KAUPTHING BANK

Consolidated Financial Statements for the year 2006

Kaupthing Bank hf.
Borgartun 19
105 Reykjavik
Iceland

Reg. no. 560882-0419

Contents

Endorsement and Signatures of the Board of Directors and the CEO

The Consolidated Financial Statements of Kaupthing Bank hf. for the year ended 31 December 2006 have been prepared in accordance with International Financial Reporting Standards (IFRS). The Consolidated Financial Statements include the Financial Statements of Kaupthing Bank hf. and its subsidiaries, together referred to as "the Bank".

Net earnings, according to the Consolidated Income Statement, amounted to ISK 86,447 million for the year ended 31 December 2006. The Board of Directors proposes a payment of dividend, ISK 14 per share, which equals 12% of net earnings for the year. An extraordinary shareholders' meeting held on 16 October 2006 approved that shareholders should be paid a dividend amounting to ISK 18,205 million in the form of 830,691,316 shares in Exista hf. The total dividend paid during the year 2006 amounted to ISK 37.6 per share. Shareholders equity, according to the Balance Sheet, amounted to ISK 323,510 million at the end of the year, including share capital amounting to ISK 7,321 million. The equity ratio of the Bank, calculated according to the Act on Financial Undertakings, was 15.0%. This ratio may not be lower than 8.0%.

Kaupthing Bank hf.'s share capital amounted to ISK 7,321 million at year-end. Share capital was increased by ISK 759 million during the year 2006. The increase net selling price was ISK 55,558 million. Registered shareholders at year-end 2006 numbered 31,730 compared to 33,027 at the beginning of the year. At the end of the year, one shareholder held more than 10.0% of the shares in the Bank, Exista B.V., which owned 23.0% of the shares.

The Board of Directors and the CEO of Kaupthing Bank hf. hereby confirm the Consolidated Financial Statements for the year ended 31 December 2006.

Reykjavik, 29 January 2007

Board of Directors

Sigurdur Einarsson
Chairman

Ásgeir Thoroddsen	Bjarnfredur Ólafsson
Brynja Halldórsdóttir	Gunnar Páll Pálsson
Hjörleifur Thór Jakobsson	María Sólbergsdóttir
Niels de Coninck-Smith	Tommy Persson

CEO

Hreidar Már Sigurdsson

Independent Auditors' Report

To the Board of Directors and Shareholders of Kaupthing Bank hf.

Report on the Consolidated Financial Statements

We have audited the accompanying Consolidated Financial Statements of Kaupthing Bank hf. and its subsidiaries (the "Bank"), which comprise the Consolidated Balance Sheet as at 31 December 2006, and the Consolidated Income Statement, Consolidated Statement of changes in Equity and Consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of Financial Statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the Financial Statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the consolidated financial position of Kaupthing Bank hf. as at 31 December 2006, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by EU.

Reykjavik, 29 January 2007

KPMG hf.

Saemundur Valdimarsson

Reynir Stefán Gylfason

Consolidated Income Statement
for the year 2006

	Notes	2006	2005
Interest income		187,451	100,009
Interest expense		(135,089)	(67,299)
Net interest income	42	52,362	32,710
Fee and commission income		40,904	23,508
Fee and commission expense		(3,620)	(1,080)
Net fee and commission income	43	37,284	22,428
Net financial income	44-49	60,157	37,282
Share of profit of associates	69	1,194	1,396
Other operating income	50	16,219	8,382
Operating income		167,216	102,198
Salaries and related expenses	52-53	(33,570)	(20,317)
Administration expenses		(19,801)	(11,594)
Depreciation and amortisation	75	(5,976)	(2,818)
Other operating expenses		(660)	(795)
Impairment on loans	55	(4,857)	(2,450)
Impairment on other assets	55	(1,270)	(1,939)
Earnings before income tax		101,083	62,284
Income tax expense	56	(14,636)	(11,228)
Net earnings		86,447	51,056
Attributable to:			
Shareholders of Kaupthing Bank hf.		85,302	49,260
Minority interest		1,145	1,796
Net earnings		86,447	51,056
Earnings per share			
Basic earnings per share	57	127.1	75.2
Diluted earnings per share	57	123.4	73.9

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Consolidated Balance Sheet
as at 31 December 2006

	Notes	2006	2005
Assets			
Cash and balances with central banks	58	106,961	34,877
Loans to credit institutions	59	485,334	195,594
Loans to customers	60-64	2,538,609	1,543,700
Bonds and debt instruments	65	318,264	390,575
Shares and equity instruments	65	159,020	114,355
Derivatives	65,93	65,454	21,047
Derivatives used for hedging	65,93	6,453	4,459
Securities used for hedging	65	115,938	82,098
Investments in associates	69	5,304	13,888
Intangible assets	70-71	68,301	54,943
Investment property	72-73	31,584	24,156
Property and equipment	74-77	30,466	22,433
Tax assets	84	5,834	5,004
Other assets	78	117,874	33,682
Total Assets		4,055,396	2,540,811
Liabilities			
Due to credit institutions and central banks		110,456	69,643
Deposits		750,658	486,175
Borrowings	79	2,399,939	1,556,567
Subordinated loans	80	216,030	102,688
Financial liabilities measured at fair value	81-83	71,264	60,273
Tax liabilities	84	23,209	18,458
Other liabilities	87-88	148,948	44,495
Total Liabilities		3,720,504	2,338,299
Equity			
Share capital		7,321	6,638
Share premium		164,028	114,606
Reserves		17,220	(1,540)
Retained earnings		134,941	74,479
Total Shareholders' Equity	89-91	323,510	194,183
Minority interest		11,382	8,329
Total Equity		334,892	202,512
Total Liabilities and Equity		4,055,396	2,540,811

Kaupthing Bank hf. Financial Statements 2006 6 Amounts are in ISK millions

Consolidated Statement of Changes in Equity
for the year 2006

	Share capital and premium	Reserves	Retained earnings	Total Share-holders' equity	Minority interest	Total equity
2006						
Equity 1 January 2006	121,244	(1,540)	74,479	194,183	8,329	202,512
Translation difference		18,289		18,289	2,176	20,465
Fair value changes in AFS financial assets		(9)		(9)		(9)
Deferred pension reserve		480		480		480
Net earnings recognised directly in equity		18,760		18,760	2,176	20,936
Net earnings according to the Income Statement			85,302	85,302	1,145	86,447
Total recognised earnings for the year		18,760	85,302	104,062	3,321	107,383
Dividends paid to equity holders, ISK 37.6 per share			(24,814)	(24,814)		(24,814)
Issued new share capital	55,558			55,558		55,558
Purchases and sales of treasury stock	(6,024)			(6,024)		(6,024)
Exercised stock options	571			571		571
Other changes			(26)	(26)	(268)	(294)
Equity 31 December 2006	171,349	17,220	134,941	323,510	11,382	334,892
2005						
Equity 1 January 2005	117,080	(670)	32,960	149,370	9,539	158,909
Translation difference		(388)		(388)	(77)	(465)
Fair value changes in AFS financial assets		(2)		(2)		(2)
Deferred pension reserve		(480)		(480)		(480)
Net earnings recognised directly in equity		(870)		(870)	(77)	(947)
Net earnings according to the Income Statement			49,260	49,260	1,796	51,056
Total recognised earnings for the year		(870)	49,260	48,390	1,719	50,109
Dividends paid to equity holders, ISK 10 per share			(3,298)	(3,298)		(3,298)
Issued new share capital	416			416		416
Restating the initial investments in shares			(4,886)	(4,886)		(4,886)
Purchases and sales of treasury stock	3,706			3,706		3,706
Exercised stock options	42			42		42
Other changes			443	443	(2,929)	(2,486)
Equity 31 December 2005	121,244	(1,540)	74,479	194,183	8,329	202,512

Kaupthing Bank hf. Financial Statements 2006 7 Amounts are in ISK millions

Consolidated Statement of Cash Flows
for the year 2006

	2006	2005
Cash flows from operating activities:		
Earnings before tax income	101,083	62,284
Adjustments to reconcile net earnings to cash flow from (used in) operating activities:		
Non-cash items included in net profit and other adjustments	1,481	4,936
Operating assets and liabilities, changes	(144,389)	23,234
Income taxes paid	(8,115)	(1,455)
Net cash (used in) from operating activities	(49,940)	88,999
Cash flows from investing activities:		
Investment in associated companies	(5,400)	(1,805)
Disposal of associated companies	20,266	6,111
Dividend received from subsidiaries	4,103	102
Payment for acquisition of subsidiaries (less cash acquired)	0	(60,356)
Purchase of intangible assets	(1,810)	(2,884)
Purchase of investment properties	(3,475)	(4,839)
Proceeds from sale of investment properties	5,367	208
Purchase of property and equipment	(13,818)	(4,965)
Proceeds from sale of property and equipment	3,283	1,452
Other changes	221	(4,855)
Net cash from (used in) investing activities	8,737	(71,831)
Cash flows from financing activities:		
Subordinated loan capital issued	111,336	42,731
Subordinated loan capital repaid	(2,601)	(3,524)
(Purchases) sales of own shares to meet share awards and share option awards	(5,800)	3,706
Proceeds from the issue of shares	55,558	0
Dividends paid	(24,814)	(3,298)
Net cash from financing activities	133,679	39,615
Net increase in cash and cash equivalents	92,476	56,783
Cash and cash equivalents at beginning of the year	81,758	26,985
Effect of exchange rate changes on cash held	28,555	(2,010)
Cash and cash equivalents at year-end	202,789	81,758

Additional information:

Paid and total purchase price of subsidiaries	0	63.708
Received and total sale price of subsidiaries	0	6.111

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Consolidated Statement of Cash Flows
for the year 2006 - notes

Non-cash items in the Income Statement and other adjustments:	2006	2005
Impairment on loans and advances	4,857	2,450
Depreciation of property and equipment	5,976	2,818
Impairment on property and equipment	1,270	1,939
Net earnings of associated companies	(1,194)	(1,396)
Investment properties, fair value change	(96)	(365)
Net gain on disposal of investment properties	(3,020)	0
Indexation and exchange rate difference	2,689	2,458
Net gain on disposal on property and equipment	(303)	(248)
Net gain on a disposal of a subsidiary	0	(3,093)
Net gain on a disposal of associated companies	(8,398)	0
Share based payment expenses	571	42
Changes in other non cash items	(871)	331
	1,481	4,936

Changes in operating assets and liabilities:		
Loans and advances, change	(1,253,947)	(394,644)
Financial assets measured at fair value, change	(51,147)	(68,042)
Financial assets available for sale, change	(2,016)	(118,012)
Tax assets, change	(3,060)	(1,276)
Other assets, change	(82,894)	(10,096)
Deposits, change	301,998	233,892
Borrowings, change	834,270	421,593
Financial liabilities, measured at fair value, change	10,872	(14,988)
Provisions, change	1,378	3,271
Tax liabilities, change	(1,788)	(1,422)
Other liabilities, change	101,945	(27,042)
	(144,389)	23,234

Cash and cash equivalents at year-end:	2006	2005
Cash in hand and demand deposits	95,828	16,828
Due from credit institutions	106,961	64,930
Cash and cash equivalents at year-end	202,789	81,758

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Notes to the Consolidated Financial Statements

General information

1. Reporting entity

Kaupthing Bank hf. is a company incorporated and domiciled in Iceland. The address of the Bank´s registered office is Borgartún 19, Reykjavik. The Consolidated Financial Statements for the year 2006 comprise Kaupthing Bank hf. (the parent company) and its subsidiaries (together referred to as "the Bank"). The Bank offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, investment banking, retail banking, capital markets services, asset management and comprehensive wealth management for private banking clients.

2. Basis of preparation

a) *Statement of compliance*
The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.

Certain comparative information have been restated.

The Financial Statements were approved and authorised for issue by the Board of Directors of Kaupthing Bank hf. on 29 January 2007.

b) *Basis of measurement*
The Consolidated Financial Statements are prepared on the historical cost basis except the following assets and liabilities that are stated at their fair value: derivative financial instruments, financial instruments held for trading, financial instruments designated at fair value through profit and loss, financial instruments classified as available-for-sale and investment properties.

