RISK REPORT 2011

Íslandsbanki

BASEL II PILLAR 3 DISCLOSURES

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Íslandsbanki is a universal bank

Íslandsbanki, with roots tracing back to 1875, is a universal bank offering Icelandic households, SMEs and corporations comprehensive financial services. With over thousand employees, and assets of around ISK 800 billion, Íslandsbanki forms one of the country's largest banking and financial services groups. The Bank has a 25% - 35% market share across all domestic franchise areas; and operates an efficient branch network in Iceland.

Building on a heritage of lending to industry in Iceland, the Bank has developed specific expertise in two industry sectors, seafood and geothermal energy, that together form the basis for its overseas strategy. With its focused approach in these fields, Íslandsbanki offers valuable services to industry players and investors.

Íslandsbanki is majority-owned by Glitnir banki hf. which, on behalf of its creditors, holds 95% of the Bank's shares through its subsidiaries. The remaining 5% is held by the Icelandic government and is managed by Icelandic State Financial Investments.

The Bank's operating licence, granted by the Icelandic Financial Supervisory Authority (FME) in 2009, included several conditions, one of which required the Bank to make improvements to its risk management and governance framework. In January 2012, after a final sign-off project undertaken by Oliver Wyman in December 2011, the FME concluded that all the conditions set out when it granted the operating licence were now fulfilled.

More information about the Bank, its activities and strategic direction can be found in the Annual Report 2011.

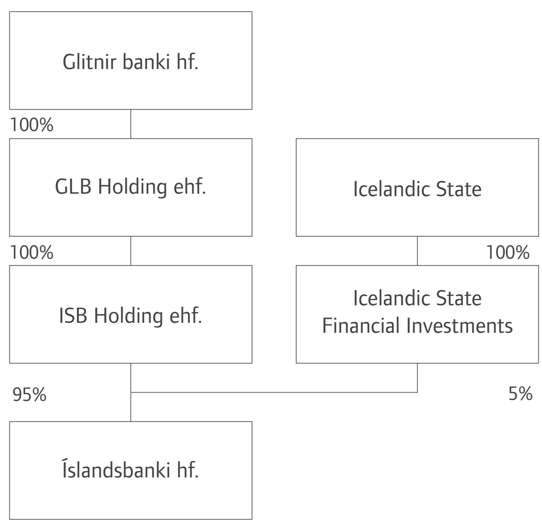

Figure 1: Íslandsbanki's ownership structure.

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1 INTRODUCTION

The objective of Íslandsbanki's Risk Report is to comply with the regulatory requirements for disclosure and to provide market participants with information that helps facilitate a better understanding of Íslandsbanki's risk profile and its 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 Report provides key information on the Bank's capital structure and adequacy, material risk exposures and risk assessment processes. In addition, it provides comprehensive information about the restructuring and recalculation of distressed debt which have been key tasks since the establishment of the Bank in 2008. The Risk Report also gives a short introduction to the Basel III framework and an overview of the main domestic legislative and regulatory changes, as well as information on the Bank's remunerations policy.

The Bank's risk appetite is implemented through the Board of Directors' (BoD) approved policies. At year-end 2011, the Bank was in compliance with its defined risk appetite and all regulatory requirements were fulfilled. The Bank's Tier 1 capital ratio was 19.1% and its total capital ratio was 22.6%.

1.1 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 sets rules for the calculation of the total minimum capital requirements for credit, market and operational risk
- Pillar 2 – Supervisory review and evaluation process sets forth the framework for the Supervisory Review and Evaluation Process (SREP) and the framework for banks' Internal Capital Adequacy Assessment Process (ICAAP)
- Pillar 3 – Market discipline 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

The CRD has been implemented in the European Union (EU), and is included in Icelandic financial legislation as part of the European Economic Area (EEA) agreement.

Discrete national requirements for Icelandic banks on Pillar 3 disclosures 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 requirements 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.

Under Pillar 2, the Bank makes an annual assessment of its internal capital adequacy (ICAAP) which is an integral part of the Bank's capital and risk management.

The FME has reviewed the Bank's last ICAAP report, as a part of the supervisory review process (SREP). The results from this review process were presented to the Bank in 2011. The results show that the current capitalisation levels are well above both internal and regulatory requirements. The Bank will submit the next ICAAP report to the FME in April 2012.

[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. www.bis.org/publ/bcbs157.pdf.

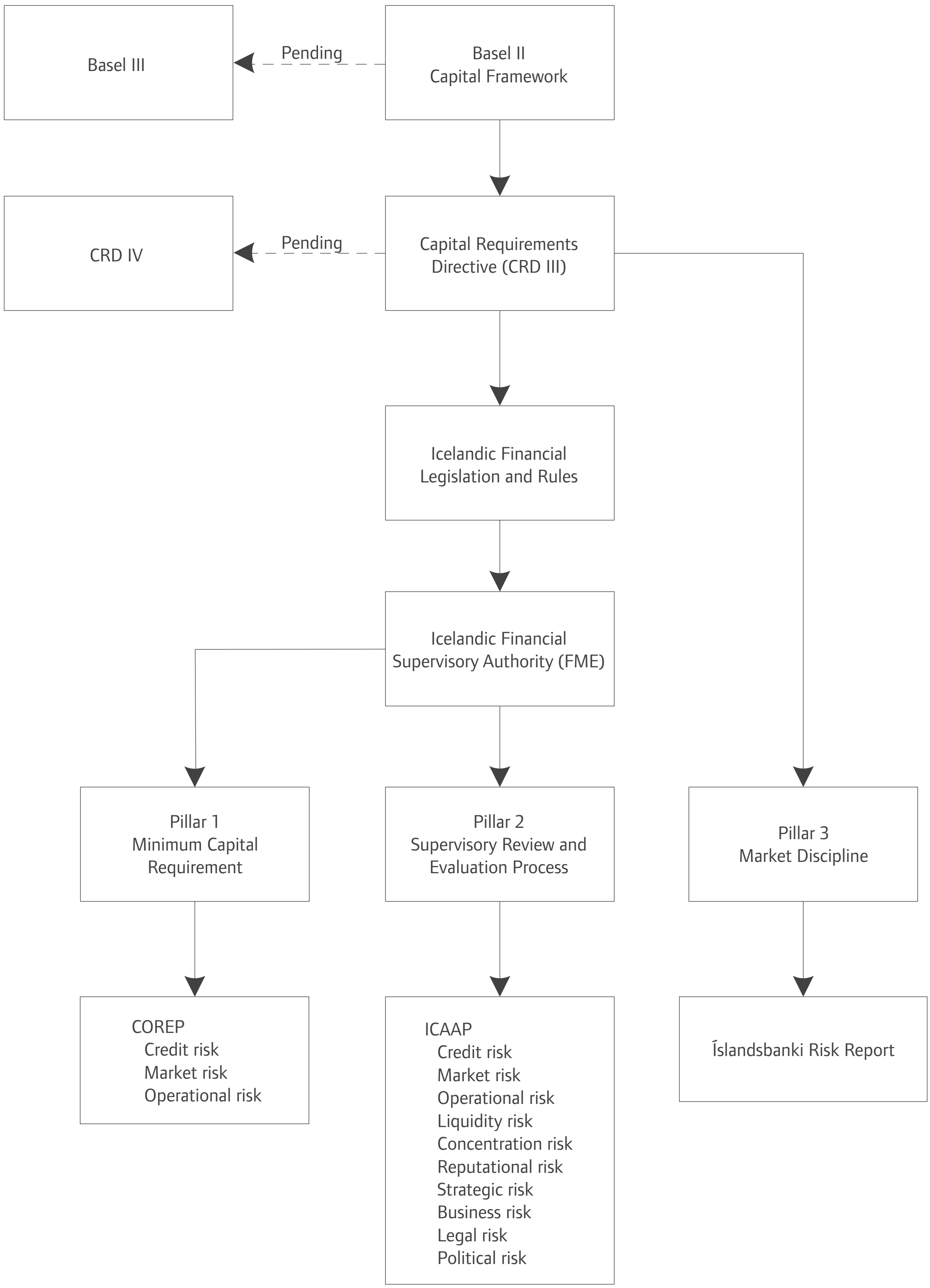

Figure 1.1: Regulation overview.

1.2 DISCLOSURE POLICY

Under Pillar 3, banks are required to have a formal disclosure policy approved by their Boards of Directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

In accordance with these requirements, the Bank has in place a Disclosure and Communication Policy approved by its BoD. This policy outlines the governing principles and framework for external disclosure and communication.

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 and information is considered to be confidential if the Bank is bound from disclosure by law.

The Risk Report may not be considered as containing any investment advice. All views expressed herein are those of the author(s) at the time of writing and may be subject to change without notice. Íslandsbanki holds no obligation to update, modify or amend this report in the event that any matter contained herein changes or subsequently becomes inaccurate. The Risk Report is informative in nature, and should not be interpreted as a recommendation to take, or not to take, any particular investment action. Nothing in this report shall be interpreted as an offer to customers nor is it intended to constitute a basis for entitlement of customers. Risk and capital management information as required under IFRS is published quarterly in the financial statements.

Risk and capital management disclosures are available on the Bank's official website:
www.islandsbanki.is/riskreport and www.islandbanki.is/ir

1.3 CONSOLIDATION AND VERIFICATION

The Risk Report applies to the Íslandsbanki on consolidated level, usually referred to as "the Bank" or "Íslandsbanki." The definition of Íslandsbanki on consolidated level is the same as used in the Annual Report 2011. Names and primary businesses of major subsidiaries at year-end 2011 are listed in Table 1.1. The basis for consolidation used in the Risk Report is fully consolidated.

On 29 November 2011 Íslandsbanki merged with the Icelandic bank Byr hf. (hereafter referred to as "Byr"). The merger resulted in an increase in assets of around ISK 120 billion. The quantitative disclosure for the parent company as well as the consolidated Bank includes Byr for the reporting date 31 December 2011. In some instances, where a merged view has not been presented, a separate Byr disclosure or applicable qualitative comment will be provided.

This Risk Report has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statement 2011. Where reference is made to audited information, it will be clearly marked as so.

The Risk Report 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 some discrepancy between financial information in the Consolidated Financial Statement 2011 and information in the Risk Report 2011. All amounts are presented in ISK million, unless otherwise stated.

NAME	MAIN BUSINESS	OWNERSHIP	LOCATION
Kreditkort hf.	Credit card issuer	100%	Iceland
Borgun hf.	Credit card acquirer	61.3%	Iceland
Íslandsssjódir hf.	Fund management	100%	Iceland
Midengi ehf.	Asset management	100%	Iceland
Jardboranir ehf.	Geothermal drilling company	100%	Iceland
Höfdatorg ehf.	Real estate company	72.5%	Iceland
Hringur Eignarhaldsf. ehf.	Holding company	100%	Iceland
Allianz Ísland hf.	Insurance sales company	100%	Iceland
Bréfabær ehf.	Real estate company	100%	Iceland
Fjárvari ehf.	Real estate company	100%	Iceland
Island Fund S.A. (ISB Asset Management)	Asset & Fund Mgmt	99.9%	Luxembourg
Glacier Geothermal & Seafood Corporation	Holding company	100%	USA

Table 1.1: Names and primary business of the major subsidiaries at year-end 2011. Fully consolidated.

2 RISK MANAGEMENT AND CREDIT CONTROL 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 and capital management strategy. The financial market crisis and the resulting market volatility have further emphasised the importance of effective risk management.

2.1 ORGANISATIONAL STRUCTURE OF RISK MANAGEMENT AND CREDIT CONTROL

Risk Management and Credit Control in Íslandsbanki has a staff of 42 well educated employees who work continuously to improve the risk management framework of the Bank. The Bank's Risk Management and Credit Control is organised as shown in figure 2.1.

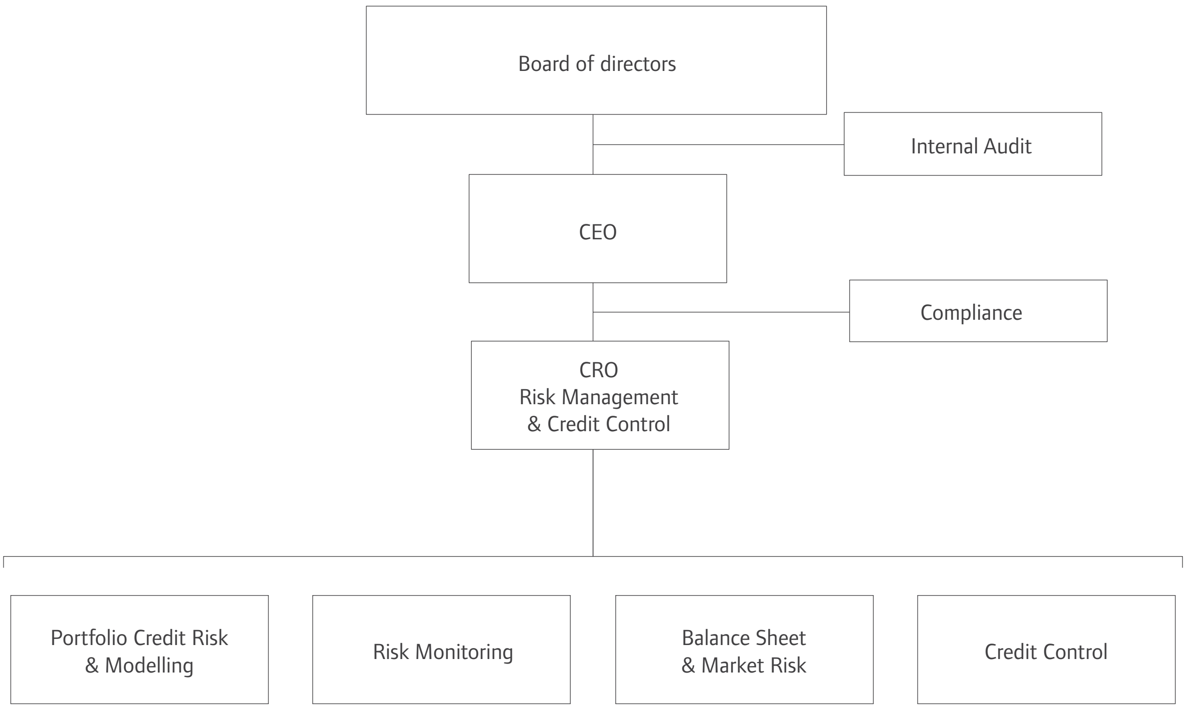

Figure 2.1: Organisational structure of Risk Management and Credit Control.

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.

The Chief Executive Officer (CEO) is responsible for developing and maintaining adequate and effective risk management and internal control functions within Íslandsbanki. In addition, the CEO appoints the Chief Risk Officer (CRO) as well as the members of the Executive Board, the Risk Committee, the Investment Committee and the Asset and Liability Committee.

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, as well as internal directives and instructions.

The Chief Risk Officer (CRO) is a member of the Executive Board and is responsible for the risk management organisation within Íslandsbanki. The CRO heads the Risk Management and Credit Control department and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for organising risk management within Íslandsbanki in order to ensure that Íslandsbanki has the right resources and an appropriate organisation to manage its risks efficiently. This includes risk management functions in branches and subsidiaries.

The Risk Management and Credit Control department is independent from business lines and legal entities. The existence of an independent Risk Management and Credit Control department does not absolve management from its responsibility to manage all risks arising in their businesses and functions.

Decision-making that involves risk is based on a committee structure, presented later in this chapter. In addition to the oversight provided by the risk committees, Risk Management and Credit Control monitors risk within the business units on a company-wide basis.

Risk Management and Credit Control reports on risk and compliance with limits to internal and external stakeholders and ensures an appropriate escalation in the event of limit breaches. Risk Management **and** Credit Control advises on risk and risk assessment. It develops, maintains and tests risk models and provides other forms of support within its expertise. Risk Management and Credit Control also manages the capital adequacy assessment process (ICAAP) for the Bank.

The Risk Management and Credit Control department is responsible for maintaining and developing internal directives and frameworks regarding risk management. The department is also responsible for setting competency standards, for training staff on the Bank's policies, internal directives and frameworks related to risk management and for assisting heads of business units in risk management issues as well as to respond to questions.

The responsibilities of the Risk Management and Credit Control department are further divided into the following four sub-units:

2.1.1 PORTFOLIO CREDIT RISK AND MODELLING

The Portfolio Credit Risk and Modelling unit is responsible for measuring, monitoring and reporting the credit risk for all financial assets. This entails developing, maintaining and enhancing risk management models used for credit risk. The unit monitors credit risk limits set in the Credit Risk Policy and reports on credit risk to internal and external stakeholders. Any public or formal disclosure by the Bank on credit risk is reviewed by the unit. The Portfolio Credit Risk and Modelling unit does not take part in any individual credit decisions.

2.1.2 RISK MONITORING

The Risk Monitoring unit is responsible for the development of a robust operational risk management framework and efficient tools and techniques for measuring and monitoring operational risk throughout the Bank. Risk Monitoring collects operational risk loss event data and facilitates the risk and control self assessment (RCSA) process for each business unit. Risk Monitoring measures key risk indicators (KRI's) in order to detect changes in the Bank's operational risk profile. The implementation of the Bank's business continuity management framework is co-ordinated by Risk Monitoring.

Risk Monitoring performs inspections on the execution of credit processes and procedures in the Bank. Uniform and pre-defined inspections of the execution of all credit processes at individual branches or business units are performed on a regular basis, as well as special investigations on the execution of specific processes throughout the Bank.

Risk Monitoring monitors the operation of Markets with respect to adherence to exposure limits for the Bank's trading desks, adherence to counterparty credit limits, and collateral requirements for customers and the Bank. Margin calls are handled by Risk Monitoring.

2.1.3 BALANCE SHEET AND MARKET RISK

The Balance Sheet and Market Risk unit is responsible for measuring and monitoring of market risk, liquidity risk and the Bank's capitalisation. This includes reporting to internal and external stakeholders on the respective risk positions.

The Balance Sheet and Market Risk unit manages the Internal Capital Adequacy Assessment Process (ICAAP) for the Bank and maintains the pricing model for loans.

The unit provides strategic support to the Markets operations of the Bank as well as to other business units on aspects related to market risk, liquidity risk or capital consumption.

2.1.4 CREDIT CONTROL

The Credit Control unit is accountable for the execution and implementation of the credit process in accordance with the Bank´s Credit Risk Policy and credit rules. This entails administration of credit committees and taking part in individual credit decisions at the committee level, ensuring that all credit decisions are in line with the Bank's Credit Risk Policy and Credit Rules. Credit Control is independent from the business units and provides an objective balance to the credit decision making process.

Credit Control provides support and guidance to business units on credit and credit processing, while interacting with business units on a daily basis on all issues regarding credit. That includes monitoring of watch–list credits, non–performing loans and defaults. Credit control is responsible for the distressed credit workout process, processing of individual distressed cases, as well as the development and implementation of standardised restructuring solutions.

Credit Control is responsible for the assessment of specific impairments as well as final write-offs.

2.2 MATERIAL RISKS AND RISK POLICIES

Each year the Board decides on material risks within Íslandsbanki and accordingly defines the risk appetite.

The Risk Management and Credit Control department is responsible for identifying the risks inherent in the Bank's operations. The identification is done at business unit level and then summarised for the Bank.

The results from the risk identification process are compared to the Bank's risk strategy and risk appetite. For the key material risk types a specific risk policy is defined and approved by the Board of Directors. The need for a specific risk policy is based on the assessment of the proportionality of the risk types in the Bank's operations and business strategy.

Currently, the following four risk types have been defined as key to the Bank's operations and business strategy and their assessment, management and limits are defined in specific risk policies:

- Credit risk (chapter 4)
- Market risk (chapter 5)
- Liquidity risk (chapter 6)
- Operational risk (chapter 7)

Concentration risk is defined as material but currently managed according to the source of concentration. Concentration risk is considered in the Credit Risk Policy, Market Risk Policy and Liquidity Risk Policy.

The Bank has also identified business risk, strategic risk and political risk as material to the Bank's operations. These risk types are not covered in separate risk policies, but closely monitored and addressed in the regular ICAAP review. More information about them can be found in Chapter 7.

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

Figure 2.2 provides an overview of the risk management documents subject to the approval of the Board of Directors.

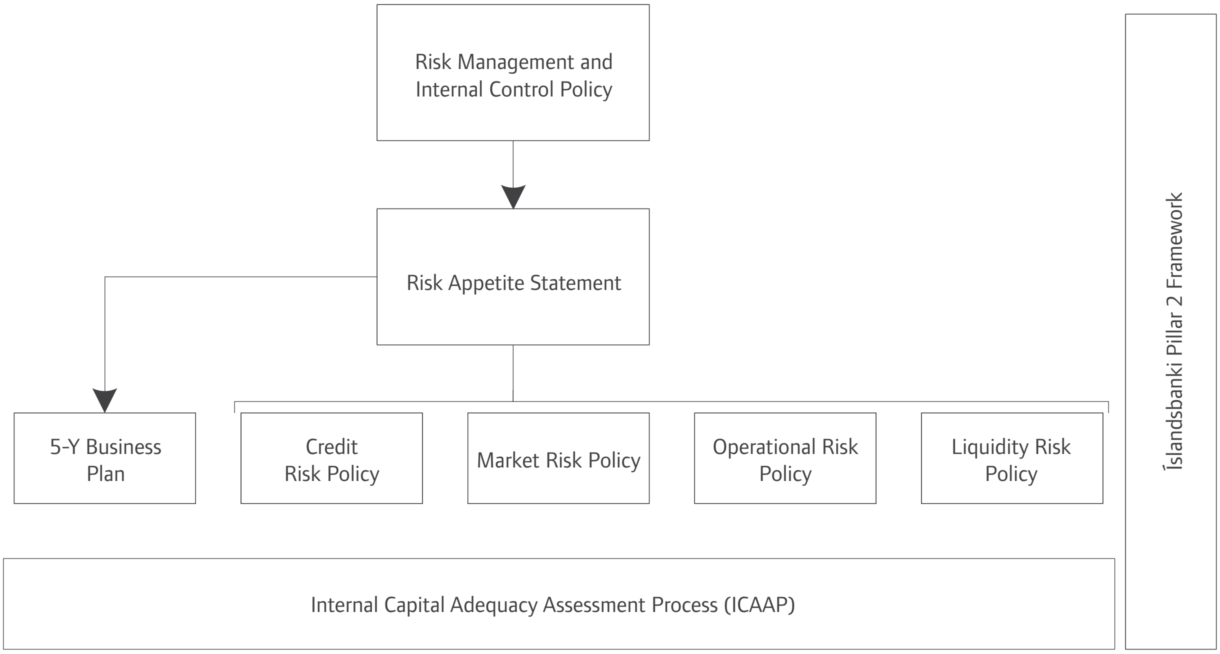

Figure 2.2: Risk management documents subject to the approval of the Board of Directors.

