Bank's position in debt instruments. The credit rating is based on Standard and Poor's ratings or equivalent. The unrated bonds were mostly acquired through restructuring activities.

	31.12.2010	31.12.2009
Icelandic government and government guaranteed bonds	34,658	36,683
Foreign AAA rated government bills	30,724	29,583
Unrated bonds	2,642	433
Total debt instruments	**68,024**	**66,701**

Table 12: Bonds and debt instruments by rating class (carrying amount, ISK m). Consolidated, unaudited.

Unsettled Transactions

At 31 December 2010 unsettled transactions totalled ISK 1,085 million. This is in line with positions due to normal business activities.

Guarantees and Undrawn Commitments

The Bank's credit exposure deriving from guarantees and undrawn commitments totalled ISK 20,270 million at the end of 2010, taking the appropriate credit conversion factor into account.

Exposure 31.12.2010	Banks	Indvdviduals	Companies	Public sector	Total
Guarantees	0	484	4,780	0	5,265
Undrawn overdrafts	327	1,607	2,973	236	5,143
Credit cards	4	1,998	378	32	2,413
Lines of credit	303	0	2,130	5,017	7,449
Total	**634**	**4,090**	**10,261**	**5,285**	**20,270**

Exposure 31.12.2009	Banks	Indvdviduals	Companies	Public sector	Total
Guarantees	0	480	5,662	0	6,142
Undrawn overdrafts	310	1,605	2,219	222	4,355
Credit cards	8	3,581	461	30	4,079
Lines of credit	0	5	1,260	1,790	3,055
Total	**319**	**5,670**	**9,602**	**2,041**	**17,632**

Table 13: Off-balance sheet credit exposures from guarantees and undrawn commitments (credit converted exposure ISK m). Parent, unaudited.

Derivatives

The Bank uses derivatives to hedge currency exposure. The Bank carries relatively low indirect exposure due to margin trading with clients; in these cases the Bank holds collaterals for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

IMPAIRED LOANS

Loans are classified as impaired if contractual cash payments are not expected to be fully honoured and if the financial restructuring of the obligor is expected to lead to a loss for the Bank.

Not all financial restructuring will lead to a loss for the Bank, even if part of the debt is written off. This is because of the difference between the claim value and the carrying amount as mentioned earlier in this chapter.

Past due loans that have not been impaired are loans which are expected to be restructured without a loss to the Bank. In some cases, the loss is avoided because of the deep discount, in some cases there is sufficient collateral, and in some cases the assessment is that contractual payments are likely to be fulfilled.

The foreign exchange gain or loss on loans in foreign currencies to borrowers with ISK cash flow is realised in full. However, since the Bank does not expect to recover foreign exchange gains relating to these loans, an offsetting impairment, FX impairment, is charged to the loan. This FX impairment should not be interpreted as a loss from the transfer price, since the assets were considered to be ISK assets at the time of transfer.

When a specific assessment indicates that the expected recovery of a loan will be higher than the initial assumption, the difference is recognised as an income due to revised estimated future cash flow. This income is offset against the charge for specific impairment losses in the income statement.

Table 14 shows a breakdown of the loan portfolio, based on whether the loans are classified as impaired, past due but not impaired, or neither past due nor impaired. The impaired loans are split by whether the impairment is due to FX impairment only or whether there has been a specific impairment made.

The full carrying amount of all loans that give rise to a specific impairment is included in impaired loans even if parts are covered by collateral. Therefore, the carrying amount of impaired loans does not indicate amounts that are likely to be lost.

At 31 December 2010	Loans that are neither past due nor impaired	Past due but not impaired	Loans with specific impairment	Loans with FX impairment only	Total
Loans to banks	30,842	8	20	0	30,870
Loans to individuals	123,086	21,194	617	27,817	172,713
Loans to corporate entities	142,018	18,343	89,595	32,562	282,518
Government secured customer loan	52,182	0	0	0	52,182
Loans to central government and state-owned enterprises	1,273	15	1,018	533	2,839
Loans to municipalities	3,534	5	1,370	0	4,909
Total	**352,935**	**39,565**	**92,620**	**60,911**	**546,031**

Table 14: Carrying amount of impaired and past due loans at year-end 2010 (ISK m). Consolidated, unaudited.

Portfolio	Carrying amount	Off balance sheet	RWA	Average RW
Central governments or central banks	54,346	10,038	1,535	3%
Regional governments or local authorities	5,735	831	1,031	18%
Administrative bodies and non-commercial undertakings	7,071	64	1,569	22%
Institutions	35,623	2,389	11,539	32%
Corporates	234,329	20,204	217,977	93%
Retail	129,643	25,575	82,914	64%
Secured by real estate property	70,469	0	24,664	35%
Past due items	60,959	178	63,873	105%
Other items	18,755	0	21,679	116%
Government secured customer loan	50,151	0	0	0%
Total	**667,082**	**59,279**	**426,783**	**64%**

Table 15: Risk weighted assets at year-end 2010 (ISK m). Parent, unaudited.

In addition to the assessment of a specific impairment for individual loans, the Bank assesses the appropriate collective allowance for impairment which reflects losses that have been incurred, but have not been identified in the reporting period, i.e. cannot be allocated to individual loans yet. This is called latent impairment in the Consolidated Financial Statement.

The set of loans that make the basis for the collective allowance are all loans that are not specifically impaired and were not acquired at a deep discount. Loans to financial institutions and loans in repo deals do not contribute, as the Bank believes it has already identified all incurred losses on these types of loans.

The incurred but not yet identified loss for other types of loans is estimated based on risk classes and historical loss rates.

CAPITAL REQUIREMENTS

Íslandsbanki reports capital requirements for credit risk according to the standardised Basel II approach. Table 15 shows exposure amounts and corresponding risk-weighted assets for the different portfolios as at 31 December 2010 for the parent company. Only residential real estate and securities issued by the central government are used as credit risk mitigants to reduce capital requirements. For securities the Financial Collateral Simple Method is applied.

OTHER CREDIT RISK DISCLOSURES

This section describes the restructuring plan and the monitoring of the restructuring progress.

Restructuring of the Loan Portfolio

The financial restructuring of individuals and corporations represents the biggest challenge for the Bank in 2011.

In 2010 the Bank put great effort and considerable resources into developing debt relief programmes and restructuring frameworks for its customers. Since the autumn of 2008, the Bank has worked with the government and the Icelandic Financial Services Association (SFF) on developing general guidelines for the restructuring of loans to both individuals and companies. Parliament has passed various acts and issued numerous regulations since the autumn of 2008 regarding the treatment, settlement and processing of indebted individuals and companies. Figure 14 shows the main initiatives taken by the Bank in 2010, either singlehandedly or in cooperation with the government or the other banks.

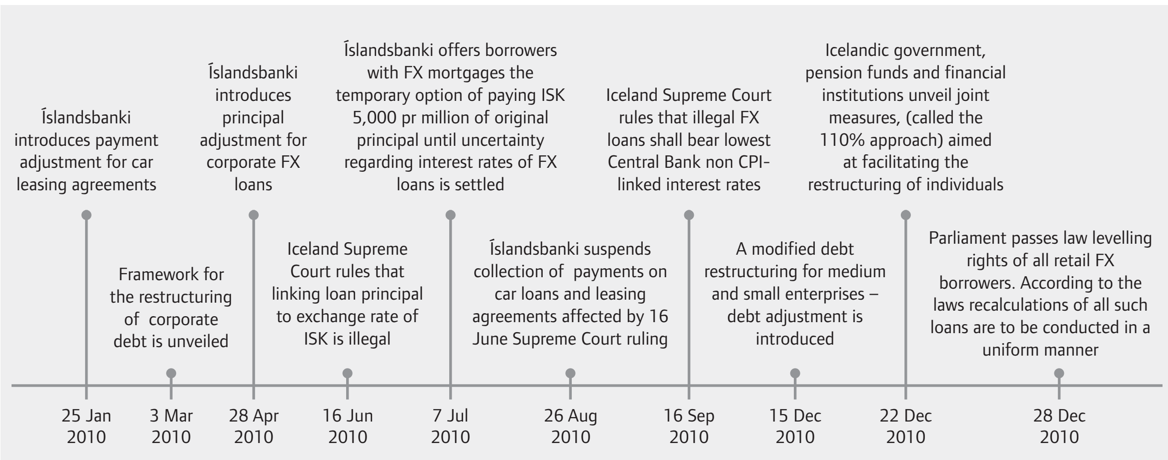

Figure 14: The 2010 debt restructuring timeline.

Individuals

The largest part of loans to individuals is in the form of mortgages. Other lending is in the form of term loans, short-term financing and leasing. Figure 15 presents the various debt restructuring programmes offered to customers with mortgages and other terms loans with charge on real estate:

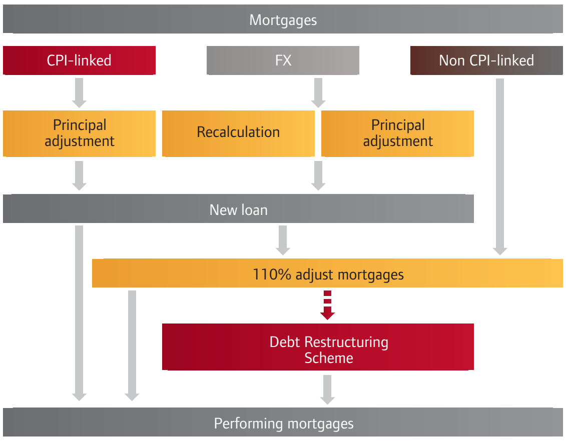

Figure 15: Debt restructuring framework for mortgages.

Principal Adjustment

In November 2009, Íslandsbanki became the first bank in Iceland to offer a principal adjustment for both the CPI-linked and foreign currency denominated types of mortgages. Around 15% of all mortgage borrowers have taken advantage of this offer and opted to convert their loans to non-index linked mortgages in lieu of a decrease in the principal. The loan principle was reset based on the value of the CPI in September 2008 and the principal of foreign currency denominated loans was reset based on exchange rates on 29 September 2008. In August 2010, the offer of principal adjustment for CPI-linked mortgages ended, but customers with foreign currency mortgages can choose between principal adjustment and the recalculation described below.

Recalculation of Foreign Currency Loans

In June 2010 the Icelandic Supreme Court ruled that some foreign currency linked loans to individuals were in fact loans in ISK, since these were loans where the principal was illegally indexed to foreign currency exchange rates. Following this ruling, the Icelandic Supreme Court ruled in September 2010 that such illegal foreign currency loans should be recalculated as if they had born the lowest non CPI-linked interest rates recorded by the Central Bank from the time of issuance. Following these rulings, the Icelandic parliament passed a bill that required all foreign currency mortgages to be recalculated according to the methodology described above and subsequently converted to ISK. The Bank estimates that around 4,000 mortgages will be recalculated based on these criteria in 2011. The ruling of the Supreme Court did not have a material effect on the carrying amount of the loans in question because they were already recognised at a deep discount.

110% Adjustment of Mortgages

Near the end of 2010 the Icelandic government, pension funds and financial institutions unveiled a joint agreement, called the "110% adjustment of mortgages", aimed at restructuring the debt of households with a mortgage debt significantly higher than the market value of their property. All foreign currency mortgages will be recalculated and converted to ISK loans prior to this offering. The Bank estimates that approximately 2,000 households are potentially eligible for the 110% mortgage adjustment in 2011. For the success of this scheme it is important to have a robust and reliable estimate of the market value of real estate. If the estimate is too low then the Bank will write off more than necessary, resulting in a smaller loan portfolio going forward and a smaller income base for the future. On the other hand, if the estimate is too high, the scheme is less likely to help borrowers in need of financial relief. To reduce this risk, the Bank has called for an independent valuation of all properties from authorised real estate agents. To reduce risk even further, the agreement states that each property's official valuation from the Iceland Property Registry (FMR) serves as a lower bound for its market value.

In both the recalculation and the 110% adjustment, the Bank decided to adjust a larger set of loans than strictly required, by including all loans to individuals with residential real estate as collateral, excluding overdrafts and other short-term debt. The Bank thus included all loans that were previously offered a principal adjustment.

