Risk and Capital Management 2013

Pillar III risk report of Landsbankinn hf.
31.12.2013

Landsbankinn hf. in brief

Landsbankinn hf. was founded on 7 October 2008 by the Ministry of Finance on behalf of the Icelandic State Treasury. The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank is licensed as a commercial bank and operates in accordance with Act No. 161/2002 on Financial Undertakings. Landsbankinn is subject to supervision of the Financial Supervisory Authority of Iceland (FME) in accordance with Act No. 87/1998 on Official Supervision of Financial Activities.

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

The bank's initial balance sheet was introduced in December 2009; at the same time, a settlement was negotiated between Landsbankinn (NBI hf., now Landsbankinn hf.) and Landsbanki Íslands hf. (now LBI hf.).

Under the terms of the settlement agreement, the National Treasury of Iceland acquired an 81.3% share in the bank and Landskil ehf., a subsidiary of Landsbanki Íslands hf., 18.67%. Total issued share capital amounted to ISK 24 billion.

Ownership of Landsbankinn changed as of 11 April 2013. The 18.67% share held by Landskil on behalf of the Winding-up Board of LBI hf. was transferred to the Icelandic State and 2% of shares came to Landsbankinn hf. in accordance with the agreement from 2009. The holding transferred to Landsbankinn was intended for disbursement among the bank's employees. On 30 September 2013, part of that asset was assigned to around 1400 current and former Landsbankinn employees.

The Icelandic State now holds 97.9% of shares in the bank, Landsbankinn hf. holds 1.6% and around 1400 current and former Landsbankinn employees hold 0.5%.

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1 Highlights of 2013 and Outlook

The global economy continues to be volatile and under stress, and the Group's continued commitment to sound risk management has proved to be effective. This was reflected in an increased core tier 1 capital ratio to 27.1%, strong liquidity position and a positive overall effect from rating migration.

The Group recognises that maintaining and continually enhancing its risk management capabilities will be critical in the years ahead to ensure that the Group's financial and strategic objectives are achieved within appropriate levels of risk appetite.

Landsbankinn is confident and well-prepared for the future due to solid and improved quality in its well-diversified credit portfolio and a strong liquidity and capital position. Landsbankinn is fully compliant with the liquidity coverage ratio (LCR) requirements, both on Group level and on currency level. Landsbankinn already meets the CRD IV / CRR capital requirements and will foreseeably still meet them when implemented.

On 20 January 2014, the international rating agency Standard and Poor‘s (S&P) assigned Landsbankinn the credit rating grade BB+ with a stable outlook. In its rating report, S&P states that it is the company‘s view that Landsbankinn operates with significant liquidity and capital buffers and low leverage in a difficult economic environment. S&P expresses the view that Landsbankinn has been well managed since its creation in 2008, demonstrating superior operating efficiency and a reduction of non-performing loans. S&P's full report can be seen here

Defined risk appetite and risk limits have been in place for two years and have proven effective measures to reduce risk in line with the Group‘s strategy. The Bank‘s overall risk level improved significantly in 2013 which is clearly reflected in the assessment of decreased Economic Capital. Credit quality continued to improve with an average exposure weighted probability of default of 4.7% and 5.3% 90 days past due ratio which is broadly in line with the 2013 credit risk appetite. At the same time the Economic Capital usage for credit and concentration risk decreased reflecting model improvements and improved credit quality.

The Economic Capital due to legal and regulatory risk was reduced during the year, for one thing due to limited dispute exposure and, for another, due to a more risk sensitive calculation method.

In 2013 the Group submitted a formal application to the Financial Supervisory Authority (FME) to use the Foundation Internal Rating Based Approach (F-IRB). Subject to certain minimum conditions and disclosure requirements, banking corporations

that have received a Supervisor's approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. If provided by the FME, an approval will be a clear indicator of improved quality of the Group's risk management. The FME aims to respond to the Group's application by year-end 2014.

Moderate growth in private consumption is expected in the next few years, driven by increased purchasing power and rising employment level. Public consumptions however have contracted considerably in recent years, or by little less than 7% in 2008-2012. The impact of public consumption on economic growth has been negative during the period, a turnaround from previous years. Having regard for the fiscal position, it is not likely that public consumption will contribute much to economic growth in coming years.

It appears that total capital formation will contribute less to economic growth in coming years than previously expected. This is due, inter alia, to less extensive developments in heavy industry.

In light of deteriorating terms of trade, limited access to international credit markets and falling trade surplus, the Group expects the ISK nominal exchange rate to give way rather than appreciate in coming years. Declining inflation since the beginning of 2012 has stifled inflation expectations somewhat.

The economic situation in Europe, Iceland's most important market region, has been difficult of late. The outlook is for some improvement but hitherto the situation in Europe has not only affected exports and trade, but also affected Icelandic access to international capital markets.

Despite ambitious goals set by authorities five years ago, capital controls still hold sway on the domestic financial market and no comprehensive strategy has been formed to lift controls in the foreseeable future. Limited access to international credit markets and a lack of diverse investment options will continue to hamper the domestic market in the near term. The equities market is likely to continue to be the driving force of the financial market in coming years, both due to expectations of improved performance of largest companies and new listing.

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

2 Disclosure Policy

2.1 Introduction

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

The Basel II framework consists of three 'Pillars'.

- Pillar I sets out the minimum capital amount that meets the firm's credit, market and operational risk
- Pillar II requires the firm to assess whether its Pillar I capital is adequate to meet its risks (Internal Capital Adequacy Assessment Process, ICAAP) and is subject to annual review by the Financial Supervisory Authority (FME) (Supervisory Review and Evaluation Process, SREP)
- Pillar III requires disclosure of specified information about the underlying risk management controls and capital position

This publication, Risk and Capital Management 2013, reviews the Group's organisation and processes relating the identification and management of the risk type characteristic of a financial group with its type of business concept. It also describes The Group's risk position on the basis of the requirements under Pillar III.

2.2 Disclosure policy

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

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

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

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

2.3 Frequency of publication

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

2.4 Verification

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

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

This publication, Risk and Capital Management 2013, has not been audited by external auditors. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statements 2013. There may be some discrepancy between financial information in the Consolidated Financial Statement 2013 and information in the Risk and Capital Management 2013 as the report has been prepared in accordance with the Capital Requirements Directive and the Basel II capital framework, rather than in accordance with IFRS.

2.5 Media and location of publication

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

3 Risk Management

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

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

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

3.1 Risk appetite

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

The Bank's risk appetite has been reviewed, revised and implemented for 2014. The statement of the Bank's risk appetite is as follows:

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

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

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

Executives and employees are responsible for monitoring and managing risks taken on within their units in accordance with the Bank's rules and applicable law. Decisions are based on in-depth

Risk identification

Personal Banking		Corporate Banking		Markets	
Credit risk	High	Credit risk	High	Operational risk	High
Operational risk	Moderate	Operational risk	Moderate	Market risk	Moderate
Market risk	Low	Market risk	Low		
		Treasury			
		Liquidity risk	High		
		Market risk	High		
		Operational risk	Moderate		
		Credit risk	Low		

and professional discussions with the Bank's long-term interests in mind. Regular and thorough follow-up on decisions and risk monitoring is an integral part of the Bank's operations.

3.2 Risk identification

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

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

The table above provides a link between the Group's business units and the principal risks that they are exposed to. The significance of risk is assessed within the context of the Group as a whole and is measured based on allocation of the Economic Capital within the Group.

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

3.3 Risk Management structure

The Group wishes to meet the highest and latest international standards and recommendations for bank's risk management in order to support its business model. The Group therefore devotes substantial resources to developing and maintaining procedures and tools to fulfil this ambition.

The Group's risk management is based on guidelines, policies and instructions set forth by the Board of Directors. On the Basis of the Board of Directors' general instructions, the Group has prepared specific instructions on risk management for the individual business units. These instructions are used as the basis for business and control procedures, among other things, at the units.

3.3.1 Risk committees

Proper organisation of the work of the Board is a prerequisite for the smooth operation of the Group and the Directors' work. The establishment of sub-committees can improve procedures in the issues that the Board is obliged to attend to and can make its work more effective.

The Board assesses the need for establishing sub-committees according to the size and scope of the bank at each time, and the composition of the Board. The bank's corporate governance statement must provide information on the establishment and appointment of sub-committees. Three sub-committees operate within the Board of Directors, preparing discussion by the Board of specific areas of operation and investigating in more detail matters related to them.

The Audit and Risk Committee shall endeavour to ensure the quality of Landsbankinn's annual accounts and other financial information, as well as the independence of its auditors. The committee's function is,

The Bank's risk management governance structure at year-end 2013 is as follows:

Risk committees

Supervision by the Board of Directors			Board of Directors		
			Audit & Risk Committee, Remuneration Committee, Strategic Development Committee and direct oversight of Internal Audit		
Key risk management bodies and committees			**The CEO**		
			Executive Management Committee, Risk & Finance Committee, Credit Committee, Security Committee		
Risk types	Compliance risk	Credit risk	Market risk	Operational risk	Liquidity risk

among other things, to supervise accounting procedures. The committee also monitors the organisation and function of internal auditing and risk management, as well as risk management of credit risk, market risk, liquidity risk, reputational risk and other risks as the case may be. Moreover, the committee supervises the auditing of the annual and consolidated accounts of the Bank and assesses the independence of Landsbankinn's external auditors and also supervises other tasks performed by external auditors and submits proposals to the Board of Directors for the selection of external auditors.

The Remuneration Committee establishes the Bank's terms of employment with regard to the salaries of the CEO of the Bank and those of the members of the Board of Directors, which are subject to the approval of the Board of Directors. In addition to this, the Remuneration Committee fulfils the function of the Board with regard to preparing and submitting proposed terms to the Board and negotiating salaries and terms of employment with the CEO. The Remuneration Committee also discusses the development of wage agreements as well as the development of wage expenditure and the number of employees. For further details on the Group's Remuneration policy, see 9.1 Landsbankinn's 2013 Remuneration report.

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

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

The Credit Committee deals with credit risk – both credit limits on individual customers as well as credit risk policy issues – while the Risk & Finance Committee covers primarily market risk, liquidity risk, operational risk and legal risk. The Risk & Finance Committee monitors all the Bank's risks and is responsible for enforcing the Bank's risk appetite and risk limits, and reviews and approves changes to risk models before presented to the Board of Directors. The Executive Management Committee serves as a forum for consultation and communication between the CEO and managing directors, addressing the main current issues in each division. This committee makes all major decisions not being considered in other standing committees. The Security Committee is a forum for discussions and decisions on information safety, personnel security, responsibilities in specific security areas and the Group's safety procedures.

3.3.2 Risk Management Division

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

The Risk Management Division is comprised of six departments.

- The Credit Management Department is responsible for risk assessment and veto right on credit applications from customers with exposures exceeding the credit limits of individual business units and customers which have been classified yellow, orange or red (see section 5.1.5 Control and monitoring). Secondary voting on decisions exceeding the authorisation of the Risk Management Division is referred to the Bank's Credit Committee;

- The Credit Risk Monitoring Department is responsible for monitoring credit risk in the Bank's credit portfolio. This is done by operating a credit monitoring system. The Credit Risk Monitoring Department is also responsible for the portfolio valuation methodology and for the operation of the Bank's write-off process. In addition the department works with other departments on impairment analysis;

- The Market Risk Department is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the Bank's banking book. Market Risk is also responsible for monitoring all derivatives trading the Bank enters into, both for hedging and trading purposes. Market risk monitoring also includes FX balance monitoring for the Bank as well as providing limit monitoring for pension funds under management by the Bank. The Market Risk Department is also responsible for comprehensive risk reporting to various departments and committees;

- The Operational Risk Department is responsible for ensuring that Bank operational risks are monitored and that the Bank implements and maintains an effective operational risk management framework. The department assists the Group's managers with operational risk assessment incidents related to normal operations and operational loss incidents analysis, and oversees continuity plans. The Operational Risk Department leads the work on the Bank's certification under the ISO 2701 standard for information security;

- The Models and Analysis Department is responsible for providing, developing and maintaining the Bank's internal models and related processes to measure risk, including the Economic Capital framework; as well as to support the implementation of such models and processes within the Bank. In addition, the Department is responsible for credit risk, economic capital and risk appetite reporting within the Bank as well as reporting to supervisory authorities.

3.3.3 Compliance

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

3.3.4 Internal audit

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

3.4 Risk measurement

The Group regularly monitors and assesses its current risk profile in the most important business areas and for the most important risk types. It also constantly seeks to improve the process for its risk appetite in order to supplement the risk management framework and to support the business model.

The risk appetite framework considers key risks relevant to the Group's business activities by setting risk appetite goals and limits. The risk appetite is on an aggregate level represented in terms of credit risk, market risk, liquidity risk, operational risk and funding risk and it varies how detailed they are as well as which metrics are used depending on their properties and are suited to enable the Bank to manage risk in an efficient manner.

Credit risk pertains, inter alia, to the quality of the loan portfolio, probability of default, defaults, concentration risk and large exposures. The Bank has been successful in reducing risk in relation to all of these factors. Revised limits on credit risk are based on reducing the risk even further in 2014.

Measurements of market and liquidity risk were within limits the entire year and the Bank has revised limits that relate to market risk in relation to the business plan.

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

Measurements of operational risk were within limits right up to the

Principal reporting to the Board of Directors

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

end of the year when one deviation from the risk appetite was documented due to four incidents - of the total documented during the year – which occurred earlier than 2013.

Economic Capital is also a key element in the management of the Group's risk and capital structure as well as in the day-to-day financial management. Economic Capital is the capital required to cover the Group's unexpected loss one year into the future. One of the benefits of Economic Capital is the fact that it comes up with an aggregate figure for all risk types, products and business units. It thus produces one unified risk measurement expressed in a single unit of value, and the capital will at any time reflect the Group's risk the next year. Further details on Economic Capital can be seen in section 4.5.

3.5 Risk monitoring

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

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

4 Capital Management

4.1 Capital management structure

The Group's capital management governance structure for year-end 2013 is as follows:

Capital management structure

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

4.2 Capital management framework

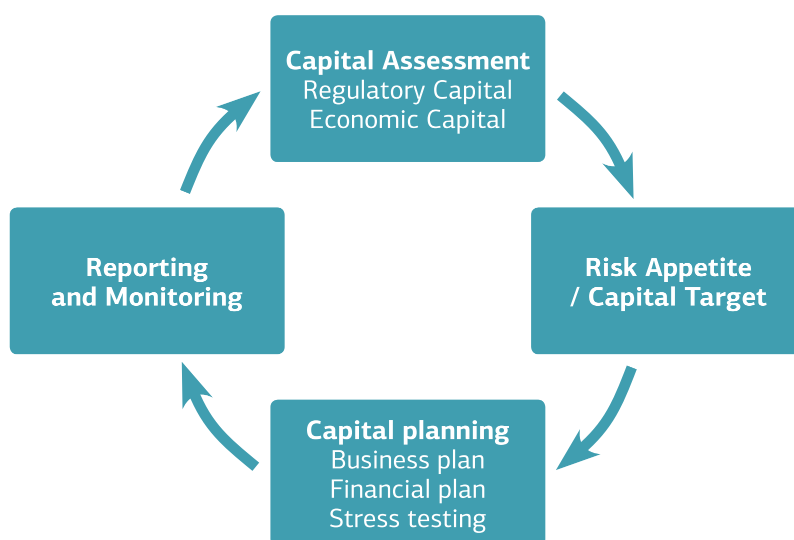
The purpose of the Group's capital management is to support the Group's strategy and ensure that it has sufficient capital to cover its risks at all times.

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

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

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

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



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

4.3 The Capital base

The Group's equity at 31 December 2013 amounted to ISK 242.3 billion (31.12.2012: ISK 225.2 billion). The Capital Adequacy Ratio, calculated in accordance with Article 84 of Act No. 161/2002, on Financial Undertakings, was 26.7% at 31 December 2013 (31.12.2012: 25.1%). Under the Act the minimum requirement for this ratio is 8%. The capital base consists of Tier 1 capital and the breakdown is as follows:

The capital base

Capital base	31.12.2013	31.12.2012
Share capital	23,618	24,000
Share premium	120,700	123,898
Statutory reserve	7,046	5,053
Retained earnings	90,002	72,120
Non-controlling interests	935	95
Intangible assets	-585	-541
Deferred tax assets	0	-48
Tier 1 capital	**240,774**	**225,166**
Deduction from original and additional own funds	-3,865	-3,815
Capital base	**236,909**	**220,762**

Risk-weighted assets		
Credit risk	684,655	679,516
Market risk	99,763	98,486
Operational risk	104,500	101,393
Total risk-weighted assets	**888,918**	**879,395**

Tier 1 capital ratio	**27.09%**	**25.54%**
Capital adequacy ratio	**26.65%**	**25.10%**

The Group's capital adequacy ratio rose in 2013, mainly because of its earnings of ISK 28 billion after taxes. A dividend payment of ISK 10 billion was made.

4.3.1 Tier 1 capital and statutory deductions

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

Tier 1 capital and statutory deductions

	2013	2012
Valitor	2,905	3,155
Borgun	960	660
Total	**3,865**	**3,815**

1 Article no.55 under http://www.althingi.is/lagas/127b/1996113.html
2 Other deductions are goodwill and investments in own shares which do not apply to the Group at the year-end 2012

» Carrying amounts of intangible assets

» Deferred tax assets

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

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

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

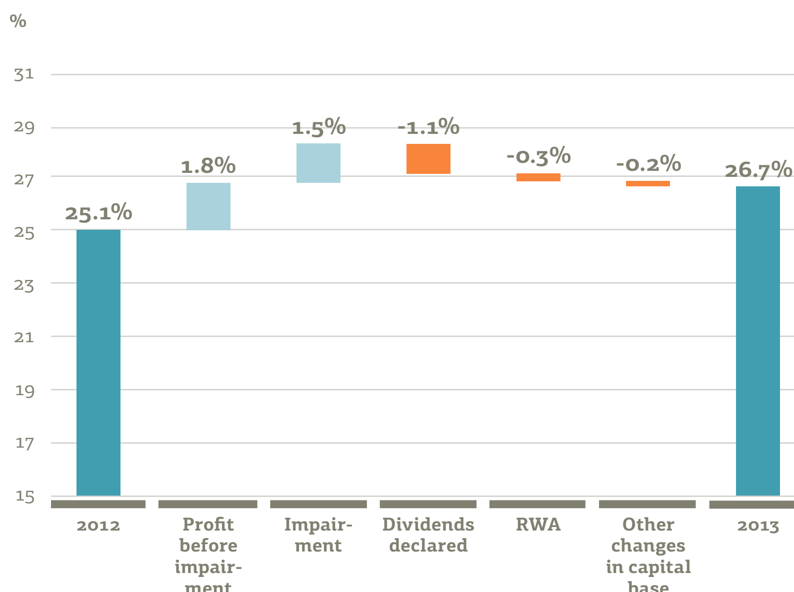
4.4 Capital Requirement

The regulatory minimum capital requirement under Pillar I of the Directive is 8% of risk-weighted assets for credit risk, market risk and operational risk. The Group uses the standardized approach[3] in measuring Pillar I capital requirements for credit risk and market risk. For operational risk it uses the basic indicator approach[4] in calculating capital requirement.