Non-current assets and disposal groups held for sale are stated at the lower of carrying amount and fair value less costs to sell, unless IFRS 5 requires that another measurement basis shall be used.

c) *Functional and presentation currency*
The Consolidated Financial Statements are presented in Icelandic krona (ISK), which is the Bank´s functional currency. Except as indicated, financial information presented in ISK has been rounded to the nearest million.

d) *Use of estimates and judgements*
The preparation of the Financial Statements in conformity with IFRS requires management to make judgements, estimates and assumptions. These judgements, estimates and assumptions affect the application of accounting policies and the reported amounts of assets and liabilities as well as, income and expenses in the Financial Statement presented. Actual results may differ from the estimates and the assumption made.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Judgements made by management in the application of IFRS that have significant effect on the Financial Statements and estimates with a significant risk of material adjustment in the next year are discussed in note 37.

Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these Consolidated Financial Statements, and have been applied consistently by Bank's entities.

3. Basis of consolidation

a) *Subsidiaries*
Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than the 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Bank. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued, plus cost directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Bank's share of the net identifiable assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the Income Statement.

3. cont.

b) *Special purpose entities*
Special purpose entities are entities that are created to accomplish a narrow and well-defined objective such as the securitisation of particular assets, or the execution of a specific borrowing or lending transaction. The Financial Statements of special purpose entities are included in the Bank´s Consolidated Financial Statements where the substance of the relationship is that the Bank controls the special purpose entity.

c) *Funds management*
The Bank manages and administers assets held in unit trusts and other investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Bank controls the entity. Information about the Bank´s funds management and securitisation activities is set out in note 67.

d) *Transactions eliminated on consolidation*
Intragroup balances, unrealised income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements. Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Bank's interest in the entity. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

4. Associates

Associates are those entities over which the Bank has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes goodwill and accumulated impairment loss.

Investments in associates held as venture capital in Investment Banking are not accounted for on an equity basis but are designated upon initial recognition as financial assets at fair value through profit or loss and accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement.

The Consolidated Financial Statements include the Bank's share of the total recognised income and expenses of associates on an equity accounted investees, from the date that significant influence commences until the date that significant influence ceases. When the Bank's share of losses exceeds its interest in an equity accounted associate, the Bank's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for as non-current assets held for sale.

5. Foreign currency

a) *Functional currencies*
Items included in the Financial Statements of each of the Bank's entities are measured using the functional currency of the respective entity.

b) *Foreign currency transactions*
Transactions in foreign currencies are translated to the respective functional currencies of Bank entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortised cost in foreign currency translated at the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on retranslation are recognised in profit or loss, except for differences arising on the retranslation of available-for-sale equity instruments or a financial liability designated as a hedge of the net investment in a foreign operation.

c) *Foreign operations*
The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on aquisition, are translated to Icelandic krona, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic krona at average exchange rates approximating the exchange rates current at the dates of the transactions.

5. cont.

Foreign exchange difference arising on translation are recognised directly in equity. Since 1 January 2004, the Bank´s date of transition to IFRSs, such differences have been recognised in the *Translation reserve*. When a foreign operation is disposed, in part or in full, the relevant amount in the *Translation reserve* is transferred to the Income Statement.

d) *Hedges of net investment in foreign operations*
See accounting policy 10d.

6. Income and Expense

a) *Interest income and expense*
Interest income and expense are recognised in the Income Statement as it accrues, taking into account the effective yield of the asset or an applicable floating rate. Interest income and expense includes the amortisation of any discount or premium or other differences between the initial carrying amount of an interest bearing instrument and its amount at maturity calculated on an effective interest rate basis.

The effective interest rate method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised at the rate of interest used to discount the impairment loss. Interest income on financial assets which have been written down as a result of impairment is calculated based on the net amount of the financial asset taking the write-down into consideration.

b) *Fee and commission*
The Bank provides various services to its clients and earns income there from, such as income from Investment Banking, Corporate Banking, Capital Markets, Asset Management and Retail Banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction-type services are recognised when the service has been completed. Fees that are performance-linked are recognised when the performance criteria are fulfilled.

c) *Net financial income*
Net financial income comprises of Net trading income and Net income from other fincancial instruments at fair value.

Net trading income comprises gains less losses related to trading assets and liabilities, and includes all realised and unrealised fair value changes, interest, dividends and foreign exchange differences.

Net income from other financial instruments at fair value relates to non-qualifying derivatives held for risk management purposes and financial assets and liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, interest, dividends and foreign exchange differences.

Dividend income is recognised in the Income Statement on the date that the dividend is declared.

d) *Lease payments made*
Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

Minimum lease payments made under finance leases are apportioned between the finance expense and the reduction of the outstanding liability. The finance expense is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of liability. Contingent lease payments are accounted for by revising the minimum lease payments over the remaining term of the lease when the lease adjustment is confirmed.

6. cont.

e) *Income tax*

Income tax comprises current and deferred tax. Income tax is recognised in the Income Statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

The deferred income tax asset / liability has been calculated and entered in the Balance Sheet. The calculation is based on the difference between Balance Sheet items as presented in the tax return on the one hand, and in the Financial Statements on the other, taking into consideration a carry-forward tax loss. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Financial Statements, mostly because revenues, especially of financial assets, are recognised earlier in the Financial Statements than in the tax return. A calculated tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviwed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

7. Impairment of financial assets

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

a) *Impairment on loans*

The Bank recognises losses for impaired loans promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Bank's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

(i) significant financial difficulty of the borrower;

(ii) a breach of contract, such as a default on installments or on interest or principal payments;

(iii) the Bank granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;

(iv) it becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;

(v) the disappearance of an active market for that financial asset because of financial difficulties; or

(vi) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:

– adverse changes in the payment status of borrowers in the group; or
– general national or local economic conditions connected with the assets in the group.

Individually assessed loans

Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, the following factors are considered:

– the Bank's aggregate exposure to the customer;
– the amount and timing of expected receipts and recoveries;
– the likely dividend available on liquidation or bankruptcy;
– the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
– the realisable value of security (or other credit mitigates) and likelihood of successful repossession; and
– the likely deduction of any costs involved in recovery of amounts outstanding.

7. cont.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Income Statement. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account:

– future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the assets;

– historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);

– the estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan; and

– future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash

– management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period (for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. The amount of any reversal is recognised in the Income Statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in the Balance Sheet. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Income Statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Income Statement.

b) *Impairment of financial assets available-for-sale*

The Bank determines that available-for-sale equity investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Bank evaluates among other factors, the normal volatility in share price. In addition, impairment may be appropriate when there is evidence of deterioration in the financial strength of the investee, industry and sector performance, changes in technology, and operational and financing cash flows. The amount of impairment loss is recognised in the Income Statement. Impairment losses are subsequently reversed if the reasons for the impairment loss charged no longer apply.

c) *Calculation of recoverable amount*

The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate (i.e. the effective interest rate computed at initial recognition of these financial assets).

d) *Reversals of impairment*

An impairment loss in respect of financial assets carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of an investment in an equity instrument classified as available-for-sale is not reversed through profit or loss. If the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the Income Statement, the impairment loss shall be reversed, with the amount of the reversal recognised in the Income Statement.

However, any subsequent recovery in the fair value of an impaired available-for-sale equity security is recognised directly in equity. Changes in impairment provisions attributable to time value are reflected as a component of interest income.

8. Impairment of non-financial assets

The carrying amounts of the Bank's non-financial assets, other than investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset´s recoverable amount is estimated. The recoverable amount of goodwill is estimated at each reporting date.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets and groups. Impairment losses are recognised in profit or loss. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable. An impairment loss is reversed only to the extent that the asset´s carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

9. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable (such as share, commodity or bond prices, an index value or an exchange or interest rate), which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

The Bank uses derivatives for trading purposes and to hedge its exposure to market price risk, foreign exchange and interest rate risk arising from operating, financing and investing activities.

Derivatives are recognised at fair value. Fair value changes are recognised in the Income Statement, except in the case of derivatives that are designated and are effective hedging instruments, whose fair value changes are recognised in accordance with the accounting policies in note 10. Changes in fair values of derivatives are split into (i) interest income, (ii) foreign exchange differences and other gains and losses. Interest income is recognised on accrual basis. Derivatives with positive fair values are recognised as trading assets and derivatives with negative fair values are recognised as trading liabilities.

The fair value of derivatives is determined in accordance with the accounting policy presented in note 13.

10. Hedging

Due to the Bank's risk positions and funding structure, its risk management policies require that the Bank should minimise its exposure to changes in foreign currency rates and manage interest rate risk, credit risk and market price risk exposure within certain guidelines (see also separate section on risk management). The Bank uses both derivative and non-derivative financial instruments to manage the potential earnings impact of these risks.

Several types of derivatives are used for this purpose, including interest rate swaps and currency swaps, options, financial futures, forward contracts and other derivatives. The purpose of the Bank's hedging activities is to protect the Bank from the risk that the net cash inflows will be adversely affected by changes in interest or exchange rates, credit ratings or market prices. The Bank enters into transactions to ensure that it is economically hedged in accordance with risk management policies. For qualifying hedge relationships, the Bank uses hedge accounting.

Each qualifying hedge relationship is evidenced and driven by management's approach to risk management and the decision to hedge the particular risk. Where hedge accounting is applied the Bank assesses, both at the inception of the hedge and each time the Bank prepares its annual or interim Financial Statements, whether the derivatives used as hedges are highly effective in offsetting the changes in value or cash flows associated with the hedged items. A hedge is normally regarded as highly effective if the changes in fair value or cash flows of the hedged item are expected to almost fully offset the changes in fair value or cash flows of the hedging instrument. Actual effectiveness results must be within a range of 80 to 125 percent on a cumulative basis. The designation and effectiveness measurement follows the methodologies that management has in place for risk identification and measurement. The ineffective portion of any gain or loss on a hedging instrument is recognised in the Income Statement.

10. cont.

The Bank's risk management activities concentrates on hedging the Bank's net exposure based on its asset and liability positions. Therefore the Bank monitors its interest rate risk exposures by reviewing the net asset or liability gaps within repricing bands. For hedge accounting purposes, the Bank designates the benchmark interest rate exposure of a portion of the underlying gross exposure as the hedged item and the hedge relationship is viewed at a micro level, considering only the relationship between the hedged item and the hedging instrument.

Where the Bank hedges a portfolio of loans in respect of interest rate risk it groups the loans into homogenous layers, each with specific maturities.

The Bank designates hedge relationships only for fair value hedge accounting and net investments in foreign operations.

The treatment of changes in fair value depends on their classification into the following categories:

a) *Fair value hedges*

Fair value hedges seek to eliminate risks of changes in the fair value of a recognised asset or liability or firm commitment that will give rise to a gain or loss that will be recognised in the Income Statement.

When a derivative hedges the changes in fair value of recognised assets or liabilities or an identified portion of such assets or liabilities, any gain or loss on the hedging instrument is recognised in the Income Statement. The hedged items are also stated at fair value in respect of the risk being hedged, with any gain or loss being recognised in the Income Statement. The gains and losses on the hedging instruments and hedge items are presented together in the Income Statement as *Net financial income* .

If the derivative expires or is sold, terminated or exercised, it no longer meets the criteria for fair value hedge accounting, or the designation is revoked, hedge accounting is discontinued. Any adjustment up to that point, to a hedged item for which the effective interest method is used, is amortised to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

b) *Other non-trading derivatives*

When a derivative is not held for trading, and is not designated in a qualifying hedge relationship, all changes in its fair value are recognised immediately in profit or loss as a component of *Net financial income.*

c) *Embedded derivatives*

Derivatives may be embedded in another contractual arrangement (a "host contract"). Th Bank accounts for embedded derivatives separately from the host contract when the host contract is not itself carried at fair value through profit or loss, and the characteristics of the embedded derivatives are not clearly and closely related to the host contract. Separated embedded derivatives are accounted for depending on their classification, and are presented in the Balance Sheet together with the host contract.

d) *Hedges of net investments in foreign operations*

Hedges of net investments in foreign operations seek to eliminate the exposure to foreign currency risks of the net investments.