Debt Restructuring Scheme

In more complex cases and when the financial difficulties of customers are more severe, the standardised solutions mentioned above are not sufficient. In such cases, customers are offered the Debt Restructuring Scheme (DRS) where all debt above 100% of collateral value, defined as a residential home and a vehicle, are written off immediately. From the beginning of the customer acceptance of the scheme, the customer has to be able to service at least 60% of the collateral value, with the possibility of structuring the remaining 40% in a flexible payment loan.

At year-end 2010, the Bank has estimated that 1,000 individuals might potentially require comprehensive debt restructuring in the form of DRS.

Asset-Based Financing (ABF)

After the Supreme Court ruling in June 2010, Íslandsbanki suspended collection of payments on car loans and leasing agreements due to the uncertainty regarding the legitimacy of foreign currency loans in Iceland. In October 2010, the Bank's ABF unit offered customers holding foreign currency car loans and leasing agreements a recalculation based on the lowest interest rate published by the Central Bank. The average principal reduction is 40% and customers that have overpaid are allowed to choose between a cash repayment or the reduction of remaining principal. At year-end 2010, 54% of ABF's foreign currency loans had been recalculated and ISK 1,300 million repaid to customers.

Companies

After the collapse of the banking system in 2008, a substantial part of the Bank's corporate loan portfolio was categorised as distressed debt. Restructuring of distressed debt was one of the Bank's main tasks in 2010. Although a number of important milestones were achieved last year, the restructuring process has turned out to be more time consuming than anticipated. The delay in completion is in most cases due to complexity where many creditors are involved.

The Bank's goal is to establish a balance between the assets and liabilities of its customers. After restructuring, the corporate loans will be in currencies that reflect the income of the business.

Principal Adjustment for Companies

In April 2010, Íslandsbanki offered principal adjustment to companies with foreign currency loans. Companies with foreign currency loans that are predominantly served with ISK, income are offered principal adjustment upon converting their loans to ISK, based on the exchange rates of 29 September 2008. At year-end 2010, approximately 150 companies had accepted principal adjustment.

Debt Adjustment

The Bank introduced the first debt adjustment solution in March 2010, following a joint agreement within the Icelandic banking sector and the government. The methodology is in accordance with law no. 107/2009, which stipulates how debt adjustment for businesses should be processed and how financial institutions must conduct financial restructuring.

A revised methodology introduced in October 2010 provides a streamlined solution for overleveraged smaller businesses.

Debt structure is adjusted to 100% of the value of the company, as measured by either assets or operating value. Term and maturity of restructured loans are in accordance with the Bank's general rules on credit, market and liquidity risk.

When a company's capacity to service debt is lower than the value of assets then the difference needs to be funded by equity. New equity and restructured debt is therefore equal to the estimated value of assets or debt service capacity, whichever is higher, in addition to other available collateral.

To encourage injection of new equity, the revised solution offers an additional debt forgiveness if new equity is used to pay down debt until the debt level reaches 70%.

For smaller businesses, with debt below ISK 1 billion, where owners are less likely to have access to new equity, a three-year subordinated facility can be offered in cases where debt capacity is less than the estimated value of assets and other available collateral. The subordinated facility has no payments of principal and a subsidised interest rate that will be added to the principal.

The debt adjustment scheme is extremely dependent on appropriate valuation of the overleveraged companies. The same arguments apply to this scheme as to the 110% adjustment for mortgages except that the number of customers is lower and the difficulty in achieving a robust and reliable valuation is higher.

Other Restructuring

For complex cases where general restructuring solutions do not suffice, the Bank can offer tailor made solutions where each case is evaluated separately. In some cases the Bank needs to acquire the company in part or in full. Íslandsbanki has publicly announced that all companies that the Bank has or may acquire through restructuring will be sold at the earliest time possible. To ensure a professional and objective sale process a special asset management company, Midengi hf., was founded in 2009, to hold and manage stakes in companies and other assets temporarily acquired by the Bank.

Loan Portfolio Analysis

The Icelandic Financial Supervisory Authority (FME) monitors the Bank's loan portfolio restructuring progress through standardised monthly reports, the so-called LPA (Loan Portfolio Analysis) reports. The FME has defined ten categories of customers and ranked them depending on which restructuring programme they have gone through or according to the severity of their financial difficulties. The categorisation is on the obligor level, not the facility level. All loans to a given obligor belong to the category of the loan in the most severe category.

Íslandsbanki has grouped these ten categories together to make the following four groups:

Group 1: Customers that have not yet requested any change in initial contract. However, this does not always imply that the customers will not need assistance in the future.

Group 2: Customers that have had some modification of initial contract but are currently paying according to the new schedule. Modifications include general offers such as principal adjustment and payment adjustment schemes. These general offers do not require the customers to be in financial difficulties. This category also includes formal restructuring such as partial write-offs associated with the debt adjustment scheme.

Group 3: Customers that have been identified as in need of further restructuring. This includes customers that are more than 90 days past due and customers that are currently in or are waiting for formal restructuring.

Group 4: Customers in legal collection or liquidation.

Note that this categorisation tracks the progress of the Bank's restructuring framework, but does not always indicate that the restructuring is fully completed. For example, it is possible that a customer currently in group 1 will later apply for general offers such as principal adjustment. Customers that have been restructured and are currently performing might still be placed in group 3 because of the nature of the solution or because documentation is not finalised.

Figures 16 and 17 show how the loan portfolio was divided into these four LPA groups every quarter in 2010. The first graph is for individuals and the second one for companies.

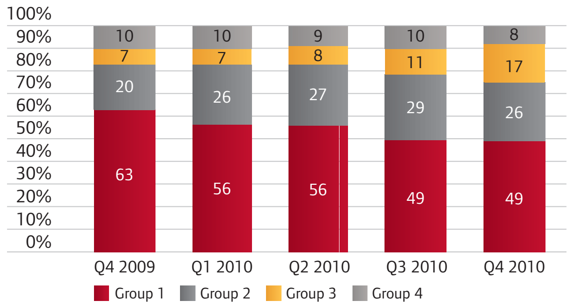

Figure 16: LPA for individuals, percentage of carrying amount. Parent, unaudited

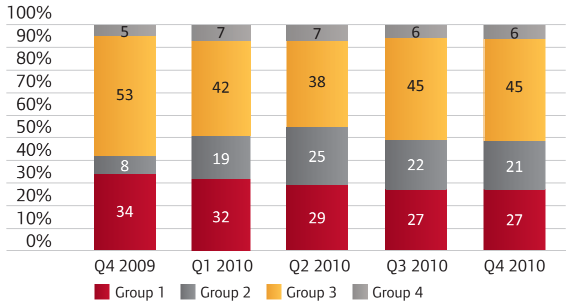

Figure 17: LPA for companies, percentage of carrying amount. Parent, unaudited

5 Market Risk

The financial market in Iceland has undergone substantial changes since the fall of the three largest banks in 2008. This change has transformed capital markets activity in Iceland from a fairly developed equity, fixed income, currency and derivatives market to a world of capital controls and virtually non-existent equity market where the main focus is on government-backed fixed income securities.

Under the capital controls, the ISK appreciated by roughly 8% in 2010. At the same time, both indexed and non-indexed market rates decreased substantially in line with the Central Bank lowering its policy rate. Indexed rates decreased by up to 84 basis points, while non-indexed rates decreased by up to 512 basis points. The main equity index OMXI6, which comprises six companies in the Icelandic and Faroese markets, increased by 15% in 2010.

Market risk has been identified as one of the material risk factors in the Bank's operations. The Bank takes on market risk as part of its business strategy. Interest rates and mismatches between the value of assets and liabilities denominated in foreign currency account for the largest market risk factors in the Bank's activities. Other important market risk factors are inflation risk and price risk.

DEFINITION OF MARKET RISK

Íslandsbanki defines market risk as the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, including those that arise from factors such as interest rates, equity prices, commodity prices and foreign exchange rates.

One component of market risk is the specific risk, as opposed to systemic or general market risk, related to individual securities that are being traded, i.e. the risk of loss from an individual security's price changing for reasons other than general movements in market prices. Market risk concentrations are covered by concentration limits and monitoring of market risk exposures.

STRATEGY, ORGANISATION AND RESPONSIBILITY

The ultimate responsibility for managing market risk lies with the Board of Directors. The Board determines the market risk appetite for the Bank in the Bank's *Market Risk Policy*. The policy is reviewed annually and outlines the appetite statement and limits for the market risk for the whole Group. The roles and responsibilities of all relevant stakeholders are clearly defined in the *Market Risk Policy*. The objective of market risk management is to manage and control market risk exposures, while optimising the return on risk and ensuring that the market risk profile is in line with the Bank's appetite, as approved by the Board. The Bank's strategy is to have a modest market risk profile. This strategy is reflected in the overall market risk limit applied for the whole Group and is reported to the Board of Directors at least once a month.

ALCO supervises market risk. The committee decides on market risk limits for single units and portfolios that take on market risk in the Bank, based on the overall limit set by the Board. Risk Management is responsible for monitoring and reporting on the Bank's overall market risk position and compliance to limits. The business units and subsidiaries that have market risk related business operations are responsible for identifying, measuring, monitoring and reporting on the risk in their operations.

The Bank separates market risk exposures into two portfolios, trading and banking book (non-trading portfolio). Positions in the trading portfolio are undertaken mainly as part of the

Risk type	Description
Interest rate risk	Current or prospective risk to earnings or capital arising from adverse movements in interest rates. Main sources of interest rate risk are as follows: *Re-pricing risk:* Arising from differences between the timing of rate changes for assets and liabilities *Yield curve risk:* Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve) *Basis risk:* Arising from changing rate relationships among yield curves that affect the institution's activities *Optionality risk:* Arising from interest rate related options embedded in the institution's products
Inflation risk	The risk that earnings or capital may be negatively affected from the changes in the inflation level
Credit spread risk	The risk that earnings or capital may be negatively affected from movements in bond risk premium for an issuer
Currency risk	The risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or holding assets or liabilities in foreign currencies
Price risk	The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of debt instruments, equity instruments or commodity products
Trading liquidity risk	The risk that the Bank is unable to easily liquidate or offset particular position without moving market prices due to inadequate market depth or market disruption, thus negatively affecting the earnings or capital

Table 16: Main categories of market risk.

Bank's proprietary trading and the Bank's liquidity portfolio. The positions are managed through specific limits on risk factors, products and portfolios. Limits are also set to manage the concentration risk towards single issuers or instruments, as well as to manage trading liquidity risk which is significant in the current environment. The Bank is also exposed indirectly to market risk through customers' derivative positions. Those positions are however subject to strict margin requirements.

Banking book positions that contribute to the market risk are subject to various limits. Positions in the banking book are mainly assets and liabilities from the commercial and retail banking activities which contribute to the Bank's interest rate risk, inflation risk and currency risk exposures. All equity exposures in the banking book are included when managing the equity risk in the Bank. The main equity exposure in the Bank is in private equity that is categorised as non-trading and either held for sale (available for sale) or designated at fair value through profit and loss.

MEASUREMENT AND MONITORING

The Bank uses different tools to monitor and limit market risk exposures. These tools consist of conventional risk measures, such as notional amounts and sensitivity measures, which are subject to the limit hierarchy used to manage market risk. The Bank also uses stress tests to simulate the effects on the portfolios from extreme but plausible market events and Value at Risk (VaR) measures for selected portfolios. These tools are used as complementary information to notional limits and sensitivity measures but are not subject to the limit structure for market risk.

Limit Structure

The Board has defined the market risk appetite of the Bank relative to the Bank's Tier 1 equity. Given predetermined shift in risk factors, the amount at risk should be between 10% and 20% of the equity. All market risk limits are set by ALCO and must be in accordance with the appetite defined by the Board. Each risk type then has its own set of limits that Risk Management proposes and monitors. The main limits are:

- Interest rate risk: End-of-day BPV, intraday BPV, total long and short position in underlying securities, open delta position in underlying securities, duration of underlying securities
- Currency risk: Total open spot position per currency, total notional in underlying derivatives
- Equity risk: Total position in equities

Monitoring

Monitoring of limits and margin requirements performed by Risk Management follow a predefined process. All breaches are reported to ALCO, which decides on appropriate actions, depending on the severity of the breach.