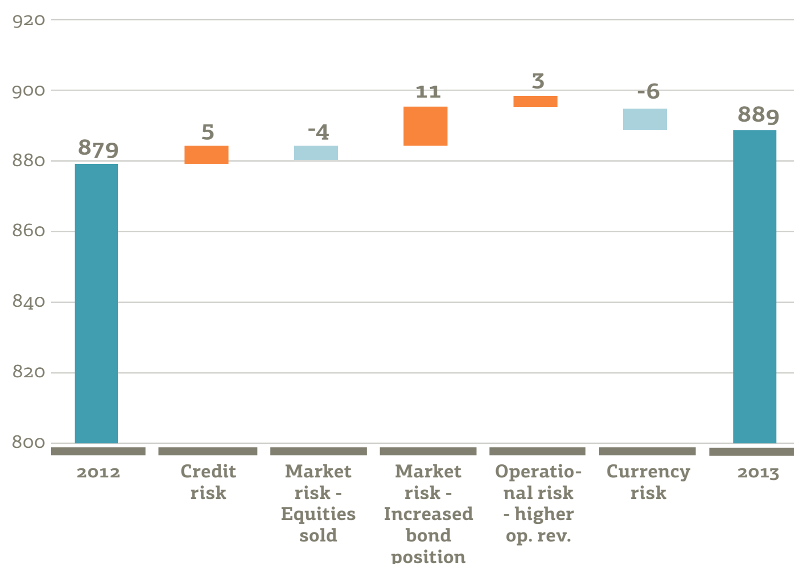
Risk-weighted assets (RWA) for credit risk, the single largest risk type, amounted to 77% of total RWA. RWA for market risk amounted to 12% of RWA.

Total risk-weighted assets increased by 1% in 2013.

Change in capital ratio



Change in risk Weighted Assets



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

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

Capital requirement

Capital requirement and risk-weighted assets	31.12.2013		31.12.2012	
Credit risk breakdown	Capital requirement	RWA	Capital requirement	RWA
Central governments or central banks	81	1,011	6	77
Regional governments or local authorities	221	2,768	353	4,416
Administrative bodies	205	2,567	6	69
Institutions	1,864	23,306	1,834	22,926
Corporations	32,946	411,819	30,480	381,005
Retail	7,818	97,723	9,437	117,964
Secured by real estate property	4,447	55,586	3,030	37,870
Past due items	2,811	35,143	4,174	52,175
Items belonging to regulatory high risk categories	1,066	13,323	974	12,170
Short-term claims on institutions and corporate	0	0	0	0
Other items	3,313	41,410	4,068	50,844
Credit risk	**54,772**	**684,655**	**54,361**	**679,516**
Market risk breakdown				
Traded debt instruments	2,321	29,006	1,439	17,991
Equities	4,130	51,621	4,426	55,321
Market risk	**6,451**	**80,628**	**5,865**	**73,312**
Currency risk	1,531	19,135	2,014	25,174
Operational risk	8,360	104,500	8,111	101,393
Total capital requirement and RWA	**71,114**	**888,918**	**70,351**	**879,395**

Economic capital

Risk	Calculation method
Credit risk	The credit risk EC model is the asymptotic single risk factor (ASRF) model from the Basel II internal rating based (IRB) approach's risk weight formula, i.e. the EC equals the capital requirements of the IRB approach in the capital requirements directive. The main input to the model are the risk parameters probability of default (PD), loss given default (LGD) and exposure at default (EAD).
Market risk	Market risk EC for interest rate risk in the trading book is calculated using the standardised measurement method of the Basel framework, i.e. EC equals the Bank's capital requirements for interest rate risk. However market risk EC for equity risk is calculated using the following risk weights: • 290 % for exchange traded equity exposures. • 370 % for all other equity exposures.
Currency risk	For FX positions a VaR-model is used to calculate EC 1-day 99% VaR as well as stressed VaR (SVaR) are calculated and scaled to one-year 99% VaR in accordance with the Basel framework. Stressed VaR is calculated from the worst case of the previous 250 trading days. EC for FX-risk equals the sum of the two one-year 99% VaR measures.
Concentration risk	EC for single name concentration is calculated by adjusting for the granularity and non-homogeneity in the portfolio. This is necessary as the credit risk EC model assumes that the portfolio is infinitely large and homogenous, hence the single name concentration EC is given as an add-on. An internal model is used to measure the additional EC for credit risk related to industry concentrations in the loan portfolio, i.e. a concentration add-on. EC is given by the increase in credit risk EC when a correlation adjusted for the concentration in the portfolio is used.
Interest rate risk in the banking book	Interest rate risk in the banking book EC is equal to the loss of economic value resulting from a simultaneous parallel shift in the relevant interest rate curves.
Operational risk	EC for Operational risk is calculated using the basic indicator approach, which means that it equals the Group's capital requirement.
Business risk	Economic Capital for Business risk is calculated using an internal model, which is based on the volatility of the Bank's income, before profit or loss due to any other material risk.
Legal and regulatory risk	Economic Capital for legal and regulatory risk is calculated by adding the potential loss of on-going disputes weighted by their status within the legal system.

Economic Capital ISK million	2013	2012
Credit risk - Loans to customers and credit institutions	63,770	68,764
Credit risk - Other assets	4,379	5,041
Market risk	12,124	5,865
Currency risk	2,728	3,676
Operational risk	8,360	8,111
Single name concentration risk	7,736	8,099
Industry concentration risk	3,175	2,710
Interest rate risk	9,925	10,688
Business risk	4,180	4,056
Legal and regulatory risk	5,711	18,913
Total	**122,088**	**135,923**
EC/RWA	**13.7%**	**15.5%**

4.5 Economic Capital

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

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

Economic Capital decreased during 2013 mainly due to improved quality of the loan portfolio and lower assessment of EC for Legal and regulatory risk. EC for Market risk increased significantly due to higher risk weights applied to Equities in line with the

Weighted average

Credit risk at 31 December 2013	Probability of default (PD)*	Loss given default (LGD)**	Exposure at default (EAD)	Economic Capital (EC)
Financial institutions	0.2% (1.5%)	45.0%	59.820	1.421
Public entities	0.9% (1.2%)	45.4%	15.842	553
Individuals	4.4% (2.7%)***	33.0%	243.616	8.690
Corporations	5.5% (6.0%)***	44.8%	603.202	53.107
Total	**4.7% (4.6%)**	**41.7%**	**922.480**	**63.770**

*Numbers in parenthesis from 31.12.2012
**Loss given default calculations are based on foundation IRB LGD, except for individuals where internal LGD's are used.
***New credit rating model for individuals and new PD estimates have an impact of increase on the measurement values of the PD even though the quality in the loan portfolio has improved. For further details see 5.2.3 Migration analysis.

Stress testing	
Baseline scenario	The banks business plan, based on the most recent macroeconomic forecast of Economic Research. This scenario is in fact the most likely one to occur.
Mild recession	The scenario assumes a slight contraction in GDP growth for the first few years followed by a return to trend growth in the last years.
Illegal indexation	This scenario assumes that Consumer Price Index (CPI) linked loans to individuals are to be deemed illegal in the same manner as the FX loans.
Reverse stress test	The scenario assumes a massive downturn in the export sector, hitting the economy severely with several implications for the bank and the economy. The starting point is to create a series of events that will result in a solvency ratio below 12% at a given time.

Financial Supervisory Authority's (FME) requirements. Credit risk is the largest source of risk confronting the Bank and in the year 2013 the EC for this risk type decreased reasonably. Economic Capital is estimated at 13.7% of RWA for year-end 2013.

Below is a further breakdown for credit risk, probability of default by asset class as well as loss given default, exposure at default and EC. Probability of default has decreased significantly the past two years, mainly because of improved quality in the corporate loan book. Numbers for 2012 are shown in parenthesis.

4.6 Stress testing

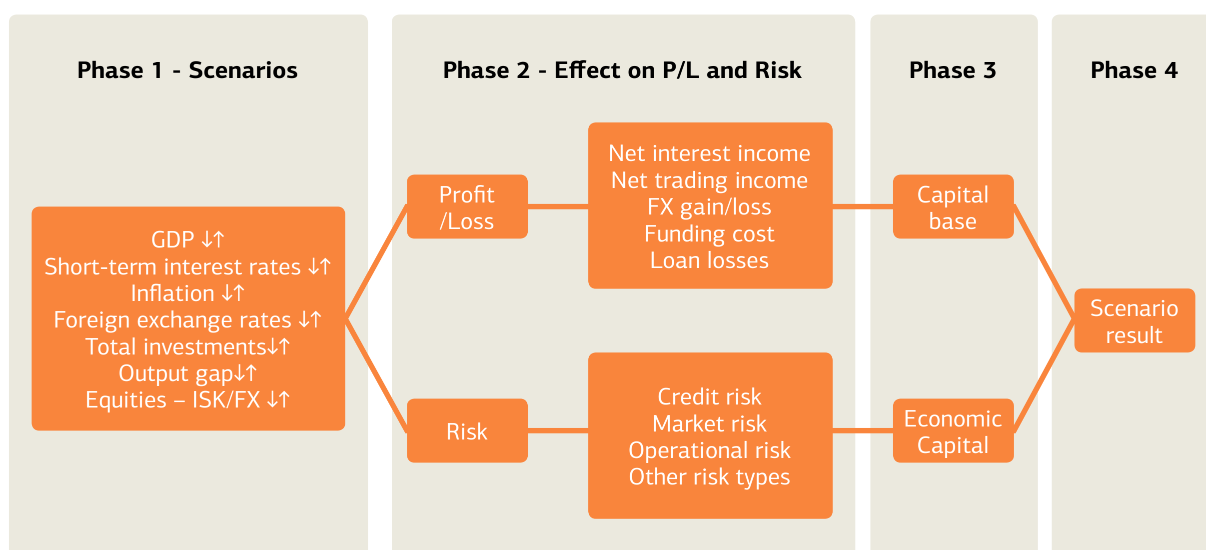
As a part of ICAAP and the capital planning process, internal stress tests are used as an important risk management tool in order to determine how severe, unlikely but plausible, changes in the business and macro environment affect the capital need. Stress tests reveal how the capital need varies during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

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

In 2013, the Group developed 2 new scenarios, as well as a baseline scenario and a recurring mild recession scenario. These scenarios forecast developments of key macro indicators over a given period. Scenarios demonstrate an alternative development of key economic variables induced by various shocks compared to the baseline macroeconomic and inflation forecast of Landsbankinn's Economic Research.

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

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



The Group uses a loan loss model which incorporates macroeconomic variables and produces probability of default (PD), default rates as well as loss given default (LGD) which can then be translated into loan losses.

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

The purpose of a mild recession scenario is to analyse how much additional capital is needed to ensure that the Group will not have to intervene with management actions, other than not paying dividends, in the case of a mild recession. Mild recession is also important when the Group assesses the appropriateness of the risk appetite related to capital as well as to assess the size of the minimum internal buffer.[5]

The Illegal indexation of CPI linked loans scenario is intended to focus on the legality of such loans to individuals.

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

4.7 Summary of Capital Requirement and Economic Capital

At 31.12.2013 the Group estimated its Economic Capital at ISK 122.1 billion (13.7% of RWA) and the capital requirement to be ISK 77.1 billion under Pillar I.

The add-on for Pillar I risks is ISK 20 billion (2.3% of RWA), mainly due to credit risk. Pillar II risks require ISK 30.7 billion of capital (3.5% of RWA), the biggest risks being Interest rate risk in the banking book.

According to the preliminary SREP for 2013, based on year-end 2012, the FME has lowered its requirements to 16,7%, according to the banks decrease in Economic Capital, i.e. risk, and less uncertainty regarding loans in foreign currency. This replaces the 19.5% requirement determined by the FME in the previous SREP process, based on year-end 2011. The Group has complied with this requirement as well as taken strategic objectives into consideration into account in determining a capital target of a capital ratio in the range of 20% to 23%.

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

4.8 Consolidation methods

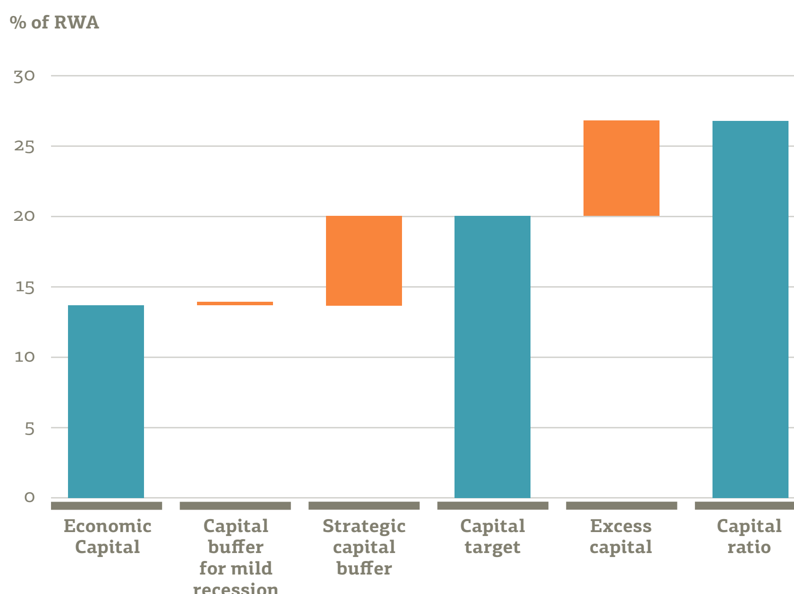
Risk and Capital Management 2013 is based on the definition of the Landsbankinn Group used in the 2013 Annual Report and complies with IFRS. Subsidiaries are entities over which the Group has the power to govern financial and operating policies so as to obtain benefits from their activities, generally accompanied by a shareholding of over half of the voting rights. Subsidiaries are fully consolidated in the financial statements according to the acquisition method. In capital requirement calculations and Economic Capital the Group consolidates its subsidiaries with a full look-through approach, that is, the Group looks through the subsidiary and down at each individual asset.

The main subsidiaries held directly or indirectly at 31.12.2013 were as follows:[6]

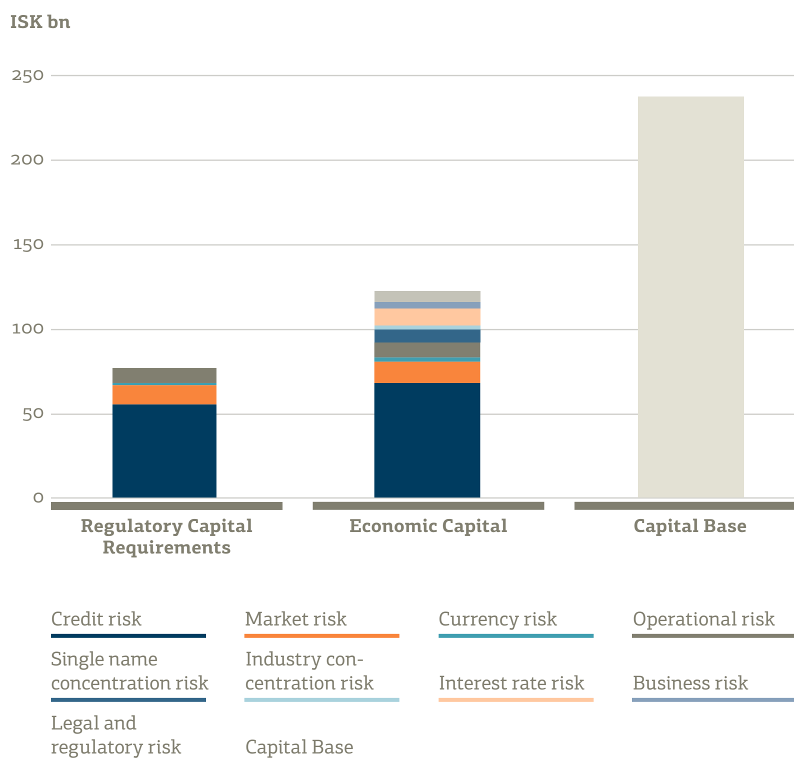
Associates are those entities in which the Group has significant influence, but not control, over financial and operating policies. Significant influence is presumed to exist when the Group holds, directly or indirectly, between 20-50% of the voting power of another entity. The Group accounts for investments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

Investments in associates at 31.12.2013 are as follows:

Summary of capital requirement and economic capital



Landsbankinn Capital position as of 31.12.2013



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

Consolidation methods

Company	Ownership interest	Activity
Horn fjárfestingarfélag hf. (Iceland)	100%	Investment company
Landsbréf hf. (Iceland)	100%	Management company for mutual funds
Hömlur ehf. (Iceland)	100%	Holding company*
Lindir Resources ehf.	78%	Investment company

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

4.9 New capital regulations

The Bank does not have information on amendments to acts of law and/or regulations that will, with any certainty, lead to additional requirement of economic capital buffers. While plans have been presented to commence preparation of new legislation that could potentially have such effect the Bank regards such potential effect not to be certain enough to call for a requirement of economic capital buffers.

On 1 January 2014, a new framework for prudential requirements for banking entered into force in the EU. The framework, referred to as CRD IV, consists of two parts, an updated Directive (CRD IV, Capital Requirements Directive) and a Regulation (CRR, Capital Requirements Regulation)

The new CRD IV framework has not been taken into the EEA Agreement and is therefore, not yet at least, binding on Iceland under international public law. The reason for this is that CRD IV is closely linked to a new EU institutional framework for financial services, introduced with regulations in 2010. Three European supervisory authorities, mandated to work closely with national supervisors, were set up under this

Associates	Ownership interest	Carrying amount at 31 December 2013	Carrying amount at 31 December 2012
Framtakssjóður Íslands hf.	28%	8,882	8,113
Valitor Holding hf.	38%	2,905	3,155
Borgun hf.	31%	960	660
IEI slhl.	28%	621	-
Reiknistofa bankanna hf.	37%	613	629
Motus ehf.	48%	191	125
Auðkenni hf.	20%	50	38
Other	-	2	10
Reginn hf.	0%		2,798
Total		**14,224**	**15,528**

framework: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). These regulations have not been incorporated into the EEA Agreement and have thus not transposed into Icelandic law. These regulations are considered to involve the transfer of executive powers that would go beyond the provisions of the Icelandic Constitution. This has postponed the incorporation of the CRD IV framework into the EEA Agreement.

CRD IV provides for the adoption of technical standards in various fields. The technical standards are prepared by EBA and stipulate more detailed provisions on the basis of the CRD IV framework. The technical standards will, for instance, include provisions on the harmonisation of the frequency and form of reporting to supervisors. All reports from European banks are expected to be submitted simultaneously and in a standardised form, to regulators and from there on to EBA.

In Iceland, the Directive is expected to be transposed through a bill of legislation amending the Act on Financial Undertakings No. 161/2002 that is planned to be submitted to the Icelandic Parliament, Althingi, in the 2014 spring session. Preparatory work is under way for the transposition of the Regulation which is expected to be transposed through an annex to a regulation adopted on the basis of a provision in Act on Financial Undertakings.