Exchange differences arising from the translation of the net investment in foreign operations and of related hedges are taken to *Translations reserve* in equity. The portion of the gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in equity. The ineffective portion is recognised immediately in the Income Statement. They are recycled and recognised in Income Statement upon disposal of the operation. In respect of all foreign operations, any differences that have arisen before 1 January 2004, the date of transition to IFRS, are presented as *retained earnings* in the equity statement.

11. Cash and cash equivalents

Cash and cash equivalents in the Consolidated Statement of cash flows consist of cash, demand deposits with the central banks and demand deposits with other credit institutions.

12. Loans

Loans are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term. Loans include loans provided by the Bank to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

When the Bank is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of an asset to the lessee, the arrangement is presented within loans.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo or stock borrowing"), the arrangement is accounted for as a loan, and the underlying asset is not recognised in the Banks´s financial statements.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method, except when the Bank chooses to carry the loans at fair value through profit or loss as descrbed in accounting policy 13 b). Accrued interest is included in the carrying amount of the loans.

13. Financial assets measured at fair value through profit and loss.

a) *Trading assets*

Trading assets are financial instruments acquired principally for the purpose of generating profits from short-term price fluctuations or from a dealer's margin.

b) *Financial assets designated at fair value through profit or loss*

The Bank classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Income Statement as *Net financial income* if doing so results in more relevant information because:

i) the assets are managed, evaluated and reported internally on a fair value basis;
ii) the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
iii) the assets contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

The assets classified according to the above-mentioned conditions consist of:
i) fixed interest rate loans originated by the Bank whose fixed interest has been changed into floating by entering into corresponding interest rate swaps,
ii) equity and debt instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis, including equity instruments held by the venture capital organisation of the Bank which give the Bank significant influence over the issuer but not control,
iii) structured products that contain embedded derivatives,
iv) mortgage loans originated by the Bank's subsidiary in Denmark. These are financial assets that are granted by the Bank by providing money directly to a debtor. They are initially recorded at fair value, which is the cash given to originate the loan and are subsequently measured at fair value. The fair value of mortgage loans is based on the fair value of the underlying mortgage bonds.

Interest and dividend income that arises from these assets are included in *Interest income* and *Net financial income*, respectively. *Interest income* on debt instruments is recognised on an accrual basis.

14. Financial assets available-for-sale

Financial assets available-for-sale consists of unlisted equity instruments held for long time investment purposes.

Financial assets available-for-sale are recognised at fair value. Unrealised gains or losses on available-for-sale investments are recognised in equity, net of income taxes, until such investments are disposed of or until they are determined to be impaired. On disposal of an available-for-sale investment, the accumulated unrealised gain or loss included in equity is transferred to the Income Statement and recognised as *Other operating income*. Gains and losses on disposal are determined using the average cost method.

Dividend income on available-for-sale financial assets is included in *Dividend income* in the Income Statement. Exchange rate differences arising on equity instruments are recognised in equity.

15. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation models. The Bank uses widely recognised valuation models for determining the fair value of common and more simple financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

For more complex instruments, the Bank uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, and are derived from market prices or rates or are estimated based on assumptions. When entering into a transaction, the financial instrument is recognised initially at the transaction price, which is the best indicator of fair value, although the value obtained from the valuation model may differ from the transaction price. This initial difference, usually an increase, in fair value indicated by valuation techniques is recognised in income depending upon the individual facts and circumstances of each transaction and not later than when the market data becomes observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value on the Balance Sheet.

16. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all risks and rewards of ownership.

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Bank specified in the contract is discharged or cancelled or expires.

17. Offsetting financial assets and financial liabilities

Financial assets and liabilities are setoff and the net amount reported in the Balance Sheet when, and only when, the Bank has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Bank´s trading activity.

18. Amortised cost measurement of financial assets and financial liabilities

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

19. Repurchase agreements

A repurchase agreement involves the sale of securities subject to the simultaneous agreement to repurchase the same securities at a certain later date and at an agreed price. In repurchase agreements, the cash received, including accrued interest is recognised in the Balance Sheet. The proceeds from the legal sale of these securities are reported as borrowings.

The control of the securities remains with the Bank throughout the entire term of the transaction and the securities continue to be reported in the Bank's Balance Sheet as Bonds and debt instruments, as appropriate. Interest incurred is recognized as interest expense over the life of each agreement.

20. Leases - lessor

The Bank classifies leases based on the extent of the transfer of risks and rewards incidental to ownership of leased assets. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership.

Operating leases - lessee

Property and equipment which the Bank leases to third parties under operating leases are classified in the Balance Sheet as investment property or property and equipment on a property-by-property basis. Lease payments under operating leases where the Bank is the lessee are recognised as an expense on a straight-line basis over the lease term.

21. Intangible assets

a) *Goodwill*
Goodwill arises on the acquisition of subsidiaries.

Acquisitions prior to 1 January 2004
In respect of acquisitions prior to 1 January 2004, goodwill is included on the basis of its deemed cost, which represents the amount recognised under previous GAAP.

Acquisitions on or after 1 January 2004
All business combinations after 1 January 2004 are accounted for by applying the purchase method. Goodwill has been recognised on the acquisition of subsidiaries and associates. In respect of business acquisitions that have occurred since 1 January 2004, goodwill represents the difference between the cost of the acquisition and the net fair value of the net identifiable assets, liabilities and contingent liabilities of the acquiree.

Acquisitions of minority interests
Goodwill arising on the acquisition of a minority interest in a subsidiary represents the excess of the cost of the additional investment over the carrying amount of the net assets acquired at the date of exchange.

Subsequent measurement
Goodwill is measured at cost less any accumulated impairment losses.

b) *Other intangible assets*
Intangible assets other than goodwill that are acquired by the Bank are stated at cost less accumulated amortisation and impairment losses. Software and customer base are examples of other intangible assets.

c) *Subsequent expenditure*
Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

d) *Amortisation*
Amortisation is recognised in the Income Statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill is systematically tested for impairment at each reporting date. Other intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software	5 years
Customer base	10 years

22. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both. Investment property are stated at fair value. The Bank uses internal real estate experts who determine the fair value of investment property by applying recognised valuation techniques. In cases where prices of recent market transactions of comparable properties are available, fair value is determined by reference to these transactions. The fair values are based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

23. Property and equipment

a) *Owned assets*
Items of property and equipment are measured at cost less accumulated depreciation and impairment losses.

When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

b) *Subsequent costs*
The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. All other costs are recognised in the Income Statement as an expense as incurred.

23. cont.

c) *Depreciation*

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Income Statement on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Real estate	25-50 years
Machinery and equipment	3-5 years
Operating lease	3-10 years

The residual value is reassessed annually.

24. Non-current assets and disposal groups held for sale

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Investment Property held for sale is carried at fair value. Impairment losses on initial classification as held for sale are included in the Income Statement, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement.

Non-current assets and disposal groups held for sale are mainly mortgages foreclosed and disposal entities. Disposal entities are consolidated.

25. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method, except where the Bank chooses to carry the liabilities at fair value through profit or loss.

26. Borrowings

Some of the borrowings of the Bank are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised in the Income Statement over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

27. Subordinated loans

Subordinated loans are classified as other financial liabilities and consist of liabilities in the form of subordinated capital which, in case of the Bank's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, the bonds are included within Tier I and Tier II, as shown in note 80. On the one hand, there are subordinated loans with no maturity date that the Bank may not retire until 2011 and 2014 and then only with the permission of the Financial Supervisory Authority. These liabilities qualify as Tier I capital in the calculation of the equity ratio. On the other hand, there are subordinated loans with various dates of maturity over the next 25 years.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at amortised cost with any difference between cost and redemption value being recognised in the Income Statement over the period of the borrowings on an effective interest basis.

28. Financial liabilities measured at fair value

a) *Trading liabilities*

Trading liabilities primarily consist of derivatives with negative fair values and delivery obligations for short sales of securities. Hedging derivatives such as those used for internal risk control but not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain on financial assets/liabilities measured at fair value. Interest expenses on trading liabilities are included in *Interest expenses* .

Kaupthing Bank hf. Financial Statements 2006 20 Amounts are in ISK millions

28. cont.

b) *Financial liabilities designated at fair value through profit or loss*

The Bank classifies certain financial liabilities upon their initial recognition as financial liabilities at fair value with fair value changes recognised in profit or loss if doing so results in more relevant information because:
i) it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different base or
ii) financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank's risk management or investment strategy, and information about it is provided internally on that basis to the Bank’s key management personnel.

If the Bank becomes a party to instruments containing embedded derivatives which meet specific conditions, the Bank classifies the instruments into this category in order to avoid the complexity of applying the rules on separation and accounting for the embedded derivatives.

The liabilities classified according to the above-mentioned conditions consist of:
Mortgage bonds issued by the Bank are financial liabilities that are created by the Bank by issuing bonds that correspond to the terms of the underlying mortgage loans.

Transaction costs related to financial liabilities designated at fair value through profit and loss are included in the Income Statement as interest expense.

Mortgage funding is recognised when cash is advanced to the Bank from issuing bonds. They are initially recorded at fair value, which is the cash received and are subsequently measured at fair value. Fair value of issued mortgage bonds is the current market price. Illiquid mortgage bonds will be carried at a value calculated by discounting cash flows.

Financial liabilities designated at fair value through profit or loss are measured at fair value and changes in their fair value are recognised in the Income Statement as *Net financial income* . Interest expenses that arises from these liabilities is recognised on an accrual basis in *Interest expense* .

29. Provisions

A provision is recognised in the Balance Sheet when the Bank has a present legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

30. Other assets and other liabilities

Other assets and other liabilities are stated at cost.

31. Financial guarantees

Financial guarantees are contracts that require the Bank to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Financial guarantee liabilities are initially recognised at their fair value, and inital fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment (when a payment under the guarantee has become probable). Financial gurantees are included within other liabilities.

32. Employee benefits

a) *Defined contribution plans*

Obligations for contributions to defined contribution pension plans are recognised as an expense in profit or loss when they are due.

b) *Share-based payment transactions*

The grant date fair value of options granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period in which the employees become unconditionally entitled to the options. The amount recognised as an expense is adjusted to reflect the actual number of share options that vast.

The fair value of share appreciation rights is measured using the Black-Scholes formula. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behaviour), expected dividends, and the risk-free interest rate (based on government bonds). Service and non-market performance conditions attached to the transactions are not taken into account in determining fair value.

33. Share Capital

a) *Treasury shares*
Acquired own shares and other equity instruments (treasury shares) are deducted from equity. No gain or loss is recognised in Income Statement on the purchase, sale, issue or cancellation of treasury shares. Consideration paid or received is recognised directly in equity.

Incremental transaction costs of treasury share transaction are accounted for as a deduction from equity (net of any related income tax benefit).

When classifying a financial instrument (or component of it) in the Consolidated Financial Statements, all terms and conditions agreed between members of the Bank and the holders of the instrument are considered. To the extent there is an obligation that would give rise to a financial liability, the instrument is classified as financial liability, rather than an equity instrument.

b) *Dividend on shares*
Dividends on shares are recognised in equity in the period in which they are approved by the Bank's shareholders.

34. Earnings per share
The Bank presents basic and diluted earnings per share data for its ordinary shares.

Earnings per share are calculated by dividing the net earnings attributable to equity holders of the Bank by the weighted average number of ordinary shares outstanding during the year.

Diluted earnings per share are calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. The Bank calculates dilutive potential ordinary shares by determining the number of shares that could have been acquired at fair value (determined as the average annual market share price of the Company´s shares) based on the monetary value of the subscription rights attached to outstanding share options. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

35. New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2006, and have not been applied in preparing these consolidated financial statements. The Bank will apply the following new standards, amendments and interpretations when effective:

– *IFRS 7 Financial Instruments*: *Disclosures* requires entities to provide disclosures in their Financial Statements that enable users to evaluate the significance of financial instruments for the entity´s financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks. IFRS 7 which becomes mandatory for the Bank´s 2007 Financial Statements, is expected to have impact on additional disclosures.

