Pillar 3 Risk Disclosures

Arion Bank 2023

Disclaimer

Declaration

The Board of Directors of Arion Bank is responsible for the Bank's risk management framework and for ensuring that satisfactory risk policies and governance for controlling the Bank's risk exposure are implemented. The Board reviews on a regular basis the status of risk management issues to assess the management and monitoring of the Bank's risks.

It is the Board's assessment that the Bank has in place adequate risk management arrangements with respect to the Bank's risk profile and risk policy.

Risk statement

Arion Bank is a strongly capitalized bank. It aims to excel by offering agile and reliable financial solutions which create future value for its customers, shareholders, and wider society. The Bank provides diverse and value-adding services for its customers, guided by sustainability and responsibility. Its application of digital solutions increases customer convenience and improves operating efficiency while simultaneously mitigating operational risk by reducing the need for manual input. The Bank is committed to supporting the economy and financing of households and corporates despite challenging and uncertain times.

The Bank's business strategy is aligned with its risk appetite as set by the Board. This is achieved by monitoring and managing the Bank's risk profile at any given time against risk limits and targets derived from the risk appetite statement. The Board reviews and approves the Bank's risk policies and enterprise risk management architecture.

Liquidity
Total LCR
192%

Capital adequacy
Total capital ratio
24.1%

Large exposures
No group exposure over 10% of Tier 1 capital
0.0%

Credit risk is one of the Bank's primary risk factors. The Bank's credit policy underpins its credit strategy as integrated in the business plan. Credit risk is managed in line with risk appetite metrics, which address credit quality, as well as single-name, sectoral and geographical concentration risks. In line with its risk appetite, the Bank has successfully reduced single-name concentration in recent years through enhanced focus on and management of the risk factor, in part through its strategy to originate to distribute. At the end of 2023, the Bank had no exposures equal to or exceeding 10% of Tier capital, and the 12-month expected credit loss rate was 30 bps.

The Bank invests its own capital on a limited and selective basis in transactions, underwriting and other activities that involve market risk. Market risk is managed in accordance with the risk appetite and risk limit framework. At the end of 2023, total net equity position in the trading book and total equity position in the banking book was 1.6% and 2.9%, respectively, of normalized own funds. This is a level comparable to that of year-end 2022, but materially lower than what it had been in previous years.

The Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirements. The Bank's funding profile supports its liquidity profile. Liquidity positions are managed on a day-to-day basis using internal limits and targets in line with risk appetite and regulatory standards. The Bank's liquidity coverage ratio was 192% at the end of 2023, while the regulatory requirement was 100%.

The Bank's business units are primarily responsible for managing their own operational risks with support from control functions. The Bank's operational risk framework integrates risk management practices into processes, systems, and culture. Organizational restructuring during the year brought together a number of support functions including back office, legal services, human resources and operations management in a new division that is intended to increase collaboration between those units, improve the management of transformation projects, and increase the overall efficiency of operations. This new division will play a key role in the continued development and shaping of the Bank's corporate culture.

The Bank has no tolerance for internal fraud and compliance breaches, and the risk appetite statement further attends to observation of standards of market integrity, good practice and conduct, and minimization of incidents and mistakes.

As with the financial sector generally, the incidence of attempted fraud against the Bank's customers is continually increasing and evolving. The Bank relies on experienced internal and external experts for advising, implementing, operating, and monitoring security controls in use, and participates in several security risk- and fraud-focused forums for threat intelligence sharing, combined with the use of automated threat intelligence.

The Bank has integrated sustainability risk into its enterprise risk management framework, incorporating environmental, social and governance factors in decision making and strategy. This is an area of rapid evolution, in which the Bank endeavours to reflect regulatory requirements and employ best practices with respect to ESG-related risk management. The Bank seeks to ensure that its activities and the services it provides do not adversely impact people or the environment and is committed to supporting the global effort to transition to a net zero carbon economy.

The Bank is well capitalized with a capital adequacy ratio of 24.1%, and CET1 ratio of 19.7% at the end of 2023 exceeding both the regulatory requirements and the risk appetite.

The Board of Directors of Arion Bank

Maintaining stability through adverse financial conditions and natural disruptions

In 2023, the Icelandic economy performed well despite significant tightening of financial conditions, as the Central Bank raised its key policy rate to 9.25% to counter persistent inflation, measured at 7.7% at year-end. Housing prices stabilized during the year but continued demand still seems to counterweigh the adverse impact of increasing costs. The impact on the construction sector is apparent through the Bank's credit activities as requests for add-ons and extensions of credit in response to escalating costs and reduced sales velocity are common. At year-end there were signs of reduced economic activity as private consumption, in real terms, had dropped 1.7% at Q3 compared with the year before and GDP growth was reduced to 1.1% following a period of strong post-Covid growth.

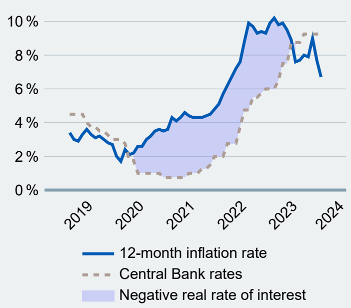
Seismic activity continued on the Reykjanes peninsula resulting in the evacuation of fishing town Grindavík with considerable damage to housing and infrastructure. This adds to a series of rare events that have impacted the economy and the Bank, including the pandemic and war in Ukraine. The magma pressure that started building up in October beneath the surface of Svartsengi, close to the well-known tourist attraction Blue Lagoon and the Svartsengi power station, was first released through significant earthquakes near Grindavík on November 10, followed by volcanic eruptions in December, January February, each lasting no more than three days. As the magma pressure continues to build, the likelihood of further seismic events remain.

The Group's amount at risk in relation to the Grindavík area is limited relative to the town's share of the economy, see analysis in Section 4.6 of this report. Damages resulting from earthquakes or magma are covered by the National Catastrophe Insurance of Iceland. The Bank however faces possible credit loss for cases where properties are deemed undamaged but inhabitable, which may be subject to insurance claim disputes. At the time of writing a goverment intervention is likely, which will impact the assessment of expected credit loss going forward.

Despite the challenging macroeconomic conditions and series of rare events occurring almost back-to-back, the Bank has maintained a strong level of profitability throughout. As subsequent chapters of this report demonstrate, key risk indicators are healthy across the board, and the organization as a whole — risk management included — continues to evolve and adapt to the ever-changing external environment in which the Bank operates.

Credit quality metrics remain strong while default rates are slowly trending upwards. The bulk of interest rate resets of fixed rate mortgages occur in the second half of 2024, and the impact on the Bank's credit risk profile largely depends on economic developments e.g. upcoming collective wage agreements, inflation and monetary policy, which in turn may be impacted by geopolitical developments in 2024 and other external factors. If interest rates remain high, it is evident that a significant group of borrowers will refiance to inflation-linked mortgages, which offer lower payment burden. While tourism has recovered well from the impact of Covid-19, a disproportionally high ratio of tourism-related corporate exposures remain in Stages 2 and 3, or around 23.6%.

Figure Inflation and interest rates



The impact of high interest rates is indeed apparent in the development of the Bank's balance sheet, as the indexation imbalance is fast growing due to customers refinancing to CPI-linked loans. The imbalance was ISK 105.3bn at year-end compared with ISK 26.6bn the previous year. The Bank's interest rate risk has also increased as the duration of indexed borrowings is growing through new issuance with limited growth of matching assets to hedge the risk.

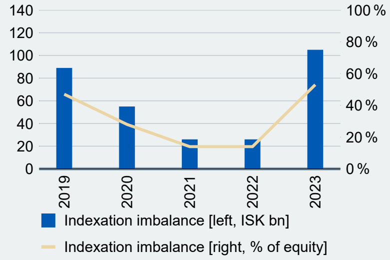
Domestic market conditions were challenging in 2023. The OMXI10 dropped by nearly 19% from year-end 2022 to November 2023, but recovered somewhat before year-end. Leverage has been significantly reduced in the market as evidenced by the Bank's securities derivative hedging portfolio has reduced by 56% over the last two years. In 2022, the Bank reduced its appetite for equity position risk.

CRO Message

The Bank is faced with strong competition on various fronts. Increasing interest rates have motivated more active competition for domestic deposits, reflected in a relatively high pass-through rate and doubling of the Bank's interest expenses year-on-year. Pension funds have reemerged on the market for residential mortgages. The global tightening of liquidity has resulted in increased funding spreads for smaller issuers such as Arion, which has contributed to considerable refinaning of foreign denominated loans with larger institutions in the Nordics. The Bank is however, to a considerable degree, dependent on foreign issuance due to MREL requirements, a systemic risk for Icelandic financial institutions.

The year saw further work towards strengthening of the Group's operational risk management framework. An organizational change in Q3 converged various support functions within a new cross-functional unit called Operations & Culture, headed by Birna Hlín Káradóttir, COO. The Bank has put considerable emphasis on reinforcing AML/KYC procedures, where a dedicated first line team within the new unit plays a key role. Furthermore, the Bank has strengthened controls and governance in relation to investment services and activities.

Figure Development of the Bank's indexation imbalance



The Bank's revised Information Security Management System was certified based on the latest 2022 version of the ISO 27001 standard. The Bank is well placed to meet the requirements of the upcoming Digital Operational Resilience Act (DORA). External fraud attempts have increased considerably over the last few years, as threat actors have become more sophisticated, breaking the barrier previously provided by the Icelandic language. The Bank is dedicated to helping ensuring optimal security for its valued customers and established an Anti-Fraud Committee to ensure seamless reaction and optimal implementation of fraud prevention measures.

Úlfar F. Stefánsson, Chief Risk Officer

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1 Introduction

The Pillar 3 Risk Disclosures comprise information on Arion Bank's risk profile, risk management, and capital adequacy. The report is based on disclosure requirements set out in Regulation EU 575/2013 (CRR) and pertains to the conditions of the Bank's prudential consolidation, which excludes insurance subsidiaries. The disclosures contain information on new and forthcoming legislation as well as information on the Bank's remuneration policy.

1.1 Arion Bank at a Glance

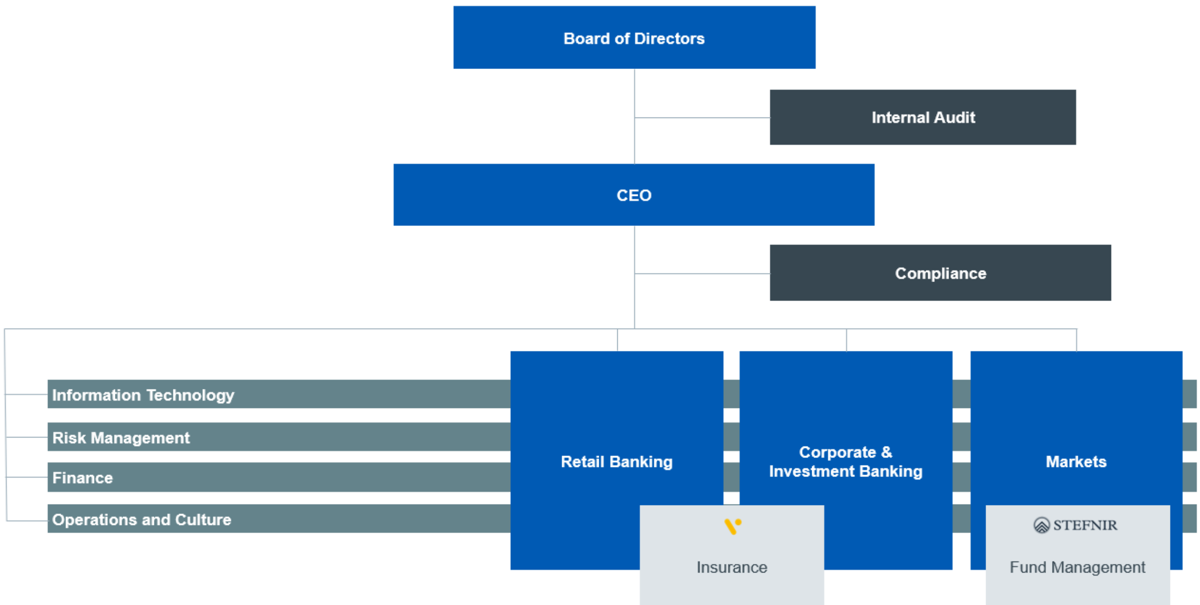
Arion Bank is a strongly capitalized bank that provides a broad range of banking services to corporations and individuals

Arion Bank ('the Bank') is a well-balanced and diversified universal relationship bank operating in the Icelandic financial market. The Bank is listed on the Nasdaq Iceland and Nasdaq Stockholm regulated markets. The Bank is classified as a domestic systematically important institution (D-SII) in Iceland.

The Bank, whose roots date back to 1930, is built on strong heritage and infrastructure. Arion Bank is a strongly capitalized bank that provides a broad range of banking services to corporations and individuals. The Bank aims to be a driving force in the success of its customers by offering smart and reliable solutions that promote financial health and create future value for society as a whole.

The Bank operates several branches across Iceland but has been optimizing its branch network in recent years by streamlining branch premises and introducing digital branches. Numerous digital solutions have been launched in recent years, improving customer convenience, and increasing operational efficiency.

Figure 1.1 Arion Bank's organizational chart



The Bank consists of three business segments: Retail Banking, Corporate & Investment Banking and Markets. Furthermore, the Bank's strategic subsidiaries are important to its service offering. Stefnir is the largest fund management company in Iceland and Vörður is the fourth largest insurance company, providing both life and non-life insurance. This diverse service offering means that Arion Bank's revenue base is broad. The loan portfolio is well diversified between retail and corporate customers, and between different business sectors. The result is a good distribution of risk relative to the Icelandic economy.

In 2023, the Group has continued the process of integrating the operations of Arion Bank and Vörður with the aim to apply the Bank's distribution channels to drive the Group's bancassurance strategy, thus creating a 'one-stop shop' with a broad range of financial and insurance products under a strong brand.

Iceland is uniquely positioned to become the financial hub in the Arctic. The Bank views opportunities in the region as an important component of a more sustainable future

There are four support units within the Bank: Finance, Risk Management, Information Technology and Operations & Culture. The cross-functional support unit Operations & Culture was set up in 2023, to coordinate the delivery of strategic goals, leading transformation, and building a strong corporate culture.

As part of the Bank's long-term vision, the Bank sees opportunities to actively participate in the growth of the Arctic region and its increasing importance in the global economy and the fight against climate change. In its activities outside of Iceland, the Bank's focus is on sectors that are familiar to the Bank, primarily segments that relate to the country's knowledge and export industries.

At year-end 2023, the number of full-time equivalent (FTE) positions at Arion Bank was 737 with an additional 85 FTE in subsidiaries.

The Bank's Annual and Sustainability Report 2023 provides further information about the Bank, such as strategy and vision, sustainability policy, and corporate governance.

1.2 Regulatory Framework

Capital and risk management disclosure requirements for financial institutions are stipulated by the Basel framework. The framework is an international accord on capital requirements and is intended to strengthen measurement and monitoring of financial institutions' capital by adopting a more risk sensitive approach to capital management.

The Basel framework encompasses three complementary pillars:

- Pillar 1 — capital adequacy requirements
- Pillar 2 — supervisory review
- Pillar 3 — market discipline

The CRD V / CRR II package was implemented in Iceland in 2021

In 2013, the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive (CRD IV: Directive No. 36/2013) and the Capital Requirements Regulation (CRR: Regulation No. 575/2013). This regulatory framework represented the EU's first major step in implementing the Basel III reforms, aimed to strengthen regulation, supervision and risk management of banks, e.g. with increased level of capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress. The framework constitutes the cornerstone of the so-called European Single Rule Book for financial regulation.

In 2019, the EU Council adopted revised rules on capital requirements (CRD IV/CRR II) and resolution (BRRD/SRM), thus finalizing the Basel III implementation and setting the stage for what is widely refered to as Basel IV.

The CRR was incorporated into the EEA Agreement in late 2019. In June 2021, CRD IV/CRR II was implemented through Act No. 44/2021 and Regulation No. 749/2021, while Bank Recovery and Resolution Directive II (BRRD II) provisions were excluded. The CRR, including CRR II, was fully transposed into national law in 2022 with Act No. 38/2022, amending Act No. 161/2002 on financial undertakings. With Act No. 38/2022, BRRD II provisions were partially implemented, e.g. the elements that had to be present as provisions of CRR II. BRRD II was fully transposed into Icelandic law with Act No. 63/2023, but secondary legislation establishing the timeline for compliance has not yet been published. The implementation of the final Basel III Accords in the EU is expected in 2025 and is likely to follow soon after in Iceland.

1.3 Pillar 3 Risk Disclosures

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfill its legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures are prepared in accordance with legislative requirements regarding public disclosure, including EU Regulation 2021/637 which implements technical standards with regard to disclosure requirements under Part Eight of the CRR.

EBA standardized disclosure templates can be found in the Additional Pillar 3 Risk Disclosures document on the Bank's website.

Information in the disclosures refers to Arion Bank's consolidated situation as per CRR, which consists of the parent entity, Arion Bank, and its subsidiaries, excluding insurance subsidiaries; together referred to as 'the Bank'. The Bank is subject to consolidated supervision by the Financial Supervisory Authority of the Central Bank of Iceland (FSA). The basis of consolidation for financial accounting purposes differs from regulatory capital reporting purposes. The differences in the scopes of consolidation are set out in template EU LI3 in the Additional Pillar 3 Risk Disclosures. Where necessary, a distinction is made in the report between the consolidated situation and the parent entity.

The Bank is subject to consolidated supervision by the Financial Supervisory Authority of the Central Bank of Iceland (FSA)

All financial figures, calculations and information in the disclosures are based on financial information as at 31 December 2023 and presented in million krona, unless otherwise stated. Due to rounding, numbers in the disclosures may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures. The disclosures are published on an annual basis in conjunction with the Consolidated Financial Statements and the Annual and Sustainability Report. The EBA standardized disclosure templates are published quarterly, semi-annually or annually in accordance with CRR.

The disclosures are reviewed for accuracy and appropriateness, and verified and approved internally, in line with the Bank's disclosure policy. Information in the disclosures is not subject to external audit. Summarized information on risk management and capital adequacy is presented in the Bank's Consolidated Financial Statements.

1.4 Communication Policy

The Bank has in place a communication policy, approved by the Board of Directors, addressing the requirements laid down by law for information on risk management and capital. Accordingly, the Bank may omit information if it is not regarded as material. Information is regarded as material in disclosures if its omission or misstatement could change or influence the assessment or economic decisions of a user relying on the information.

In addition, if required information is deemed to be proprietary or confidential, the Bank may decide to exclude it from the Pillar 3 Risk Disclosures. The Bank defines information as proprietary which, if shared, would undermine the Bank's competitive position. Information is regarded as confidential if there are obligations binding the Bank to confidentiality.

2 Risk Management

The Bank is in the business of taking informed risk. Risk is primarily incurred from extending credit to customers, but is exposed to a range of other risk types such as liquidity risk, market risk, operational risk, compliance risk, sustainability risk, and business risk, all of which are inherent in the Bank's strategy, product range and operating environment.

Risk transparency helps employees make better decisions. The Bank's risk management policy is to maintain a strong culture in which risk is everyone's business. Senior management devotes a significant portion of its time to managing the Bank's risks.

The Bank's strategy is to have in place an effective risk management framework, which entails the identification and quantification of significant risks and risk exposures, risk monitoring, and actions and controls to limit risks.

2.1 Internal Controls and Lines of Reporting

The Bank is committed to the highest standards of corporate governance in its business. The Bank's corporate governance framework is based on legislation, regulations and recognized guidelines in force at each time. The ultimate responsibility for setting the Bank's risk and governance policies and for ensuring effective internal control and management of risk rests with the Board of Directors. The enforcement of the Board's policies is delegated to the Chief Executive Officer (CEO) who has in turn established a risk committee structure at management level. The CEO delegates decision-making responsibilities to Managing Directors, Chief Credit Officer (CCO) and others as committee voting members, while assigning internal control responsibilities to the Chief Risk Officer (CRO) and the Compliance Officer.

The Bank's risk management policy is to maintain a strong culture in which risk is everyone's business

Acting within an authority delegated by the Board, the Board Risk Committee (BRIC) is responsible for the oversight and review of prudential risks and capital adequacy. The BRIC reviews the Bank's risk appetite at least semi-annually, see Section 2.4, and recommends changes to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls, as well as considering potential implications of material regulatory change proposals.

Figure 2.1 Internal control structure

Internal Audit is responsible for the independent review of the risk management and control environment. Its objective is to provide reliable, valuable, and timely assurance to the Board and Executive Management on the effectiveness of controls, mitigating current and evolving material risks, and in so doing enhancing the risk culture within the Bank. The Board Audit Committee (BAC) reviews and approves Internal Audit's plans and resources, and evaluates the effectiveness of the function. The Chief Internal Auditor is appointed by the Board and accordingly has an independent position in the Bank's organizational chart.

The Compliance Officer and Compliance function operate according to a charter for compliance defined by the Board of Directors. The Compliance Officer reports to the CEO, with unhindered access to the Board. Compliance submit quarterly Compliance Updates to the BRIC and annually to the Board of Directors.

The CRO and the Risk Management function operate according to a charter for Risk Management defined by the Board of Directors. The CRO is a member of the Executive Management Committee, chair of the Executive Risk Committee, and a non-voting member in other risk committees. The CRO reports to the CEO and has unhindered access to the Board.

A group-level risk assessment is periodically performed through the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP). Section 2.6 outlines the organization of the Risk Management division.

The Bank's subsidiaries adhere to their respective ownership policies, approved by the Board of Directors, which stipulates among other things the Group's internal control policy, risk appetite, and reporting mechanisms between the companies. Individual subsidiaries are responsible for implementing their own risk management frameworks. The CEO, on behalf of the Board of Directors of Arion Bank, interacts with the boards of directors of individual subsidiaries. Through the group-level ICAAP and ILAAP, the CRO interacts with individual subsidiaries' risk officers and consolidates the assessment of capital requirements for the Bank.

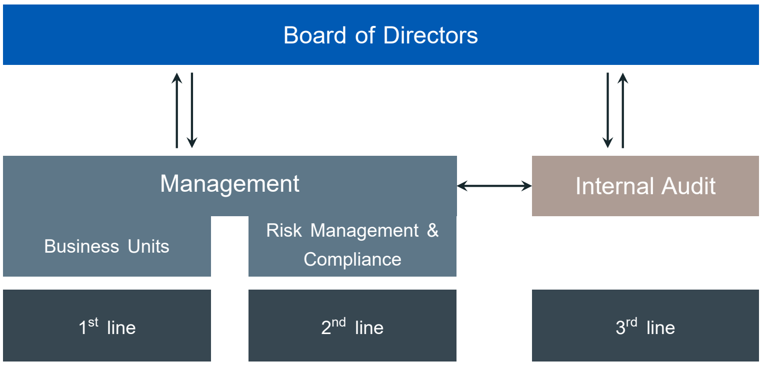
For further information on the Bank's governance arrangements, refer to Corporate Governance Statement for the year 2023. The statement provides information on directorships held by Board members, on their background and expertise, and the considerations and suitability criteria used in the nomination process, including diversity.

2.2 Three Lines Model

The Bank uses a Three Lines Model for organizing the internal control system. All lines work together to contribute to the creation and protection of value, seeking alignment with the prioritized interests of stakeholders. Alignment of activities is achieved through communication, cooperation, and collaboration. This ensures the reliability, coherence, and transparency of information needed for risk-based decision making.

The Bank organises its internal control system using the Three Lines model

Figure 2.2 Three lines



The role of the Board of Directors

The Board of Directors is ultimately accountable for the internal control system at Arion Bank. The Board ensures that appropriate structures and processes are in place for effective governance, in accordance with regulatory requirements and recognized guidelines.

The Board of Directors determines the Bank's risk appetite and tolerance

The Board of Directors delegates authority and responsibility formally and provides resources to management to achieve the organization's objectives, while ensuring legal, regulatory, and ethical expectations are met. It also determines the Bank's risk appetite and tolerance. The rules of procedure of the Board of Directors can be found on the Bank's website.

For additional oversight, the Board of Directors appoints subcommittees with established charters.

The role of Management

Management comprises first and second line roles. Its responsibility is to achieve organizational objectives and manage risks by designing and implementing a control system.

First line roles are most directly aligned with the delivery of products and services and include the roles of support functions. They lead and direct actions and application of resources and have primary responsibility for maintaining appropriate structure and processes for the management of operations and risks.

Second line roles, i.e. the Risk Management and Compliance functions, support and facilitate the management of risk through complementary expertise, support, and monitoring, and through challenging the adequacy and effectiveness of risk management practices. Second line roles are separated from first line roles, and do not have first line responsibilities. Notwithstanding this separation, first line roles may be assigned second line responsibilities for complementary expertise. In order to ensure adequate independence, the second line has direct access to the Board of

Directors and BRIC.

The role of Internal Audit

Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance arrangements, risk management, and controls, through systematic and disciplined processes, expertise, and insight. It reports its findings to management, the BAC, and the Board of Directors to promote and facilitate continuous improvement.

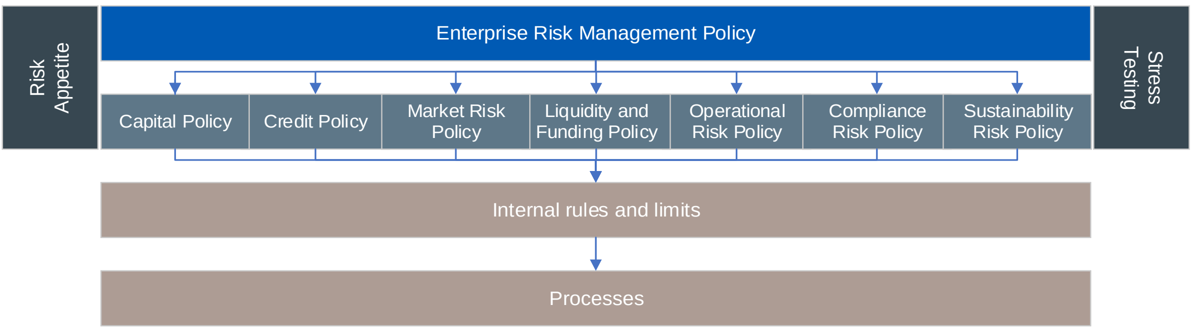
2.3 Risk Policies

To ensure that existing and potential material risks are identified, monitored and managed, the Bank has an enterprise risk management policy in place. The policy is reviewed and approved by the Board of Directors annually. The policy outlines, at a high level, the key aspects of the Bank's risk management. The Bank recognizes that risk-taking is an integral part of its business activities and must therefore be managed in an effective manner and in line with the Bank's risk appetite, see Section 2.4.

The significant risks the Bank is exposed to are defined within the risk management policy. Seven risk types have been defined as significant: credit, market, liquidity, operational, conduct and compliance, sustainability, and business risk. The Board sets a specific policy for activities related to each risk, with the exemption of business risk which is addressed in the Bank's strategy and business plan process. The policies are reviewed and approved by the Board annually. The Bank's risk management policy and risk type policies are implemented through the Bank's risk appetite framework, stress testing framework, internal rules and limits, and processes. The policies for each risk type are discussed further in the following chapters.

The Bank's risk management policies define the significant risk types the Bank is exposed to. The policies are reviewed annually

Figure 2.3 Risk policies implementation



2.4 Risk Appetite

A risk appetite is one of the key components of risk governance. A well-defined risk appetite is critical for managing risk and is essential for reinforcing a strong risk culture. In order to establish, communicate, and monitor its risk appetite, the Bank has in place a risk appetite framework.

The purpose of the risk appetite is to provide a common framework to the Board and management to communicate, understand, and assess the types and level of risk that the Board is willing to accept in pursuit of the Bank's strategy. The risk appetite framework is reviewed and approved by the Board semi-annually.

The Bank's risk appetite is articulated through a risk appetite statement and translated into risk limits developed and maintained by the CEO or relevant management level committee. Ongoing compliance with risk appetite is monitored by Risk Management and Compliance. The Board and BRIC are promptly notified if any risk appetite metrics are exceeded. Internal and external limits are monitored by the second line functions in accordance with the Bank's procedures.

The Bank's risk appetite is taken into consideration and aligned with the Bank's strategic objectives, business plan, operations, recovery plan, and remuneration. Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits.

Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits

The Board's direct involvement in setting and approving appetite for the Bank's most material risk exposures is a key part of ensuring the timely and appropriate disclosure of risk through the Bank's hierarchy of governance. This is complemented by in-depth management information and reporting tailored to the intended audience.

An overview of the Bank's quantitative risk appetite metrics are shown in Table 2.1. The risk appetite statement includes qualitative criteria such as tolerance statements for various operational risk and regulatory compliance breaches, as well as sustainability risk metrics pertaining to the Bank's own operations, i.e. on gender pay parity and green financing.

Table 2.1 Risk appetite metrics

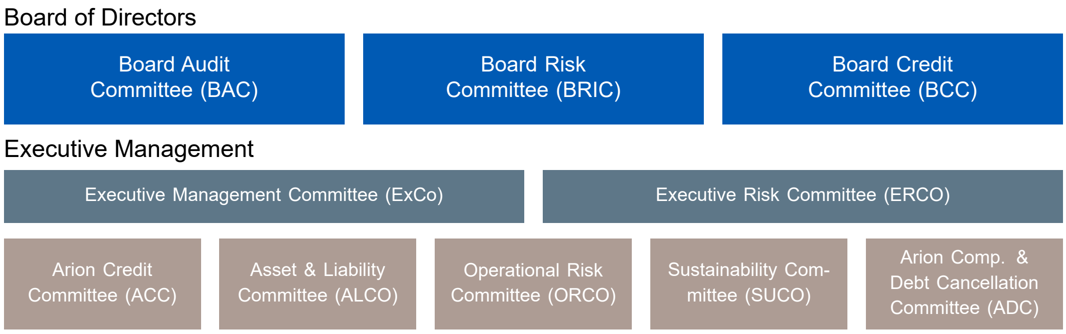
Category	Risk metrics / risk factors
Capital adequacy	Capital adequacy ratios Leverage ratio MREL
Liquidity and funding risk	Liquidity coverage ratios Net stable funding ratio Tangible assets over wholesale funding Asset encumbrance ratio
Market risk	Foreign currency imbalance Interest rate risk and indexation risk Equity position in the banking book Equity position in the trading book, Value-at-Risk
Securities financing and counterparty credit risk	Uncollateralized exposure as per stress test
Credit risk	Sectoral and geographical concentrations Large exposures and single-name concentration Expected credit loss Average loan to value of residential mortgage portfolio Leveraged transactions
Operational risk	Operational losses KYC adequacy ratio Enhanced due diligence adequacy ratio
Sustainability risk	Green loans ratio Gender pay gap

2.5 Risk Committees

The Bank operates several committees to manage risk. The structure of risk committees within the Bank can be split into two levels: board level and executive level. The committees define lines of responsibility and accountability within the Bank. They are charged with overseeing risk and the delegation of authority and forming a control environment for the Bank.