MARKET RISK EXPOSURE

The sensitivities for each risk factor are outlined in Table 18. They demonstrate what the Bank considers to be reasonably possible and severe. The shift factors are estimated by studying historical figures combined with the Bank's own estimates of possible future movements. The table shows the effects each stressed risk factor would have had on the Bank's profit and loss and equity had the maximum position over the year been hit.

Risk factor	Adverse change in risk factor	Effect on profit before tax in 2010	Effect on profit before tax in 2009
Interest rate risk	100 bp	1,470	1,983
Exchange rate risk	10%	5,002	4,309
Price risk	20%	1,070	1,700

Table 18: Risk factor sensitivity (ISK m). Consolidated, unaudited.

Interest Rate Risk

To manage interest rate risk the Bank uses sensitivity measures like basis point value (BPV). The BPV measures the effect of a 0.01% parallel upward shift in the yield curve on the market value of the underlying position. Thus a BPV of ISK 1 million means that a 0.01% parallel upward shift in the yield curve would result in a reduction of ISK 1 million in the market value of the underlying asset.

Interest Rate Risk in the Trading Portfolio

The bond trading book is divided into three portfolios: Market Making, Proprietary Trading and Liquidity Portfolio.

	2010			2009		
Exposure	Maximum	Minimum	Average	Maximum	Minimum	Average
Equity risk (trading, net position)	275	-25	39	3,556	-3	1,258
Equity risk (banking book, net position)	5,076	1,484	2,467	4,946	688	2,292
Interest rate risk (100 bp parallel shift, trading)	712	1	288	705	14	244
Interest rate risk (100 bp adverse shift, banking book)	758	390	574	1,278	344	816
Inflation risk (net position)	29,319	17,043	23,372	97,038	26,770	62,075
FX risk (net position)	50,023	759	42,431	43,093	29,972	37,565
Derivatives (MV)	429	-134	148	0	0	0

Table 17: Market risk exposure (ISK m). Consolidated, unaudited.

The Bank acts as a market maker of treasury bonds and government guaranteed bonds issued by the Housing Financing Fund (HFF) as well as bonds issued by Municipality Credit Iceland Plc. (LS) and Reykjavík City. The role of a market maker is to enhance price formation in the secondary market and to be a provider of liquidity.

The aim of Proprietary Trading is to make a profit from short-term fluctuations in both index-linked and non-index linked bonds. Since October 2008, the market for corporate bonds has been virtually non-existent. As a result, Proprietary Trading invests mainly in highly liquid government bonds and HFF bonds, but significantly less in municipal bonds. Government bonds can be either non-index linked or linked to the Icelandic Consumer Price Index (CPI). Duration ranges up to nine for non-indexed bonds, while the CPI-linked HFF bonds have a duration of up to 13 years.

At the end of 2010, the BPV for the indexed and non-indexed bonds was ISK -1.38 million and ISK -1.87 million, respectively. This means that a 0.01% parallel upward (downward) shift in the yield curve will decrease (increase) the value of the indexed and non-indexed bonds by approximately ISK 1.38 million and ISK 1.87 million, respectively, or ISK 3.24 million in total. All bond trading positions are subject to BPV limits, both intraday and end-of-day limits. In addition to BPV limits, both short and long positions in the underlying are limited.

Inflation risk in the trading book is minimal and is not separately reported. It is included in the Bank's total exposure to the CPI.

The maximum total position in the trading portfolio over the year was ISK 43.9 billion (2009: ISK 33.5 billion) whereof the largest position in indexed securities was ISK 4.7 billion (2009: ISK 3.5 billion) and the largest position in non-indexed securities was ISK 43.5 billion (2009: ISK 31 billion).

The trading book also includes bond options and interest rate swaps. Bond options and interest rate swaps are subject to BPV limits. Additionally the bond options are subject to net delta limits.

The Bank also holds a significant amount of foreign triple-A credit rated government bills in its liquidity portfolio. These bills are held for cash management purposes and can be liquidated with a short notice. Duration ranges up to six months and the sensitivity measured in BPV is ISK 0.6 million.

For the sensitivity analysis in the trading portfolio, the Bank estimates a possible but reasonable shift in interest rates. Table 21 demonstrates sensitivity to the change in interest rates, with all other variables held constant.

		2010			2009	
Long positions	**MV**	**Duration**	**BPV**	**MV**	**Duration**	**BPV**
Indexed	2,124	9.01	-1.91	2,800	6.51	-1.82
Non-indexed	34,078	0.86	-2.92	33,471	0.83	-2.78
Total	36,202	1.33	-4.83	36,271	1.27	-4.61
Short positions						
Indexed	1,129	4.74	0.54	2,707	5.27	1.43
Non-indexed	7,961	1.32	1.05	4,625	1.12	0.52
Total	9,090	1.75	1.59	7,332	2.65	1.95
Net position	27,112	1.20	-3.24	28,939	0.92	-2.66

Table 19: Bonds and debt instruments in the trading portfolio (ISK m). Consolidated, audited.

	2010		2009	
Country	**MV**	**BPV**	**MV**	**BPV**
Canada	0	0.00	3,570	-0.03
France	5,380	-0.06	0	0.00
Germany	3,844	-0.04	0	0.00
Netherlands	5,379	-0.10	0	0.00
Norway	1,953	-0.06	6,458	-0.21
UK	3,473	-0.02	9,066	-0.19
USA	10,695	-0.34	10,489	-0.24
Total	**30,724**	**-0.62**	**29,583**	**-0.67**

Table 20: Origin of government issued bills in the Bank's trading portfolio (ISK m). Consolidated, audited.

Currency	Parallel upward shift in yield curve (basis points)	2010 Profit or loss	2009 Profit or loss
ISK, indexed	100	-138	-40
ISK, non-indexed	100	-125	-158
CHF	40	0	0
EUR	20	-4	0
GBP	40	-1	-8
JPY	20	0	0
USD	40	-13	-9
Other	40	-3	-9
Total		**-284**	**-224**

Table 21: Sensitivity analysis for bonds and debt instruments in the trading portfolio (ISK m). Consolidated, audited.

Interest Rate Risk in the Banking Book

Interest rate risk in the banking book arises from the Bank's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as market rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Bank holds government bonds designated at fair value related to the equity contribution from the Icelandic state of ISK 30.3 billion (2009: ISK 30.4 billion). The bonds pay floating rates and they carry relatively low interest rate risk.

The Bank's main source of interest rate risk in the banking book are fixed rate mortgage loans, covered bond debt, loans in the mortgage payment adjustment scheme and fixed term deposits.

Of special concern are loans in the government mortgage payment adjustment scheme whose cash flows follow the index for mortgage payment adjustment. This is an option for retail clients to lower their payment burden. The solution is aimed at CPI-linked ISK loans. The payment evolves according to the payment index instead of the consumer price index. The payment index is composed of employment and wage index. This increases the interest rate risk of the loan portfolio because contractual payments change according to an index that cannot be fully matched on the liability side. At the end-of 2010, 56% of individuals' CPI-linked mortgages were in the payment index scheme.

As a result of the Supreme Court ruling deeming some of the Bank's foreign currency loans unlawfully linked to foreign currencies, a part of the leasing portfolio has been converted to non–indexed ISK loans that carry the lowest non-indexed rate published by the Central Bank. This Central Bank rate is the lowest of the Icelandic banks' public rates, which are usually rates on highly collateralised mortgage debt. In 2011, loans carrying this interest rate will increase, since loans in the mortgage portfolio will be converted from foreign currency to ISK upon the customer's request. This increases the interest risk in the banking book since the dynamics of the interest rate applicable are not easely predictable as they reflect the minimum rate acquired from different sources at any given time.

Risk Management is responsible for measuring, monitoring and reporting on the Bank's interest rate risk in the banking book. The Treasury unit is responsible for managing the Bank's interest rate risk within limits set by ALCO. The management of interest rate risk in the banking book is supplemented by monitoring the sensitivity of the Bank's financial assets, financial liabilities and earnings to changes in the underlying interest rates. Standard scenarios include an adverse 100 basis point parallel shift in all yield curves.

Assets	0–3 months	3–12 months	1–2 years	2–5 years	5–10 years	Over 10 years	Total
Cash and balances with Central Bank	28,966	0	0	0	0	0	28,966
Bonds and debt instruments	31,142	659	0	0	0	22	31,823
Loans to credit institutions	30,520	350	0	0	0	0	30,870
Loan to customers	389,088	37,855	9,481	60,557	2,572	15,607	515,161
Total	479,716	38,864	9,481	60,557	2,572	15,629	606,820
Off-balance sheet items	47,903	0	0	0	0	0	47,903
Liabilities							
Deposits from Central Bank	26	0	0	0	0	0	26
Deposits from credit institutions	86,856	1,037	8,319	0	0	0	96,212
Deposits from customers	322,274	2,521	0	1,420	943	0	327,158
Debt issued and other borrowed funds	432	0	0	808	52,639	1,546	55,425
Subordinated loans	21,241	0	0	0	0	0	21,241
Total	430,829	3,558	8,319	2,228	53,582	1,546	500,062
Off-balance sheet items	48,216	0	0	0	0	120	48,336
Net interest gap on 31 December 2010	48,575	35,306	1,162	58,329	(51,010)	13,963	106,326

Table 22: Interest rate adjustment periods in the banking book at year-end 2010 (ISK m). Consolidated, audited.

Assets	0–3 months	3–12 months	1–2 years	2–5 years	5–10 years	Over 10 years	Total
Cash and balances with Central Bank	36,901	0	0	0	0	0	36,901
Bonds and debt instruments	30,430	0	0	0	0	0	30,430
Loans to credit institutions	84,493	2,892	0	0	0	31	87,416
Loans to customers	380,548	61,985	17,129	7,973	3,494	18,482	489,611
Total	532,371	64,877	17,129	7,973	3,494	18,513	644,357
Liabilities							
Deposits from Central Bank	28	0	0	0	0	0	28
Deposits from credit institutions	132,091	0	0	6,973	0	0	139,064
Deposits from customers	339,659	0	0	0	0	0	339,659
Debt issued and other borrowed funds	5,210	0	0	649	56,828	0	62,687
Subordinated loans	24,843	0	0	0	0	0	24,843
Total	501,831	0	0	7,622	56,828	0	566,281
Net interest gap on 31 December 2009	30,541	64,877	17,129	351	(53,334)	18,513	78,077

Table 23: Interest rate adjustment periods in the banking book at year-end 2009 (ISK m). Consolidated, audited.

Interest risk in the banking book is managed using limits based on the Bank's market risk appetite. Currencies are divided into three groups and given weights based on historical interest rate volatilities in the respective currencies. These weights are used to scale the possible parallel shift of the yield curves. The limit for the impact of the weighted parallel shift of yield curves is set as 1% of Tier 1 equity. In the following tables all interest bearing assets and liabilities are bucketed into a maturity ladder. Variable rate instruments are grouped based on the next interest adjustment date. Fixed rate instruments are grouped according to the residual term to maturity. Sensitivity calculations are however based on the duration of the underlying assets and liabilities.

For sensitivity analysis in the banking book a 100 bps shift in ISK, non-indexed, interest rates is considered reasonable. Shifts in other currencies are chosen using the same scaling factors as in the trading portfolio. Index-linked ISK rate shifts are also scaled down since on longer time scales a significantly stronger mean reversion is exhibited than for non-indexed rates. This reduces the interest rate risk in long-term positions. Table 24 shows the net fair value impact of the applied shifts on the Bank's assets and liabilities using a duration approach.

Currency	**Parallel upward shift in yield curve (basis points)**	**2010 Fair value impact**	**2009 Fair value impact**
ISK, indexed	40	-684	-519
ISK, non-indexed	100	62	172
CHF	40	-5	-3
EUR	20	3	3
GBP	40	0	1
JPY	20	-2	-2
USD	40	1	-1
Other	40	1	-1
Total		**-624**	**-349**

Table 24: Sensitivity analysis for bonds and debt instruments in the banking book (ISK m). Consolidated, audited.