– *IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies* addresses the application of IAS 29 when an economy first becomes hyperinflationary and in particular the accounting for deferred tax. IFRIC 7, which becomes mandatory for the Bank´s 2007 Financial Statements, is not expected to have impact on the Consolidated Financial Statements Income statement or equity statement. The main impact will be on additional disclosures.

– *IFRIC 8 Scope of IFRS 2 Share-based Payment* addresses the accounting for share-based payment transactions in which some or all of goods or services received cannot be specifically identified. IFRIC 8 will become mandatory for the Bank´s 2007 Financial Statements, with retrospective application required. The Bank has not yet determined the potential effect of the interpretation.

– *IFRIC 9 Reassessment of Embedded Derivatives* requires that a reassessment of whether embedded derivative should be separated from the underlying host contract should be made only when there are changes to the contract. IFRIC 9, which becomes mandatory for the Bank´s 2007 Financial Statements, is not expected to have any impact on the Consolidated Financial Statements.

– *IFRIC 10 Interim Financial Reporting and Impairment* prohibits the reversal of an impairment loss recognised in a previous interim period in respect of goodwill, an investment in an equity instrument or a financial asset carried at cost. IFRIC 10 will become mandatory for the Bank´s 2007 Financial Statements, and will apply to goodwill, investments in equity instruments, and financial assets carried at cost prospectively from the date that the Bank first applied the measurement criteria of IAS 36 and IAS 39 respectively (i.e., 1 January 2004).

36. Business segment is a distinguishable component of the Bank that is engaged either in providing products or services (business segment) which is subject to risks and rewards that are different from those of other segments. The Bank´s primary format for segment reporting is based on business segments.

37. Critical accounting estimates and judgements in applying accounting policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

a) Impairment losses on loans

The Bank reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Income Statement, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

b) Fair value of derivatives

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

c) Qualifying hedge relationships

In designating financial instruments as qualifying hedge relationships, the Bank has determined that it expects the hedge to be highly effective over the life of the hedging instrument.

d) Securitisations

In applying its policies on securitised financial assets, the Bank has considered both the degree of transfer of risk and rewards on assets transferred to another entity and the degree of control exercised by the Bank over the other entity:

i) When the Bank, in substance, controls the entity to which financial assets have been transferred, the entity is included in these consolidated financial statements and the transferred assets are recognised in the Bank´s Balance Sheet.
ii) When the Bank has transferred financial assets to another entity, but has not transferred substantially all of the risk and rewards relating to the transferred assets, the assets are recognised in the Bank´s Balance Sheet.
iii) When the Bank has transferred substantially all the risk and rewards relating to the transferred assets to an entity that it does not control, the assets have been derecognised from the Bank´s Balance Sheet.

Details of the Bank´s securitisation activities are given in note 67.

Segment Reporting

38. Segment information is presented in respect of the Bank's business and geographical segments. The primary format, business segments, is based on the Bank´s management and internal reporting structure.

Inter-segment pricing is determined on an arm's length basis. Business segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital and funding cost.

Segment capital expenditure is the total cost incurred during the year to acquire property and equipment and intangible assets other than goodwill.

Business segments

The Bank comprises the following main business segments:

Capital Markets is divided into two parts: Capital Markets and Proprietary Trading. Capital Markets handles securities brokerage for the Bank's clients. Proprietary Trading handles transactions for the Bank's own account in all major markets, as well as undertaking the Bank's market making for stocks and bonds.

Investment Banking provides various services to corporate clients through its four main products areas: M&A advisory, capital market transactions, acquisition and leverage finance and principle investment.

Treasury is responsible for inter-bank trading, the Bank’s funding, derivatives and foreign exchange trading and brokerage.

Banking provides general banking services to retail customers in Iceland and services such as advice and assistance in financing to medium-sized and large companies, particularly in Iceland, Sweden, the UK and Denmark.

Asset Management and Private Banking manage financial assets for institutional, corporate and private clients. Asset Management is organised into three units: Alternative and Mutual Fund Management, Asset Management for Institutional Investors and Services for Institutional Investors. Private Banking consists of two units: Customer Relations and Portfolio Management.

Cost centres are: Overhead, Back office, Risk Management, Finance, Legal department, Information Technology and Human Resources.

Geographical segments

The bank operates in four main geopgrahical regions, being: Iceland, Scandinavia, United Kingdom (UK) and Luxembourg.

39. Summary of the Bank's profit centres' operations:

2006	Capital Markets	Investment Banking	Treasury	Banking	Asset Managem. and Private Banking	Elimination and cost centres	Total
Net interest income	(1,513)	(3,349)	11,492	45,903	817	(988)	52,362
Net fee and commission income	7,396	9,577	2,927	5,744	11,231	409	37,284
Net financial income	7,913	42,984	8,411	750	531	(432)	60,157
Other income	(1)	43	26	6,631	962	9,751	17,412
Operating income	13,795	49,256	22,856	59,028	13,541	8,740	167,216
Operating expense	(6,205)	(3,636)	(3,078)	(14,969)	(7,380)	(24,738)	(60,006)
Impairment	(123)	1	(5)	(4,851)	(1,138)	(11)	(6,127)
Total expense	(6,328)	(3,635)	(3,083)	(19,820)	(8,518)	(24,749)	(66,133)
Earnings before cost allocation	7,467	45,621	19,773	39,208	5,023	(16,009)	101,083
Allocated cost	(3,206)	(888)	(2,015)	(8,744)	(3,427)	18,279	0
Earnings before income tax	4,262	44,733	17,758	30,465	1,595	2,270	101,083
Net segment revenue from external customers	20,697	53,425	(52,166)	135,108	9,516	636	167,216
Net segment revenue from other segments	(6,902)	(4,169)	75,022	(76,080)	4,025	8,104	0
Operating income	13,795	49,256	22,856	59,028	13,541	8,740	167,216
Depreciation and amortisation	9	8	11	3,512	21	2,415	5,976
Total assets	214,433	108,946	1,649,940	2,597,032	12,386	(527,341)	4,055,396
Total liabilites	183,637	47,998	1,600,859	2,421,953	4,171	(538,114)	3,720,504
Allocated equity	30,796	60,948	49,081	175,079	8,215	10,773	334,892
Total liabilites and equity	214,433	108,946	1,649,940	2,597,032	12,386	(527,341)	4,055,396
Capital expenditure	259	38	285	6,957	705	7,383	15,627

2005	Capital Markets	Investment Banking	Treasury	Banking	Asset Managem. and Private Banking	Elimination and cost centres	Total
Net interest income	(1,120)	(2,322)	4,733	32,076	632	(1,289)	32,710
Net fee and commission income	4,730	7,592	1,364	3,165	5,256	321	22,428
Net financial income	16,008	18,416	2,637	232	100	(111)	37,282
Other income	35	163	0	3,419	0	6,161	9,778
Operating income	19,653	23,849	8,734	38,892	5,988	5,082	102,198
Operating expense	(3,113)	(1,808)	(1,481)	(10,580)	(4,186)	(14,357)	(35,524)
Impairment	0	(22)	6	(2,395)	0	(1,978)	(4,390)
Total expense	(3,113)	(1,830)	(1,475)	(12,975)	(4,186)	(16,335)	(39,914)
Earnings before cost allocation	16,540	22,019	7,259	25,917	1,802	(11,253)	62,284
Allocated cost	(1,751)	(706)	(877)	(5,356)	(1,758)	10,448	0
Earnings before income tax	14,789	21,313	6,382	20,561	44	(805)	62,284
Net segment revenue from external customers	22,830	25,620	(33,915)	78,481	4,482	4,700	102,198
Net segment revenue from other segments	(3,177)	(1,771)	42,649	(39,589)	1,506	382	0
Operating income	19,653	23,849	8,734	38,892	5,988	5,082	102,198
Depreciation and amortisation	19	22	4	1,475	15	1,283	2,818

Kaupthing Bank hf. Financial Statements 2006 25 Amounts are in ISK millions

Geographic analysis

40. Operating income specified by location of its markets and customers.

The geographical analysis of operating income is provided in order to comply with IFRS and does not reflect the way the Bank is managed.

2006	Iceland	Scandi-navia	UK	Luxem-bourg	Other	Total
Net interest income	16,592	17,311	12,099	4,882	1,478	52,362
Net fee and commission income	14,724	5,935	10,543	4,356	1,727	37,284
Net financial income	34,995	17,181	5,975	1,842	164	60,157
Other income	12,233	993	4,168	0	19	17,413
Operating income	78,544	41,420	32,785	11,079	3,388	167,216

Financial gains relating to the sale of Exista hf., amounting to ISK 26,084 million, is included in Net financial income in Iceland. Financial gains relating to the sale of VÍS hf., amounting to ISK 7,421 million, is included in Other income in Iceland.

2005	Iceland	Scandi-navia	UK	Luxem-bourg	Other	Total
Net interest income	10,224	10,642	7,698	3,715	431	32,710
Net fee and commission income	8,859	3,814	6,364	2,896	495	22,428
Net financial income	6,217	10,218	18,015	1,907	925	37,282
Other income	6,048	1,742	1,986	2	0	9,778
Operating income	31,349	26,417	34,063	8,520	1,851	102,198

41. Assets specified by location of its markets and customers.

2006	Iceland	Scandi-navia	UK	Luxem-bourg	Other	Total
Cash and cash balances with central banks	964	40,616	65,007	42	332	106,961
Loans to credit institutions	88,421	126,909	139,308	50,414	80,282	485,334
Loans to customers	573,238	1,085,119	506,626	271,469	102,157	2,538,609
Financial assets measured at fair value	332,744	261,918	30,621	36,426	3,420	665,129
Other assets	76,149	111,686	66,316	4,899	313	259,363
Assets	1,071,516	1,626,247	807,878	363,251	186,504	4,055,396

2005	Iceland	Scandi-navia	UK	Luxem-bourg	Other	Total
Cash and cash balances with central banks	811	32,078	59	1,929	0	34,877
Loans to credit institutions and customers	531,743	776,470	297,642	70,693	62,746	1,739,294
Financial assets measured at fair value	247,761	185,399	160,956	5,492	12,926	612,534
Other assets	69,362	36,809	45,389	2,165	381	154,106
Assets	849,677	1,030,756	504,046	80,279	76,053	2,540,811

Kaupthing Bank hf. Financial Statements 2006 26 Amounts are in ISK millions

Notes to the Income Statement

Net interest income

42. Interest income and expense is specified as follows:

2006	Interest income	Interest expense	Net interest income
Cash and balances with central banks	911	0	911
Loans, receivables and deposits	150,405	(43,470)	106,935
Borrowings	0	(77,613)	(77,613)
Subordinated loans	0	(10,665)	(10,665)
Securities	28,191	(2,372)	25,819
Financial lease	5,359	0	5,359
Other	2,585	(969)	1,616
Interest income and expense	187,451	(135,089)	52,362

2005			
Cash and balances with central banks	367	0	367
Loans, receivables and deposits	79,297	(18,855)	60,442
Borrowings	0	(37,776)	(37,776)
Subordinated loans	0	(3,646)	(3,646)
Securities	15,356	(6,862)	8,494
Financial lease	3,375	(94)	3,281
Other	1,614	(66)	1,548
Interest income and expense	100,009	(67,299)	32,710

Net fee and commission income

43. Fee and commission income and expense is specified as follows:

Fee and commission income	2006	2005
Securities trading	11,413	8,263
Derivatives	3,582	1,680
Lending	2,901	1,665
Other fee and commission income	23,008	11,900
Fee and commission income	40,904	23,508
Fee and commission expense		
Received guarantees	(139)	(61)
Securities trading	(2,052)	(937)
Other fee and commission expense	(1,429)	(82)
Fee and commission expense	(3,620)	(1,080)
Net fee and commission income	37,284	22,428