The risk committees define lines of responsibility and accountability within the Bank

Figure 2.4 Risk committee structure



Board level risk committees are established by the Board and comprise members of the Board or external representatives nominated by the Board. An overview of the risk committees at Board level and their responsibilities is shown in Table 2.2.

Table 2.2 Board level committees

Committee	Responsibilities
Board Audit Committee (BAC)	The BAC assists the Board in meeting its responsibilities in monitoring the effectiveness of the Bank's internal governance and controls and in meeting its external financial reporting obligations under applicable laws and regulations. The BAC supervises accounting procedures, the organization and function of the Bank's internal audit, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The BRIC advises and supports the Board on the alignment of the Bank's risk policy, high-level strategy and risk appetite, and risk management structure. The BRIC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BRIC assesses whether incentives which may be contained in the Bank's remuneration system, including variable remuneration, are consistent with the Bank's risk policy.
Board Credit Committee (BCC)	The BCC operates under the authority of the Board, which has delegated to the Committee authority to approve certain material proposals regarding credit origination, debt cancellation, underwriting, and investments. The BCC can delegate specific authority to the CEO.

In addition to the three Board-level risk committees, the Board has established the Board Remuneration Committee (BRC) and the Board Tech Committee (BTC). The BRC's main role is to prepare a remuneration policy for the Bank. The policy is reviewed by the Board at least annually and submitted to the Annual General Meeting (AGM) for approval. The BTC's role is to advise the Board on the development of the Bank's IT function, including strategy, enterprise architecture and alignment of IT function within the Bank's business.

Executive level risk committees, which are primarily composed of the CEO and Managing Directors, or their designated representatives, are shown in Table 2.3.

Table 2.3 Executive level risk committees

Committee	Responsibilities	Chair
Executive Risk Committee (ERCO)	The ERCO oversees the implementation of risk policies and ensures that the Bank's limit framework adheres to risk appetite. The committee reviews the Bank's ICAAP, ILAAP, and stress testing, and approves economic scenarios, credit models, and specific provisions under IFRS9. The ERCO approves the rules and procedures of other risk committees, and defines credit rules for the ACC.	CRO
Arion Credit Committee (ACC)	The ACC makes decisions on credit cases within limits set by the BCC. ACC reviews reports concerning the credit portfolio and has an advisory role to the CEO on credit related matters. Risk Management is authorized to veto all decisions or escalate to the BCC for final approval.	CEO
Arion Composition and Debt Cancellation Committee (ADC)	The ADC deals with applications to reach composition with debtors, within limits set by the BCC.	CEO
Asset and Liability Committee (ALCO)	The ALCO is responsible for strategic planning relating to the development of the Bank's balance sheet as well as the planning of liquidity and funding, capital activities, and decides on underwriting and investment exposures within limits set by the BCC. The CRO or their deputy is a non-voting participant in committee meetings and is authorized to escalate decisions relating to investments, divestments, and underwriting to BCC for final approval.	CFO
Operational Risk Committee (ORCO)	The ORCO is responsible for managing operational risk and compliance, which includes information security, financial crimes, regulatory compliance, and data managment. The CRO, the Compliance Officer, and the Chief Security Officer are non-voting members.	CEO
Sustainability Committee (SUCO)	The SUCO promotes the consideration of environmental, social, and governance factors in the Bank's decision making. The SUCO reviews risk assessments of ESG factors and climate risk impact and oversees ESG disclosures as well as the Bank's Green Financing Framework.	CEO

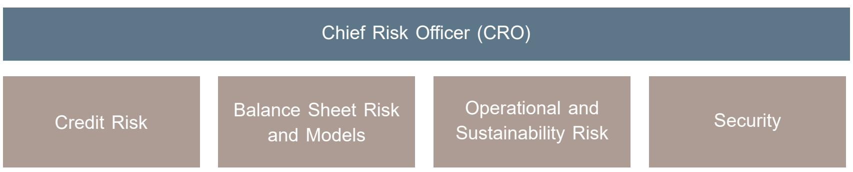
2.6 The Risk Management Division

The Risk Management division focuses on the identification, quantification, monitoring, and control of risk. The division facilitates informed decision making in all risk areas of the Bank by providing expertise and support. Risk Management ensures compliance with internal and external limits, and standards and regulations. Strong emphasis is placed on reporting risk to relevant stakeholders in a clear and meaningful manner.

The Risk Management division is divided into four departments: Credit Risk, Balance Sheet Risk and Models, Operational and Sustainability Risk, and Security.

Risk Management ensures compliance with internal and external limits, standards and regulations

Figure 2.5 The Risk Management Division



Credit Risk

The unit Credit Risk ensures Risk Management's involvement in credit decisions and analyzes and monitors credit cases submitted to the Bank's credit committee. Credit Risk represents Risk Management at Arion Credit Committee (ACC) meetings and has the power to veto the ACC's credit decisions and escalate to the Board Credit Committee (BCC) for final approval. The department also administers and organizes credit committee meetings and advises on changes to credit rules.

Credit Risk is responsible for the approval of corporate credit ratings, performed by account managers, by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings. The unit is also responsible for supervising the valuation of collateral and validating the connectivity of related parties within the loan book.

The department is responsible for monitoring credit quality of loans on a single-name basis and determining appropriate levels of provisioning for problem loans.

Balance Sheet Risk and Models

The unit Balance Sheet Risk and Models is responsible for analyzing, monitoring, and reporting on risks on a portfolio level, including credit risk, market risk and liquidity risk. The department is also responsible for capital adequacy, credit modelling, and stress testing.

Within the scope of market risk are risks resulting from balance sheet mismatches, i.e. interest rate risk foreign exchange risk, and risks arising from the Bank's trading activities. The department interfaces with the Bank's Treasury, Market Making and Capital Markets and reports its analysis and stress testing results for market, funding, and liquidity risk to ALCO.

The department is responsible for the development of credit rating models, assessment of expected credit loss under IFRS 9, the calculation of regulatory capital requirements, development of economic capital models, methodology for allocation of capital, and stress tests.

The department also provides varied quantitative support to the Bank's business units.

Operational and Sustainability Risk

The unit Operational and Sustainability Risk is responsible for the internal control framework and supports the first line in managing operational risks. It seeks to ensure that internal processes and controls minimize the risk of loss as effectively as possible. The department develops and maintains tools for identifying, measuring, monitoring, and controlling operational risk, such as Risk and Control Self-Assessment (RCSA) and loss data collection.

The department is also responsible for supporting the Bank's adherence to requirements and guidelines in the area of sustainability, and develop the Bank's approach to assessing climate-related financial risks and risks related to social and governance factors.

Security

Headed by the Bank's Chief Security Officer (CSO), the unit supervises physical and information security management in the Bank's second line. The unit is responsible for maintaining the Bank's Information Security Management System (ISMS), which has been ISO 27001:2022 certified. The unit supports the first line in relation to external fraud.

2.7 The Compliance Function

The Compliance function focuses on the identification, monitoring, and control of conduct risk, compliance risk, and financial

Balance Sheet Risk and Models provides quantitative support to the Bank's business units. Operational and Sustainability Risk supports the first line in managing operational risks crime risk.

The role of Compliance is to apply effective precautionary measures to ensure that the Bank complies with applicable regulatory requirements, and to foster an affirmative corporate culture in this respect. Key compliance processes include advice and support, training, and compliance monitoring.

The Compliance Officer also serves as the Bank's Data Protection Officer and Money Laundering Reporting Officer.

2.8 Reporting

The Bank's aim is to provide accurate and transparent risk information to relevant stakeholders. Risk Management places a strong emphasis on risk reporting and on allocating adequate resource to ensure the fulfillment of the Bank's policy. Risk information is regularly reported to the Board of Directors and its subcommittees. The CEO, the CRO, and executive-level committees receive risk reports on a regular basis, ranging from daily monitoring reports to the Annual Report. The primary reporting within the Bank is shown in Table 2.4.

The Bank's Annual and Sustainability Report, Financial Statements, and Pillar 3 Risk Disclosures are all available on the Bank's website. Furthermore, the Bank delivers regular reports to the FSA; i.e. a monthly report on the Bank's loan portfolio quality, a quarterly report on the Bank's capital requirements (COREP) and large exposures; and annual reports on the Bank's Recovery Plan, ICAAP, ILAAP, and stress testing.

Table 2.4 Primary reporting within the Bank

Report	Contents	Frequency	Recipient
Credit risk report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the credit quality of the loan portfolio.	Monthly	ACC/ADC
Liquidity report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit developments, secured liquidity, funding measures, and other relevant liquidity information.	Monthly	ALCO
Market risk report	A report containing analysis of key market risk developments, including information on foreign exchange, indexation and index risk, margin trading, and other relevant market risk information.	Monthly	ALCO
Operational risk report	An overview of relevant risk measures for operational and compliance risk, including a summary of deviation events, major IT incidents, loss data analysis, and net promoter score.	Monthly	ORCO
Sustainability risk report	Selected sustainability risk measures, including development of green products and gender equality	Monthly	SUCO
Risk report	An aggregate report containing the credit risk portfolio report, the liquidity and market risk report, and the operational risk report as well as information on the Bank's risk appetite, recovery indicators, ICAAP status, and other risk management concerns.	Monthly	Board BRIC ExCo ERCO
ICAAP	Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval.	Annually	Board BRIC ERCO
ILAAP	Evaluation of the Bank's total risk exposure and liquidity adequacy. The report is submitted for review and/or approval.	Annually	Board BRIC ERCO
Recovery plan	A plan providing measures to be taken by the Bank to restore its financial position following a significant deterioration of its financial situation. A status report on recovery indicators is submitted monthly to the ALCO.	Annually	Board BRIC ALCO
Internal bank-wide stress test	Evaluation of the impacts on the Bank's earnings and own funds, the Bank's capital and liquidity ratios, and other risk appetite metrics under various stress scenarios. The report is submitted for review and/or approval.	Annually	Board BRIC ERCO
Compliance updates	An aggregate report covering key events regarding both compliance risk and financial crime risk	Quarterly	BRIC
Compliance report	An annual report summarizing previous year with regards to both compliance risk and financial crime risk	Annually	Board BRIC

3 Capital Management

An adequate amount of capital ensures that the Bank is able to absorb losses associated with the risks that are inherent in its operations without its solvency being jeopardized and allows the Bank to remain a going concern, even in periods of stress.

The Bank employs various techniques to estimate adequate capital levels and to ensure that capital is fruitfully deployed. The Bank's ICAAP is the cornerstone of the Bank's capital adequacy assessment and is aimed at identifying and measuring the Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance with its risk profile and strategy.

3.1 Governance and Policy

The Bank's capital policy and dividend policy are established by the Board of Directors based on recommendations from the BRIC. The policies are reviewed on an annual basis.

The Bank's CEO is responsible for carrying out the Bank's capital strategy in adherence to set policies. As established by the CEO, this responsibility is part of the principal authority of the Asset and Liability Committee (ALCO). The CRO is responsible for compliance with regulatory requirements and supervises the Bank's ICAAP and allocation of capital. The Bank's stress testing framework is integrated with the Bank's business planning process and ICAAP, and is used to assess whether capital levels are acceptable under stressed conditions.

The Bank's medium term target for Common Equity Tier 1 (CET1) ratio is to be 150 to 250bps above the regulatory requirement and maintain maximum utilization of Additional Tier 1 (AT1) and Tier 2 (T2) capital to meet Pillar 1 and Pillar 2 capital requirements. Relative to the total CET1 regulatory requirement of 14.9% and the increase in the countercyclical capital buffer due in March 2024, this implies a CET1 target of 16.8–17.8%.

The Bank's dividend policy is to pay out 50% of net earnings attributable to shareholders as dividend and in addition use special distributions to bring own funds towards the normalized composition. In line with this, the Bank intends to distribute dividends of ISK 12.9 billion which has been subtracted from CET1 when calculating the capital ratios.

At year-end 2023 the Bank's CET1 ratio was 19.7% and total capital ratio 24.1%. The ratios account for a foreseeable equity reduction of ISK 13 billion through dividend distribution

3.2 Capital Adequacy Requirements

The Bank's capital adequacy is determined in accordance with Act No. 161/2002 on Financial Undertakings and Regulation on Prudential Requirements, through which EU Capital Requirements Directive and Regulation have been adopted.

The Bank's calculation of REA is based on standardized approaches for the assessment of credit risk, counterparty credit risk, credit valuation adjustment risk, market risk, and operational risk. The total regulatory capital requirement is presented as a percentage of REA and consists of the items shown in the following table:

Table 3.1 Capital requirements

Source	Description
Pillar 1 requirement	The 8% minimum regulatory requirement
Pillar 2R requirement	The additional capital requirement determined by the Bank's own internal assessment of capital adequacy (ICAAP) and FSA's subsequent supervisory regulatory assessment process (SREP)
Combined capital buffer requirement	The aggregated capital requirement due to four capital buffers, the level of which is determined by law (capital conservation buffer) and by the FSA following guidance from the Financial Stability Council (buffers for systemic risk, systemically important financial institutions (SII), and countercyclical effects)

As part of the SREP, the results of internal or external bank-wide stress tests may result in non-binding additional capital guidance, defined as Pillar 2G.

The Pillar 1 requirement may be met with different capital instruments, restricted as follows, expressed as a percentage of REA:

- Common Equity Tier 1 (CET1) capital shall exceed 4.5%
- Tier 1 (CET1 and AT1) capital shall exceed 6%
- Total capital shall exceed 8%

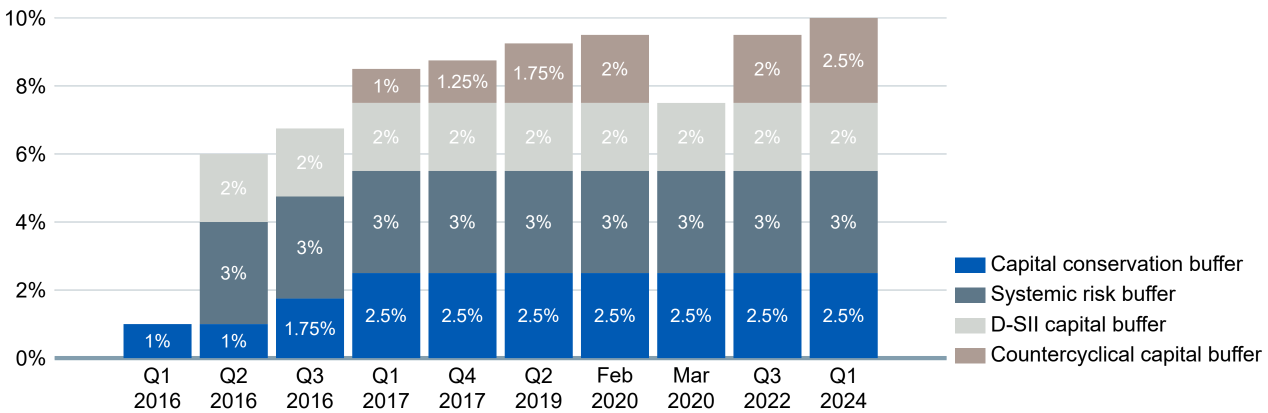
The same proportion applies to the Pillar 2 capital add-on, i.e. it can be composed of 56.25% CET1 capital, 18.75% AT1 capital, and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

Capital Buffers

Capital buffers were incorporated into Icelandic law with the adoption of CRD IV / CRR. The systemic risk buffer only applies to domestic exposures and is applied cumulatively with the D-SII buffer. The countercyclical buffer was set to 0.0% in March 2020 as a response to the COVID-19 crisis but rose again to 2.0% on 29 September 2022. The buffer will rise to 2.5% on 16 March 2024 based on a decision of the Financial Stability Committee from 14 March 2023.

The development of the capital buffers is shown in the chart below. The requirements are presented as percentage of REA.

Figure 3.1 Implementation of capital buffer levels for Icelandic D-SIIs



The effective countercyclical capital buffer for the Bank is determined using the weighted average of the respective capital buffer levels in the countries where the Bank has exposure and the weighting is based on the percentage of the relevant REA in each country. The same method is used for the determination of the effective systemic risk buffer, where the buffer only applies to domestic exposures. Given the Bank's geographic credit risk profile at year-end 2023, the effective combined capital buffer requirement for the Bank is 9.2%. Templates EU CCyB1 and EU CCyB2 show details regarding the calculation of the countercyclical buffer requirement.

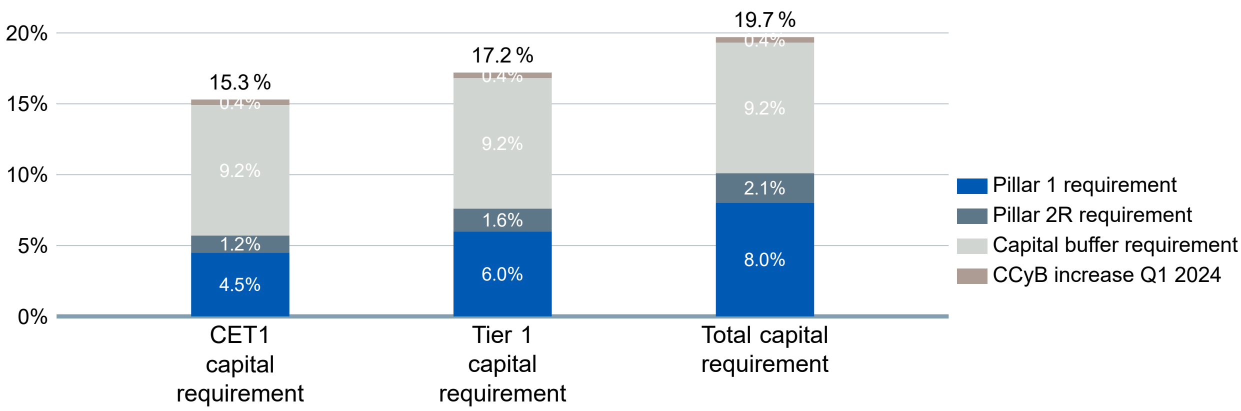
Table 3.2 Arion Bank's capital buffer requirements at year-end 2023

Capital buffer	Domestic exposures	Foreign exposures	Institution-specific buffer rate
Capital conservation buffer	2.5%	2.5%	2.5%
Systemically important institution buffer	2.0%	2.0%	2.0%
Systemic risk buffer	3.0%	0.0%	2.8%
Countercyclical capital buffer	2.0%	CCyB of country	1.9%
Total	**9.5%**	**4.5%+CCyB**	**9.2%**
REA credit risk weight	92.3%	7.7%	

Arion's Capital Requirements

The Bank's total regulatory requirement, comprising Pillar 1, Pillar 2, and the capital buffer requirements, is 19.7%. The following figure shows how this requirement is broken down by type.

Figure 3.2 Arion Bank's own funds regulatory requirements with combined capital buffer requirements at 31 December 2023



3.3 Capital Management

In addition to regulatory capital requirements, the Bank performs its own assessment of capital need and allocates capital to business units on a quarterly basis. The Bank's ICAAP and stress testing are key elements of the Bank's capital management framework and are performed on an annual basis. In addition to providing quantitative analysis, the processes are an important tool for management that give an insightful understanding of the risks associated with the Bank's operations and business planning.

Internal Capital Adequacy Assessment Process

The ICAAP is the Bank's internal assessment of its capital need. The ICAAP is carried out in accordance with the Act No. 161/2002 on financial undertakings with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure, and manage the Bank's total risk exposure. The scope of ICAAP excludes insurance subsidiaries which perform their independent Own Risk and Solvency Assessment (ORSA).

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank has sufficient capital for its risk profile. The Bank's ICAAP report is approved annually by the Board of Directors, the CEO, and the CRO and submitted to the FSA.

The ICAAP is the Bank's internal assessment of its capital need

In addition to the above, the Bank uses the ICAAP to:

- Raise risk-awareness of all the Bank's activities and to provide a detailed view of the Bank's risk profile for management and the Board of Directors.
- Carry out a process to adequately identify and measure the Bank's risk factors.
- Carry out a process to monitor that the Bank's capital is adequate and used in relation to its risk profile.
- Review the soundness of the Bank's risk management systems and controls that are used to assess, quantify and monitor the Bank's risks.

Managing Directors with their key personnel and key personnel from the Bank's subsidiaries participate in the process of identifying and evaluating high risk areas, and discuss their management of risk, in cooperation with Risk Management. The result from the identification phase serves as the basis for the risk assessment within the Bank's ICAAP. Risk categories identified for the operating segments are shown in Table 3.3.

Table 3.3 Risk identification down to operating segment

Business Units	Credit risk	Market risk	Liquidity risk	Operational risk	Compliance risk	Sustainability risk	Business risk
Retail Banking	✓			✓	✓	✓	✓
Corporate and Investment Banking	✓			✓	✓	✓	✓
Markets	✓	✓		✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓	✓	
Other divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓

The Bank's ICAAP methodology involves assessing key risks that are not believed to be adequately addressed under Pillar 1. For each risk factor, a capital add-on is applied on top of the minimum 8% regulatory capital requirements. The main risk elements for which additional capital is required are:

- Interest rate risk in the banking book (IRRBB) and indexation risk
- Single name concentration of credit risk
- Credit risk for segments of the loan portfolio that are deemed higher risk
- Equity position risk

The 2023 SREP, based on year-end 2022 financials, resulted in a Pillar 2R capital requirement of 2.1% of REA

The Icelandic Financial Stability Committee is responsible for setting the Systemic Risk Buffer. Its value has been set to 3% for domestic exposures. Justification for this value is still based on the recommendation from the Financial Stability Council from 2016 where numerous systemic risk factors are cited to justify the level of the buffer. The Bank does therefore not include these risk factors in its Pillar 2 capital assessment. Among those is the lack of diversification of the Icelandic economy, which is reflected in sector concentration in the Bank's loan portfolio. As part of the Pillar 2 capital assessment, the Bank uses internal models to assess capital needs for credit risk.

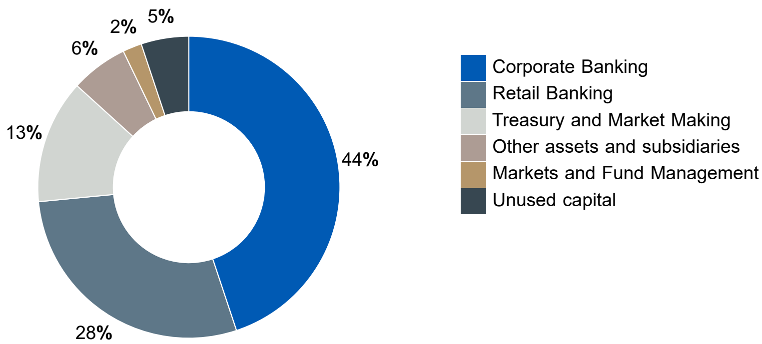
Following the ICAAP process, the FSA conducts the supervisory review and evaluation process (SREP). In that process the FSA sets the Pillar 2R capital requirement which the Bank must hold own funds for and may, on the basis of stress test results, issue non-binding additional capital guidance, called Pillar 2G. Lastly, the Bank must hold own funds to meet the combined capital buffer requirement.

The SREP of 2023, which was based on financial figures from 31 December 2022, resulted in a Pillar 2R capital requirement of 2.1% of REA.

Capital Allocation and Capital Planning

The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP and SREP. The risk-adjusted performance of the business units is based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning on a quarterly basis, based on the Bank's rolling business plan for each business unit. Capital is allocated both based on current need and on the basis of a 6-month forward horizon.

Figure 3.4 Allocated capital for Q4 2023, current need and 6 month horizon



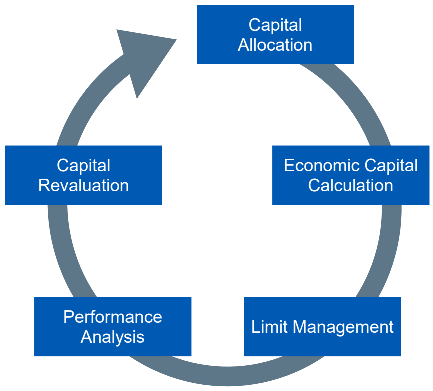
The focus of capital management at the Bank is to normalize the capital structure in the medium term and consequently maintain the Bank's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

Stress Testing

Stress tests provide an important management tool for the Bank. The results of stress tests raise risk awareness and improve general understanding of the Bank's operations and are to be considered for strategic, capital, and contingency planning. The results of stress tests are incorporated into the review of the risk appetite and the Bank's limit framework.

The Bank's stress testing framework outlines the scope and re-

Figure 3.3 Capital planning and monitoring process



sponsibilities for stress testing in the Bank. Within the framework's scope are the ICAAP and ILAAP, which are carried out in parallel, the Recovery Plan, as well as firm-wide and regulatory internal stress tests on the Bank's business plan. The framework is aligned with FSA's guidelines No. 2/2015 and EBA's Guidelines on Stress Testing (EBA-GL-2018-04). Stress testing at the Bank consists of sensitivity analysis and scenario analysis.

Stress testing involves estimating the impact of the stress scenario on the Bank's earnings and capital adequacy as well as the impact for the Bank's liquidity ratios, other risk appetite metrics, and recovery indicators. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers and suggests relevant stressed scenarios.

Figure 3.5 The stress testing process at the Bank.

Scenario description - the story	Macro economic impact - time series	PD / LGD / IFRS9 stages	Micro economic impact - translation	Assumptions in business model altered - effects reported	Management actions
Cross department workshops, meetings and collaboration with the Chief Economist	Chief Economist, Risk Management, Finance	Risk Management	Finance, Chief Economist, Risk Management	Finance, Risk Management	Finance, Risk Management

Scenario analyses are carried out on the Bank's business plan. The Bank's Chief Economist contributes an economic base case projection as well as stressed projections that are used in the Bank's capital planning and in preparation of the Bank's five year business plan. The design of the bank-wide internal stress test is challenged and reviewed by the Executive Risk Committee and the Board Risk Committee.

One of the stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FSA. The Bank also performs various regularly scheduled stress tests and targeted ad-hoc stress tests.

3.4 Capital Ratios

Scope of Consolidation and Exposure Amounts

The Bank's consolidated situation for prudential purposes and capital adequacy is different from the accounting consolidation. The Bank owns an insurance subsidiary, Vörður, which is fully consolidated in the Group financial statements. For prudential purposes, it is consolidated using the equity method and is excluded from supervision on a consolidated bases as stipulated by CRR. Vörður is supervised by the FSA and its solvency requirements are calculated in accordance with the Icelandic Insurance Companies Act.

For further details on the companies within the scope of consolidation, please refer to the template EU LI3 in the Pillar 3 Risk Disclosures. Template EU LI1 shows the difference in amounts between the carrying values in the financial statements and the carrying values under the scope of regulatory consolidation and a breakdown of the framework under which these amounts fall.

The main sources of differences between the carrying values as reported in the financial statements and the exposure amounts for regulatory purposes are off balance sheet amounts which fall under the credit risk framework and potential future exposure for items under the counterparty credit risk framework. Template EU LI2 shows a reconciliation between these amounts.

Credit risk accounted for 86% of the Bank's REA at year-end 2023. The Bank's REA for credit risk (excluding CCR) increased by ISK 21 billion in 2023. The increase is mainly due to loans to customers which grew by ISK 68 billion during the year.

A breakdown of the Bank's REA is shown in Note 47 of the Consolidated Financial Statements and in template EU OV1.

The Bank's holdings of the own funds instruments of Vörður which are not deducted from own funds are instead risk weighed at 250%. Template EU INS1 shows these amounts. The Bank is not a part of a financial conglomerate and thus template EU INS2 does not apply to it.

The Bank does not use the internal ratings based (IRB) approach for any exposures and it does not have any exposure to securitizations. EU templates related to these types of exposures are therefore omitted.

Figure 3.6 Development of REA [ISK m]

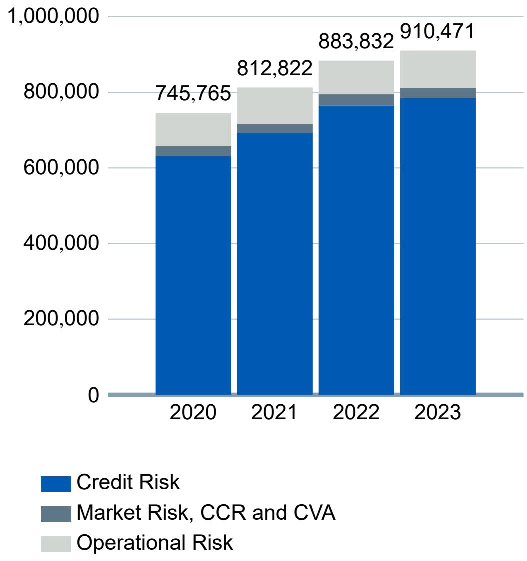


Table 3.4 Overview of risk-weighted exposure amount (EU OV1)

31 December [ISK m]	REAs		Minimum own funds requirements
	2023	2022	2023
Credit risk (excluding CCR)	**759,559**	**738,966**	**60,765**
of which the standardized approach	759,559	738,966	60,765
CCR	**11,122**	**20,655**	**890**
of which the standardized approach	7,442	14,645	595
of which CVA	3,680	6,010	294
Market risk	**15,817**	**8,880**	**1,265**
of which the standardized approach	15,817	8,880	1,265
Operational risk	**98,740**	**89,166**	**7,899**
of which standardized approach	98,740	89,166	7,899
Amounts below the thresholds for deduction (subject to 250% risk weight)	**25,233**	**25,227**	**2,019**
Total	**910,471**	**882,894**	**72,838**

Own Funds

The Bank's own funds are composed of Common Equity Tier 1, Additional Tier 1 and Tier 2 issuances and the size of each layer of own funds is presented net of regulatory adjustments.

CET1 capital before regulatory adjustments consists exclusively of equity issued by Arion Bank. The regulatory adjustments to CET1 are primarily the deduction of intangible assets and the deduction of foreseeable dividends. Other items are smaller. The Bank applies the IFRS9 transitional arrangements, as amended by Regulation (EU) 2020/873, to phase in the effects on capital of the impairments requirements of IFRS9, in particular the increased impairments related to the effects of the Covid-19 pandemic. Template EU IFRS9-FL shows the effects on capital and REA if these arrangements were not available.

