

Conclusions of the Supervisory Review and Evaluation Process at Arion Bank hf.

The Financial Supervisory Authority (FME) evaluates risk factors in the operations of financial institutions in the Supervisory Review and Evaluation Process (SREP) and assesses how financial institutions handle these risk factors in their operations, cf. the Financial Undertakings Act No. 161/2002. Such an assessment is performed annually at institutions considered systemically important.

The process evaluates factors such as business model, corporate governance, credit and concentration risk, market risk, operational risk, liquidity and funding risk and stress testing. When evaluating these risk factors, the FME uses the *Common Criteria and Methodologies for SREP* which are based on the European Banking Association's (EBA) guidelines on the same subject.

SREP reveals to what extent the measures taken by a financial institution in respect of risk factors are adequate, whether management is reliable and whether the capital base is sufficient with respect to the risks inherent in the activities. On the basis of SREP, the FME is authorized, amongst other things, to prescribe a higher capital ratio than the statutory minimum of 8%, improvements to internal processes, the impairment of assets when calculating own funds, restrictions or limits to the activities of the financial institution or the reduction of the risks factors associated with activities. The FME can also make various critical comments and recommendations during the process

Arion Bank submitted its capital adequacy assessment as of 31 December 2017, in the form of an ICAAP/ILAAP report, to the FME in April 2018. The FME sent the Bank its draft conclusions of the SREP in June 2018, where the Bank was given the opportunity to express its views, cf. Section IV of the Administrative Procedures Act No. 37/1993. The response of the Bank was received in August 2018. The FME has now completed SREP and sent Arion Bank a letter containing its conclusions in September 2018.

FME's additional capital requirement for Arion Bank hf. (Pillar II-R)

The main conclusion of SREP was that from 30 September 2018 Arion Bank should maintain an additional capital requirement of 2.9% of risk-weighted assets. The additional requirement is in respect of credit risk, market risk, and the risk associated with subsidiaries which is not adequately taken into consideration when calculating the minimum capital requirement (Pillar I). The additional requirement is divided so that CET1 capital shall be a minimum of 1.6% of risk-weighted assets and Tier 1 capital shall be a minimum of 2.2% of risk-weighted assets¹.

The FME's additional capital requirement is in addition to the minimum capital requirement and capital buffers:

¹ Cf. Article 86 g (4.a) and 86 g (7) of the Financial Undertakings Act No. 161/2002

- Minimum capital requirement (pillar I) is 8% of risk-weighted assets. The requirement is divided so that CET1 capital shall be a minimum of 4.5% of risk-weighted assets and Tier 1 capital shall be a minimum of 6% of risk-weighted assets².
- The combined capital buffer requirement is 8.4% of risk-weighted assets and it shall be met entirely with CET1 capital. The combined capital buffer requirement takes into account the domestic/foreign composition of risk-weighted assets, which differs between banks. Based on the 0.5 percentage point increase in the countercyclical capital buffer on 15 May 2019, the combined buffer requirement will be 8.9%, all other things being equal. The FME recommends that Arion Bank maintain capital in accordance with the proposed increase in the countercyclical capital buffer³.

The FME's overall capital requirement for Arion Bank hf, on a parent and group level, is therefore 19.3% of risk-weighted assets and comprises the minimum capital requirement, the FME's additional capital requirement and capital buffers.

The FME has informed Arion Bank hf. that when assessing capital requirement, it is necessary to examine events which could potentially occur at a later date. The board of directors of Arion Bank therefore needs to ensure that the Bank is able to continue normal lending activities, including during economic downturns, and that the Bank's funding is structured in such a way that it facilitates the Bank's access to the financial markets in challenging conditions.

Critical comments and demands for corrective action

The FME made the following critical comments to Arion Bank hf. and requested that appropriate corrective action be taken.

The FME was critical of internal controls regarding loans to customers. With respect to this and to the changes made to credit control at the Bank recently, the FME requested that the Bank's Internal Auditor perform an audit of the Bank's lending process in certain divisions and that it submit its findings to the FME.

The FME was critical that the number of demands for corrective action by the Internal Auditor which had not been completed within the specified time limit had increased. The FME requested that the Bank take measures to address this. The FME also requested that the Bank take appropriate measures to improve risk awareness among employees.

With respect to the performance of stress testing, the FME made a critical comment to the effect that there needed to be an improvement in the discussion of the response of management to shock scenarios, their suggestions for action to mitigate the impact of the scenarios and the Bank's assessment of the impact of mitigation actions. The FME requested that this be rectified.

The FME was critical of the fact that the Bank had not maintained its own methodology for assessing the extent of sector concentration risk and requested that this be rectified.

² Cf. Article 84 (1) of the Financial Undertakings Act No. 161/2002

³ See also decisions on capital buffers on the FME's website:
<https://www.fme.is/eftirlitsstarfsemi/fjarmalastodugleiki/eiginfjaraukar/>

The FME was also critical of the Bank's supervision of the outsourcing of certain projects and requested that the contents of outsourcing agreements concerning them be reviewed and that supervision by the Bank be improved.