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Net financial income

44. Net financial income is specified as follows:

	2006	2005
Dividend income	5,074	1,808
Net gain on financial assets and liabilities not at fair value	142	147
Net gain on financial assets and liabilities at fair value	52,023	33,920
Net foreign exchange gain	2,918	1,407
Net financial income	60,157	37,282

Dividend income

45. Dividend income is specified as follows:

Dividend income on available-for-sale financial assets	54	50
Dividend income on trading assets	3,703	1,723
Dividend income on assets at fair value through profit and loss	1,317	35
Dividend income	5,074	1,808

Net gain on financial assets and liabilities not at fair value

46. Net gain on financial assets and liabilities not at fair value are specified as follows:

Net realised gain on loans and finance leases	103	3
Net realised gain on available-for-sale assets	32	138
Net realised gain on financial liabilities measured at amortised cost	0	6
Other net realised gain	7	0
Net gain on financial assets and liabilities not at fair value	142	147

Net gain on financial assets and liabilities at fair value

47. Net gain on financial assets and liabilities at fair value are specified as follows:

Net gain on trading portfolio	12,997	14,223
Net gain on assets designated at fair value through profit and loss	38,668	19,226
Fair value adjustments on hedge accounting	358	471
Net gain on financial assets and liabilities at fair value	52,023	33,920

48. Net gain on trading portfolio are specified as follows:

Loss on interest rate instruments and related derivatives	(3,643)	(1,720)
Gain on equity instruments and related derivatives	11,226	12,961
Gain on foreign exchange trading	463	751
Gain on other derivatives	4,951	2,231
Net gain on trading portfolio	12,997	14,223

49. Net gain on assets designated at fair value through profit and loss are specified as follows:

(Loss) gain on interest rate instruments designated at fair value	(2,623)	13
Gain on equity instruments designated at fair value	41,291	19,213
Net gain on assets designated at fair value through profit and loss	38,668	19,226

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Other operating income

50. Other operating income is specified as follows:

	2006	2005
Gain on disposals of assets other than held for sale	8,784	3,896
Income from operating lease	4,128	769
Fair value adjustments on investment properties	513	400
Realised gain on investment properties	216	67
Net income (loss) from assets held for sale	7	(13)
Other income	2,571	3,263
Other operating income	16,219	8,382

Personnel

51. The Bank's total number of employees is as follows:

Average number of full time equivalent positions during the year	2,630	2,318
Full time equivalent positions at the end of the year	2,719	2,368

52. Salaries and related expenses are specified as follows:

Salaries	16,388	11,041
Bonus payments	11,606	5,407
Salary related expenses	5,576	3,869
Salaries and related expense	33,570	20,317

A subsidiary of the Bank, Kaupthing Singer & Friedlander, has a defined benefit pension scheme. All accrued cost in respect of the plan has been entered into the Financial Statements. Based on actuarial calculation the total liability is ISK 3,140 million at year end 2006.

53. Salaries to the executives of the Bank, their stock options and shares owned at year-end are specified as follows:

	Salaries	Benefits	Bonuses	Pension fund payment	Stock options shares	Shares at year-end
CEO:						
Hreidar Már Sigurdsson	69.5	2.1	69.5	27.8	1.6	6.4
Directors:						
Sigurdur Einarsson, Chairman	69.5	30.5	69.5	27.8	1.6	7.4
Ásgeir Thoroddsen	4.6					-
Bjarnfredur Ólafsson	5.3					-
Brynja Halldórsdóttir	4.6					-
Finnur Ingólfsson	4.6					-
Gunnar Páll Pálsson	4.6					-
Hjörleifur Thor Jakobsson	4.6					-
Niels de Coninck-Smith	3.5					-
Tommy Persson	4.6					-
María Sólbergsdóttir	1.2				-	-
CEO in Iceland and Denmark:						
Ingólfur Helgason	30.0	2.0	40.0		0.5	3.3
Lars Johansen	57.0	3.2	25.4			-
Five Group Managing Directors	99.9	9.0	97.0	3.5	1.6	4.6

The remuneration of the Chairman of the Board and the other directors of the board is decided by the annual general meeting of shareholders. In addition board members receive remuneration for work in committees of the board, such as audit, compensation and credit committees.

Kaupthing Bank hf. Financial Statements 2006 29 Amounts are in ISK millions

53. cont.

Remuneration to the Chairman of the Board, CEO and other members of "senior management" consist of base salary, variable salary/bonus, other benefits, extra pension contributions and stock-based compensation. The other members of senior management comprise the 5 persons who together with the CEO make up senior management. For the Chairman of the Board and CEO, the bonus is maximized at 100% of base salary. For the other members of senior management bonus is generally maximized at 100% of the base salary. Bonus to the Chairman of the Board, CEO and other senior management is based on the banks 15% minimum return on equity. Pension contributions and remuneration in the form of stock-based compensation and other benefits to the CEO and other members of senior management are part of the total remuneration package.

Remuneration to the CEO and the Chairman of the Board for the financial year 2006 was decided by the board based on the recommendation from the compensation committee. Remuneration to other members of group management was decided by the CEO.

Pension fund payments are extra pension contributions to the senior management and the Chairman of the Board. The Bank pays as well pension contributions to board members and senior management based on Icelandic law. There are no pension liabilities related to board members or senior management.

Bjarnfredur Ólafsson, a board member of the Bank, is a partner in the law firm Logos. The firm has provided the Bank legal services. Total fee paid to the firm was ISK 31.7 million for the year 2006.

The CEO and the Chairman of the Board exercised in 2006 stock options that were granted 2003. The difference in exercise price and market price were ISK 674 million for each of them.

Should the Chairman of the Board resign he shall receive salary payments for 12 months onwards, but otherwise his salary payments shall continue for 48 months from the date of the termination of employment. The CEO's term of notice is 12 months, but should his employment terminate due to other reasons his salary payments shall continue for 48 months.

Additional information on stock options can be found in note 99.

Auditor's fee

54. Auditor's fee is specified as follows:

	2006	2005
Audit of the Financial Statements	262	140
Other related audit service	33	33
Review of the Interim Financial Statements	36	42
Other service	121	71
Auditor's fee	452	286
Fee to others than the Parent Company's auditors, included in the above total	366	237

Impairment

55. Impairment is specified as follows:

Impairment on loans	4,857	2,450
Impairment on goodwill	451	1,522
Impairment on intangible assets	819	417
Impairment on other assets	1,270	1,939
Impairment on assets	6,127	4,389

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56. Tax assets and tax liabilities recognised in the Income Statement are specified as follows:

	2006	2005
Current tax expense		
Current year	10,154	8,115
Deferred tax expense		
Changes in temporary differences	4,482	3,113
Total income tax expense	14,636	11,228

Reconciliation of effective tax rate:		2006		2005
Earnings before income tax		101,083		62,284
Income tax using the domestic corporation tax rate	18.0%	18,195	18.0%	11,211
Effect of tax rates in foreign jurisdictions	(0.3%)	(290)	0.8%	526
Non-deductible expense	1.4%	1,394	0.4%	252
Tax exempt revenues	(2.8%)	(2,786)	(0.2%)	(145)
Tax incentives not recognised in the Income Statement	0.2%	171	(0.9%)	(532)
Other changes	(2.0%)	(2,048)	(0.1%)	(84)
Effective tax rate	14.5%	14,636	18.0%	11,228

Earnings per share

57. Earnings per share are specified as follows:

	2006	2005
Net earnings attributable to the shareholders of Kaupthing Bank hf.	85,302	49,260
Weighted average share capital:		
Weighted average of outstanding shares for the year	671.0	655.2
Effects of stock options	20.3	10.9
Weighted average of total shares for the year	691.3	666.1
Basic earnings per share	127.1	75.2
Diluted earnings per share	123.4	73.9
Number of outstanding shares at the end of the year, million	732.1	663.8
Number of total shares at the end of the year, million	752.4	674.8
Average number of own shares, million	8.4	5.7
Number of own shares at the end of the year, million	8.4	0.7

Notes to the Balance Sheet

Cash and balances with central banks

58. Cash and balances with central banks are specified as follows:

	2006	2005
Cash and cash balances	10,537	16,869
Cash equivalent	96,424	18,008
Cash and balances with central banks	106,961	34,877

Kaupthing Bank hf. Financial Statements 2006 31 Amounts are in ISK millions

Loans to credit instituitons

59. Loans to credit institutions specified by types of loans:

	2006	2005
Money market loans	242,284	97,544
Bank accounts	95,828	46,881
Overdrafts	7,902	1,733
Repos	50,753	0
Other loans	88,567	49,436
Loans to credit institutions	485,334	195,594

Loans to customers

60. Loans to customers specified by types of loans:

Overdrafts	113,354	101,452
Finance lease	93,006	51,212
Subordinated loans	7,369	7,647
Other loans	2,341,462	1,396,342
Provision for loans	(16,582)	(12,953)
Loans to customers	2,538,609	1,543,700

61. Loans to customers specified by sectors:

Individuals	16.6%	17.3%
Holding companies	13.5%	9.8%
Industry	24.3%	19.1%
Real estate	15.6%	12.7%
Service	19.9%	27.0%
Trade	8.5%	12.4%
Transportation	1.6%	1.7%
Loans to customers	100.0%	100.0%

62. Specification of subordinated loans:

Loans to customers	4,907	5,796
Bonds and other fixed income securities	2,462	1,851
Subordinated loans	7,369	7,647

63. Provisions on loans are specified as follows:

Specific provision	13,404	9,155
Collective assessment	3,178	3,798
Provision on loans	16,582	12,953

64. Changes in the provision on loans are specified as follows:

Balance at the beginning of the year	12,953	12,294
Acquisition through business combination	0	1,765
Impairment on loans during the year	4,857	2,450
Exchange rate difference on translation	1,786	(518)
Write-offs during the year	(3,203)	(3,212)
Payment of loans previously written-off	189	174
Provision on loans	16,582	12,953

Included within interest income is ISK 642 million (2005: ISK 552 million) with respect of interest income accrued on impairment on financial assets and ISK 161 million (2005: ISK 112 million) with respect to the unwind of the impairment provision discount.

Non-performing loans are classified as aggregated exposures of customers for which the Bank has made specific provisions in part or in full. Non-performing loans amounted at year end 2006 to ISK 25,506 million (2005: ISK 15,078 million), 1.00% of total loans to customers (2005: 0.98%).

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Financial assets

65. Financial assets are specified as follows:

2006	Trading assets	Fin. assets designated at fair value	Fin. assets available for sale	Derivatives used for hedging	Total
Bonds and debt instruments					
Listed	26,208	246,620	0	0	272,828
Unlisted	3,559	31,369	0	0	34,928
Mortgage loans	0	10,508	0	0	10,508
Bonds and debt instruments	29,767	288,497	0	0	318,264
Shares and equity instruments					
Listed	78,463	35,353	0	0	113,816
Unlisted	10,481	34,559	164	0	45,204
Shares and equity instruments	88,944	69,912	164	0	159,020
Derivatives					
OTC derivatives	50,011	0	0	0	50,011
Futures	15	0	0	0	15
Other trading derivatives	15,428	0	0	0	15,428
Derivatives	65,454	0	0	0	65,454
Derivatives used for hedging					
Fair value hedge	0	0	0	2,953	2,953
Portfolio hedge of interest rate risk	0	0	0	3,500	3,500
Derivatives used for hedging	0	0	0	6,453	6,453
Securities used for hedging					
Bonds and debt instruments	66,732	0	0	0	66,732
Shares and equity instruments	47,011	2,195	0	0	49,206
Securities used for hedging	113,743	2,195	0	0	115,938
Financial assets	297,908	360,604	164	6,453	665,129
2005					
Bonds and debt instruments					
Listed	169,714	78,730	0	0	248,444
Unlisted	0	130,098	0	0	130,098
Mortgage loans	0	12,033	0	0	12,033
Bonds and debt instruments	169,714	220,861	0	0	390,575
Shares and equity instruments					
Listed	54,273	18,323	0	0	72,596
Unlisted	10,025	31,567	167	0	41,759
Shares and equity instruments	64,298	49,890	167	0	114,355
Derivatives					
OTC derivatives	12,644	0	0	0	12,644
Futures	18	0	0	0	18
Other trading derivatives	8,385	0	0	0	8,385
Derivatives	21,047	0	0	0	21,047
Derivatives used for hedging					
Fair value hedge	0	0	0	982	982
Portfolio hedge of interest rate risk	0	0	0	3,477	3,477
Derivatives used for hedging	0	0	0	4,459	4,459
Securities used for hedging					
Bonds and debt instruments	28,710	0	0	0	28,710
Shares and equity instruments	53,388	0	0	0	53,388
Securities used for hedging	82,098	0	0	0	82,098
Financial assets	337,157	270,751	167	4,459	612,534

Kaupthing Bank hf. Financial Statements 2006 33 Amounts are in ISK millions

66. Bonds and debt instruments designated at fair value specified by issuer:

	2006	2005
Financial institutes	270,879	117,982
Government	1,032	81,666
Corporates	16,586	21,213
Bonds and debt instruments designated at fair value	288,497	220,861

Pledged assets

67. Pledged assets are specified as follows:

Mortgage loans in Kaupthing Mortgage fund	84,165	0

In the ordinary course of business, the Bank enters into transactions that result in the transfer of financial assets to third parties or special entity. The Bank has transferred retail mortgage loans to the Kaupthing Mortgage Fund, but has retained substantially all of the credit risk associated with the transferred assets, and continues to recognise these assets within loans to customers.