Íslandsbanki's Risk Appetite Statement is a high level statement of the Bank's risk tolerance and financial targets. The Risk Appetite Statement is intended to support the Bank's business strategy by defining limits and targets for core factors in the Bank's risk profile and operations.

The Risk Appetite Statement is further implemented through the Board approved policies that provide more details for individual risk types. Finally, the risk appetite is translated to specific risk limits that are approved by the relevant committees.

The strategic targets of the management are further defined in the Bank's business plan that is approved by the Board of Directors. The business plan gives a 5-year baseline view for the development of the Bank's operations and provides a basis for the stress testing and capital planning part of the capital assessment.

The internal capital adequacy assessment process (ICAAP) aims at identifying and assessing the risks inherent in the Bank's operations and for integrating the Bank's business strategy and business plan on one hand and its risk profile on the other. This is to ensure that the Bank at all times holds enough capital to support its risk profile and business strategy.

The Pillar 2 document describes Íslandsbanki's framework for covering the Bank's responsibilities under Basel II, Pillar 2. The objective of the document is to provide a high level overview of how each of the Pillar 2 functional components is covered within the Bank's risk management and risk governance framework.

2.3 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 2.1 shows the material risk factors identified in each business unit.

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

Table 2.1: The material risk factors indentified within each business unit.

2.3.1 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 (Ergo) and its two independently operated subsidiaries: Kreditkort, a credit card issuer and Borgun, a credit card acquiring company.

The main risk within Retail Banking is credit risk due to their lending activities. 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.

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.

2.3.2 CORPORATE BANKING

Corporate Banking offers a broad range of credit services and advisory services to medium-sized and large corporations. Credit risk and credit concentration risk are the main material risk factors 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.

2.3.3 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 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.

2.3.4 WEALTH MANAGEMENT

Wealth Management (VÍB) 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 still present due to a loan portfolio that is being run down.

2.3.5 TREASURY

Treasury is a part of the Finance and Treasury unit. 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 its main responsibilities is the management of 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 and related to single large depositors or groups of depositors.

2.4 RISK MANAGEMENT COMMITTEE STRUCTURE

The organisational structure for committees governing the Bank's risks is shown in Figure 2.3

The implementation of the risk management framework, limit setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee, Investment 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 to decide on individual positions. The members of these committees are appointed by the CEO and their mandate letters and work procedures are approved by the Board.

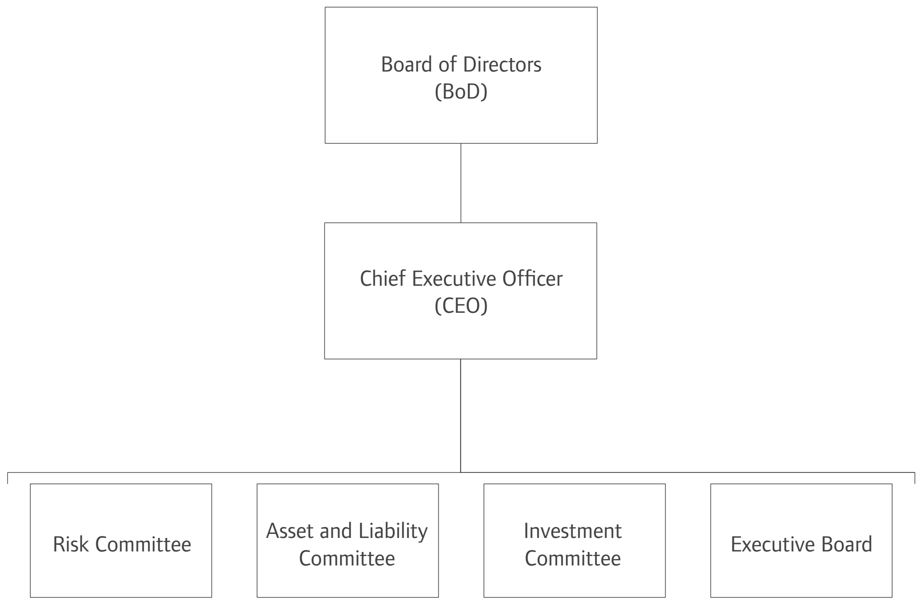

Figure 2.3: Risk Management Committee structure.

2.4.1 RISK COMMITTEE

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks at 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 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 referred to a more senior committee. In turn, credit decisions exceeding the limits of the Risk Committee need to be referred to the Board for confirmation.

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

2.4.2 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.

2.4.3 INVESTMENT COMMITTEE

The Investment Committee makes decisions pertaining to the purchase or sale of equity stakes in companies as well as other types of investments such as investment funds and real estate.

2.4.4 EXECUTIVE BOARD

The Executive Board is responsible for the operational risk framework at 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 Board supervises reputational risk, business risk and strategic risk. The Executive Board governs the Bank's Operational Risk Policy.

2.5 REPORTING

Íslandsbanki aims to have clearly defined and efficient reporting lines to ensure compliance with the approved risk limits and target. 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 to the technological platform to support risk management better. 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 manage and mitigate risk proactively.

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

Risk Management and Credit Control 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 Investment Committee, the Executive Board and, when applicable, Internal Audit. The frequency varies from daily or intraday reporting on positions that change frequently or are of special concern, to weekly, monthly and quarterly reporting on positions and portfolios that are more stable in nature. The Compliance function has access to all reports to regulators.

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

The Bank's quarterly Financial Statements are prepared in accordance with the International Financial Reporting Standards (IFRS) as approved by the European Union. Regulatory reports are prepared based on the Capital Requirements Directive along with discretionary rules and requirements made by the Central Bank (CB) and the Financial Supervisory Authority (FME).

In addition, the Bank works and reports according to the guidelines issued by Nasdaq OMX Iceland for listed companies, since Íslandsbanki is an issuer of listed (covered) bonds.

3 CAPITAL MANAGEMENT

Íslandsbanki's capital ratios have been increasing throughout 2011, but lowered at the end of the year as a result of the merger with Byr. At 31 December 2011, the Bank's Tier 1 capital was ISK 120.5 billion or 19.1% of risk weighted assets. At the same time, the total capital ratio, including Tier 2 subordinated debt was 22.6%. For comparison, the Tier 1 capital amounted to ISK 121 billion at the end of 2010 and the Tier 1 and total capital ratios were 22.6% and 26.6% respectively. The FME has reviewed the Bank's capital position under Pillar 2 of the Basel II framework. Both the internal assessment of the Bank (ICAAP) and the results from the supervisor (SREP) confirm the Bank's strong capital position. The current capitalisation levels are well above both internal and regulatory requirements.

3.1 CAPITAL MANAGEMENT FRAMEWORK

The Bank's capital management framework aims to ensure that the Bank's capitalisation is adequate for its underlying risks and 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).

3.2 CAPITAL COMPOSITION

Íslandsbanki's total capital is composed of two parts:

- Tier 1 capital: Ordinary share capital, Share premium, Other reserves, Retained earnings, Minority interest. Tax assets and intangible assets are deducted from Tier 1 capital.
- Tier 2 capital: Consists of a 10 year subordinated bond issue 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.

The Bank's total capital composition is shown in Table 3.1.

Tier 1 Capital	**31.12.2011**	**31.12.2010**
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,661	2,498
Retained earnings	55,133	53,174
Minority interest	909	791
Tax assets	(2,629)	(283)
Intangible assets	(544)	(187)
Total Tier 1 capital	**120,530**	**120,993**
Tier 2 capital		
Qualifying subordinated liabilities	21,937	21,241
Total regulatory capital	**142,467**	**142,234**

Table 3.1: The Bank's total capital composition (ISK m). Consolidated, audited.

3.3. 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 operates under temporary discretionary capital requirements made by the Icelandic Financial Supervisory Authority (FME), requiring a minimum core Tier 1 ratio of 12% of risk weighted assets and a Total Capital ratio of 16%. Table 3.2 shows Íslandsbanki's capital ratios at the end of 2011 and 2010.

Íslandsbanki's Capital Ratios	31.12.2011	31.12.2010
Total RWA	629,419	534,431
Total Capital Base	142,467	142,234
Total Tier 1 Capital	120,530	120,993
Total Capital ratio	22.6%	26.6%
Tier 1 ratio	19.1%	22.6%

Table 3.2: Capital and capital ratios (ISK m). Consolidated, audited.

The Bank has adopted the Basel II standardised approach for credit risk and market risk when calculating the capital requirements under Pillar 1 and the basic indicator approach for operational risk.

3.3.1 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.

3.3.2 MARKET RISK

The RWA for bonds and equities are calculated as the product of 12.5 and the total capital requirements (reflecting that the minimum capital requirements are 8% of RWA). For foreign exchange risk the RWA are calculated as the maximum of the Bank's total long and total short positions. The minimum capital requirements for foreign exchange risk are then derived as 8% of the RWA.

3.3.3 OPERATIONAL RISK

Under the Basic Indicator Approach for operational risk capital calculations, RWA are derived from the minimum capital requirement multiplied by 12.5 as for the bonds and equities under market risk. The minimum capital requirement for operational risk is equal to 15% of the relevant indicator, where the relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

The Bank's minimum capital requirements and RWA under Pillar 1 are shown in Table 3.3.

Íslandsbanki's Capital Requirements and RWA	31.12.2011		31.12.2010	
	Minimum Capital Requirements	RWA	Minimum Capital Requirements	RWA
CREDIT RISK	**42,584**	**532,301**	**35,247**	**440,586**
Central governments or central banks	105	1,314	123	1,535
Regional governments or local authorities	91	1,143	83	1,031
Administrative bodies and non-commercial undertakings	194	2,423	126	1,569
Institutions	687	8,589	512	6,398
Corporates	17,401	217,513	17,163	214,543
Retail	9,614	120,177	7,092	88,649
Secured by real estate property	2,249	28,117	1,973	24,664
Past due items	6,330	79,123	5,064	63,296
Property, equitpment, non-current assets held for sale and other assets	4,387	54,840	2,756	34,452
FV shares, investment in assosiates and shares held for sale	1,525	19,061	356	4,448
MARKET RISK	**1,336**	**16,695**	**1,181**	**14,766**
Traded debt instruments	61	757	274	3,429
Equity	91	1,138	92	1,154
Foreign exchange	1,184	14,800	815	10,183
OPERATIONAL RISK	**6,434**	**80,423**	**6,326**	**79,079**
Total	**50,354**	**629,419**	**42,755**	**534,431**

Table 3.3: Capital requirements and RWA under Pillar 1 (ISK m). Consolidated, unaudited.

The changes in Íslandsbanki's RWA in 2011 are also displayed in Figure 3.1. There are three main factors that contributed to the rise in RWA: Increase in assets due to the merger with Byr, increase in assets due to acquisition of subsidiaries and increase in fair value (FV) of shares. The increase in RWA from these three factors amounted to ISK 109 billion.

The fall in RWA amounted to ISK 17 billion, due to volume changes, partly offset by reduction in customers' loan balances due to restructuring or repayment of debt.

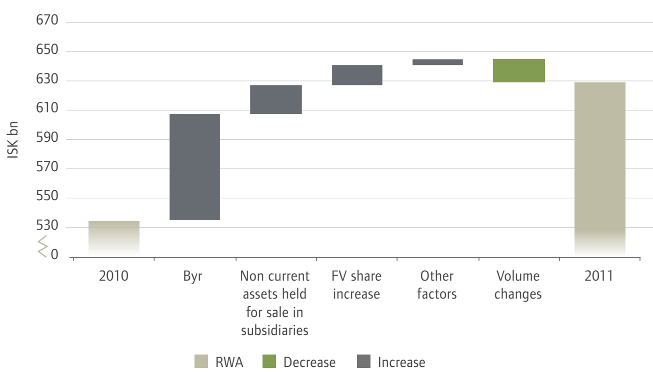

Figure 3.1: Changes in RWA from 2010 to 2011 (ISK bn). Consolidated, unaudited.

3.4 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.

3.5 ICAAP

Under Pillar 2 of the Basel II rules Íslandsbanki has in place an internal capital adequacy assessment process (ICAAP). Through the ICAAP, all material risks to which the Bank is exposed, not covered or not fully covered under Pillar 1, are assessed and the corresponding capital requirement estimated. The ICAAP report is approved by the Board of Directors and submitted to the FME once a year. As a part of the supervisory review and evaluation process (SREP), the FME reviews the ICAAP report. The results from the last review process were presented to the Bank in August 2011. The results confirm that the current capitalisation levels are well above of both internal and regulatory requirements.

The building blocks of the capital assessment process at Íslandsbanki are described in figure 3.2.

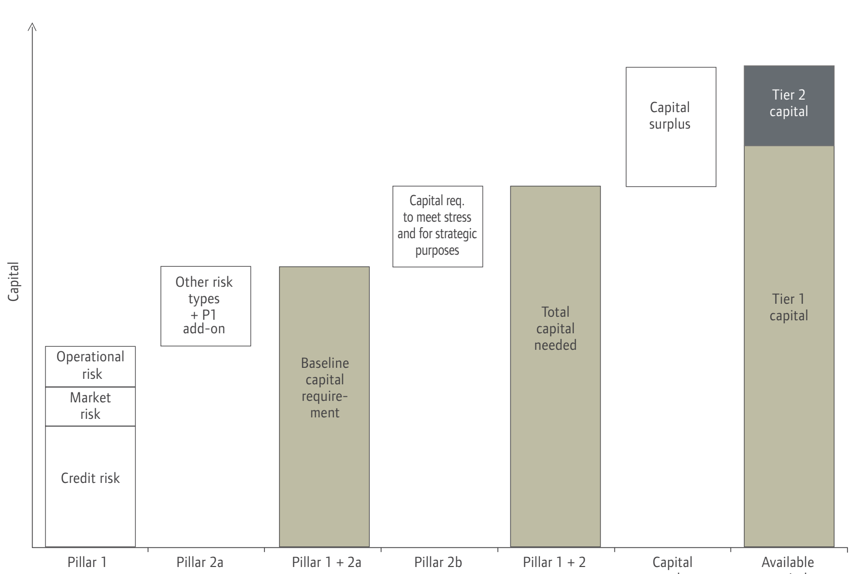

Figure 3.2: Íslandsbanki's ICAAP methodology.

1. Capital requirements under Pillar 1

The first step in assessing the capital requirements is based on the Pillar 1 calculations according to what has been described in chapter 3.1.

2. Capital requirements under Pillar 2

Under Pillar 2, additional capital requirements are estimated as follows:

a. Other risk types and risk not fully covered under Pillar 1.

   In addition to the minimum capital required under Pillar 1 further capital might be required under Pillar 2 due to other risk factors or due to understatement of the Pillar 1 risk factors. The capital requirements under Pillar 1 and Pillar 2a form the baseline capital requirement for the Bank.

b. Reduction in available capital due to stress testing and for strategic purposes.

   The baseline capital requirement is estimated based on "normal business conditions". The Bank however needs to make sure that its capital is sufficient to support the business under stressed market conditions and that it supports the Bank's business strategy for the years to come. Thus, the Bank might need to hold a capital buffer in order to be able to withstand stressed market conditions and to support intended growth.

   In order to estimate the size of the capital buffer needed, the Bank's business plan is stressed based on various assumptions relevant to the Bank's risk profile and business strategy.

3.5.1 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 business units of the Bank. Íslandsbanki's economic research unit provides a baseline economic scenario that is used as a basis in the Bank's business model. Each business unit prepares its individual business plan and the consolidated business plan, approved by the Board, is then used as a basis for stress testing.

The stress testing process consists of impact assessment for different risk factors and the key drivers of the Bank's operations. The assessment is based both on statistical models and expert judgement and is aimed at providing a basis for capital planning, comparing the results with the Bank's risk appetite and taking action where necessary.

4 CREDIT RISK

At the end of 2011 the Bank's total credit exposure from lending amounted to ISK 608 billion as compared to ISK 546 billion at the end of 2010. This represents an increase of 11.4%.

The main reason for this increase is the acquisition of Byr in December 2011. The loan portfolio from Byr is mostly to individuals and small companies and therefore the acquisition strengthened the retail part and diversified the loan portfolio. Before the acquisition, the loan portfolio had been gradually decreasing since repayments of outstanding loans exceeded new lending.

Restructuring of the loan portfolio was one of the Bank's key projects in the year 2011. The debt of households was reduced considerably through recalculation of foreign currency loans and the 110% mortgage adjustment measure. These restructuring schemes have not affected the carrying amount of these loans because of the deep discount. The indebtedness of companies was also reduced through debt adjustment and recalculation of foreign currency loans.

The credit quality of the loan portfolio has increased in the year 2011, both as measured by the LPA metric and in terms of the problem loans ratio. However, there is still work to be done, in particular for the loans acquired from Byr. The Bank believes that the portfolio can be restructured into a performing loan portfolio without further impairment.

The Bank undertakes credit risk by offering loans, guarantees and other credit products in the conduct of its business plan. 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 bank in 2008 and Byr in 2011 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.

4.1 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 credit concentration risk, default risk, recovery risk, country risk and settlement risk.

Concentration risk is the significantly increased risk of any type that is driven by common underlying factors, e.g. sector, economy, 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.

4.2 STRATEGY, ORGANISATION AND RESPONSIBILITY

The Bank's strategy is to maintain a modest credit risk profile. At a consolidated level the Bank aims to have long-term average annual credit losses less than 0.9% of the credit portfolio. This risk appetite is reflected in the credit risk limit structure and guided through the use of credit risk assessment models.

Credit risk activities are controlled through exposure limits applied to counterparties, sectors and with limits specific for different products.

The Bank's credit process is based on a committee structure. The Risk Committee is responsible for supervising and monitoring credit and counterparty risk and governs the Bank's credit rules and procedures. The Risk Committee appoints credit committees and allocates credit authorisation limits to its subcommittees and to individual employees. The Risk Committee handles credit cases in accordance with the authorisation limit set by the Board and is accountable for loan loss provisions, impairments and final write-offs.

Branch managers and loan officers are assigned credit authorisation limits. If a proposed customer exposure exceeds credit authorisation limit, the credit proposal is taken to a committee that has the sufficient authorisation limit. All credit decisions at the individual authorisation level are based on the "four eyed principle", where at least two authorised employees must approve each decision. All credit decisions are documented and registered. Each customer is assigned a credit limit which is reviewed at least annually.

The Credit Control unit is accountable for the execution and implementation of the credit process in accordance with the Bank´s Credit Risk Policy and credit rules. Risk Monitoring performs inspections on the execution of credit processes and procedures in the Bank. The Portfolio Credit Risk and Modelling unit is responsible for measuring, monitoring and reporting of credit risk.

4.3 THE CREDIT PROCESS

The Bank's Credit Rules set out the general principles governing lending, guarantees and other products that expose the Bank to credit risk. All credit decisions are based on careful evaluation of the inherent credit risk involved, the customers' financial standing, future projected cash flows and overall creditworthiness. Trust between the Bank and its clients are a prerequisite for all lending. Sufficient collateral alone can not justify lending to customers with insufficient payment capacity.

To mitigate risk the Bank requires collateral that is appropriate for the product offered. Since the Bank does not seize collateral unless a borrower faces serious repayment difficulties, the valuation of collateral focuses on its future expected value at the time 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. Collateral without formal reference values are not included in loan-to-value calculations.

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.

4.4 MEASUREMENT AND MONITORING

The Bank uses internal rating models to assess the default probability of corporate and retail customers. The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its industry, management, market position and sector. The corporate rating model assigns each obligor to one of ten risk classes. One risk class is for companies in default, and nine risk classes are for performing obligors.

For retail customers the Bank uses two different statistical rating models. One model is for individuals and another is for very small entities (VSE) which are companies with a total exposure to the Bank of less than ISK 150 million. These 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.

Table 4.1 shows the mapping from risk classes to default probability (PD) ranges for the three different rating models. The PD corresponds to the observed long-term average default rate, where 90-day past due or specific impairment was used as the default criterion.

Risk Class	Corporate model	VSE model	Individuals model
1	0.25%	–	0.15%
2	0.43%	–	0.37%
3	0.75%	–	0.73%
4	1.3%	0.48%	2.15%
5	2.3%	1.0%	3.85%
6	4.1%	2.9%	5.0%
7	7.1%	8.0%	7.9%
8	12.5%	16%	14.6%
9	21.8%	35%	34%

Table 4.1: Risk class mapping in PD ranges for different rating models.

For the corporate portfolio, default data for the period 30 June 2002 to 30 June 2008 was used for model calibration, i.e. the periods in the aftermath of the Icelandic banking crisis were excluded from the long-term average.

For the individuals and VSE portfolios, the full available period from 30 June 2004 to 30 June 2011 was used for calibration. 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.

Figures 4.1 through 4.3 show the distributions of the loan portfolio into PD ranges for the three different models. We use PD ranges instead of risk classes to make the figures comparable between models. Loans taken over from Byr and loans in default are excluded from the figures. The distributions for the VSE and Individual models are relatively similar between years. The distribution for the Corporate model, on the other hand, shows a shift to lower PD ranges due to restructuring of obligors.

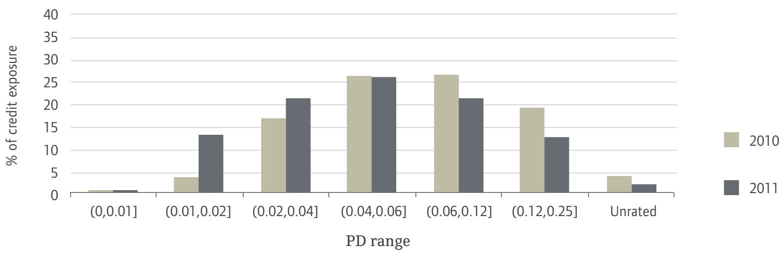

Figure 4.1: Distribution of credit exposure into PD ranges for corporates. Loans taken over from Byr and loans in default are excluded from the figures. Parent, unaudited.