The Bank uses the simplified approach for the calculation of additional value adjustments and thus template EU PV1 does not apply.

The Bank's Additional Tier 1 capital consists of a USD 100 million subordinated liability issued in Q1 2020.

The Bank's Tier 2 capital consists of subordinated liabilities issued in 2019 in SEK, NOK, ISK, and EUR and in Q4 2022 in ISK, see Note 34 in the Consolidated Financial Statements. The contractual maturities range from 2029 to 2033, and the first call option becomes active as of July of 2024.

Template EU CCA provides further details on each of the Bank's own funds and eligible liabilities instruments.

Template EU CC1 presents the composition of the Bank's own funds. The Bank's own funds are reconciled with the balance sheet in the Group's financial statements via template EU CC2 and cross references to the relevant rows in template EU CC1 are provided. Table 3.5 is an extract from EU CC1 with the data that is most relevant to the Bank.

Figure 3.7 Development of own funds [ISK m]

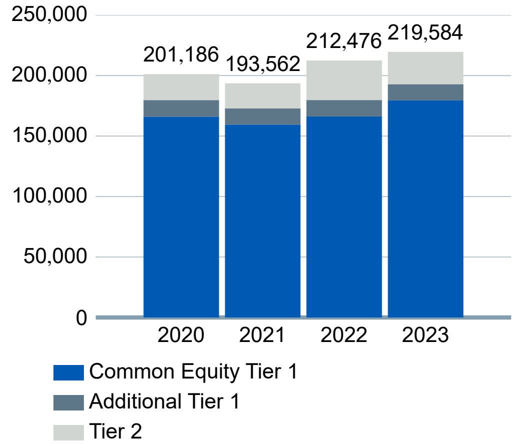


Table 3.5 Reconciliation of own funds

Own funds [ISK m]	2023	2022
Total equity	**199,301**	**187,956**
Non-controlling interest not eligible for inclusion in CET1 capital	-503	-649
Common Equity Tier 1 capital before regulatory adjustments	**198,798**	**187,307**
Intangible assets	-7,211	-6,425
Additional value adjustments	-227	-224
Foreseeable dividend and buyback	-12,877	-15,980
Adjustment under IFRS9 transitional arrangements	952	1,142
Common equity Tier 1 capital	**179,435**	**165,820**
Non-controlling interest eligible for inclusion in T1 capital	117	105
Additional Tier 1 capital	13,217	13,396
Tier 1 capital	**192,769**	**179,321**
Tier 2 instruments	28,062	33,935
Tier 2 instruments of financial sector entities (signif. invest.)	-1,247	-1,155
Tier 2 capital	**26,815**	**32,780**
Total own funds	**219,584**	**212,101**

Capital Position

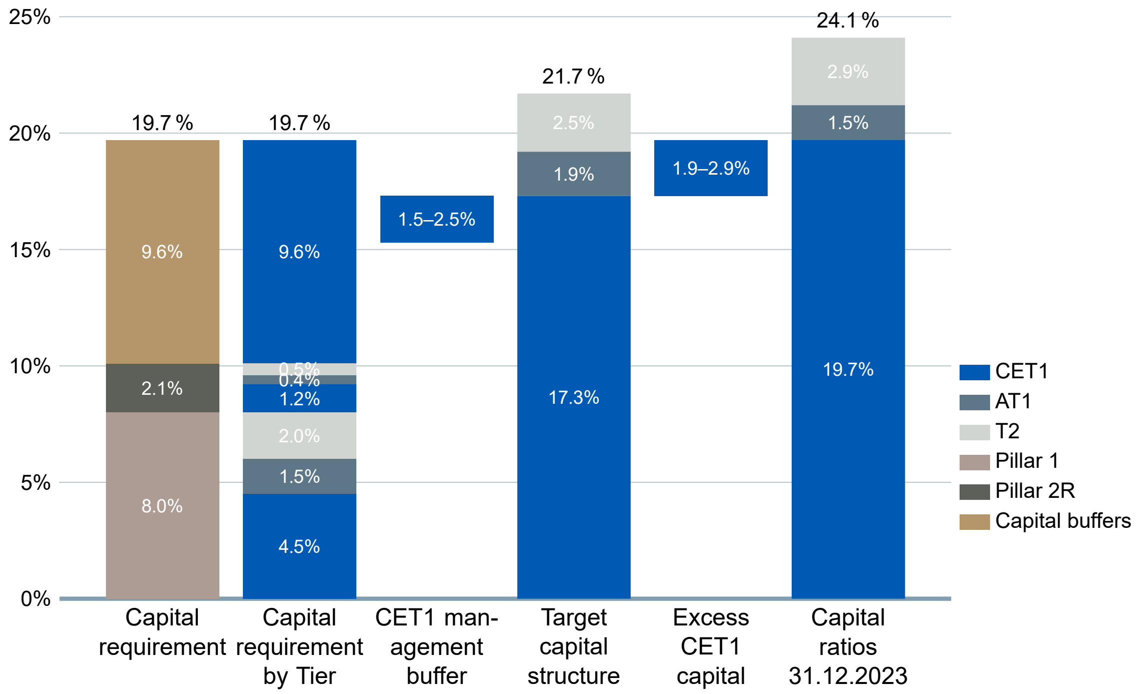
At year-end 2023, the Bank's CET1 ratio was 19.7%, well above the CET1 requirement which was 14.9%. The total capital ratio was 24.1%.

The following figure shows the Bank's capital position and the capital requirement, along with a normalized capital structure under CRR.

The Bank's own funds at 31 December 2023 take into account a foreseeable equity distribution of ISK 13 billion through dividends.

The foreseeable dividend corresponds to 50% of profits as per the Bank's dividend policy.

Figure 3.8 Arion Bank's capital requirement, target capital structure and capital ratios. The capital buffers include the announced increase in the countercyclical buffer in Iceland to 250bps which takes effect in March 2024.



The Bank's capital position was very strong at the end of 2022 with CET1 ratio of 18.8%. This position has been strengthened considerably in 2023 and at year-end 2023 the CET1 ratio was 19.7%, 440bps above all regulatory capital requirements (CET1, Tier 1 and Total capital). When the increase of the countercyclical buffer in Iceland from 2.0% to 2.5% takes effect in Q1 2024 this position will be 400bps above of the expected regulatory requirements. This position is well above the Bank's medium term target which is a CET1 management buffer of 150–250bps.

In the short term, rating considerations impact capital management. The Bank's issuer ratings from Moody's and S&P are A3 (stable outlook) and BBB (stable outlook), respectively. Both rating agencies' assessment of the Bank's capital position is 'Very Strong' as per the different methodologies. S&P raised the economic risk in the Banking Industry Country Risk Assessment (BICRA) for Iceland from 4 to 5 in May 2022. This raised the threshold needed to maintain 'Very Strong' capital position according to the S&P methodology. The economic risk BICRA rating was however put on a positive trend in November 2023 which could indicate that the rating will be moved back to 4 in the future. The Bank will adhere to capital thresholds of the rating agencies in the short term, which implies raising the Tier 1 management buffer to around 450-500bps. The expectation is however that constructive economic development and/or positive impact of other rating factors will result in convergence of capital benchmarks over the medium term.

The template EU KM1 shows the development of key metrics related to own funds, REA, capital ratios, capital requirements, and the leverage ratio. The following table shows an extract of this data.

Table 3.6 Overview of own funds and capital adequacy, the announced increase in the countercyclical buffer in Iceland is not included.

31 December [ISK m]	2023	2022
Own funds		
Common Equity Tier 1 (CET1) capital	179,435	165,820
Tier 1 capital	192,769	179,321
Total own funds	219,584	212,101
Risk-weighted exposure amount	910,471	882,894
CET1 capital ratio	19.7%	18.8%
Tier 1 capital ratio	21.2%	20.3%
Total capital ratio	24.1%	24.0%
Own funds requirement		
Pillar 1: Minimum capital requirement	8.0%	8.0%
of which CET1 requirement	*4.5%*	*4.5%*
of which Tier 1 requirement	*6.0%*	*6.0%*
Pillar 2: Additional capital requirement (ICAAP/SREP)	2.1%	3.5%
of which CET1 requirement	*1.2%*	*2.0%*
of which Tier 1 requirement	*1.6%*	*2.6%*
Combined capital buffer requirement	9.2%	9.3%
of which capital conservation buffer requirement	*2.5%*	*2.5%*
of which systemically important institution buffer requirement	*2.0%*	*2.0%*
of which systemic risk buffer requirement	*2.8%*	*2.8%*
of which countercyclical capital buffer requirement	*1.9%*	*2.0%*
Total CET1 capital requirement	14.9%	15.8%
Total Tier 1 capital requirement	16.8%	17.9%
Total capital requirement	19.3%	20.8%
Leverage ratio		
Exposure measure for leverage ratio calculation	1,550,334	1,517,369
Leverage ratio	12.4%	11.8%

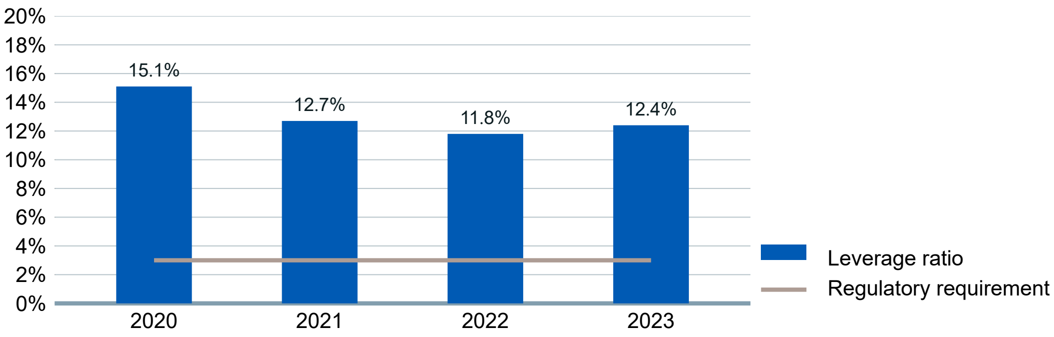
3.5 Leverage Ratio

The leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting the Bank's Tier 1 capital against a measure of its exposures.

At year-end 2023, the Bank had a strong leverage ratio of 12.4%, significantly higher than the 3% minimum prescribed by CRR. The ratio is exceptionally high in international context, and reflects the particular case of the major Icelandic financial institutions, which are classified as systemically important while applying the standardized approach for credit risk. As such, Arion Bank has a relatively high combined capital buffer requirement of 9.2%, which is applied to a standardized REA. The Bank's average risk-weight, the ratio of the risk-weighted exposure amount and the exposure measure for the leverage ratio, is 59% for the consolidated situation.

Arion Bank is a rare example of a systemically important institution that applies the standardized approach for credit risk. This is reflected in an exceptionally strong leverage ratio in international comparison

Figure 3.9 Development of the Bank's leverage ratio



The Bank's Tier 1 capital and the total exposure increased in 2023 but the rate of increase in Tier 1 was significantly higher, leading to an increase in the leverage ratio. In light of the strong leverage ratio, the Bank's management of the risk of excessive leverage is currently confined to the monitoring of the Board of Directors' risk appetite for leverage.

For further details on the Bank's leverage ratio, please refer to templates EU LR1, EU LR2 and EU LR3.

3.6 MREL

The Icelandic law on the resolution of credit institutions and investment funds, Act no. 70/2020, entered into force on 1 September 2020. This transposed the BRRD (2014/59/EU) into Icelandic law. BRRD II was transposed into Icelandic law with Act No. 63/2023, but secondary legislation establishing the timeline for compliance has not yet been published.

With the approval of the Bank's resolution plan in October 2023, the Central Bank of Iceland's Resolution Authority made a decision on the minimum requirement for own funds and other eligible liabilities (MREL), in accordance with Act No. 70/2020, based on year-end 2022 data.

The requirements are expressed as a fraction of total REA (MREL-TREA), and as a fraction of the total exposure measure (MREL-TEM). The requirement for MREL-TREA, which can only be met with eligible liabilities and own funds not used to fulfill the combined buffer requirement, was set at 20.2%, double the combined Pillar 1 and Pillar 2R requirement. The Bank's MREL-TREA adequacy ratio at year-end 2023 was 28.6%. The MREL-TEM requirement was set at 6.0%, double the leverage ratio requirement per the CRR. The Bank's MREL-TEM adequacy ratio was 22.2% at year-end 2023.

A MREL subordination requirement of 13.5% is expected to come into effect in August 2026

BRRD II introduces a subordination requirement for eligible liabilities, whereby a part of the MREL requirement must be met with own funds or liabilities that are subordinate to ordinary unsecured claims. As a consequence, a new class of securities has been introduced into the liability structure of institutions, the so-called senior non-preferred liabilities, which are senior to own funds issuances (T1 and T2), but subordinate to ordinary unsecured claims and senior preferred liabilities.

Despite not being a G-SII nor exceeding the EUR 100 billion threshold set out in the CRR, the Bank considers it probable that a subordination requirement will be imposed on it as a D-SII. MREL policy indicates that this will be set at 13.5% of REA. The Bank expects the requirement to come into effect on 1 August 2026, three years after the effective date in the EEA. This is regardless of the implementation timeline in Iceland.

Template EU KM2 shows key metrics relating to MREL, while templates EU TLAC1 and EU TLAC3b show the MREL composition and creditor ranking, respectively.

3.7 CRR 3

Legislation to implement the Basel IV framework in the European Union has progress most of its way through the EU legislative process. Dubbed CRR 3, the initial text was published by the European Commission in October 2021. The text of the provisional agreement on the regulation was published on 6 December 2023 and it is expected to apply in the EU from January 2025. Most likely it will be implemented in Iceland at the same time.

For Arion Bank, the key changes to capital requirements are summarized in Table 3.7.

When all of these factors are taken together, REA is not expected to change significantly with the adoption of CRR 3. The expectation is a reduction in REA of around 0.5% or less, although some uncertainty remains. The Bank will provide updates closer to the implementation date.

REA is not expected to change significantly with the adoption of CRR 3. The expectation is a reduction in REA of around 0.5% or less

Table 3.7 Impact of CRR3

Exposure type	Impact
Residential real estate	Under the current rules, exposure secured with residental real estate property has risk weight 35%. This applies subject to certain conditions being fulfilled and provided LTV < 80%. For loans with LTV above 80%, it is allowed to split the exposure in two parts, and the portion which is secured with LTV below 80% receives 35% risk weight and the other portion will receive risk weight based on the characteristics of the borrower. In principle, the same method will apply under CRR 3 but the numbers will be different, the portion which is below LTV 55% will receive 20% risk weight and what is above LTV 55% will receive risk weight based on characteristics of the borrower. Furthermore, the property valuation methods will be changed. Instead of using the most up-to-date valuation available, an average valution over six years must be used. Overall, the Bank expects a slight increase in REA due to these changes.
Corporate loans	Various changes are proposed for corporate loans, including new risk weights for income producing real estate, changes to risk weights for loans secured by commercial real estate, and new risk weights for construction exposures. Taken together, these changes are expected to yield a small decrease in REA.
Equity	The treatment of equity exposures will be overhauled. Currently, they receive 100% risk weight under the standarized approach but will generally receive 250% in the new framework. This will lead to an increase in REA. However, currently these exposures receive a capital requirement add-on under Pillar 2. This should no longer be needed. Therefore, the total effect on capital requirement from this change will be small and these changes will gradually take effect during a five-year transition period.
Off-balance sheet exposures	The credit conversion factor (CCF) for off balance sheet exposures will be changed. Loan commitments which now receive either 20% of 50% risk weight based on duration will now generally receive 40% CCF. Also, certain unconditionally cancellable commitments which now receive 0% CCF will receive 10% CCF. This will lead to an increase in REA.
Operational risk	Due to the small size of the Bank, capital requirements for operational risk will fall into the lowest bracket. A limit will be introduced on the extent that interest income contributes to this requirement. These two factors are expected to lead to a reduction in REA.

4 Credit Risk

Credit risk is defined as the current or prospective risk to earnings and capital arising from the failure of an obligor to discharge an obligation at the stipulated time or otherwise to perform as agreed. Credit risk arises anytime the Bank commits its funds to loans, guarantees, or other credit instruments, resulting in capital or earnings being dependent on counterparty, issuer, or borrower performance.

Loans to customers are the primary source of credit risk but credit risk is also inherent in other types of financial assets, such as loans to credit institutions, bonds, derivatives, and in commitments and guarantees such as unused credit lines or limits. Credit risk is inherent in business units connected to lending activities, as well as trading and investment activities, i.e. Corporate and Investment Banking, Retail Banking, Markets, and Treasury within Finance.

Table 4.1 Sources of credit risk

Source	Description
Loans to customers	The loan portfolio is the Bank's main asset. Loans to customers comprise loans to individuals and loans to corporates which, for the purpose of this report, include loans to municipalities and public sector entities. Types of instruments include collateralized loans such as property loans, construction loans, mortgages, vehicle loans, and uncollateralized short and long term loans such as overdrafts and cashflow loans.
Commitments and guarantees	The Bank often commits itself to ensuring that funds are available to customers as required. The most common commitments to extend credit are allowances on checking account overdrafts, credit cards, and credit lines. Commitments and guarantees are unused amounts and are classified as off-balance sheet exposures.
Balances with the Central Bank and loans to credit institutions	The Bank maintains cash and balances with the Central Bank in the form of certificates of deposits, mandatory reserve deposits, and other balances. Furthermore, the Bank holds money-market deposits and deposits in nostro accounts with credit institutions. Such exposures form a significant part of the Bank's liquidity buffer.
Bonds and debt instruments	The Bank trades and invests in bonds and debt instruments, both listed and unlisted. High quality bonds form a significant part of the Bank's liquidity buffer.
Financial derivatives	Counterparty credit risk arises from forward contracts, swaps, and options. The exposures are subject to position limits, hedging requirements, and collateral requirements. Eligible underlying market factors are interest rates, foreign exchange rates, securities, and commodities. The Bank also uses derivatives for market risk hedging and engages in securities lending. See further information in Section 4.7.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made for short term trading purposes and assets repossessed as a result of credit recovery, i.e., restructuring or collection. For further information on equity risk in the banking book, see Section 4.3.

4.1 Governance and Policy

The Bank's credit risk policy and credit risk appetite are established by the Board of Directors and reviewed on an annual basis.

According to the policy, the Bank offers various forms of credit to individuals and organizations, and maintains a diversified loan portfolio composition to avoid excessive risk concentration. The Bank favors long-term relationships and sustainable development with an emphasis on innovative and export-driven companies. The Bank is active in the financing of real estate and, as such, facilitates home ownership and real estate development. The Bank finances and supports market transactions and market activities of its clients and thus promotes efficiency and liquidity in financial markets.

The Bank's risk appetite framework further specifies the desired level of risk exposure through qualitative and quantitiative statements. The framework addresses credit quality, collateral coverage, portfolio composition, and single-name, sectoral, and geographical concentrations. It is ensured that the Bank's credit strategy and business model conform to its credit risk policy and risk appetite.

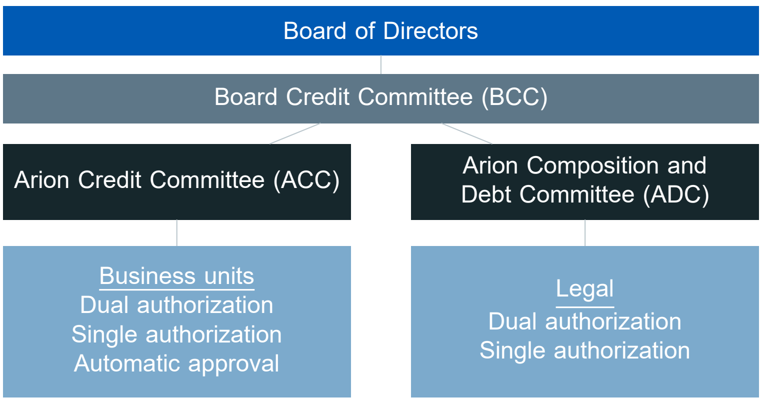
In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, which outlines responsibilities, rules, and criteria for credit risk arising from the Bank's operations. At the management level, the Arion Credit Committee (ACC) is the principal authority for credit origination and credit management, and the Arion Composition and Debt Cancellation Committee (ADC) is responsible for debt cancellation, debt restructuring, and composition agreements. The ADC is chaired by the CEO and the ACC is chaired by the CEO and Deputy CEO and delegates. Risk Management administers and attends all committee meetings and is authorized to reject or escalate decisions.

In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, outlining responsibilities, rules, and criteria for credit risk arising from the Bank's operations

The ACC and the ADC operate within limits set by the Board of Directors, which is the Bank's supreme authority in matters relating to credit risk exposures. The Board delegates credit decisions that exceed the authority of the ACC and the ADC, and do not require risk appetite exemptions, to the Board Credit Committee (BCC).

The Executive Risk Committee, chaired by the CRO, approves changes to the credit framework and ensures alignment with the Bank's risk appetite and credit risk policy. BCC reviews the credit framework on an annual basis.

Figure 4.1 Credit approval hierarchy



4.2 Credit Risk Management

Credit risk management entails diversification of risk, well-informed lending decisions, good oversight of portfolio performance, and the identification of weaknesses to facilitate timely recovery.

To ensure well-informed lending decisions, borrowers' key risk and performance indicators are analyzed and made available to the credit committee. Credit applications address certain elements that serve as the basis for a decision, such as the customer profile, financial analysis of the customer, repayment ability, proposed collateral, credit rating of the customer, and connected clients and their total exposure. The credit is assessed on its own merit and in the context of the Bank's detailed credit framework and criteria. Various controls ensure that a loan is only disbursed following a thorough review of all documents and the registration of all relevant information regarding the loan and collateral into the Bank's systems.

During the repayment phase, the credit portfolio is closely monitored by the first and second lines. Credit risk metrics are aggregated monthly, based on consistent criteria, to analyze the credit quality, expected loss, collateral coverage, single-name, sectoral and geographical concentrations, and early warning indicators. For the purpose of measuring credit risk and facilitating manual and automatic credit decisions, Risk Management maintains statistical and expert judgement models that assess the likelihood of default and the liquidation value of collateral.

Risk Management performs periodic reviews of the loan book, which entails analysis of individual exposures in cooperation with the first line. The process ensures continuous monitoring of credit risk, with the aim of identifying early warning signs, problem loans, and sector development. Specific impairments are determined as part of the process.

Monthly credit risk reports are sent to the ACC, the BRIC, and the Board of Directors.

4.3 Credit Risk Exposure

The Bank is exposed to credit risk from both on-balance sheet exposures and off-balance sheet exposures. The tables in this section do not include exposures on the Bank's trading books or counterparty credit risk (CCR) exposures unless otherwise stated.

The exposure amounts shown are on different basis: Exposure at default amounts, according to the rules on capital requirements, are derived from original exposure (gross carrying value including off-balance sheet amounts), net exposure after applying specific credit risk adjustments to the original exposure, adjusted exposure value (net exposure after applying credit risk mitigation (CRM), i.e. exposure net of collateral), and exposure at default (EAD) which is the adjusted exposure value after applying credit conversion factors (CCF) to off-balance sheet items. Also shown are risk-weighted exposure amounts (REA), which is EAD multiplied with the relevant risk-weight.

Table 4.2 Credit risk exposure and credit risk mitigation effects (EU CR4)

31 December 2023 [ISK m]	Net exposures before CCF and CRM		EAD post CCF and CRM		REAs and REA density	
	On-balance sheet	Off-balance sheet	On-balance sheet	Off-balance sheet	REAs	REA density
Central governments or central banks	230,330	163	231,682	6	71	0.0%
Regional governments or local authorities	10,692	2,453	11,055	476	2,306	20.0%
Public sector entities	0	0	0	0	0	0.0%
Multilateral development banks	0	0	69	1	0	0.0%
Institutions	20,171	2	20,171	20	7,946	39.4%
Corporates	365,411	84,468	362,552	31,393	431,618	109.6%
Retail	120,956	55,309	120,217	8,002	96,533	75.23%
Secured by mortgages on immovable property	599,567	5,956	599,499	1,735	220,159	36.6%
Exposures in default	15,627	283	15,382	87	18,605	120.3%
Exposures associated with particularly high risk	1,454	0	1,454	0	2,181	150.0%
Covered bonds	1,386	0	1,386	0	277	20.0%
Collective investments undertakings	617	0	617	0	585	94.9%
Equity	14,703	0	14,703	0	29,839	203.0%
Other items	19,755	0	19,755	0	19,722	99.8%
Total	**1,400,667**	**148,634**	**1,398,540**	**41,720**	**829,844**	**57.6%**

Table 4.2 Continued

31 December 2022 [ISK m]	Net exposures before CCF and CRM		EAD post CCF and CRM		REAs and REA density	
	On-balance sheet	Off-balance sheet	On-balance sheet	Off-balance sheet	REAs	REA density
Central governments or central banks	211,059	140	213,833	1	60	0.0%
Regional governments or local authorities	7,536	1,768	7,876	426	1,659	20.0%
Public sector entities	0	0	0	0	0	0.0%
Multilateral development banks	0	0	275	3	0	0.0%
Institutions	25,629	2	27,160	40	11,069	40.7%
Corporates	387,075	120,477	375,848	44,483	405,852	96.6%
Retail	127,993	56,802	126,256	10,092	93,347	68.5%
Secured by mortgages on immovable property	555,813	3,618	555,694	1,044	197,577	35.5%
Exposures in default	9,849	206	9,694	55	11,656	119.6%
Exposures associated with particularly high risk	2,189	0	2,189	0	3,130	143.0%
Covered bonds	18,898	0	18,898	0	3,780	20.0%
Collective investments undertakings	2,068	0	2,068	0	1,485	71.8%
Equity	15,470	0	15,470	0	30,500	197.2%
Other items	19,495	0	19,495	0	19,661	100.9%
Total	**1,383,072**	**183.013**	**1,374,755**	**56,143**	**779,775**	**54.5%**

By far the largest source of credit risk REA is loans to customers. This exposure mostly falls into the exposure classes *Corporates*, *Retail*, and *Secured by mortgages*. The Bank's credit risk-weight density, or REA density, measured as REA relative to EAD, increased in 2023 from 54.5% to 57.6%. For further breakdown see Tables 4.2 and 4.3.

Table 4.3 Exposure at Default (post CRM and CCF) by exposure classes and risk-weights (EU CR5). The last column refers to ratings from external rating agencies. CRR exposures are included in this table.

31 December 2023 [ISK m]	Risk weights									Of which
Exposure classes	0%	20%	35%	50%	75%	100%	150%	Other	Total	unrated
Central gov. or central banks	231,369	357	0	0	0	0	0	0	231,726	5,090
Regional governments or local authorities	0	11,531	0	0	0	0	0	0	11,531	0
Public sector entities	0	0	0	0	0	0	0	0	0	0
Multilateral dev. banks	70	0	0	0	0	0	0	0	70	70
Institutions	0	24,530	0	7,281	0	0	0	0	28,811	0
Corporates	0	159	0	2,438	0	430,367	0	0	432,964	430,129
Retail exposures	0	0	0	0	128,711	0	0	0	128,711	128,705
Exposures secured by mortgages on immovable property	0	0	577,505	12,363	0	11,851	0	0	601,719	601,719
Exposures in default	0	0	0	0	0	9,394	6,140	0	15,535	15,535
Exposures associated with particularly high risk	0	0	0	0	0	0	1,454	0	1,454	1,454
Covered bonds	0	1,386	0	0	0	0	0	0	1,386	0
Units or shares in collective investments undertakings	0	0	0	0	0	446	16	154	617	617
Equity exposures	0	0	0	0	0	4,612	0	10,091	14,703	0
Other items	0	0	0	0	141	19,611	0	3	19,755	0
Total	**231,439**	**34,963**	**577,505**	**22,082**	**128,852**	**476,281**	**7,611**	**10,248**	**1,488,980**	**1,217,839**

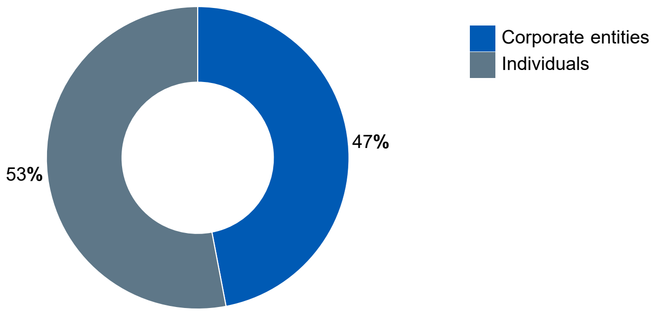
Table 4.3 Continued

31 December 2022 [ISK m]	Risk weights									Of which
Exposure classes	0%	20%	35%	50%	75%	100%	150%	Other	Total	unrated
Central gov. or central banks	213,669	302	0	0	0	0	0	0	213,972	6,054
Regional governments or local authorities	0	8,302	0	0	0	0	0	0	8,302	0
Public sector entities	0	0	0	0	0	0	0	0	0	0
Multilateral dev. banks	278	0	0	0	0	0	0	0	278	278
Institutions	0	34,120	0	8,493	0	0	0	0	42,613	0
Corporates	0	159	0	2,876	0	425,919	153	0	429,107	420,157
Retail exposures	0	0	0	0	136,833	0	0	0	136,833	136,833
Exposures secured by mortgages on immovable property	0	0	538,710	9,678	0	8,348	0	0	556,737	556,737
Exposures in default	0	0	0	0	0	5,906	3,843	0	9,748	9,748
Exposures associated with particularly high risk	102	0	0	0	0	0	2,087	0	2,189	2,189
Covered bonds	0	18,898	0	0	0	0	0	0	18,898	0
Units or shares in collective investments undertakings	0	0	0	0	0	1,248	93	727	2,068	2,068
Equity exposures	467	0	0	0	0	4,671	0	10,331	15,470	15,470
Other items	0	0	0	0	0	19,219	0	135	19,354	19,495
Total	**214,516**	**61,782**	**538,710**	**21,047**	**136,833**	**465,312**	**6,175**	**11,192**	**1,455,569**	**1,169,029**

Credit Risk Exposure by Sector

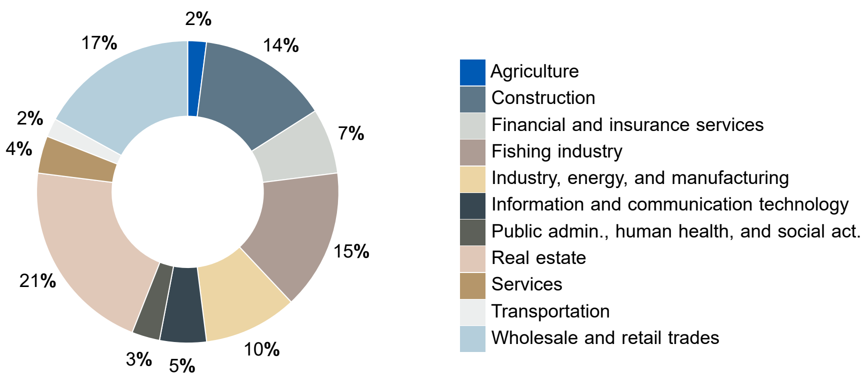
The Bank's loan book is diversified with regard to individuals and industry sectors. Credit exposure to individuals represents 53% of loans to customers, of which 90% are mortgage loans.