The Bank has entered into repurchase agreements that are conducted under terms usual and customary to standard lending, and stock borrowing and lending activities. Pledged assets according to these agreements amounted to ISK 121 billion at year end 2006 (2005: ISK 48 billion).

68. The Bank sold equity instruments during the year with a fair value of EUR 450 million for cash that has been included as a cash flow from operating activities. The Bank has continuing on and off Balance Sheet exposure to the market price of the equity shares with a maximum potential exposure of EUR 360 million against which the Bank has placed EUR 81 million cash collateral, subject to a requirement for additional collateral based on changes in the market price of the equity shares. The Bank has maximum potential exposure of EUR 360 million, although the Bank has the right to increase the exposure to EUR 400 million.

Investment in associates

69. Investment in associates are specified as follows:

	2006	2005
Carrying amount at the beginning of the year	13,888	3,649
Additions	5,400	1,805
Sold during the year	(11,868)	(42)
Transfers	0	7,671
Profit share	1,194	1,396
Dividend received	(4,103)	(102)
Foreign currency translation	792	(489)
Carrying amount at the end of the year	5,304	13,888

Main associates are specified as follows:	Currency	Total assets	Total liabilities	Ownership	Profit share	Nominal value	Book value
Drake Management LLC, USA	USD	11,578	7,329	20.0%	604	10	2,082
Greiðslumiðlun hf., Iceland	ISK	30,173	28,007	39.5%	165	84	1,757
Mezzanin Kapital A/S, Denmark	DKK	5,696	3,313	22.7%	(1)	159	542
FMS Holding af 2004 A/S, Denmark	DKK	633	302	25.0%	2	113	265
Reiknistofa Bankanna, Iceland	ISK	1,717	199	17.3%	0	0	263
JHM Holsted Holding A/S, Denmark	DKK	1,545	761	25.0%	0	197	197
Eighteen other associates					424	20	198
					1,194		5,304

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Intangible assets

70. The Bank performed impairment test on the carrying amount of goodwill as at 31 December 2006. Impairment tests are performed in the 4th quarter each year, based on the budgets and business plans approved by the Board of Directors and other assumptions.

Goodwill is distributed among cash-generating units (CGU) in keeping with the main emphasis of monitoring and managing activities. The emphasis of the Bank has been shifting such that the subsidiaries are less considered as the core of operations. Instead, operations are tending more towards placing emphasis on the Bank's operational units. The integration of these changes in emphasis into the Bank's organization has begun and a number of organisational changes have already been made, all with the aim of uniting the Bank and increasing its transparency.

The Bank has now defined the five independent CGU of the Bank's operation, each devising its own budget and responsible for its own results. Furthermore, the costs of the ancillary units are distributed proportionally among the CGU. The CGU are as follows: 1) Capital Markets, 2) Investment Banking, 3) Asset Management & Private Banking, 4) Treasury, and 5) Banking. With regard to this operational restructuring and planning within the group, goodwill in the Bank's accounts has been distributed among the CGU according to its origin. As part of the apportioning of the Bank's goodwill, the recoverable amount is measured by value in use.

Each CGU is assessed on its own, in which expectations for return on equity, payout ratio, equity and yield are the main variables in the assessment of each CGU. An independent operating budget acts as the basis for results for the first year of the scheme, after which the next three years are based on the return objectives for each CGU and after that it is based on long-term yield of comparable units. The Bank aims to achieve consolidated 15% return on equity over the next four years. Return objectives are different within each CGU. In the budget for 2006, return on equity is expected to be higher than the Bank's objective. In the assessment, future return on equity is expected to be similar to the average of group of comparable units to each CGU.

2006	Goodwill	Discount rate	Net earnings: Est. CAGR, year 1-4
Capital Markets	5,815	12.7%	<2%
Investment Banking	8,596	12.7%	<2%
Treasury	5,001	12.7%	<2%
Asset Management and Private Banking	5,454	10.6%	18.0%
Banking	38,252	9.6%	<2%
	63,118		
2005			
Capital Markets	4,618	10.9%	<2%
Investment Banking	6,826	10.9%	<2%
Treasury	3,971	10.9%	<2%
Asset Management and Private Banking	4,689	9.0%	>100%
Banking	30,377	8.2%	<2%
	50,481		

The management assesses that likely changes in the key parameters discussed will not cause the carrying amount of goodwill to exceed the recoverable amount.

71. Intangible assets are specified as follows:

2006	Goodwill	Other intangible assets	Total
Balance at the beginning of the year	50,481	4,462	54,943
Exchange rate difference	13,088	792	13,880
Additions during the year	0	1,810	1,810
Impairment	(451)	(819)	(1,270)
Amortisation	0	(1,062)	(1,062)
Intangible assets	63,118	5,183	68,301

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71. cont.

2005

	Goodwill	Other intangible assets	Total
Balance at the beginning of the year	34,011	1,087	35,098
Acquisition through business combination	394	942	1,336
Exchange rate difference	(1,178)	(69)	(1,247)
Additions during the year	18,775	2,883	21,658
Impairment	(1,521)	0	(1,521)
Amortisation	0	(381)	(381)
Intangible assets	50,481	4,462	54,943

In 2006 Kaupthing Singer & Friedlander closed its Investment Management business in Leeds. Impairment testing was undertaken on these balances as at 30 September 2006 based on the most recent information available. The results of the impairment testing suggested a full write-off of intangible assets amounting to ISK 819 million and goodwill amounting to ISK 451 million or total ISK 1,270 million.

Investment property

72. Investment property are specified as follows:

	2006	2005
Balance at the beginning of the year	24,156	19,155
Exchange rate difference	3,426	5
Additions during the year	3,475	4,839
Disposals during the year	(2,347)	(208)
Revaluation during the year	96	365
Transfers	2,778	0
Investment property	31,584	24,156

The Bank's investment properties were revalued at 31 December 2006 by independent professionally qualified valuers which have recent experience in the location and category of the investment property being valued. Valuations were based on current prices in an active market for all properties except for the properties located in Iceland where the Bank used discounted cash flow projections.

73. Leases as lessor

The Bank leases investment property as operating leases (see note 20). The future minimum lease payments under non-cancellable leases are as follows:

	2006	2005
Less than one year	1,682	917
Over 1 year and up to 5 years	4,391	3,768
Over 5 years	21,682	15,263
Minimum lease payments under non-cancellable leases	27,755	19,948

During the year 2006 ISK 2,274 million (2005: ISK 1,530 million) was recognised as rental income in the Income Statement and ISK 20 million (2005: ISK 2 million) in respect of repairs and maintenance was recognised as an expense in the Income Statement relating to investment property.

In the Income Statement, direct operating expenses include ISK 32 million relating to investment property that was unlet compared to ISK 5 million for the year before.

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Property and equipment

74. Property and equipment are specified as follows:

	Real estate	Machinery and equipm.	Operating lease	Total 2006	Total 2005
Balance at the beginning of the year	8,276	7,998	19,368	35,642	10,781
Acquisitions through business combination	0	0	0	0	22,884
Exchange rate difference	467	1,361	6,019	7,847	(411)
Additions during the year	4,571	3,643	5,604	13,818	4,965
Disposals during the year	(1,996)	(1,301)	(1,330)	(4,627)	(2,159)
Transfers	(2,234)	0	(579)	(2,813)	0
Impairment	0	0	0	0	(418)
Gross carrying amount at the end of the year	9,084	11,701	29,082	49,867	35,642
Previously depreciated	1,665	5,476	6,069	13,210	4,689
Acquisitions through business combination	0	0	0	0	7,274
Exchange rate difference	(289)	1,279	1,970	2,959	(235)
Depreciation during the year	301	1,436	3,177	4,914	2,437
Transfers	445	0	(480)	(35)	0
Disposals during the year	(78)	(668)	(901)	(1,647)	(955)
Total depreciation at the end of the year	2,044	7,523	9,834	19,401	13,210
Property and equipment	7,040	4,178	19,248	30,466	22,433

75. Depreciation and amortisation in the Income Statement is specified as follows:

	2006	2005
Depreciation of property and equipment	4,914	2,437
Amortisation of intangible assets	1,062	381
Depreciation and amortisation	5,976	2,818

76. Property under construction

During the year ended 31 December 2006, the Bank's construction cost of a new building for future use as headquarters; incurred up to ISK 1,212 million including the acquisition cost of the land in the year 2005.

77. Leases as lessor

The Bank leases out property and equipment under operating leases (see note 20). The future minimum lease payments under non-cancellable leases are as follows:

	2006	2005
Less than one year	851	3
Over 1 year and up to 5 years	3,322	19
Over 5 years	4,414	102
Minimum lease payments under non-cancellable leases	8,587	124

During the year ended 31 December 2006 ISK 2,033 million was recognised as rental income in the Income Statement and ISK 8 million in respect of repairs and maintenance was recognised as an expense in the Income Statement relating to property and equipment. Comparative amounts for the year 2005 amounted ISK 1,530 million and ISK 2 million, respectively.

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Other assets

78. Other assets are specified as follows:

	2006	2005
Unsettled securities trading	90,427	16,091
Accounts receivables	8,617	6,997
Accrued income	8,004	4,868
Prepaid expenses	2,846	2,887
Non-current assets and disposal groups classified as held for sale	2,334	2,302
Sundry assets	5,646	537
Other assets	117,874	33,682

Unsettled securities trading was settled in less than three days from the reporting.

Borrowings

79. Borrowings are specified as follows:

Bonds issued	1,762,483	1,158,806
Bills issued	156,203	164,910
Money market loans	373,285	200,581
Other loans	107,968	32,270
Borrowings	2,399,939	1,556,567

Included are Repurchase agreements with banks amounting to ISK 94,913 million at the end of December compared to ISK 14,376 millon at year end 2005.