Currency Risk

Currency risk arises when financial instruments are not denominated in the reporting currency, especially if there is a mismatch in the currency denomination of assets and liabilities. Near year-end, the Bank narrowed the currency imbalance between its assets and liabilities significantly by entering into a currency interest rate swap. This brought the imbalance down to ISK 759 million (2009: ISK 38.9 billion). Although this reduced the currency risk against ISK significantly, the Bank was still subjected to some currency risk due to a mismatch between other currencies in Q1 2011. As a part of the Bank's policy to minimise currency risk, the Bank closed these mismatches in Q1 2011 with a cross currency swap. Over the past couple of years, the ISK has been subject to capital controls that have substantially reduced trading volume and volatility for the ISK against foreign currencies. The figure below shows the distribution of daily returns in EUR/ISK and EUR/USD. It is the Bank's view that the volatility in EUR/ISK will increase after the removal of the capital controls. The Bank is well prepared for this change as it now has minor currency risk.

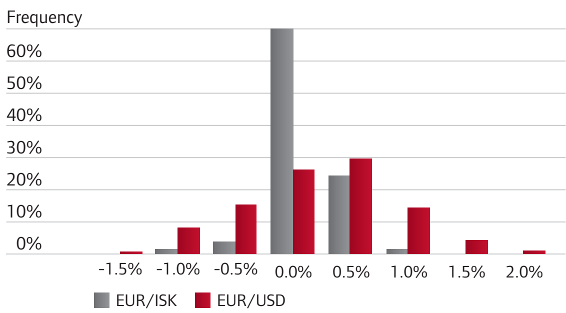

Figure 18: Distribution of daily changes of the EUR/ISK and EUR/USD crosses in 2010. Consolidated, unaudited.

2010	Held for trading	Designated at fair value	Non-current assets and disposal groups held for sale	Total
Listed	411	51	0	462
Unlisted	0	2,560	0	2,560
Total	**411**	**2,611**	**0**	**3,022**
2009				
Listed	477	63	0	540
Unlisted		1,710	0	1,710
Total	**477**	**1,773**	**0**	**2,250**

Table 25: Shares and equity instruments at year-end 2010 and 2009 (ISK m). Consolidated, audited.

Shares and Equity Instruments

The Bank's equity exposure arises from proprietary trading, market making and investment activities, mainly in ISK denominated shares. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the equity risk and concentration risk in the Bank's portfolio.

The Bank has a well defined strategy outlined in the *Market Risk Policy* for investments in shares and equity instruments. The Bank has established an asset management and holding company, Midengi, a subsidiary of the Bank, for the purpose of managing and selling assets the Bank has acquired through the restructuring process. The price risk of the subsidiary's underlying assets is included in the sensitivity analysis.

Sensitivity

For sensitivity analysis the Bank uses a 20% decrease in equity prices for the trading portfolio and a 40% decrease for the banking book.

Portfolio	Drop in equity prices	2010 Profit or loss	2009 Profit or loss
Trading	20%	-85	-95
Banking book	40%	-1,045	-709
Total		**-1,130**	**-805**

Table 26: Sensitivity analysis for equities (ISK m). Consolidated, audited.

Other Risk

Derivatives

The Bank offers interest rate swaps (IRS), bond options, foreign exchange currency options (FX options), foreign exchange swaps (FX swaps), outright forwards (FX forwards) and repurchase agreements (REPOs) either for customers' speculative or hedging purposes. All derivative positions that carry market risk are subject to market risk limits. Interest rate swaps are limited with BPV and maturity limits. FX swaps and FX forwards are subject to notional limits dependent on the underlying currency. Bond options are subject to several limits, including a limit on total notional underlying and an open delta position per underlying instrument. REPOs are also subject to several limits, including total market value of underlying instruments.

The Bank, itself, uses derivatives to hedge out currency exposure. The Bank carries relatively low indirect exposure risk as it holds collateral for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

Inflation

The Bank, itself, is exposed to inflation in Iceland since assets linked to the Consumer Price Index (CPI) exceed liabilities linked to the CPI. The carrying amount of all indexed assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI affect the Bank's profit and loss. The mismatch between the CPI-indexed assets and liabilities is reported to ALCO and is subject to a limit decided by the committee. On 31 December 2010 the CPI gap amounted to ISK 25 billion (2009: ISK 27 billion). Thus a 1% increase in the index would have a positive impact on the profit and loss account to the amount of ISK 250 million and a 1% decrease would result in a similar loss, all other factors held constant.

USE OF MODELS

The Bank uses conventional risk measurements to measure market risk exposures. The Bank also uses Value at Risk methods for the following purposes:

- In-house regular reporting of currency risk
- Margin requirement calculations, for derivative counterparties
- Capital calculations for counterparty risk
- Determination of trading limits

CAPITAL REQUIREMENTS

The Bank calculates its capital requirements for market risk using the standardised approach according to the Capital Requirements Directive (CRD).

Table 27 shows the capital requirements for market risk at Íslandsbanki at the end of 2010 and 2009. The capital requirement for currency risk decreases substantially between years as the foreign exchange non-trading position has been significantly reduced by the aforementioned swap agreement.

Capital Requirements for Market Risk at Group level

	2010		2009	
Risk exposure	**Capital requirements**	**RWA**	**Capital requirements**	**RWA**
Interest rate risk	274	3,429	234	2,924
Equity risk	92	1,154	22	271
Foreign exhange risk	815	10,183	3,114	38,922
Commodity risk	0	0	0	0
Total	**1,181**	**14,766**	**3,369**	**42,117**

Table 27: Capital requirements and risk weighted assets (RWA) for market risk (ISK m). Consolidated, audited.

Stress Testing

As a part of the ICAAP process, the Bank runs stress tests on both its trading and banking books in order to quantify the effect that severe changes in micro- and macroeconomic factors might have on the Bank's income statement and equity. These two portfolios are handled differently due to their inherent differences. The following risk factors are simulated on a forward looking basis:

- Equities: All shares owned by the Bank
- Interest rate risk: All market bonds as well as interest rate risk in the banking book
- Foreign exchange risk: The Bank's currency imbalance
- Inflation risk: The Bank's inflation imbalance
- Direct market risk through derivatives: For example, bond options, FX options, interest rate swaps and currency interest rate swaps carry direct market risk
- Indirect market risk through derivatives: Credit losses can occur in the case of severe market movements and insufficient collateral

6 Liquidity Risk

Liquidity risk is considered a material risk factor in the Bank's operations. Since the financial crisis in 2008, banks have put increased emphasis on improving their liquidity risk management. Liquidity risk has also been the focal point of regulatory changes, both domestically and internationally. Íslandsbanki aims to comply with international best practice in its management of liquidity risk. As a result, the Bank's liquidity risk framework has been revised to prepare for recent and upcoming regulatory changes, including the new Basel III rules.[7]

DEFINITION OF LIQUIDITY RISK

Íslandsbanki defines liquidity risk as the risk of not being able to fund its planned growth or its financial obligations as they come due, or of only being able to do so substantially above the prevailing market cost of funds.

FUNDING AND LIQUIDITY IN 2010

Deposit Development

The funding environment for Íslandsbanki has been characterised by the extensive deposit guarantee given by the Icelandic government following the collapse of the three largest Icelandic banks in the fall of 2008. Throughout 2010, investors in Iceland continued to direct the majority of their investments to deposits and government papers.

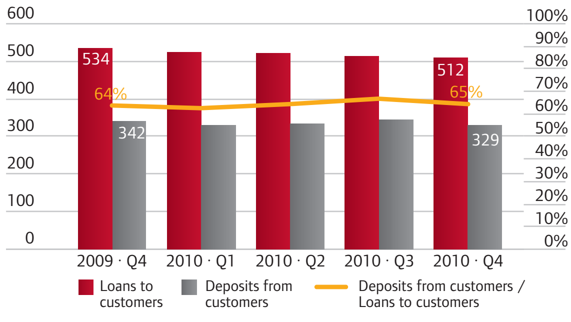

Figure 19: Development of deposits to customers and loans to customers (ISK bn)[8]. Parent, unaudited.

Deposits remain Íslandsbanki's main funding source and one of the metrics that is constantly monitored is the deposit to loan ratio. The ratio can be defined in at least two ways:

1. Total deposits against total loans. This definition of the ratio includes all deposits and all loans on the Bank's balance sheet, irrespective of the counterparty, including transactions between banks.
2. Customer deposits against loans to customers. This definition of the ratio excludes deposits from other financial institutions as well as lending to financial institutions.

The former ratio, total deposits against total loans, was 79% at the end of 2010 as compared to 85% at the end of 2009. The latter ratio, customer deposits against loans to customers, remained fairly stable, and was just under 65% at the end of 2010, as compared to 64% at the end of 2009.

The main factor contributing to the drop in the total deposit ratio is an 11% contraction in total deposits which is in line with the development in the market in general. At the same time, deposits from customers decreased by 4%, from ISK 342 billion to ISK 329 billion. According to figures published by the Central Bank of Iceland total deposits in the Icelandic banking system decreased from ISK 1,581 billion to ISK 1,414 billion, or 11% throughout 2010. However, the effect of decreasing deposits on the Bank's total deposit ratio is offset by the fact that total lending decreased by 6% over the same period.

Íslandsbanki emphasis on managing its deposits towards reduced concentration. This is reflected in internal liquidity measures where a special concentration charge is applied to account for the possible outflow of single large depositors.

The Bank's deposits have been categorised into six different groups, based on the classification of the Basel III liquidity risk standards. The groups are listed below in decreasing order of estimated stability. The defining criteria for the groups are as follows:

Deposit class	Criteria
Retail individuals, stable	Individuals with total deposits less than EUR 100,000
Small business, stable	Legal entities with total deposits less than EUR 100,000 other than specially categorised in the group non-financial corporate and other legal entities
Retail individuals, less stable	Individuals with total deposits greater than EUR 100,000
Small business, less stable	Legal entities with total deposits greater than EUR 100,000 and less than EUR 1,000,000 other than specially categorised in the group non-financial corporate and other legal entities
Non-financial, corporates	Legal entities with total deposits greater than EUR 1,000,000 as well as sovereign, central bank and public sector entities
Other legal entities	Financial institutions, insurance companies, fiduciaries, beneficiaries and special purpose vehicles

Table 28: Basel III criteria for deposit categorisation.

Figure 20 shows a breakdown of the Bank's total deposits totalling ISK 430 billion at year-end 2010, according to the Basel III definitions in Table 28. The last category, other legal entities, is further broken down into fiduciaries, domestic financial institutions, foreign financial institutions and other.

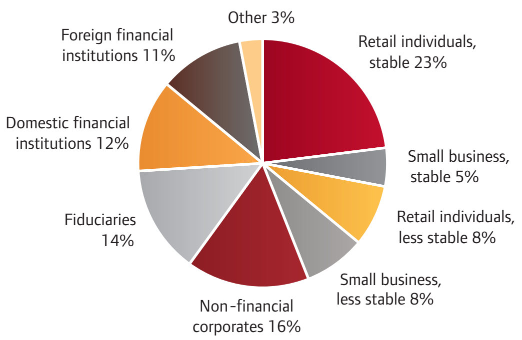

Figure 20: Total deposits of ISK 430 bn, breakdown by counterparty type year-end 2010. Parent, unaudited.

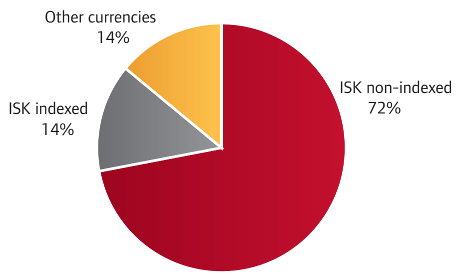

Figure 21: Total deposits of ISK 430 bn, currency composition year-end 2010. Parent, unaudited.