Figure 4.2 Loans to customers, by counterparty type



Real estate activities is the largest industry sector comprising 21% of loans to corporates or 10% of the Bank's total net credit risk exposure. According to the Bank's analysis, the sector distribution of the corporate loan book mirrors the sector distribution of credit from all lenders in the Icelandic economy, in line with the Bank's risk appetite. The Bank's sector diversification is as good as can be expected for a bank which primarily operates in Iceland.

Figure 4.3 Sector distribution of loans to corporate entities



Arion Bank monitors the risk associated with the tourism industry. The Bank has not modified its standard industry classification to incorporate a separate tourism sector, opting instead to monitor the exposure internally alongside the standard sectors. To define the tourism industry, the Bank has adopted a classification from the Central Bank of Iceland which identifies, primarily, 19 activities from ISAT08 as core tourism activities. According to this definition, the Bank has determined that its exposure to the tourism industry was 7% of loans to customers at the end of 2023, compared to 7% in 2022. The tourism exposure draws mainly from four standard industry sectors: Wholesale and retail trades (57%), Real estate (26%), and Services (8%).

7% of loans to customers are dependent on tourism activities

For EBA standardized disclosures of credit risk exposure by sectors please refer to template EU CQ5.

Credit Risk Exposure by Geographic Area

The Bank is not significantly exposed to credit in other countries than Iceland. The total net exposure is 88% towards counterparties domiciled in Iceland.

The majority of the 12% foreign credit exposures is due to liquid assets in foreign currencies, which includes short term deposits and money market loans at credit institutions, and sovereign bonds, the counterparties of which have high grade or upper medium grade credit ratings from certified external credit agencies (ECAI).

Figure 4.4 Geographic distribution of total exposure

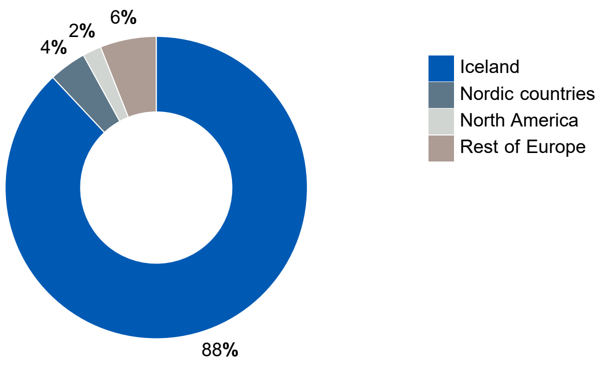
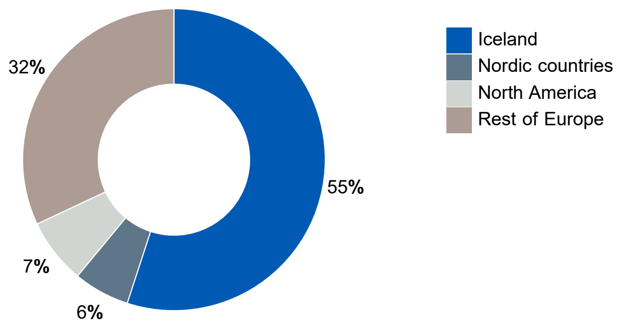


Figure 4.5 Geographic distribution of total exposure to credit institutions, central governments and central banks



For EBA standardized disclosures of credit risk exposure by geographic area please refer to template EU CQ4.

Connected Clients and Large Exposures

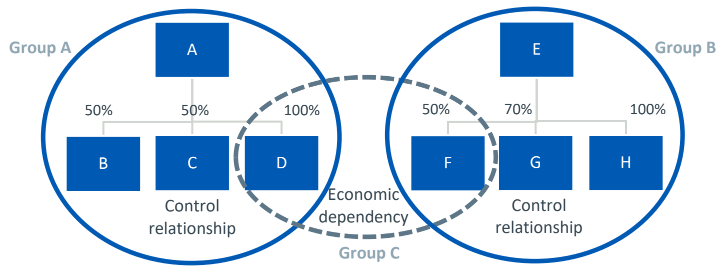
A large exposure is defined as an exposure to a group of connected clients which exceeds 10% of the Bank's Tier 1 capital. This definition changed with the adoption of CRR II in June 2021. Previously, the definition was 10% of eligible capital which corresponded to own funds for the Bank. According to the CRR, the legal maximum for individual large exposures, net of eligible collateral, is 25% of Tier 1 capital.

The Bank seeks to limit its credit concentration risk through diversification of the loan portfolio by limiting large exposures to groups of connected clients. No single large exposure shall exceed limits expressed in the Bank's risk appetite without a special exemption granted by the Board of Directors.

Party relations are monitored both prior to granting a loan and during its lifetime

The Bank connects clients according to internal rules that comply with the Act on financial undertakings No. 161/2002 and relevant EBA guidelines. The internal rules define criteria that comply with the regulatory conditions and describe the roles and responsibilities related to the interpretation and maintenance of connected clients. The Bank evaluates the relationship of customers with respect to both control and economic dependencies. Economic dependencies between two companies within different groups of connected clients do not necessarily combine these groups into one but could rather result in a separate group. This relationship is illustrated in Figure 4.6.

Figure 4.6 Connected clients



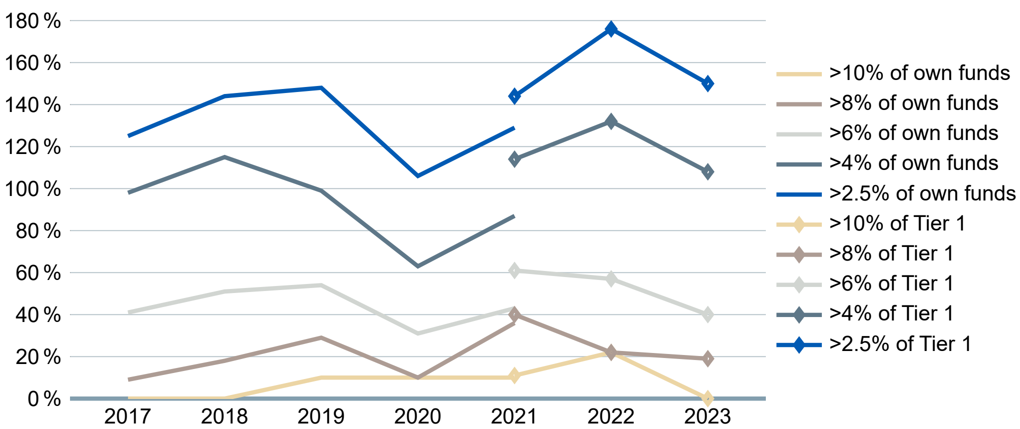
No groups of connected clients within Loans to Customers were classified as *large exposures* at year-end 2023

Account managers are responsible for maintaining and reviewing party relations both prior to the granting of a loan and during its lifetime. Risk Management monitors the party relations and manages the Bank's relationship database.

At year-end 2023 the Bank had no large exposure within loans to customers. At year-end 2022 the Bank had two large exposures.

The sum of group exposure exceeding 10%, net of eligible collateral, decreased from from 22% of Tier 1 capital to 0% year-on-year. The sum of group exposures exceeding 2.5%, net of eligible collateral, also decreased, from 176% to 150% of Tier 1 capital, see Figure 4.7. Furthermore, the sum of group exposures exceeding 8% decreased from 22% to 19% of Tier 1 capital. The decrease in net group exposures is primarily attributable to increased Tier 1 capital, while there was also a reduction in net exposure to the largest groups.

Figure 4.7 Total of net exposures to groups of connected clients (excluding loans to financial institutions)



Equity Positions in the Banking Book

Exposure limits for equity positions in the banking book are defined in the Bank's risk appetite statement. The banking book primarily comprises investments that are not made for short-term trading purposes and assets repossessed as a result of credit recovery, i.e. restructuring or collection.

Table 4.4 Equity exposure in the banking book

31 December 2023 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		36	36
Equity instruments with variable income	3,13	4,497	7,627
Fund shares - Bonds		162	162
Fund shares - Other	4	1,218	1,222
Total equity exposure in the banking book	**3,134**	**5,913**	**9,047**
Unrealized gain/loss at year-end 2023			207
31 December 2022 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		42	42
Equity instruments with variable income	1,487	3,857	5,344
Fund shares - Bonds		699	699
Fund shares - Other	4	2,198	2,202
Total equity exposure in the banking book	**1,491**	**6,795**	**8,286**
Unrealized gain/loss at year-end 2022			2,264

4.4 Collateral Management and Valuation

The Bank's initial valuation of a collateral takes place during the credit approval process. Credit rules outline the acceptable levels of collateral for a given counterparty and exposure type. The collateral obtained by the Bank is typically one of the following:

- Cash and securities: Cash, treasury notes and bills, asset backed bonds, listed equity, and funds that consist of eligible securities
- Real estate: Residential property, commercial real estate, and land
- Vessels: Ships with assigned fishing quota and other vessels
- Other collateral: Fixed and current assets including vehicles, equipment, inventory, and trade receivables

In addition to securing collateral, mitigation of credit risk is achieved through the use of guarantees, master netting agreements, and applicable terms and conditions.

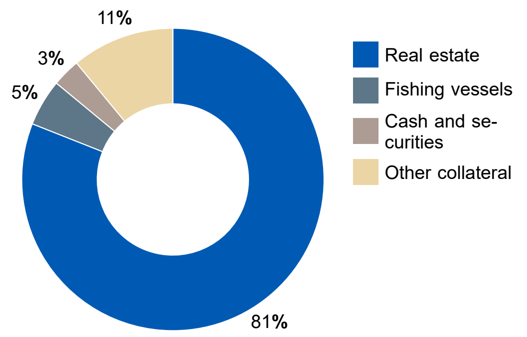
Collateral valuation standards and guidelines have been set by the ACC to ensure coordinated collateral value assessment. Risk Management reviews the standards and guidelines for appropriateness and opines on individual cases as needed.

The standards and guidelines cover the following subjects:

- Agriculture
- Fishing vessels and fishing quota
- Inventory, trade receivables, and other movable assets
- Project financing
- Real estate
- Securities

The Bank operates a collateral management system to consolidate the Bank's collateral data. Table 4.5 shows the collateral held by the Bank for loans to customers, broken down by busi-

Figure 4.8 Collateral by type



ness sector. Collateral held at year-end is to the largest extent real estate collateral, which makes up 81% of the total collateral. At year-end 2023 loans to customers were secured by collateral conservatively valued at ISK 1.070.160 million, which results in a collateral coverage ratio of 92.8% compared to 90.6% at the end of 2022.

The credit exposure to the Central Bank of Iceland and financial institutions is unsecured as it is due to the Bank's own deposit accounts and money market loans.

The collateral coverage ratio of loans to customers at the end of 2023 was 92.8% compared to 90.6% at the end of 2022

Table 4.5 Collateral for loans to customers. The collateral value is capped by book value.

31 December 2023 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2023	Unsecured ratio % 2022
Individuals, Mortgages	15	548,962	0	33	549,010	0.1%	0.0%
Individuals, Other	314	9,900	16	16,993	27,223	54.5%	45.2%
Real estate activities	2,027	108,604	28	1,621	112,280	1.6%	2.1%
Construction	433	72,143	30	3,177	75,783	2.5%	20.4%
Fishing industry	972	14,085	53,137	11,188	79,382	4.1%	14.7%
Information and communication technology	65	1,422	0	12,912	14,399	44.6%	33.5%
Wholesale and retail trade	40	51,332	3	29,253	80,628	10.7%	7.5%
Financial and insurance activities	19,732	6,701	0	13,914	40,347	2.8%	10.7%
Industry, energy, and manufacturing	791	34,318	22	16,531	51,662	5.7%	11.2%
Transportation	0	1,254	803	4,026	6,083	28.1%	61.2%
Services	187	10,265	1,220	8,071	19,743	11.0%	15.1%
Public sector	10	2,235	6	202	2,453	82.7%	78.3%
Agriculture and forestry	0	10,461	0	706	11,167	3.2%	5.2%
Total	**24,586**	**871,682**	**55,265**	**118,627**	**1,070,160**	**7.2%**	**9.4%**

Figures 4.10 and 4.11 show the mortgage portfolio broken down by loan to value bands based on the gross carrying amount of the mortgages. In Figure 4.10 a prime mortgage exposure to a particular borrower appears in a single bar in the chart (whole-loan approach). In Figure 4.11 however, an alternative representation of the loan to value profile is shown, where each exposure is split into pieces and each piece is placed into the appropriate loan to value band. A single exposure can therefore be spread between several bands on the bar chart with the loan-splitting approach.

The value of real estate is based on observed market value for two years from purchase, and is then replaced by an estimated value based on a third party statistical model, which is updated on a monthly basis. The downward shift of the loan to value between 2022 and 2023 can be attributed to continued appreciation of property values.

Figure 4.9 Mortgage portfolio by location

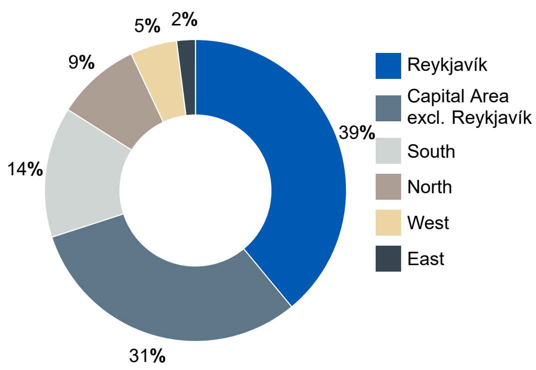


Figure 4.10 Loan to value of mortgage loans [ISK m], whole-loan approach

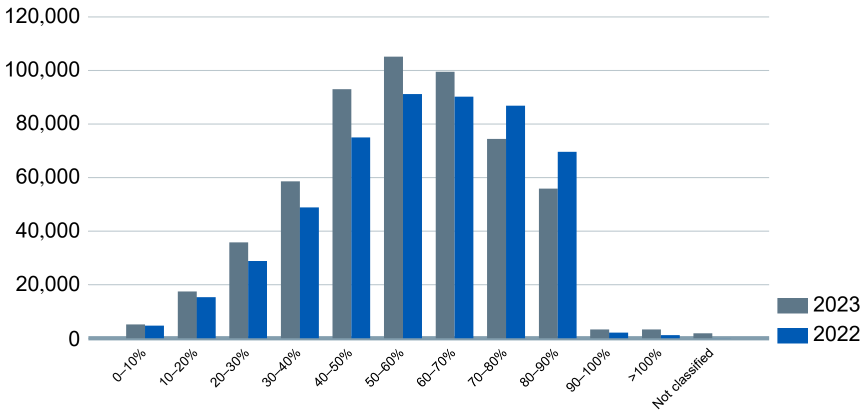
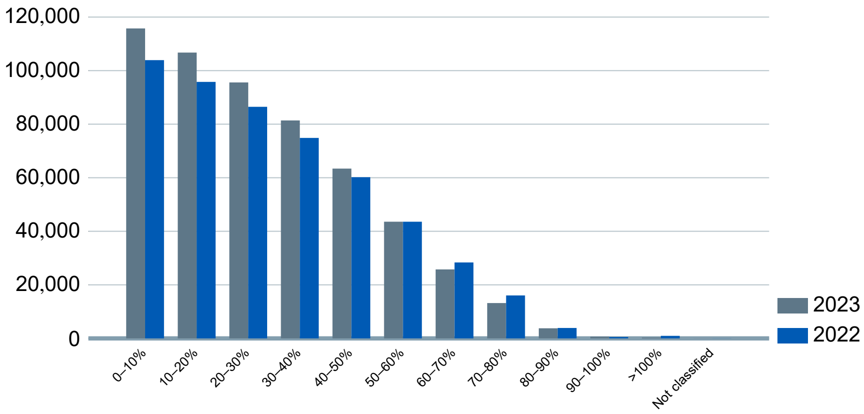


Figure 4.11 Loan to value of mortgage loans [ISK m], loan-splitting approach



At year-end 2023, 89% of mortgages, by value, had a loan-to-value ratio below 80%, compared to 86% at the end of 2022, according to the whole-loan approach. However, according to the loan-splitting approach, 99% of mortgages had loan-to-value ratio below 80%. According to the loan-splitting approach, 86% of mortgages were below 55% loan-to-value, compared to 83% at the end of 2022. The 55% mark is relevant for REA calculation under CRR 3, see Section 3.7. As shown in Figure 4.9, the mortgaged properties are primarily located in the Capital Area or 70% of the portfolio, by value.

4.5 Credit Rating

As outlined in Chapter 3, the Bank uses the standardized approach to calculate capital requirements for credit risk. Nevertheless, it is the Bank's policy to apply sophisticated credit rating models to monitor the development of credit risk and to estimate customers' default probability. These estimates are used extensively within the Bank as they play a role in both the manual and automatic evaluation of loan applications, portfolio monitoring, calculation of loss allowance, and internal economic capital calculations.

The Bank applies different credit rating models to different types of borrowers and exposures. The Bank has also created separate application versions of some of the models in order to rate new exposures and loan commitments.

Table 4.6 Probability of Default models

Model for:	Description
Large corporates	Defined as corporate clients with a) individual exposure over ISK 300 million or b) individual exposure over ISK 150 million and related exposure over ISK 300 million. The model is statistical and is based on quantitative information drawn from financial statements as well as qualitative data entered by account managers and approved by lending units.
Retail corporates	Defined as corporate clients with a) individual exposure below ISK 150 million or b) individual exposure between ISK 150 million and ISK 300 million and related exposure below ISK 300 million. The model is statistical, runs automatically, and uses quantitative internal and external information found to be predictive of default.
Other entities	The Bank has different models for other entities - holding companies, construction project finance, state related entities and municipalities, unions, etc.
Individuals, mortgages	Applied to all mortgages, for which there are standard loan collateral agreements. The model is statistical, runs automatically, and is based on historical behavior and characteristics of the customer and the exposure.
Individuals, consumer loans	Applied to all consumer loans - credit cards, overdrafts, etc. The model is statistical, runs automatically, and is based on historical behavior of customers and characteristics of the customer and the exposure.
Individuals, other exposures	The Bank has different models for other smaller exposure portfolios to individuals - car loans, guarantees, loans for work purposes, and other loans.

The Bank's probability of default (PD) models are developed within Balance Sheet Risk and Models, a department within Risk Management, while the validation of the models is performed independently by another department in Risk Management, Operational and Sustainability Risk.

Credit Exposure by Rating

Table 4.7 shows the portfolio's rating status, by exposure. A default rating grade (DD) is assigned to an exposure when it has been in arrears for over 90 days or the customer is deemed unlikely to pay.

Around 1.4% of the portfolio, by exposure, was assigned a default rating at the end of 2023, which is 0.5 percentage points higher than at the end of 2022. Active PD values are translated into an internal rating scale of letters from AAA to CCC-. The scale is shown in Table 4.8. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

Figure 4.12 Distribution of exposure by portfolio

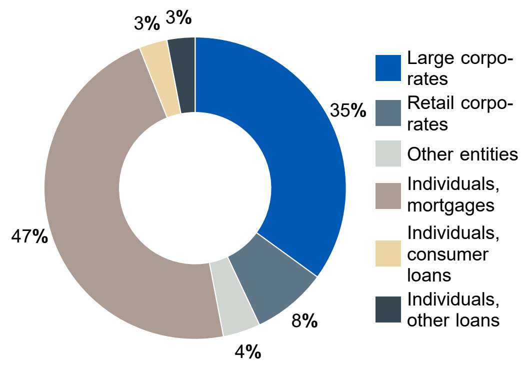


Table 4.7 Breakdown of rating status by exposure

	2023			2022		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	98.9%	1.1%	0.0%	99.2%	0.6%	0.2%
Retail corporates	95.3%	4.7%	0.0%	97.3%	2.7%	0.0%
Other entities	99.5%	0.0%	0.4%	99.8%	0.0%	0.2%
Individuals, mortgages	98.9%	1.1%	0.0%	99.2%	0.8%	0.0%
Individuals, consumer loans	99.2%	0.7%	0.0%	99.3%	0.7%	0.0%
Individuals, other exposures	97.5%	2.5%	0.0%	97.5%	2.0%	0.5%
Total	**98.6%**	**1.4%**	**0.0%**	**99.0%**	**0.9%**	**0.1%**

Table 4.8 Rating scale

Risk class	Rating	Lower PD	Upper PD
0	AAA	0.000%	0.006%
	AA+	0.006%	0.018%
	AA	0.018%	0.029%
	AA-	0.029%	0.045%
	A+	0.045%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
1	BBB+	0.17%	0.26%
	BBB	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	14.00%
	CCC	14.00%	31.00%
	CCC-	31.00%	99.99%
5	DD	100.00%	100.00%

The rating distributions of each of the four largest portfolios are discussed below.

Large corporates

The exposure-weighted average PD for the large corporate portfolio was 1.6% at year-end 2023, which was the same as for year-end 2022. In terms of exposure (Figure 4.13), approximately 20% have been upgraded to a better credit rating, while 17% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated (e.g. new customers), or rated by the model for retail corporates.

Figure 4.14 shows the large corporates portfolio broken down by ratings. The distribution was relatively stable in 2023.

Figure 4.14 Distribution of exposure by rating for large corporates

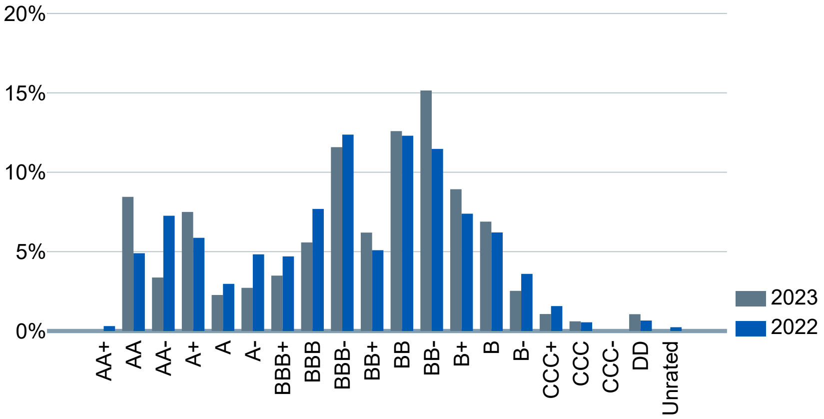
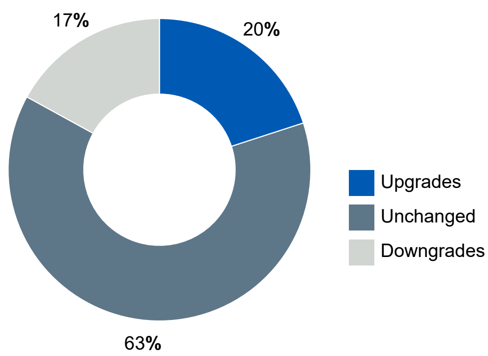


Figure 4.13 Risk class rating migration by exposure between 2022 and 2023 – Large Corporates



Retail corporates

The exposure-weighted average PD was 2.8% at year-end 2023, compared to 3.1% at year-end 2022. In terms of exposure (Figure 4.15), 23% have been upgraded to a better rating whereas 16% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.16 shows the retail corporate portfolio broken down by rating. The increase in DD rating in 2023 aligns with the rising trend of past due exposures among retail corporates. This shift comes after a period of exceptionally low default rates during the COVID-19 years, signaling a transition toward a more normalized credit environment.

Figure 4.15 Risk class rating migration by exposure between 2022 and 2023 – Retail Corporates

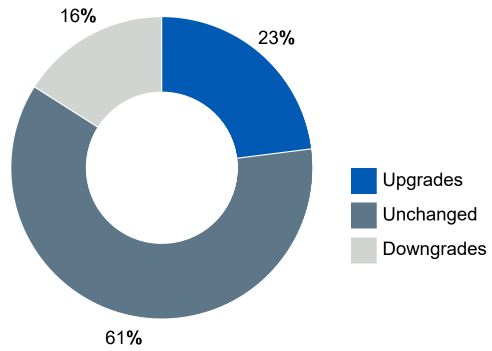
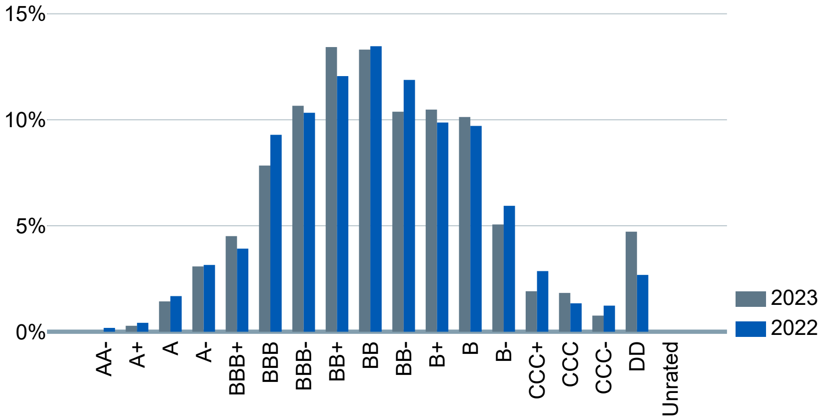


Figure 4.16 Distribution of exposure by rating for retail corporates



Mortgages to individuals

The exposure-weighted average PD for the mortgage portfolio was 0.5% in year-end 2023, compared to 0.5% in year-end 2022. In terms of exposure (Figure 4.17), approximately 15% of mortgages have been upgraded to an improved credit rating and 13% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.17 Risk class rating migration by exposure between 2022 and 2023 - mortgages to Individuals

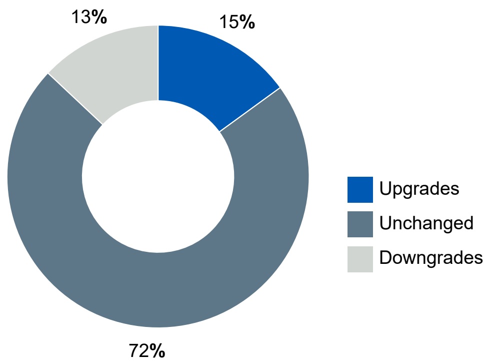
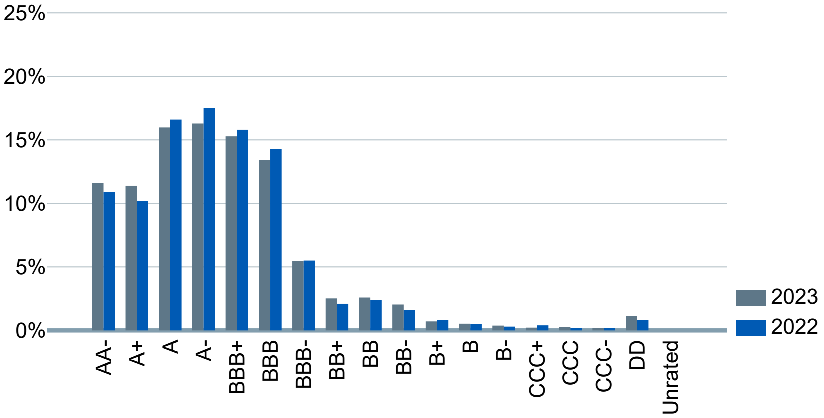


Figure 4.18 Distribution of exposure by rating for mortgages to individuals



Consumer loans

Figure 4.20 shows the consumer loans (overdrafts, credit cards, and unsecured short-term loans) portfolio broken down by rating. A very similar credit profile is observed between years.

Figure 4.20 Distribution of exposure by rating for consumer loans

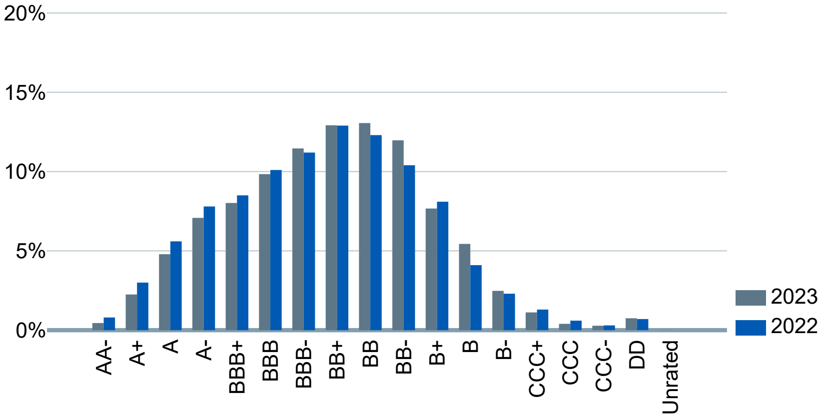
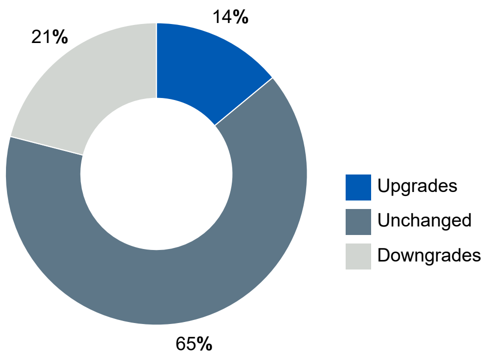


Figure 4.19 Risk class rating migration by exposure between 2022 and 2023 - Consumer loans



Model performance

At year-end 2023 the discriminatory power of the four rating models with the largest exposure is in line with or exceeds the Bank's internal requirements and the prediction accuracy is satisfactory. The comparison values for the average PiT (point-in-time) PD estimates at the end of 2022 and observed default rates in 2023 are shown in the following table.