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Subordinated loans

80. Subordinated loans are specified as follows:

	Currency	Orginal interest	Interest change	Interest after change	Maturity date	2006 Book value	2005 Book value
Loans that qualify as Tier I capital:							
Issued in 2001	ISK	8.7%	2011		No maturity date	1,310	1,232
Issued in 2004	EUR	5.9%	2014	3 m Euribor + 245 bps.	No maturity date	15,095	12,545
Issued in 2005	EUR	6.3%	2010	6.3%	No maturity date	16,685	13,517
Issued in 2005	ISK	3 m Reibor + 1,4%			No maturity date	3,353	3,352
Issued in 2005	USD	5.1%			No maturity date	11,798	10,555
Issued in 2006	ISK	3 m Reibor + 1,4%			No maturity date	3,576	
						51,817	41,201
Loans that qualify as Tier II capital:							
Issued in 1996	DKK	0.0%			2007	228	370
Issued in 1999	EUR	6.4%			2009	3,067	2,545
Issued in 1999	JPY	0.0%			2032	3,513	3,057
Issued in 1999	USD	4.8%			2032	3,948	3,660
Issued in 2000	ISK	7.0%	2007	9.0%	2012	2,135	1,974
Issued in 2000	ISK	6.0%	2005	7.5%	2010	0	1,216
Issued in 2001	ISK	6.0%	2006	7.5%	2011	122	129
Issued in 2001	ISK	8.0%	2006	10.0%	2011	0	1,223
Issued in 2002	ISK	6.0%	2007	7.5%	2012	1,021	948
Issued in 2002	ISK	7.5%	2009	10.0%	2014	1,429	1,334
Issued in 2002	ISK	8.0%			2026	264	247
Issued in 2002	EUR	3 m Euribor + 115bps.	2007	3 m Euribor + 365bps.	2012	474	374
Issued in 2003	GBP	7.5%			2019	6,976	5,646
Issued in 2004	ISK	5.4%	2009	7.4%	2014	1,666	1,557
Issued in 2004	EUR	3 m Euribor + 65bps.	2009	3 m Euribor + 165 bps.	2014	28,281	22,284
Issued in 2004	DKK	3.0%			2008	142	112
Issued in 2005	USD	7.5%	2010	4x(CMS 10y/2y) 10%/3,75%	2045	5,512	4,835
Issued in 2005	EUR	6.5%	2010	4x(CMS 10y/2y) 9%/3%	2045	7,903	6,227
Issued in 2005	EUR	3 m Euribor + 40bps.	2012	3 m Euribor + 140bps	2017	4,758	3,749
Issued in 2006	USD	7.1%			2016	92,774	
						164,213	61,487
Subordinated loans						216,030	102,688

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Financial liabilities measured at fair value

81. Financial liabilities measured at fair value are specified as follows:

	2006	2005
Trading liabilities	51,095	32,003
Derivatives used for hedging - portfolio hedge of interest rate risk	8,768	13,276
Mortgage funding measured at fair value	11,401	14,994
Financial liabilities measured at fair value	71,264	60,273

82. Trading liabilities are specified as follows:

	2006	2005
Short position in equity instruments held for trading	2,122	3,765
Derivatives held for trading	48,788	27,942
Other liabilities held for trading	185	296
Trading liabilities	51,095	32,003

83. Derivatives used for hedging are specified as follows:

	2006	2005
Fair value hedge	1,070	0
Portfolio hedge of interest rate risk	7,698	13,276
Derivatives used for hedging	8,768	13,276

Tax assets and tax liabilities

84. Tax assets and liabilities are specified as follows:

	Assets	Liabilities
Current tax	26	10,180
Deferred tax	5,808	13,030
Tax assets and liabilities	5,834	23,210

85. Deferred tax assets and liabilities are specified as follows:

2006	Assets	Liabilities	Net
Balance at the beginning of the year	5,004	10,343	(5,339)
Exchange rate difference on translation	234	690	(456)
Other changes		(581)	581
Calculated income tax for the year	596	15,232	(14,636)
Income tax recognised in equity	0	(2,474)	2,474
Income tax to be paid in next year	(26)	(10,180)	10,154
Net tax assets and (liabilities)	5,808	13,030	(7,222)

2005			
Balance at the beginning of the year	1,092	4,408	(3,316)
Acquisition through business combination	3,987	4,333	(346)
Disposals during the year		(474)	474
Exchange rate difference on translation	(150)	(932)	782
Calculated income tax for the year	75	11,303	(11,228)
Income tax to be paid in next year	0	(8,295)	8,295
Net tax assets and (liabilities)	5,004	10,343	(5,339)

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86. Changes in deferred tax assets and liabilities are specified as follows:

2006	At Jan. 1	Exchange rate and other adjustment	Business combination and disposal	Recognised in profit or loss	Recognised in equity	At Dec. 31
Shares in other companies	1,516	190		1,326		3,032
Currency linked assets and liabilities	502	65		3,447	(2,474)	1,540
Loans	5,643	724		(942)		5,425
Derivatives	(841)	(183)		1,121		97
Investment property and property and equipment	455	104		888		1,447
Other assets and liabilities	(667)	(734)		(1,303)		(2,704)
Carry forward taxable loss	(1,269)	(291)		(55)		(1,615)
Change in deferred tax	5,339	(125)	0	4,482	(2,474)	7,222

2005						
Shares in other companies	575	(57)	(22)	1,020		1,516
Currency linked assets and liabilities	346	(38)	(12)	206		502
Loans	3,639	(480)	(141)	2,625		5,643
Derivatives	(153)	16	6	(710)		(841)
Investment property and property and equipment	356	(31)	(14)	144		455
Other assets and liabilities	65	(7)	(3)	(722)		(667)
Carry forward taxable loss	(1,512)	(185)	58	370		(1,269)
Change in deferred tax	3,316	(782)	(128)	2,933	0	5,339

Other liabilities

87. Other liabilities are specified as follows:

	2006	2005
Unsettled securities trading	91,661	8,478
Provisions	4,666	3,271
Accounts payable	4,410	3,573
Sundry liabilities	48,211	29,173
Other liabilities	148,948	44,495

Unsettled securities trading was settled in less than three days from the reporting date.

88. Provisions are specified as follows:

Provision for pensions	3,679	2,815
Provision for losses on guarantees	263	0
Other provisions	724	456
Provisions	4,666	3,271

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Equity

Shareholders' equity

89. According to the Parent Company's Articles of Association, total share capital amounts to ISK 7,405 million. At year-end 2006 own shares amounted to ISK 84 million and share capital, according to the Balance Sheet, thus amounted to ISK 7,321 million. One share has a nominal value of ISK 10. The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Bank.

Increase of share capital during the year is broken down as follows:	2006		2005	
	Share capital	Market value	Share capital	Market value
Shares outstanding at 1 January	6,638	495,195	6,521	293,732
Issued new shares	759	55,558	39	416
Purchases and sales of treasury stock	(76)	(5,730)	78	3,706
Changes in market value		70,673		197,340
Shares outstanding at 31 December	7,321	615,696	6,638	495,194
Own shares	84	7,064	7	485

90. Movement in share capital during the year segregates as follows:

2006	Share capital	Share premium	Stock options	Total
Balance at 1 January 2006	6,638	114,437	169	121,244
Purchases and sales of treasury stock	(76)	(5,948)		(6,024)
Issued new shares	759	54,799		55,558
Exercised stock options		224	(224)	0
Stock option expense			571	571
Balance 31 December 2006	7,321	163,512	516	171,349

2005				
Balance at 1 January 2005	6,521	110,402	157	117,080
Purchases and sales of treasury stock	78	3,628		3,706
Issued new shares	39	377		416
Exercised stock options		30	(30)	0
Stock option expense			42	42
Balance 31 December 2005	6,638	114,437	169	121,244

The cost of issuing new shares in 2006, amounting to ISK 1,939 million, has been deducted from share premium.

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91. Movement in reserves were as follows:

2006	Pension reserve	Fair value reserve	Translation reserve	Total
Balance at 1 January	(480)	(2)	(1,058)	(1,540)
Translation difference	0	0	18,289	18,289
Changes in fair value of available-for-sale financial assets	0	(9)	0	(9)
Deferred pension reserve	480	0	0	480
Balance 31 December	0	(11)	17,231	17,220

2005	Pension reserve	Fair value reserve	Translation reserve	Total
Balance at 1 January	0	0	(670)	(670)
Translation difference	0	0	(388)	(388)
Changes in fair value of available-for-sale financial assets	0	(2)	0	(2)
Deferred pension reserve	(480)	0	0	(480)
Balance 31 December	(480)	(2)	(1,058)	(1,540)

Fair value reserve
The fair value reserve includes the cumulative portion of the cumulative net change in fair value of available-for-sale investments until the investment is derecognised.

Translation reserve
The translation reserve compromise all foreign exchange differences arising from the translation of the financial statements of foreign operations that are not integral to the operations of the Bank, as well as from the translation liabilities that hedge the Bank's net investment in a foreign subsidiaries.

Pension reserve
The pension reserve includes the changes in the pension obligation.

92. Equity at the end of the year amounts to ISK 334,892 million. The equity ratio, calculated in accordance to Article 84 of the Act on Financial Undertakings, was 15.0%. According to the law the ratio may not be lower than 8.0%.

The ratio is calculated as follows:

	2006		2005	
	Book value	Weighted value	Book value	Weighted value
Risk base:				
Assets recorded in the Financial Statements	4,055,396	2,875,539	2,540,811	1,841,833
Assets deducted from equity		(66,922)		(62,590)
Guarantees and other items not included in the Balance Sheet		259,023		166,028
		3,067,640		1,945,271
Equity:				
Tier I capital:				
Equity		334,892		202,512
Intangible assets		(65,276)		(54,943)
Assets deducted from equity		0		(6,742)
Subordinated loans		51,817		41,201
Tier II capital:				
Subordinated loans		160,717		61,285
Investment in credit institutions		(21,324)		(6,451)
		460,826		236,862
Equity ratio		15.0%		12.2%
Thereof Tier I ratio		10.5%		9.4%

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93. Derivatives remaining maturity date of principal and book value are specified as follows:

2006	Principal				Book value	
	Up to 3 months	Over 3 months and up to a year	Over 1 year	Total	Assets	Liabilities
Currency and interests rate derivatives, agreements unlisted:						
Forward exchange rate agreements	1,428,174	137,042	4,879	1,570,095	13,178	12,575
Interest rate and exchange rate agreements	117,595	364,708	1,942,931	2,425,234	37,976	30,529
Options - purchased agreements	53,139	22,730	62,242	138,111	2,870	63
Options - sold agreements	48,438	24,876	40,738	114,052	93	2,452
	1,647,346	549,356	2,050,790	4,247,492	54,117	45,619
Equity derivatives:						
Equity swaps, agreements unlisted	35,888	9,076	4,886	49,850	8,430	3,369
Equity options, purchased unlisted agreements	4,308	0	2,700	7,008	90	73
Equity options, sold unlisted agreements	338	0	2,700	3,038	151	10
Futures, agreements listed	1,527	0	0	1,527	15	0
Contracts for differences	3,959	0	0	3,959	32	0
	46,020	9,076	10,286	65,382	8,718	3,452
Credit derivative contracts:						
Credit default swaps	4,257	0	212,928	217,186	36	8
Total rate of return swaps	0	0	45,999	45,999	0	1,733
	4,257	0	258,927	263,184	36	1,741
Bond derivatives:						
Bond swaps, agreements unlisted	22,360	2,939	25,471	50,770	2,307	102
Options - purchased agreements	0	401	13,931	14,332	6,729	0
Options - sold agreements	0	401	13,931	14,332	0	6,717
	22,360	3,741	53,333	79,434	9,035	6,819
Derivatives	1,719,983	562,173	2,373,336	4,655,492	71,907	57,631

2005	Up to 3 months	Over 3 months and up to a year	Over 1 year	Total	Assets	Liabilities
Currency and interests rate derivatives, agreements unlisted:						
Forward exchange rate agreements	519,031	44,442	595	564,068	5,820	4,264
Interest rate and exchange rate agreements	78,372	167,328	777,591	1,023,291	14,558	40,044
Options - purchased agreements	2,399	4,395	25,945	32,739	861	0
Options - sold agreements	7,310	6,401	21,504	35,215	143	432
	607,112	222,566	825,635	1,655,313	21,382	44,740
Equity derivatives:						
Equity swaps, agreements unlisted	60,252	17,987	0	78,239	2,517	4,729
Equity options, purchased unlisted agreements	5,501	0	2,000	7,501	56	0
Equity options, sold unlisted agreements	2,357	0	2,000	4,357	0	144
Futures, agreements listed	920	0	0	920	0	2
	69,030	17,987	4,000	91,017	2,573	4,875
Credit derivative contracts:						
Credit default swaps	2,545	2,638	173,309	178,492	75	1
Bond derivatives:						
Bond swaps, agreements unlisted	6,343	4,218	25,155	35,716	71	1,154
Derivatives	685,030	247,409	1,028,099	1,960,538	24,101	50,770

The objective of the above-mentioned agreements is to control currency and interest rate risk of the Bank. The credit risk is valued at ISK 30,575 million when calculating the capital ratio of the Bank at 31 December 2006 and ISK 27,158 million at 31 December 2005.