Liquidity Position

Íslandsbanki has maintained a good liquidity position throughout 2010 and all regulatory and internal metrics have been well above limits.

Short-term Outlook

The outlook for 2011 is positive regarding liquidity. There is continuing strong inflow from loan repayments, especially in the seafood portfolio, while demand for new lending is somewhat limited due to, among other factors, the excess leverage of the Icelandic financial system. In order to diversify its funding sources and prepare for investors moving away from deposits as their primary investment instrument, the Bank plans to start issuing bonds and commercial papers in the domestic market in 2011. The Bank is not reliant on access to foreign funding in the short-term and is not expecting any issuance in international markets in 2011. However, any international issuance by the Icelandic government and a government rating upgrade would enhance the ability of the Icelandic banks to raise funds abroad.

One of the main uncertainties regarding liquidity relates to the lifting of the capital controls. The Bank is well prepared to meet short-term outflow of funds but successful implementation of removing the controls is vital for the health and stability of the financial system. Íslandsbanki expects the Central Bank to work in close co-operation with the Icelandic banks on the removal of the capital controls.

Medium-term Outlook

Over the next couple of years, demand for bonds, especially secured debt, is expected to increase and bond issuance to become a larger part of the Bank's funding, resulting in a lower deposit to loan ratios.

Figure 22 shows the development of total deposits and lending in the Icelandic banking system since January 2004. The yellow line shows the resulting deposit-to-loan ratio for the system over the period. From 2004 until late 2008, lending growth outpaced growth in deposits resulting in a significant drop in deposit-to-loan ratios. After the collapse of the Icelandic banking system late in 2008, the value of the banks' loan portfolios almost halved, although deposits increased in the wake of the declaration of full the deposit guarantee given by the Icelandic government. As a result, current deposit-to-loan ratios are high in historical perspective.

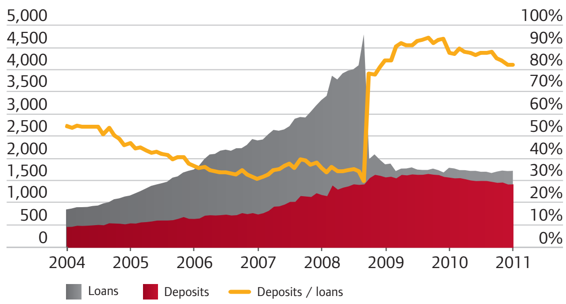

Figure 22: Deposits and lending in the Icelandic banking system (ISK bn). Source: Central Bank of Iceland.

In the medium-term, investors are expected to move away from deposits again, leaving deposit-to-loan ratios at similar levels as in 2004, or in the 50%-60% range. However, this development is highly dependent on the recovery of the Icelandic securities market, removal of the capital controls and changes in the depositors' insurance scheme.

It should be noted that the figures presented for the system include transactions between the banks themselves. When transactions between the banks are excluded, as in Figure 22 showing the development of Íslandsbanki's deposit-to-loan ratios, the ratios are generally lower. For example, at year-end 2009 Íslandsbanki's "total deposits to total loans" ratio was 85%, as compared to "deposits from customers to loans to customers" ratio of 64%. At year-end 2010 these ratios were 79% and 65%, respectively.

STRATEGY, ORGANISATION AND RESPONSIBILITY

The Bank strives to take a conservative and prudent approach to managing liquidity risk and its liquidity strategy assumes that the Bank can sustain a prolonged period of stress. This strategy is fulfilled by ensuring that the Bank:

- Has back-up liquidity sources to meet all maturing liabilities for at least 12 months without access to the funding markets – i.e. under severely stressed market conditions

- Maintains a prudent balance between the maturity of assets and liabilities

- Enforces a prudent amortisation profile on its portfolio of loans to customers in order to reduce the refunding risk of both the Bank's customers and the Bank itself

- Has clear limits with respect to liquidity risk in the main operating currencies and fulfils external limits on liquidity at all times

- Has in place well defined liquidity risk stages and a contingency plan that details the management actions for each stage

The ultimate responsibility for Íslandsbanki's liquidity risk management lies with the Board of Directors. The Board defines the Bank's risk appetite and issues the Bank's *Liquidity Risk Policy*, which is applicable at Group level.

ALCO is responsible for communicating the *Liquidity Risk Policy* to the business units and the subsidiaries and for ensuring its compliance. This is done through internal pricing, lending quotas or other limits as applicable.

The Interbank Desk is responsible for the day-to-day management of liquidity within the limits set by ALCO.

The Treasury is responsible for the Bank's funding and its long-term liquidity management. Treasury makes proposals to ALCO for internal pricing and lending quotas if applicable.

Risk Management is responsible for monitoring and reporting on the Bank's overall liquidity position and compliance to limits, both internally and externally. Risk Management also makes suggestions to ALCO and the Board of Directors on the liquidity risk appetite, limit structure and the liquidity risk management framework.

Measuring and Monitoring

Liquidity Measures

The Bank uses various metrics and measures, both static and forward looking, to assess and quantify its liquidity position and thereby its liquidity risk. The main measures are based on analysing the mismatch in cash flows from all assets and liabilities under normal and stressed business conditions, on assessing the balance between long-term assets and long-term funding sources, and assessing the ratio between the Bank's liquidity back-up and maturing liabilities. The assumptions for the internal liquidity measures are reviewed regularly.

To maintain the Bank's target of being able to meet all liabilities for at least 12 months without access to funding markets, Íslandsbanki has a portfolio of liquid assets as described above. This policy is in line with international guidelines such as those issued by the Bank for International Settlement (BIS) and guidelines from the Icelandic Financial Supervisory Authority (FME). The Interbank desk is responsible for the management of the Bank's liquidity portfolio. This includes managing an overview of assets that can be used as collateral for secure borrowing. The Interbank desk makes suggestions for the composition of the back up to ALCO and then manages the portfolio within the limits approved.

The classification of liquid assets and coverage requirements at Íslandsbanki is summarised in Table 29.

Based on the above classification and the Bank's assumptions for possible outflow of funds, the Bank monitors the ratio of liquid assets A, B and C against outflow under different scenarios.

	Immediately available assets	Other highly liquid assets	Other liquid assets
Liquidity class	A	B	C
Liquidation time	Up to 3 days	3 to 15 days	15 days to 6 months
Asset class and liquidity requirements	• Cash and cash equivalents • Collateral that can be used for secure borrowing at central banks within three days • Other highly liquid government bonds (0% risk weight under Basel, low volatility, official quotes) that cannot be used as collateral for borrowing under repurchase contracts but are considered highly liquid under stressed market conditions • Committed government credit facilities without MAC clauses	• Other collateral that can be used for borrowing under already established repurchase contracts	• Other unencumbered assets that can be liquidated within a few months but where the price and liquidation period is more uncertain

Table 29: Íslandsbanki's classification of liquid assets.

Liquidity Reporting

One of the first tasks after the establishment of Íslandsbanki in October 2008 was to make sure that the lessons from the liquidity crisis were reflected in the Bank's policies and processes. As part of this, much effort has been put into improving risk reporting. Each month, the Board of Directors receives a detailed Risk Dashboard, which covers all material risk factors in the Bank's operations, including liquidity risk. In addition to the Dashboard, Risk Management, Treasury and ALCO get daily reports from the Interbank desk on main changes in the Bank's liquidity position and every week the liquidity position is reported to the same internal parties in more detail.

Regulatory reports on the liquidity position are provided on a monthly basis as required by the Central Bank and the FME.

Liquidity Stress Testing

Currently the Bank has in place a simple but robust stress testing framework for liquidity. Specialists from Risk Management and Treasury are working on enhancing the stress testing methodology for liquidity risk.

Liquidity Contingency Plan

Íslandsbanki's *Liquidity Risk Policy* assumes that the Bank has in place a Liquidity Contingency Plan. The main purpose of the contingency plan is to identify liquidity or funding problems as early as possible and thereby improve the Bank's ability to respond to such situations. As a part of the liquidity contingency plan, the Bank has defined five liquidity stages reflecting different levels of severity. The liquidity stage is determined based on both predefined risk triggers and on qualitative assessment. For each stage, management and reporting actions have been defined and communicated to the respective parties, including the Board of Directors, the Central Bank and the FME.

Liquidity Position

Table 30 shows the composition of the Bank's liquidity backup at the end of 2010 and 2009. The ratio of liquid assets against maturing liabilities, as defined by internal requirements, remained above minimum levels throughout 2010.

Composition and amount of liquidity back-up	31.12. 2010	31.12. 2009
Cash and balances with central bank	30,799	38,743
Domestic bonds eligible as collateral against borrowing at the Central Bank	54,881	50,130
Foreign government bonds	30,378	29,584
Short-term placements with credit institutions	28,332	31,887
Government liquidity facility	25,000	25,000
	169,390	**175,344**

Table 30: Composition and amount of liquidity back-up (ISK m). Consolidated, audited.

In addition to these internal limits, the Bank is subject to liquidity requirements posed by the Central Bank of Iceland and the FME.

Central Bank Liquidity Ratios

The Central Bank liquidity requirements[9] stipulate that liquid assets, according to definitions provided by the Central Bank, shall cover maturing liabilities over one and three months. These rules apply to and are reported for the parent company. Figure 23 shows the development of the Central Bank liquidity ratios for Íslandsbanki in 2010.

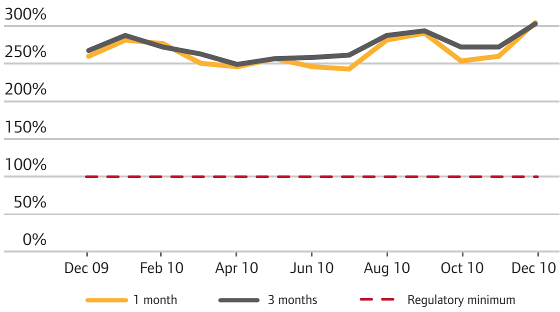

Figure 23: Central Bank liquidity ratios. Parent, unaudited.

FME Liquidity Ratios

The FME has introduced two liquidity measures that Icelandic banks are currently required to fulfil. The former requires banks to hold cash and cash like assets amounting to at least 5% of demand deposits and the latter to hold liquid assets amounting to at least 20% of all deposits. The FME's definitions for liquid assets are the following:

- Cash and cash-like assets: Notes, deposits with the Central Bank and other domestic and foreign financial institutions
- Liquid assets: Cash and cash-like assets, notes eligible for repurchase agreements with the Central Bank, foreign Government bonds, covered bonds and other highly liquid assets

Figure 24 shows the development of the FME liquidity ratios for Íslandsbanki in 2010.

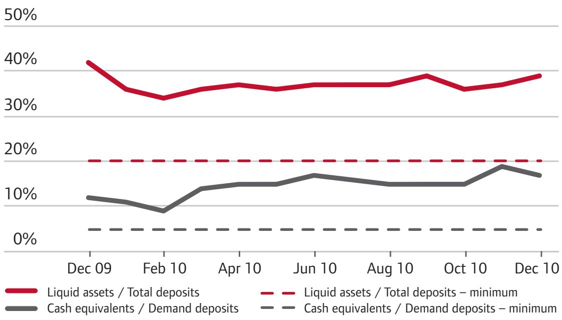

Figure 24: FME liquidity ratios. Parent, unaudited.

Liquidity Coverage Ratio and Net Stable Funding Ratio

In addition to the above regulatory liquidity requirements, the Bank for International Settlements (BIS) has issued new requirements in the document *International Framework for Liquidity Risk Measurement, Standards and Monitoring*, which introduces new regulatory standards for liquidity risk management. These new standards are focused on implementing common liquidity measures for all banks, i.e. the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). These standards are a part of the Basel III framework and will be implemented over the next seven years.

Íslandsbanki has set internal targets regarding these new liquidity measures and has started to report the LCR and NSFR ratios internally, based on the latest definitions published by the Basel Committee. The Basel III liquidity ratios have yet to be implemented into the Icelandic regulatory framework.