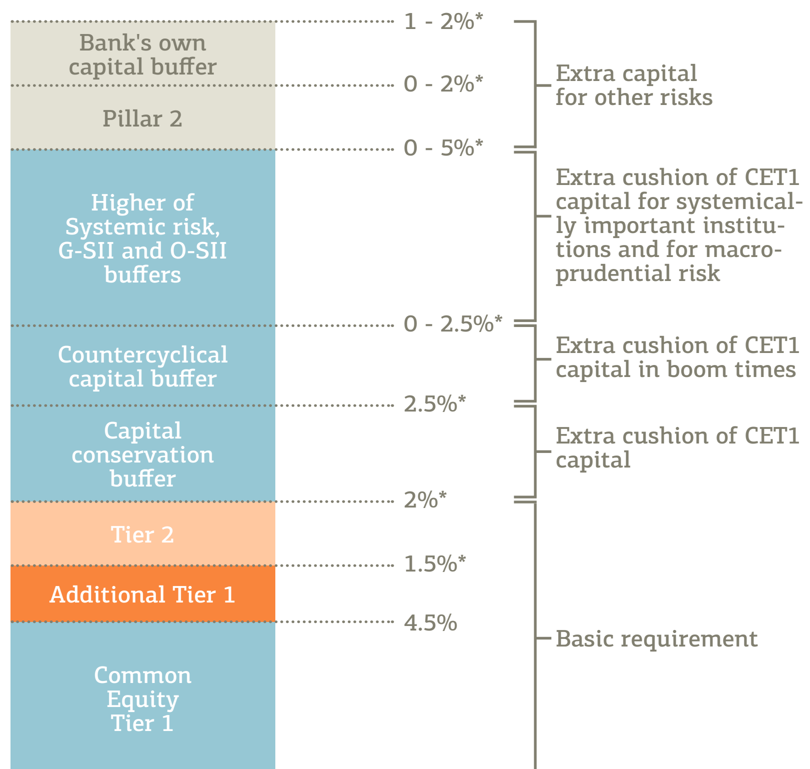
CRD IV includes, inter alia, the transposition of the Basel III standard that introduced provisions in the following areas: (i) a redefinition of the financial instruments that may form the capital framework of banks, aimed at increasing the quality of the capital base, (ii) new capital buffers, aimed at increasing the stability of the financial system; and, (iii) a leverage ratio that restricts the build-up of debt in financial undertakings. Basel III (and CRD IV) assumes incremental transposition, a phase-in whereby implementation will begin in 2014-15 and end in 2018-19. Individual states, Sweden for one, have however availed themselves of the possibility to expedite implementation of certain provisions of Basel III.

Currently, the Bank does not have information on proposals for the implementation of the aforementioned provisions of CRD IV into Icelandic law. The Bank does not expect the implementation of the provisions to lead, overall, to an increase in capital requirements for the Bank. This view is based on the Bank´s strong capital and liquidity position and the already far reaching capital requirements imposed by the FME under Pillar 2.

The Bank expects that the redefinition of common equity and liquidity ratio (points i and iii) will have a very limited impact on the Bank, all things remaining equal. The Bank expects that the introduction of the capital buffers (the capital conservation buffer, the countercyclical capital buffer, the systemic risk buffer and the systemic important institutions buffer) will lead to a review of the criteria applied by FME for deciding how much additional capital is to be required under Pillar 2 (and together with Pillar 1). The Bank thus considers that the imposition of the capital buffers will lead to a decrease in current requirement of capital under Pillar 2.

However, there are some indications that the interpretation of the FME is simply to add the buffers on top of the current capital requirements under Pillar 2, i.e. with no revision of the criteria applied by FME for deciding how much additional capital is to be imposed under Pillar 2. Should this interpretation prevail, significant additional capital requirements could be made in respect to the Bank. The Bank expects to enter into discussions with the FME on the interpretation of the relevant provisions of Basel III / CRD IV, the implementation of these provisions into Icelandic law and the application of the rules with regard to the Bank.

Even though the interpretation of the FME would prevail, the Bank will neither need to revise its business plan nor risk appetite targets, due to the strong capital position.



*Assumed upper bounds (values can be higher)

5 Credit risk

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

At the end of 2013, 77% of the Group's risk-weighted assets were due to credit risk. On the same date, total loans and advances to customers amounted to ISK 748.384 million (2012: ISK 730.436 million), with ISK 680.468 million coming from lending activities (2012: ISK 666.087 million) and ISK 67.916 million from loans and advances to financial institutions (2012: ISK 64.349 million).

5.1 Credit risk management

Credit risk is mainly managed through the credit process and the Group's credit risk models which include PD, LGD and EAD modelling. The models are used for various purposes, e.g. in management reporting.

5.1.1 Identification

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

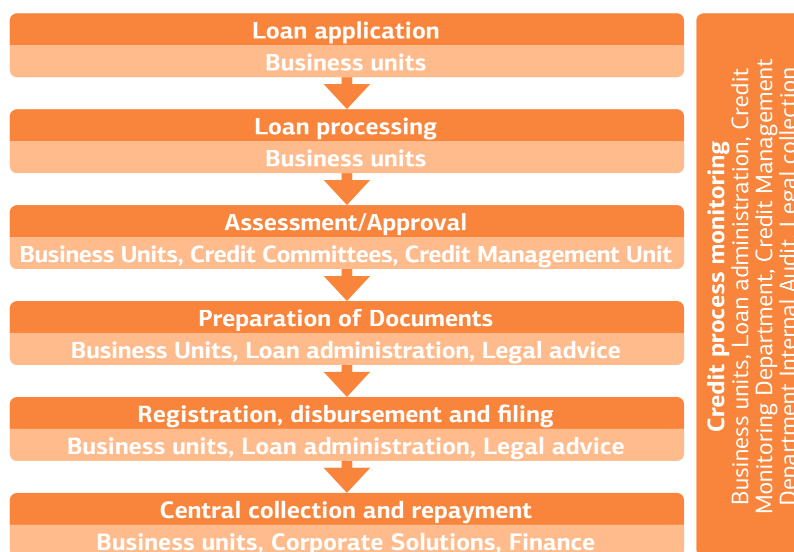
The Group's activities may activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed.

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

5.1.2 Assessment

Credit risk is measured in three main dimensions: the probability of default (PD), the loss given default (LGD) and the exposure. For the purpose of measuring PD the Bank has developed an internal rating system, including a number of internally developed rating models. The objectives of the rating system are to provide a meaningful assessment of obligor characteristics; a meaningful differentiation of credit quality; and accurate and consistent quantitative estimates of default risk, i.e. probabilities of default (PD). Internal ratings and associated PD play an essential role in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an obligor rating scale which reflects exclusively quantification of the risk of



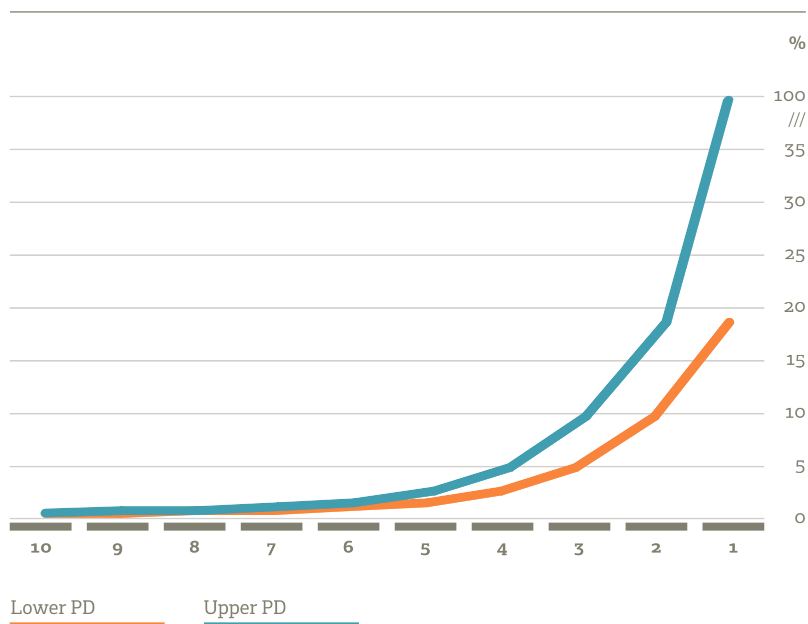
obligor default, i.e. credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors from '1' to '10', '10' indicating the highest credit quality, and the grade '0' for defaulted obligors. The rating assignment is supported by rating models, which take information such as industry classification, financial accounts and payment behaviour into account.

The rating assignment and approval is an integrated part of the credit approval process and assignment shall be updated at least annually or when material information on the obligor or exposure becomes available, whichever is earlier.

In 2013 the Group implemented in 2013 a new credit rating model for individuals. Considerable changes in the rating distribution resulted from the implementation compared to the former model. The new model's discriminatory power significantly exceeds the Basel II regulatory minimum requirement of 0.5. Furthermore, the new model is well calibrated, i.e. the weighted probability of default for each rating grade is equal to the actual default rate with respect to reasonable error limits.

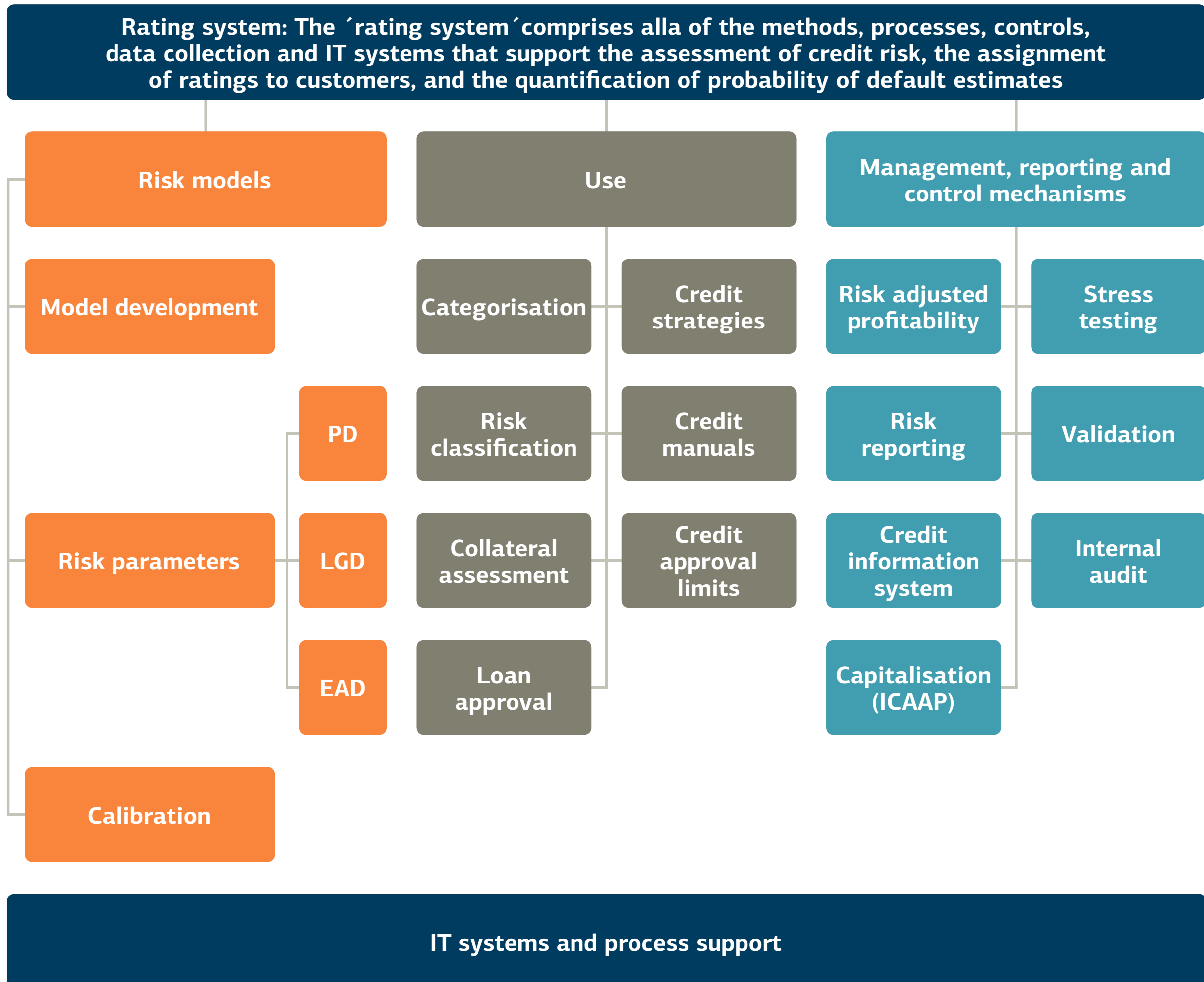
LGD is measured using the models defined in the Basel framework for the purpose of Economic Capital calculations. In addition

Rating category and PD band



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

Internal rating grade	S&P	Lower PD	Upper PD
10	AAA/AA+/AA/AA-	0.00%	0.04%
9	A+/A/A-	0.04:	0.10%
8	BBB+	0.10:	0.21%
7	BBB/BBB-	0.21%	0.46%
6	BB+/BB	0.46%	0.99%
5	BB-	0.99%	2.13%
4	B+	2.13%	4.54%
3	B	4.54%	9.39%
2	B-	9.39%	18.42%
1	CCC/C	18.42%	100.00%



the Bank has implemented in the business processes an internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the aforementioned Basel model.

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

5.1.3 Management and policy

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

the risk policy is reflected in the Bank's internal framework of regulation and guidelines. The Bank's executives are responsible for the Bank's business units to execute the risk policy appropriately as the CEO is responsible for the oversight of the process as a whole.

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

5.1.4 Mitigation

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

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

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the Bank's credit policy. Credit extended by the Bank may be secured on residential or commercial properties, land, securities, transport vessels, fishing vessels together with their non-transferable fishing quotas, aircraft, etc. The Bank also secures its loans by means of receivables, inventory and operating assets, such as machinery and equipment. Residential mortgages involve the underlying residential property. Less stringent requirements are set for securing short-term personal loans, such as overdrafts and credit card borrowings.

The Bank regularly assesses the market value of collateral received. The Bank has developed models to estimate the value of the most frequent types of collateral. For collateral for which no valuation model exists, the Bank estimates the value manually. It calculates the value as the market value less a haircut. The haircut represents a conservative estimate of the costs to sell in a forced sale. Costs to sell include maintenance costs in the period over which the asset is up for sale, fees for external advisory services and any loss in value. For listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability.

The Bank monitors the market value of mark to market collateral and may require additional collateral in accordance with the underlying loan agreements.

The Bank is consistently improving its collateral system, which is developed internally and allows the Bank to analyse the quality and value of the collateral held to secure the loan portfolio.

In order to limit further the credit risk arising from financial instruments, the Bank enters into netting agreements, under which the Bank is able to set off all contracts covered by the netting agreement against the debt in case of default. The arrangements generally include all market transactions between the Bank and the client.

Generally, collateral is not held over loans and advances to financial institutions, nor is it usually held against bonds and debt instruments.

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

5.1.4.1 Derivative financial instruments

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

Commensurate collateral and margin requirements are in place for all derivative contracts the Bank enters into. Collateral management and monitoring is performed daily and derivative contracts with clients are fully hedged.

The Bank's supervision system monitors both derivatives exposure and collateral value and calculates the credit equivalent value for each derivative intraday. It also issues margin calls and manages netting agreements.

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

5.1.5 Control and monitoring

The Bank employs an internal Early Warning System to monitor exposures in order to identify signs of weakness in customer earnings and liquidity as soon as possible. To monitor customers, the Bank uses – supplemental to ratings – a credit monitoring

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

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

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

5.1.6 Impairment process

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

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

The Group has significantly reduced granting loans in foreign currency unless the customer's income is in the same currency or a comparable currency. This also applies to granting CPI indexed loans to corporate customers.

5.2 Credit portfolio

5.2.1 Credit exposure

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

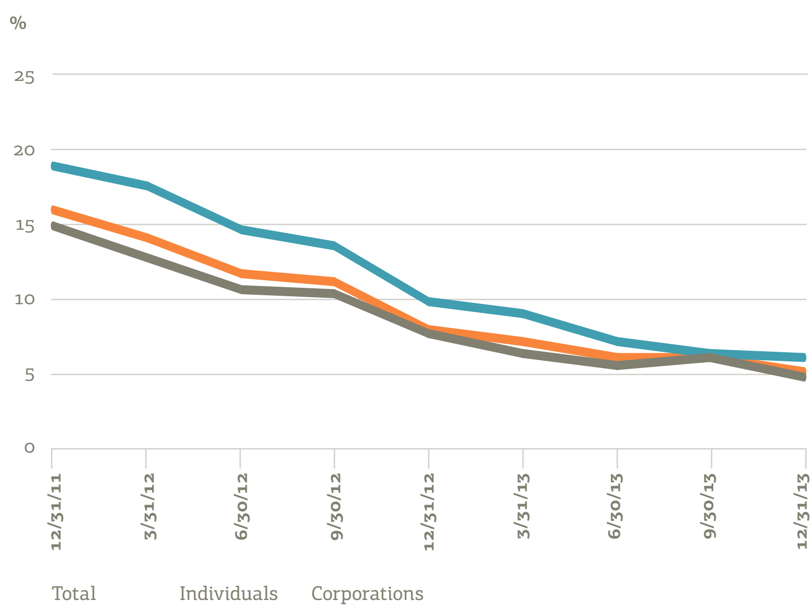
At the end of 2013, the total carrying amount was ISK 1.104 billion. Some ISK 681 billion are derived from lending activities, ISK 291 billion from bonds and debt instruments, and ISK 0.7 billion is derived from the carrying amount of derivatives.

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

5.2.1.1 Credit exposure from lending activities

At the end of 2013, the Group's total credit exposure from lending activities amounted to ISK 680,468 million, against ISK 666,087 million at the end of 2012. This represents an increase of 2.2%. In 2013, credit demand remained low and did not result in a significant increase in credit exposure. The low demand related to both personal and corporate customers.

90 days past due ratio



Lending capacity in the Icelandic banking system, as well as credit supply, has exceeded demand in the past few years. Lending operations have thus extensively focused on services to existing customers and refinancing of their loans as well as restructuring clients in financial distress. The impact of financial restructuring on a number of clients, both individuals and corporations, and the recalculation of FX-linked debt reduced the 90 days past due ratio from 8% to 5%. Since the beginning of 2013 credit exposure in over 90 days past due decreased from ISK 55 billion to ISK 36 billion. The decrease is mainly due to the fact that corporate loans were restructured, returned to performing standing or written off in part or whole. Partially this is also due to more accurate analysis and increased monitoring of new defaults, where emphasis is put on reacting as soon as possible when default occurs.

At the same time, the portfolio quality has improved considerably as the average probability of default is now 4.7% (discussed further in section 5.2.3). Usually some time passes after restructuring is completed until its effects are seen in the loan portfolio. Therefore it can be assumed that the impact of restructuring already completed has not fully emerged.

The credit portfolio

At 31 December 2013

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	21,520	-	-	-	-	21,520
Bonds and debt instruments	111,902	151,895	26,799	-	-	290,596
Equities and equity instruments	-	3,966	32,309	-	-	36,275
Derivatives instruments	-	654	-	-	-	654
Loans and advances to financial institutions	67,916	-	-	-	-	67,916
Loans and advances to customers	680,468	-	-	-	-	680,468
Other financial assets	6,367	-	-	-	-	6,367
Total	**888,246**	**156,515**	**59,108**	**-**	**-**	**1,103,796**

At 31 December 2012

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount
Cash and balances with Central Bank	25,898	-	-	-	-	25,898
Bonds and debt instruments	113,203	100,950	14,055	-	-	228,208
Equities and equity instru-ments	-	1,107	35,774	-	-	36,881
Derivatives instruments	-	1,043	-	-	-	1,043
Loans and advances to financial institutions	64.349	-	-	-	-	64,349
Loans and advances to custom-ers	666.087	-	-	-	-	666,087
Other financial assets	10.481	-	-	-	-	10,481
Total	**880,018**	**103,100**	**49,829**	**-**	**-**	**1,032,947**

Credit exposure from lending activities

At 31 December 2013	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	292,615	394,085	61,684	748,384
Loans and advances to institutions	292,456	388,085	0	680,468
Past due loans	16%	6%	0%	10%
Impaired	5%	8%	0%	7%
Loans and advances to customers past due more than 90 days	8%	3%	0%	5%

At 31 December 2012	Personal Banking	Corporate Banking	Treasury	Total
Credit exposure	293,285	380,408	56,740	730,433
Loans and advances to customers	292,480	373,607	0	666,087
Past due loans	22%	5%	0%	12%
Impaired	10%	20%	0%	16%
Loans and advances to customers past due more than 90 days	14%	4%	0%	8%

Developments of the quality of the Group's credit portfolio have been positive since taking over part of the domestic operations of LBI hf. on the Bank's foundation in 2008. In the majority of segments, there was an improvement in credit quality in the year 2013.