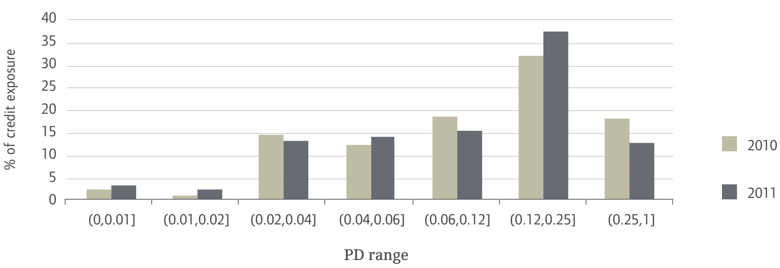

Figure 4.2: Distribution of credit exposure into PD ranges for very small entities. Loans taken over from Byr and loans in default are excluded from the figures. Parent, unaudited.

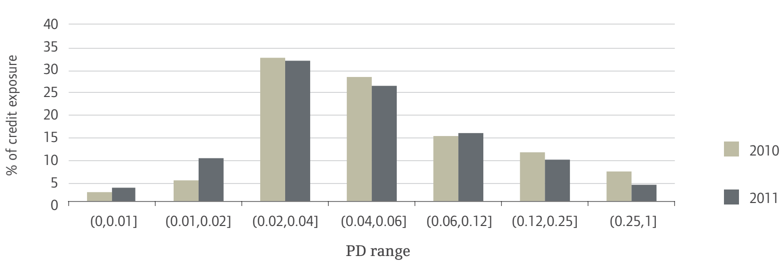

Figure 4.3: Distribution of credit exposure into PD ranges for individuals. Loans taken over from Byr and loans in default are excluded from the figures. Parent, unaudited.

4.4.1 CARRYING AMOUNT OF LOANS

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 was 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 first 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.

Loans are considered to be impaired if the Bank has set aside impairment of a specific amount in addition to the deep discount. This amount is called the impairment allowance. This definition is used in the Notes to the Financial Statements in order to reconcile with the movement in the provision for impairment losses for loans and receivables.

Impairment can be divided into three segments, specific impairment, collective impairment of foreign exchange gain and latent impairment. Loans are classified as impaired or with specific impairment if contractual cash payments are not expected to be fully honoured and the financial restructuring of the obligor is expected to lead to a loss for the Bank. Loans with collective impairment only are loans denominated in foreign currency that are estimated to be serviced by customers that only have cash flow in ISK. For those loans, an increase in the loan balance in ISK terms due to depreciation of the ISK is fully offset with the so called foreign exchange impairment. Latent impairment in the Consolidated Financial Statement reflects losses that have been incurred but not identified in the reporting period, i.e. losses that cannot be allocated to individual loans yet.

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.

4.4.2 DIFFERENCE BETWEEN CLAIM VALUE AND CARRYING AMOUNT

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 directly visible on the Bank's financial statements and should not be confused with the impairment allowance in the Financial Statements. The initial difference between claim value and the deep discount carrying amount was stated 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 ledger types that are, unlike the initial impairment and the remaining discount, visible in the financial statements. These ledgers are foreign exchange impairment, added impairment, and added recovery.

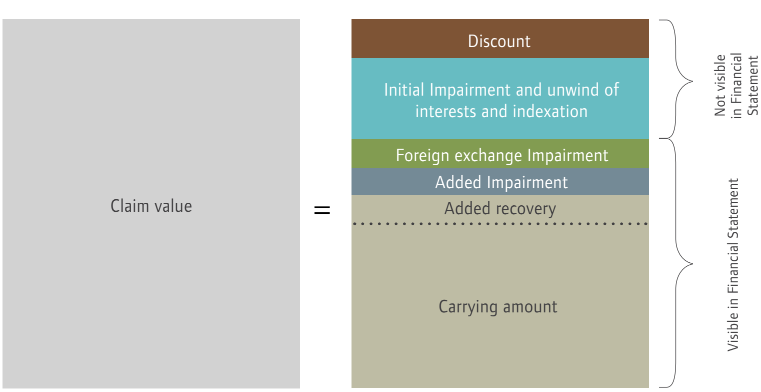

Figure 4.4: Segmentation of claim value and visibility in the Financial Statement.

Figure 4.4 shows how the claim value divides into six different segments. Added impairment or added recovery is 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 assumed. Added recovery, on the other hand, indicates that the expected recovery has surpassed the initial expectation.

The gross amount of loans at amortised cost is the carrying amount in addition to the impairment allowance, i.e. the foreign currency impairment and the added impairment.

4.4.3 IMPAIRED LOANS

Table 4.2 shows impaired and past due loans at the end of 2011 before and after the impairment allowance, i.e. the gross amount and the carrying amount. This table is a combination of Notes nr. 32, 34 and 66 in the Financial Statements. The classification of impaired loans is explained below.

At 31 December 2011

Impaired and past due loans	**Loans that are neither past due nor impaired**	**Past due but not impaired**	**Loans with specific impairment**	**Loans with collective impaiment only**	**Total**
Loans to Credit Institutions					
Gross	43,655	–	555	–	44,210
Allowance	–	–	555	–	555
Net	43,655	–	0	–	43,655
Loans to individuals					
Gross	177,724	40,138	8,318	8,909	235,089
Allowance	–	–	3,349	3,551	6,900
Net	177,724	40,138	4,969	5,358	228,189
Loans to Companies					
Gross	230,738	30,825	92,017	17,329	370,909
Allowance	–	–	28,831	5,872	34,703
Net	230,738	30,825	63,186	11,457	336,206
Thereof latent impairment					915
Carrying amount, total	452,116	70,963	68,155	16,815	608,050

At 31 December 2010

Impaired and past due loans	**Loans that are neither past due nor impaired**	**Past due but not impaired**	**Loans with specific impairment**	**Loans with collective impaiment only**	**Total**
Loans to Credit Institutions					
Gross	30,842	8	606	–	31,456
Allowance	–	–	586	–	586
Net	30,842	8	20	–	30,870
Loans to individuals					
Gross	123,086	21,194	726	36,560	181,566
Allowance	–	–	110	8,742	8,853
Net	123,086	21,194	616	27,817	172,713
Loans to Companies					
Gross	199,007	18,363	136,910	41,031	395,310
Allowance	–	–	44,927	7,936	52,863
Net	199,007	18,363	91,983	33,095	342,447
Thereof latent impairment					991
Carrying amount, total	**352,935**	**39,565**	**92,619**	**60,912**	**546,031**

Table 4.2: Impaired and past due loans (carrying amount, ISK m). Consolidated, unaudited.

Loans with **specific impairment** have been individually assessed and found to be further impaired from the deep discount. The added impairment is recognised as a loss for the Bank due to revised estimated future cash flow. If, on the other hand, a specific assessment indicates that the expected recovery of a loan will be higher than the initial assumption, then the difference is recognised as income and the loan is not considered to be impaired.

The foreign exchange gain or loss due to currency movements is realised in full, but since the Bank does not expect to recover foreign exchange gains relating to loans to customers with ISK cash flow, an offsetting impairment called **foreign exchange impairment** is charged to the loan. This 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.

Latent impairment is an addition to the assessment of a specific impairment. 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. The loan portfolio acquired from Byr is recognised at fair-value as at 30 November 2011 and does therefore not contribute to the latent impairment.

The incurred but not yet identified loss is estimated based on risk classes and historical loss rates.

Past due loans that have not been impaired are loans where contractual interest or principal payments have passed due date without the obligor making full payment but specific impairment is not appropriate. These loans are expected to be restructured without a loss to the Bank. Loss can be avoided due to the deep discount, because of sufficient collateral, or because contractual payments are eventually expected to be fulfilled. An age analysis of past due loans can be found in Note nr. 67 in the Financial Statements.

Note that the loan portfolio acquired from Byr was measured at fair value on acquisition and has therefore not been specifically impaired by the Bank after the acquisition. However, a large part of the portfolio is past due and therefore the past due but not impaired loans have increased between reporting dates.

4.4.4 PROBLEM LOANS

Since the loan portfolio from Byr was acquired at fair-value, and is kept at a deep discount, almost no loans from Byr are classified as impaired loans. Substantial part of the portfolio is however more than 90 days past due, and would normally be impaired.

Because of the deep discount, the definition of impaired loans in the financial statement does therefore not give the full picture of loans where the customer is in payment difficulties. In order to complete the picture we can add loans that are more than 90 days past due but not impaired. This is the Bank's definition of problem loans.

The ratio of gross problem loans over gross loans has been steadily decreasing since June 2010. Financial restructuring of customers is the main reason for the decrease and in particiular solutions for customers with foreign currency loans have made a big impact. The problem loan ratio for individuals is systematically lower than for the total portfolio.

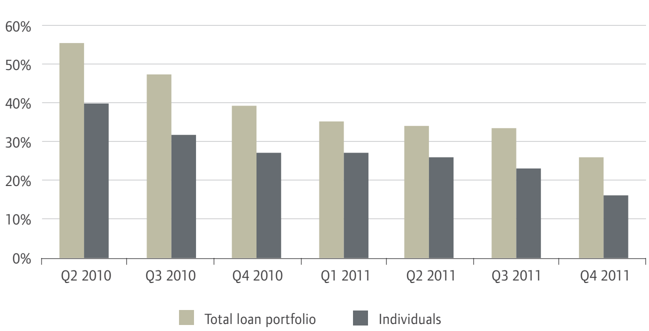

Figure 4.5: Problem loans ratio of the total loan portfolio and individuals. Consolidated, unaudited.

4.4.5 LOAN WRITE-OFFS

Final write-offs of loans are generally made when all means of legal recourse have been exhausted, when an agreement has been reached with a borrower on a final settlement of a claim, or when a decision has been made by courts that limit recourse. Final write-offs are also made through restructuring schemes where part of loans are written off in order to lower the debt of obligors. These schemes include the 110% mortgage adjustment, debt adjustment, principal adjustment and more. In the notes to the Financial Statements, the amount written off refers only to the part of the claim value that is visible in the statements. This means that when only the initial impairment and discount is used against write-offs then nothing is shown.

4.4.6 REPOSSESSED ASSETS HELD FOR SALE

It is in the best interest of the Bank and the customer to improve the customer's position rather than to acquire assets from the customer. The Bank acquires assets only if all other means to improve the customer's financial standing have been exhausted. Repossessed assets are classified into two groups, repossessed collateral and assets of disposal groups classified as held for sale. The first group represents collateral that has been repossessed and the second group represents assets of companies in which the Bank holds more than 50% share, without being consolidated subsidiaries. At the end of 2011 the Bank's repossessed assets amounted to ISK 43 billion. The Bank acquired these assets through repossessions following loan defaults, debt restructuring and bankruptcies of its customers. The increase in repossessed assets at the end of the year 2011 is mainly due to the merger with of Byr and restructuring of Höfðatorg ehf.

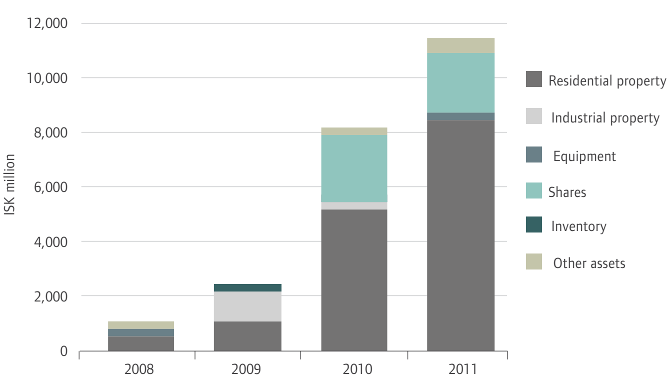

Figure 4.6: Repossessed collateral held for sale at year-end 2011 (carrying amount, ISK m). Consolidated, unaudited.

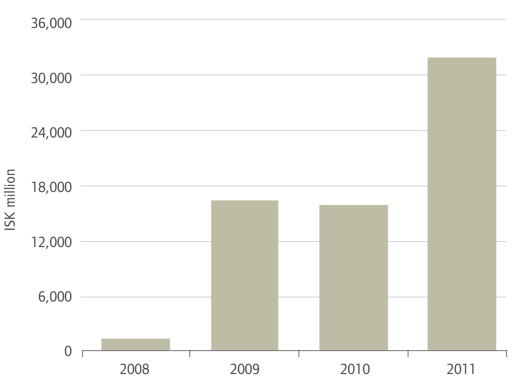

Figure 4.7: Assets of disposal groups classified as held for sale at year-end 2011 (carrying amount, ISK m). Consolidated, unaudited.

4.4.7 BORROWER CONCENTRATION

The Bank actively seeks to limit large exposures. A large exposure is defined as an exposure to a group of connected clients that exceeds 10% of the Bank's regulatory capital. 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.

The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) in Law no. 161/2002 on Financial Undertakings, where groups of connected clients are defined.

At 31 December 2011, the Bank had one large exposure to a group of connected clients that amounted to 15% of the Bank's total 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.

4.4.8 INDUSTRY SECTOR CONCENTRATION

The Bank's industry sectors are groups of entities that have similar primary activities, underlying risk factors and behaviour characteristics. A see-through principle is applied for holding companies that own other companies but do not produce goods or services, i.e. the holding company can be classified in the same sector as its investments and not as an investment company.

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 concentrations against limits are reported internally on a monthly basis.

4.4.9 GEOGRAPHIC CONCENTRATION

Country risk is the risk of losses that may occur due to economic difficulties or political unrest. Country risk includes political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, i.e. economic factors that could have significant influence on the business environment.

Specific geographical limits are established to managing country risk. The geographic limits apply to the country from where the credit risk arises. Iceland is considered to be a home market and is as such not subject to geographic limits. This limit is reported internally on a monthly basis.

4.4.10 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 versus 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. Capital requirements for settlement risk are covered as part of operational risk capital.

4.5 CREDIT PORTFOLIO EXPOSURES

Credit risk exposure comprises both on-balance sheet and off-balance sheet items. Exposure to credit risk for on-balance sheet assets is the carrying amount as reported in the Statement of Financial Position. The exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. For capital requirement purposes credit conversion factors are applied to guarantees and undrawn commitments. For derivative contracts the exposure is calculated by adding expected future credit exposure to the market value of the contract.

The Bank currently has no credit exposure to securitisation.

Sources of credit risk	**31.12.2011**	**31.12.2010**
Loans to customers	564,394	515,161
Loans to credit institutions and central banks	101,647	61,669
Debt instruments	58,662	68,024
Guarantees and undrawn commitments	63,136	56,959
Derivatives	1,481	211
Total	**789,320**	**702,024**

Table 4.3: The main sources for credit risk at the Bank (carrying amount, ISK m). Consolidated, audited.

4.5.1 LOANS TO CUSTOMERS

Loans to customers represent the largest part of the Bank's credit risk exposure. At year-end 2011 the loan portfolio amounted to ISK 564,395 million. The acquisition of Byr diversified the loan portfolio since the acquired loan portfolio was mostly to individuals and small companies.

Loans to individuals
Loans to individuals derive from lending activities to individuals and households and can be broken down by product types as follows.

Product type	31.12.2011	31.12.2010
Mortgages	140,517	105,637
Term loans	46,220	33,148
Leasing	11,177	11,678
Overdrafts	14,506	7,943
Credit cards	15,769	14,307
Total	**228,189**	**172,713**

Table 4.4: Breakdown of loans to individuals by product type (carrying amount, ISK m). Consolidated, audited.

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

The loan-to-value (LTV) is an important risk factor when measuring risk of a mortgage portfolio. The LTV is the current carrying amount of the loan under consideration divided by the value of the property. For second charge mortgages the combined loan to value (CLTV) is the current carrying amount of the loan under consideration plus the outstanding balance of all previous liens divided by the value of the property.

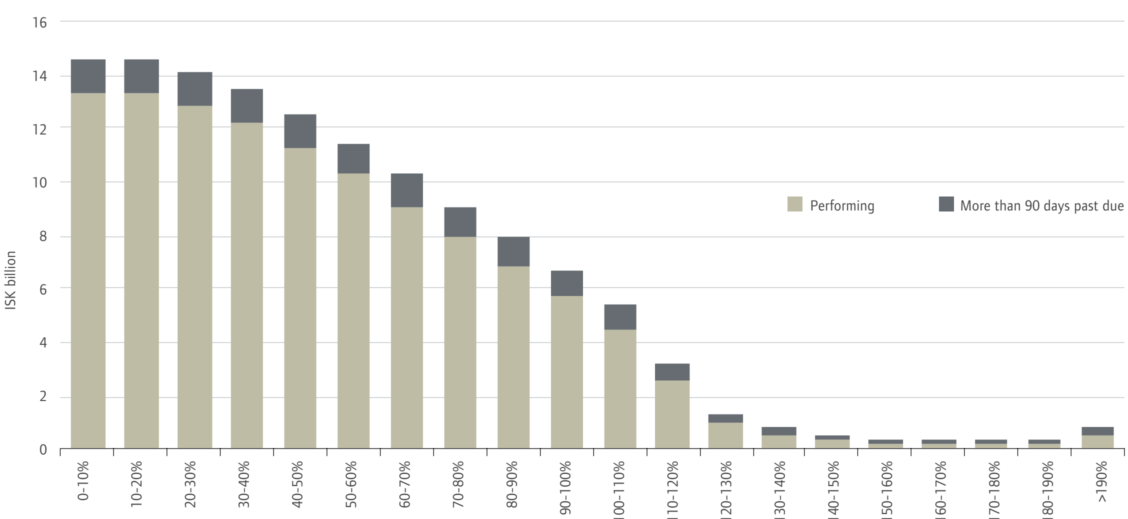

Figure 4.8: Breakdown of the mortgage portfolio by LTV bands, year-end 2011 (carrying amount, ISK m). Parent, unaudited.

Figure 4.8 shows how the mortgage portfolio is distributed in loan-to-value bands. 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.

For example, if a loan with a current carrying amount of 6 million is on the first charge of a property valued at 20 million, then 2 million are assigned to each of the 0-10%, 10-20% and 20-30% LTV bands (totalling to 6 million). If the same loan had been on the second charge of the same property and the loan on the first charge totals to 10 million then 2 million are assigned to each of the 50-60%, 60-70% and 70-80% LTV bands.

The top part of the columns identify the part of the loans that are more than 90 days past due.

For capital requirement purposes, residential real estate mortgages to individuals are divided into two segments, the part that is covered up to 80% loan-to-value and the amount that exceeds 80% loan-to-value. The part that is classified with an LTV below 80% receives a 35% risk weight when calculating the capital requirements as compared to 75% for the remaining part. The value of the property is obtained from the Iceland Property Registry (FMR) which is updated once per year.

The mortgages acquired from Byr in December were not used to reduce capital requirements at the end of 2011 because the Bank did not have the required level of comfort for the collateral information. On-going review and registration of collateral from Byr is expected to increase the proportion of mortgages with 35% risk weight. Mortgages secured with a universal pledge do not have a well-defined LTV and do therefore not carry the reduced risk weight.

Mortgages	Performing		More than 90 days past due		
	Exposure	Risk weight	Exposure	Risk weight	Total
Loan-to-value below 80%	80,352	35%	8,142	50%	88,493
Loan-to-value above 80%	13,700	75%	2,194	100%	15,893
Undefined LTV	9,715	75%	863	100%	10,578
Newly aquired Byr mortgages	19,750	75%	5,803	100%	25,552
Total	**123,516**		**17,001**		**140,517**

Table 4.5: Mortgage portfolio year-end 2011 (carrying amount, ISK m). Parent, unaudited.

Term loans

Term loans to individuals are often secured with residential real estate but 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.

Leases

Lease agreements to individuals are mostly provided for car purchases. The Bank considers them to be loan agreements, although they have the legal form of a lease. The underlying asset of the lease agreement is the collateral for the Bank.

Overdrafts and credit cards

Overdrafts and credit cards to individuals are usually uncollateralised short-term consumer loans. The increase in overdrafts between years is mostly due to the acquisition of Byr.

Loans to Companies

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

Loans to companies by sector	31.12.2011		31.12.2010	
Commerce and Services	63,956	19%	50,887	15%
Construction	14,699	4%	17,088	5%
Energy	3,505	1%	2,122	1%
Financial institution	1,400	0%	4,248	1%
Government secured customer loan	38,798	12%	52,182	15%
Industrials	33,969	10%	20,956	6%
Investment companies	24,392	7%	42,124	12%
Public sector and non-profit organisations	9,538	3%	10,383	3%
Real estate	75,329	22%	74,524	22%
Seafood	70,620	21%	67,934	20%
Total	**336,206**	**100%**	**342,448**	**100%**

Table 4.6: Loans to companies by sector (carrying amount, ISK m). Consolidated, audited.

The industry breakdown in Table 4.6 shows the Bank's credit exposure by industry 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. One large government secured customer loan is also indicated separately since it would otherwise skew the industry breakdown.

Currency composition of loans to customers

As a principle, the Bank aims to have the currency composition of loans to customers in balance with customer needs. In particular, loans to customers whose income is predominantly in ISK should be denominated in ISK. The Bank is actively working on aligning its customers' currency balances through recalculation and principal adjustment of foreign currency loans. The Bank has also increased the offering of non-indexed long-term loans such as mortgages, and this has been well received. The following table shows a breakdown of loans to customers by four currency and indexation types.