Table 4.9 Model performance

Model portfolio	Average PiT PD at the end of 2022	Avg. observed default rate in 2023
Mortgages	0.4%	0.6%
Consumer Loans	1.1%	1.2%
Retail Corporates	2.7%	3.2%
Large Corporates	2.0%	3.3%

In Figures 4.21 and 4.22, the actual default rate for each grade in 2023 is compared to the PiT and TtC (through-the-cycle) probability of default at the end of 2022 for individuals (Mortgages and Consumer loans) and corporates (Large and Retail corporates), respectively. The dots representing PiT ratings are a measure of model performance but the TtC dots that are generally below the PD bands are indicative of a benign credit environment. In the figures the highest-rated rating classes are grouped together due to their relatively low exposure.

Figure 4.21 Comparison of actual default rate in 2023 and predicted default probability - Individuals

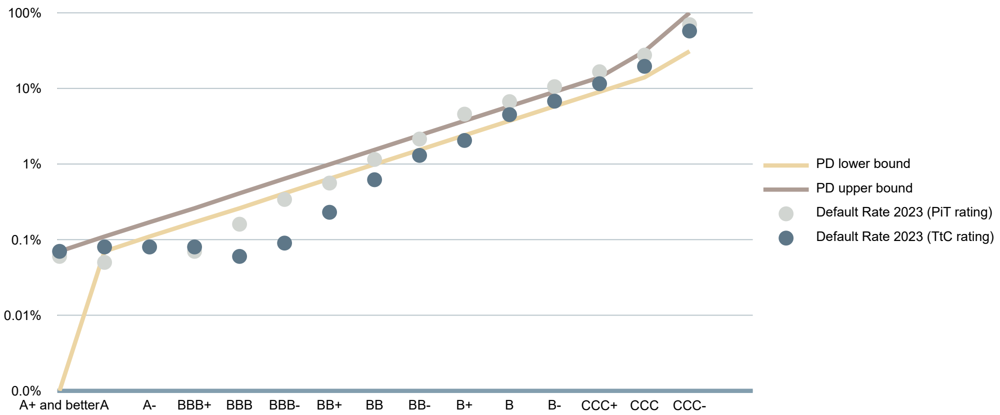
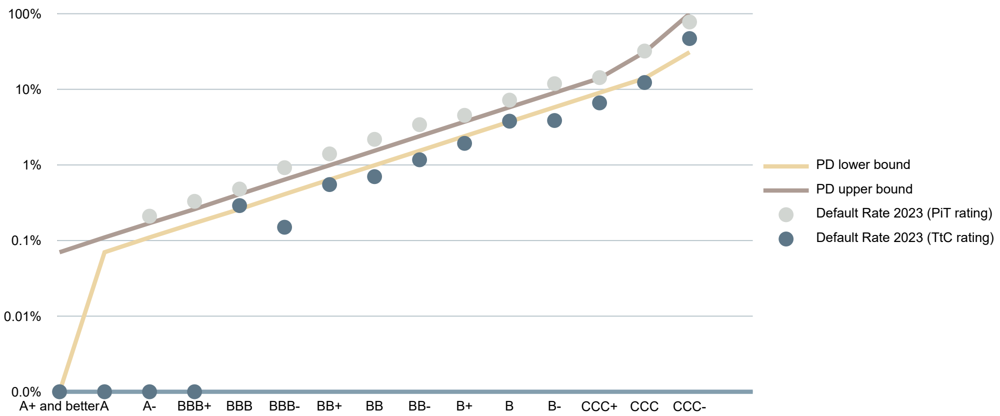


Figure 4.22 Comparison of actual default rate in 2023 and predicted default probability - Corporates



4.6 Portfolio Credit Quality and Provisions

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio. The credit portfolio quality is regularly aggregated and assessed in terms of industry concentration, single-name concentration, product type, and credit rating. Risk Management presents its findings to the ACC and the BRIC on a monthly basis.

Grindavík events

The volcanic events in the vicinity of Grindavík have an impact on the credit quality of a section of the Group's loan portfolio. The carrying amount of loans to individuals and corporates domiciled in the area is ISK 10.3 billion, thereof ISK 8.3 billion to corporates and ISK 2.0 billion to individuals. These loans are well collateralized with strong average LTVs of 53% for the mortgage portfolio and 42% for the corporate portfolio.

The Bank's exposure to residential properties in Grindavík is ISK 2.1 billion

Of the loans to corporates, ISK 6.0 billion is secured by fishing vessels with appurtenant quota which are not impacted by the events. The other main collateral is residential and commercial real estate. These are required by law to be insured against the risk of fire based on an official fire insurance value, which is generally higher than the tax value in the area. The Natural Catastrophe Insurance of Iceland covers real estate up to the fire insurance value in case of destruction by a natural disaster. In such cases the real estate collateral holds its value as a credit risk mitigant. Compensation has been paid out for some of the properties that have been deemed destroyed.

It should be noted that these events are still ongoing, with an eruption occurring after the year-end reporting date on 14-15 January, with lava flow partly within the town's perimeter. Thus, the Bank will continue to monitor the situation and work with its customers through these times of uncertainty. The Bank has transferred most of the exposure in Grindavík (96%) to stage 2 as this event amounts to a significant increase in credit risk. Impairments remain immaterial at year-end 2023. The assessment of expected credit losses will however be subject to careful review in the coming quarters and may be impacted by a possible government intervention.

Interest rate increase and reset of fixed nominal rates

Following an unprecedented period of low interest rates during the pandemic, the Central Bank responded to inflationary pressures through steep increases to its policy rate, which rose from 0.75% in May 2021 to 9.25% in December 2023. The Bank's residential mortgage portfolio continued to grow in 2023, with an increased demand for index-linked loans, especially loans with floating interest rates, since index-linked loans offer lower monthly payments.

The renewed demand for index-linked mortgages can be observed in Figure 4.23. The share of index-linked loans decreased from 49% of the residential mortgage portfolio at year-end 2020 to 36% at year-end 2021, before rising to 51%. It is expected to rise further as the fixing period on a significant number of nominal-rate loans expires in 2024.

Figure 4.23 Development of residential mortgages [ISK m]

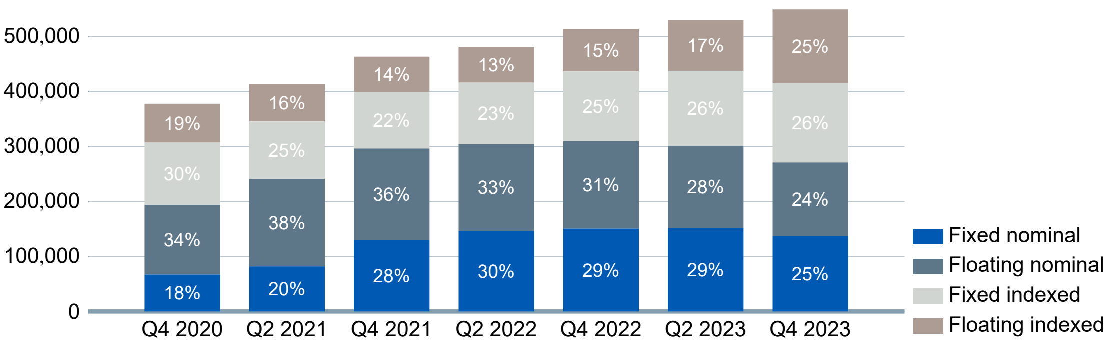
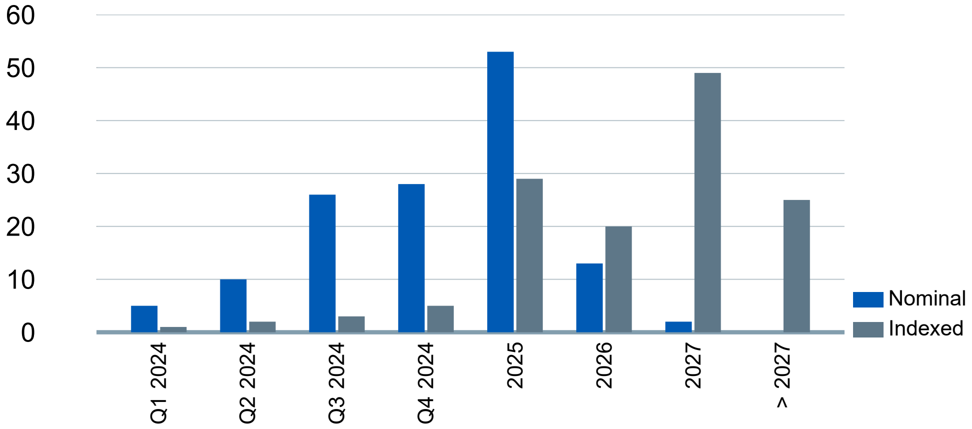


Figure 4.23 also shows the development of fixed nominal-rate residential mortgages. Demand for this product picked up significantly when interest rates started to rise in 2021, a trend that has since reversed. The interest rate reset profile for fixed rate mortgages can be seen in Figure 4.24, where the bulk of fixed nominal-rate loans are scheduled to reset in Q3 and Q4 of 2024 and in 2025.

Figure 4.24 Interest rate reset profile for fixed rate mortgages [ISK bn]



The Bank regularly carries out analysis of its mortgage portfolio to forecast the potential impact from interest rate resets on customers' credit quality. The most recent analysis was conducted in Q3 2023 and showed that monthly payments increase by 62% on average and that 64.6% of borrowers that had a positive credit assessment at origination of the loan would have maintained the assessment after the interest rate reset. If borrowers with a negative credit assessment choose to refinance with index-linked loans, 96.5% would achieve positive assessment.

To support borrowers nearing their reassessment date, the Bank has introduced capped interest payments where the remaining interest is applied to the principal.

Impairment and Provisions

Provisions for credit loss are made according to the IFRS9 three-stage expected credit loss model. For credit impaired loans, Stage 3 provisions are made based either on a portfolio level assessment or by individual assessment of credits, depending on the size of the exposure and other factors which affect whether an individual assessment is warranted. For loans that are not impaired, provisions are either made for a 12-month expected credit loss (Stage 1) or a lifetime expected credit loss (Stage 2). Expected credit loss calculations are based on the borrower's probability of default (PD), loss given default (LGD), and the exposure at default (EAD).

For corporate exposures, a cross-default approach is applied, i.e. if a corporate borrower has one impaired credit then all exposures to this borrower are moved to Stage 3 and classified as risk class 5 (DD rating). For individuals, the same applies within each credit model portfolio and a default in one portfolio can result in a default in other portfolios if the defaulting exposure is significant.

The level of detail for credit monitoring depends on the size of the exposure, where factors such as delinquency by the borrower, forbearance measures, and the internal credit rating (see Section 4.5) are considered. For larger borrowers, interviews with account managers are also conducted.

For further information on the measurement of impairment, see Note 58 on Expected credit losses in the Bank's Consolidated Financial Statements for 2023.

Past Due Exposures

Figures 4.25 and 4.26 show the development of past due exposures from year-end 2016 for individuals and corporates at facility level and cross-default level. Until 2020 cross-default at obligor level is shown, but since the introduction of a new definition of default it is more relevant to study exposure in Stage 3. In order to show the effects of this change in perspective, both values are shown for two years. Stage 3 exposures for loans to individuals increased in 2023, as did Stage 3 exposures for corporates which have significantly increased in 2023, due to a large single-name default.

Customer loans that are more than 90 days past due represent 0.34% of the total loan book at year-end 2023, measured at facility level

Figure 4.25 Development of past due exposures to individuals

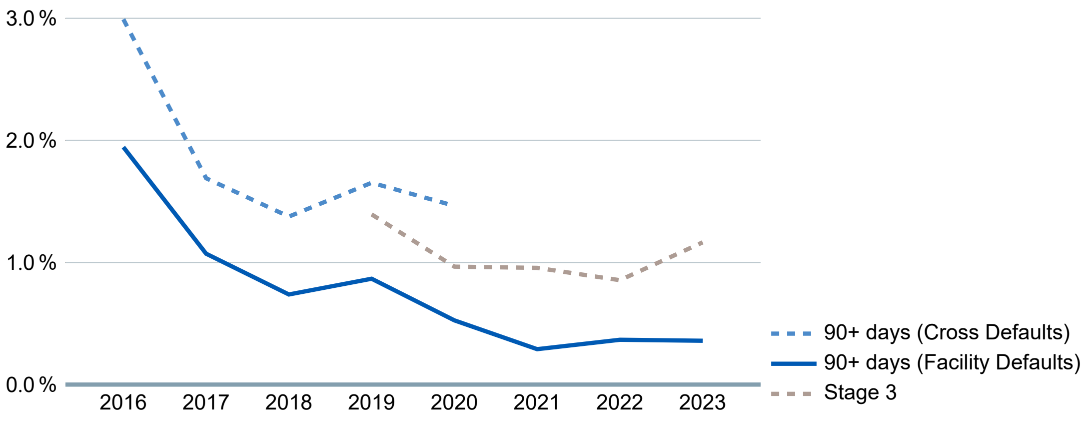
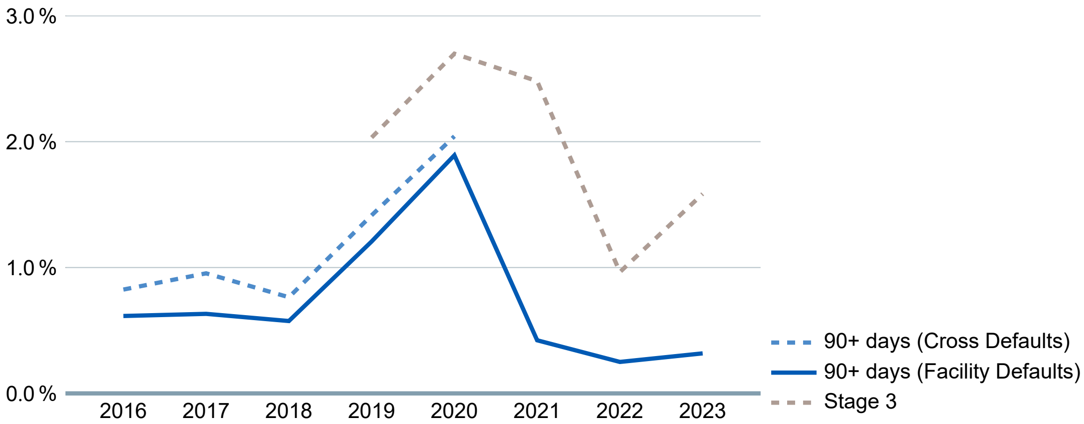


Figure 4.26 Development of past due exposures to companies, parent company



Loans to customers that are more than 90 days past due were 0.34% of the total loan book at year-end 2023 when measured at facility level. The ratio of loans in Stage 3 was 1.4% of book value, thereof 1.2% for individuals and 1.6% for corporates.

Template EU CQ3 shows credit quality by past due days.

Moratoria and Forbearance

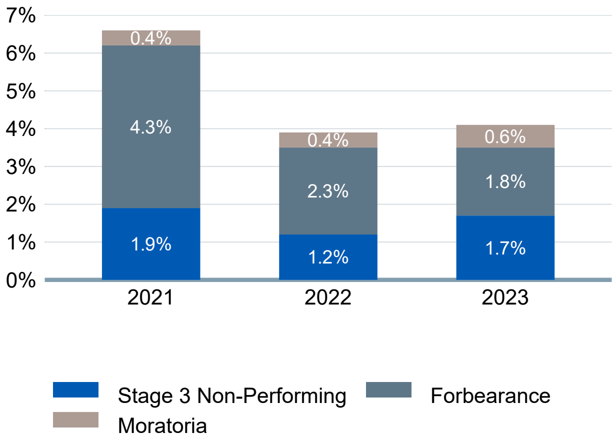
The Bank has adopted the definition of forbearance in Article 47b of the CRR. According to the definition, an exposure is considered forborne if concessions, such as modification of terms or debt refinancing, have been granted due to the client's current or expected financial difficulties and those concessions would not have been granted in the absence of those financial difficulties.

The Bank is willing to consider forbearance measures in situations when a client is unable to comply with terms and conditions due to financial difficulties if there is a realistic possibility that the terms and conditions can be met again. This is especially considered in cases when the Bank and the client have enjoyed a long-standing business relationship.

The decision to apply a forbearance measure is subject to the Bank's credit granting mechanism, as described in Section 4.1, and for potential forbearance cases there is, as a part of the relevant individual's or credit committee's decision, a determination of whether the concession constitutes forbearance.

Credit quality of forborne exposures is shown in templates EU CQ1.

Figure 4.27 Development of Default, Forbearance, and Moratoria. Shown as percentage of total gross carrying amount



Following the earthquakes and volcanic eruptions in the Grindavík region, the Bank offered moratoria to residential property owners in the region

Following the earthquakes and volcanic eruptions in the Grindavík region, the Bank offered moratoria to residential property owners in the region. Most of the owners accepted the moratoria.

In Figure 4.27 moratoria due to summer holiday, maternity leave, job loss and moratoria due to events in Grindavík are all listed under Moratoria.

Forborne loans decreased from 2.3% in 2022 to 1.8% in 2023. The decrease was mostly in the Wholesale and retail trades sector, which includes hotel operations, followed by Individuals, and Service sectors. However, this was offset by an increase in the Real Estate and construction sector of similar size as the decrease in the Wholesale and retail trades.

For further information, see Note 44 on forbearance in the Bank's Consolidated Financial Statements for 2023.

Expected Credit Loss

The 12-month expected credit loss (ECL) is defined as the amount of credit loss that the Bank expects, on average, in the next twelve months. The Bank accounts for expected credit loss according to the IFRS9 three stage model. In addition, the Bank holds capital to be able to meet unexpected loss.

The Bank has developed an ECL model for IFRS9 calculations. This model is also used for impairment predictions in the annual budget and the pricing of credit where credit spreads take into account the exposure's expected loss, cost of capital, and operational cost.

Expected credit loss is calculated using the formula $ECL = PD \cdot LGD \cdot EAD$ where each credit exposure's ECL is derived from the facility's probability of default (PD), loss given default (LGD), and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see Section 4.5. For impairment calculations, ECL values are calculated in several different scenarios and the impairment is based on the weighted average ECL.

For impairment calculations, ECL values are calculated in several different scenarios

The main components of LGD are:

- the *cure-rate* of the exposure, which describes the probability that the customer returns to a non-defaulting status, without a write-off and any loss occurring for the Bank, within 18 months from the default event
- the *collateral gap* of the defaulted exposure, with haircuts based on historical evidence and expert judgment
- assessment of recoveries of defaulted non-collateralized exposures, conditional on non-cure

The main components of EAD are:

- the *expected outstanding amount* at a given time in respect to the repayments schedule
- the *expected prepayment* to be made based on historic values

Table 4.10 shows the 12-month Expected Loss rate for different customer and exposure classes for exposures in Stage 1 and Stage 2. The PD and LGD values are weighted by the corresponding exposure, taking off-balance sheet items into account. The ECL values shown are impacted by the IFRS9 macroeconomic forecasts.

Table 4.10 Expected credit loss by exposure type

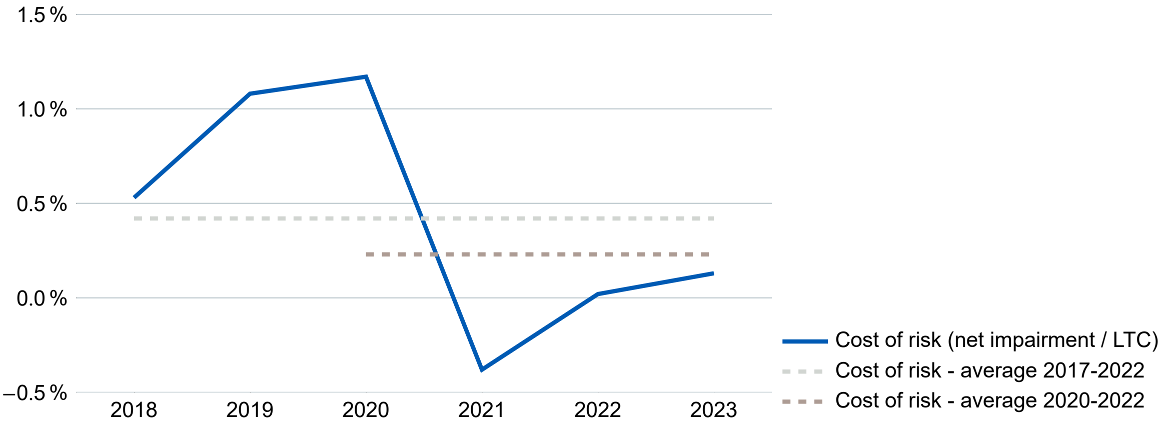
31 December 2023	PD	LGD	EL
Corporates - Large	1.5%	9.8%	0.4%
Corporates - Retail	2.7%	8.0%	0.5%
Corporates - Other	2.3%	23.4%	0.9%
Individuals - Mortgages loans	0.5%	2.1%	0.1%
Individuals - Other	1.5%	31.9%	0.8%
Weighted average	**1.2%**	**8.0%**	**0.3%**

31 December 2022	PD	LGD	EL
Corporates - Large	1.6%	12.8%	0.5%
Corporates - Retail	3.1%	7.6%	0.6%
Corporates - Other	1.9%	21.2%	0.8%
Individuals - Mortgages loans	0.5%	1.4%	0.0%
Individuals - Other	1.6%	30.1%	0.7%
Weighted average	**1.2%**	**8.7%**	**0.3%**

To provide a long-term view on the Bank's credit losses, the so-called cost of risk measure can be calculated. This is defined as the net impairment from the income statement divided by the average book value of loans to customers at the beginning and the end of the year. Since macroeconomic forecasts affect the calculation of the impairment under IFRS9, this measure is rather volatile in the short term but such volatility is averaged out over a longer time horizon.

Figure 4.28 shows the development of the cost of risk for the years 2018–2023 for the parent company, along with two average values; over the whole period and, to reflect better on the current period, the average value over the years 2020–2023. There, the average is 0.23%, compared to 0.42% for the 6 year period. The cost of risk measure is shown for the parent company to better reflect historical credit losses, as in some cases the Bank takes over and consolidates a failed company, after which further losses do not go through the Group's net impairment line.

Figure 4.28 Cost of Risk development



Problem Loans

The Bank has implemented EBA Guidelines 2016/07, which provide a further explanation and details of the definition of default in Article 178 of the CRR. The Bank's implementation complies with the guidelines and is suited to the Bank's size and procedures. The guidelines require the Bank to consider the co-debtor group for a facility and a cross-default mechanism if the obligor is in default on a large obligation.

The problem loans ratio was 1.7% at year-end 2023, compared to 1.2% in 2022

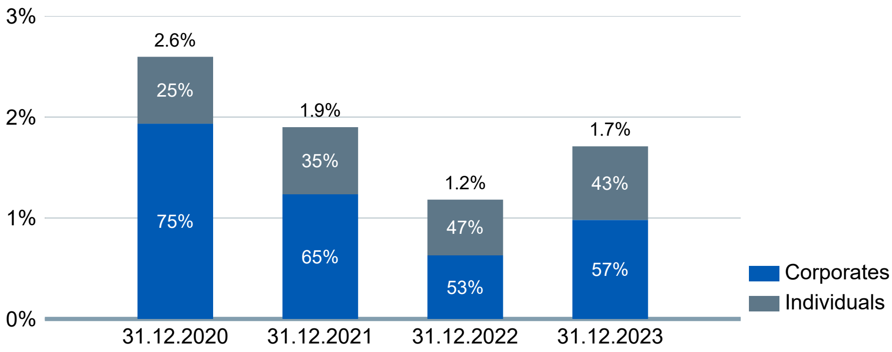
The definition can be divided into three types of default; unlikely to pay, 90 days past due and cross-default, and probation with or without forbearance. Default is considered on an obligor level for companies. For individuals, default is considered on the level of each PD model and cross default on an obligor level applies when the exposure in default is significant.

For 90 days past due, the amount in arrears must be above a relative threshold of 1% and an absolute threshold of ISK 15,000 for retail exposures and ISK 75,000 for other exposures.

The Bank has aligned its definition of *problem loans* with IFRS9. Problem loans are defined as loans in Stage 3 and the *problem loans ratio* is calculated based on the gross carrying value of loans. At year-end 2023, the problem loans ratio for the Bank is 1.7% of the loan portfolio and has increased since the end of 2022 from 1.2%.

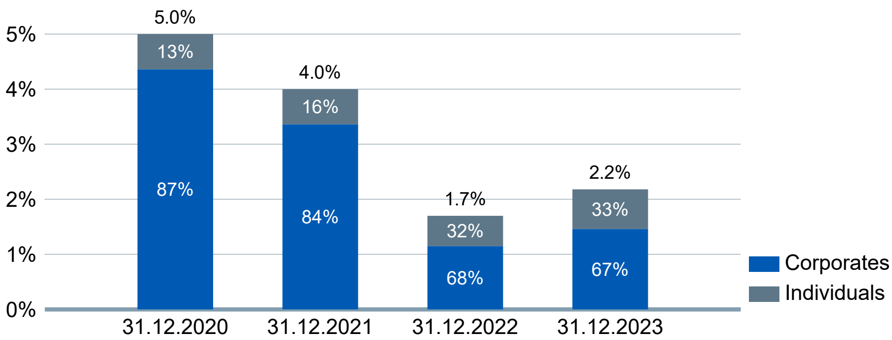
At year-end 2023, 57% of problem loans are, by value, loans to corporates and 43% to individuals.

Figure 4.29 Development of problem loans (Group)



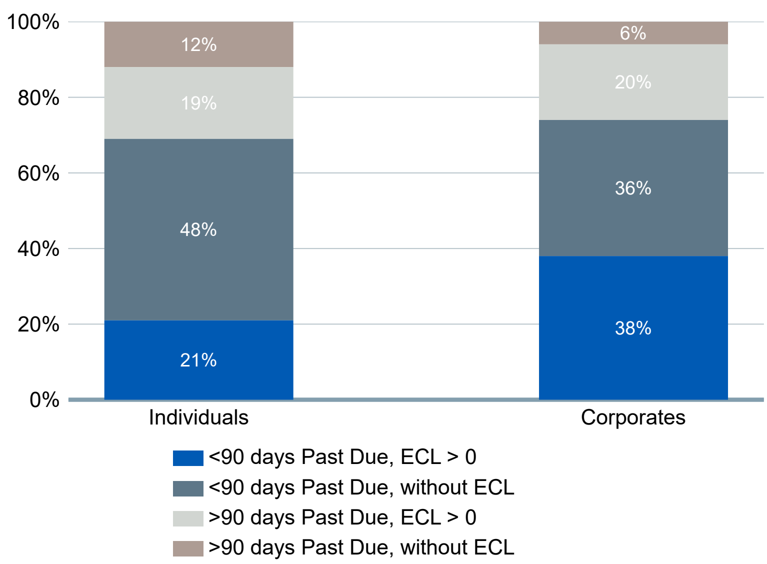
In Figure 4.28 the cost of risk for the parent company is shown and, for comparison, the development of problem loans for the parent company is shown in Figure 4.30. This is done to show companies that have been consolidated during the collection and restructuring processes. At year-end 2023, the problem loans ratio for the parent company is 2.2% of the loan portfolio and has increased since the end of 2022 from 1.7%.

Figure 4.30 Development of problem loans (Parent company)



The breakdown of problem loans by status is shown in Figure 4.31. Around 49% of the problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

Figure 4.31 Breakdown of problem loans by status



4.7 Counterparty Credit Risk

Counterparty credit risk is the risk of the Bank's counterparties in derivative transactions, securities financing transactions, securities lending, or repurchase agreements defaulting before the final settlement of the contracts' cash flows.

The Bank offers financial derivative instruments to investors. Table 4.11 shows derivative trading activities currently permitted. The derivative instruments are classified according to primary risk factor and type of derivative instrument.

To limit and control the counterparty credit risk associated with derivatives trading, the Bank requires collateral and sets limits on customer's total exposure.

Table 4.11 Permitted derivative trading activities

Primary risk factor	Swaps	Forwards	Options
Interest rate	✓		
Foreign exchange	✓	✓	✓
Securities		✓	✓
Commodities	✓	✓	✓

To limit and control the counterparty credit risk associated with derivatives trading, the Bank requires collateral and sets limits on customer's total exposure. Generally, collateral is required to cover potential future losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. The margin-call process is monitored by Risk Management. These exposure limits are generally client-specific and may refer specifically to different categories of contracts.

Note 25 in the Bank's Consolidated Financial Statements provides a breakdown of the aggregated underlying notional and fair value by derivative type.

Value changes are made in response to changes in interest rates, exchange rates, security prices, and commodity prices. Counterparty credit risk arising from derivative financial instruments is the combination of the replacement cost of instruments with a positive fair value and the potential for future credit risk exposure. The REA for counterparty credit risk is calculated using the standardized method introduced in CRR II. This accounts for the replacement cost, potential future exposure, and the credit mitigation from collateral.

Table 4.12 CCR exposures by standardized risk-weights and exposure class (EU CCR3)

31 December 2023 [ISK m]	Risk weights						
Exposure classes	0%	20%	50%	75%	100%	Others	Total
Central governments and central banks	38						38
Regional governments or local authorities							
Institutions		1,347	7,274				8,621
Corporates			266		38,752		39,018
Retail				492			492
Other items					65	485	550
Total	**38**	**1,347**	**7,540**	**492**	**38,818**	**485**	**48,720**

Table 4.13 Composition of collateral for exposures to CCR (EU CCR5)

31 December 2023	Collateral used in derivative transactions				Collateral used in SFTs	
[ISK m]	Fair Value of Collateral received		Fair Value of Collateral posted		Fair Value of Collateral received	Fair Value of Collateral posted
Item	Segregated	Unsegregated	Segregated	Unsegregated		
Cash - domestic currency		2,173			1,250	
Cash - other currency		715		8,052		
Domestic sovereign debt		288				
Other sovereign debt						
Local government debt						
Institutions		193			10,111	10,246
Corporate bonds						
Equity securities		6,117			9,362	
Other collateral					486	
Total		**9,486**		**8,052**	**21,208**	**10,246**

5 Market Risk

Market risk is defined as the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flow of financial instruments. The risk arises from balance sheet imbalances on the banking book and trading positions in bonds, equities, currencies, derivatives, and any other commitments depending on market prices and rates. The primary market risk factors are interest rate risk, equity risk, currency risk, and indexation risk.

5.1 Governance and Policy

The Bank's market risk policy and market risk appetite are established by the Board of Directors and reviewed on an annual basis.

In accordance with the market risk policy, the Bank's CEO has set up a market risk framework, which outlines responsibilities, rules, and the limit framework for market risk arising from the Bank's operations. On the management level, ALCO is the principal authority for management and monitoring of market risk.