At the end of the year, the impairment ratio was 6.0% (end 2012: 4.3%). The increment is due to loans acquired at deep discount which have gone through restructuring.

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

Credit exposure from lending activities

At 31 December 2013	Personal Banking	Corporate Banking	Treasury	Total
Financial institutions	158	6,073	61,684	67,916
Public entities	2,019	7,996	-	10,015
Individuals	199,006	2,480	-	201,485
Corporations	80,798	241,868	-	468,968
Fisheries	10,612	135,690	-	146,302
Construction and real estate companies	9,341	117,892	-	127,233
Holding companies	12,391	43,423	-	55,814
Retail	11,549	24,424	-	35,974
Services	29,699	16,918	-	46,617
ITC	2,743	16,716	-	19,459
Manufacturing	10,230	15,107	-	25,337
Agriculture	4,173	3,541	-	7,714
Other	672	3,846	-	4,518
Total	**281,981**	**258,416**	**61,684**	**748,384**

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

Credit exposure from lending activities

At 31 December 2013			Collateral types			
Collaterals after haircut	**Real Estate**	**Deposits**	**Other**	**Securities**	**Ships**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	2,362	44	96	0	0	2,502
Individuals	178,271	1,064	21,655	3,686	456	205,131
Corporations	166,661	2,765	75,095	53,835	140,026	438,381
Construction and real estate companies	97,092	1,103	2,249	372	33	100,849
Holding companies	6,855	118	2,915	33,851	0	43,738
Fisheries	10,763	541	23,701	9,240	138,676	182,921
Manufacturing	9,425	297	3,892	6,510	389	20,513
Agriculture	5,658	5	556	0	15	6,234
ITC	454	53	6,285	1,990	4	8,786
Retail	12,289	292	16,938	282	18	29,819
Services	23,713	357	18,558	1,590	891	45,109
Other	412	0	1	0	0	413
Total	**347,294**	**3,872**	**96,846**	**57,521**	**140,481**	**646,014**

At 31 December 2012			Collateral types			
Collaterals after haircut	**Real Estate**	**Deposits**	**Other**	**Securities**	**Ships**	**Total**
Financial institutions	0	0	0	0	0	0
Public entities	2,217	28	70	0	0	2,316
Private households	148,193	1,397	13,818	2,390	847	166,646
Corporations	172,364	2,690	53,735	44,466	144,508	417,763
Construction and real estate companies	90,604	1,191	1,801	168	0	93,765
Holding companies	4,632	128	4,000	29,292	0	38,052
Fisheries	7,284	167	11,518	5,462	144,105	168,537
Manufacturing	9,196	283	2,149	5,756	0	17,383
Agriculture	7,403	0	3,882	0	0	11,285
ITC	438	117	6,087	2,516	0	9,158
Retail	13,205	407	14,937	614	0	29,163
Services	39,568	396	9,360	657	403	50,383
Other	35	0	1	0	0	36
Total	**322,774**	**4,115**	**67,623**	**46,856**	**145,355**	**586,724**

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

5.2.2 Risk concentration

Concentration risk includes (i) single name concentrations of large (connected) individual counterparties [7] and (ii) significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location, instrument type or other.

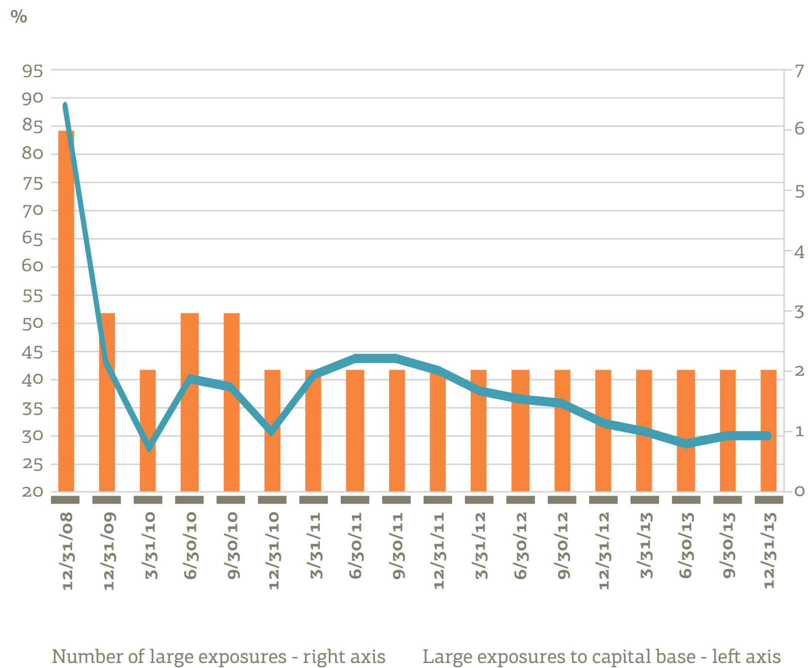
Limit management for single name and segment concentrations are set, monitored and managed through the Bank's risk appetite as well as limit management system. The Bank's risk profile for concentration risks is reported monthly to the Risk & Finance Committee and the Board of Directors according to internal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

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

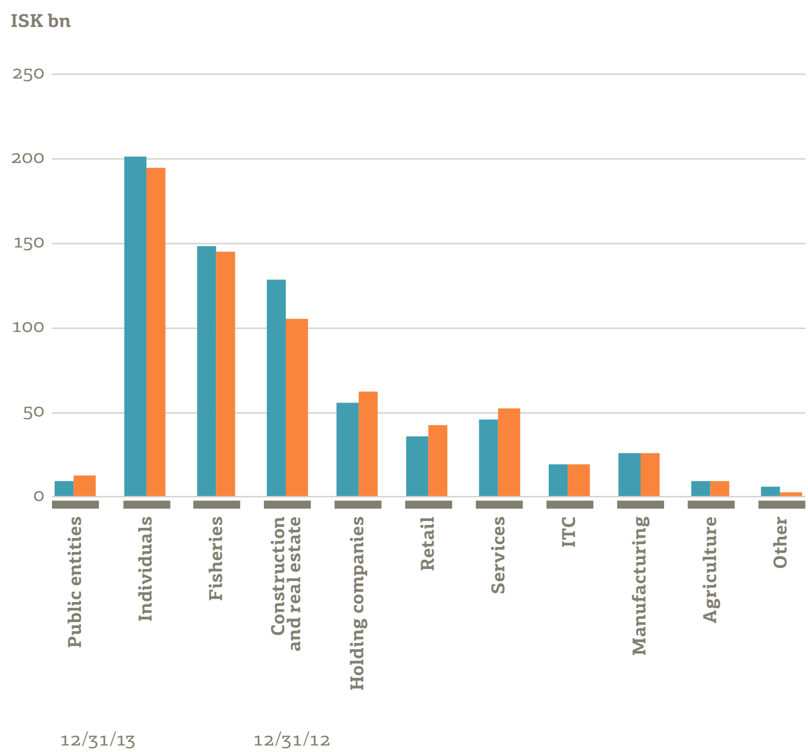
According to FME rules on large exposures (216/2007), exposures to a single customer or a group of related customers – after the deduction of particularly secure claims – may not exceed 25% of the capital base. In addition, the sum of exposures that each equal or exceed 10% of the capital base may not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

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

Large exposures



Industry segmentation of credit exposure



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

As on single name concentration the Bank's Board of Directors has introduced portfolio limits for the year 2013 for segment concentration in the Bank's risk appetite.

It is a logical consequence of the Bank's business model that credit exposure from lending activities is concentrated to some industries. At the end of 2013, lending to retail customers represented 30% of the Bank's total credit exposure (year-end 2012: 27%). Most of the demand from retail customers is for property financing and the Bank's lending to retail customers is therefore mostly secured on real estate.

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

Risk concentration

Customers domiciled in Iceland accounted for 93% of the Group's total credit exposure (2012: 94%). Exposure to foreign counterparties relates mainly to the management of the Group's foreign liquidity reserves.

5.2.3 Migration analysis

Migration analysis in this section is based on the Group's rating scale and PD estimates. At the end of 2013, the average exposure-weighted PD was 4.7% (2012: 4.6%). The PD for corporations was 5.5% (2012: 6.0%).

In addition to a new credit rating model for individuals, a new

Probability of default (PD)

(%)		31.12.2013	31.12.2012	31.12.2011
Financial institutions		0.2%	1.5%	3.1%
Public entities		0.9%	1.2%	0.9%
Individuals		4.4%	2.7%	2.8%
Corporations		5.5%	6.0%	8.8%
	Construction and real estate companies	7.5%	7.6%	10.6%
	Holding companies	5.1%	8.5%	12.3%
	Fisheries	4.2%	4.3%	8.7%
	Industry	4.8%	4.3%	6.5%
	Agriculture	6.1%	3.9%	5.0%
	ITC	4.3%	4.5%	1.7%
	Retail	6.5%	7.8%	9.5%
	Other	5.8%	14.8%	12.9%
	Services	6.2%	4.4%	6.7%
Total		**4.7%**	**4.6%**	**6.6%**

estimation for the rating grade PDs was implemented during 2013. The new PD estimates the probability of default in the lower rating grades higher than before, which gives a more descriptive picture of the default rate, based on historical data. This has therewithal an impact of increase on the measurement values of the average probability of default in the loan portfolio. Therefore the average exposure-weighted PD measures higher compared to 31 December 2012 even though the quality in the loan portfolio has improved.

Probability of default (PD)

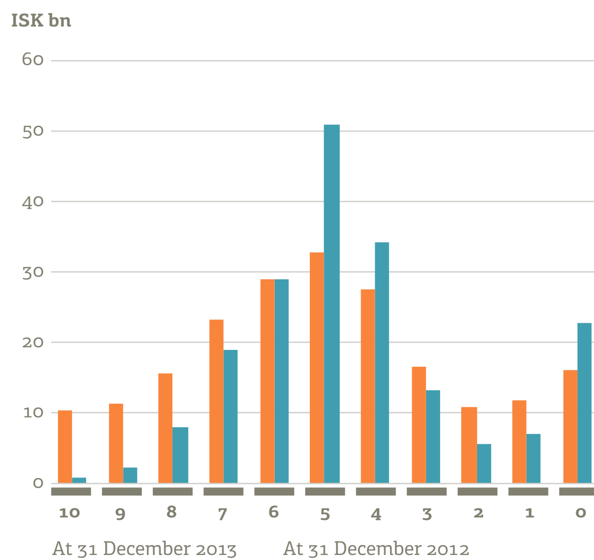
(%)		31.12.2013*	31.12.2012*
Financial institutions		0.2%	1.5%
Public entities		0.7%	1.2%
Individuals		2.5%**	2.7%**
Corporations		4.5%	6.0%
	Construction and real estate companies	7.2%	7.6%
	Holding companies	4.7%	8.5%
	Fisheries	3.6%	4.3%
	Industry	3.9%	4.3%
	Agriculture	4.6%	3.9%
	ITC	4.0%	4.5%
	Retail	5.2%	7.8%
	Other	5.1%	14.8%
	Services	5.2%	4.4%
Total		**3.5%**	**4.6%**

*according to old PD band
**according to old credit rating model for individuals

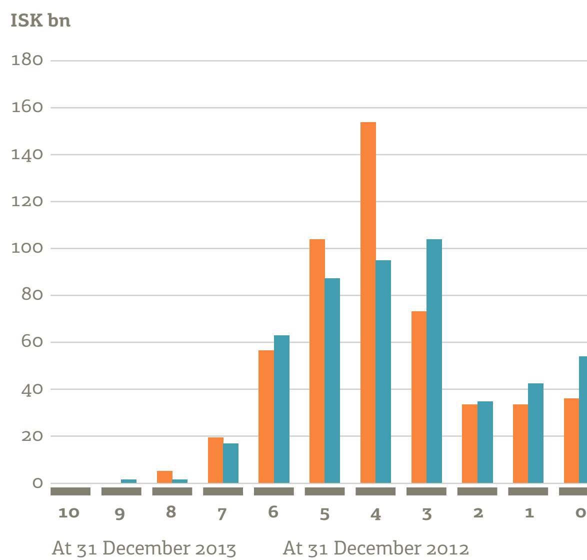
The table above shows the PD values according to the old PD estimates and credit rating model for individuals for comparison.

The charts below show the rating grade distribution of the loan portfolio broken down by individuals and corporations.

Rating grade distribution - Individuals



Rating grade distribution - Corporations



The figures show the rating grade migration for corporations and individuals during 2013, based on existing customers at year-end 2012 and 2013. Migration is shown both in terms of number of customers and exposure.

Migration analysis does not cover customers with evidence of default, i.e., customers in rating category 0.

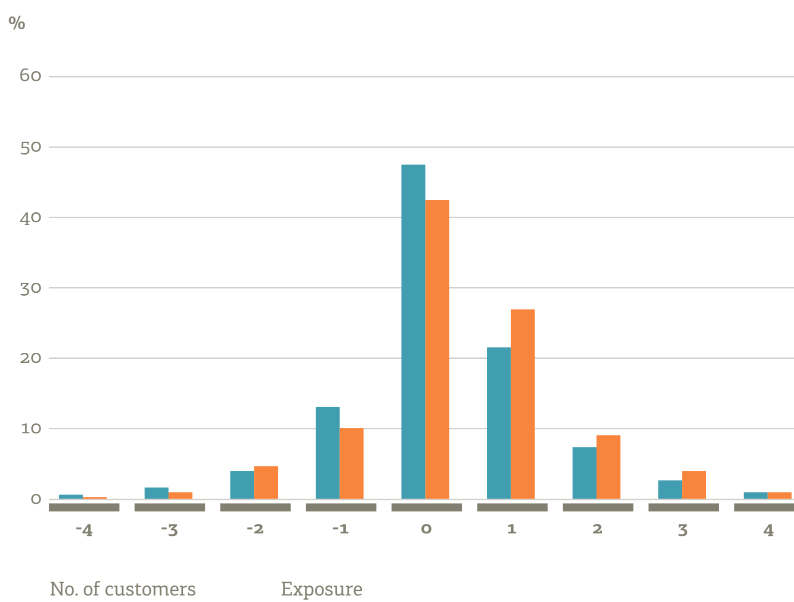
Out of the total exposure in the corporate portfolio, approximately 58% migrated up or down during 2013. This corresponds to 49% of counterparties. Upward migration was significantly higher than downward migration during 2013.

In the retail customer portfolio, approximately 78% migrated either up or down in 2013 with respect to exposure and 83% in terms of customer numbers.

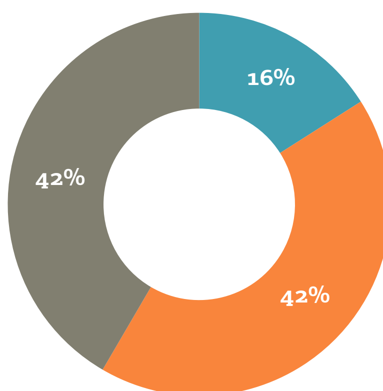
On an overall level, migration had a positive impact on credit risk economic capital during 2013 and reduced IRB credit risk economic capital for corporations by approximately 20%. This calculation does not take into account the changes in exposure distribution nor rating distribution of lost and new customers or customers who defaulted during the year.

The rating and risk grade distribution changes mainly due to

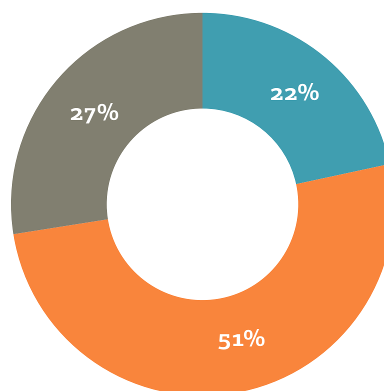
Rating migration of corporations in 2013



Rating migration of corporations in 2013 Carrying amount



Rating migration of corporations in 2013 No. of customers



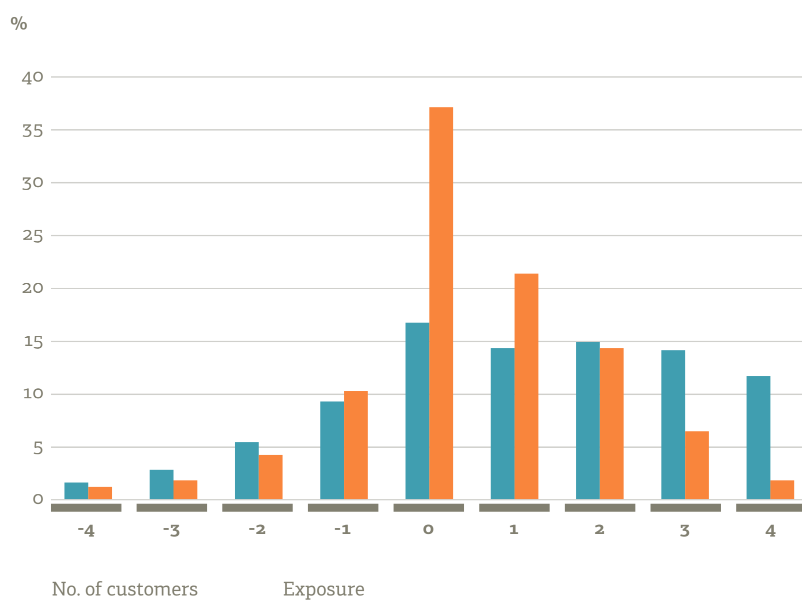
three factors: Changes in rating grade for existing customers, or pure migration; different rating grade distribution of new customers and customers leaving the Group, compared to the rating grade distribution of existing customers during the comparison period; and, increased or decreased exposure per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

Altogether, the percentage of upgrades was higher than the percentage of downgrades mainly because of the retail segment. At the end of 2013, the average exposure-weighted PD for corporate customers was 5.5% (2012: 6.0%). For individuals, the average exposure-weighted PD was 4.4% (2012: 2.7%) but as mentioned before a new credit rating model for individuals and new PD estimates have an impact of increase to the measurement value.

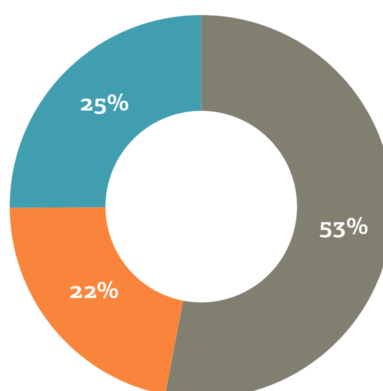
The default rate, which is measured by number of customers and not exposure weighted, for corporate customers for 2013 was 6.7% compared to the predicted 9.2%. For individual rating grades, the default rate was mainly lower than expected, except for grade 7 – though not significant. There were no defaults in grades 8, 9 and 10.

The default rate for individuals for 2013 was 3.2% compared to the predicted 3.2%.