Currency and indexation 2011	Foreign currency	Foreign currency with ISK cash flow	Non-indexed ISK	CPI linked ISK	Total
Individuals	51	8,037	92,362	127,738	228,189
Commerce & Services	1,472	7,370	44,375	10,740	63,956
Construction	–	3,135	8,118	3,446	14,699
Energy	560	550	267	2,128	3,505
Financial institutions	142	–	1,181	77	1,400
Government secured customer loan	–	–	38,798	–	38,798
Industrials	7,041	2,831	18,429	5,669	33,969
Investment companies	1,723	10,928	9,077	2,664	24,392
Public sector & non-profit organisations	–	471	4,682	4,386	9,538
Real estate	7,023	14,801	19,548	33,957	75,329
Seafood	67,126	905	1,701	887	70,620
Total	**85,138**	**49,028**	**238,538**	**191,692**	**564,395**

Currency and indexation 2010	Foreign currency	Foreign currency with ISK cash flow	Non-indexed ISK	CPI linked ISK	Total
Individuals	–	27,028	51,690	93,995	172,713
Commerce & Services	3,511	16,732	21,859	8,784	50,886
Construction	–	5,147	9,789	2,152	17,088
Energy	322	1,234	410	155	2,122
Financial institutions	24	15	4,205	4	4,248
Government secured customer loan	–	–	52,182	–	52,182
Industrials	921	7,473	6,612	5,948	20,955
Investment companies	8,182	11,309	20,743	1,890	42,124
Public sector & non-profit organisations	–	2,541	3,298	4,544	10,383
Real estate	439	33,102	13,596	27,387	74,525
Seafood	61,369	860	3,482	2,223	67,935
Total	**74,770**	**105,442**	**187,866**	**147,083**	**515,161**

Table 4.7: Currency composition of loans to customers. (carrying amount, ISK m). Consolidated, unaudited.

4.5.2 COLLATERAL

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. In the case of corporate entities the Bank takes a charge over assets such as real estate, fishing vessels, cash and securities as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured.

In some cases the Bank uses guarantees as a credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in maximum exposure to credit risk. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

For income producing real estate companies the collateral is sometimes in the form of a charge over rental agreements instead of the underlying property. Government guaranteed real estate projects are considered to be unsecured.

Valuation of collateral is based on market price, official valuation from the Iceland Property Registry or expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation of financial effect, based on a conservative valuation from the Bank's Quota Board.

Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Bank's actual maximum exposure to credit risk.

The financial effect of collateral is now disclosed for the first time. The Bank is still in the process of registering necessary collateral information for this purpose, in particular for loans recently acquired from Byr. For these loans only collateral for mortgages is included. Therefore the table understates the value of total collateral and the on-going registration will improve the picture. Comparative figures for 2010 are not available.

Collateral	Real estate	Fishing vessels	Cash & Securities	Other collateral	Credit exposure	Unsecured credit exposure	Unsecured portion (%)
Cash and balances with Central Bank	–	–	–	–	57,992	57,992	100%
Loans to credit institutions	–	–	–	–	43,655	43,655	100%
Loans and commitments to customers	268,923	62,382	51,531	19,021	564,395	162,538	29%
Individuals	170,491	71	1,148	3	228,189	56,476	25%
Commerce and Services	15,728	–	725	10,504	63,956	36,999	58%
Construction	7,757	–	457	1,270	14,699	5,215	35%
Energy	2,517	–	83	149	3,505	756	22%
Financial institutions	44	–	47	–	1,400	1,309	94%
Government secured customer loan	–	–	38,799	–	38,798	0	0%
Industrials	7,362	–	294	5,703	33,969	20,611	61%
Investment companies	2,933	–	8,901	389	24,392	12,169	50%
Public sector and NPO	3,455	–	9	200	9,538	5,874	62%
Real estate	54,679	154	675	–	75,329	19,821	26%
Seafood	3,959	62,157	392	803	70,620	3,308	5%
Bonds and debt instruments	–	–	–	–	58,662	58,662	100%
Derivatives	–	–	600	–	1,481	881	59%
Total	**268,923**	**62,382**	**52,131**	**19,021**	**726,184**	**323,728**	**45%**

Table 4.8: Collateral at end-year end (carrying amount, ISK m). Consolidated, unaudited.

4.5.3 BALANCES WITH THE CENTRAL BANK AND LOANS TO CREDIT INSTITUTIONS

Cash and balances with the Central Bank totalled ISK 58 billion at end of 2011 compared to ISK 31 billion at end of 2010. This includes certificates of deposits, mandatory reserve deposits and other balances with the Central Bank. The increase between years is due to the Bank's subsidiaries, the acquisition of Byr and liquidity management.

Icelandic credit institutions are defined according to Act no. 161/2002 on Financial Undertakings. The Bank also has exposures to foreign credit institutions, mostly in the form of money-market deposits. Loans to credit institutions amounted to ISK 44 billion at the end of 2011, of which ISK 35 billion were loans to foreign credit institutions. Exposures to foreign financial institutions are classified further in the country risk exposure section.

Loans to the Central Bank and credit institutions	31.12.2011	31.12.2010
Central banks	57,992	30,799
Domestic credit institutions	8,332	7,126
Foreign credit institutions	35,323	23,744
Total	**101,647**	**61,669**

Table 4.9: Loans to the Central Bank and credit institutions (carrying amount, ISK m). Consolidated, unaudited.

Deposits with foreign credit institutions mainly relate to the management of the Bank's foreign liquidity reserves. Foreign deposits are only allowed with credit institutions that have been allocated a credit limit by the Risk Committee. When applying for a credit limit for a specific credit institution a thorough analysis is represented to the committee with key parameters concerning the institution in question. Credit rating is essential for the analysis and the country risk for the respective credit institution is reviewed regularly.

Foreign credit institution rating	31.12.2011	31.12.2010
AA	8,667	4,898
A	26,614	21,927
Unrated	42	193
Total	**35,324**	**27,018**

Table 4.10: Credit rating for foreign credit institutions (carrying amount, ISK m). Consolidated, unaudited.

4.5.4 BONDS AND DEBT INSTRUMENTS

The Bank is exposed to credit risk as a result of trading and investing in bonds and debt instruments, e.g. as part of the Bank's liquidity management, and as a result of restructuring activities.

Table 4.11 presents the Bank's position in bonds and debt instruments. The credit rating here is based on Standard and Poor's ratings or equivalent. The unrated bonds were mostly acquired through restructuring activities but also include bonds issued by Icelandic financial institutions and municipalities.

Bonds and debt instruments	31.12.2011	31.12.2010
Icelandic government and government guaranteed bonds	38,563	34,658
Foreign AAA rated government bills	10,799	30,724
Foreign AA+ rated government bills	5,522	–
Unrated bonds	3,779	2,642
Total	**58,662**	**68,024**

Table 4.11: Bonds and debt instruments by rating class (carrying amount, ISK m). Consolidated, unaudited.

4.5.5 UNSETTLED TRANSACTIONS

At 31 December 2011 unsettled transactions totalled ISK 2,199 million. This is in line with positions due to normal business activities.

4.5.6 GUARANTEES AND UNDRAWN COMMITMENTS

The Bank's maximum credit exposure deriving from guarantees and undrawn commitments totalled ISK 63,136 million at the end of 2011.

Exposure 31.12.2011	Financial guarantees	Undrawn overdrafts	Undrawn loan commitments	Credit card commitments	Off-balance sheet total
Individuals	1,058	9,797	–	19,392	30,247
Commerce and Services	1,444	4,343	2,018	1,522	9,326
Construction	1,577	1,084	–	272	2,933
Energy	4	203	5,345	5	5,557
Financial institutions	1,012	1,363	5,000	48	7,422
Government secured customer loan	–	–	–	10	10
Industrials	1,055	1,993	225	352	3,625
Investment companies	12	72	–	81	165
Public sector and non-profit organisations	73	1,096	–	380	1,548
Real estate	339	513	–	68	920
Seafood	320	986	5	73	1,384
Total	**6,893**	**21,449**	**12,592**	**22,202**	**63,136**

Exposure 31.12.2010	Financial guarantees	Undrawn overdrafts	Undrawn loan commitments	Credit card commitments	Off-balance sheet total
Individuals	920	7,945	–	15,829	24,694
Commerce and Services	1,308	3,339	1,072	1,052	6,771
Construction	2,499	643	–	197	3,340
Energy	–	201	5,045	1	5,247
Financial institutions	–	1,239	5,000	50	6,289
Government secured customer loan	–	–	–	10	10
Industrials	2,265	1,458	1,827	316	5,867
Investment companies	82	529	–	49	660
Public sector and non-profit organisations	22	944	–	304	1,270
Real estate	700	434	510	49	1,694
Seafood	606	452	–	60	1,118
Total	**8,404**	**17,186**	**13,453**	**17,916**	**56,959**

Table 4.12: Guarantees and undrawn commitments (ISK m). Consolidated, audited.

4.5.7 DERIVATIVES

The Bank uses derivatives to hedge currency, interest and inflation 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 held for trading or for other purposes are insignificant.

Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

4.5.8 INDIRECT EXPOSURE

The Bank has indirect exposure to counterparties, i.e. an exposure that is not direct but becomes direct at the event of default of other counterparties. Table 4.13 shows the largest indirect exposures to issuers of securities.

Type of security	31.12.2011
Housing financing fund	2,808
Iceland government bonds	2,734
Shares listed on OMX Iceland	556
Other securities	85
Total	**6,184**

Table 4.13: Indirect exposure (ISK m). Parent, unaudited.

4.5.9 COUNTRY RISK EXPOSURE

Exposure to countries other than Iceland amounted to ISK 63 billion at the end of December 2011 and relates mainly to the management of the Bank's foreign liquidity reserves. The following table shows a breakdown of credit exposure by country of domicile. Exposures to financial institutions and central government are shown separately. Other obligor types are mostly individuals with current domicile abroad.

Country	Financial institutions	Central Government	Other obligor types	Total
Norway	6,709	2,119	2,495	11,324
Denmark	5,884	3,205	1,848	10,937
USA	3,347	5,522	621	9,489
UK	6,363	–	2,673	9,036
Belgium	5,677	–	17	5,695
Netherlands	–	3,179	190	3,369
Luxembourg	2,981	–	236	3,217
Germany	1,841	–	689	2,530
Sweden	1,343	–	921	2,264
France	–	1,588	297	1,886
Switzerland	1,063	–	131	1,194
Other countries	115	794	1,356	2,265
Total	**35,324**	**16,407**	**11,474**	**63,204**

Table 4.14: Credit exposure by country and obligor type at year-end 2011 (carrying amount, ISK m). Parent, unaudited.

4.6 CAPITAL REQUIREMENTS

The Bank reports its Pillar 1 capital requirements for credit risk according to the standardised Basel II approach. Table 4.15 shows exposure amounts, risk weights and corresponding risk-weighted assets for the different portfolios as at 31 December 2011. Currently, only residential real estate and securities issued by the central government are used as credit risk mitigants to reduce capital requirements. The Financial Collateral Simple Method is applied for securities.

The Bank has one significant exposure to a former financial institution which 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.

	Exposure		Credit Risk Mitigation			
	On balance sheet	Off balance sheet (after CCF)	Guarantees	Financial collateral	Inflow	RWA
Central governments or central banks	**55,335**	**1,060**	**–**	**–**	**48,185**	**1,314**
0%	55,226	1,060	–	–	42,351	–
20%	–	–	–	–	3,989	798
50%	108	–	–	–	1,845	516
Regional governments or local authorities	**4,441**	**194**	**–**	**–**	**–**	**1,143**
20%	4,170	194	–	–	–	873
100%	271	–	–	–	–	271
Financial institutions	**41,656**	**503**	**–**	**–**	**–**	**8,589**
20%	41,495	368	–	–	–	8,373
50%	161	–	–	–	–	80
100%	–	136	–	–	–	136
Administrative bodies and non-commercial undertakings	**2,367**	**2,732**	**5,349**	**–**	**–**	**2,423**
100%	2,367	2,732	5,349	–	–	2,423
Corporates	**256,174**	**4,092**	**38,790**	**3,963**	**–**	**217,513**
100%	256,174	4,092	38,790	3,963	–	217,513
Retail	**152,107**	**8,162**	**–**	**33**	**–**	**120,177**
75%	152,107	8,162	–	33	–	120,177
Secured by real estate property	**80,336**	**–**	**–**	**–**	**–**	**28,117**
35%	80,336	–	–	–	–	28,117
Past due items	**72,336**	**57**	**–**	**51**	**–**	**79,123**
50%	8,142	–	–	–	–	4,071
100%	42,539	8	–	51	–	42,496
150%	21,655	50	–	–	–	32,556
Other items	**67,548**	**–**	**–**	**–**	**–**	**73,901**
100%	54,840	–	–	–	–	54,840
150%	12,707	–	–	–	–	19,061
Grand Total	**732,298**	**16,801**	**44,139**	**4,046**	**48,185**	**532,301**

Table 4.15: Exposure, risk weights and risk-weighted assets per asset class at year-end 2011. Consolidated, unaudited.

4.7 LOAN PORTFOLIO ANALYSIS

FME monitors the progress of the restructuring of the Bank's loan portfolio through standardised monthly reports, the so-called LPA (Loan Portfolio Analysis) reports. FME modified the report in June 2011 for further clarification purposes. The report details 19 customer categories ranking 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. These 19 categories form the following three groups:

Group 1 Customers that have not 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 the initial contract but are currently paying according to the new schedule. Modifications include general offers such as principal adjustment and payment adjustment schemes and recalculation of foreign currency loans. 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 and the 110% mortgage adjustment.

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

This categorisation tracks the progress of the Bank's restructuring framework, but does not always indicate that the restructuring is fully completed. 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 4.9 and 4.10 show how the loan portfolio was divided into the three LPA groups every quarter since the end of 2009. The first graph is for individuals and the second is for companies. The sudden shift in Q2 2011 is due to changes in the definition of categories made by FME.

Management monitors the LPA metric on a monthly basis. The LPA metric is defined as the total carrying amount of loans to customers in group 3 divided by the total carrying amount of loans to customers. At the end of year 2011 the LPA metric was 22.6% and increased by 3% after the acquisition of Byr. Figure 4.11 shows a further breakdown of the LPA metric. Close to half of the workout portfolio is already in finalisation stages of documentation.

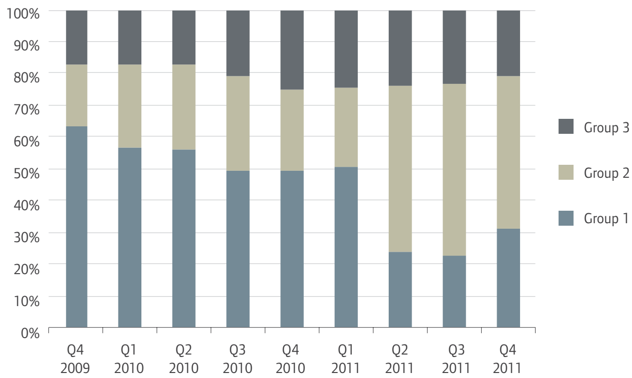

Figure 4.9: LPA groups for individuals. Parent, unaudited.

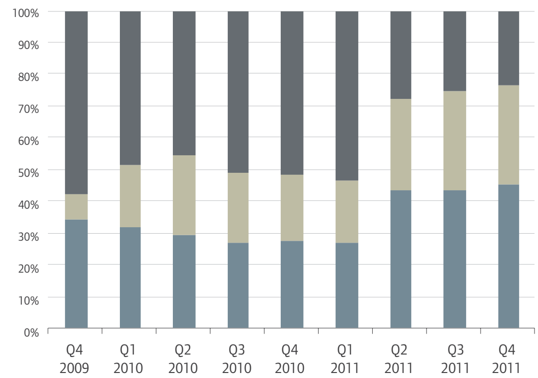

Figure 4.10: LPA groups for companies. Parent, unaudited.

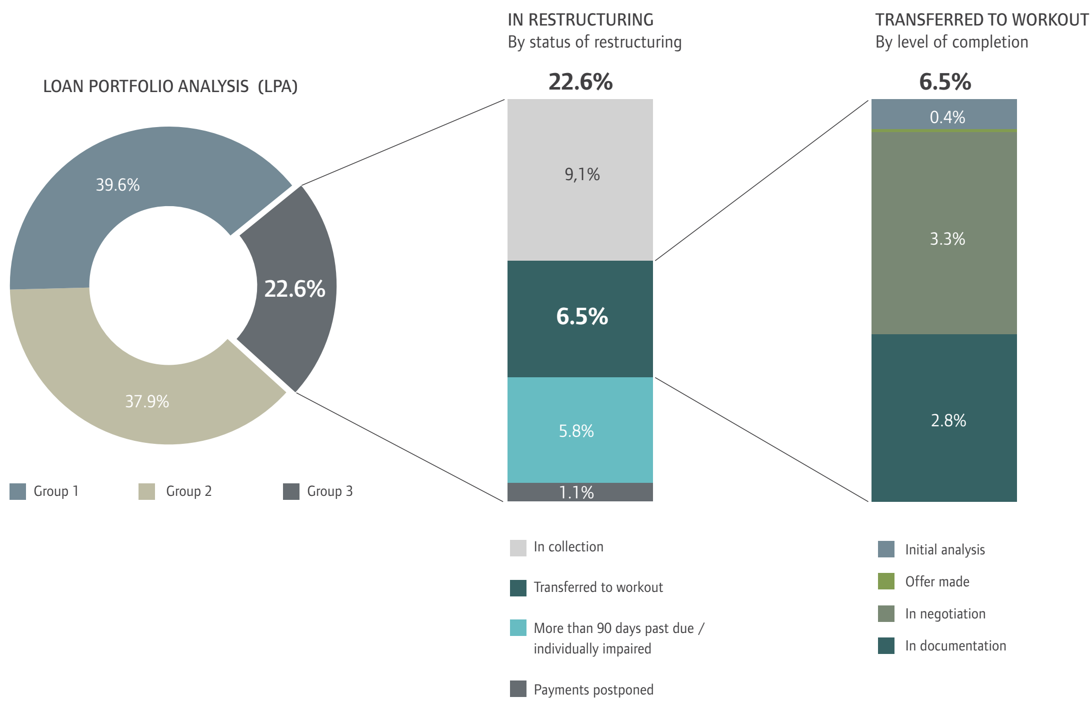

Figure 4.11: Subcategories of the Loan Portfolio Analysis. Parent, unaudited.

5 MARKET RISK

The market risk profile has changed somewhat since 2010 with two significant changes worth mentioning. Firstly, the currency exposure was reduced markedly between years through a currency swap at the end of 2010. This results in a much lower average and maximum currency exposure in 2011 than in 2010. Secondly, exposure towards equities in the non-trading book increased substantially through the acquisition of Byr. These positions are not considered to be a part of the Bank's long-term strategy.

In addition to the factors mentioned above, the Bank assumed a somewhat increased exposure to interest rate risk in the banking book through the Byr acquisition, both through increases in the loan portfolio and through long-dated government bonds that are not classified as a part of the Bank's trading portfolio.

Market risk has been identified as one of the material risk factors in the Bank's operations. The Bank takes on market risk as a part of its business strategy and aims at keeping a moderate market risk profile. Market risk is mainly originated in the banking book due to mismatches in assets and liabilities with respect to currencies, interest reset dates and inflation indexation and due to shares and equity instruments acquired through restructuring. These positions are however managed within strict limits according to the Bank's market risk appetite as approved by the Board.

The Bank also takes on market risk in relation to its trading activities or other activities of the Markets or Treasury units. Those positions are subject to a strict limit structure both end-of-day and intraday and are closely monitored by Risk Management and Credit Control.

5.1 DEFINITION OF MARKET RISK

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

The Board has defined the market risk appetite of the Bank relative to the Bank's Tier 1 capital. Given predetermined shift in risk factors, the amount at risk should not exceed 20% of Tier 1 capital.

5.2 STRATEGY, ORGANISATION AND RESPONSIBILITY

The overall responsibility for managing market risk within the Bank lies with the Board of Directors. The Board determines the market risk appetite for the Bank in the Market Risk Policy which also states the roles and responsibilities in relation to market risk management.

The objective of the market risk management framework 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. This strategy is reflected in the overall market risk limits applied for the Bank and reported to the Board of Directors at least once a monthly .

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 and Credit Control is responsible for monitoring and reporting on the Bank's overall market risk position and compliance to limits. The 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 a part of the Bank's flow trading and through the Bank's liquidity portfolio. The positions are managed with 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 domestic 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 market risk are subject to various limits. Positions in the banking book mainly relate to 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 Bank's equity exposure is in both listed and unlisted shares.

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 and the timing of cash flows. *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 adverse movements in inflation level.
Credit spread risk	The risk that earnings or capital may be negatively affected from the adverse 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 a 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 or equity instruments.
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 5.1: Main categories of market risk within Íslandsbanki.

5.3 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 contribute 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 are used for selected portfolios. These tools are used as complementary information to notional limits and sensitivity measures but are not a part of the formal limit structure for market risk.

Limit Structure

All market risk limits are set by ALCO and must be in accordance with the appetite defined by the Board. Risk Management and Credit Control monitors the trading activities of the Bank and ensures that positions and margin requirements are in accordance with limits. All breaches are reported to ALCO, which decides on appropriate actions, depending on the severity of the breach. The main types of market risk 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.

5.4 MARKET RISK EXPOSURE

Table 5.2 displays the main categories of market risk exposures in 2011 and 2010. Since many of the exposures are quite volatile by nature, especially those in the trading book, the exposure displayed represents the maximum, minimum and average exposure in each category over the year.

Exposure	2011 Maximum	2011 Minimum	2011 Average	2010 Maximum	2010 Minimum	2010 Average
Equity risk (trading, net position)	204	2	101	275	(25)	39
Equity risk (non-trading, net position)	14,530	4,995	10,896	5,076	1,484	2,467
Interest rate risk (100 bp parallel shift, trading)	390	1	143	712	1	288
Interest rate risk (Moody's shift, non-trading)	1,442	639	818	910	705	836
Inflation risk (net position)	30,859	16,600	24,872	29,319	17,043	23,372
FX risk (net position)	13,687	(2,580)	3,070	50,023	759	42,431
Derivatives (MV)	132	(4,474)	(1,679)	429	(134)	148

Table 5.2. Market risk exposure (ISK m). Consolidated, unaudited.

5.5 SHARES AND EQUITY INSTRUMENTS

The Bank's equity exposure arises mainly from shares acquired through restructuring of companies but also from flow trading. Most of the shares are denominated in ISK. 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 established an asset management and holding company, Miðengi, a subsidiary of the Bank, for the purpose of managing and selling assets acquired through the restructuring process. The price risk of all subsidiaries' underlying assets is included in the sensitivity analysis in Table 5.3.