OTHER

Changes in the Depositors Insurance Fund and their impact on Íslandsbanki

Currently, there is considerable uncertainty about the changes in the legislation concerning the Icelandic Deposit Insurance Fund (TIF). The annual premium to be charged has not been decided and therefore it is difficult to assess the financial impact on the Bank and the Bank's ability to retrieve the costs through an increased interest margin. There is also uncertainty about the impact that the new legislation will have on customer behaviour, especially on the behaviour of customers whose deposits will be insured.

7) Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems, December 2010.

8) To make the figures on loans to customers comparable over the period, the exposure to a government secured customer amounting to approximately ISK 52 billion at the end of 2010 that which was previously classified under loans to credit institutions has been added to the 2009 figures at the carrying amount at that time.

9) http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713.

7 Operational Risk

Operational risk is inherent in all activities performed by Íslandsbanki. Operational risk differs from financial risk (e.g. credit risk and market risk) in that there is generally no financial gain in taking operational risks, whereas the costs of avoiding certain operational risks may outweigh the benefits. It may be financially prudent for the Bank to tolerate such risks, and the assessment of the costs and benefits should then rest with the relevant business unit.

The Bank has implemented an operational risk management framework within the parent company that fulfils the requirements for the standardised approach. This means that the Bank has catered for all three qualifying criteria[10)] below and will ensure that they are embedded into businesses as ongoing regular processes:

- Registration of all loss event data into a system
- Risk and Control Self Assessment (RCSA) throughout the Bank
- Management reporting that provides operational risk reports to relevant functions within the Bank

DEFINITION OF OPERATIONAL RISK

The Bank defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external threats."[11] This definition includes legal risk but excludes reputational risk and strategic risk.

STRATEGY, ORGANISATION AND RESPONSIBILITY

The Bank's operational risk strategy can be summarised by the following principles:

- Accept no unnecessary risk
- Accept risk when benefits outweigh the costs
- Mitigate unacceptable risks and prevent loss

The responsibility for Íslandsbanki's operational risk management lies with the Board of Directors. The Board of Directors approves the Bank's *Operational Risk Policy* which is applicable at Group level.

The Executive Board is responsible for making the necessary resources available to manage operational risk effectively throughout the Bank.

Risk Management is responsible for developing and maintaining the Bank's operational risk framework, as well as ensuring its consistent implementation across the Bank. Whereas Risk Management is the owner of the operational risk management framework and the central unit for monitoring, each business unit is primarily responsible for managing and controlling its own operational risk.

MEASUREMENT AND MONITORING

The Bank has implemented a framework to capture both actual and potential operational losses.

Operational loss events which result in losses of more than ISK 100,000 and incidents that could potentially cause substantial losses (near-misses) are collected through a web-based system and are registered into the Bank's database. This information is used to prevent similar incidents from happening again. Events in the database are categorised according to the Basel II event categories. The database holds all information on actual losses and provides a basis for management reports.

In 2010, 168 operational loss events were registered in the Bank. Failures in execution, delivery and process management accounted for 59% of the total loss amount in 2010. Included in that category was the year's single largest loss, which accounted for 25% of the total loss amount.

One of the notable operational risk events in 2010 was when part of the Bank's foreign currency loans were deemed unlawful. This incident, which originated in Glitnir, had limited impact on Íslandsbanki's financial results, since these loans were acquired at deep discount from Glitnir as described in Chapter 4. This event has been used to improve processes and review the products offered in order to avoid similar incidents in Íslandsbanki.

Figures 25 and 26 show the breakdown of loss events and amounts by Basel categories in 2010.

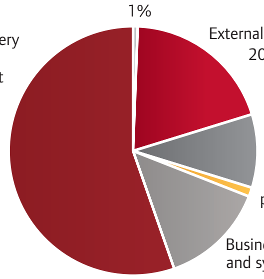

Figure 25: Breakdown of loss events by Basel II categories in 2010. Parent, unaudited.

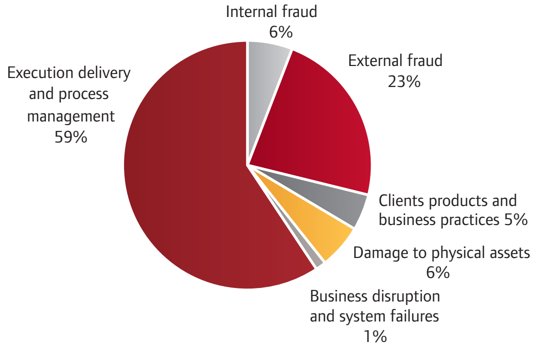

Figure 26: Breakdown of loss amounts by Basel II categories in 2010. Parent, unaudited.

One of the responsibilities of Risk Management is to ensure that all actual losses (and near misses) are registered in the operational risk database. A strong risk culture is important in achieving this goal. Risk Management is constantly seeking information about potential incidents and looking for ways to increase operational risk awareness among employees. As risk awareness increases within the Bank, fewer loss registrations are originated by Risk Management. In 2010, the vast majority of the loss registrations originated from the departments themselves.

In addition to the collection of actual losses, the Bank uses the RCSA process to identify and assess all potential risks. For all risks determined unacceptable, a mitigation plan is set up and assigned to a relevant person with a target completion date. This self-assessment process is undertaken at least once a year by all units within the Bank and the main findings and mitigation plans are reported to senior management and the business owners. The ultimate purpose of this framework is to improve the way the Bank operates through regular review of policies, processes and systems.

The Risk Management produces management reports intended to provide an overview of the Bank's operational risk profile to support or stimulate the management's decisions. The reports are based on registered operational losses and are submitted at least quarterly to the Board of Directors, the Executive Board and relevant business owners.

The event registration methodology has been extended for other purposes within the Bank, for example to improve data quality and efficiency and the accuracy of internal and external reporting.

CAPITAL REQUIREMENT

Íslandsbanki uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for operational risks.

Under the Basic Indicator Approach the capital requirement for operational risk is equal to 15% of the relevant indicator. The relevant indicator is the average over three years of the sum of net interest income and net non-interest income. Given the short operating history of Íslandsbanki, figures from 2009 and 2010 are currently used for calculating the minimum capital for operational risk in 2010.

The total capital requirement for operational risks in 2010 was ISK 6.3 billion.

LEGAL RISK

Legal risk is the potential loss that may occur to an investment as a result of insufficient, improperly applied, or simply unfavourable legal proceedings in the country in which the investment is made. Legal risk is defined as part of operational risk and managed as such. There are various legal issues that the Bank faces that can significantly impact the Bank's financial and reputational standing. Some of the issues are listed below.

Loans in foreign currencies have been challenged before Icelandic courts. The outcome can have a significant impact of the recovery of the Bank on such claims. The result of the challenges is not expected to have a negative impact on the Bank's capital, however, since the deep discount of the portfolio acquired from Glitnir is expected to cover the possible impact.

A number of other legal issues, e.g. regarding litigation threats, netting agreement, allocation of liens, guarantees and comparable rights are being pursued that can affect the Bank's recovery, and are in some way related to the circumstances leading to the establishment of Íslandsbanki in late 2008.

The Bank is actively reviewing contract documentation in order to mitigate possible further litigation cases of significance to the Bank. Should a significant financial implication become likely from legal proceedings, the Bank will address such issues immediately and report to the Board of Directors and if relevant through the financial accounts.

The Legitimacy of Foreign Currency Loans

As previously stated, the Supreme Court has published rulings confirming that the indexation of loans to foreign currencies is illegal. In the case of loans containing such a non-binding indexation, the loans must be recalculated based on the lowest rates published by the Central Bank for the respective period. These rulings have substantially decreased the uncertainty related to the Bank's foreign currency loan portfolio.

Even if there is still some uncertainty with respect to which loan contracts are deemed to contain a non-binding indexation, the reference to the lowest Central Bank rate for settling the respective contracts limits the downside for the Bank.

Íslandsbanki, in co-operation with the FME, has made a thorough assessment of the impact of different outcomes from the ruling of its foreign currency loan portfolio. Given that the Central Bank rates will be used for settling the loan contracts deemed illegal, the result is not expected to have a negative impact on the Bank's capital since the Bank considers the impact within the current impairment allowances.

Litigation Threats

Several former customers of Glitnir private banking services have threatened litigation against the Bank in order to claim compensation for alleged mistakes made by Glitnir's employees. A few of those customers have already filed lawsuits against the Bank with the Reykjavík District Court. The Bank has not accepted any liability and will challenge the lawsuits on the grounds that these claims relate to events that happened prior to the incorporation of the Bank and the assignment of certain liabilities and assets on 15 October 2008 and therefore are not the responsibility of the Bank in any way. The District Court of Reykjavík has now ruled in favour of the Bank in the case of Hrafninn ehf. vs. Íslandsbanki, stating that the Bank cannot be held responsible for Glitnir employees' mistakes. This ruling may be appealed.

Netting Agreement

When certain assets and obligations were transferred from Glitnir to Íslandsbanki, the FME ruled that customers would, upon the liquidation of Glitnir, maintain their right to claim netting of assets and liabilities held by Glitnir prior to acquisition on 15 October 2008. As a result, the Bank anticipates that it may have to write off those assets netted against liabilities in Glitnir.

The Bank has made an agreement with Glitnir that the latter will compensate the Bank for losses that may result from the netting of assets and liabilities. The claims in question are priority claims on the liquidated assets of Glitnir and the netting exercise is unlikely to affect either the net asset value or the earnings of the Bank.

Allocation of Liens, Guarantees and Comparable Rights

When certain assets and obligations were transferred from Glitnir to the Bank, the FME ruled that the Bank would take over all rights used to secure the performance of obligations of the debtors of Glitnir, including all liens, guarantees and other comparable rights connected to the claims of the Bank.

The FME also ruled, however, that the Bank should be accountable to Glitnir for specific collateral of its customers, as applicable, due to claims and derivatives that were not transferred to the Bank. The Bank has, in accordance with this decision, transferred certain collateralised obligations of customers to Glitnir. One customer filed a lawsuit against the Bank with the Reykjavík District Court challenging the Bank's decision to transfer the customer's money market deposit to Glitnir, which the Bank, in good faith, identified as collateral for a foreign exchange future contract. The District Court ruled in favour of the Bank, although that ruling may still be subject to an appeal. Any future allocation of collateral will be made under an agreement with Glitnir, whereby Glitnir indemnifies the Bank against any future claims arising from the transfer of such rights.

Dispute over the Bank's Claim on Straumur's Assets

Following the takeover of Straumur-Burdarás Investment Bank hf. (Straumur) by the FME on 4 April 2009, the Bank assumed deposit obligations from Straumur. The Bank also provided Straumur with funds to meet obligations towards depositors in its Danish branch. As a payment, Straumur issued a bond guaranteed with a lien over nearly all of Straumur's assets. Deposits created in relation to settlement of prior debts were excluded.

The government committed to fund the Bank's liquidity needs in relation to the said obligations by lending government bonds to the Bank. If the Straumur bond is not fully paid by the end of the term of the bond, the Bank may hold the remaining government bonds without further obligation.

The Straumur Resolution Committee accepted and acknowledged the claim and the lien. However, some creditors of Straumur disputed the Bank's claim on the Straumur estate and the Resolution Committee filed the dispute with the Reykjavík District Court.

The creditors claimed that the Emergency Act passed on 6 October 2008, where deposits were moved up to priority ranking on bankruptcy, was unconstitutional and therefore illegal. The creditors claimed that the bond and lien should never have been issued and was therefore void and should not enjoy priority ranking.

An agreement has been reached with the creditors of Straumur regarding the Banks claim and implementation of the agreement is expected to be finalised in H1 2011. Under the agreement the creditors receive a partial payment and are given second ranking liens after the Bank, in turn the creditors will withdraw their claim. The Bank is expecting that Straumur will be able to repay the Bank in full.

Formal investigation by the EFTA Surveillance Authority (ESA) into state aid granted in the restoration of certain operations of Glitnir and the establishment and capitalisation of Íslandsbanki

The ESA decided to open formal investigations into the alleged state aid granted in October 2008 and autumn of 2009 to rescue the domestic operations of the three main Icelandic banks, Glitnir, Kaupthing and Landsbanki, and to establish and capitalise the new successor banks, now called Íslandsbanki, Arion and NBI (Landsbanki), respectively.