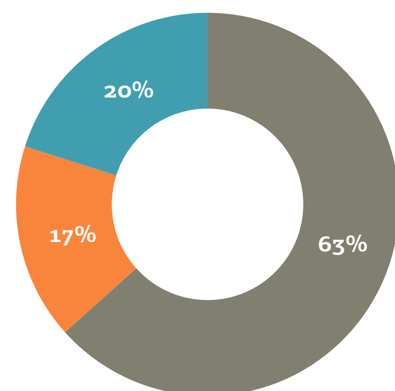
Rating migration of individuals in 2013



Rating migration of individuals in 2013 Carrying amount



Rating migration of individuals in 2013 No. of customers



5.2.4 Loan impairment

Total allowance for impairment totalled to ISK 51 billion in 2013, compared to ISK 44 billion in 2012. Allowances increased in nearly all industry sectors during 2013 while the overall carrying amount increased slightly. The increase in allowances is mainly due to loans acquired at deep discount which now have been restructured.

At the end of 2013, 87% of the portfolio consisted of claims that were neither past due nor impaired. The accumulated impairment loss amounted to ISK 8 billion.

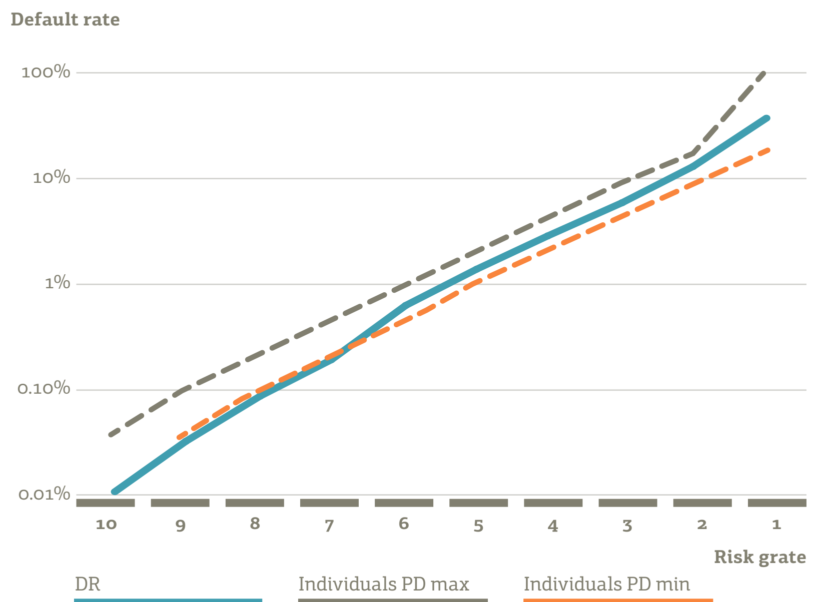
5.2.5 Credit risk analysis by industry sectors

This section describes developments in credit quality in selected segments of the Group's lending portfolio in the years 2013 and 2012.

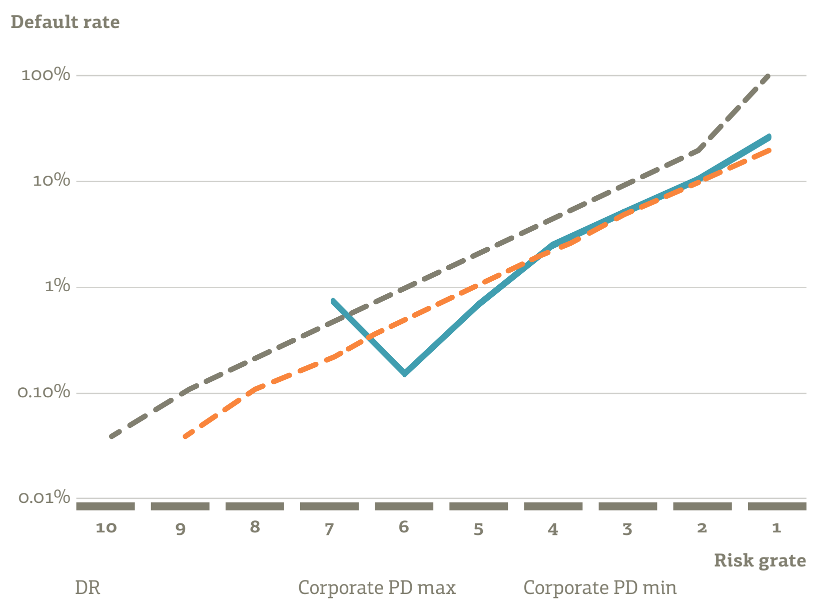
5.2.5.1 Fisheries

At the end of 2011 Icelandic fish product prices in foreign currency started decreasing and continued to decrease on the first quarter of 2013. In the springtime 2013 the price drop ceased and the prices have gone slightly upwards since. Although the prices in year end 2012 was 5% lower than at its peak at year end 2011, it is still historically high and about 9%

12 month default rate vs. probability of default band - Individuals 2013



12 month default rate vs. probability of default band - Corporations 2013



Loan impairment

	Individual allowance	Collective allowance	Total
Open 1.1.2013	-28,523	-15,507	-44,030
New provisions	-16,686	0	-16,686
Reversals	1,659	5,815	7,474
Provisions used to cover write-offs	2,156	0	2,156
Translation difference	117	26	143
Closing 31.12.2013	-41,277	-9,666	-50,944

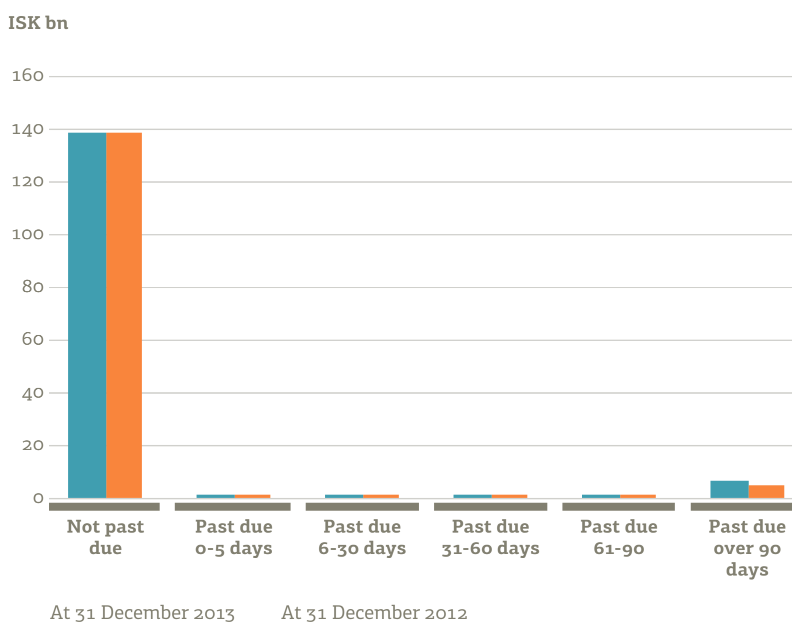
	Individual allowance	Collective allowance	Total
Open 1.1.2012	-19,696	-8,724	-28,420
New provisions	-11,719	-6,723	-18,442
Reversals	2,353	0	2,353
Provisions used to cover write-offs	586	0	586
Translation difference	-47	-60	-107
Closing 31.12.2012	**-28,523**	**-15,507**	**-44,030**

higher than the average between 2006 and 2012.

This, combined with historically weak Icelandic króna, has transformed the industry's conditions of operation for the better. The sector's EBITDA amounted to ISK 80 billion in 2011 and 2012 compared to an average ISK 31 billion over the previous 4 years before the króna's devaluation.

The sector's debts are mostly in foreign currencies as its income is for the most part also in foreign currencies. Thus, the sector's debts increased substantially due to the króna's devaluation in 2008 and 2009, and the capital position worsened significantly. The sector's underlying performance though improved even more and therefore the ratio of debt to EBITDA has not been

Gross carrying amount - Past due Fisheries



more favourable to the fishing industry for over 10 years. This increase in operating profit has enabled the companies to delev-erage their debts and at year end 2013 the sector's capital posi-

Loan impairment

	1.1.-31.12.2013		
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-16,686	0	-16,686
Write-offs	-7,430	0	-7,430
Provisions used to cover write-offs	2,156	0	2,156
Reversals	7,474	0	7,474
Recoveries	6,369	0	6,369
Translation diff	143	0	143
Impairment loss for the period	-7,975	0	-7,975
Impairment of claims reversed	0	269	269
Net impairment loss for the period	-7,975	269	-7,706

	1.1.-31.12.2012		
Impairment loss	**Customers**	**Financials**	**Total**
New provisions	-18,442	0	-18,442
Write-offs	-1,161	0	-1,161
Provisions used to cover write-offs	586	0	586
Reversals	2,353	0	2,353
Recoveries	811	0	811
Translation diff	-107	0	-107
Impairment loss for the period	-15,960	0	-15,960
Impairment of claims reversed	0	3,700	3,700
Net impairment loss for the period	-10,503	3,700	-12,260

tion was not far from what was experienced before the króna's devaluation.

Loans and advances to customers in the fisheries industry amounted to ISK 146,302 million at 31 December 2013 (2012: 142,952).

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

Fisheries	2013	2012
Gross carrying amount	155,176	149,477
Performing - Individual allowance	-6,745	-2,448
Non-performing - Individual allowance	-1,348	-1,496
Collective allowance	-782	-2,582
Carrying amount	146,302	142,952

The impaired exposure in the sector amounts to ISK 27 billion and the amount of not individu-

ally impaired loans is ISK 127 billion. The collective allowance is ISK 0.8 billion.

At the end of 2013, the loans and advances to fisheries customers in rating grades 4-6 represented 62% of the total.

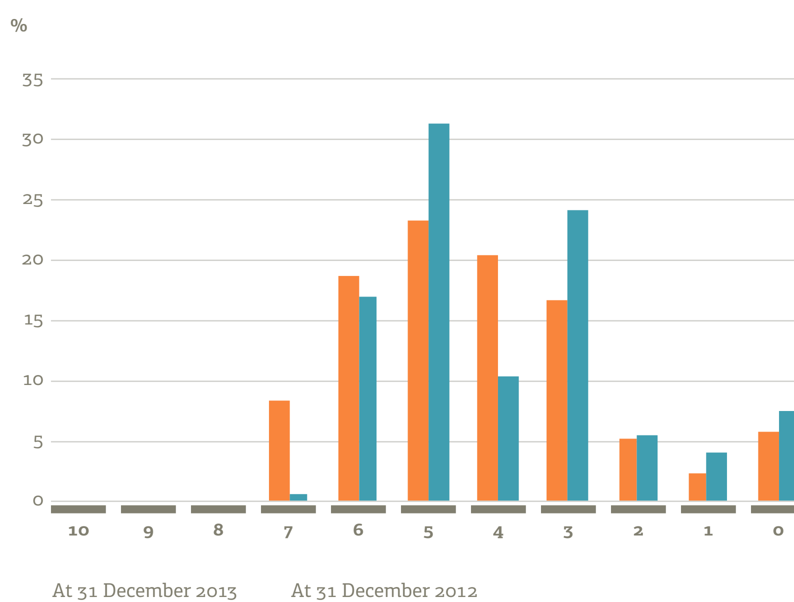
The sector's average exposure-weighted PD was 4.2% at 31 December 2013 and improved during the year. Credit extended by the Group to the fisheries industry is mainly secured by transport and fishing vessels together with their non-transferable fishing quotas, or 76% of the total sector's collateral.

Loans and advances to customers in the fisheries industry, broken down by colour classification, migrated positively during 2013. As at 31 December 2013, loans classified as green were 76% of the sector's portfolio compared to 72% at year-end 2012.

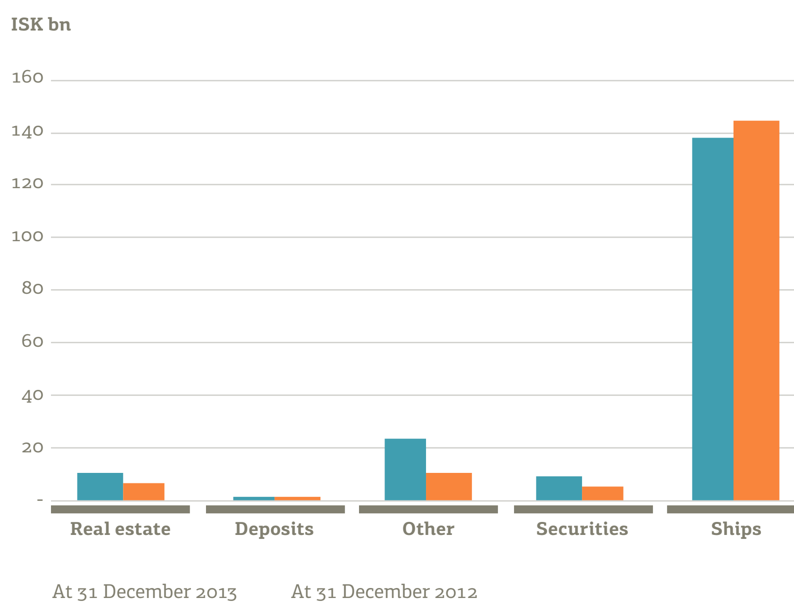
5.2.5.2 Construction and real estate companies

The past 10 years in Iceland's real estate service may be divided in two different periods. During the former half of the period the market was very vivid until it experienced a complete collapse in 2008 and 2009. The number of trades in 2009 was thus only 20% of what it was in 2007. Transactions have increased steadily since, notwithstanding the pace has decelerated lately. The

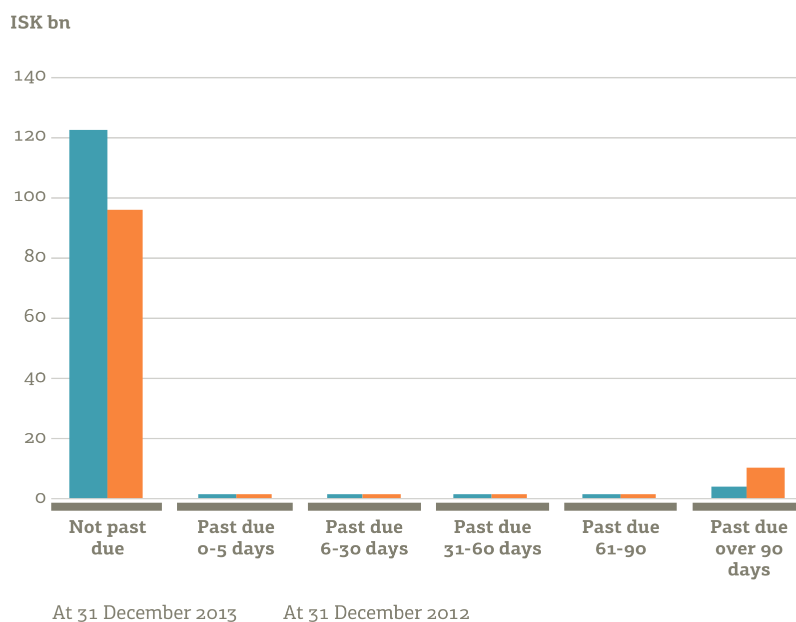
Loans and advances to fishery customers per rating grade



Fisheries - Collateral types



Gross carrying amount - Past due Construction and real estate companies



Construction and real estate companies	2013	2012
Gross carrying amount	136,224	112,558
Performing - Individual allowance	-3,704	-1,926
Non-performing - Individual allowance	-3,098	-1,869
Collective allowance	-2,191	-3,835
Carrying amount	127,233	104,928

number of residential property transactions in the capital area increased by 10% in 2013 but 14% in 2012. 8 percentage points are still lacking in order to achieve the average trading rate as of the previous 10 years.

The status of those who are expecting a decreased capital on their indexed loans, by the government's administrative action, will presumably be clear by springtime 2014. It is hard to assess what impact it will have on the property market when the action's specifications unfold. Presumably part of the group will conclude buying is feasible on account of decreased uncertainty and thus the market will rekindle. Then again a considerable amount of people probably chooses rather to wait and exploit the on-offer tax free savings option. Thus the action's total effect will probably not emerge until second half of 2014.

Loans and advances to construction and real estate companies amounted to ISK 127,233 million at 31 December 2013 (2012: ISK 104,928 million). Credit exposure to the sector represented 19% of the Group's loan portfolio.

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

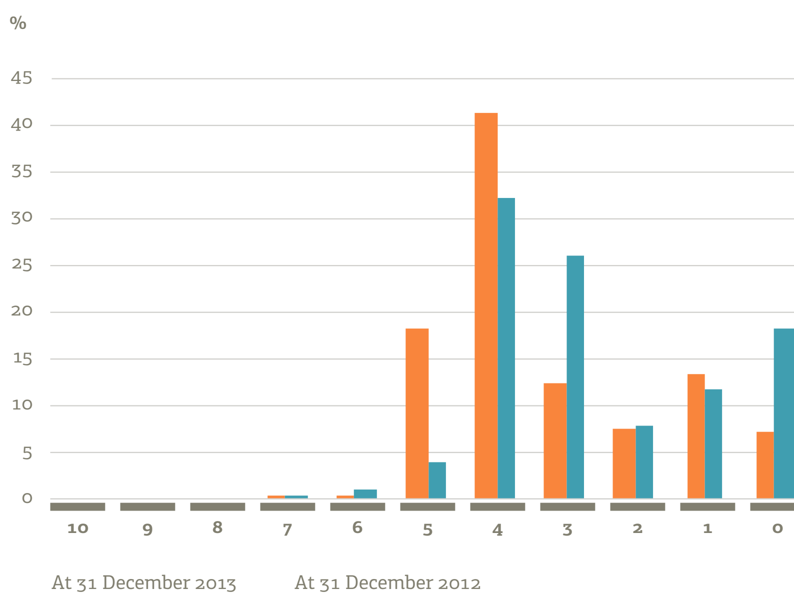
The impaired exposure in the sector amounts to ISK 14 billion and the amount of not individually impaired loans is ISK 120 billion. The collective allowance is ISK 2.4 billion.

At the end of 2013, loans and advances to construction and real estate customers in rating grades 4-6 represented 60% of the total. The majority is thus now in higher rating grades than a year before, indicating positive development and improvement in the sector's credit quality. Credit extended by the Group to construction and real estate companies is furthermore well secured, mainly by real estate.

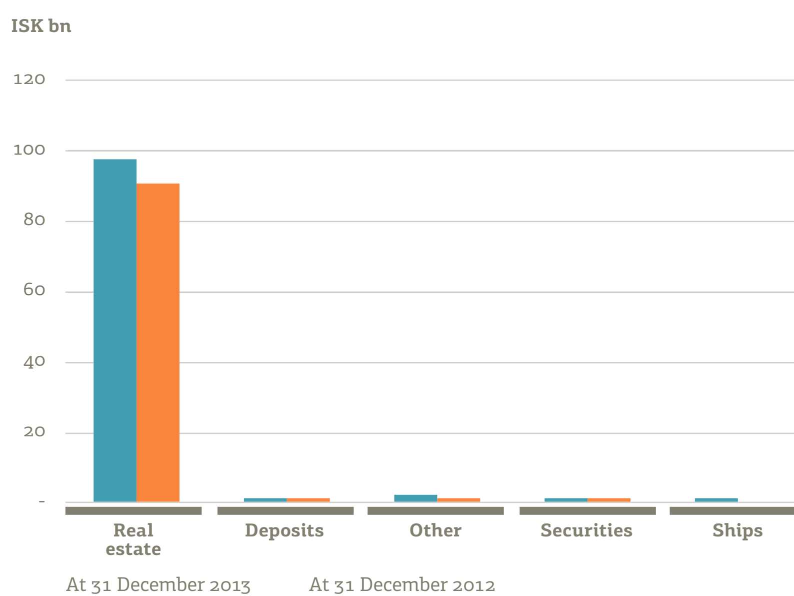
The sector's average exposure-weighted PD was 7.5% at 31 December 2013 and improved during the year.