2011	Held for trading	Designated at fair value	Non-current assets and disposal groups held for sale	Securities used for hedging	Total
Listed	202	5,216	–	112	5,529
Unlisted	191	5,394	2,182	–	7,767
Total	**393**	**10,610**	**2,182**	**112**	**13,296**
2010					
Listed	411	51	–	–	462
Unlisted	–	2,560	–	–	2,560
Total	**411**	**2,611**	**–**	**–**	**3,022**

Table 5.3. Shares and equity instruments at year-end 2011 and 2010 (ISK m). Consolidated, audited.

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. At year-end 2011 and 2010 the impact of the sensitivity measure was ISK 5.2 billion and ISK 1.1 billion, respectively.

5.6 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 fixed income trading book is divided into three portfolios: Flow trading, hedge portfolio and liquidity portfolio.

The **flow trading portfolio** consists of positions that the Bank takes on as a market maker for Icelandic 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 the Bank as a market maker is to enhance price formation in the secondary market and to be a provider of liquidity to clients.

Since the fall of the Icelandic banks in 2008 the market for corporate bonds has been virtually non-existent. As a result the Bank 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 ten years for non-indexed bonds, while the CPI-linked HFF bonds have duration of up to 14 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day limits. In addition to BPV limits, both the total short and long positions in the underlying bonds are limited. Inflation risk in the trading book is minimal and is not separately reported but included in the Bank's total exposure to the CPI.

At the end of 2011, the BPV for the indexed and non-indexed bonds was ISK 0.41 million and ISK -0.25 million, respectively.

The Bank also holds a significant amount of foreign triple-A credit-rated[2] government bills in its **liquidity portfolio**. These bills are held for cash management purposes and can be liquidated at short notice. Duration ranges up to six months and the sensitivity measured in BPV was ISK -0.3 million at the end of 2011.

	2011		2010	
Country	**MV**	**BPV**	**MV**	**BPV**
Denmark	3,205	(0.08)	–	–
Finland	794	(0.00)	–	–
France	1,588	(0.01)	5,380	(0.06)
Germany	–	–	3,844	(0.04)
Netherlands	3,179	(0.05)	5,379	(0.10)
Norway	2,033	(0.06)	1,953	(0.06)
UK	–	–	3,473	(0.02)
USA	5,522	(0.13)	10,350	(0.34)
Total	**16,321**	**(0.33)**	**30,379**	**(0.62)**

Table 5.4. Origin of government issued bills and BPV in the Bank's Liquidity portfolio (ISK m) at year-end 2011 and 2010. Consolidated, audited.

The **hedge portfolio** consists of hedge positions against bond options and interest rate swaps contracts. Bond options and interest rate swaps are subject to BPV limits. Additionally the bond options are subject to e.g. net delta limits. The net BPV of unhedged positions is close to zero.

The maximum total position in the trading portfolio over the year, excluding the hedge portfolio,was ISK 26.6 billion (2010: ISK 43.9 billion) whereof the largest position in indexed securities was ISK 2.3 billion (2010: ISK 4.7 billion) and the largest position in non-indexed securities was ISK 26.4 billion (2010: ISK 43.5 billion).

		2011			2010	
Long positions	**MV**	**Duration**	**BPV**	**MV**	**Duration**	**BPV**
Indexed	379	9.22	(0.35)	2,124	9.01	(1.91)
Non-indexed	17,231	0.32	(0.55)	34,078	0.86	(2.92)
Total	**17,610**	**0.51**	**(0.90)**	**36,202**	**1.33**	**(4.83)**
		2011			**2010**	
Short positions	**MV**	**Duration**	**BPV**	**MV**	**Duration**	**BPV**
Indexed	962	7.89	0.76	1,129	4.74	0.54
Non-indexed	364	8.17	0.30	7,961	1.32	1.05
Total	**1,326**	**7.97**	**1.06**	**9,090**	**1.75**	**1.59**
Net position	**16,284**	**(0.09)**	**0.16**	**27,112**	**1.20**	**(3.24)**

Table 5.5. Bonds and debt instruments in the trading portfolio at year-end 2011 and 2010 (ISK m). Consolidated, audited.

For the sensitivity analysis in the trading portfolio, the Bank estimates a possible but reasonable shift in interest rates. Table 5.6 demonstrates sensitivity to the change in interest rates, with all other variables held constant.

[2] According to the long-term issuer rating from Moody's.

Currency	Parallel upward shift in yield curve (basis points)	2011 Profit or loss	2010 Profit or loss
ISK, indexed	100	41	(138)
ISK, non-indexed	100	7	(125)
CHF	40	0	0
EUR	20	(1)	(4)
GBP	40	0	(1)
JPY	20	0	0
USD	40	(5)	(14)
Other	40	(6)	(3)
Total		**36**	**(284)**

Table 5.6. Sensitivity analysis for bonds and debt instruments in the trading portfolio at year-end 2011 and 2010 (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's main source of interest rate risk in the banking book are fixed rate mortgage loans, covered bond debt, loans in payment detention and fixed-term deposits.

Risk Management and Credit Control 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.

Interest rate risk in the banking book is managed using limits based on the Bank's market risk appetite. All assets and liabilities are divided into four interest rate groups and given weightings based on historical interest rate volatilities in the respective groups according to a methodology from Moody's. These weightings are used to scale the possible parallel shift of the yield curves. In the following tables all interest bearing assets and liabilities are bucketed according to their next interest reset dates or maturity, whichever comes first. 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 for 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.

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Cash and balances with the Central Bank	56,016	–	–	–	–	–	56,016
Bonds and debt instruments	32,218	1,153	1,069	370	1,398	4,458	40,666
Loans to banks	43,551	104	–	–	–	–	43,655
Loans to customers	420,171	27,158	35,739	63,895	1,914	15,517	564,394
Total assets	**551,956**	**28,415**	**36,808**	**64,265**	**3,312**	**19,975**	**704,731**
Off-balance sheet items	59,201	–	10,007	3,115	113	–	72,436
Liabilities							
Deposits from the Central Bank	73	–	–	–	–	–	73
Deposits from banks	61,711	1,061	–	–	–	–	62,772
Deposits from customers	456,329	3,383	759	807	1,665	–	462,943
Short positions	–	3,567	1,815	477	–	–	5,859
Debt issued and other borrowed funds	7,221	–	–	6,679	49,133	188	63,221
Subordinated loans	21,937	–	–	–	–	–	21,937
Total liabilities	**547,271**	**8,011**	**2,574**	**7,963**	**50,798**	**188**	**616,805**
Off-balance sheet items	62,484	–	9,862	3,070	–	–	75,416
Net interest gap on 31 December 2011	**1,402**	**20,404**	**34,379**	**56,347**	**(47,373)**	**19,787**	**84,946**

Table 5.7. Interest rate adjustment periods in the banking book at year-end 2011 (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	28,966	–	–	–	–	–	28,966
Bonds and debt instruments	31,142	659	–	–	–	22	31,823
Loans to credit institutions	30,520	350	–	–	–	–	30,870
Loan to customers	389,088	37,855	9,481	60,557	2,572	15,607	515,161
Total	**479,717**	**38,864**	**9,481**	**60,557**	**2,572**	**15,629**	**606,820**
Off-balance sheet items	47,903	–	–	–	–	–	47,903
Liabilities							
Deposits from Central Bank	26	–	–	–	–	–	26
Deposits from credit institutions	86,856	1,037	8,319	–	–	–	96,212
Deposits from customers	322,274	2,521	–	1,420	943	–	327,158
Debt issued and other borrowed funds	432	–	–	808	52,639	1,546	55,425
Subordinated loans	21,241	–	–	–	–	–	21,241
Total	**430,829**	**3,558**	**8,319**	**2,228**	**53,582**	**1,546**	**500,062**
Off-balance sheet items	48,216	–	–	–	–	120	48,336
Net interest gap on 31 December 2010	**48,575**	**35,306**	**1,162**	**58,329**	**(51,010)**	**13,963**	**106,327**

Table 5.8. Interest rate adjustment periods in the banking book at year-end 2010 (ISK m). Consolidated, audited.

Table 5.9 shows the net fair value impact of the applied shifts on the Bank's assets and liabilities based on the duration of the underlying exposures.

		2011	2010
Currency	Parallel upward shift in yield curve (basis points)	Fair value impact	Fair value impact
ISK, indexed	40	(935)	(684)
ISK, non-indexed	100	(487)	62
CHF	40	5	(5)
EUR	20	3	3
GBP	40	(1)	0
JPY	20	(3)	(2)
USD	40	(8)	1
Other	40	1	1
Total		**(1,425)**	**(624)**

Table 5.9. Sensitivity analysis for bonds and debt instruments in the banking book at year-end 2011 and 2010 (ISK m).
Consolidated, audited.

5.7 INFLATION RISK

The Bank 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 through interest income. 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 2011 the CPI gap amounted to ISK 22 billion (2010: ISK 25 billion). Thus a 1% increase in the index would have a positive impact on the profit and loss account to the amount of ISK 220 million and a 1% decrease would result in a similar loss, all other factors held constant.

5.8 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. When assessing its active currency imbalance Íslandsbanki treats part of its foreign currency denominated loans as ISK assets (FX/ISK) since the recovery of these loans is assumed to be capped in ISK terms. In addition to traditional factors there are several untraditional factors that can impact the measured currency imbalance. These are:

- Reclassification of assets between FX/ISK assets and real foreign currency denominated loans
- Recalculation and conversion to ISK of real foreign currency denominated loans
- Revaluation of real foreign currency denominated loans

As a part of the Bank's effort to minimise currency risk, the Bank aims to eliminate currency mismatches as soon as they become apparent, no matter how the mismatch might arise

5.9 Derivatives

The Bank offers interest rate swaps (IRS), cross currency interest rate swaps (CIRS), bond options, foreign exchange currency options (FX options), foreign exchange swaps (FX swaps), outright forwards (FX forwards), equity forwards, bond forwards and repurchase agreements (REPO's) either for customers' speculative or hedging purposes. All derivative positions that carry market risk are subject to market risk limits. Interest rate swaps, both IRS and CIRS, are limited with BPV and maturity limits while options are subject to several limits, including a limit on the open delta position per underlying instrument.

Derivatives that do not carry direct market risk (due to hedging), e.g. forward agreements for FX and securities, carry notional limits that limit the Bank's indirect exposure to the underlying risk factors. The Bank, itself, uses derivatives to hedge out currency exposure, interest rate risk in the banking book as well as inflation risk. Other derivatives in the Bank held for trading or for other purposes are insignificant.

5.10 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

5.11 CAPITAL REQUIREMENTS

The Bank calculates its Pillar 1 capital requirements for market risk using the standardised approach according to the Capital Requirements Directive (CRD). Table 5.10 shows the capital requirements for market risk at Íslandsbanki at the end of 2011 and 2010. The Bank accounts for the market risk not covered under Pillar 1 in its internal capital adequacy assessment under Pillar 2.

Íslandsbanki maintained a moderate market risk profile throughout 2011 with market risk accounting for 2.7% and 2.8% of the Bank's capital requirement under Pillar 1 at the end of 2011 and 2010, respectively.

	2011		2010	
Risk exposure	**Capital requirement**	**RWA**	**Capital requirement**	**RWA**
Equity risk	91	1,138	92	1,154
Foreign exchange risk	1,184	14,800	815	10,183
Interest rate risk	61	757	274	3,429
Total	**1,336**	**16,695**	**1,181**	**14,766**

Table 5.10: Capital requirements and risk weighted assets (RWA) for market risk at year-end 2011 and 2010 (ISK m). Consolidated, audited.

5.12 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 exposures 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 that carry direct market risk.
- Indirect market risk through derivatives: Credit losses can occur in the case of severe market movements and insufficient collateral.

In the year 2011 the Bank issued covered bonds. According to law 11/2008 and FME's regulation 528/2008 the Bank runs weekly stress tests comparing the net present value of the issued bonds and the loans in the cover pool under various stress scenarios, including a sudden and permanent interest rate shock.

6 LIQUIDITY RISK

Íslandsbanki maintained a good liquidity position throughout 2011. The ratio of cash equivalents against demand deposits was at 22% at the end of 2011 as compared to 17% at the end of 2010. The ratio of liquid assets against total deposits was at 36% at the end of 2011 as compared to 39% at the end of 2010. The FME requirements assume that these ratios are above 5% and 20% respectively.

The 1 and 3 month Central Bank liquidity ratios stood at 143% and 142% at the end of 2011 compared to 150% and 152% at the end of 2010.

Through the merger with Byr, the Bank's deposit to loan ratios increased substantially. The ratio of customer deposits against loans to customers increased from 65% at the end of 2010 to 82% at the end of 2011. The ratio of total deposits to total loans increased from 79% to 87% over the same period.

The funding environment for Íslandsbanki has been characterised by the capital controls, a slow recovery of the domestic securities market and the extensive deposit guarantee given by the Icelandic government following the collapse of the three largest Icelandic banks in the fall of 2008. Throughout 2011, investors in Iceland continued to direct the majority of their investments to deposits and government paper. This is reflected in high deposit to loan ratios throughout the system.

The Bank's first covered bond issuance in December 2011 was well received by investors and raises optimism regarding further reliance on covered bonds as a stable source of long-term funding for the Bank.

Liquidity risk is considered a material risk factor in the Bank's operations. The core activity of the Bank relates to accepting deposits of very short to medium term and extending debt to borrowers that is generally of a longer term. This transformation of maturity between depositors and borrowers exposes the Bank to liquidity risk. The Bank's strategy for managing liquidity risk assumes that the Bank can at all times meet its financial obligations as they fall due.

6.1 DEFINITION OF LIQUIDITY RISK

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

6.2 STRATEGY, ORGANISATION AND RESPONSIBILITY

The overall 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.

The Asset and Liability Committee (ALCO) supervises and decides on limits for liquidity risk. ALCO is responsible for approving the Liquidity Risk Policy and submitting it to the Board of Directors for final approval.

The Risk Management and Credit Control department is responsible for communicating the Bank's Liquidity Risk Policy to the business units and the subsidiaries. Risk Management and Credit Control makes suggestions to ALCO and the Board of Directors on the liquidity risk appetite, limit structure and the liquidity risk management framework. Risk Management and Credit Control is also responsible for reporting on the Bank's overall liquidity position and compliance to limits, both internally and externally.

The Treasury is responsible for managing the liquidity of the Bank within limits set by ALCO and for reporting on the funding status of the Bank. Treasury makes proposals to ALCO for internal pricing and lending quotas if applicable. The day-to-day management of liquidity is delegated by Treasury to the Interbank Desk.

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. 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.[3]

[3] Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems, December 2010.

The main components of the Bank's liquidity strategy assume 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 adequate 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

This Bank's liquidity management framework 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).

6.3 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.

6.4 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 and Credit Control, 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.

6.5 LIQUIDITY POSITION

Íslandsbanki has maintained a good, and relatively stable, liquidity position throughout 2011 and all regulatory and internal metrics have been well above limits.

The Bank's liquidity strategy aims at maintaining a healthy ratio of liquid assets in order to fulfil internal and external liquidity requirements but at the same time earning an acceptable return on the Bank's assets. Table 6.1 shows the composition of the Bank's liquidity backup at the end of 2011 and 2010.

Composition and amount of liquidity back-up	31.12.2011	31.12.2010
Cash and balances with Central Bank	53,162	30,799
Domestic bonds eligible as collateral against borrowing at the Central Bank	55,024	54,881
Foreign government bonds	16,323	30,378
Short-term placements with credit institutions	36,695	28,332
Government liquidity facility	25,000	25,000
	186,204	**169,390**

Table 6.1: Composition and amount of liquidity back-up (ISK m). Parent, unaudited.

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

6.6 FME LIQUIDITY RATIOS

The FME has two liquidity measures that Icelandic banks are 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. These rules apply to and are reported for the parent company. 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 6.1 shows the development of the FME liquidity ratios for Íslandsbanki in 2011. As of mid-year 2011 the ratios increased but lowered again at the end of year mainly due to the merger with Byr. Both ratios are still well above the regulatory minimum.

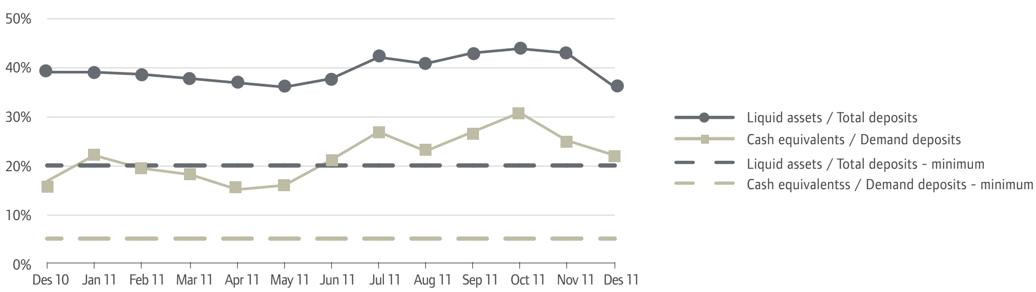

Figure 6.1: FME liquidity ratios. Parent, unaudited.

6.7 CENTRAL BANK LIQUIDITY RATIOS

The Central Bank liquidity requirements 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 6.2 shows the development of the Central Bank liquidity ratios for Íslandsbanki in 2011.

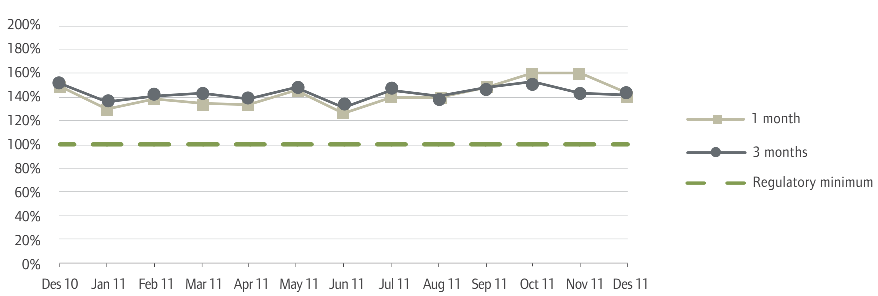

Figure 6.2: Central Bank liquidity ratios. Parent, unaudited.

During 2011, the Central Bank requested a change in the methodology in classification of deposits in the CB liquidity report. The previous method that the Bank used had been defined after discussions with the CB in early 2010 but in August 2011, the Central Bank asked that the Bank changed the methodology. The change resulted in a significant drop in the reported ratios which are however still well above the required minimum. As a consequence, the ratios shown in the Risk Report for 2010 are not comparable to those reported here.

6.8 LIQUIDITY COVERAGE RATIO AND NET STABLE FUNDING RATIO

In December 2010, The Bank for International Settlements (BIS) introduced new regulatory standards for liquidity risk management in the document *International Framework for Liquidity Risk Measurement, Standards and Monitoring*. These new standards are a part of the Basel III framework and are focused on implementing common liquidity measures for all banks, i.e. the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The current plans assume that the LCR will be implemented as of year-end 2015 and the NSFR as of year-end 2018. However there is still substantial uncertainty with respect to the final interpretation of the standards and their implementation in Iceland.

Íslandsbanki is monitoring the international developments in this respect and the LCR and NSFR ratios are calculated and reported internally in order to anticipate the impact if and when implemented. Íslandsbanki is also in good dialogue with the Icelandic regulator in relation to the implementation of the Basel III liquidity ratios and has for example provided the regulator with information for an impact study performed in 2011.

6.9 LIQUIDITY STRESS TESTING

Currently the Bank has in place a simple but robust stress testing framework for liquidity. The stress tests are intended to assess the development of the Bank's liquidity position under stressed market conditions without access to new funding. The stress testing framework is supplemented by a Liquidity Contingency Plan.

6.10 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.

6.11 FUNDING

Deposits

Deposits remain Íslandsbanki's main funding source and one of the metrics that is constantly monitored is the deposit to loan ratio. The merger of Íslandsbanki and Byr at the end of 2011 strengthened the Bank's deposit funding even further and the ratio of customer deposits against loans to customers increased from 65% at the end of 2010 to 82% at the end of 2011. The ratio of total deposits to total loans, i.e. including transactions with other banks, increased from 79% to 87% over the same period.

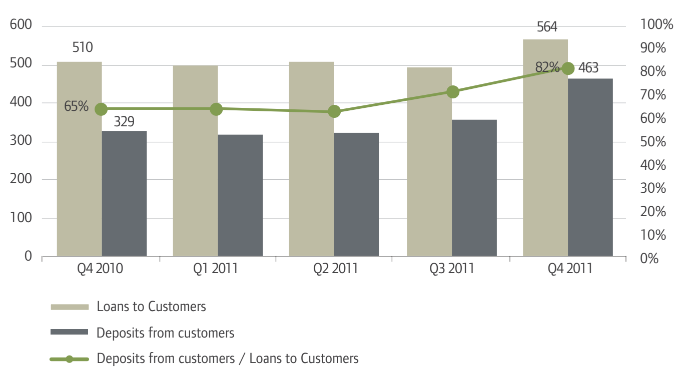

Figure 6.3: Development of deposits from customers and loans to customers (ISK bn). Consolidated, unaudited.

Íslandsbanki puts emphasis on managing its deposits so as to reduce concentration. This is reflected in internal liquidity measures where a special concentration charge is applied to account for the possible outflow from 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	Basel III 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 corpo rate and other legal entities
Non-financial corporate	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 6.2: Basel III criteria for deposit categorisation.

Figure 6.4 shows a breakdown of the Bank's total deposits totalling ISK 534 billion at year-end 2011, according to the Basel III definitions in Table 6.2. The last category, other legal entities, is further broken down into fiduciaries, domestic financial institutions, foreign financial institutions and other.

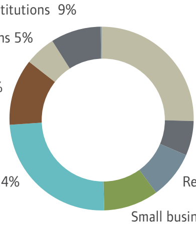

Figure 6.4: Total deposits of ISK 534 billion, breakdown by counterparty type year-end 2011. Parent, unaudited.

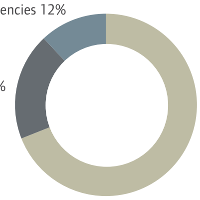

Figure 6.5: Currency composition year-end 2011. Parent, unaudited.