ESA claims that it should have been notified beforehand of the measures taken by the Icelandic government to restore certain operations of the old Icelandic banks and to establish and capitalise the new banks. The Icelandic authorities should also have submitted detailed restructuring plans outlining viable future for the banks without the need for future state support.

Other

- Investigations on behalf of public (such as those being conducted by the Special Prosecutor's office as well as the SIC report) and private parties (such as the resolution committee and the winding up board of Glitnir), may lead to litigation against some of the Bank's current employees. The Bank is actively assessing the potential financial and reputational implications for the Bank resulting from such cases.

- Agreement on personal guarantees and third-party mortgages: In order to enhance the effectiveness of prior general agreements on debt refinancing, there is pressure on banks and other financial institutions to reach an agreement on the processing of personal guarantees (co-signers) and third-party mortgages, e.g. where a third party has granted a pledge in his property for another individual.
- Bankruptcy law amendment: Parliament has changed the special statute of limitations in force when bankruptcy proceedings are concluded. Instead of 4–10 years, the statute of limitations will henceforth take effect two years from the formal closing of the bankrupt estate. Moreover, strict limitations will be enforced that limit the creditors' options of renewing a claim in order to reset the time limit.

10) Directive 2006/48/EC of the European Parliament and of the Council annex X part 2 paragraph 4.

11) Directive 2006/48/EC of the European Parliament and of the Council article 4 paragraph 12.

8 Concentration Risk

Concentration risk is the significantly increased risk of any type that is driven by common underlying factors, e.g. industry sector, economic factors, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes:

- Large individual exposures or liabilities to parties under common control.
- Significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Concentration risk is currently managed differently, depending on the source of concentration. Credit concentration risk is discussed in Chapter 4, market concentration risk is discussed in Chapter 5 and liquidity concentration risk in Chapter 6.

9 Significant Risks

The Bank has identified the following five risk types as significant but not material:

Business & Strategic Risk

Business risk is the risk that operating income decreases because of lower revenues or increase in costs not caused by one of the other risk types. Strategic risk is the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

The Bank's management continuously monitors changes in the business environment and the impact on the Bank's strategy and current activities. This is especially challenging in the current environment, since the financial crisis in Iceland has left the market wounded and trust between parties impaired.

Reputational Risk

Reputational risk is the current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution by customers, counterparties, shareholders/investors, or regulators. The Bank is experiencing increased reputational risk in the current environment. The perceived connection between Íslandsbanki and Glitnir causes increased reputational risk for Íslandsbanki since customers do not always distinguish between issues originating in Glitnir and those originating in the new Bank. To address that risk, internal procedures have been set up to minimise reputational risk. All larger projects in the Bank that are identified as posing reputational risk must have a special communication plan. The Bank has also implemented contingency plans to address reputational crises.

Settlement Risk

Settlement risk is the risk that a party will fail to deliver on the terms of a contract at the time of settlement. Settlement loss can occur because of default at settlement and because of any timing differences in settlement between two parties. The amount at risk or the potential loss is the principal of the transaction.

To mitigate settlement risk on individual counterparties, the Bank utilises the services of clearing houses and also applies the general rule of delivery vs. payment. If such a rule is not applicable due to the nature of the business relationship, a settlement limit is assigned to the counterparty to limit the risk. A future goal to mitigate foreign currency settlement risk is to participate in the global foreign currency clearing system CLS (Continuous Linked Settlement).

Settlement risk is currently not treated as a separate material risk type in the Bank. Capital requirements for settlement risk are covered as part of operational risk capital.

Political Risk

Political risk is the risk that a government will significantly alter its policies or other regulations so that it significantly affects one's investment or business. Political decisions can affect the Bank's operations in different ways. Some of the political issues that are being discussed or worked on and might affect the Bank are listed below.

The Bank's Operational Environment

The government has made many changes to the banking and corporate environment since the banking crisis hit Iceland in 2008. New regulations have been implemented, a new tax on banks has been put in place and the corporate income tax has been raised. New regulations or further tax increases can't be ruled out.

Changes in the Fishing Quota System

The current government has proposed ideas involving a gradual redemption of the fishing quota over a 20-year period. An independent study conducted by the University Of Akureyri (UNAK) indicates that this would have a severe negative effect on companies in the fisheries sector. Companies controlling 40–50% of the quota could become insolvent, which would lead to substantial losses for the Bank. The results from the UNAK study are broadly in line with Íslandsbanki's own assessment. Given the results from the study, the Bank believes it is not likely that the government proposal will go through Parliament unchanged, and the impact of the eventual legislation will be less than indicated above. However, the uncertainty regarding these matters negatively affects the industry and does not support the recovery of the Icelandic economy.

Changes to the Current Laws Governing the Geothermal Energy Sector

There has been much discussion about the geothermal sector in the Icelandic Parliament. The discussion mostly revolves around the maximum leasing time of the geothermal resources and possible restrictions on foreign ownership of the power plants. Restrictive actions taken by the government in this matter could affect the willingness of foreign entities to invest in the sector and in Iceland in general. As the geothermal sector is defined as one of the Bank's niches, any regulations regarding the sector are closely monitored and its impact on the Bank's business model is assessed accordingly.

Funding of Tax Credit for Interest Payment on Mortgages

The Icelandic government, financial institutions and pension funds have agreed to find ways to address the debt problems of Icelandic homeowners. To this end, a letter of intent was signed between the parties on 3 December 2010 with the aim of funding a new tax credit for interest payments on mortgages. The credit will amount to ISK 6 billion per year over a two-year period in 2011 and 2012. To date, the scale of the Bank's contribution has not been determined.

Changes in the Depositors Insurance Fund and the impact on Íslandsbanki

Currently, there is considerable uncertainty about the changes in the legislation concerning the Icelandic Deposit Insurance Fund (TIF). The annual premium to be charged has not been decided and it is therefore difficult to assess the financial impact on the Bank.

10 Pending Regulation Changes

International and domestic regulations of financial institutions are currently undergoing a period of significant change in response to the global financial crisis. The Icelandic economy has gone through a period of significant adjustments (see Chapter 1) and the domestic changes are part of initiatives taken to enhance the Icelandic financial regulatory framework. The main pending international and domestic regulations are presented below.

BASEL III

The Bank for International Settlements (BIS) develops global regulations for international banking; and the Basel Committee on Banking Supervision is a cooperative body organised under BIS.

The new international regulatory framework for banks[12], Basel III[13], has been developed to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. In December 2010, the Basel Committee issued the Basel III rules text along with a global implementation plan extending throughout 2018.

The main changes in the Basel III rules relate to stricter requirements for the level and quality of banks' capital base, a ceiling on banks' leverage and the introduction of new international measures for liquidity risk. Due to the strong capital position of Íslandsbanki and the fact that the Bank's capital is largely composed of share capital and retained earnings, the stricter capital requirements will not be restrictive to the Bank except for the general impact that such requirements have on banks' earnings and profitability. The leverage ratio is not expected to be restrictive to the current risk appetite of the Bank either.

However, the Basel III liquidity metrics, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), will require the Bank to make some adjustments to its funding structure and liquidity management. Even if the methodology behind these metrics is generally in line with the Bank's liquidity risk framework, the criterion is somewhat stricter than the Bank's internal requirements assume. It should be emphasised that the Icelandic regulator has not issued any guidelines on the implementation of the LCR and NSFR ratios in Iceland nor has it indicated whether there will be any discretionary rules or allowances made for Icelandic banks.

Íslandsbanki has set internal targets regarding compliance to the LCR and NSFR liquidity ratios and started to report those internally, based on the latest definitions published by the Basel committee.

REMUNERATION

In December 2010, the Basel Committee issued, for consultation, additional Pillar 3 requirements on remuneration. The proposed requirements are intended to make it easier for market participants to assess the quality of the compensation practices. In addition it will contribute to promote a greater convergence and consistency of disclosure on remuneration. CRD III has proposed that these requirements should be in force from 1 January 2011.

Currently there is no profit sharing programme in place at Íslandsbanki. The salaries and other benefits of the Bank's management and Board of Directors are disclosed in the Annual Report, according to IFRS standards. The Remuneration Committee of the Board is working on further developing the Bank's remuneration policy. This is being done in adherence to amendments of the Act on Financial Undertakings (75/2010) and rules imposed by the Icelandic Financial Supervisory Authority (FME).

Once approved and implemented, the Bank will disclose information on its remuneration strategy in the Risk Book.

ACT ON FINANCIAL UNDERTAKINGS

Changes have already been made to the Icelandic Act on Financial Undertakings, mostly to address recommendation made in the socalled Jännäri report on banking regulation and supervision.[14]

The main changes are as follows:

- The Financial Supervisory Authority (FME) gets authorisation to intervene in the operation of individual branches. This will in particular allow the regulator to impose restrictions if there are significant imbalances in the operations of the bank. An example of such an imbalance could presumably be significant deposit collection in a branch in one country to fund operations in another country.
- Stricter requirements are made on professional qualifications, financial status and financial record, e.g. for Board members, CEO and internal audit function. A new provision has been added to the effect that board members and CEO must not have been convicted for breach of certain laws, including competition laws and special laws that apply to parties subject to official supervision of financial activities, including the Act on Financial Undertakings. Employees of a financial institution, as well as certain external parties providing services to a financial institution, can not sit on the Board of the same institution.
- Various modifications regarding active shareholders, and disclosure of largest owners: A notification is needed to the FME if parties are expected to increase or decrease a qualifying holding in a financial undertaking. The FME will then have a limited period of time to submit comments on the acquisition. The conditions stipulate that the FME can make comments on, or reject the purchase. Although this is only a minor change from current rules, it will affect the FME in certain ways.
- Regular stress testing as a part of risk management: Such an arrangement is considered to give an earlier notice if significant risks are present.
- Monitoring of systemic risk: The centralised national credit register for overview of large exposures (greater than ISK 300 million) is held at the national level. The main purpose

of the register is to ensure that regulators, in this case the FME and the Central Bank, have a sufficient overview of the status of their banks' clients that are systemically important, or large, and that disruptions in their operations may have an impact beyond the business relationship and the financial undertaking.

- Rules regarding lending will be tightened. Stricter practices on large exposures and connected lending, as well as new requirements for connecting clients, are the fundamental changes. Financial institutions will be strictly prohibited from borrowing to purchase shares in the company if the collateral for the purchase are the same shares. With defined exceptions the Bank can not extend loans to related parties, including Board members and key managers. The exceptions allow such lending up to 1% of the Banks capital base, with strong guarantees. This provision seeks to ensure that board members, owners and key managers do not affect financial institutions in order to have more access to credit than others.

- The FME will write new rules regarding normal business practice, compensation and profit sharing schemes and sufficient guarantees.

- There will be stricter rules regarding activities other than those naturally linked to the authorised activities of commercial banks on a temporary basis and for the purpose of concluding transactions or re-organising the activities of customers.

- It is made explicit that the combined ownership of shares in a financial undertaking, by itself and its subsidiaries, may not exceed 10%. This amendment aims prevent circumvention of the previous limit of 10% ownership of own shares.

RULES ON CAPITAL REQUIREMENT AND RISK WEIGHTED ASSETS

The FME's rules on the *Capital Requirement and Risk Weighted Assets of Financial Undertakings* (No. 215 of 2 March 2007), and the Icelandic implementation of the Capital Requirements Directive CRD, will be updated in the near future. The draft of the changes has been circulated within the financial sector for discussion. Most of the changes concern further clarification of the rules and do not change the calculation of capital requirements within the Bank.

The article regarding capital requirements due to exposure to regional governments will be changed. Currently, the rules do not reflect the CRD, where the risk weight for regional governments is 20%. The changes will align the rules more with the directive where this kind of exposure in foreign currency will be risk weighted as exposures to institutions. This implies a 100% risk weight under current circumstances.

The effect for Íslandsbanki's capital requirement is an increase of ISK 85 million and marginal decrease in capital ratios.