Loans and advances to customers in the construction and real estate sector, broken down by colour classification, migrated positively during 2013. Loans classified as green were at 31 December 2013 67% of the sector's portfolio compared to 52% at year-end 2012.

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



Construction and real estate companies - Collateral types



6 Market risk

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

Since capital controls are in effect in Iceland, local markets have been fairly inactive for the past few years. The domestic equity market has, however, been growing over the last 2 years showing increased turnover and new listings of companies. Icelandic companies listed on the OMX main list are now 11, but in 2013 three new companies were listed and at least three more new listings are expected in 2014. In 2013 turnover in the Icelandic stock market almost tripled and market value increased by 36%. The Icelandic krona has stabilized following increased Central Bank activity. The annual inflation rate has been around 3.9% over the past year, but the Central Bank expects it to move below 2.5% by end of 2016. Overall, the bond yields were mostly the same at the beginning and end of 2013, although the yield fluctuated quite a bit during the year, especially for indexed bonds. Corporate bond issues increased over the year and it is likely that it will increase further in 2014 at the expense of government bonds and housing bonds.

6.1 Market risk management and policy

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

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

Market risk mitigation is reflected in the Group's overall risk appetite by identifying the target level and strategy of market risk factors. The main focus has been on reducing exposure in unlisted equities and that will also be the focus for the year 2014.

Other market risk mitigation plans are made on a case-by-case

Total exposure subject to market risk

	Net position at year-end (ISK m)	
	2013	2012
Equities and equity instruments	**34,908**	**36,881**
Listed	7,192	2,666
Unlisted	27,717	34,215
Bonds and debt instruments	281,898	219,291
Net FX position	14,457	-20,039

basis involving hedging strategies and risk reductions through diversification.

6.2 Control and monitoring

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

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

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

6.3 Market risk exposure

The table above summarizes the Group's exposure to market risk at year-end 2013.

The source of the majority of the Group's equity exposure is in unlisted equities that are, for the most part, legacy positions obtained through corporate restructuring or were acquired when the bank was established in 2008. The Bank's main focus in 2013 was on reducing this exposure and that will continue to be the focus for the year 2014. The increment in listed positions is due to the Group's increased participation in Iceland's expanded stock market.

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

6.4 Measuring market risk

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

Total market risk, measured as ratio of risk weighted assets to total RWA was 11.5% at year-end 2013 and increased by 0.3 percentage points between years. The increase is mainly due to increased interest rate risk following underwriting activities last year. Excluding underwriting commitments, the duration of the Group's fixed income portfolio is low. Equity price risk decreased by 0.7 percentage points between years and further reduction of equity price risk will be a key objective in 2014. Foreign exchange

Total market risk (RWA measure) at year-end

	2013		2012	
	RWA (ISK m)	Ratio to RWA	RWA (ISK m)	Ratio to RWA
Equity price risk	49,185	5.6%	55,321	6.3%
Interest rate risk (trading book)	31,790	3.6%	17,991	2.0%
Foreign exchange risk	19,976	2.3%	25,174	2.9%
Total	**100,951**	**11.5%**	**98,486**	**11.2%**

risk was 2.3% at year-end and is well within the Group's risk appetite.

6.4.1 Equity price risk

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

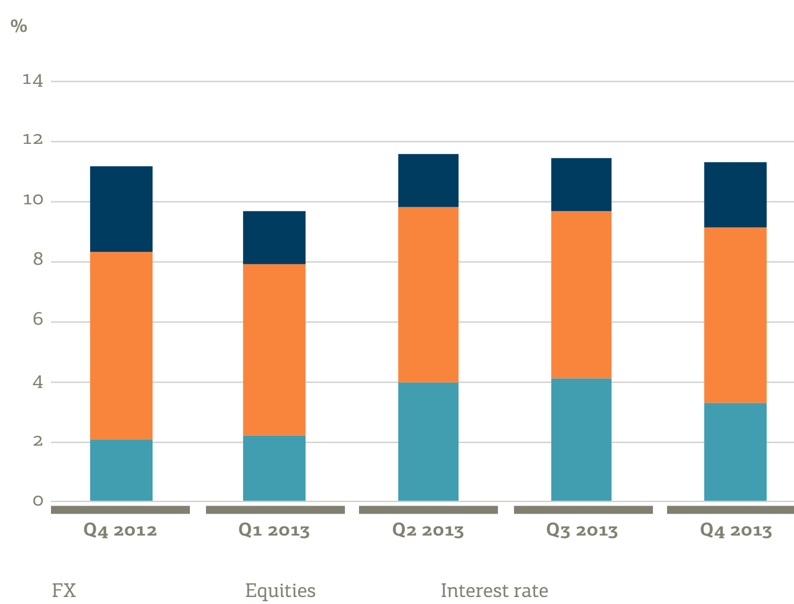
The Bank's main equity portfolios consist of a trading portfolio strictly focused on listed equites as part of market making and a proprietary portfolio containing both listed and unlisted equities as part of asset and liability management. Furthermore, the Bank has a hedge portfolio for derivative sales, containing listed equities.

The Bank's total equity exposure at year-end can be summarized as in the following table.

6.4.2 Interest rate risk

Interest rate risk is the risk of loss arising from the impact of changes in market prices related to interest rate linked instruments. The Bank separates its fixed income portfolios, which are

Total market risk (ratio to total RWA)



Equities and equity instruments

	Net position at year-end (ISK m)	
	2013	2012
Listed	7,192	2,666
Unlisted	27,717	34,215
Total	**34,908**	**36,881**

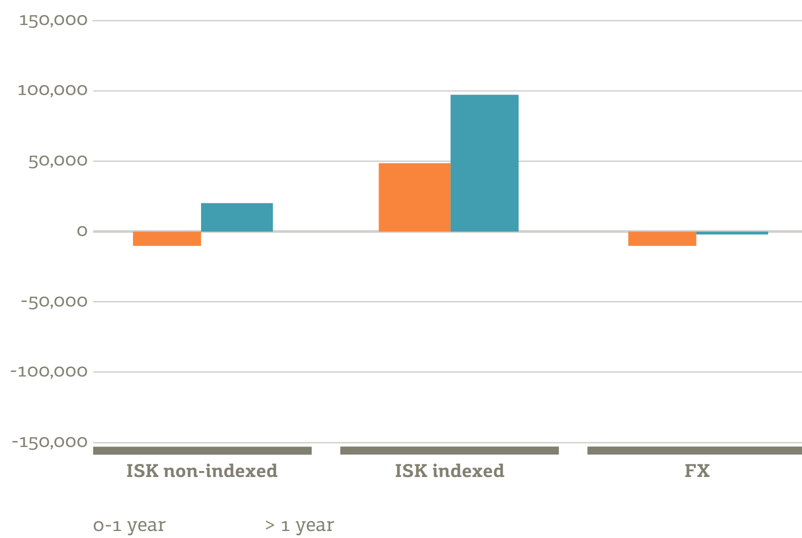
subject to interest rate risk, into trading and non-trading portfolios. The trading portfolios contain exposures due to market making, which is highly concentrated on government-guaranteed bills/bonds, a hedge portfolio for total return swaps (TRS) contracts, which also contains government-guaranteed bills/bonds and a proprietary bond portfolio containing corporate issuances, as well as government-guaranteed bonds. The Bank's non-trading portfolios consist of a liquidity management portfolio containing foreign government bills and a proprietary portfolio as part of asset and liability management, including bonds classified as loans and receivables.

Overall, the Group's interest rate risk on bonds and debt instruments is low mainly consisting of government bonds with low average duration. The Group's net interest rate exposure at year-end 2013 is summarized below:

Bonds and debt instruments

	Net position at year-end (ISK m)	
	2013	**2012**
Trading	57,866	91,866
Non-trading	224,032	127,424
Total	**281,898**	**219,291**

Asset and liability mismatch at year-end 2013



Interest rate risk in the banking book at year-end

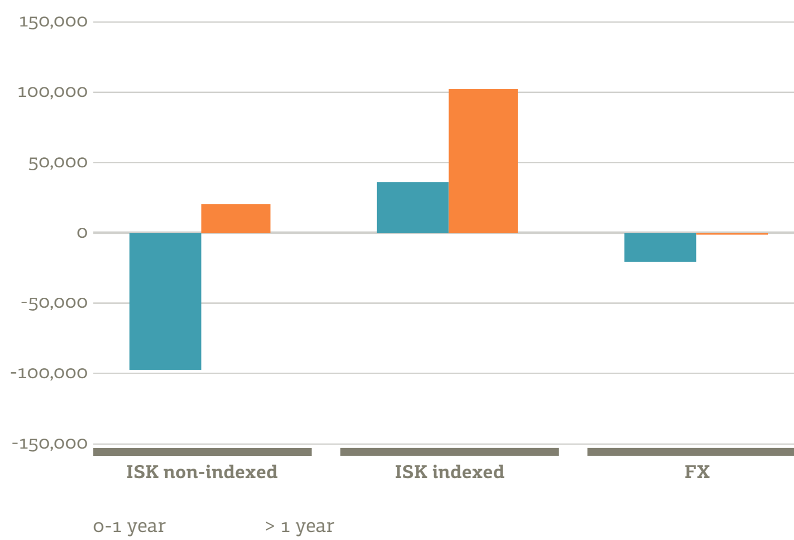
		2013		2012	
	Shift (bps)	Ec. value	% of equity	Ec. value	% of equity
ISK non-indexed	400	-2,416	-1.1%	-2,686	-1.2%
ISK indexed	240	-6,758	-3.0%	-7,525	-3.4%
EUR	200	92	0.0%	-338	-0.2%
USD	200	-4	0.0%	-107	0.0%
GBP	200	101	0.0%	14	0.0%
JPY	200	-18	0.0%	-13	0.0%
CHF	200	-27	0.0%	-13	0.0%
Other	200	-16	0.0%	-20	0.0%
Total		**-9,045**	**-4.0%**	**-10,688**	**-4.8%**

6.4.2.1 Interest rate risk in the banking book

Interest rate risk in the banking book is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. Changes in interest rate on the Bank's assets and liabilities impact its interest rate margin and/or the value of its shareholders' equity. This risk is primarily the result of duration mismatch of assets and liabilities. A liquidity management portfolio, consisting of foreign government bills and managed by Treasury is included as it is part of a hedge against liabilities in foreign currencies which belong to the banking book. The total mismatch of assets and liabilities in the banking book at year-end 2013 and 2012 is shown in the graphs below:

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

Asset and liability mismatch at year-end 2012



6.4.3 Foreign exchange risk

Foreign exchange risk (FX risk) is the risk of adverse movements due to exchange rate fluctuations. Foreign exchange risk within the Bank may arise from holding as-

sets in one currency and liabilities in another, or from a spot or forward foreign exchange trade, currency swaps or other currency contracts which are not matched with an offsetting contract. The net FX balance at year-end 2013 can be seen below:

Net FX balance

	Net position at year-end (ISK m)	
	2013	**2012**
CHF	-265	1,432
EUR	15,492	-24,584
GBP	-829	763
JPY	-643	1,108
USD	1,150	-590
Other	-448	1,832
Total	**14.457**	**-20,039**

6.4.4 Other market risk

Other market risk within the Bank is comprised only of inflation risk. Inflation risk is the risk that the fair value or future cash flows of CPI-indexed financial instruments may fluctuate due to changes in the Icelandic CPI index. Mismatch between CPI-linked assets and liabilities exposes the Bank to inflation risk. The Group's total CPI indexation balance at year-end amounted to ISK 163,291 m.

In a scenario of ongoing high (low) inflation, floating unindexed interest rate are likely to remain higher (lower) than would be the case in the reverse scenario, thus counterbalancing the positive (negative) income effects for the Group in the longer term.

Furthermore, historical observations suggest that the likelihood of severe deflation resulting in material losses is very low.

6.5 Market risk VaR

A value at risk (VaR) model is used to compute Economic Capital for FX risk. Landsbankinn uses VaR as a common ground for measuring market risk in different products. An internal VaR

model is in place for the quantification of market risk, including FX risk. The basic building blocks of the model, key assumptions and parameters, as well as its limitations, are explained below.

The three main parameters of VaR are:

» a collection of assets for which VaR is to be calculated

» a confidence level

» a time horizon (i.e. holding period of assets)

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

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

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

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

Back-testing shows the model works well, having less than four outliers on an annual basis, which is equal to the expected number of outliers given the confidence level.

6.5.1 Stress test / sensitivity analysis

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

7 Liquidity risk

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

Liquidity risk is identified as one of the Group's key risk factor, in light of the Bank's current operating environment. Accordingly, great emphasis is put on liquidity risk management within the Bank, which is both reflected in the risk appetite of the Bank as well as in internal liquidity management policies and rules.

7.1 Identification

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

7.2 Management

The objective of the liquidity management policy is to ensure that sufficient liquid assets and funding capacity are available to meet financial obligations and sustain withdrawals of confidence sensitive deposits in a timely manner and at a reasonable cost, even in times of stress.

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

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

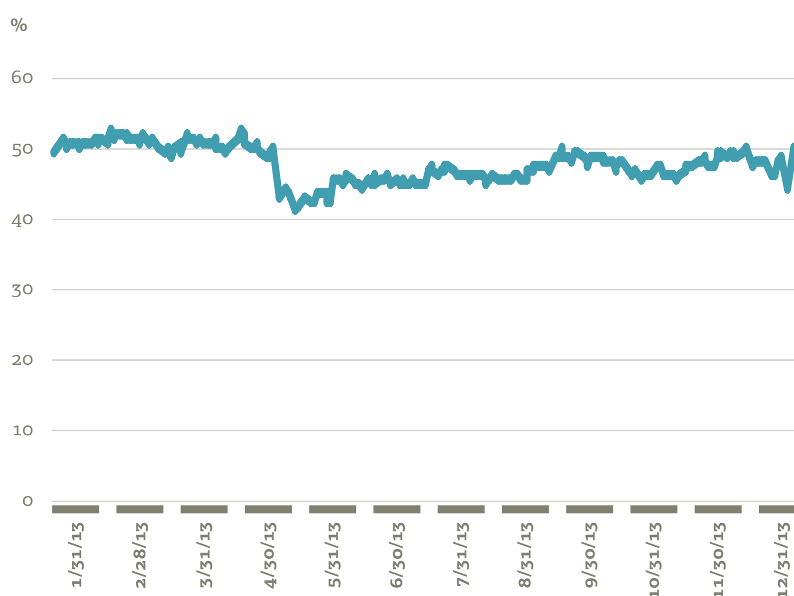
The Bank monitors intraday liquidity risk, short-term 30 day liquidity risk, liquidity risk for one year horizon and risk arising from mismatches of longer term assets and liabilities.

The Group's liquidity management process includes: projecting expected cash flows in a maturity profile rather than relying merely on contractual maturities; monitoring balance sheet liquidity; monitoring and managing the maturity profile of liabilities and off-balance sheet commitments; monitoring the concentration of liquidity risk in order to avoid undue reliance on large financing

counterparties projecting cash flows arising from future business; and, maintaining liquidity and contingency plans which outline measures to take in the event of difficulties arising from liquidity crisis.

The liquidity management policy is built on international standards on liquidity risk measurements developed by the Basel Committee on Banking Supervision e.g. the Liquidity Coverage ratio (LCR) and the Net Stable Funding Ratio (NSFR) and it also applies measurements that best suit the operating environment of the Bank.

Core liquidity ratio 2013



7.3 Assessment

The Group measures two key indicators to monitor and manage short-term liquidity risk; LCR and core liquidity ratio.

7.3.1.1 Liquidity Coverage Ratio (LCR)

The Group measures the Liquidity Coverage Ratio (LCR) as a key indicator for short-term liquidity. The objective of the ratio is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The ratio is calculated as follows:

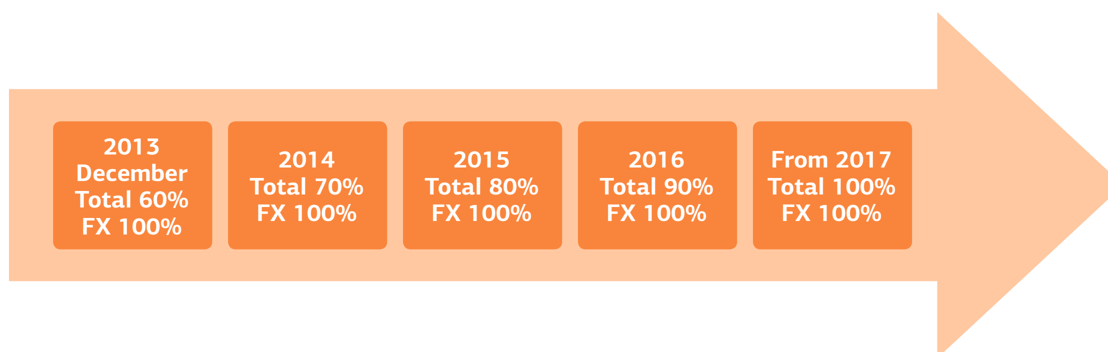
The Group's LCR as of 31 December 2013 was 102% and 208% for foreign currencies.

7.3.1.2 Core liquidity ratio

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

The definition of the liquidity benchmark measurement is as follows:

$$\frac{\text{High quality liquid assets}}{\text{maximum}\ (25\%\ \text{outflow;outflow-inflow})}$$



Liquid assets of the Group as of 31 December 2013 amounted to ISK 310 billion and the Group could withstand 50% withdrawal of all deposits.

7.3.2 Basel III Liquidity ratios

It is the intent of the Bank to utilise the framework published by the Basel Committee on Banking Supervision e.g. the Liquidity Coverage ratio (LCR) and the Net Stable Funding Ratio (NSFR) to further ensure the Bank's ability to measure and withstand liquidity needs in the short term (LCR) as well as to promote more medium and long-term funding of the assets and activities of the Bank (NSFR). As stated earlier LCR is a short term liquidity ratio whereas NSFR has a time horizon of one year and its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities.

Implementation on LCR is already in place within the Group in line with the regulatory changes made by the Central Bank in December 2013. Implementation on NSFR is in progress and a further analysis is on-going parallel to the work of the Central Bank of Iceland and the Icelandic Financial Supervisory Authority (FME). The Bank reported impact surveys for LCR and NSFR to the Icelandic regulators in the year 2013 and has co-operated with them on implementation on these ratios. The Bank will continue to work closely with the Icelandic regulators in the year 2014 as well as follow the development of these measurements in Europe.

7.4 Stress test / sensitivity analysis

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

7.5 Control and monitoring

The Bank's Risk and Finance Committee (RAFC) sets limits for liquidity risk tolerance through the liquidity management policy by determining an acceptable level of liquidity position under normal and stressed business conditions. Furthermore, the Board of Directors is responsible for determining the Bank's overall risk appetite, including liquidity risk. RAFC is also responsible for deciding on strategies, policies and practices on liquidity risk in accordance with the risk tolerance while taking into account key business lines, products, legal structures and regulatory requirements.

The Board of Directors reviews the Bank's Risk Appetite each month with regards to liquidity risk and, furthermore, the Board also discusses the Bank's balance sheet with respect to liquidity position in their monthly meetings. Risk-related matters are also discussed in detail by the Audit and Risk Committee of the Bank, including the comprehensive Risk Report published by Risk Management every four months.

The Bank's Treasury Department is responsible for day-to-day liquidity management within the Bank and that entails closely monitoring current trends and potential market developments that may present significant and complex challenges for the Bank's liquidity strategy. The stock of high-liquid assets is

under the control of Treasury which must manage the assets in accordance with the Bank's liquidity management policy.