According to the policy, the Bank invests its own capital on a limited and carefully selected basis in transactions, underwritings, and other activities that involve market risk. The Bank aims to limit market exposure and imbalances between assets and liabilities in balance with its strategic goals for net profit.

The Bank invests its own capital on a limited and carefully selected basis in transactions, underwritings, and other activities that involve market risk

5.2 Market Risk Management

Market risk controls vary between trading and banking (non-trading) books where the trading book holds positions with trading intent, according to the CRR, that are actively managed on a daily basis. The limit framework for the trading book is explicit and subject to daily monitoring, while such a framework does not apply to the banking book due to the nature of the exposure. The banking book market risk exposure is monitored and reported on a monthly basis. The Board of Directors has set limits on various market risk exposures in the Bank's risk appetite statement.

Table 5.1 Sources of market risk

Origin	Source	Risk Management
Trading Book	Positions held for market making and proprietary trading purposes. Trading derivatives and associated hedge positions managed within Treasury and Capital Markets.	Explicit position limits and hedging requirements. Daily monitoring.
Banking Book	Balance sheet imbalances, e.g. mismatches between assets and liabilities in terms of currency denomination, indexation, and term fixing of interest rates.	Board of Directors' risk appetite and strategic management of ALCO. Natural hedging and explicit derivatives hedging. Monthly monitoring.

Risk Management is responsible for measuring and monitoring market risk exposure and compliance with the limit framework. The performance, exposure, and relevant risk measures for the trading book are summarized and reported to the relevant employees and managing directors on a daily basis. Exposures and relevant risk measures are reported on a regular basis to ALCO, BRIC, and the Board of Directors.

5.3 Market Risk Measurement

Market risk exposure and price fluctuations in markets are measured on an end-of-day basis. The Bank uses various risk measures to calculate market risk exposure, see Table 5.2.

Table 5.2 Market risk measurement methods

Market risk type	Measurement methods
Equity risk	Exposure to equity is measured with net and gross positions. VaR and stress tests are used to assess risk of loss under current and severe circumstances. Indirect positions are also monitored, e.g. equity collateral.
Interest rate risk	Interest rate risk is quantified as the change in fair value and/or variability in net interest income, after simulating yield curve movements. This is done for all positions sensitive to interest rates. Prepayment risk and behavioral duration of non-maturing deposits is reflected in the Bank's models.
Foreign exchange risk	Foreign exchange risk is quantified using the net balance of assets and liabilities in each currency. This includes current positions, forward positions, delta positions in FX derivatives, and the market value of derivatives in foreign currency. The VaR method is used to quantify possible losses.
Indexation risk	Indexation risk is quantified using the net balance of CPI-linked assets and liabilities. In assessing possible loss to earnings due to indexation, the CPI is simulated in conjunction with interest rate movements.

5.4 Capital Requirements

The Bank's capital requirements for market risk under Pillar 1 are calculated using the standardized method as defined in CRR. They are summarized in template EU-MR1.

Table 5.3 Market risk minimum capital requirements (EU MR1)

31 December 2023 [ISK m]	REAs	Capital requirements
Outright products		
Interest rate risk (general and specific)	4,802	384
Equity risk (general and specific)	6,264	501
Foreign exchange risk	4,751	380
Commodity risk		
Options (non-delta)		
Securitization (specific risk)		
Total	**15,817**	**1,265**

As part of the ICAAP, the Bank considers various market risk factors where the Pillar 1 capital requirements may not be sufficient. Additional capital may be needed for foreign exchange risk, interest rate risk in the banking book which includes indexation risk, and the risk that a prolonged stressed period leads to losses from trading book activities.

5.5 Foreign Exchange Risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to imbalances between assets and liabilities for different currencies.

Figure 5.1 Development of the Bank's Currency imbalance [ISK bn]

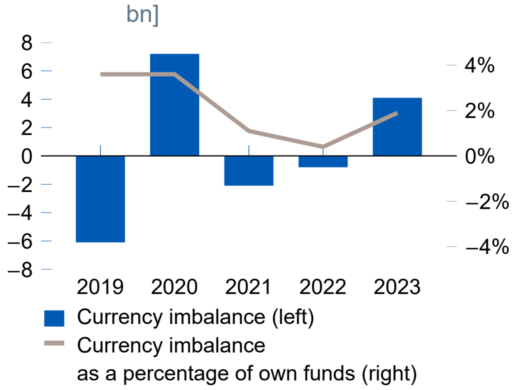


Table 5.4 Net position of assets and liabilities by currency and Value-at-Risk results

Foreign currency [ISK m]	Net Exposure	10 day 99%VaR
EUR	4133	111
USD	-24	1
DKK	582	16
SEK	-449	20
Other	-96	7
Diversification	-	-44
Total	**4146**	**111**

At year-end 2023, the Group's currency imbalance was 1.9% of total own funds. According to the Central Bank's rules No. 784/2018, the currency imbalance may not exceed 10% of total own funds or ISK 25bn, whichever is lower.

5.6 Indexation Risk

Indexation risk is defined as the risk of loss in earnings due to movements in the Consumer Price Index (CPI), i.e. inflation or deflation. A considerable part of the Bank's balance sheet consists of indexed assets and liabilities, the value of which is directly linked to the CPI. This risk factor should not be mistaken for inflation risk which represents the risk of loss in real value due to inflation.

At year-end 2023, the total amount of CPI-linked assets was ISK 397.8 billion and the total amount of CPI-linked liabilities was ISK 292.5 billion. Therefore, the net CPI-linked imbalance was ISK 105.3 billion.

The indexation imbalance of the Bank's consolidated situation, which excludes insurance operations, and is the scope of prudential requirements for which these disclosures apply, was ISK 90.3 billion at year-end 2023.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. In the period from 2014 to 2020 inflation was around or below the Central Bank of Iceland target inflation of 2.5%. In 2021, inflation started rising again and peaked at 10.2% in February 2023. Inflation has since decreased and measured 7.7% at year-end 2023. The Bank measures its capital requirements due to indexation risk in conjunction with interest rate risk as inflation is a dominant factor in the dynamics of interest rates and therefore cannot be viewed independently.

Figure 5.2 Development of the Bank's Indexation imbalance [ISK bn]

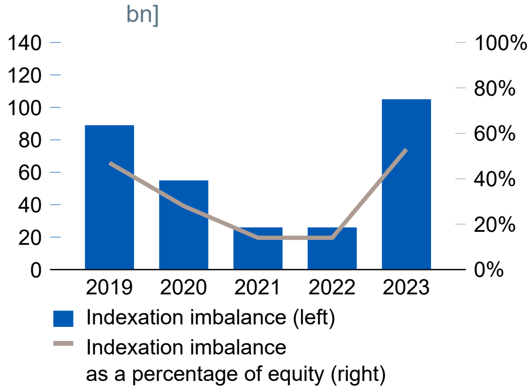
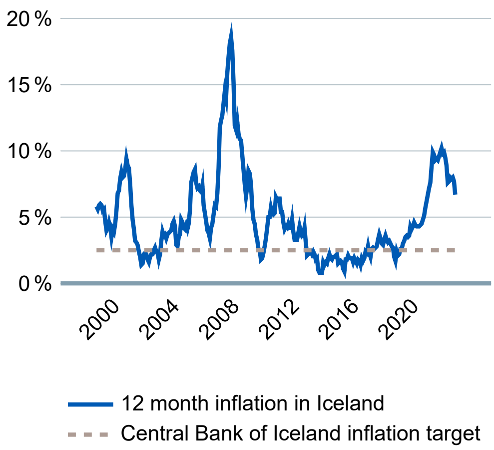


Figure 5.3 12-month inflation in Iceland



5.7 Interest Rate Risk in the Banking Book

Interest rate risk is the risk of loss through changes in fair value or net interest income caused by changing interest rates. The Bank's balance sheet is subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods. A substantial part of liabilities such as deposits have floating interest rates while assets in general have longer fixing periods.

The Bank's strategy for managing interest rate risk is to strive for a balance in the interest-fixing profile between assets and liabilities.

The Bank's interest rate risk for foreign currencies is limited as foreign-denominated assets predominantly have short fixing periods and the Bank generally applies cash flow hedging for its foreign-denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common.

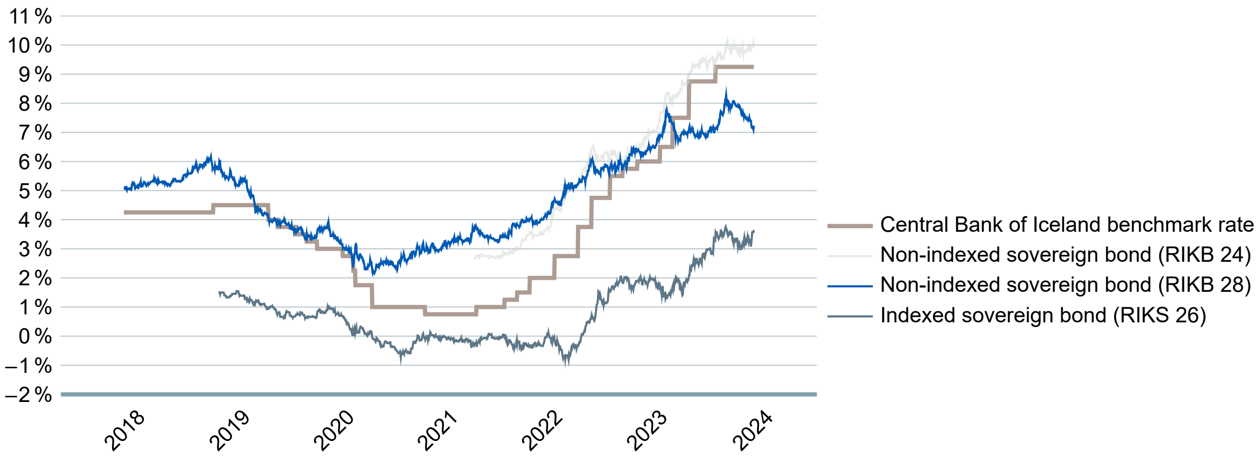
For a breakdown of the Bank's interest-bearing assets and liabilities by interest-fixing periods, see Note 45 of the Consolidated Financial Statements.

Prior to and during the COVID-19 pandemic, as interest rates declined and refinancing conditions improved, there was a surge in prepayments and loan refinancing. Many customers shifted from fixed-rate to floating-rate loans, leading to a reduction in the average duration of the Bank's assets and putting pressure on the Bank's net interest income due to tighter margins on deposit funding. However, following the pandemic, interest rates rose, and many customers quickly moved back to fixed-rate loans, which increased the average duration of the Bank's assets and increased the Bank's interest rate risk for nominal rates.

As the Central Bank policy rate increased from 0.75% to 9.25% from mid-2021 to August 2023, the appetite for fixed-rate loans has receded significantly. This has resulted in a decrease in the average duration and lower interest rate risk for nominal rate assets. Now as the payment burden has become heavier for non-indexed floating-rate loans and inflation concerns subside, demand for indexed loans has increased, as these offer lower monthly payments.

The Bank's balance sheet is subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods

Figure 5.4 Development of the Central Bank of Iceland benchmark rate and yields of sovereign bonds



Figures 5.5 to 5.6 show the Bank's interest fixing profile for the Bank's mortgages to individuals and covered bonds, indexed and non-indexed.

Figure 5.5 Interest fixing profile of the Bank's indexed mortgages and covered bonds [ISK m]

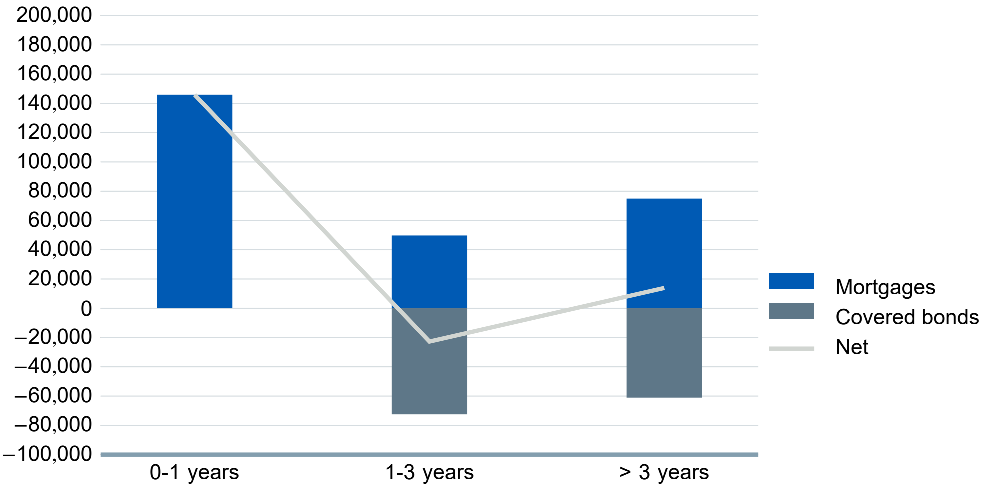


Figure 5.6 Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]

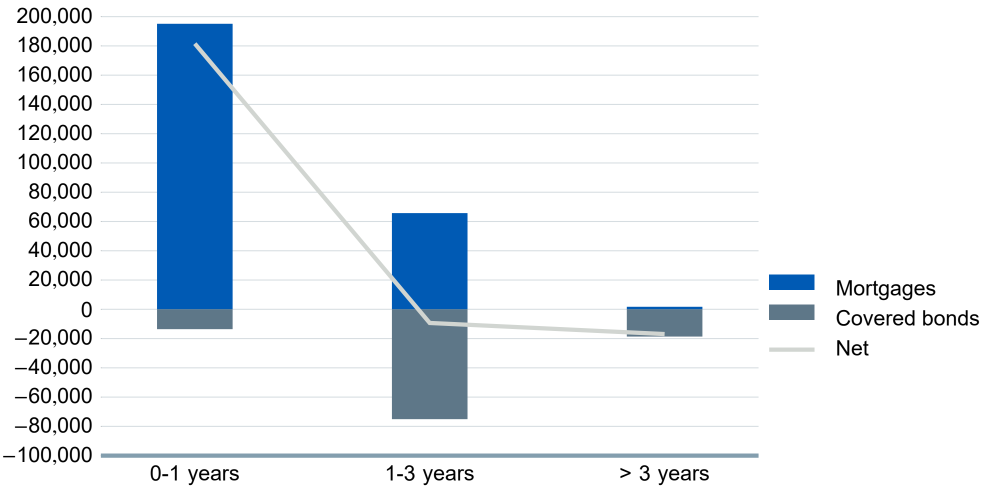


Table 5.5 shows the fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched liabilities and the expected behavior of non-maturing deposits. For non-maturing deposits, the longest repricing maturity is 3 years and the average repricing maturity of core non-maturing deposits is 1.5 years. Note that the Bank's book value is not affected in the same way as the fair value. Fixed rate loans rose in response to the low interest rates observed in 2020 and 2021. However, with the sharp increase in interest rates in 2022 and 2023, the Bank has become increasingly mindful of the sensitivity to fair value changes.

Table 5.5 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book by interest rate base

	2023		2022	
31 December [ISK m]	-100bps	+100bps	-100bps	+100bps
ISK, CPI index-linked	-1,855	1,721	-1,994	2,782
ISK, Non Index-linked	-1,487	1,462	-1,106	886
Foreign currencies	-418	416	-36	32

In EBA Guidelines EBA/GL/2018/02, six supervisory shock scenarios are defined for changes in interest rates. These are called *parallel up*, *parallel down*, *flattener*, *steepener*, *short rates up*, and *short rates down*. Template EU-IRRBB1 shows the effect these shocks would have on the net fair value of the Bank's assets and liabilities and the Bank's net interest income should they occur. New guidelines on IRRBB and regulatory technical standards on IRRBB standardized approach and supervisory outlier tests have been developed by the EBA based on authority granted in CRD V. They are based on the same principles as the current guidelines and will form the basis for the SREP assessment for IRRBB.

The capital assessment for interest rate risk in the banking book for domestic rates is calculated through simulations of nominal and real yield curve movements and the value of the CPI. The dynamics between interest rates and the CPI are calibrated to historical data and economic fundamentals. Significant diversification is observed due to the relationship between inflation and interest rates. Prepayment rates are dynamic in the model as changing interest rates affect customers' repayment spreads. Economic capital is the 1% worst loss due to fair value losses and loss to net interest income due to changes to the CPI. For foreign currencies, the Bank applies a 200bps shock interest rate hike.

5.8 Trading Book

The trading book is defined as the Bank's positions held with trading intent, which includes market making and proprietary trading positions as well as non-strategic derivatives positions and associated hedge positions. The purpose of strategic derivatives is to reduce imbalances on the balance sheet and hedge against market risk. Non-strategic derivatives are offered to the Bank's customers to meet their investment and risk management needs. Financial instruments in the trading book are exposed to price risk, i.e. the risk of possible losses from adverse movement in the market prices at which securities in the Bank's possession are valued.

Market Making and Proprietary Trading

Securities positions in relation to the Bank's market making and proprietary trading activities are shown in Table 5.6.

Table 5.6 Positions within the Bank's market making activities and proprietary trading

31 December [ISK m]	2023	2022
Bonds	7,377	4,547
Equity	3,115	1,651
Total	**10,492**	**6,198**

Market making and proprietary trading are subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD, and trader. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2023 average and maximum exposure in both equity and bonds.

Table 5.7 The Bank's proprietary trading exposure

	Bonds		
31 December 2023 [ISK m]	Long	Short	Net
Year-end	7,438	-61	7,377
Average	7,634	-114	7,521
Maximum	9,741	-1,473	9,741

	Equity		
31 December 2023 [ISK m]	Long	Short	Net
Year-end	3,115	0	3,115
Average	2,317	-5	2,312
Maximum	3,660	-49	3,660

Trading Derivatives

The Bank's derivative operation is twofold: a) a trading operation where the Bank offers a variety of derivatives to customers to meet their investment and risk management needs and b) a strategic operation where the Bank uses derivatives to hedge various imbalances on its own balance sheet in order to reduce risk such as currency risk.

Trading derivatives are subject to a rigid limit framework where exposure limits are set per customer, per security, per interest rate etc. Forward contracts on securities are traded within Capital Markets and bear no direct market risk since they are fully hedged. Commodity swap agreements are also fully hedged. Derivatives for which the Bank takes on market risk are traded within Treasury and are subject to interest rate limits per currency and an open delta position limit for each underlying security.

Table 5.8 Derivatives on the trading book

31 December 2023 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	135	308	178	130	30,239	Market risk
Interest rate and exchange rate agreements	4	4	67	-63	938	Market risk
Bond swap agreements	24	67	50	16	2,070	Credit risk
Share swap agreements	516	3,062	1,029	2,033	24,766	Credit risk
Commodity swap agreements	19	15,505	15,280	225	69,720	Credit risk
Options	4	1	1	0	18	Market risk
Total	**702**	**18,947**	**16,606**	**2,341**		

31 December 2022 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	179	2,297	57	2,24	43,312	Market risk
Interest rate and exchange rate agreements	14	29	153	-124	9,169	Market risk
Bond swap agreements	31	272	14	259	6,340	Credit risk
Share swap agreements	550	3,693	974	2,719	27,966	Credit risk
Commodity swap agreements	19	15,505	15,505	0	69,720	Credit risk
Options	2	0	0	0	6	Market risk
Total	**795**	**21,796**	**16,703**	**5,094**		

Counterparty credit risk is the risk of the Bank's counterparty in a derivative contract defaulting before final settlement of the derivative contract's cash flows. This risk is addressed in section 4.7.

Trading Book Risk

The trading book's profit or loss is calculated daily. Table 5.9 shows the 10-day 99% Value-at-Risk for the trading book position at the end of 2023, based on historical data collected over the previous 250 business days. The risk of loss is calculated for each instrument and portfolio within the trading book, as well as for the aggregate portfolio. Loss due to currency risk is not taken into account in the loss distribution as it is addressed in the Bank's VaR calculations for currency risk which covers both the banking book and the trading book.

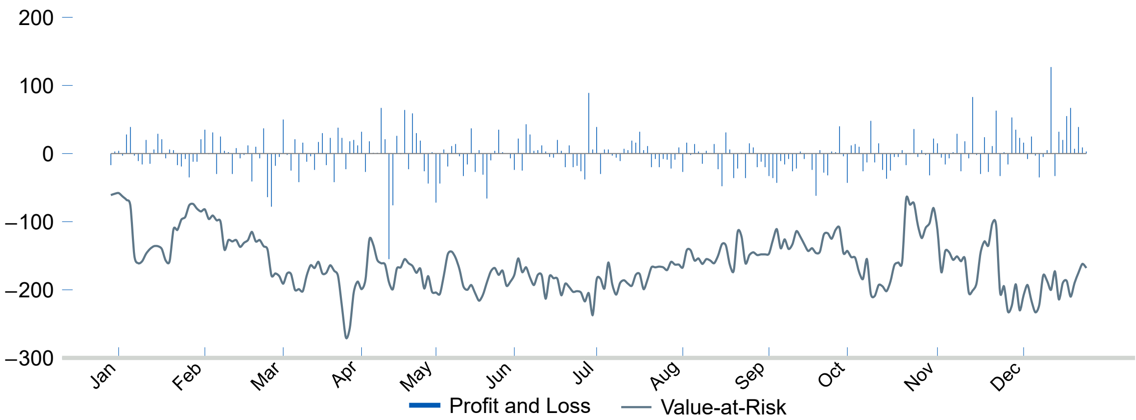
Table 5.9 Value-at-Risk for the trading book with a 99 percent confidence level over a 10-day horizon

31 December 2023 [ISK m]	10 day 99%VaR
Equities	233
Equity options	0
Bonds	446
Bond options	0
Interest rate swaps	4
Diversification effects	-151
Trading book Total	**531**

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 531 million over a 10-day period.

Figure 5.7 further shows the daily profit and loss of the Bank's trading book for 2023 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss never exceeded the VaR during the 250 business days, but exceeding 2.5 times is to be expected by the risk measure.

Figure 5.7 Backtesting of the Bank's one-day 99 percent Value-at-Risk for 2023 [ISK m]



6 Liquidity Risk

Liquidity risk is the current or prospective risk that the Bank, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can only secure them at excessive cost. Liquidity risk arises from the inability to manage unplanned changes or loss of funding sources.

An important source of funding for the Bank is deposits from individuals, corporations, and institutional investors. As the maturity of loans generally exceeds the maturity of deposits, the Bank is exposed to liquidity risk.

6.1 Governance and Policy

The Bank's liquidity and funding policy and related risk appetite statements are established by the Board of Directors and reviewed annually.

In accordance with the liquidity and funding policy, the Bank's CEO has set up a liquidity and funding framework, which outlines responsibilities, strategy, and methods in relation to the Bank's liquidity and funding risk. On the management level, ALCO is the principal authority for management and monitoring of liquidity and funding.

According to the liquidity and funding policy, the Bank follows a conservative approach to liquidity exposure, liquidity pricing, and its funding requirement. The Bank maintains a sufficient level of liquid assets to meet expected and unexpected cash flows and collateral needs, without it having adverse financial impact on the Bank. The Bank shall have a funding profile that supports its liquidity profile and allows the Bank to withstand extended periods of stress without reliance on volatile funding or external support. The Bank manages its asset and liability mismatches, seeks a balanced maturity profile, and diversifies its funding between deposits and wholesale funding.

At year-end 2023, Arion Bank's strong liquidity position was reflected in the LCR values, namely 192%, 828% and 117% for total, EUR and ISK respectively

6.2 Liquidity Risk Management

Liquidity risk is a key risk factor and emphasis is placed on managing it. The Bank's liquidity risk is managed by Treasury on a day-to-day basis and monitored by Risk Management. Treasury provides all divisions with funds for their activities in exchange for an internal interest charge. A small part of the Group's total liquidity risk is due to subsidiaries, all of which have their own liquidity management.

ALCO is responsible for liquidity management conforming to the policies and risk appetite set by the Board. The committee meets at least monthly to review liquidity reports and make strategic decisions on liquidity and funding matters.

Liquidity risk is controlled by limit management and monitoring. Active management of liquidity is only possible with proper monitoring capabilities. An internal liquidity report is issued daily for Treasury and Risk Management staff and at ALCO meetings monthly, liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, stress tests, and any relevant information or risk management concern regarding liquidity and funding risk.

For best practice liquidity management, the Bank follows the FSA's *Guidelines for Financial Institutions' Sound Liquidity Management*, No. 2/2010, which are based on *Principles for Sound Liquidity Risk Management and Supervision*, issued by the Basel Committee in 2008.

Internal Liquidity Adequacy Assessment Process

In conjunction with the ICAAP, see Section 3.3, the Bank runs the Internal Liquidity Adequacy Assessment Process (ILAAP) with the purpose of assessing the Bank's liquidity position. The ILAAP is carried out in accordance with the Act on Financial Undertakings with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure and manage the Bank's liquidity risk.

The Bank's ILAAP report is approved annually by the Board of Directors, the CEO, and the CRO and submitted to the FSA. The FSA reviews the Bank's ILAAP report as part of the SREP.

Contingency Plan for Liquidity Shortage

The Bank monitors its liquidity position and funding strategies on an on-going basis, but recognizes that unexpected events, economic or market conditions, earning problems, or situations beyond its control could cause either a short or long-term liquidity crisis.

The Bank's Contingency Plan for Liquidity Shortage is continuously active and the contingency level is reviewed at ALCO meetings monthly, based on various analyses and stress tests. ALCO reviews a liquidity risk report from Risk Management and receives projections on sources of funding and the use of funds from Treasury.

The contingency plan is linked to the Bank's Recovery Plan which is triggered if recovery indicators indicate a possible recovery situation. In adverse circumstances, the Bank's emergency team takes over control from ALCO.

6.3 Liquidity and Funding Risk Measurement

In December 2010, the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and standardize liquidity risk measurements between banks.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions over a period of 30 days. Different outflow weights are applied to each deposit category and the measure is thus dependent on the stickiness of each bank's deposit base. The ratio is therefore comparable throughout the banking sector. The LCR is the Bank's key risk indicator for short-term liquidity.

While the focus of LCR is on short term liquidity, the NSFR is aimed at requiring banks to maintain an overall stable funding profile. In the context of NSFR, funding with maturity greater than one year is considered stable. Different weights are applied to funding with shorter maturities depending on the type of funding. The aggregated weighted amounts are defined as the Available Stable Funding (ASF). Similarly, on-balance and off-balance sheet items on the asset side are weighted differently, depending on their liquidity and maturity, to form a bank's Required Stable Funding (RSF) under NSFR. The ratio of the two gives the NSFR.

According to the Central Bank's Liquidity Coverage Requirements for Financial Institutions, effective 1 January 2023, the Bank must maintain a minimum Liquidity Coverage Ratio (LCR) Total of 100% and a minimum LCR in ISK of 50%. Additionally, there are specific requirements regarding the LCR in EUR whereby the Bank must maintain a minimum LCR EUR of 80% if its liabilities in EUR constitute 10% or more of its overall liabilities.

The Bank is required to maintain a minimum of 100% for NSFR in total and to monitor the NSFR in significant currencies, i.e currencies having at least 5% share of the their total liabilities.

In addition to these regulatory requirements, the Bank monitors and reports its LCR for currencies for which aggregate liabilities exceed 5% of its total liabilities. The Bank reports the LCR and NSFR measures to the Central Bank of Iceland on a monthly basis.

In addition to using LCR and NSFR for liquidity and funding measurement, the Bank performs various analyses, including liquidity survival horizons and stress tests in relation to the concentration of deposits.

6.4 Liquidity Position

At year-end 2023, the Bank's liquidity buffer amounted to ISK 252,424 million, or 17% of total assets and 32% of total deposits. Composition of the Bank's liquidity buffer is shown in Note 46 of the Bank's Consolidated Financial Statements.

The Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, 192%, 828% and 117% for total, EUR, and ISK, respectively.

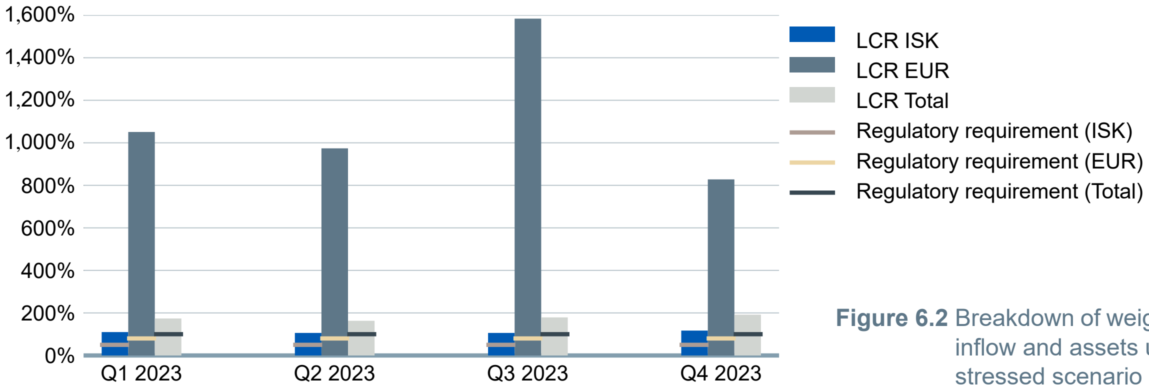
Table 6.1 Liquidity Coverage Ratio

31 December 2023	ISK	EUR	Total
Liquidity Coverage Ratio	117%	828%	192%
LCR Central Bank requirements	50%	80%	100%

The Bank maintained a strong liquidity position throughout 2023, both in EUR and in total, with an LCR well above the regulatory minimum of 80% and 100%. The development of LCR ISK, LCR

EUR and Total LCR is shown in figure 6.1. Standardized disclosure on the calculation of the LCR are provided in template EU LIQ1.

Figure 6.1 Development of the Bank's LCR



Breakdown of LCR

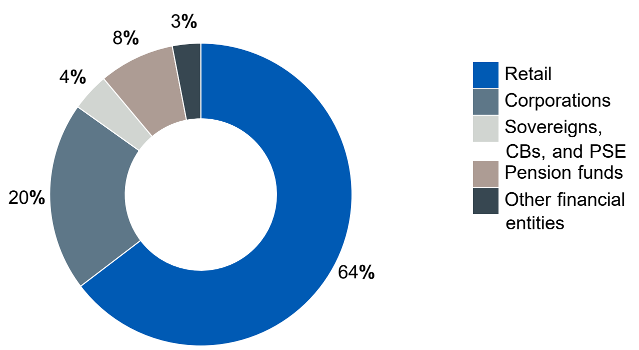
At 31 December 2023, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 298,754 million, substantially exceeding the weighted outflow of ISK 177,926 million. Of the total stressed outflow, ISK 164,787 million are due to deposits which are further analyzed in the following section. Figure 6.2 further shows the contribution of the Bank's main components to the LCR's weighted outflows, inflows, and assets.