The Byr merger has strengthened the Bank's deposit funding, not only in terms of amount but also in terms of the ratio of deposits considered to be stable. The ratio of deposits from retail individuals and small businesses has gone from 44% at the end of 2010 to 50% at the end of 2011. Thereof, 32% are considered stable in nature and 16% less stable, compared to 31% and 13% at the end of 2010. The distinction between stable and less stable is based on the size of the deposits, i.e. smaller deposits are considered more stable than larger ones. The type of relationship that the Bank has with the customer is also taken into account. Table 6.3 shows how the deposit composition has changed over 2011.

Deposit breakdown	31.12.2011	31.12.2010
Retail individuals, stable	26%	23%
Small business, stable	6%	5%
Retail individuals, less stable	8%	8%
Small business, less stable	10%	8%
Non-financial corporates	24%	16%
Fiduciaries	12%	14%
Domestic financial institutions	5%	12%
Foreign financial institutions	9%	11%
Other	0%	3%
	100%	100%

Table 6.3: Deposit breakdown end of 2011 and end of 2010. Parent, unaudited.

Short-term Outlook

The outlook for 2012 is positive regarding liquidity. Deleveraging in the Icelandic financial system continues to limit demand for new loans while loan repayments continue to provide a strong inflow of cash. In anticipation of a decrease in appetite for low yielding investments such as deposits and government securities the Bank expects to issue bonds and commercial papers in the domestic market in 2012. The Bank is not reliant on access to foreign funding in the short-term and is exploring the possibility of raising funds in international markets. However, foreign issuance is highly dependent on the Icelandic governments continued ability to raise funds abroad and the potential for an upgrade of the sovereign rating.

One of the main uncertainties regarding liquidity relates to the lifting of capital controls. The Bank is well prepared to deal with a short-term outflow of funds but successful lifting of the controls is vital for the health and stability of the financial system.

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 6.6 shows the development of deposits and lending in the Icelandic banking system since January 2004. The blue 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 residential deposits increased in the wake of the declaration of the full deposit guarantee given by the Icelandic government. As a result, current deposit-to-loan ratios are very high from a historical perspective.

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.

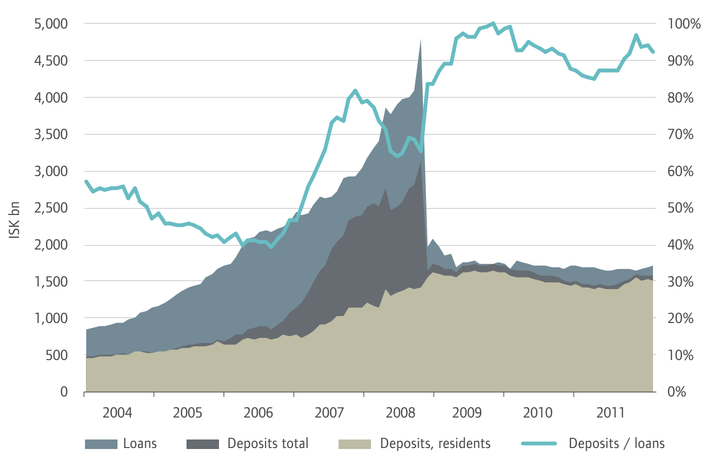

Figure 6.6: Deposits and lending in the Icelandic banking system (ISK bn). Source: Central Bank of Iceland.

It should be noted that the figures presented for the system does not include transactions between banks. According to the Central Bank Statics deposits in the system increased between end of year 2010 and 2011. As shown is figure 6.6 deposits decrease over the first six months and then increase again. In the second half of 2011 FME withdrew the operating license of the old banks. Before the old banks were classified as credit institutions and not included in the numbers but after losing their operating license they were classified as holding companies and included in the numbers. This is the main reason for the increase in deposits in the system in the second half of 2011.

7 OPERATIONAL RISK

In 2011, a total of 239 loss events were registered in the Bank's loss event database. The loss events are categorized according to Basel II convention, and the category Clients, products and business practices accounts for 43% of all loss events, and the category Execution, delivery and process management accounts for 32% of all loss events. The most frequent types of loss events also caused the largest accumulated loss amounts. The category Clients, products and business practices accounts for 65% of the total lost amount attributed to operational risk in 2011.

In 2011, the Bank continued to strengthen the framework for operational risk management. The Board of Directors has updated the Operational Risk Management Policy and the Executive Board has approved a Business Continuity Management Framework, which is now being implemented in the Bank.

7.1 DEFINITION OF OPERATIONAL RISK

The Bank has adopted the definition of operational risk from the CRD 2006/48/EC of the European Parliament and of the Council, where operational risk is defined "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." The Bank's definition of operational risk includes legal risk, compliance risk, and reputational risk.

7.2 STRATEGY, ORGANISATION AND RESPONSIBILITY

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank and its subsidiaries. The policy outlines a framework for operational risk management in the Bank. The operational risk management framework is described in further detail in several subdocuments, such as the Business Continuity Management Framework, the Security Policy, and the Crisis Communication Policy, all of which are approved by the Executive Board.

According to the Operational Risk Management Policy, the Executive Board is responsible for the operational risk framework, and The Risk Monitoring unit within Risk Management and Credit Control is responsible for the implementation of the operational risk framework throughout the Bank.

The Bank takes on financial risk, such as credit risk or market risk, for the purpose of generating revenue, and the appropriate pricing of financial risk is at the core of the Bank's business. Undertaking operational risk, however, does not generate revenue for the Bank, and therefore the Bank's aim is to accept no operational risk unless the cost of preventing risk outweighs the benefits. The Bank has implemented an operational risk management framework within the parent company that fulfils the Basil II Accord's requirements for the standardised approach.

The main tools for operational risk management are:

- Registration of all operational risk loss events occurring in the Bank
- A process of Risk and Control Self Assessment (RCSA) throughout the Bank
- Monitoring of Key Risk Indicators (KRI) throughout the Bank
- Business continuity management
- Management reporting that provides operational risk reports to relevant functions within the Bank

In the Operational Risk Management Policy, the Board has defined limits for acceptable losses due to operational risk. If quarterly losses exceed a certain limit, a special report of the losses and a risk mitigation plan is delivered to the Executive Board or the Board of Directors.

Whereas Risk Monitoring is responsible for the development of the operational risk management framework and for monitoring operational risk, each business unit is primarily responsible for managing and controlling its own operational risk.

7.3 MEASUREMENT AND MONITORING

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

Operational risk 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 in the Bank's loss event database. The database holds all information on actual losses, categorised according to Basel II convention, and provides a basis for management reports. Also, the loss event data are necessary for the development of more sophisticated methods of capital requirements assessment.

In 2011, a total of 239 loss events were registered in the Bank's loss event database. The category *Clients, products and business practices* account for 43% of all loss events, and Execution, delivery and process management account for 32% of all loss events.

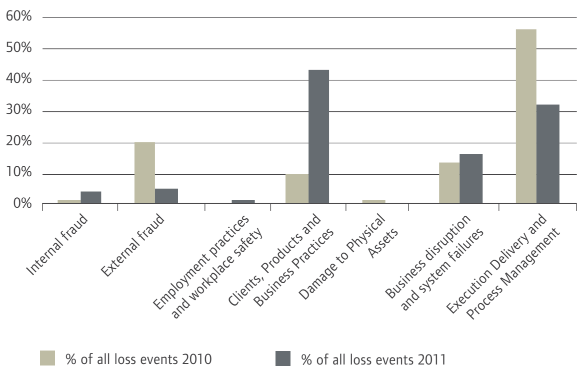

Figure 7.1: Breakdown of loss events in 2010 and 2011 based on Basel II event categories. Parent, unaudited.

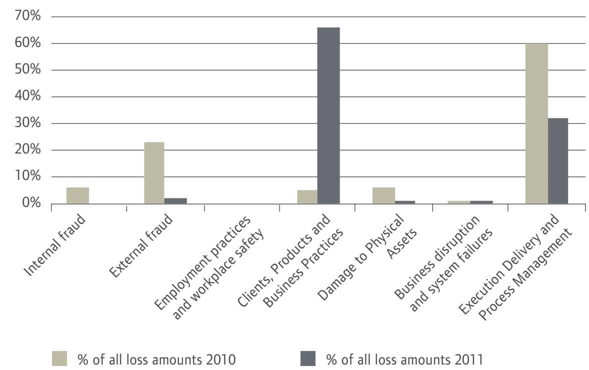

Figure 7.2: Breakdown of loss amounts in 2010 and 2011 based on Basel II event categories. Parent, unaudited.

In 2011, the most frequent types of loss events also caused the largest accumulated loss amounts. *Clients, products and business practices* account for 65% of the total lost amount attributed to operational risk in 2011

One of the responsibilities of Risk Monitoring 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, and in 2011, most of the loss registrations originated from the various business units rather than from Risk Monitoring.

In addition to the collection of actual losses, the Bank uses the Risk and Control Self Assessment process to identify and assess all potential operational 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 approximately 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 purpose of this framework is to improve the way the Bank operates through regular review of policies, processes and systems.

Risk Monitoring 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, KRI measurements and RCSA results and are submitted at least quarterly to the Board of Directors, the Executive Board and relevant business owners.

7.4 CAPITAL REQUIREMENT

The Bank uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for Pillar 1 operational risks, in accordance with FME regulations 215/2007 on capital management.

Under the Basic Indicator Approach the capital requirement for operational risk is equal to 15% of a relevant indicator. The relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

The Bank uses operational risk scenario analysis in the ICAAP process to assess the need (if any) for Pillar 2 capital in addition to the Pillar 1 regulatory minimum.

7.5 REPUTATIONAL RISK

Reputational risk is the risk to earnings or capital arising from adverse perceptions of the Bank by customers, counterparties, shareholders, investors, or regulators. Unfavourable perceptions can affect the Bank's ability to maintain existing business relationships or establish new relationships, and serious harm to the Bank's reputation may limit the Bank's access to funding.

Following the collapse of the Icelandic banking sector in 2008, the public perception of financial institutions in Iceland has been unfavourable. Additionally, the Bank has recognised that in addition to the general sentiment toward financial institutions, the perceived connection between Íslandsbanki and Glitnir causes specific reputational risks 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 Executive Board has also approved a Crisis Communication Policy where responses to reputational crises are outlined.

Changes in the Bank's reputation according to specific measures are portrayed in management reports on operational risk.

7.6 LEGAL RISK

Legal risk is the risk to earnings or capital arising from uncertainty in the applicability or interpretation of contracts, law or regulation, for example when legal action against the Bank is concluded with unexpected results, when contracts are not legally enforceable or rendered illegal by a court's ruling. Legal risk is defined as part of operational risk and managed as such. The Bank faces various legal issues that can significantly impact the Bank's financial and reputational standing. The legal issues are mainly related to the circumstances leading to the establishment of Íslandsbanki in late 2008 and the foreign currency and exchange-rate indexed loans. The main legal issues are described further in the Annual Report 2011, Contingencies note 60.

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.

7.7 OTHER MATERIAL RISKS

The Bank has identified other risk types that are material to the Bank's operations. These are not covered in separate risk policies, but closely monitored and addressed in the regular ICAAP review.

7.7.1 BUSINESS AND 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.

7.7.2 POLITICAL RISK

Political risk is the risk that a government policy, significantly different from current law or regulation, will be enforced, resulting in new legislation or new regulation that adversely affects the Bank's business or the value of the Bank's assets. Several new laws and regulations affecting the Bank were enacted in 2011, and changes in the regulatory environment are discussed in Chapter 9. Several points of policy, published in the current government's policy statement from 2010, await implementation, the most significant being the government's plan to introduce new legislation on the fishing quota system.

The Bank considers the political uncertainties during the ICAAP process and capital - if needed - is allocated to political risk in the Pillar 2 process.

8 REMUNERATION

8.1 BASEL REQUIREMENTS

In July 2011 the Basel Committee issued additional Pillar 3 requirements on remuneration. The requirements are intended to allow market participants to assess the quality of the compensation practices. In addition they will contribute to promote a greater convergence and consistency of disclosure on remuneration.

8.2 ICELANDIC LAW AND REGULATION

On 30 June 2011, the Icelandic Financial Supervisory Authority (FME) published rules on remuneration policy for financial undertakings (700/2011), in adherence to amendments of the Act on Financial Undertakings (161/2002, changes 75/2010). The rules reflect a fairly conservative framework for remuneration schemes within the financial sector. According to the rules a financial undertaking intending to pay variable remuneration to one or more employees is required to have in place a remuneration policy approved by the board of directors and reviewed at least annually and account for the remuneration policy to the FME. The remuneration policy shall fulfil the following requirements:

- Not encourage unreasonable risk taking
- Not contravene the long-term interests of the undertaking and the stability of the financial system
- Conform to viewpoints related to the protection of the undertaking´s customers, its creditors and shareholders or guarantee capital owners
- Conform in other respects to proper and sound business practices

The rules state that the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. Risk control, compliance and internal audit shall review and analyse whether variable remuneration complies with the undertaking's remuneration policy and the FME rules. Variable remuneration shall not be paid to employees in risk management, internal auditing or compliance.

8.3 REMUNERATION AT ÍSLANDSBANKI

Íslandsbanki has a formal remuneration policy, approved by shareholders. The remuneration policy is published on the official website of the Bank.[4] The salaries and other benefits of the Bank's management and Board of Directors are disclosed in the Annual Report, according to IFRS standards.

[4] www.islandsbanki.is/um-islandsbanka/skipulag/verklag/starfsreglur/

9 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 main international change ahead is the proposed Basel III framework from the Basel committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector.

The Icelandic economy has gone through a period of significant adjustments and many of the domestic legislative and regulatory changes are intended to enhance the Icelandic financial regulatory framework. Some of the main regulation changes are presented below.

9.1 BASEL III FRAMEWORK

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

The new international regulatory framework for banks,[5] Basel III, 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 first version of the Basel III framework and issued a revised version in June 2011.[6] The global implementation plan of the framework extends 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 restrict 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.

9.2 DOMESTIC CHANGES

The most significant changes to the Bank's operating environment are new or increased taxes, laws governing the working out of issues arising from recent Supreme Court rulings, and changes to the legislative framework for financial institutions. In addition, changes have been made to the law on the Depositors' and Investors' Guarantee Fund.

9.2.1 INCREASED TAXATION OF FINANCIAL INSTITUTIONS

Since the collapse of the Icelandic banking sector in 2008, the taxation of financial institution has been increased by the raising of several taxes and the introduction of new taxes. In the year 2011, the estimated total tax and regulatory fees paid by the financial industry in Iceland was ISK 25,209 million, and the estimate for 2012 is ISK 30,069 million.[7] The most significant changes in 2011 were:

- Law on the funding of the Financial Supervisory Authority (FME): The law grants the FME the right to collect ISK 2002 million from the regulated parties in the year 2012. In 2011, the FME collected ISK 1,582 million from financial institutions.[8] FME has stated that its need for investigative capacity and funding due to restructuring will be at a maximum in 2012, and in the following years the operations of FME will be slightly reduced.[9]
- Law on the funding of the operations of the Debtors' Ombudsman no. 166/2011: Financial institutions shall collectively fund the estimated ISK 1,050 million cost of the operations of the Debtors' Ombudsman. Each financial institution will be charged 0.03% of all loans.
- Law on the introduction of a new financial undertakings tax no. 165/2011: All financial institutions shall pay a new tax, amounting to 5.45% of all salaries and related expenses. Income above ISK 1,000 million in 2012 will be

[5] www.bis.org/bcbs/basel3.htm
[6] www.bis.org/publ/bcbs189.htm
[7] Icelandic Financial Services Association Annual Report 2011.
[8] Bill proposing an amendment of the law on the financing of the Financial Supervisory Authority no. 99/1999.
[9] FME Annual Report 2011.

subject to a new 6% tax. The expected total amount collected in 2011 for the salary tax is ISK 2,250 million and the expected amount to be collected on 2012 income is ISK 2,250 million. The numbers represent the financial sector as a whole.

- Law on special actions regarding state finances no. 164/2011: A banking tax introduced in 2010 (law no. 155/2010) subjected financial institutions to a new tax amounting to 0.041% of each institution's total liabilities. The new law subjects financial institutions to an additional tax of 0.0875% of each institution's total liabilities.

The chart shows the development of taxes and regulatory fees from 2003 - 2012. The numbers for 2011 and 2012 are estimates. Payments toward the Depositors' Insurance Fund are included.

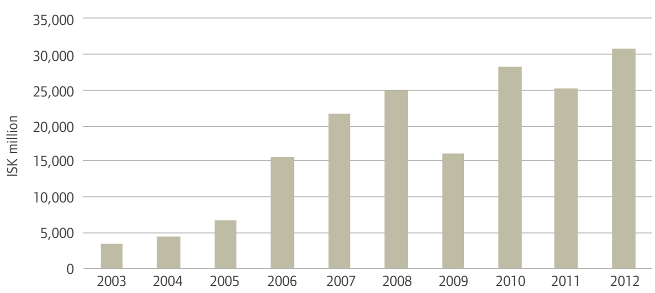

Figure 9.1: Development of taxes and regulatory fees from 2003 – 2012.
Source: Icelandic Financial Services Association Annual Report 2011.

9.2.2 DISENTANGLEMENT OF COMPLICATIONS RESULTING FROM THE COLLAPSE OF THE BANKING SECTOR IN 2008

Following the rulings made by the Supreme Court on the illegality of foreign currency indexation of loans and the ruling on disputed financial leasing contracts, the Parliament has passed laws to minimize the uncertainty as to how to implement the findings of the Supreme Court. In December 2010, the Parliament passed an amendment to the law on interest and indexation no. 38/2001 (Act. no. 151/1010), thereby ensuring the general and uniform implementation of the Supreme Court's ruling on the illegality of foreign currency indexation of loans. The Supreme Court ruled on 15 February 2012 that the law is unconstitutional, thereby making the recalculation of loans based on the law subject to further scrutiny.

In 2011, the Parliament acted to clarify the recalculation/reimbursement of VAT collected on financial leasing contracts following the Supreme Court ruling on disputed leasing contracts (ruling no. 282/2011) by passing an amendment to the VAT law no. 183/2011.

In 2009, the Parliament passed an act on solutions for individuals, homes and companies because of the bank- and currency collapse no. 107/2009. In 2011, amendment was passed, extending the duration of the law to the end of 2012, previously scheduled to expire by the end of 2011.

Partly on the basis of the 2009 act, the financial institutions agreed on common procedures regarding the financial restructuring of small and medium sized companies and debt relief for homeowners and other individuals. In September 2011, the total write-downs as a result of corporate and private debt restructuring amounted to ISK 172.6 billion. for the financial sector as a whole. Despite the considerable relief already granted to deeply indebted households, there still is considerable pressure from various consumer organisations for further debt relief measures.

9.2.3 CHANGES TO THE LEGISLATIVE FRAMEWORK FOR FINANCIAL INSTITUTIONS AND SECURITIES MARKETS

The changes that have been made to the legislative framework involve both the enactment of amendments to law intended to clarify and further govern the dissolution process of insolvent financial undertakings, and the introduction of EC directives into Icelandic law.

- Law on securities funds, investment funds and professional investors' funds no. 128/2011: A new legislative framework for the operations of funds.
- Law on payment service no. 120/2011: An enactment of EC directive no. 2007/64/EC (Payment Service Directive).
- Amendment to the law on financial undertakings no. 119/2011: The legislative framework for financial undertakings (law no. 161/2002) has been changed to enact the Directive 2009/111/EC, containing several amendments to EC directives on financial institutions. The amendments lower the limit on total large exposures and narrow the definition of Tier 1 capital. In addition, changes were made to the chapters on risk management and the regulation of financial institutions.

- Amendment to the law on financial undertakings no. 78/2011: Changes have been made to the legislative framework for financial undertakings (law no. 161/2002) regarding the dissolution process of insolvent financial institutions.

9.2.4 CHANGES TO THE DEPOSITORS' AND INVESTORS' GUARANTEE FUND

A comprehensive bill proposing a new legal framework for the Depositors' and Investors' Guarantee Fund was introduced in the Parliament in 2010. The bill did not advance to a final vote. However, an amendment to the law on the Depositors' and Investors' Guarantee Fund no. 98/1999 was approved by Parliament.

- Amendment to the law on the Depositors' and Investors' Guarantee Fund no. 55/2011: The law on the Depositors' and Investors' Guarantee Fund no. 98/1999 was changed to form a new and separate division of the Depositors' and Investors' Guarantee Fund. Deposits in Icelandic banks are now guaranteed by the new division. Premiums, paid by banks licensed to accept deposits from the public, were increased from ISK 2,400 million in 2010 to an estimated ISK 4,200 million in 2011. Each financial institution shall pay a premium amounting to 0.3% of all deposits, as well as an additional premium based on the institution's risk index. The risk index - to be determined by FME - can raise the premium to as much as 0.9% of all deposits.
- The amendments to the law on the Depositors' and Investors' Guarantee Fund include definitions of guaranteed deposits, thereby excluding certain depositors from the guarantee provided by the Fund, and also excluding certain types of deposits. All deposits from financial institutions, the state and municipalities, securities funds, pension funds, whole-sale deposits and money market deposits are excluded from the guarantee provided by the Fund.

FME has determined the risk index for Íslandsbanki based on three parameters, namely the LPA metric[10] , the capital ratio, and ratio of deposits to total liabilities. The conclusion has been a premium in the range 0.42%-0.43% as shown in Table 9.1.

	Q2 2011	Q3 2011	Q4 2011
Base premium	0.300%	0.300%	0.300%
Risk premium			
due to LPA metric	0.100%	0.100%	0.089%
due to capital ratio	0.000%	0.000%	0.000%
due to ratio of deposits to total liabilities	0.021%	0.028%	0.041%
Total premium	**0.421%**	**0.428%**	**0.430%**

Table 9.1: Depositors' and Investors' Guarantee Fund total premium.

The Bank is actively working on reducing the premium due to LPA metric by completing the restructuring of the loan portfolio. The increase in premium due to the ratio of deposits to total liabilities is explained by the merger with Byr which resulted in a higher proportion of deposit funding.