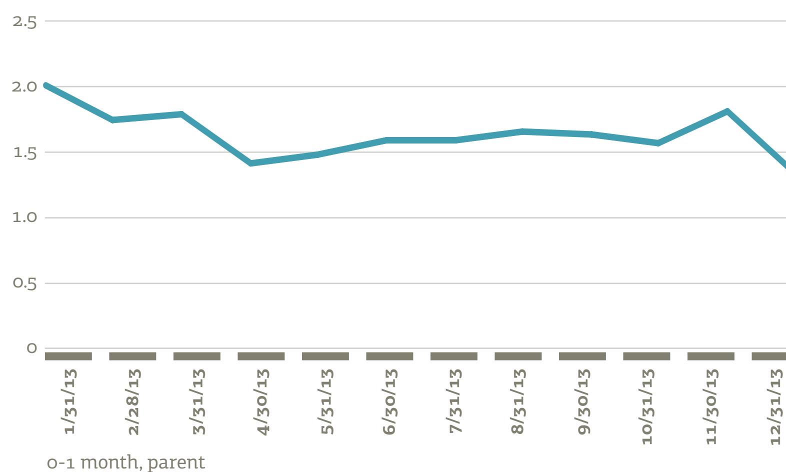
The Risk Management Division of the Bank regularly evaluates the Group's liquidity position and monitors internal and external events and factors that may affect the liquidity position. Risk Management ensures compliance with the Bank's liquidity management policy and that its liquidity requirements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

7.6 Requirements from supervisory authorities

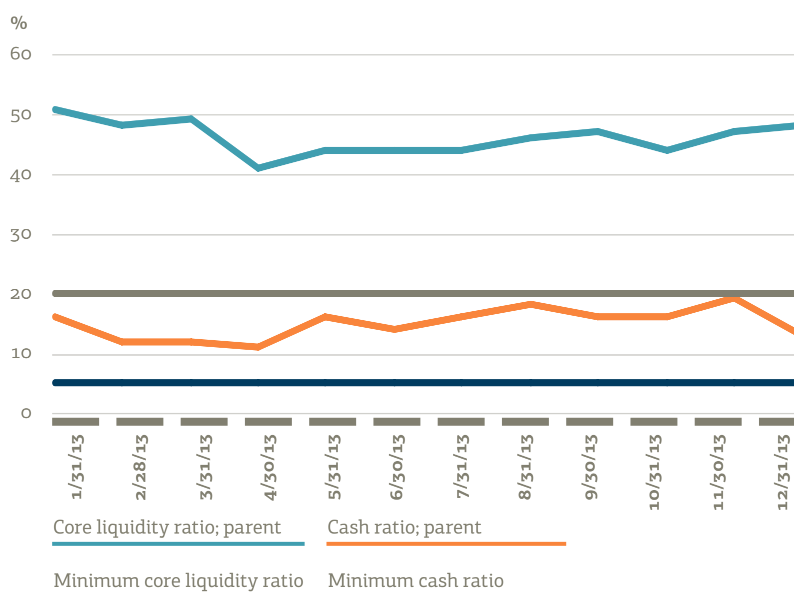
The Central Bank of Iceland issued new Rules on Liquidity Ratio, no. 1055/2013 and the rules took effect on 1 December 2013. The Central Bank Rules on liquidity are based on international standards developed by the Basel Committee on Banking Supervision but are adapted to Icelandic conditions e.g. including special requirements on foreign currency liquidity and treatment of risk related to the winding-up of the old banks.

The rules require the Group to maintain a liquidity coverage ratio minimum of 60% for total LCR and 100% for FX by year-end 2013. According to the implementation schedule, presented

Liquidity ratio set by the Central Bank of Iceland



Liquidity ratios set by the FME



below, the total LCR minimum will gradually increase to 100% from 2014 to 2019; whereas the FX ratio is constant.

In 2013 the Bank followed liquidity rules set by the Central Bank of Iceland to govern the ratio of weighted liquid assets and liabilities as well as following guidelines No. 1/2008 from the FME on best practices for managing liquidity in banking organisation. Former liquidity rules set by the Central Bank require the ratio of weighted assets to weighted liabilities to stay above 1 for the next three months, and involve a stress test, weighting assets and liabilities with specific coefficients and reflecting how accessible each asset would be in a liquidity crisis and how great the need would be to repay the liability in question when due. The Bank was well above 1 in all time bands in the year 2013.

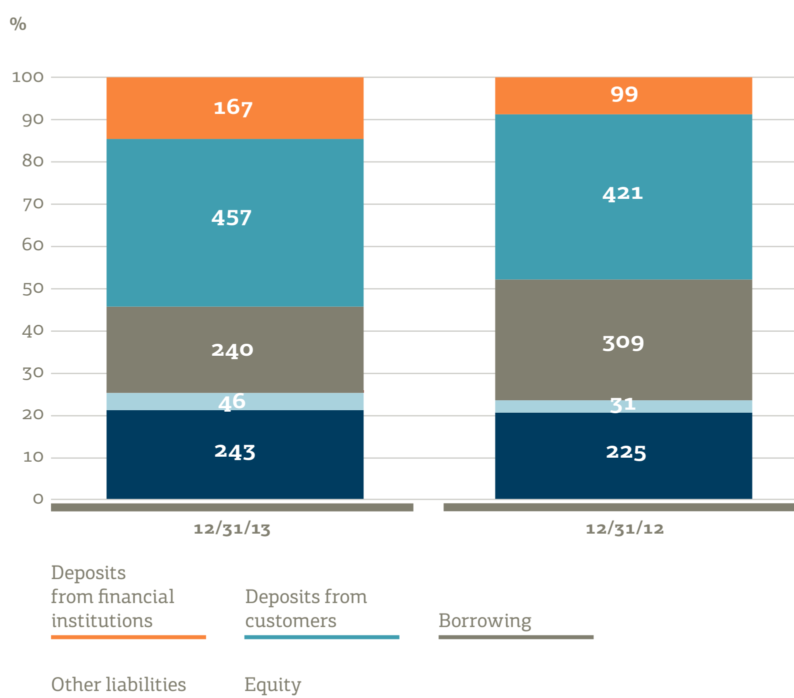
The guidelines set by the Financial Supervisory Authority require the ratio of core liquid assets to deposits to be greater than 20% and the ratio of cash and cash equivalents to on-demand deposits to be greater than 5%.

The Bank submits monthly reports on its liquidity position to the Central Bank and the FME.

7.7 Liquidity Contingency Plan

The Bank has in place a Contingency Funding Plan which is set to provide a framework for detecting an upcoming liquidity event with predefined early warning

Funding profile



indicators and actions for preventing temporary or longer term liquidity disruptions.

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

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

7.8 Funding and refinancing risk

7.8.1 Funding

Landsbankinn's funding is divided into four parts. Deposits from customers is the Bank's primary funding but the bank also funds itself through borrowing in the form of bond issues as well as deposits from financial institutions. Last but not least the bank finances itself with contributions from owners in the form of equity. Figure to right shows these main funding items as of 31 December 2013.

7.8.2 Borrowing

The main form of borrowing undertaken by the Bank is through a bonds issue to LBI hf,

which was negotiated when the assets and liabilities of Landsbanki Islands were transferred to Landsbankinn. The borrowing was twofold, bond "A" and a contingent bond.

Bond A

The bonds are 10 year installment bonds denominated in three currencies: EUR, USD and GBP with first installments due on the principal in 2014 and the final due date in 2018. The "A" bond is secured with a 127.5% loan to value ratio. In the second quarter of 2012, Landsbankinn paid the first five due dates with a prepayment to LBI hf. so the next contractual payment date is in 2015.

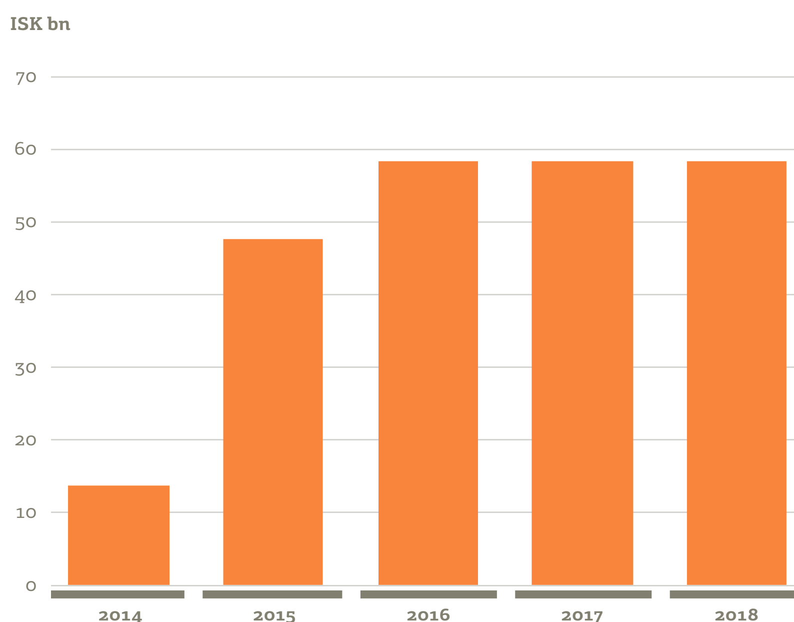
Contingent bond

The contingent bond was linked to the possible increase in value of a part of Landsbankinn's loan portfolio. The contingent bond was issued in the beginning of April 2013 for the equivalent amount of ISK 92 billion. The loan to value ratio of the contingent bond is 118.5%.

In addition to the prepayment in 2012 Landsbankinn made another prepayment to LBI hf. in December 2013, equivalent to approx. ISK 50 billion in foreign currency. The prepayment was divided pro-rata to the outstanding bonds to LBI hf., thereby lowering the contractual payments of Landsbankinn in the years 2014-2018.

The total amount of the bonds to LBI hf. at year end 2013 is equivalent to ISK 237 billion.

Annual installments of secured bonds



Covered bonds

Landsbankinn has set up covered bond programme with the main purpose of providing funding for the Bank's mortgage loan portfolio as well as hedging the bank's fixed interest rate risk. Landsbankinn has issued two tranches, one in the 2nd quarter and another in December, under the same series in 2013, a three year fixed rate bond. At year-end, the covered bonds outstanding amounted to approx. ISK 2 billion.

Landsbankinn aims to refinance, at least a part of, the Bank's debt with LBI hf. with the issuance of bonds on international credit markets no later than 2016. The Bank is also in talks with LBI on amending the terms of the outstanding bonds issued to LBI hf.

7.8.3 Credit rating

Landsbankinn aims to secure the best possible funding for the bank at any time. An important part of that is to establish the Bank's access to international credit markets. In 2013 Landsbankinn put considerable effort into aquiring a credit rating from an international credit rating agency and in January 2014 the Bank received a public credit rating from Standard and Poors (S&P): BB+ / B rating with a stable outlook. S&P's full report can be seen here.

The ratings reflect, according to S&P, their "'bb" anchor for banks operating in Iceland and S&P's view of Landsbankinn's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding and "adequate" liquidity.

8 Operational risk

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

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

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

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

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

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

8.1 Control

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

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

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

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

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

8.2 Measurement, mitigation, processes and control

In order to understand the effects of the exposures to operational risks the Bank continually assesses its operational risks. A number of tools are used to identify and assess operational risk.

- Self-assessment. The Bank assesses its operations and activities against a menu of potential risk vulnerabilities. As a part of this internally driven procedure, the Bank has set up a well-documented process to identify strengths and weaknesses in the operational risk environment. The self-assessment is done by senior directors for operations under their control and then reported up to managing directors. This is done on a two year cycle and more often if there are material changes in the operational risk environment of departments. The self-assessment identifies control gaps, enabling appropriate corrective action to be taken.
- Risk Mapping. This process involves mapping all reported incidents by risk type and to business units. This exercise reveals areas of weakness, leads to corrective action and assists in prioritizing subsequent management action.
- Key Risk Indicators (KRIs) are statistics and/or metrics, often financial, which can provide insight into the Bank's risk position. These indicators are reviewed periodically to alert the Bank of changes that indicate risk concerns. The Bank is still in the early stages of developing and adapting the use of KRIs in its risk reporting.
- The Bank is certified in adherence to ISO 27001, the international standard on Information Security. This standard helps the Bank in assessing and monitoring operational risk in the certified areas.

For the last 3 years, “Execution, delivery and process management” has by far the largest number of events, or 43 in 2012 and 29 out of 39 in 2013.

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

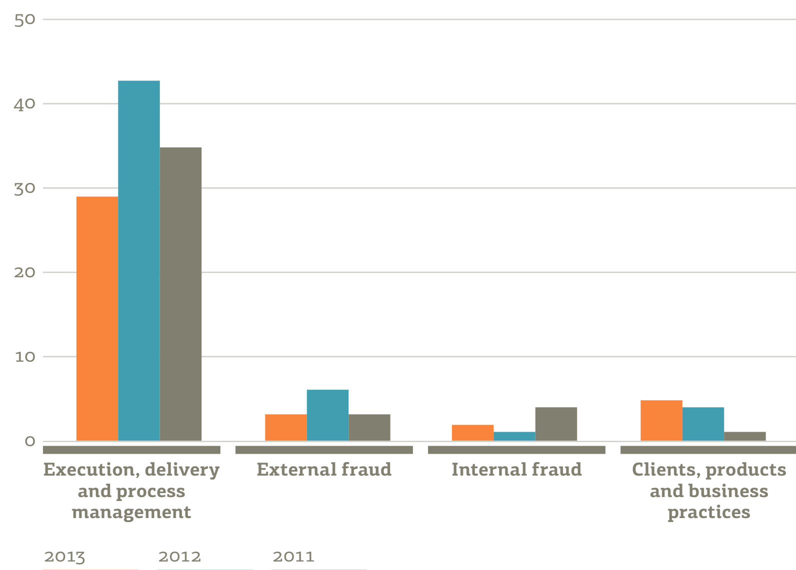
8.2.1 Mitigation

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

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

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

Number of loss incidents based on Basel II classification



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

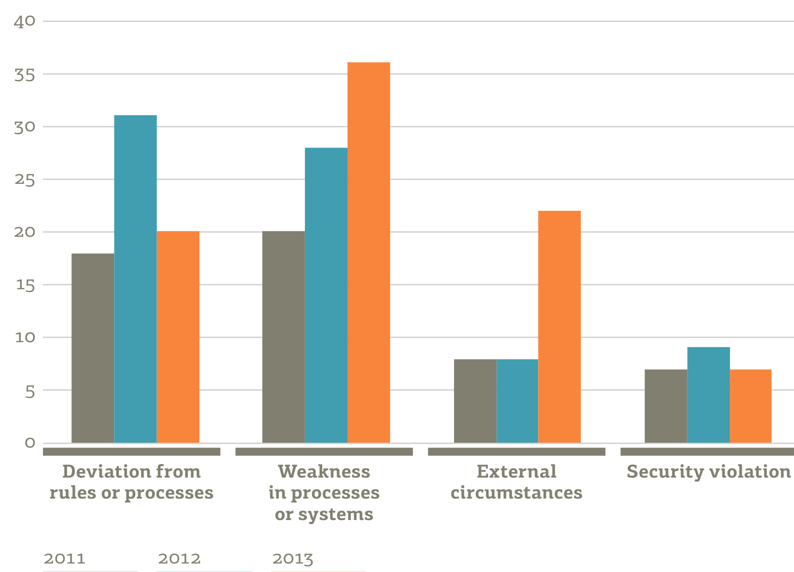
8.2.2 Control and monitoring

The Board and the CEO set detailed rules on operational risk governance and responsibilities. Day-to-day management of operational risk is a part of all man-

agers' responsibilities and they are also responsible for monitoring and controlling the operational risk in their departments. Managers evaluate operational risk through risk self-assessment focusing on key risks identified with top-down management involvement.

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

Operational incidents



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

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

9 APPENDIX

9.1 Landsbankinn's 2013 Remuneration report

9.1.1 Introduction

Landsbankinn hf. emphasises hiring and employing exceptional personnel. The aim of the remuneration policy is to make Landsbankinn a desirable workplace for qualified employees to ensure the bank's competitiveness, continued development and acceptable profitability. The remuneration policy shall support sound operations in the long term and not encourage unreasonable risk-taking. It is the Bank's aim that the terms of employment of executives and other employees are competitive without being leading in the market. In determining terms of employment, responsibility and performance shall be taken into account, as well as equal rights perspectives.

9.1.2 Governance

The remuneration policy of Landsbankinn shall be approved by its Board of Directors. Furthermore, the remuneration policy shall be submitted to the bank's AGM for approval or rejection. The remuneration policy may be reviewed more than once yearly and any amendments submitted to a shareholders' meeting for approval. The remuneration policy serves as an indicative guideline for the bank and the Board of Directors. The Board of Directors shall enter any deviations from the remuneration policy and substantiation thereof in the minutes. Deviations shall be presented to the bank's next AGM.

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

Until the AGM 17 April 2013 the Remuneration committee members were Gunnar Helgi Hálfdánarson (chairman), Andri Geir Arinbjarnarson and Ólafur Helgi Ólafsson. After the AGM the Remuneration committee members are Tryggvi Pálsson (chairman), Helga Björk Eiríksdóttir and Kristján Þ. Davíðsson.

9.1.3 Remuneration and risk-taking

9.1.3.1 General

The agreement made by the Minister of Finance on behalf of the State, Landsbankinn hf. and Landsbanki Íslands hf. dated 15 December 2009 provides that Landsbankinn offer an employee incentive scheme. The incentive scheme shall comply with FME rules on performance-linked remuneration with financial undertakings. Proposals for a performance-linked salary system and accompanying changes to the remuneration policy shall be submitted to an extraordinary shareholders meeting. Until such time, the Board of Directors may not approve linking salaries to performance.

9.1.3.2 Allocation of shares to employees

A shareholders' meeting of Landsbankinn hf., held on 17 July 2013, approved rules on the allocation of shares to employees. In allocating shares to employees, Landsbankinn fullfilled the requirements of the financial settlement with LBI hf. and imposed on it by the Icelandic State. Key points of the allocation of shares:

- Designated for allocation were shares previously owned by LBI hf. and the transfer was in accordance with an agreement between Landsbankinn, LBI hf. and the Icelandic State dated 15 December 2009;
- About half of the value of shares for allocation went to the national treasury in the form of taxes;
- The holding of just over 1400 current and former employees of Landsbankinn hf. is under 1%;
- Employees are obliged to comply with stringent requirements for the sale of the shares and may not sell their shares for a period of three years from allocation unless the bank's shares are listed on the exchange, at which point employees would be authorised to sell part of their shares.

The transfer of shares was in accordance with an agreement dated 15 December 2009 between Landsbankinn hf. (then NBI hf.), LBI hf. (then Landsbanki Íslands hf.) and the Minister of Finance on behalf of the Icelandic State on a financial settlement between Landsbankinn hf. and LBI hf. With the State's approval, LBI hf. required that Landsbankinn hf. created an employee incentive programme for the employees of Landsbankinn hf. which the State required the bank to apply to all employees. The incentive programme was to be linked to the value of certain asset portfolios of larger companies on which the final amount of the contingent bond provided for in the settlement agreement was based. External third party valuators concluded that the contingent bond should be issued in full.