Deposit Categories

As per the LCR methodology, the Bank's deposit base is categorized based on the type of deposit holders. Deposits are also classified as stable or less stable based on business relations and insurance scheme coverage. Each category is given an expected outflow weight based on stickiness, i.e. the likelihood of withdrawal under stressed conditions.

At year-end 2023, 64% of the Bank's deposit base is due to retail clients. The Bank has placed emphasis on increasing its retail deposit base. Figure 6.3 shows the distribution of the Bank's deposit base.

Figure 6.3 Distribution of deposits by LCR categories at year-end 2023



Concentration of Deposits

As seen in Figure 6.5, 73% of the Bank's deposits mature within 30 days. At year-end 2023, 15% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors as shown in

Figure 6.2 Breakdown of weighted outflow, inflow and assets under LCR's stressed scenario as of 31 December 2023 [ISK m]

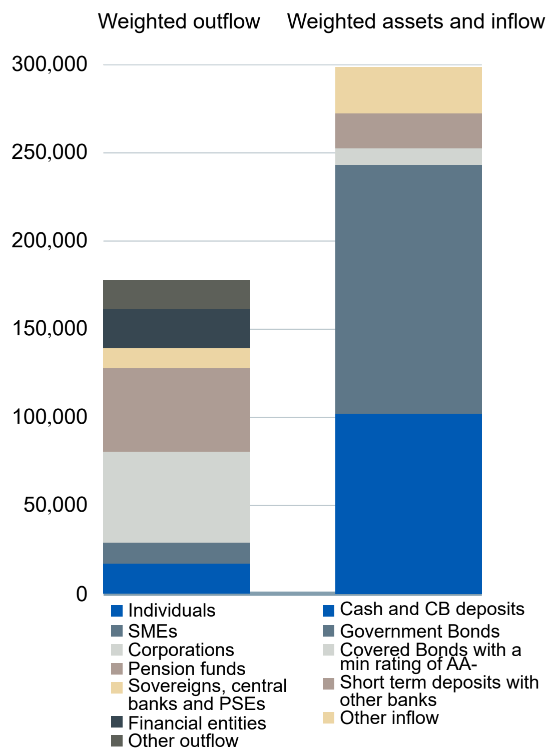


Figure 6.4.

Figure 6.4 Concentration of deposits on demand within 30 days

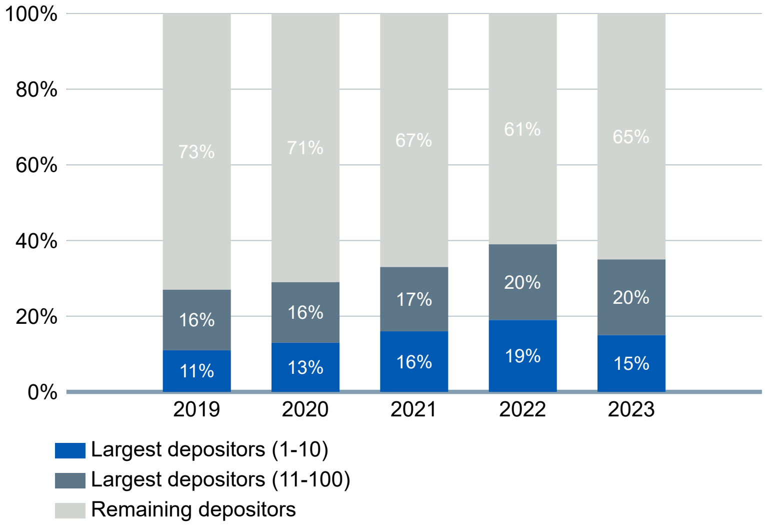
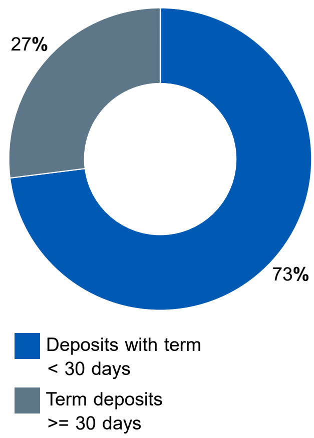


Figure 6.5 Deposit term distribution



6.5 Funding

Over the past few years, the Bank has taken significant steps to diversify its funding options, issuing green bonds in EUR and ISK and issuing covered bonds in euros. The Bank pursues prudent funding and liquidity management strategies which is reflected in the Bank's strong liquidity ratios and steady maturities of long-term debt over the next few years.

In May 2023, Arion Bank issued EUR 300 million senior preferred notes with a maturity of 3 years. The notes pay a coupon of 7.25% which corresponds to a spread of 407 bps over mid-swaps. The issuance attracted strong demand from a diverse group of investors on the international bond market. Offers totalling approximately EUR 600 million were received from over 70 investors from more than 15 countries in Europe and Asia. The Bank simultaneously announced an invitation to holders of its outstanding EUR 300 million senior notes, due in May 2024, to tender their notes.

In the domestic market, the Bank issued a new bond series of senior preferred bonds in ISK. The new index-linked series, ARION 28 1512, sold for a total of ISK 8,740 million at a yield of 4.40%. It matures on 15 December 2028.

The Bank continued to issue covered bonds secured in accordance with the Covered Bond Act No. 11/2008. In 2023, the Bank issued bonds amounting to ISK 44.4 billion (of which ISK 22.6 billion were for own use).

Arion Bank renewed its agreement with Kvika, Íslandsbanki, and Landsbankinn on market making for covered bonds issued by Arion Bank on Nasdaq Iceland. The purpose of the agreement is to stimulate trading of benchmark-covered bonds issued by the Bank.

Moody's Investors Service rated Arion Bank's covered bonds for the first time. Arion Bank was assigned an Aa2 long-term rating for its euro-denominated covered bonds. The rating reflects the high credit quality of Arion Bank's covered bond pool, the strength of the Icelandic covered bond legislation, and the systemic importance of covered bonds. The covered bonds are governed under the Icelandic legal framework which is fully aligned with the EU harmonization directive and regulations. This is the highest rating of any Icelandic issuer.

Arion Bank's long-term issuer rating was upgraded from Baa1 to A3. Additionally, the long-term and short-term deposit rating was upgraded from A3/P-2 to A2/P-1. The outlook was changed from positive to stable. The upgrade of Arion Bank's ratings reflects the Bank's sustained performance in terms of profitability, capitalization, and strong asset quality as well as its shift towards a bancassurance business model over the past 18 months. Moody's assessment of the Bank's Environmental, Social, and Governance Risk Methodology has also been raised from G-3 to G-2. This reflects low governance risks following the Bank's improved financial strategy and risk management practices.

In May, S&P Global Ratings affirmed its BBB rating for Arion Bank and revised the outlook from stable to negative. In November, the outlook was revised back to stable. S&P has revised its rating for Arion Bank's covered bond programme from A to A+ with a stable outlook. The covered bond rating is now the same as that of the Icelandic government.

Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base continues to be an important funding source and the focal point of liquidity risk management. The ratio of loans to deposits was 145% as at 31 December 2023.

Figure 6.7 shows the development of the Bank's funding profile.

Figure 6.6 Development of loans to deposits

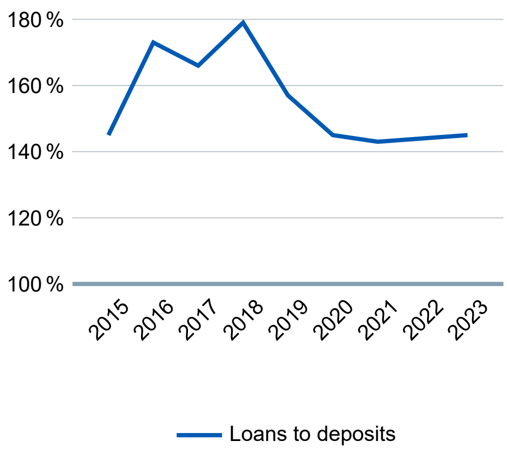
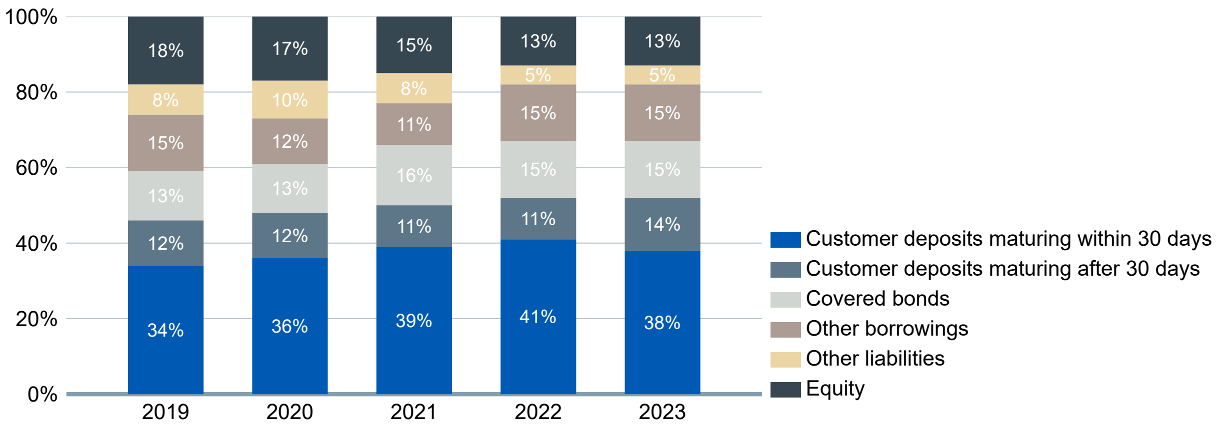


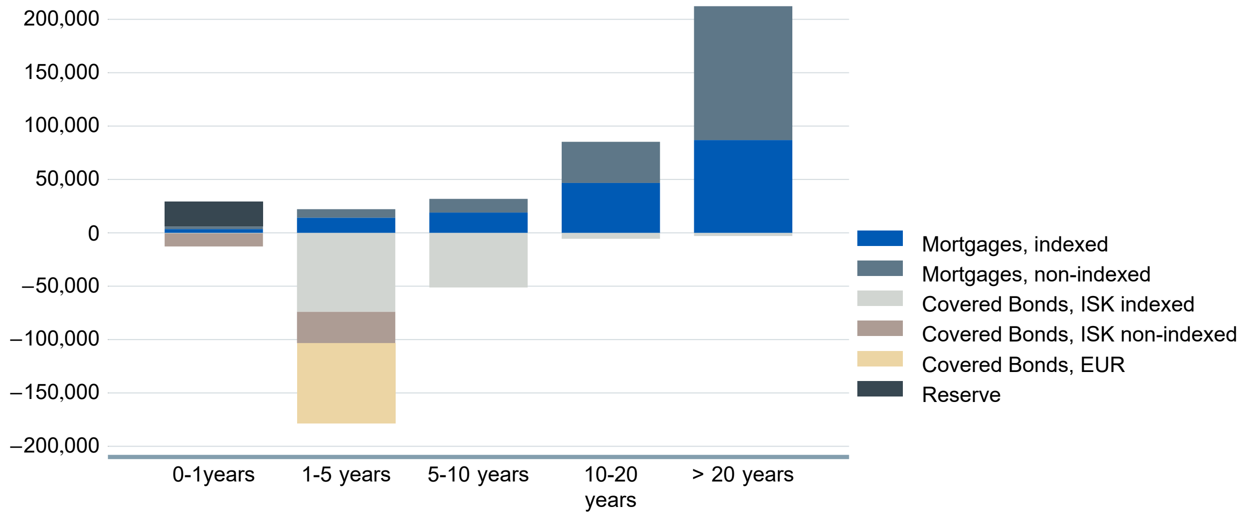
Figure 6.7 Development of funding by type



Secured Borrowings

At year-end 2023, the Bank had an outstanding amount of covered bonds totalling ISK 233 billion. Figure 6.8 shows the contractual payment profile of the Bank's covered bonds and corresponding pledged mortgages. Note that the behavioral maturity of mortgages is generally much shorter than the contractual maturity.

Figure 6.8 Contractual cashflow profile of covered bonds and corresponding pledged mortgages [ISK m]



The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, was 21% at year-end 2023. The development of the asset encumbrance ratio is shown in Table 6.2.

Table 6.2 Development of the Bank's asset encumbrance ratio

31 December	2023	2022	2021
Asset encumbrance ratio	21%	19%	19%

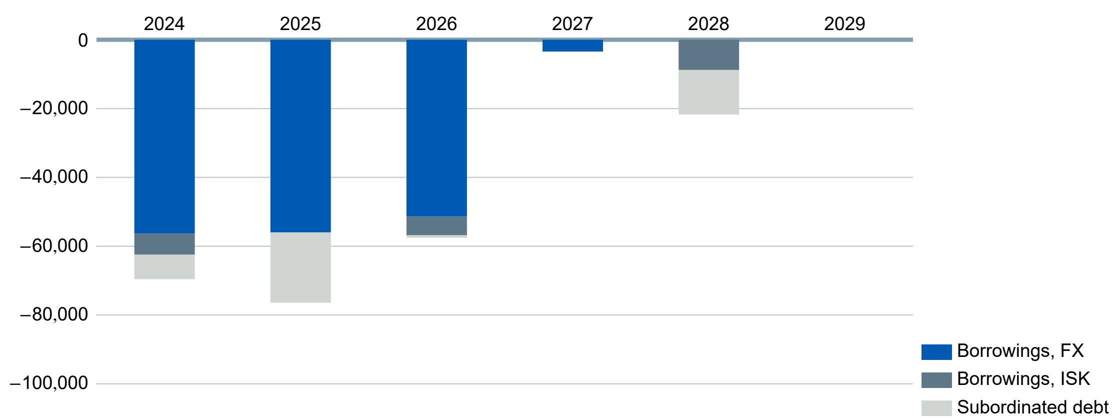
Templates EU AE1, EU AE2 and EU AE3 provide details on encumbered and unencumbered assets and collateral received.

Unsecured Borrowings

Unsecured borrowings are mostly foreign currency denominated. Figure 6.9 shows the Bank's maturity profile of borrowings other than covered bonds. The maturity dates for Tier 2 capital instruments are shown at the earliest callable date.

As the Bank's foreign currency deposits are effectively entirely covered by liquid assets, these other FX liabilities are a source of funding for loans to customers in foreign currency. The maturity of those liabilities is greater than that of the loans, so there is low maturity gap risk for the Bank's foreign currency position.

Figure 6.9 Maturity profile of borrowings, other than covered bonds [ISK m]



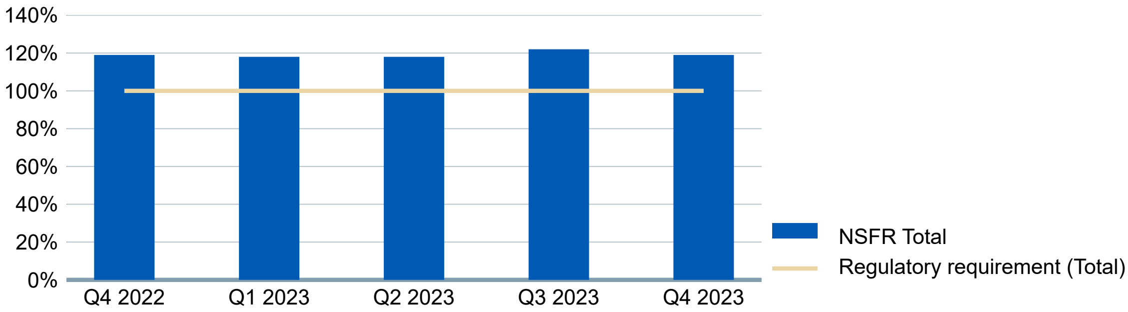
NSFR

The Bank's Net Stable Funding Ratio in all currencies (NSFR-Total) was 119% at year-end 2023, well above the regulatory minimum of 100%. The development of the NSFR over 2023 can be seen in Figure 6.10. Template EU LIQ2 provides details on ASF items and RSF items which are the basis for the calculation of the NSFR.

Table 6.3 Net Stable Funding Ratio

31 December 2023	Total
Net Stable Funding Ratio	119%
NSFR Central Bank requirements	100%

Figure 6.10 Development of the Bank's NSFR



7 Operational Risk

Operational risk is defined as the risk of direct or indirect financial loss or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events.

Operational risk is managed through a system of risk assessments, controls, loss event analysis, audits, and corrective actions, with a focus on key risk areas

Over the past years, the Group has put significant effort into the development of a comprehensive operational risk system and framework which has now been implemented. The goal was to identify and centrally register, in a comprehensive and systematic manner, the dependencies between risks, controls, operational deviations and corrective actions, in relation to products, services, systems, data assets, legal requirements, and processes. The framework supports the Bank in achieving its goals and highlights areas in its operations in need of specific attention to minimize the risk of direct or indirect loss.

7.1 Governance and Policy

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost-effective manner weighing cost and benefit. The Bank follows the Basel Committee's Principles for the Sound Management of Operational Risk. Operational risk is managed through a system of risk assessments, controls, loss event analysis, audits and corrective actions, with a focus on key risk areas. For all key risk areas, the Bank reduces its exposure to operational risk with a selection of internal controls, quality management, and with well trained and qualified staff.

The Bank's Operational Risk Policy and operational risk appetite are established by the Board of Directors and reviewed on an annual basis.

In accordance with the Operational Risk Policy, the Bank's CEO has set up an operational risk framework, which outlines responsibilities, rules and frameworks for operational risk arising from the Bank's operations. On the management level, the Operational Risk Committee (ORCO) is the principal authority for the management and monitoring of operational risk.

An operational risk report is generated by Risk Management monthly and presented to ORCO. The report gives an overview of relevant risk measures and compares them to the risk appetite as approved by the Board. The report covers operational and compliance risks, such as a summary of deviation events and major IT incidents, loss-data analysis, change management and net promoter score. Operational risk is also subject of the Bank's Risk Report, which is presented monthly to the Board Risk Committee and the Board of Directors.

The Bank applies the standardized approach for the calculation of capital requirements for operational risk.

7.2 Operational Risk Management

Each business unit is responsible for managing operational risks inherent to their operation by identifying, measuring and mitigating those risks. Risk Management and Compliance are responsible for developing and maintaining tools to identify, measure and mitigate risks. The internal control units monitor and report on the Bank's operational and compliance risks.

The Bank's operational risk management framework aims to integrate risk management practices in day-to-day operations by focusing on key risk areas. The risk structure is set up to enable the Bank to have a holistic and consistent overview of its risk profile and mitigating actions. As second line functions, Risk Management and Compliance serve as a partner to senior management, supporting and challenging them to align the business environment with the Bank's strategy to maximize potential return for the stakeholders in a cost-effective and risk-minded manner.

Arion Bank has implemented a framework for assessing operational risk based on the standard risk taxonomy developed by the Operational Riskdata eXchange Assocation (ORX), which is the largest operational risk management association in the financial services sector. ORX splits operational risks into 16 primary categories and 61 subcategories. The taxonomy includes legal risk, conduct risk and regulatory compliance. By implementing the ORX framework, the Bank has taken steps to further standardize other risk categories for risk assessment and analysis purposes.

The Bank maintains various insurance coverages for the group, its employees, and directors. The insurance coverage limits monetary loss caused by serious unexpected events, wrongful acts or legal liabilities that occur despite other operational risk management procedures.

The Bank applies the standardized approach for the calculation of capital requirements for operational risk

Risk assessment

Risk assessments are split into two categories: ad-hoc project risk assessments and regular operational risk assessments. Project risk assessments are conducted for all major projects and reviewed over the project lifecycle as part of the Bank's change management system. They are a part of the Bank's product approval process, overseen by the newly-established Operation & Culture division.

Operational risk assessments are conducted on a yearly basis starting with the ICAAP / ILAAP risk assessment process, followed by ad-hoc cross-functional assessments for key products, services and supporting processes. During the risk assessment process, the likelihood and magnitude of each risk is assessed as well as mitigating capabilities of the relevant controls. The risk level is determined based on financial and non-financial effects such as materiality thresholds, negative impact on the Bank's customers, reputational damage, and compliance failure. Possible mitigating actions are planned based on the overall inherent risk level.

Control framework

At a minimum, risks that have been identified through the risk assessment process as inherently significant or high are mitigated with controls. The controls are documented through individual control documentation, processes and procedures built on a uniform methodology to improve efficiency and increase standardization. The goal is to bring relevant risks to acceptable levels by enhancing risk awareness and mitigating activities.

Internal controls are designed to minimize losses from operational risk events to an acceptable level with the goal of optimizing operating efficiency. Furthermore, controls desgined to ensure compliance with laws and regulations and to deliver and gather reliable information on a timely basis. The Bank's controls are tested and monitored based on their significance.

The Bank's employees are ultimately responsible for registering deviation events. Risk Management maintains a platform for employees to register these events

Loss event analysis

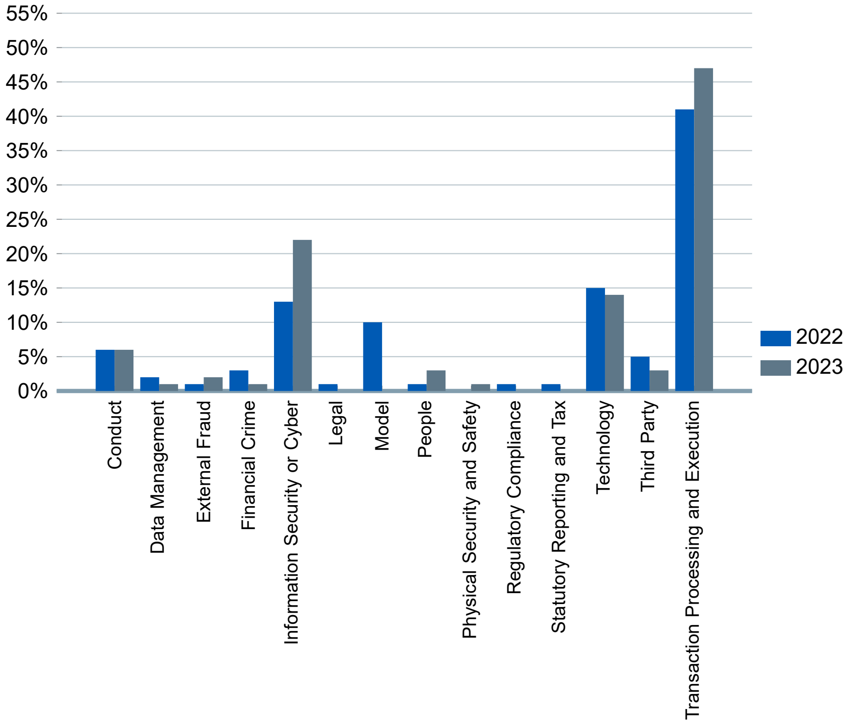
The Bank maintains an extensive database of operational deviations. Operational deviations are events that occur in the day-to-day operation which lead to direct or indirect monetary losses or events which could have caused monetary loss but did not - near-misses. Impact from these events can also be in the form of reputational or regulatory damages.

The Bank's employees are responsible for registering deviation events. Risk Management maintains a platform for employees to register these events. The Bank maintains a no-blame policy when it comes to deviation events.

Gathering information on these events provides meaningful information on the Bank's operational risk profile and the effectiveness of its internal controls. All events in the database are categorized as per the Bank's risk taxonomy and assigned to relevant business units. This categorization allows the Bank to better identify where the weaknesses within the operation may lie, both down to specific functions of the operations and business units. For severe events more detailed analysis is performed where the exact root cause of the event is identified to prevent the event from happening again.

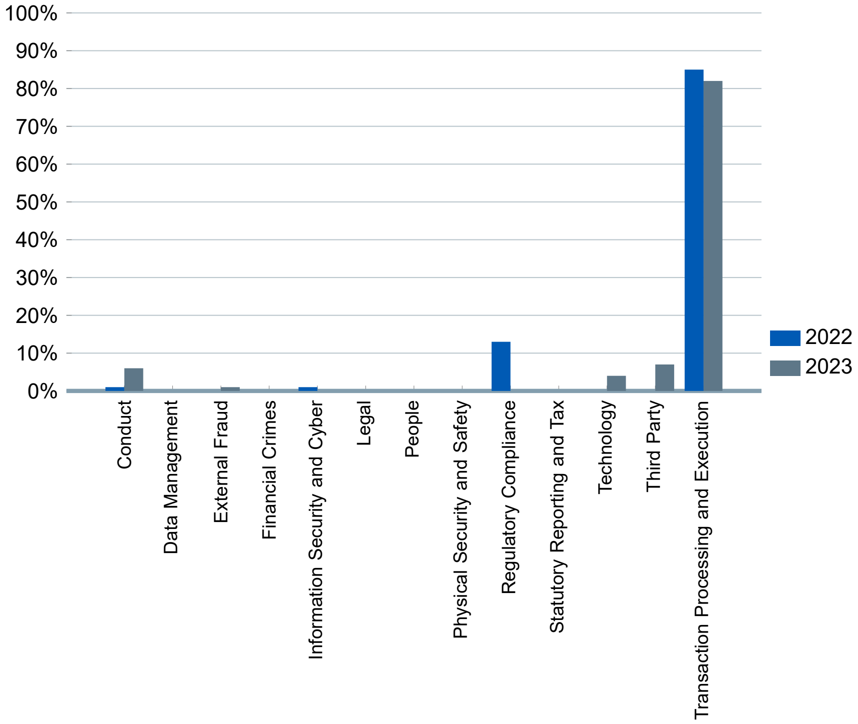
The two figures below show the comparison of registered events/monetary losses between 2022 and 2023 down to risk category.

Figure 7.1 Distribution of loss events by number, parent company



Operational Risk

Figure 7.2 Distribution of loss events by amount, parent company



Corrective actions

Any issues arising from the operational risk assessments, loss event analysis, control testing, findings resulting from internal or external audits, or regulatory demands are used to enhance the internal controls of the Bank and improve the Bank's operational risk profile. Once an issue has been identified and relevant corrective action determined, the work of implementing the action is assigned to a business unit. The business unit is responsible for the completion of the corrective action, while Risk Management and/or Compliance provide the business units with support and guidance.

Risk Management is responsible for providing a platform where the corrective actions can be stored, and their progress documented.

7.3 Primary Operational Risks

IT risk and cyber security

The Bank's information and cyber security practices are rooted in globally acknowledged and well-established security standards and frameworks. This approach is further strengthened though strategic collaborations with trusted partners and vendors specializing in information security. Equally important is the cultivation of a culture of security awareness among the Bank's employees.

Within the Bank, a risk-centric approach to information security services as the cornerstone of its strategy. This approach is designed to ensure seamless business continuity by safeguarding the confidentiality, integrity and availability of data, systems, and services. It is also dedicated to adhering to all relevant laws and regulations governing data security. To maintain the highest standards of security and compliance, the Bank has implemented the three lines governance model which serves as a robust framework that ensures the quality and effectiveness of the Bank's security practices and initiatives.

The Bank's Chief Security Officer is responsible for the supervision of both IT and security risks, as well as daily operations pertaining to the Bank's information security. Additionally, the ORCO is responsible for carrying out and upholding the Bank's security policies.

The management of information security risks adheres closely to the Bank's Information Security Management System (ISMS), which is based on industry best practices and recognized standards.

In the first half of 2023, the Bank successfully achieved ISO 27001:2022 certification, affirming the high quality of its data security management system. This certification validates the Bank's approach to mitigating risks associated with data asset security, demonstrating its commitment to adhering to best practices and principles outlined in the ISO standard.

The certification contributes to the Bank's work to ensure compliance with the Digital Operational Resilience Act (DORA). Using ISO 27001 controls and processes, the Bank can effectively map DORA's requirements, ensuring that its practices are in harmony with the regulation's stipulations. ISO 27001 encompasses a large range of controls and best practices for information security, many of which have direct relevance to the concept of digital operational resilience. These include key areas such as incident response, access control, business continuity, and data protection. By adopting and implementing these controls, the Bank is well-equipped to meet DORA's stringent security prerequisites.

Furthermore, adherence to the ISO standard fosters a culture of continuous improvement within the Bank's information security framework. The Bank's ISMS is key to this endeavour, facilitating ongoing monitoring, measurement, and review of security controls and practices. This allows the Bank to promptly identify areas for enhancement and to make necessary adjustments that improve its security posture. In doing so, the Bank remains committed to maintaining the highest standards of data security and operational resilience, in line with both ISO 27001 and DORA requirements.

Conduct and regulatory compliance

The Conduct and Compliance Policy sets out the principles and standards for conduct and compliance and the management of associated risks at Arion Bank.

Conduct risk is defined as the risk of any action of the Bank, or its representatives, leading to customer detriment or having adverse effect on market integrity, whereas compliance risk is defined as the risk of not complying with applicable rules and guidelines. The Bank has no tolerance for breach of compliance which is systemic, severe, repeated, intentional, or the result of gross negligence, nor misconduct that results in unfair outcomes for its customers, is likely to have material negative impact on market integrity, or the Bank's reputation.

The key processes for managing conduct and compliance risk are:

The Bank has a business continuity management system (BCMS) to ensure that critical operations can be maintained and recovered in a timely fashion in the event of significant operational disruption

Operational Risk

- A process for risk assessment, planning and reporting of conduct and compliance risk
- Suitable procedures and processes, including a detailed process for product development, whistleblowing, and for managing conflicts of interest
- Horizon scanning and change management process
- Providing staff with ready access to training and support on matters relating to conduct and compliance
- Monitoring and testing process.

Staff are expected to conduct themselves with integrity and perform their duties with due skill, care and diligence. Staff is also expected to promptly alert of any suspicion or knowledge of misconduct. Each business unit within the Bank is primarily responsible for managing the conduct and compliance risks inherent in their operation, with the Compliance function acting as a second line, providing support and challenge to the business units.

The Bank uses a risk-based approach for managing conduct and compliance risk. In addition to the regular operational risk assessments, the Bank performs an annual compliance risk assessment, assessing the relative importance of different legal requirements for the Bank's operations and the effectiveness of controls in place to ensure compliance. Based on this risk assessment, the Board of Directors approves an annual Compliance Plan to prioritize the Bank's risk mitigating measures.

The Compliance function provides quarterly compliance briefs to the Board Risk Committee on the execution of the Conduct and Compliance Policy, and an annual report to the Board of Directors.