9.2.5 CHANGES IN THE FISHING QUOTA SYSTEM

The government has proposed ideas involving a gradual redemption of the fishing quota over a 20-year period. Íslandsbanki submitted comments on these changes in June 2011 where the Bank expressed great doubts about these changes. According to the Bank´s comments, most of the changes will result in a negative impact on the operating environment for seafood companies. The industry will become less efficient, profitability will be reduced and the incentive and ability to invest will decrease and the competitive position of the Icelandic fishing industry in overseas markets will be weakened. This will, according to the Bank´s comments, affect the companies´ ability to meet their obligations and therefore reduce the value of the Bank´s portfolio and call for increased impairment and substantial losses for the Bank.

9.2.6 CHANGES TO THE CURRENT LAWS GOVERNING THE GEOTHERMAL ENERGY SECTOR

There has been 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 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, the regulations regarding the sector are closely monitored and its impact on the Bank's business model is assessed accordingly.

[10] See section 4.3

10 RESTRUCTURING

One of the main tasks of Íslandsbanki since its establishment in October 2008 has been restructuring of customers' debt. To that end, the Bank has offered various measures for both individuals and companies. These measures range from being a part of a general restructuring scheme either stipulated by the authorities or following court rulings regarding the legitimacy of foreign currency loans to being offered only for the Bank's customers.

The Bank's cumulative write-offs and remissions from its establishment to year-end 2011 amount to ISK 347 billion, of which ISK 83 billion is to individuals and ISK 264 billion is to companies.

This chapter describes the different measures underlying these figures.

10.1 DEBT RESTRUCTURING MEASURE FOR COMPANIES

One of the Bank's main tasks in 2011 was restructuring of distressed corporate debt and a number of important milestones were achieved that year. The Bank is faced with choices between debt relief, forcing companies into bankruptcy or converting debt to equity. The Bank's goal is to establish a balance between the assets and liabilities of companies in need of restructuring and to sell the stakes acquired through restructuring at the earliest time possible.

In this chapter the various measures offered in 2011 are discussed while the timeline below shows measures that have been on offer since the Bank's establishment in October 2008.

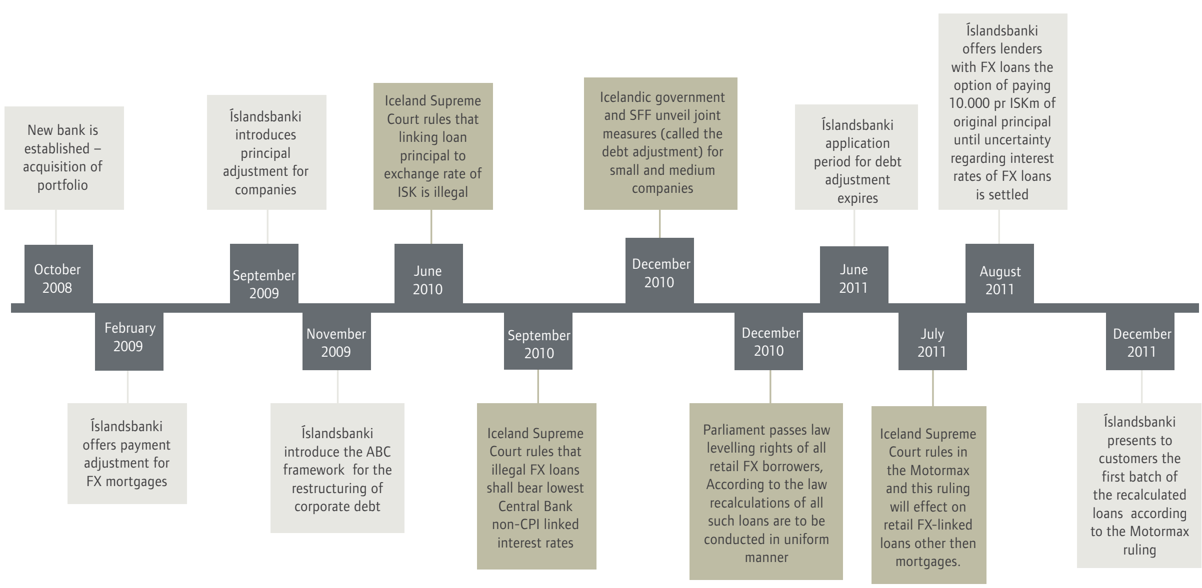

Figure 10.1: Timeline of corporate debt restructuring measures since 2008.

10.1.1 DEBT ADJUSTMENT

The debt adjustment scheme ("Beina brautin") is based on a joint agreement between most members of SFF (Icelandic Financial Services Association) and the Icelandic government. It is applied uniformly in all Icelandic financial institutions with minor variations. According to the agreement all companies eligible for the programme were to receive an offer of refinancing before 1 June 2011.

Definition of the measure
The measure is based on adjusting the debt of companies down to a value that matches their asset value or cash flow value, whichever is higher, in addition to other available collateral. The post-restructuring debt structure comprises:

a. Debt based on the company´s ability to service it, taking into consideration the cash flow as well as potential sale of assets. The debt can be in the form of long-term debt with a normal repayment profile, overdraft facilities, operational funding and loans with an irregular repayment profile. Non-business related assets are in most cases sold or taken over by the Bank.

b. In cases where the asset value is higher than the cash flow value the difference is converted to a deferred loan. The deferred loan has a term of three years with no instalments and carries low interest rates that are all paid at the end of the term. If the deferred loan is pre-paid, partially or in full, by new equity within the three year time period, a pre-determined discount is given. The deferred loan can include covenants on behalf of the creditors, for example limiting the company's ability to pay out dividends, sell assets or increase management salaries.

The debt adjustment measure was tailored for companies with total debt of ISK 1 billion or less. However, the methodology has been successfully applied to on larger companies as well, in those cases injection of new equity has beeb required.

Íslandsbanki approach

Building on the jointly agreed framework, each financial institution applied minor variations to the debt adjustment methodology. For example, Íslandsbanki decided on a sensible approach to personal guarantees of owners of the company and an incentivising time schedule for injection of shareholders equity in exchange for further debt relief.

The application window for debt adjustment according to the agreement was open until 1 June 2011. At that time, credit cases of 210 companies that applied for the measure had been approved by the Bank's credit committees. At year-end 2011, approximately 40 companies out of 210 had been finalized resulting in a total write-off of ISK 7.4 billion. At the same time, Byr received around 40 applications and before merging into Íslandsbanki two applications were finalised resulting in a write off of ISK 0.4 billion. The remaining applications were merged to Íslandsbanki debt adjustment measure.

10.1.2 RECALCULATION OF FOREIGN CURRENCY LOANS

The Supreme Court in Iceland passed a ruling on 9 June 2011 stating that a foreign currency loan taken out by a company named Mótormax ehf. from Landsbanki Íslands was in fact an ISK denominated loan, illegally linked to the value of foreign currencies.

On 15 February 2012 the Supreme Court in Iceland passed a ruling that affects the legitimacy of banks' recalculations of loans that were illegally linked to the value of foreign currencies. Two debtors of Frjálsi Fjárfestingarbankinn (Frjálsi) challenged the recalculation methods on the basis that previous payments made by the debtors and received without any reservation by the creditors could not be recalculated. They argued that having a final receipt of payment the debtor had no reason to assume that any additional payment would be required. Citing previous judgments, the Supreme Court did recognise that in some situations a party to an agreement could be awarded the right to adjust the manner in which the agreement was concluded if obviously flawed from the outset. However, when deciding on accepting such changes, the courts have to consider the effect on each party, their expertise and overall stature. The Supreme Court found that of the two parties, it was more reasonable that the party with more expertise should bear the risk of flaws in the contract and to assume the subsequent burden of the payments regarded as final.

The Supreme Court ruled in favour of the debtors and denied Frjálsi the opportunity to use set-off against unpaid interest to pay legal cost awarded to the debtors in an earlier ruling by the Court. The Supreme Court found that since Frjálsi had, without any reservation, collected and given receipt for final payment of interest during the course of the loan, Frjálsi should not be able to claim the difference of what the customer actually paid and what the customer should have paid if the Bank would have claimed the higher Central Bank interest rate.

The Supreme Court found that the amendment to law on interest and indexation (Act 151/2010), which Althingi passed in December 2010 and instructed banks to recalculate foreign currency linked mortgages, violates the provisions of the Icelandic Constitution that protect the freedom to hold property as the legislator cannot pass law that retroactively deprives a person of an asset without adequate compensation.

As more rulings are published by the Supreme Court the precedent is progressively expanded. Many questions remain outstanding regarding the legitimacy of foreign currency linked loans.

Definition of the measure

In December 2010, Althingi passed a law (151/2010) on how the recalculation of loans with illegal indexation to foreign currencies should be done. The law included significant changes to previous law (38/2001) on interests and indexation. The law also included a few transitional provisions one of which requires financial institutions to recalculate all loans conforming to section B of the 68th statutory provision of the law on income tax (90/2003).

The legislative measure on how the recalculation should be done was not temporary but the provision gives permission to recalculate interests backward in time from the day the contract was made until the day of the recalculation. The computation rule in the law was based on the rulings of the Supreme Court including 92/2010, 153/2010 and 471/2010.

Íslandsbanki approach
Íslandsbanki has sought external legal opinions regarding which loans are applicable for recalculation and on the interest rates applied. Immediately after the Mótormax ruling in June 2011, the Bank started categorising its loans with respect to its applicability.

The Supreme Court ruling clearly states that loan contracts in foreign currency that do not define the loan amount in that currency (only state the ISK amount) and are disbursed in ISK shall be considered loans in Icelandic krona. Such loan contracts are illegal and have to be recalculated. The Supreme Court has however not ruled on documents that clearly state the foreign currency amount of the loan. Therefore it is still uncertain whether such documents will be considered contrary to law based on the fact that they were disbursed and repaid in Icelandic krona. The majority of Íslandsbanki's loan contracts fall into this category.

Prior to the Supreme Court ruling from 15 February 2012 the Bank had recalculated approximately 20 loans to companies according to Act No. 151/2010 resulting in a total reduction of principal of ISK 600 million. The Bank estimates that approximately 400 loans are subject to the ruling and will eventually be recalculated. This reduction has already been accounted for in the Financial Statements.

10.1.3 PRINCIPAL ADJUSTMENT

In early 2010, Íslandsbanki began to offer principal adjustment to companies with foreign currency loans that are predominantly served with ISK income. This measure entails converting foreign currency loans to ISK loans, based on the exchange rates of 29 September 2008. In July 2011 when this measure expired, approximately 800 companies had accepted the Bank's principal adjustment offer, resulting reduction in principal amounts to ISK 12.7 billion.

10.1.4 OTHER RESTRUCTURING

For complex cases where general restructuring solutions do not suffice, the Bank offers 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 it has or may acquire through restructuring will be sold at the earliest time possible.

Restructuring of complex corporate debt peaked in the year 2011. The restructuring has overall been successful as majority of restructured companies are now able to service their debt. Only a handful of restructuring projects have had to be re-addressed, all of which were completed relatively early in the restructuring phase before the Bank's restructuring methodology had been finalised.

In 2011 the Bank's Corporate Solutions unit fully completed 65% of its restructuring projects including the restructuring of two of the Bank's largest restructuring projects, namely, N1 a leading oil and retail company in Iceland and Höfðatorg, a real estate development company.

At year-end 2011 approximately 1,050 distressed debt cases had been closed, either with financial restructuring or in some cases with bankruptcy. Financial restructuring with non-standard solutions and final write-offs amounted to ISK 236 billion, of which ISK 150 billion are due to bankruptcies. Byr final write-off and non-standard solutions amounts to ISK 3 billion.

10.2 DEBT RESTRUCTURING MEASURES OF HOUSEHOLDS

Since establishment the Bank's has placed great emphasis on the restructuring of household debt. Various measures have been offered in this respect and the focus has been on catering to the needs of the majority of households. In the beginning the priority was on temporary solutions that eased the payment burden so that households could stay current with payments while more permanent solutions that involved debt relief were being worked on. This section describes various measures involving principal reductions while the timeline below shows what measures have been on offer since the Bank's establishment in 2008.

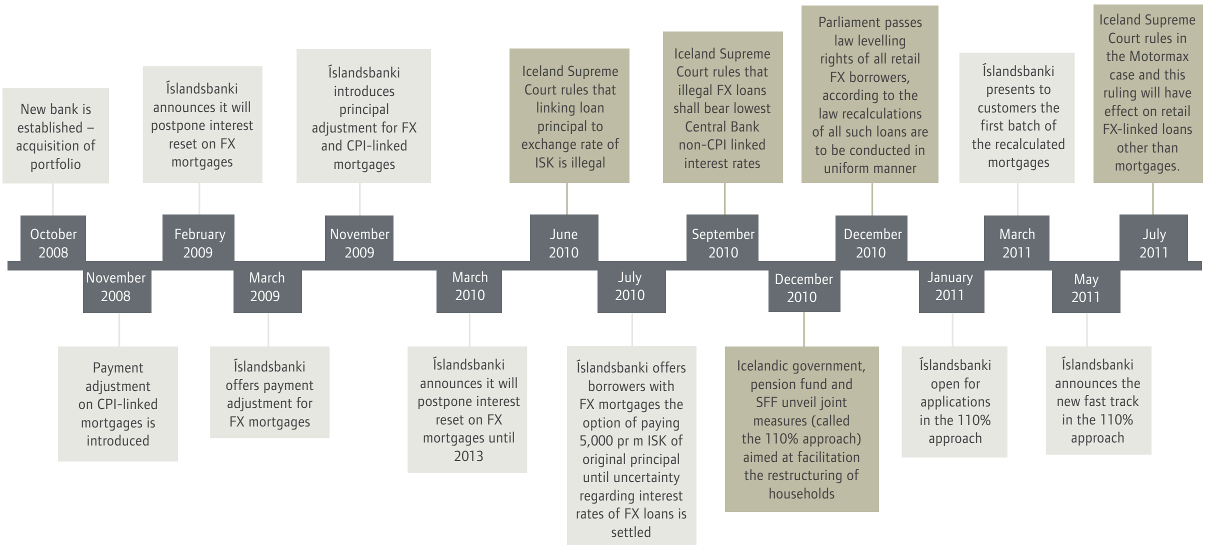

Figure 10.2: Timeline of household debt restructuring measures since 2008.

10.2.1 RECALCULATION OF MORTGAGES

Recalculation of mortgages was made available following judgments passed by the Supreme Court of Iceland in 2010 that certain types of loans linked to foreign currencies were illegitimate and subsequent legislation passed by Parliament, Act No. 151/2010 temporary provisions to Act No. 38/2001 on interests and indexation which came into effect on 29 December 2010.

Definition of the measure

The Act stipulates that all foreign currency linked mortgages and car loans should be recalculated according to a method previously set out in a ruling by the Supreme Court in September 2010.

The method assumes that the principal of the debt is calculated with interest from the date of origination until the date of recalculation using the official non-indexed interest rate published by the Central Bank of Iceland (CBI rate). The CBI rates are equal to the lowest rates offered for new loans each month by any credit institution in Iceland. Every payment that the borrower has made before the recalculation date accrues interests using the same rates and is subtracted from the recalculated principal. This method gives the principal of a new loan which has the same terms as the original loan except for the interest rate and currency. If the remaining term of the loan exceeds five years, which is usually the case for mortgages, the Act stipulates that the future loan after the recalculation shall bear the indexed CBI rate unless the borrower chooses other loan terms on offer by the lender.

Íslandsbanki approach

The Bank decided early on in the process not to limit the measure to loans which fall under the definition of the aforementioned Act on Income Tax but rather to recalculate all foreign currency linked loans to individuals with a pledge in residential homes which originated after the enactment of the Act on Interests and Indexation in July 2001. In total the Bank recalculated 3,720 loans according to the terms of the Act and the reduction in principal amounted to ISK 17.9 billion. At the same time, Byr recalculated 332 foreign currency linked loans with a reduction in principal of ISK 4.2 billion.

In addition, Íslandsbanki decided to extend the previous offer of principal adjustment of foreign currency mortgages so that customer could choose between recalculation according to the Act and the principal adjustment offered by the Bank since late 2009. Figure 10.3 shows which measure was chosen for the loans subject to the Bank's offer.

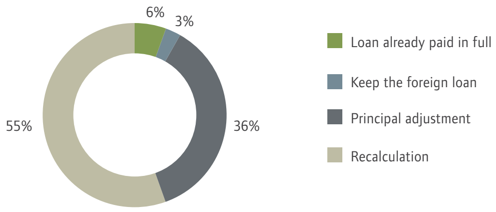

Figure 10.3: Number of loans broken down by customers' choice of recalculation, not including Byr. Parent, unaudited.

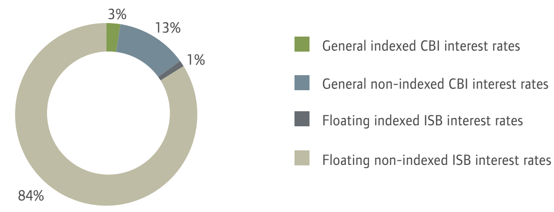

Figure 10.4: Number of recalculated loans broken down by customers' choice of interest terms, not including Byr. Parent, unaudited.

In addition, the Bank offered customers more options on future loan terms than the Act stipulated. Customers could choose between four options:

a) General indexed CBI interest rates

b) General non-indexed CBI interest rates

c) Floating non-indexed ISB interest rates with temporary interest discount

d) Fixed indexed ISB interest rates with an interest reset after 5 years

Most customers chose option c) which reflects the increased demand by individuals for non-index linked mortgages. If no option was chosen within the set deadline customers were automatically placed on CBI terms according to the Act and just under 700 loans were thus transferred unilaterally to indexed CBI terms. Figure 10.4 shows the split between customers' choice of interest rate after the recalculation.

10.2.2 110% MORTGAGE ADJUSTMENT

In November 2010 the Prime Minister's Office invited the Icelandic Financial Services Association (SFF), the Icelandic Pension Funds Association and Drómi hf. to a meeting to examine common measures for individuals whose properties were over-mortgaged. On 3 December 2010 the parties signed a Memorandum of Understanding stating that mortgages on residential property should be adjusted so that the Loan-to-value (LTV) would stand no higher than at 110% with the value defined as the higher of market value or property value according to the Property Register. On 15 January 2011 the agreement was signed by all parties. The agreement states minimum requirements, which all parties commit to. Some parties however extend the solution to more favourable offers than the agreement stipulated.

Definition of the measure
The main points of the agreement are as follows:

- Households whose LTV ratio is higher than 110% can apply for an adjustment of their mortgages down to a 110% LTV ratio. In order for the applicant and/or his spouse to be eligible for the measure, they must be the owners of the mortgaged property, payers of the mortgage and the property must be their residential home. As a part of the agreement a simpler measure was established for borrowers who apply for partial debt relief of up to ISK 4 million for individuals and ISK 7 million for single parents and couples (4/7).
- Other enforceable assets shall be taken into consideration. If the LTV ratio on those assets is below 100% the adjustment of debt will decrease accordingly.
- The pension funds will limit individual debt relief if the debt service requirement goes below 18% of gross income of the individual/couple on those loans which the agreement covers after the measure has been applied.
- Borrowers whose LTV ratio exceeds 110% of the property value, despite a debt relief, can apply for further debt relief.
- The debt relief can in total amount to ISK 15 million for individuals and ISK 30 million for single parents and couples (15/30).
- Debt relief is capped at a 110% LTV ratio. Excluded from the agreement are loans issued by the Housing Financing Fund for renovation and loans that exceeded the value of the property according to the Property Register when the loan was originated.
- The debt which can be written off according to the agreement is debt that has been undertaken in relation to the purchase of the applicant´s home, in the years preceding 2009. The debt must be pledged in the borrower's home and it must establish a right to the government interest relief programme.

- In the case of foreign currency linked loans the principal after recalculation (according to provisions of Act no. 151/2010) is to determine the LTV.
- Those borrowers who have already had their mortgage aligned to a 110% LTV ratio in relation to the application of other measures may be eligible for further debt relief if they meet the requirements of this agreement.
- The borrower shall turn to the mortgage provider who has the lowest seniority on the property. That lender will manage the case and pursue it against other creditors.

In the cases where these options do not suffice borrowers can apply for Specific Debt Adjustment at their bank or the Debtor's ombudsman.

Íslandsbanki approach

The agreement provides that if parties to an agreement are the sole parties to debt relief they could extend the debt relief above and beyond the provisions of the agreement or requirements made for eligibility. In the case of Íslandsbanki being the sole party to an agreement the implementation was extended further

- Individuals were permitted to own other assets of up to one ISK million, which did not affect the debt relief calculation
- It was not a requirement that individuals live in the mortgaged property
- There was no limit to the number of properties the applicant could own as long as they were registered in the individual's name and not in the name of a legal entity
- All mortgages were included irrespective of whether they established a right to interest relief or not

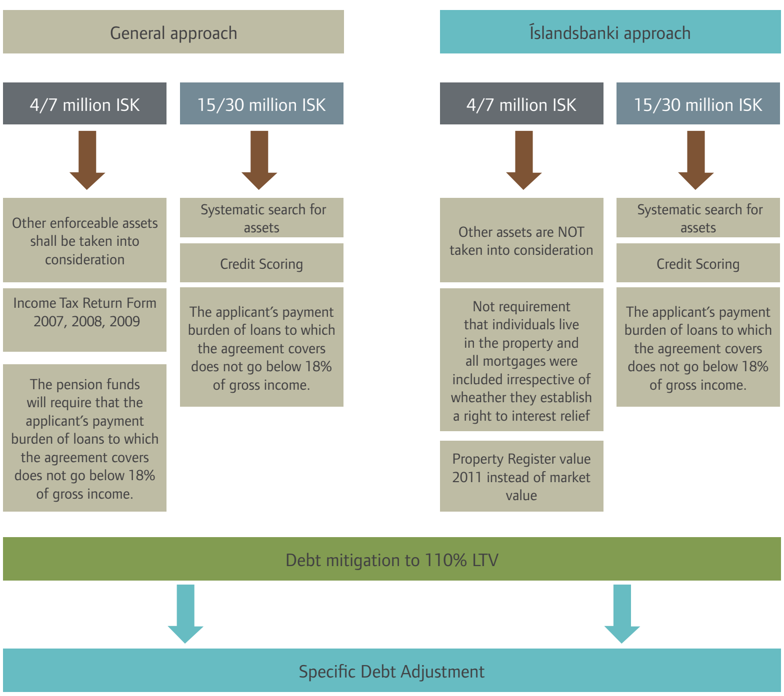

Figure 10.5: Different requirements for general 110% Mortgage Adjustment and Islandsbanki 110% Mortgage Adjustment.