Under the terms of this agreement, LBI hf. was to allocate from the estate and thereby from the assets of claim holders, 500,000,000 shares (2.08% of total shares) in Landsbankinn in accordance with allocation rules to be determined by the bank no later than at year-end 2012. No allocation rules had been determined at that time. A shareholders' meeting held on 27 March 2013 agreed that the bank was authorised to receive shares from LBI hf. and was required to transfer these shares to employees. Upon issuance of the contingent bond to LBI hf. in April, the requirement to transfer shares to employees was confirmed by the Ministry of Finance on behalf of the State.

The allocation of shares is governed by Landsbankinn's Remuneration Policy and based on FME Rules No. 700/2011, on the Salary Incentive Systems of Financial Undertakings, despite such allocation not falling under the scope of the Rules. Employees of control units will not receive shares but the bank is required by FME's Rules to ensure that these employees receive equal remuneration through other channels. It should be noted that no decision has been made to establish an incentive programme for the future.

The shares were allocated to those employees of Landsbankinn hf. and Landsbréf hf. who held permanent positions on 31 March 2013 and employees who have retired because of age, disability or terminated due to cost-cutting measures. The number of shares allocated to individual employees was relative to salary and the duration of employment at Landsbankinn during the period from 15 December 2009 to 31 March 2013.

The tax value of the shares was ISK 4.7 billion. Employees are required to pay income tax on the value of the shares as on normal salary payments. Landsbankinn retained shares in the amount of the income tax payment required from employees, financial services tax levied on financial undertakings and other salary-linked expenses and paid this amount, around ISK 2.3 billion, to the State. Around ISK 600 million was paid to pension funds and as a result, employees received shares, valued for taxation purposes, at ISK 1.8 billion, or just under 1% of shares in the bank. This amount was divided between just over 1400 current and former employees.

Upon reception of the shares, recipients oblige themselves to retain them for three years following allocation. If the Bank's shares are listed on the stock exchange, 60% of the shares may be sold one month following listing. The remaining shares (40%) may not be sold until three years have elapsed from allocation. During that time, the shares may not be mortgaged or assigned. Recipients of the shares must comply with these stringent requirements.

9.1.3.3 Incentive programmes

Beside the allocation of shares to employees, no proposals for a performance-linked salary system and accompanying changes to the remuneration policy have been submitted to an extraordinary shareholders meeting. Until such time, the Board of Directors may not approve linking salaries to performance.

9.1.4 Remuneration policies for Landsbankinn Board of Directors and CEO

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

The Board of Directors appoints the Bank's CEO. The terms of employment of the CEO shall be competitive with the terms offered managers in larger companies and in the financial market without leading the market. The CEO hires the Bank's key executives and their terms of employment shall be competitive without leading the market.

Landsbankinn makes public the terms of employment of Directors and key executives in its annual report.

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

Credit exposure (EAD)	2012	2013	
ISK billion	At 31 December	Average	At 31 December
Standardised approach for credit risk			
Central governments and central banks	113	2,766	9,915
Corporate customers	682,932	685,111	550,919
Institutions	56,138	77,796	59,923
Regional governments and local authorities	8,786	8,622	4,385
Retail customers	269,338	265,645	197,315
Retail exposures secured by real property	86,080	86,186	125,525
Standardised approach for credit risk, total	**1,103,388**	**1,126,126**	**947,981**
Total credit exposure (EAD)	**1,103,388**	**1,126,126**	**947,981**

9.2 Further disclosures required under Pillar III

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

9.2.1 Credit risk

In this section the Group in some cases reports exposure values as Exposure at Default (EAD). This is addressed specifically where applicable. Risk and Capital Management 2013, section 5, on the other hand, is based on accounting data.

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

Credit exposure (EAD) broken down by industry

At 31 December 2013 (ISK million)	Financial institutions	Public entities	Individuals	Fisheries	Construction and real estate companies	Holding companies	Retail	Services	ITC	Manu-facturing	Agriculture	Other
Standardised approach for credit risk												
Central governments and central banks	0	9,672	0	0	0	0	0	239	0	0	0	4
Corporate customers	0	1,625	4,827	181,482	153,620	74,462	35,610	40,391	21,003	29,671	6,258	1,971
Institutions	59,923	0	0	0	0	0	0	0	0	0	0	0
Regional governments and local authorities	0	3,940	0	0	10	0	0	435	0	0	0	0
Retail customers	0	732	117,653	5,529	25,239	4,149	12,503	19,009	1,755	7,168	3,487	91
Retail exposures secured by real property	0	18	124,073	19	528	127	260	450	0	48	1	0
Standardised approach for credit risk total	59,923	15,987	246,552	187,029	179,397	78,738	48,373	60,523	22,758	36,887	9,746	2,067
Total credit exposure (EAD)	59,923	15,987	246,552	187,029	179,397	78,738	48,373	60,523	22,758	36,887	9,746	2,067

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

Credit exposure (EAD) broken down by industry

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

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

Credit exposure (EAD) broken down by maturity

At 31 December 2013 (ISK million)		≥ 1 year	≥ 2 years	≥ 3 years	≥ 4 years	
	< 1 year	< 2 years	< 3 years	< 4 years	< 5 years	≥ 5 years
Standardised approach for credit risk						
Central governments and central banks	2,198	1,129	16	2,010	3	4,559
Corporate customers	163,166	75,232	49,452	38,246	57,121	167,701
Institutions	59,850	11	2	14	3	42
Regional governments and local authorities	720	1,054	474	104	81	1,953
Retail customers	73,210	8,126	8,549	9,133	7,662	90,635
Retail exposures secured by real property	429	279	124	156	124	124,413
Standardised approach for credit risk, total	299,572	85,830	58,617	49,663	64,994	389,304
Total credit exposure (EAD)	299,572	85,830	58,617	49,663	64,994	389,304

Credit exposure (EAD) broken down by maturity

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

Loans and advances by industry sectors

31.12.2013	Gross carrying amount	Not individually impaired	Individually impaired				Collective allowance	Carrying amount
			Of which performing	Individual allowance	Of which non-performing*	Individual allowance		
Financial institutions	67,916	67,916	0	0	0	0	0	67,916
Public entities	10,149	10,065	70	63	14	12	58	10,015
Individuals	217,719	193,669	11,866	6,341	12,184	6,779	3,114	201,485
Corporates								
Construction and real estate companies	136,224	122,365	5,925	3,704	7,934	3,098	2,191	127,233
Holding companies	59,808	45,547	12,641	1,836	1,620	1,420	738	55,814
Fisheries	155,176	130,702	22,454	6,745	2,020	1,348	782	146,302
Manufacturing	26,814	25,225	1,148	923	441	198	355	25,337
Agriculture	8,514	7,728	388	370	398	329	102	7,714
ITC	20,096	19,847	181	150	68	61	426	19,459
Retail	41,666	34,081	5,742	3,454	1,843	1,414	825	35,974
Services	50,375	46,620	1,502	1,082	2,253	1,663	1,013	46,617
Other	4,871	4,550	0	0	321	289	64	4,518
Total	**799,327**	**708,315**	**61,917**	**24,667**	**29,096**	**16,610**	**9,666**	**748,384**

*Non-performing past due more than 90 days

Loans and advances by industry sectors

31.12.2012	Gross carrying amount	Not individually impaired	Individually impaired				Collective allowance	Carrying amount
			Of which performing	Individual allowance	Of which non-performing*	Individual allowance		
Financial institutions	64,349	64,349	0	0	0	0	0	64,349
Public entities	11,682	7,794	3,717	51	108	11	44	11,576
Individuals	207,608	167,667	22,436	3,549	7,577	6,379	2,632	195,047
Corporations		0						
Fisheries	149,477	89,405	54,380	2,448	1,749	1,496	2,582	142,952
Construction and real estate companies	112,558	82,272	22,988	1,926	3,503	1,869	3,835	104,928
Holding companies	66,235	40,464	22,050	564	582	2,575	3,087	60,009
Retail	47,549	33,737	8,763	2,376	1,039	1,634	1,520	42,019
Services	55,917	45,944	6,713	1,323	1,028	908	986	52,700
ITC	19,770	14,202	5,287	186	50	46	126	19,413
Manufacturing	26,802	22,807	2,889	458	315	334	346	25,665
Agriculture	10,747	5,098	5,093	127	256	173	248	10,199
Other	1,772	1,573	0	0	110	90	102	1,581
Total	**774,467**	**575,313**	**154,315**	**13,007**	**16,317**	**15,515**	**15,508**	**730,437**

*Non-performing past due more than 90 days

The tables below show the Group's maximum credit risk exposure at 31 December 2013 and 2012. For on-balance sheet assets, the exposures set out below are based on net carrying amounts as reported in the statement of financial position. Off-balance sheet amounts in the tables below are the maximum amounts the Group might have to pay for guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities.

At 31 December 2013	Financial institutions	Public entities*	Indi-viduals	Fisheries	Construc-tion and real estate companies	Services	Retail	Holding companies	Manu-facturing	Agri-culture	ITC**	Other	Carrying amount
Cash and balances with Central Bank		21,520											21,520
Bonds and debt instruments	844	265,482			13,860			9,655				755	290,596
Derivative instruments	606	1					30					17	654
Loans and advances to financial institutions	67,916												67,916
Loans and advances to customers		10,015	201,485	127,233	55,814	146,302	25.337	7,714	19,459	35,974	46,617	4,518	680,468
Other financial assets	3,743	327	458	99	1193	438	20	1	5	40	2	41	6,367
Total on-balance sheet exposure	**83,022**	**254,685**	**195,647**	**142,963**	**105,231**	**53,287**	**42,019**	**60,406**	**26,270**	**10,199**	**19,415**	**2,922**	**996,066**
Off-balance sheet exposure	**4,568**	**16,832**	**20,818**	**23,508**	**8,064**	**20,192**	**7,723**	**395**	**4,088**	**8,249**	**14,355**	**646**	**129,440**
Financial guarantees	26	705	506	2,486	34	1,666	593	28	1,012	1,738	5,529	41	14,364
Undrawn loan commitments	1,500	9,687	49	19,626	7,225	16,613	5,348	35	2,007	1,238	807	433	64,569
Undrawn overdraft/ Credit card facilities	3,042	6,441	20,263	1,396	805	1,912	1,782	332	1,069	5,273	8,019	173	50,507
Maximum exposure to credit risk	**87,590**	**271,517**	**216,465**	**166,471**	**113,295**	**73,479**	**49,742**	**60,801**	**30,358**	**18,448**	**33,770**	**3,568**	**1,125,506**
Percentage of carrying amount	7.78%	24.12%	19.23%	14.79%	10.07%	6.53%	4.42%	5.40%	2.70%	1.64%	3.00%	0.32%	100.00%

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

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

				Corporations									
At 31 December 2012	**Financial institutions**	**Public entities***	**Individuals**	**Fisheries**	**Construc-tion and real estate companies**	**Services**	**Retail**	**Holding companies**	**Manufac-turing**	**Agri-culture**	**ITC****	**Other**	**Carrying amount**
Cash and balances with Central Bank		25,898											25,898
Bonds and debt instruments	9,528	216,935			3			397	352			993	228,208
Derivative instruments	1,039											4	1,043
Loans and advances to financial institutions	64,349												64,349
Loans and advances to customers		11,576	195,047	142,952	104,928	52,700	42,019	60,009	25,665	10,199	19,413	1,579	666,087
Other financial assets	8,106	276	600	11	300	587			253		2	346	10,481
Total on-balance sheet exposure	**83,022**	**254,685**	**195,647**	**142,963**	**105,231**	**53,287**	**42,019**	**60,406**	**26,270**	**10,199**	**19,415**	**2,922**	**996,066**
Off-balance sheet exposure	**4,054**	**14,215**	**28,146**	**14,374**	**30,798**	**11,465**	**8,612**	**1,147**	**2,361**	**1,049**	**2,495**	**46**	**118,763**
Financial guarantees	0	95	463	1,731	23,149	2,123	1,685	208	584	39	552	35	30,664
Undrawn loan commitments	1,500	9,022	22	10,592	5,628	2,122	1,948	278	194	701	901	0	32,908
Undrawn overdraft/ Credit card facilities	2,554	5,098	27,661	2,051	2,020	7,220	4,979	661	1,583	309	1,043	11	55,190
Maximum exposure to credit risk	**87,076**	**268,900**	**223,793**	**157,337**	**136,028**	**64,752**	**50,631**	**61,553**	**28,631**	**11,248**	**21,911**	**2,968**	**1,114,828**
Percentage of carrying amount	7.8%	24.1%	20.1%	14.1%	12.2%	5.8%	4.5%	5.5%	2.6%	1.0%	2.0%	0.3%	100.0%

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

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

31.12.2013	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised					
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	No collateral	Individual allowance	Collective allowance	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	72,484	0	0	72,484
Public entities	24	60	209	1,169	1,462	4,969	294	20,550	76	58	26,847
Individuals	2,370	10,978	19,567	33,728	66,643	119,759	86,272	52,135	13,120	3,114	222,304
Corporates											
Construction and real estate companies	348	4,546	5,167	12,397	22,458	123,137	66,030	14,138	6,801	2,191	150,741
Holding companies	495	245	1,143	2,709	4,592	50,895	34,908	12,384	3,256	738	63,878
Fisheries	3,758	6,695	22,194	35,242	67,889	99,711	69,672	7,768	8,093	782	166,494
Manufacturing	97	183	1,275	6,389	7,944	16,658	9,403	9,935	1,122	355	33,060
Agriculture	89	311	306	1,477	2,184	5,556	2,565	1,170	698	102	8,109
ITC	20	45	90	68	223	19,107	8,316	4,853	211	426	23,547
Retail	153	1,050	1,623	3,604	6,429	34,635	17,244	8,851	4,867	825	44,223
Services	235	3,789	2,791	9,922	16,736	27,608	16,282	20,386	2,744	1,013	60,973
Other	2	0	0	112	114	522	231	4,881	289	64	5,164
Total	**7,591**	**27,901**	**54,366**	**106,817**	**196,675**	**502,557**	**311,216**	**229,536**	**41,277**	**9,666**	**877,824**

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

31.12.2012	LTV Ratio – Fully collateralised					LTV Ratio – Partially collateralised					
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	Total	>100%	Collateral value	No collateral	Individual allowance	Collective allowance	Maximum exposure to credit risk
Financial institutions	0	0	0	0	0	0	0	68,404	0	0	68,404
Public entities	25	43	172	104	344	6,002	1,142	19,552	62	44	25,791
Individuals	6,621	11,206	14,577	18,473	50,878	100,197	64,967	84,679	9,928	2,632	223,193
Corporations											
Fisheries	1,091	4,765	24,202	20,277	50,335	90,952	58,291	22,564	3,943	2,582	157,326
Construction and real estate companies	320	1,833	3,167	9,321	14,641	121,949	49,980	6,765	3,795	3,835	135,725
Holding companies	402	163	1,043	1,950	3,558	49,780	32,115	14,044	3,139	3,087	61,156
Retail	159	641	1,281	1,065	3,146	42,039	17,042	10,977	4,010	1,520	50,631
Services	803	811	10,719	1,581	13,915	34,793	14,160	18,673	2,231	986	64,164
ITC	25	35	65	29	155	20,727	6,396	1,383	231	126	21,907
Manufacturing	72	278	729	1,010	2,088	19,283	10,786	7,792	792	346	28,026
Agriculture	176	119	262	64	621	10,205	3,910	970	299	248	11,249
Other	3	0	76	0	79	41	26	1,696	90	102	1,624
Total	**9,697**	**19,895**	**56,294**	**53,874**	**139,761**	**495,967**	**258,815**	**257,499**	**28,522**	**15,508**	**849,197**

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

9.2.2 Market risk

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

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

At 31 December 2013

Financial assets	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Bonds and debt instruments	152,473	15,547	10,674	**178,694**
Equities and equity instruments	8,209	1	28,064	**36,274**
Derivative instruments	0	654	0	**654**
Total	**160,682**	**16,202**	**38,738**	**215,622**

Financial liabilities	Quoted prices (unadjusted)	Observable inputs	Unobservable inputs	Total
Derivative instruments	0	583	0	**583**
Short positions	6,988	0	0	**6,988**
Contingent bond	0	0	0	**0**
Total	**6,988**	**583**	**0**	**7,571**

At 31 December 2012

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

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

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

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

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

2013	
Equities and equity instruments	**Unobservable inputs**
Carrying amount at 1 January 2012	29,876
Total gains (losses) recognised in income statement	5,561
Purchases	56
Sales	-8,432
Settlements	0
Transfers into Level 3	**10,02**
Carrying amount at 31 December 2012	**28,063**

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

9.2.3 The use of special instruments or methodologies

CRD, annex XII, part 3, point 1 (e) (i-iii)

By rating category	Credit exposure (EAD)		Exposure-weighted (EAD) Average LGD [%]		Exposure weighted (EAD) Average risk weight [%]	
Corporate customers	at 31 December 2013	at 31 December 2012	at 31 December 2013	at 31 December 2012	at 31 December 2013	at 31 December 2012
IRB-F approach						
10	0	0	0	0	0	0
9	0	0	0	0	0	0
8	0	0	0	0	0	0
7	17.702	17.582	41	42	54	55
6	61.755	78.532	45	44	83	82
5	104.757	93.575	45	45	112	108
4	161.949	101.138	45	44	135	134
3	73.194	102.785	45	45	166	169
2	32.144	36.609	46	44	230	219
1	17.784	46.578	45	44	263	258
0	75.843	103.732	46	44	0	0

CRD, annex XII, part 3, point 1 (e) (iv-v) & point 2 (d)

By rating category	Off Balance (EAD)		Exposure weighted (EAD) Average ccf [%]		Credit exposure (EAD) covered by guarantors	
Corporate customers	at 31 December 2013	at 31 December 2012	at 31 December 2013	at 31 December 2012	at 31 December 2013	at 31 December 2012
IRB-F approach						
10	0	0	0	0	0	0
9	0	0	0	0	0	0
8	0	0	0	0	0	264
7	1.267	1.553	36	99	0	8.438
6	6.182	16.132	46	99	2.334	2.171
5	4.634	10.295	40	99	0	656
4	9.444	6.749	49	93	187	0
3	3.549	6.279	48	96	0	2.135
2	1.973	1.738	50	91	0	0
1	606	2.887	62	90	0	0
0	827	1.732	49	81	0	0

CRD, annex XII, part 3, point 1 (g) & (h)-(i)

Expected losses vs. Actual value adjustments

	Central governments and central banks	Corporate customers	Institutions	Regional governments and local authorities
2013				
Actual Value adjustments	0	17.816	0	0
Expected loss	0	16.455	0	0
2012				
Actual Value adjustments	0	13.137	0	0
Expected loss	0	18.349	0	0

Note: Actual value adjustments and expected loss are not directly comparable. Actual value adjustments are defined as new individual impairment charges plus write-offs charged directly to the income statement. Expected loss is defined as the expected loss at the beginning of the period (1 January) on the basis of PD (through the cycle), LGD and CF for exposures that have not defaulted. For defaulted exposures, the expected loss equals the loan impairment charge.

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

Credit exposure (EAD) secured on collateral received (after volatility adjustment)

At 31 December 2013 (ISK million)

Approach		Guarantees	Credit derivatives	Eligible financial collateral	Real property	Other eligible collateral	Total
IRBF	Corporate customers	2.521	0	9.169	13.946	0	25.635
	IRB approach, total	2.521	0	9.169	13.946	0	25.635

Credit exposure (EAD) secured on collateral received (after volatility adjustment)

At 31 December 2013 (ISK million)

Approach		Guarantees	Credit derivatives	Eligible financial collateral	Real property	Other eligible collateral	Total
IRBF	Corporate customers	13.664	0	6.290	9.919	0	29.873
	IRB approach, total	13.664	0	6.290	9.919	0	29.873