- In 2023 the Icelandic Competiton Authority (ICA) and Arion Bank reached a settlement agreement, leading to a ISK 80 million fine imposed on the Bank due to a breach of an ICA Settlement Agreement from 2017, regarding a ban of collecting prepayment fees on loans with variable interests to individuals and small enterprises.

Further information on legal cases relating to Arion Bank can be found in Section 7.4, on litigation.

- Arion Bank was not denied registration, authorization, membership or permission to conduct certain business activities or operations during the year, nor was it subject to withdrawal, revocation or termination of registration, authorization, membership or permission. There were no issues relating to disclosure obligations in 2023
- In 2023, the Bank received no complaint concerning a data breach from the Data Protection Authority (DPA) or a third party. One individual sent a complaint to the DPA regarding the Bank's processing of his personal information. The bank sent its answer and comments to the DPA in October 2023. The matter is currently pending before the DPA. The Bank itself reported 10 incidents (2 of which concerned Vörður) to the Data Protection Authority where there was a breach of confidentiality. In all cases, the risk to an individual's rights and freedoms were minimal or limited. No incidents of theft or loss of personal data were reported during the year. Approximately 96% of employees completed a basic standard electronic personal data protection training during the year
- The FSA carried out an on-site inspection regarding AML/CTF

Each business unit within the Bank is primarily responsible for managing the conduct and compliance risks inherent in their operation at the Bank in 2022, with a final report received in April 2023. In the report, the FSA identified and reported deficiencies in the Bank's compliance with the relevant Act and regulations. In August 2023, the Bank requested that the matter be concluded by way of settlement. The matter is now pending with the FSA.

Financial crime

The Policy on Combating Financial Crime sets out the principles and standards for combating financial crime, i.e. money laundering and terrorist financing, financial sanctions, bribery and corruption. The Bank implements and upholds both domestic and internationally recognized standards in this regard.

The Bank uses a selection of measures to combat financial crime, including:

- A process for financial crime risk assessment, planning and reporting
- Suitable procedures and processes, including a detailed process for customer due diligence, and anti-bribery and corruption procedures
- Providing staff with ready access to training and support on matters relating to financial crime
- Monitoring and testing process, including sophisticated solutions for transaction monitoring, customer screening, and sanctions screening
- A process for reporting suspicious transactions and activities.

Staff are expected to remain aware of financial crime risk through participation in regular training, and to promptly report any suspicious behaviour or transactions. Approximately 98% of employees completed mandatory AML/CTF training during the year.

Each business unit within the Bank is primarily responsible for managing the financial crime risk inherent in its operation. The Compliance function is responsible for providing complementary expertise and support, and for coordinating, monitoring and assessing the Bank's AML/CTF measures.

The Bank uses a risk-based approach for managing financial crime risk. In addition to the operational risk assessments, the Bank performs a holistic financial crime risk assessment, taking into account different risk factors relating to geography, customers, products and technology, and delivery channels, as well as the Icelandic National Risk Assessment.

The Compliance function provides quarterly compliance briefs to the Board Risk Committee on the status of the execution of the Policy on Combating Financial Crime, and an annual report to the Board of Directors.

In line with regulatory requirements, the Bank has in place a policy on internal alerts which applies to any suspected irregularity, involving employees, directors, shareholders, vendors, contractors, or any party who perform duties on behalf of the Bank. Via specialised whistle-blower software, employees are anonymously able to raise their concerns in this regard. Compliance is responsible for implementing and maintaining the necessary controls and procedures, and for maintaining awareness through training.

E-training on the Bank's anti-corruption measures is available for all staff and annual participation is mandatory for certain groups of employees whose tasks are considered to pose higher risks in this regard.

Internal Audit has the primary responsibility for investigating suspected fraudulent acts or suspicious malpractices, and issues reports to the appropriate personnel, and, as appropriate, to the Board Audit Committee.

7.4 Litigation

Litigation is not uncommon in the banking industry due to the nature of the business. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank adjusts the account for any adverse effects the claims may have on its financial standing. The Bank assesses capital need in relation to litigations as part of ICAAP and holds additional capital for exceptional cases.

The largest cases concerning the Bank and possible impact on its financial position can be put into two categories: a) court cases and b) cases before supervisory authorities. To the Bank's knowledge, no administrative procedures are pending or under investigation by supervisory authorities. One case in particular warrants a review:

In April 2020, the Bank received a letter from the Consumers' Association of Iceland. The letter, which was also delivered to Landsbanki and Íslandsbanki, claimed that contractual terms on variable rate mortgages to individuals were illegal due to lack of transparency and predictability of interest rate decisions. The letter called for revised terms and compensation to borrowers who, according to the Association, have suffered damages. In light of these claims, the Bank conducted a review of its terms and processes for interest rate decisions, concluding that no changes were required and that the Association's claims against the Bank are unfounded. According to information published on the Consumer Association's website, all three banks have rejected the Association's claims. In May 2021, the Consumers' Association issued an article on its website calling for participants in a class action lawsuit. The intention is to commence court proceedings against Icelandic credit institutions to provide court precedents for loans with variable rates. Arion Bank has received information requests from a legal firm representing approximately 1200 individuals, of which 378 are borrowers of Arion Bank. One case has been filed against the Bank and with a judgement of the District Court of Reykjavík on the 7th of February 2023 the Bank was acquitted. The plaintiffs have appealed the judgement. Considering the District Court's judgement as well as an external opinion, commissioned by the Bank on its legal position, the Bank believes it likely that it will be acquitted of the claims on appeal.

In 2023, there were some legal matters or unresolved legal claims that were considered contingent liabilities. A further description of these cases can be found in Note 37 in the Consolidated Financial Statements for 2023.

8 Sustainability Risk

Sustainability risk is defined as the risk that certain activities or practices compromise the Bank's assets or reputation or the ability of future generations or segments of society to meet their own needs. This can be due to negative effects on the environment, natural or cultural resources, or social conditions.

The Bank is exposed to risks in relation to environmental, social, and governance (ESG) factors, directly through its own operations and indirectly through financial services provided to its clients.

This chapter is prepared with a view to the EBA's implementing standards on prudential disclosures on ESG risks in accordance with Article 449a in CRR and recommendations from the Task Force on Climate-related Financial Disclosures (TCFD).

The Bank seeks to ensure that its activities and the financial services it provides do not result in an unacceptable impact on people or the environment, and is committed to supporting the global effort to transition to a net zero carbon economy

8.1 Overview

Sustainability risk is defined in the Bank's Enterprise Risk Management framework as the risk of certain activities or practices compromising the Bank's assets or reputation or the ability of future generations or segments of society to meet their own needs, e.g. due to negative effects on the environment, natural or cultural resources or social conditions.

Sustainability risk is not a fully stand-alone risk type, and may increase the severity or likelihood of other financial and non-financial risks faced by financial institutions, such as compliance risk, market risk, and credit risk. For this reason, sustainability risk must be embedded in the Bank's risk management framework and its processes, rather than being considered in isolation.

Regulatory developments

On June 1 2023 Act No. 25/2023 on sustainable finance disclosure and taxonomy for sustainable investment came into force in Iceland. The act transposed into Icelandic law two EU regulations. Firstly, Regulation (EU) 2019/2088 on Sustainable Financial Disclosure (SFDR); and secondly Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (Taxonomy Regulation).

The Taxonomy Regulation, which partly came into effect in the EU on 12 July 2020, and came fully into effect on 1 January 2023, establishes a harmonized European taxonomy with definitions of what are to be considered environmentally sustainable economic activities. The aim is to allow financial market participants and issuers to:

- use a coherent approach and metrics to measure environmental characteristics,
- enhance investor confidence,
- raise awareness of the environmental impact of financial products or corporate bonds, and
- create visibility and address "greenwashing" concerns.

The Green Asset Ratio (GAR) is a key performance indicator for credit institutions. The indicator shows the ratio of a financial institution's assets which finance an economic activity aligned to the EU Taxonomy, i.e. assets considered environmentally sustainable, as a ratio of total covered assets under Delegated Regulation (EU) 2021/2178.

In 2023 total covered assets (assets in-scope for GAR calculations) were 88.8% of total assets on the Bank's balance sheet. Of the total covered assets 41.7% is considered eligible. Loans to households, i.e. residential mortgages and car loans, represent the majority of assets considered eligible under the Taxonomy Regulation today.

Implementation in Iceland

The regulation stipulates that credit institutions should use counterparties' data and KPIs to calculate their own KPIs (EU Taxonomy-eligibility and alignment). The Bank's counterparties which come under the scope of the legislation are, like the Bank, disclosing information on the EU Taxonomy for the first time in 2024 in the 2023 annual financial statements. This means that the data required to calculate the Green Asset Ratio covered by the EU Taxonomy, and to what extent these assets are considered environmentally sustainable, is not yet available. Furthermore, buildings in Iceland generally do not have Energy Performance Certificates (EPC) nor is Primary Energy Data (PED) available which is required, amongst other criteria, to demonstrate compliance with the technical screening criteria of the EU Taxonomy.

Buildings in Iceland do not generally have Energy Performance Certificates nor is Primary Energy Data available

As a result of this lack of available data, the Bank's GAR is presented as 0% in this iteration of reporting.

EU Taxonomy reporting

On 18 January 2024, the Icelandic Register of Annual Accounts announced limited exemptions, applicable to financial institutions only, from requirements to publish information defined in Annexes to the Taxonomy Regulation. The exemption has been granted due to a lack of necessary information, as the sequencing of implementation has eliminated the necessary gap between reporting from non-financial companies, the output of which is required for financial institutions' reporting, and the financial institutions' own reporting. The Bank's Taxonomy-based reporting is available as part of the its annual financial statements for 2023 on the Bank's website.

In an annex to the Pillar 3 report, the Bank discloses three quantitative templates with EU Taxonomy-related information in line with the EBA ESG Pillar 3 package. Due to lack of data the reporting of KPIs is very limited for the year 2023.

Task Force on Climate-related Disclosures (TCFD)

For the past three years the Bank has made use of the recommendations of the Task Force on Climate-related Disclosures (TCFD) to gain a better overview of the risk related to climate change. The Bank formally became a signatory to TCFD in February 2022.

In 2023 the Financial Stability Board announced that the work of the TCFD has been completed and the IFRS Foundation has taken over the monitoring of the progress of companies' climate-related disclosures. IFRS S1 and IFRS S2 fully incorporate the recommendations of the TCFD.

Given that the TCFD has now disbanded the list of supporters is no longer active. When developing the implementing technical standards (ITS), the EBA has built on the Financial Stability Board's TCFD recommendations among other things.

Double materiality assessment

In 2023, the Bank took its first step towards implementing the European Sustainability Reporting Standard, which forms part of the requirements for the forthcoming transposing of the Corporate Sustainability Reporting Directive into Icelandic law. The Bank has now published its double materiality assessment in respect of the standard for the first time. For more information on the assessment, see the relevant section in the Bank's Annual and Sustainability Report 2023.

Pillar 3 Risk Disclosures

The Bank has now disclosed the information in Tables ESGA-ESGC and Templates ESG1-ESG8, in line with EBA's implementing technical standards, for the first time following the implementation of CRR Article No. 449a in Iceland. The form of presentation, and therefore the requisite inputs, is to a large extent analogous to the Bank's reporting as part of its financial statements. Due to the lack of available data, as discussed above, the Bank is not able to complete all aspects of the templates for this iteration of disclosures.

8.2 Governance

The Bank has adopted a risk policy on sustainability, approved by the Board of Directors and reviewed annually. This policy stipulates that the Bank should ensure that its operations and services do not negatively impact people or the environment. It also states that the Bank supports Iceland's climate action plan, the goal of which is to meet the obligations of the Paris Climate Agreement and to achieve the ambitious goal of carbon neutrality in Iceland by 2040. Key performance indicators relating to ESG factors are now part of the monthly risk report to the Board, and the Bank's risk appetite with respect to these factors have been defined.

Key performance indicators relating to ESG factors are now part of the monthly risk report to the Board

Arion Bank has a Sustainability Committee (SuCo) and the management of risk in connection with ESG factors is defined as part of the Bank's risk management system. The CEO is the chairman of the committee, whose role is to monitor the Bank's performance in connection with its policy and commitment on sustainability and to ensure that ESG factors are considered in decisions and plans made by the Bank. The Green Financing Committee and Equality Committee are sub-committees of SuCo.

In addition to the CEO, the SuCo comprises the managing director of Retail Banking, Corporate & Investment Banking, Markets, Operations & Culture, and Finance. The Chief Risk Officer, the Head of Corporate Communications and Sustainability, and Sustainability Officer attend meetings but do not have voting rights. Meetings are also attended by representatives of Stefnir and Vörður if required.

The Sustainability Committee's primary responsibility is to:

- decide on the Bank's commitments related to sustainability and review the Bank's performance in relation to those commitments

- align the Bank's strategy and risk appetite considering the ESG commitments and sustainability risk management
- review risk assessment of ESG factors and other assessments of climate risk impact, for example the estimation of Arion Bank's financed carbon emissions
- oversee the Bank's Green Financing Framework
- ensure the Bank's employees are adequately educated and aware of ESG factors and sustainable finance.

More information on the Bank's governance management framework and lines of reporting can be found in Chapter 2 of this report.

Remuneration

Chapter 9 contains detailed information about the Bank's remuneration policy.

8.3 Risk management

The Risk Management Division plays an active role in the management of ESG risk. To reflect the increasing importance of this risk factor, one of the division's units is now explicitly responsible for supporting ESG risk management across the Bank. Integrating ESG risk in such a way into the existing structure of Risk Management serves the aforementioned goal of recognizing ESG risk as potentially ampliyfing other risks and ensures that it is given appropriate consideration and in the appropriate context.

The Sustainability Committee established an ESG Working Group in early 2024. The working group's mandate is to develop and perform a standardized risk assessment of environment-related financial risks between industries and geographies, and of the impact of social and governance factors. It is intended to establish a firm foundation and support mechanism for those employees responsible for credit and investment decisions and advice, where outside-in ESG risk is part of the overall risk assessment.

Credit risk is the Bank's primary risk. The Bank's credit policy emphasises sustainability, and credit rules stipulate that ESG factors should be assessed as part of the credit rating process. Both inside-out and outside-in risks and impacts are assessed in the current framework. Work is underway to further enhance this assessment, partly to better reflect this bi-directionality.

Credit risk is the Bank's primary risk. The Bank's credit policy emphasises sustainability, and credit rules stipulate that ESG factors should be assessed as part of the credit rating process

The Bank is actively building out its capabilities with respect to managing ESG risk. A key enabler is data against which to measure risk, and which can form the basis of a monitoring and reporting framework consistent with the Bank's existing arrangements. Outputs such as those from PCAF and Taxonomy reporting inform this work to a degree, while institution-specific risk drivers, such as those relating to credit exposures, must be identified and quantified in the context from which they arise. The lack of available data, e.g. from the Bank's current and potential counterparties as described above, remains an obstacle. Similarly, country-level data for Iceland is, in many cases, not readily available to the same level of detail and granularity as it is for other European countries subject to the same set of requirements.

Notwithstanding the above, the Bank's aim is to develop a comprehensive set of indicators and limits, rooted in the Board's risk appetite. This is being done with reference to the Basel Committee on Banking Supervision's *Principles for the effective manage-*

ment and supervision of climate-related financial risks. The Bank also monitors regulatory developments, such as EBA consultations that may lead to new requirements in the coming years.

8.4 Business strategy

Arion Bank places great importance on environmental and social issues and good corporate governance in its operations. It wants to act as a role model in responsible and profitable business practices, taking into account the environment, the economy, and society. Social responsibility and sustainability are part of the Bank's day-to-day activities. The Bank's code of ethics serves as a key to responsible decision-making at the Bank.

The Bank has set a number of climate-related targets for 2024. These are largely restated and updated targets that were already in place in 2023, and include the following:

- Green lending to be at least 20% of the total loan portfolio by 2030
- Sector-specific sustainability policies for most impactful sectors
- Monitoring of suppliers' environmental and climate impact
- Carbon-reduction target set and met by 2030

For more information about the Bank's targets see its Annual and Sustainability Report 2023.

Green financing framework

The Bank issued its first comprehensive *Green Financing Framework* in 2021 and has since issued four green bonds on the basis of the framework.

The Green Financing Framework classifies green loans into eight categories:

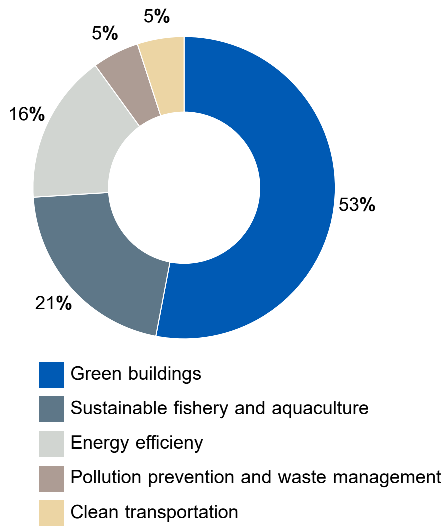
- Sustainable fishery and aquaculture
- Sustainable forestry and agriculture
- Renewable energy
- Clean transportation
- Green buildings
- Energy efficiency
- Pollution prevention and control, and
- Sustainable water / wastewater management.

At the end of 2023, green lending represented 10.7% of the Bank's total loan portfolio. After two years of solid growth in 2021 and 2022, the figure fell slightly in 2023. The Bank's target was to increase the percentage of green loans under the Green Financing Framework to at least 20% by 2030. This target was revised at the beginning of 2024. Going forward, it will apply both to green loans and loans which have a positive impact on society.

Sector-based sustainability policies

In 2023, the Bank published sustainability policies for seafood and industry, energy, and manufacturing. Reflecting its growing focus on the Arctic region as part of its business strategy, a sustainability policy specifically for the Arctic was also published. The policies outline the Bank's criteria and approach to promoting sustainability in the economy through its lending operations and business

Figure 8.1 Green loans under the Bank's Green Financing Framework by category at year-end 2023



relationships, in line with the Bank's commitments and within its risk appetite. In developing these policies, the Bank draws on the government's climate plans, as well as the plans and actions of its customers with respect to ESG factors. Further sector-specific policies will be published in 2024, covering Iceland's key sectors.

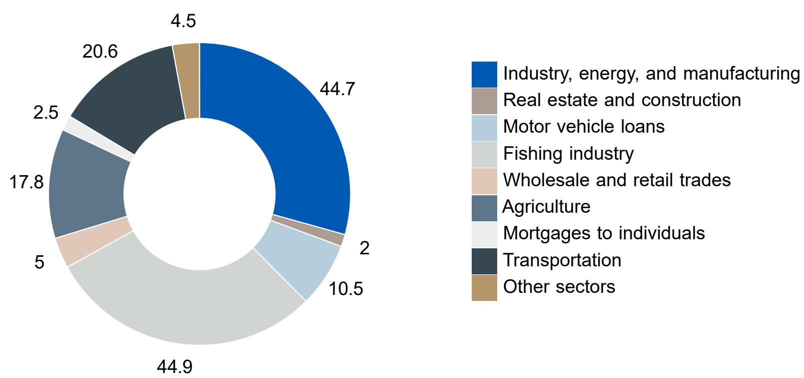
PCAF

Arion Bank is a signatory to the Partnership for Carbon Accounting Financials (PCAF), which is a global partnership of financial institutions that work together to develop and implement a harmonized approach to assess and disclose the greenhouse gas (GHG) emissions associated with their loans and investments. Assessing and disclosing the greenhouse gas emissions which are financed through lending and investments is a prerequisite for the Bank's ability to set targets on reducing emissions.

The Bank's second report on financed emissions from lending and investments is published at the same time as the 2023 Annual and Sustainability Report. To calculate financed emissions for business loans and investments, financial data from the Bank's counterparties is needed. Therefore, the calculations in the report covers lending and investments for the financial year 2022.

Financed emissions at Arion Bank in 2022 from the Bank's lending and investments amounted to 153 ktCO2e, excluding emissions from sovereign bonds. Emissions from the Bank's sovereign bonds total 149 ktCO2e, and calculations for 2021 indicate a reduction of 88 ktCO2e in this category. However, emissions from lending increased, and economic activity increased due to the fact that there were no restrictions in place in 2022 due to the global pandemic. However, the emissions intensity of the loan portfolio, i.e. greenhouse gas emissions per ISK million loaned did improve, decreasing 2% between years. Emissions intensity is used to measure actual reductions as monetary amounts can change but the ratio remains comparable.

Figure 8.2 Arion Bank's financed emissions [ktCO_2e] due to the loan book in 2023



At the end of 2023 the Bank pledged to follow the methodology of the Science Based Targets initiative (SBTi) when setting financed emission reduction targets. The calculations of financed emissions using PCAF methodology will be used in setting these targets. Affirmation of these targets by SBTi means that the Bank's targets are science-based and efforts to reduce emissions are based on scenarios where global warming does not exceed 1.5°C. The Bank has also joined the UN-convened Net-Zero Banking Alliance, a global group of banks committed to ambitious climate action.

For further information on the Bank's sustainability agenda, profile, and objectives, see the Annual and Sustainability Report 2023, which includes various non-financial information on ESG factors.

9 Remuneration

Arion Bank has a remuneration policy in place in accordance with Act No. 2/1995 on Public Limited Companies, Act No. 161/2002 on Financial Undertakings, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), European Banking Authority (EBA) Guidelines on gender neutral and sound remuneration policies of 2 July 2021 (EBA/GL/2021/04), and FSA's Rules No. 388/2016 on Variable Remuneration. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, employees, customers, and other stakeholders in an organized and transparent manner. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

9.1 Arion Bank's remuneration policy

Arion Bank's remuneration policy is framed in accordance with regulatory requirements, such as those established in Article 57a of Act No. 161/2002 on Financial Undertakings and FSA's Rules No. 388/2016 on Variable Remuneration. The Bank's remuneration policy is reviewed annually by the Board and submitted and approved at the Bank's annual general meeting. Arion Bank's remuneration policy is published on the Bank's website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2023, see Note 12. Arion Bank's remuneration policy is, furthermore, consistent with the integration of sustainability risks for the purposes of Article 5 of Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (SFDR).

Arion Bank's remuneration policy is framed in accordance with applicable regulatory requirements

The Bank's main objective concerning employee remuneration is to offer competitive salaries in order to attract and retain outstanding and qualified individuals. The Bank, furthermore, aims to ensure that the policy does not encourage excessive risk taking, but rather supports the Bank's long-term goals and sound operation. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, employees, customers, and other stakeholders in an organized and transparent manner. In accordance with Article 79a of Act No. 2/1995 on Public Limited Companies, Article 57a of Act No. 161/2002 on Financial Undertakings, and rules on good corporate governance, the Board of Directors of Arion Bank approves the Bank's remuneration policy with respect to salaries and other payments to the Board Directors, Chief Executive Officer, Managing Directors, Compliance Officer, and Internal Auditor.

9.2 Remuneration components and parameters

According to Article 57b of Act No. 161/2002 on Financial Undertakings, the combined amount of variable remuneration, including deferred payments, may not exceed 25% of annual salary of the recipient employee excluding the bonus. The rules require a deferral of at least 40% of the variable remuneration for a period of no less than four years and in the case of the CEO and employees reporting directly to the CEO, this shall be five years unless the total aggregate is less than 10% of the fixed salary of the employee, in which case the variable remuneration does not require deferral and may be paid in full.

In accordance with the rules, Risk Management and Compliance perform a risk assessment of the incentive scheme and Internal Audit regularly reviews its structure, execution, and impact on the Bank's operations. The current performance-based system was originally approved in December 2020. The current scheme, to be applied in 2024 based on 2023 performance, was approved by the Board of Directors in December 2022. Under the scheme all employees of the Bank, excluding internal controls units, are included and can receive up to 10% of their fixed annual salary for 2023 in the form of variable remuneration once the annual financial statement for 2023 has been published, on condition that the targets set out in the scheme have been reached. Managers and those employees who have the greatest influence on the Bank's value creation are eligible to receive an incentive payment of up to 25% of their fixed annual salary, in the form of shares in the Bank, but subject to deferral of 40% and a sale restriction for a period of three years for delivered shares.

A restated performance-based variable remuneration system was approved in December 2022 and will apply in 2024 based on performance in 2023

Risk Management, Compliance and Internal Audit are excluded.

The criterion used for the Bank's remuneration system to determine whether incentive payments will be paid in 2024, in part or in full, is whether the Bank's return on equity (ROE) in 2023 is higher than the weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn, and Kvika. Failure to reach this target means that no variable remuneration will be paid. The total amount paid out in incentive payments, furthermore, may not be higher than the amount by which the Bank's ROE exceeds the weighted ROE of competitors.

When estimating the variable remuneration to be paid in respect of 2023 performance, a range of factors will be taken into consideration, such as ROE of the Bank, cost-to-income ratio, bancassurance ratio, compliance with the law and code of ethics, knowledge of the customer (KYC/AML), the Bank's Sustainalytics rating, customer satisfaction score, mandatory education health, and various other metrics.

The objective of the Bank's scheme is to reflect its objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders, and employees

The objective of the scheme is to reflect the Bank's objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders, and employees. The Board of Directors re-evaluates on an annual basis the incentive scheme and its key targets in accordance with the Bank's remuneration policy, taking into consideration the current status of the Bank, market conditions, and that variable remuneration is awarded in a manner which promotes sound risk management in line with the Bank's risk policy and does not induce excessive risk-taking.

9.3 Corporate governance arrangements

The Board Remuneration Committee (BRC) and the Board Risk Committee (BRIC), which are established by the Board of Directors of Arion Bank, provide guidance to the Board on the Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer, and Chief Internal Auditor, as well as the Bank's remuneration scheme and other work-related payments. The BRC convened five times in the year 2023. The committee consists of at least three members, the majority of whom must be independent of the Bank and the Bank's day-to-day management. The CEO, Managing Directors, and other employees of the Bank cannot be members of the Committee.

The main responsibilities of the BRC are to review and propose changes to the Bank's remuneration policy to the Board, which proposes the changes to a shareholders' meeting. In addition, the BRC is tasked with ensuring that wages and other employment terms are in accordance with laws, regulations and best practices as current from time to time. The Committee decides on a salary framework for Managing Directors and the Compliance Officer, taking into consideration the size of the relevant division and level of responsibility.

The Board Remuneration Committee monitors the incentive scheme, ensuring compliance with laws, regulations and best practices. The Board Risk Committee annually assesses whether incentives are consistent with the Bank's risk policy

A performance-based variable remuneration system has been in place since 2013 and both BRC and BRIC have a role as regards its design and annual review. BRC reviews and monitors the scheme, before submitting it to the Board, and BRIC's role is to assess annually whether incentives which may be contained in the Bank's system are consistent with the Bank's risk policy.

9.4 Quantitative information on remuneration

According to disclosure requirements set out in Article 450 of the Capital Requirements Regulation (EU) No. 575/2013, financial undertakings are required to provide aggregate quantitative information on total remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution.

The criterion used for the Bank's variable remuneration scheme to determine whether an incentive payment will be paid in 2024, in part or in full, depends on a comparison of the Bank's return on equity (ROE) in 2023 with that of a weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn, and Kvika. For quantitative information on remuneration, please refer to the Bank's Additional Pillar 3 Risk Disclosures.

10 Abbreviations

ACC	Arion Credit Committee
ADC	Arion Composition and Debt Cancellation Committee
AGM	Annual General Meeting
ALCO	Asset and Liability Committee
AML	Anti-Money Laundering
ASF	Available Stable Funding
AT1	Additional Tier 1
BAC	Board Audit Committee
BCC	Board Credit Committee
BCMS	Business Continuity Management System
BICRA	Banking Industry Country Risk Assessment
BRC	Board Remuneration Committee
BRIC	Board Risk Committee
BRRD	Bank Recovery and Resolution Directive
BTC	Board Tech Committee
CCF	Credit Conversion Factor
CCO	Chief Compliance Officer
CCR	Counterparty Credit Risk
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CFO	Chief Financial Officer
CMS	Collateral Management System
COREP	Common Reporting
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Credit Risk Mitigation
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CSO	Chief Security Officer
CVA	Credit Valuation Adjustment
D-SII	Domestic Systemically Important Institution
EAD	Exposure at Default
EBA	European Banking Authority
ECAI	External Credit Assessment Institution
EEA	European Economic Area
ECL	Expected Credit Loss
ERCO	Executive Risk Committee
ERM	Enterprise Risk Management
ESG	Environmental, Social, and Governance
EU	European Union
FATF	Financial Action Task Force
FRTB	Fundamental Review of the Trading Book
FSA	Financial Supervisory Authority of the Central Bank of Iceland
FTE	Full-time equivalent
G-SII	Global Systemically Important Institution
GHG	Greenhouse Gas
ICAAP	Internal Capital Adequacy Assessment Process
ICFR	Internal Controls over Financial Reporting
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal Ratings Based
IRRBB	Interest Rate Risk in the Banking Book
ISAT08	Icelandic industry classification based on NACE Rev. 2
ISMS	Information Security Management System
KYC	Know Your Customer
LAA	Loss Absorption Amount

Abbreviations

LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
LULUCF	Land use, land-use change and forestry
MCC	Market Confidence Charge
MD	Managing Director
MREL	Minimum requirement for own funds and eligible liabilites
NFDR	Non-Financial Disclosure Regulation
NSFR	Net Stable Funding Ratio
ORCO	Operational Risk Committee
ORSA	Own Risk and Solvency Assessment
ORX	Operational Riskdata eXchange Association
PCAF	Partnership for Carbon Accounting Financials
PD	Probability of Default
PiT	Point-in-Time
PSD	Payment Services Directive
PSE	Public Sector Entities
RB	Reiknistofa bankanna hf.
RCA	Recapitalization Amount
RCSA	Risk Control Self-Assessment
REA	Risk-weighted Exposure Amount, previously referred to as Risk-Weighted Asset (RWA)
ROAC	Return on Allocated Capital
ROE	Return on Equity
RSF	Required Stable Funding
SA-CCR	Standardized Approach for Counterparty Credit Risk
SFDR	Sustainable Finance Disclosure Regulation
SDRs	Swedish Depositary Receipts
SII	Systemically Important Institution
SME	Small and Medium Enterprise
SNP	Senior Non-Preferred
SP	Senior Preferred
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SFT	Securities Financing Transaction
SUCO	Sustainability Committee
T1	Tier 1
T2	Tier 2
TCFD	Task Force on Climate-related Financial Disclosures
TtC	Through-the-cycle
UCITS	Undertaking for Collective Investment in Transferable Securities
UN	United Nations
VaR	Value at Risk

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