Change in Íslandsbanki's implementation of the agreement in May 2011

In May 2011, when two months were left of the period in which the 110% mortgage alignment could be applied for, less than 500 households had applied for this measure at Íslandsbanki. The Bank had assumed that over 3,000 households would take advantage of this measure. It was therefore clear that the Bank had not reached the households that qualified for this measure. A survey was undertaken in a target group which revealed that many customers thought that the requirements were too strict and had therefore not applied. Following these results the Bank decided to amend the measure so that more customers would be able to take advantage of the measure. Requirements for the 15/30 measure remained unchanged but changes to the 4/7 measures were as follows:

- The property value according to the Property Register could now be used for reference instead of market value with exception when the Bank considers the property value according to the Property Register to be entirely unrealistic.

- Other assets are not taken into account when assessing whether an applicant qualifies for the measure. Other assets of the borrower will therefore not decrease the possible write-down of loans as they did before.

The deadline to apply for debt relief according to the agreement was extended until 1 July 2011. At that time the Bank had received 3,300 applications but 300 applications were declined since they did not meet the requirements. At Íslandsbanki, the average debt relief per household was around ISK 3.9 million but the total reduction in principal as a result of the 110% measure in 2011 was over ISK 10.4 billion.

Byr received around 510 applications out of which 190 were declined. The total reduction in principal was ISK 0.5 billion.

10.2.3 PRINCIPAL ADJUSTMENT OF GENERAL LOANS

In May 2010 Íslandsbanki introduced a new measure in addition to the principal adjustment of mortgages to meet the needs of customers with other types of loans in foreign currencies than mortgages.

Definition of the Measure
The measure involved the reset of the principal of currency linked loans, including accrued interest, back to September 2008 and at the same time converting the loan into Icelandic krona. The principal adjustment decreased borrower's debt on average by 25% when adjusted according to the exchange rate at Íslandsbanki in September 2008. This measure was offered irrespective of what kind of pledge was made, in contrast to the principal adjustment of currency linked mortgages. Customers with loans guaranteed on a surety basis, pledge in summer houses, stock, plots etc. qualified for the measure. Customers could choose between two options for the new Icelandic loans after the principal adjustment:

- Floating non-indexed ISB interest rates with a temporary interest discount for 3 years
- Fixed CPI indexed ISB interest rates with an interest reset after 5 years

The deadline for applications for principal adjustment was closed in July 2011 both for general loans and mortgages. The Bank had then adjusted the principal of over 7,500 loans and the total principal reduction was ISK 10.4 billion. The majority of customers, or around 98%, chose floating non-indexed ISB interest rates as the future terms for the principal adjusted loan.

10.2.4 PRINCIPAL ADJUSTMENT OF CPI LOANS

Íslandsbanki has emphasised on providing debt relief solutions not only to over leveraged households or those with foreign currency linked loans but also those who faced a significant increase in their CPI-linked mortgages through increased inflation. In the period from November 2009 to August 2010, individuals with CPI-linked mortgages at the Bank were offered an approximately 10% reduction in principal upon converting their loans to a non-index linked mortgage. In addition, a temporary interest rate discount was offered; 2.0% the first year, 1.5% for the second year and 1.0% the third year. Even if the offer for principal adjustment ended in August 2010 the interest rate discount for those who accepted this measure is still valid.

This offer was open to all customers with CPI linked mortgages and was generally well accepted, even though non-indexed interest rates were rather high at the time. A comparison of a CPI-linked loan that did not accept the offer and an adjusted non-indexed loan shows that an adjustment with interest rate discount results in a considerably lower principal as well as decreased monthly payments.

To illustrate the effect, let's consider the development of two mortgages that were identical until November 2009 when one entered the principal adjustment scheme while the other continued to be CPI-linked. The example shown is for a 40 year mortgage with a principal of ISK 10 million. The variable interest rate of a non-indexed mortgage was 9.5% in November 2009 compared to 5.4% in December 2011. The CPI-linked loan has a fixed interest rate of 4.5% through the period.

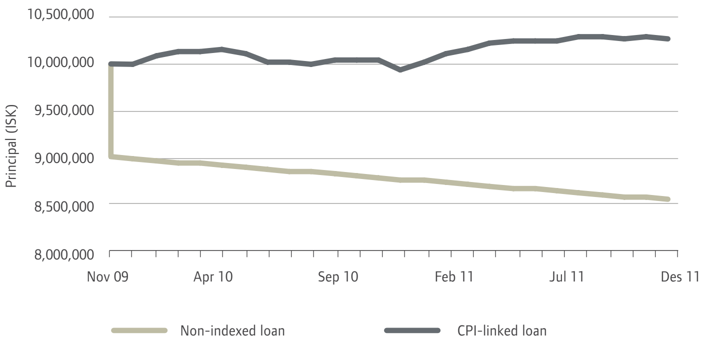

Figure 10.6: The development of the remaining principal of the loan from November 2009 to December 2011.

The principal of the non-indexed loan decreases further by 5% during the period whereas the principal of the CPI-linked loan increases by 2%.

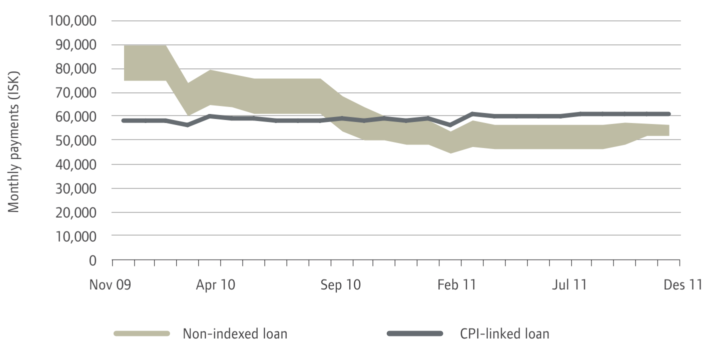

Figure 10.7: Monthly payments of an adjusted non-indexed loan compared with an unchanged CPI-linked loan.

The figure above shows the development of monthly payments of a CPI-linked loan and non-indexed loan with and without interest rate discount. The lower edge of the non-indexed loan represents the monthly payments with interest rate discount and the upper edge is monthly payments without discount, the area between therefore represent the temporary interest rate discount. The customer that accepted the offer paid around ISK 16,000 more for the first three monthly payments. For the next seven months the difference was less than ISK 4,000, and for the rest of the period the non-indexed mortgage payment was considerably lower than the CPI-linked payment. The interest rate discount amounts to ISK 320,000 for this period

10.2.5 SPECIFIC DEBT ADJUSTMENT

An agreement was made between the Icelandic Financial Services Association, the Housing Financing Fund and the Icelandic Pensions Association. The agreement was first signed 31 December 2009 and later updated December 2010 following the government's Memorandum of Understanding on measures to address household debt problems.

Definition of the Measure

The measure is intended to adjust debt to the debt servicing capacity of borrowers without the intervention of the courts. The term of debt adjustment is three years and if the borrower meets his obligations over the three year period, as regards the agreement, the measure may involve the relinquishment of claims, partial write-off of claims or a temporary deferment of payments. Borrower's debt in relation to their home and car are adjusted to 100% of market value and the contractual claims that remain at the end of the term are forgiven.

To enlarge the group eligible for the measure a borrower with debt service capacity for at least 70% of the market value of the property can take advantage of the measure instead of going into bankruptcy. The part of loans that exceeds 100% LTV ratio is set aside for 3 years without bearing interest. The payment term of this deferred loan will be negotiated when the term of the agreement ends or when the property is sold.

Debt adjustment entails an agreement between lenders and a borrower on aligning the debt and assets of the borrower to their debt servicing capacity. Assets are adjusted so that customers can live in a property which is compatible with their family size and own one car. In other respects the solutions are different depending on individuals and are aimed at providing the best possible solution for each and every customer.

The specific debt adjustment will be available until 31 December 2012. The Bank received 330 applications for this measure which was far below expectations. Many factors led to fewer applicants for the measure than anticipated. The borrower's currency linked loans had to be recalculated has to go through the 110% mortgage adjustment before being applicable for specific debt adjustment. The recalculation and the 110% measure process took longer than expected and therefore the special debt adjustment was delayed. At year-end 2011 the Bank had finalized 170 applications and the total debt reduction through this measure amounted to ISK 1.5 billion.

However, the Bank is of the opinion, an opinion it shares with the Parliamentary Supervisory Committee, that special debt adjustment is an efficient solution for those who are facing payment problems. The fact that there are virtually no debt adjustment agreements in arrears would tend to support this view.

In year 2011 Byr received around 200 applications for specific debt adjustment of which over 30 were declined. Approximately 140 applications were approved and the debt reduction amounts to ISK 0.4 billion. The remaining applications were rolled into Íslandsbanki´s specific debt adjustment measure.

10.2.6 OTHER RESTRUCTURING

The Bank also offered individuals non-standard restructuring solutions when the general solutions did not suffice. At year-end 2011 approximately 3,800 individuals had been offered non-standard solutions resulting in a reduction of principal or final write offs of ISK 26,3 billion, of which ISK 9 billion are due to bankruptcy and final write-offs.

Due to the measures mention here above the Bank has seen a decline of 97% in the share of loans with a payment holiday in year-end 2011. At the beginning of 2012 around 1% of the Bank's loans to households were in restructuring.

10.3 DEBT RESTRUCTION MEASURES OF ERGO

This past year has been eventful for Ergo. The recalculation of 12,800 car loans on the basis of the Supreme Court's decision in June 2010 has been completed. on October 2011 the Supreme Court in Iceland passed a ruling that affects the legitimacy of Ergos' financial leasing agreements.

In this section the various measures on offer within Ergo in 2011 are discussed while the timeline below shows what measures have been on offer since the Bank's establishment in October 2008.

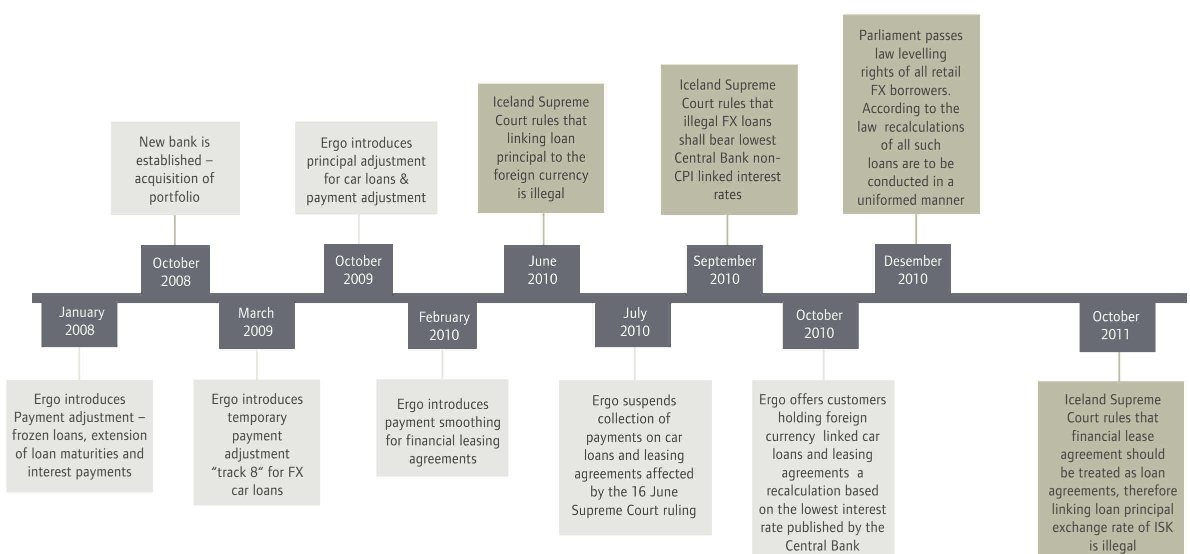

Figure 10.8: Timeline of Ergo debt restructuring measures since 2008.

10.3.1 RECALCULATION OF LEASING AGREEMENTS

During 2011 the recalculation of leasing agreements continued in accordance with Supreme Court rulings No. 92/2010, 153/2010 and 471/2010. According to these rulings it was illegal to link currencies to the aforementioned agreement forms and all such agreements had to be recalculated according to the lowest official non-indexed CBI interest rate.

Íslandsbanki approach

Around 12,800 agreements were recalculated at Ergo. The largest parts of these agreements were for individuals, around 9,800 cases.

It was decided to issue new agreements to customers who had acquired older agreements and customers had therefore to sign new agreements and terms. Ergo is the only financial leasing company which took this route and it is the Ergo's opinion that the future work with the portfolio e.g. in relation to default cases, will be simplified in the long run as a result. The process was generally well accepted by customers. At the end of 2011, 12,800 agreements were completed with a total reduction in principal of ISK 12.4 billion. A unilateral adjustment was made to agreements of those customers who were not in contact with Ergo or refused to agree to the recalculation. These cases are still being worked on with the aim of completing the project in the first quarter of 2012.

10.3.2 FINANCIAL LEASING AGREEMENTS

On 20 October 2011 a ruling was passed by the Supreme Court relating to financial leasing agreements. According to the ruling it is illegal to link foreign currencies to financial leasing agreements and the form of the agreement itself was also deemed illegal. There is still considerable uncertainty surrounding the recalculation process, mainly relating to the handling of value added tax.

Corporates and legal entities are parties to leasing agreements and individuals do therefore not qualify for this measure. Ergo has estimated that 4,200 agreements need to be recalculated, where of 2,700 have been paid-up in full.

10.4 WRITE-OFFS AND REMISSIONS

As listed above, the Bank has offered several debt relief measures and restructuring frameworks for its customers. This has been done without a significant loss to the Bank because of the deep discount. In this section the cumulative write-offs and remissions are presented. The term remission is used here for recalculations and principal reductions that are not write-offs in the usual sense but rather correction of claims due to their legitimacy or because of general offers made by the Bank. The interest rate discount that was offered in connection with principal adjustments is also considered a remission.

At year-end 2011, the Bank had written off or remitted ISK 347 billion to its customers, of which ISK 83 billion was to individuals and ISK 264 billion to companies.

The table below shows cumulated write-offs and remissions to individuals divided into various programs offered by the Bank.

Recalculation of mortgages	17.9
Recalculation of mortgages (Byr)	4.2
110% adjustment of mortgages	10.4
110% adjustment of mortgages (Byr)	0.5
Principal Adjustment of foreign currency loans	8.0
Principal Adjustment of CPI loans	2.4
Ergo, Asset based financing	9.3
Interest Discount	2.0
Specific debt adjustment	1.5
Specific debt adjustment (Byr)	0.4
Write-offs and non-standard restructuring	26.3
Total	**83.1**

Table 10.1: Write-offs and remissions to individuals from 2008 2011 (ISK bn).
Parent, unaudited.

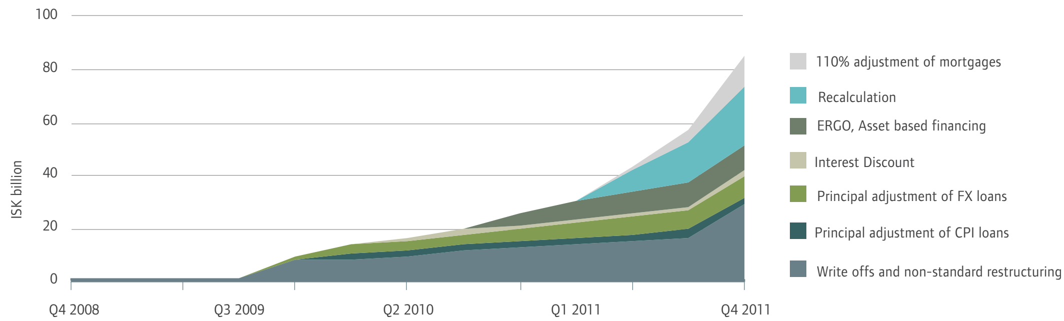

Figure 10.9: Cumulative write-offs and remission to individuals from 2008-2011. Parent, unaudited.

The table below shows cumulated write-offs and remissions to companies divided into various programs offered by the Bank.

Debt Adjustment	7.4
Debt Adjustment (Byr)	0.4
Recalculation of foreign currency loans	0.6
Principal Adjustment of foreign currency loans	12.7
Ergo, Asset based financing	3.1
Write offs and non-standard restructuring	236.2
Write offs and non-standard restructuring (Byr)	3.2
Total	**263.5**

Table 10.2: Write-offs and remissions to companies from 2008-2011 (ISK bn). Parent, unaudited.

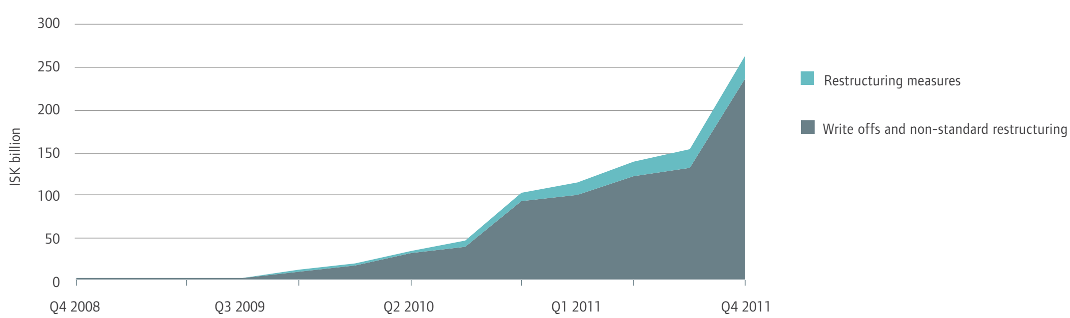

Figure 10.10: Cumulative write-offs and remission to companies from 2008-2011. Parent, unaudited.

To put these amounts into perspective one can see that write-offs and remissions that do not relate to bankruptcies are 17% of the original loan portfolio for companies and 26% for individuals. The figures below show write-offs and remissions to individuals and companies, due to debt adjustment or bankruptcies, as a percentage of the volume of the initial loan portfolio in October 2008. Figures do not include the loan portfolio acquired from Byr.

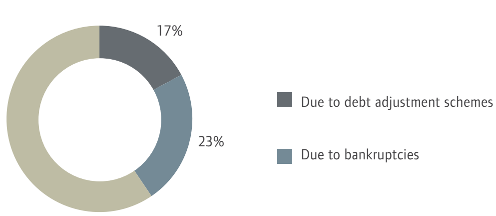

Figure 10.11: Write-offs and remissions to companies as a percentage of initial loan portfolio, not including Byr. Parent, unaudited.

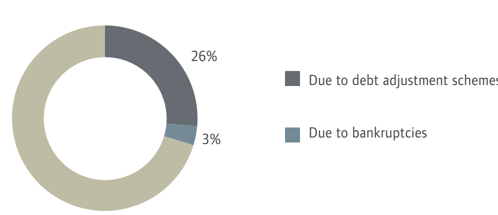

Figure 10.12: Write-offs and remissions to individuals as a percentage of initial loan portfolio, not including Byr. Parent, unaudited.

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.

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.

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 Requirements 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).

Carrying Amount: Book value of loans.

Collective Impairment of foreign exchange gain: Loans with collective impairment are loans denominated in foreign currency that are estimated to be serviced by customers that only have cash flow in ISK. For those loans, an increase in the loan balance in ISK terms due to depreciation of the ISK is fully offset with the so called foreign currency impairment.

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 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.

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.

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.

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 as follows:

(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. 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 risk to earnings or capital arising from uncertainty in the applicability or interpretation of contracts, law or regulation, for example when legal action against the Bank is concluded with unexpected results, when contracts are not legally enforceable or rendered illegal by a court's ruling.

Liquidity Coverage Ratio: A short-term measure introduced by the Basel Committee that aims to ensure that a bank maintains an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors.

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

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

LPA Metric: Total carrying amount of loans to customers that have been identified as in need of further restructuring (in group 3) divided by the total carrying amount of loans to customers.

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, such as those that arise from changes in interest rates, equity prices and foreign exchange rates.

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.

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

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, and concentration risks as well as the Banks' situation and expectations in general). It also treats stress tests.

Pillar 3: Market discipline 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.

Political risk: The risk that a government policy, significantly different from current law or regulation, will be enforced, resulting in new legislation or new regulation that adversely affects the Bank's business or the value of the Bank's assets.

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 counterparty's credit obligation.

Problem loans: Impaired loans and loans that are more than 90 days past due but not impaired.

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 risk to earnings or capital arising from adverse perceptions of the Bank 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.

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

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
BIS: The Bank for International Settlements
BoD: Board of Directors
BPV: Basis Point Value
CAE: Chief Audit Executive
CB: Central Bank
CCF: Credit Conversion Factor
CEO: Chief Executive Officer
CIRS: Cross Currency Interest Rate Swap
CLTV: Combined Loan to Value
COREP: Common reporting
CPI: Consumer Price Index
CRD: Capital Requirement Directive
CRO: Chief Risk Officer
EEA: European Economic Area
EAD: Exposure at Default
EFTA: European Free Trade Association
ESA: EFTA Surveillance Authority
EU: European Union
FME: Financial Supervisory Authority Iceland
FMR: Iceland Property Registry
FX: Foreign Currency
HFF: Housing Financing Fund
ICAAP: Internal Capital Adequacy Assessment Process
IFRS: International Financial Reporting Standards
ISDA: International Swaps and Derivatives Association
IRS: Interest Rate Swaps
ÍSB: Íslandsbanki
ISK: Icelandic Krona
KRI: Key Risk Indicators
LCR: Liquidity Coverage Ratio
LGD: Loss Given Default
LPA: Loan Portfolio Analysis
LS: Lánasjóður sveitarfélaga hf., (Municipality Credit Iceland Plc.)
LTV: Loan to Value
MAC: Material Adverse Change
MV: Market Value
NPO: Non-profit organisation
NSFR: Net Stable Funding Ratio
OBS: Off Balance Sheet Exposure
PD: Probability of Default
P&L: Profit and Loss
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
VaR: Value-at-Risk
VSE: Very Small Entities