DEPOSIT GUARANTEES AND INVESTOR-COMPENSATION SCHEME

A new bill on deposit guarantees and an investor compensation scheme has been proposed by the Parliament and the main changes are the following:

- A substantial increase in the annual premiums
- Clarifications of deposit classes, e.g. deposits, money-market deposits, and nominee account
- Limits of the depositors' rights made clearer
- Shorter time limits on repayments
- Status of the insurance fund and its board made clearer
- Fundamental changes in financing of the fund

There is still uncertainty regarding the final outcome of the new legislation, especially in connection with size of the annual premiums.

ACT ON BANKRUPTCY

A change has been made to the Act on Bankruptcy with the following effect on limitations on claims: If a claim has been stated during the proceedings but not paid, a new period shall, as regards statutes of limitation with respect to the bankrupt party, commence on the day the bankruptcy proceedings are terminated, provided that the claim was recognised. If the claim was not recognised, a new period of two years shall commence on the day the claim was stated.

Limitations on claims will only end once a claimant proves that he or she has a special interest of ending the limitation on claims again.

12) http://www.bis.org/bcbs/basel3.htm.

13) Basel III: A global regulatory framework for more resilient banks and banking systems, www.bis.org/publ/bcbs189.htm.

14) The Kaarlo Jännäri Report on Banking Regulation and Supervision in Iceland, Recommendations and Conclusions, http://eng.forsaetisraduneyti.is/news-and-articles/nr/3581.

Definitions

Added recovery: The increase in the carrying amount of a loan when the recovery is expected to surpass the initial valuation.

Basel II: Second Basel Accord. Recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel III: Pending update to the Basel Accord.

Business risk: The risk that operating income decreases because of lower revenues or increases in costs not caused by one of the other risk types.

Capital Requirement Directive (CRD): The CRD rules are based on the Basel II guidelines and came into force on 1 January 2007. The supervisory framework in the EU is designed to ensure the financial soundness of credit institutions and reflects the Basel II rules on capital measurement and capital standards. The European Commission has proposed a series of amendments which they have numbered for ease of reference (CRD I – IV).

COREP: Common Reporting is the term used to describe harmonised European Capital Requirements Directive reporting.

Concentration risk: The significantly increased risk of any type that is driven by common underlying factors, e.g. industry sector, economic factors, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes (i) large individual exposures or liabilities to parties under common control (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Credit risk: Current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the institution or otherwise fail to perform as agreed.

Credit spread risk: The risk that earnings or capital may be negatively affected by the adverse movements in bond risk premium.

Currency risk: The risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or holding assets or liabilities in foreign currencies.

EFTA Surveillance Authority (ESA): The ESA monitors compliance with European Economic Area rules in Iceland, Liechtenstein and Norway, enabling them to participate in the European internal market.

European Economic Area (EEA) Agreement: On 1 January 1994 the EEA signed agreement that allows the EFTA states to participate in the Internal Market. The EEA agreement is concerned principally with the four fundamental pillars of the Internal Market, i.e. freedom of movement of goods, persons, services and capital.

European Free Trade Association (EFTA): EFTA is an intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its four member states: Iceland, Liechtenstein, Norway and Switzerland.

Exposure at default (EAD): Expected credit exposure of facility at time of default.

Financial Collateral Simple Method: Method to determine the effects of financial collateral on solvency requirements under the Basel II Standardised approach. Institutions that apply the Standardised approach may choose between the Financial Collateral Simple Method and the Financial Collateral Comprehensive Method.

Fiduciary: An entity that is legally appointed and authorised to administrate funds of a legal entity. The fiduciary, typically a pension fund or a mutual fund, manages the assets for the benefit of the other person rather than for his or her own profit.

Government payment adjustment scheme: In November 2008 the Icelandic parliament approved a bill that allows households to lower their payment burden. The cash flows of mortgages follow the payment index instead of the consumer price index. Payment index is composed of employment and wage index.

Icelandic Financial Services Association (SFF): SFF represent all registered financial companies in Iceland. SFF's objectives are to promote a competitive operating environment for financial companies in Iceland and promote their interest internationally as well as to increase understanding of financial companies for the Icelandic economy.

Icelandic Property Registry (FMR): A government agency that is responsible for collecting, processing, storing and publishing real estate data.

Icesave: The Icesave debt dispute is a diplomatic debate that began in 2008 between Iceland on one hand and the United Kingdom and the Netherlands on the other. The debate relates to obligations against the retail creditors of Landsbanki that were offered online savings under the Icesave brand. The Icelandic Parliament has approved a bill effectively committing to a state guarantee on the obligation of the Icelandic Depositors' and Investors Guarantee Fund to cover the deposits insurance obligations in UK and the Netherlands. The President of Iceland has decided to put approval to the Icesave bill up to a public referendum that will be held in Iceland on 9 April 2011.

Inflation risk: The risk that earnings or capital may be negatively affected from the adverse movements in inflation level.

Interest rate risk: Current or prospective risk to earnings or capital arising from adverse movements in interest rates. Main sources of interest rate risk are: (i) Re-pricing risk: Arising from differences between the timing of rate changes and the timing of cash flows. (ii) Yield curve risk: Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve). (iii) Basis risk: Arising from changing rate relationships among yield curves that affect the institution's activities. (iv) Optionality risk: Arising from interest rate related options embedded in the institution's products.

Internal Capital Adequacy Assessment Process (ICAAP): The ICAAP includes an evaluation of the capital needed under Pillar 2. The Bank identifies and measures its risks and ensures that it has sufficient capital in relation to its risk appetite statement. The assessment is based on minimum capital under Pillar 1, capital add-on for other risk factors under Pillar 2 and reduction in available capital due to stress testing results. Once a year a full ICAAP report is submitted to the FME.

Latent impairment: Reflects losses that have been incurred but not identified in the reporting period. These losses are estimated on a portfolio level and cannot be allocated to individual loans.

Legal risk: The potential loss that may occur to an investment as a result of insufficient, improperly applied, or simply unfavourable legal proceedings in the country in which the investment is made.

Liquidity Coverage Ratio: A short-term measure introduced by the Basel Committee that is intended to measure banks' ability to withstand instantaneous outflow of funds. According to the metric, banks are required to maintain liquidity buffers sufficient to cover net cumulative cash outflows at all times during a 30-day period.

Liquidity risk: The risk of not being able to fund its planned growth or its financial obligations as they come due, or of only being able to do so substantially above the prevailing market cost of funds.

Loss given default (LGD): Expected loss on a credit facility in the case of default as fraction of the exposure at default.

Market risk: Current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, including those that arise from factors such as interest rates, equity prices, commodity prices and foreign exchange rates.

Material Adverse Change (MAC): Clauses that give the parties, usually the lender, the right to rescind the transaction if a material "negative event" provided for in the agreement occurs before maturity.

Net Stable Funding Ratio: A structural liquidity measure introduced by the Basel Committee. The NSFR complements the LCR because it looks beyond the 30-day time frame of the short-term metrics and aims to reduce the use of short-term funding to finance less-liquid assets. The NSFR aims to capture structural issues related to funding choices to ensure stable funding over one year in an extended firm-specific stress scenario.

Operational risk: The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Payment Index: Composed of employment and wage index.

Pillar 1: Calculation of the minimum capital requirement. Pillar 1 contains generic rules for calculating credit, market and operational risks to determine a bank's risk-weighted assets (RWA). It also stipulates the minimum capital requirement.

Pillar 2: Supervisory review and evaluation process (SREP). Pillar 2 sets forth the framework for the SREP and the framework for banks' internal capital adequacy assessment process (ICAAP). Pillar 2 concerns bank's risks in a wider sense, including risks not defined under Pillar 1 (e.g., business, pension and concentration risks as well as the Banks' situation and expectations in general). It also treats stress tests.

Political risk: The risk that a government will significantly alter its policies or other regulations so that it significantly affects one's investment or business.

Price risk: The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of debt instruments, equity instruments or commodity products.

Probability of Default (PD): Probability that a counterparty is going to default within the time horizon of one year. Default is defined as a counterparty being more than 90 days overdue on a material credit obligation, or existence of a specific provision against a counterparty's credit obligation.

Repurchase agreement (REPO): A REPO allows a borrower to use a financial security as collateral for cash loan at a fixed rate of interest. In a REPO the borrower agrees to sell immediately a security to a lender and also agrees to buy the same security from the lender at a fixed price at some later date.

Reputational risk: The current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution by customers, counterparties, shareholders/investors, or regulators.

Risk and Control Self Assessment (RCSA): A structured approach to identify and assess all potential risks in order to plan appropriate actions to mitigate them, The ultimate purpose of this framework consists in improving the way a bank operates through regular review of policies, processes and systems. The RCSA process is undertaken at least once a year by all units within the Bank.

Risk-weighted assets (RWA): Risk-weighted assets are the total of all assets held by the Bank according to a formula determined by the regulators.

Settlement risk: The risk that a party will fail to deliver on the terms of a contract at the time of settlement. Settlement loss can occur because of default at settlement and because of any timing differences in settlement between two parties. The amount at risk or the potential loss is the principal of the transaction.

SIC report: Report of the Special Investigation Commission of Althingi, the Icelandic Parliament.

Strategic risk: The current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

Subordinated loans: Debt that ranks after other debts should a company fall into receivership or go bankrupt.

Tier 1 capital: Common equity after deduction of intangible assets and tax assets in addition to Tier 1 hybrid capital.

Tier 2 capital: Subordinated loans and other hybrid capital instruments.

Total capital base: Tier 1 capital in addition to Tier 2 capital.

Total capital ratio: Total capital base divided by risk weighted assets. (Also referred to as solvency ratio).

Trading liquidity risk: The risk that the Bank is unable to easily liquidate or offset particular position without moving market prices due to inadequate market depth or market disruption, thus negatively affecting the earnings or capital.

Abbreviations

ALCO:	Asset and Liability Committee
ALM:	Asset and Liability Management
BIS:	The Bank for International Settlements
BoD:	Board of Directors
BPV:	Basis Point Value
CAD:	Capital Adequacy Directive
CAE:	Chief Audit Executive
CB:	Central Bank
CCF:	Credit Conversion Factor
CEO:	Chief Executive Officer
CFO:	Chief Financial Officer
CLS:	Continuous Linked Settlement
COREP:	Common reporting
CPI:	Consumer Price Index
CRD:	Capital Requirement Directive
CRO:	Chief Risk Officer
DRS:	Debt Restructuring Scheme
EEA:	European Economic Area
EAD:	Exposure at Default
EFTA:	European Free Trade Association
EL:	Expected Loss
ESA:	EFTA Surveillance Authority
EU:	European Union
FDI:	Foreign Direct Investments
FME:	Financial Supervisory Authority - Iceland
FMR:	Iceland Property Registry
FX:	Foreign Currency
GDP:	Gross Domestic Product
ICAAP:	Internal Capital Adequacy Assessment Process
ICA:	Iceland Competition Authority
IFRS:	International Financial Reporting Standards
IMF:	International Monetary Fund
IRB:	Internal Rating-Based
IRS:	Interest Rate Swaps
ÍSB:	Íslandsbanki
ISK:	Icelandic Krona
LCR:	Liquidity Coverage Ratio
LED:	Loss Event Data
LGD:	Loss Given Default
LIBOR:	London Interbank Offered Rate
LPA:	Loan Portfolio Analysis
LS:	Lanasjodur sveitarfelaga ohf., (Municipality Credit Iceland Plc.)
LTV:	Loan to Value
MAC:	Material Adverse Change
NSFR:	Net Stable Funding Ratio
OECD:	Organisation for Economic Cooperation Development
ORM:	Operational Risk Management
PD:	Probability of Default
P&L:	Profit and Loss
PSE:	Public Sector Entity
RCSA:	Risk and Control Self Assessment Process
REIBOR:	Reykjavik Interbank Offered Rate
RWA:	Risk-Weighted Assets
SME:	Small and Medium Entities
SREP:	Supervisory Review and Evaluation Process
SFF:	Icelandic Financial Services Association
TIF:	Icelandic Deposit Insurance Fund
UNAK:	University of Akureyri
VaR:	Value at Risk
VSE:	Very Small Entities

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