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Off Balance Sheet information

Obligations

94. The Bank has granted its customers guarantees, overdraft permissions and loan commitments. These items are specified as follows:

	2006	2005
Guarantees	324,929	196,793
Credit default swaps, investment grade	217,186	179,147
Unused overdrafts	50,927	42,558
Loan commitments	317,689	165,066

The credit risk is valued at ISK 226 billion (2005: ISK 141 billion) for Guarantees, Credit default swaps, Unused overdrafts and Loan commitments when calculating the capital ratio of the Bank.

Operating lease commitments

95. At 31 December 2006, the Bank was obligated under a number of non-cancellable operating leases for premises and equipment. The significant premises leases usually include renewal options and escalation clauses in line with general office rental market conditions as well as rent adjustments based on price indices. However, the lease agreements do not contain contingent rent payment clauses and purchase options.

96. The Bank has concluded lease agreements regarding the real estate it uses for its operations. The lease agreement is for a period of up to 18 years and the Bank has priority right of purchase or right to extend the lease agreement at the end of that period.

Future minimum lease payments	6,714

Additional information

Assets under management and custody

97. Assets under management and assets under custody are specified as follows:

	2006	2005
Assets under management	1,403,376	1,073,651
Assets under custody	1,952,813	1,426,448

The Bank provides asset custody, asset management, investment management and advisory services to its clients. These services require the Bank to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Bank´s custody are not reported in its accounts.

Related parties

98. The Bank has a related party relationship with its subsidiaries, associates, the Board of Directors of the parent company, the Managing Directors of the bank, the Managing Directors of the biggest subsidiaries, close family members of individuals referred to above and entities with significant influence as the largest shareholders of the bank which are Exista B.V. (23.0%) and Kjalar Investmens hf. (9.7%). Information regarding related parties are as follows:

Significant related companies:

Loans:	2006	2005
Balance at the beginning of the year	36,888	26,889
Additions	91,274	28,382
Reductions	(18,606)	(18,383)
Balance at the end of the year	109,556	36,888

Comparison figures in this note have been changed because of a change in the definition of related parties. Balance at the end of year 2005 is ISK 33,823 million higher than in the Financial Statement for the year 2005.

Lýsing, which is a financial institution, supervised by FSA in Iceland, had ISK 39,380 million of the total loans to related parties at the end of year 2006.

Kaupthing Bank hf. Financial Statements 2006 45 Amounts are in ISK millions

98. cont.

The Bank has granted loans to the board members and its key management. The outstanding balance of loans to the board members, management and close family members amounted to ISK 17,716 million at 31 December 2006 and ISK 7,545 million at 31 December 2005. The terms and conditions are similar for the board members and key management as loans granted to other customers of the Bank. The aforementioned amounts do not include loans related to the business activities of the board members and key management.

No unusual transactions took place with related parties in the year 2006.

Transactions with related parties have been conducted on arm's length basis.

Stock options

99. During the year 2006, the Board of Directors of Kaupthing Bank hf. have decided on the basis of the Bank's stock option scheme to grant 564 employees in the group stock options to buy shares in the Bank. Stock option holders are entitled to exercise one third of their total stock option every year for three years between 20 January and 20 February, and the first period in which options can be exercised is from 20 January to 20 February 2008. The option has an exercise price of ISK 840 per share. The Board of Directors granted options on a total of 636 thousand shares.

At the same time as granting stock options to all employees, the board of directors of the bank has also granted 455 employees stock options to buy 21.7 million shares over a three-year period, during which they can exercise one third of the stock option each year. The period in which options can be exercised is also from 20 January to 20 February each year, with the first exercise period in 2010. The option has an exercise price of ISK 830 per share during the first exercise period, ISK 872 per share during the 2011 exercise period and ISK 916 per share during the 2012 exercise period. The exercise of the options can be postponed each time until last exercise date but the strike price will increase to the price indicated by the relevant exercise date.

The terms and conditions of the grants are as follows, whereby all options are settled by physical delivery of shares.

Grant date / employees entitled:	Number of shares in thousands	Vesting conditions:	Contractual life of options	Exercise price
October 2002	180	Five years of service. The stock option is excercisable 2007	5 years	120
March 2004	3,248	Four years of service. The stock option is exercisable 2007-2008	4 years	303
December 2002	887	Six years of service. One third of total stock option is exercisable each year 2007-2008	6 years	65.22
November 2005	3,593	Three years of service. One third of total stock option is exercisable each year 2007-2009	3 years	600
November 2005	7,815	Three years of service. One third of total stock option is exercisable each year 2007-2009	3 years	600/630 /660
December 2006	636	Three years of service. One third of total stock option is exercisable each year 2008-2010	3 years	840
December 2006	21,675	Five years of service. One third of total stock option is exercisable each year 2010-2012	5 years	830/872 /916
Total share options	38,034			

The number and weighted average exercise prices of share options is as follows:

	2006		2005	
	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options
Outstanding at the beginning of the year	494	20,811	209	12,630
Forfeited during the year	521	(1,447)	112	(376)
Exercised during the year	278	(3,641)	108	(4,085)
Granted during the year	871	22,311	641	12,642
Outstanding at the end of the year	735	38,034	494	20,811

The options outstanding at 31 December 2006 have an exercise price in the range of 65,22 to 916 and a weighted average contractual life of 3.9 years.

The fair value of services received in return for share options granted is measured by reference to the fair value of share options granted. The estimate of the fair value of the services received is measured based on the Black-Scholes model. The contractual life of the option is used as an input into this model. Expectations of early exercise are not incorporated into the Black-Scholes model.

99. cont.

The fair value of options granted during the year determined using the Black-Scholes valuations model was ISK 3,449 millions which will be amortised over contractual life of options. The significant inputs into the model were share prices of 840 (830, 872 and 916 for key management), expected volatility of 22.2%, option life disclosed above, annual risk free interest rate of 8.9%, and expected dividends yield of 2.0%. The expected volatility is based on the historic volatility over the last 36 months before the grant date. Expected leave rate is 15% per year (9% for key employees).

The fair value of options granted in 2005 determined using the Black-Scholes valuations model was ISK 1,127 million which will be amortised over contractual life of options. The significant inputs into the model were share prices of 600 (600, 630 and 660 for key management), expected volatility of 15%, option life disclosed above, annual risk free interest rate of 7.4%, and expected dividends yield of 2.3%. The expected volatility is based on the historic volatility over the last 12 months before the grant date.

The Board of Directors of FIH Erhvervsbank has granted the employees of FIH a stock option scheme which can be exercised 2008, 2009 and 2010. The options can only be exercised for 30 days after the Financial Statements have been published. During 2006 ISK 347 million (2005: ISK 43 million) has been entered among Salaries and related expenses and ISK 360 million (2005: ISK 39 million) in the Balance Sheet as liability.

Events after the Balance Sheet date

100. There have been no material post Balance Sheet events which would require disclosure or adjustments to the 31 December 2006 Financial Statements. On 29 January 2007 the Board of Directors approved the Financial Statements and authorised for publication.

Risk management disclosure

101. Kaupthing is a northern European bank offering comprehensive retail, corporate and investment banking services to individuals, companies and institutional investors. The Bank has five core business areas: Banking; Asset Management and Private Banking; Investment Banking; Capital Markets and Treasury. It also has ancillary divisions such as Risk Management, IT, Finance and Sales and Marketing.

The Bank faces various types of risks related to its business as a financial institution arising from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below.

Material risks

a) *Credit risk*

Credit risk is the current or prospective risk to earnings and capital arising from the failure of an obligor to repay principal or interest at the stipulated time or otherwise to perform as agreed. This risk is enhanced if the assigned collateral only partly covers the claims made on the borrower or if its value is variable or uncertain. Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. The risk comprises concentration risk, residual risk, credit risk in securitisation, cross border (or transfer) risk and more.

b) *Market risk*

Market risk is the current or prospective risk that changes in financial market prices and rates will reduce the value of a security or portfolio. The risk arises from market making, dealing, and position taking in bonds, securities, currencies, commodities, derivatives, and any other commitment depending on market prices and rates.

c) *Operational risk*

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business areas and in the ancillary divisions.

d) *Liquidity risk*

Liquidity risk is the risk arising from the possible inability of the Bank to meet its liabilities when they come due. It is an unavoidable source of risk in Kaupthing's operations as the Bank requires funding to support its investments.

Credit Risk Strategy

Carefully monitored credit risk is a base for stable profits. Undertaking credit risk is a cornerstone in the Bank's strategy for maintaining at least 15% long term return on equity. The main asset of the Bank is its loan portfolio, and therefore managing and analysing the loan portfolio is very important. The emphasis is on keeping a high quality credit portfolio, by seeking business with strong parties, maintaining a strict credit process, critically inspecting loan applications, identifying and reacting to possible problem loans at an early stage and other measures.

101. cont.

a) *Credit structure*

A fundamental requirement is to have a comprehensive structure for credits which is coherent across the group and within each subsidiary as well. The highest authority in credits is the parent company Board Credit Committee. The structure is based on a hierarchy of Credit Committees below the Board Credit Committee which operate on 2-3 levels and within different limits depending on the size of subsidiaries. The principle of central management of risk is maintained by having the bank's Group CEO or his deputy as a member of the Board Credit Committee in each subsidiary. This is necessary since the Group CEO is responsible for maintaining the bank's exposures within legal and policy limits and then the decision authority needs be included.

The pricing of each credit granted should reflect the risk taken. The client's interests should be guarded at all times and it must be considered likely that the client will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

It is the aim of the credit strategy that, in the long run, write-offs should be less than 5% of interest income. All aspects of the credit process should be designed and implemented with this long term goal in mind.

Provisions for losses should reflect the expected loss, both for loans for which specific provisions exist as well as for portfolios of performing loans. The collective assessment of such portfolios should be based on default predictions and loss given default parameters.

The Bank's total credit risk should be limited through diversification of the loan portfolio across sectors and by limiting large exposures.

b) *Quantification and Rating model description*

The basic elements for the quantification of credit risk are the probability of default, the loss given default, and exposure at default. These quantities need to be measured with an effective and accurate credit rating system. Information, both quantitative and qualitative, must be gathered, both specifically in regard to the counterparty and to its general economic situation in order to estimate its creditworthiness. Furthermore, a facility rating should be performed to determine the loss parameters in case of a default.

The policy of the bank is to apply sophisticated credit models to monitor credit risk. These credit models are also the foundation for the application of internal rating based approach to calculate capital requirements. Therefore, the development, implementation and application of these models must be in accordance with the bank's Basel II strategy.

Sources of Credit Risk

a) *Loan portfolio*

The main assets of Kaupthing Bank are its loans, to maintain and further improve the quality of the loan portfolio it is imperative to scrutinise all applications and weed out potential problem loans as early as possible, as well as constantly monitor the current loan portfolio. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

b) *Commitments and guarantees*

The Bank often commits itself to and ensures that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on check accounts, credit cards and credit lines. Potential loss on these accounts is equal to the amount of the limits although they may only be partly used at any one time. In practise, the potential loss is less severe since many of these commitments can be recalled immediately by the Bank in case the clients do not meet credit standards.

Guarantees carry the credit risk to the full amount similar as loans, since they represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties.

c) *Derivatives trading*

Derivative financial instruments used by the Bank include swaps, futures, forwards, options and other similar types of contracts whose value changes in response to changes in interest rates, foreign exchange rates, security prices, commodity prices or price indices. Limits on the net open derivative positions on these types of contracts are strictly controlled by the Bank. These limits are generally client specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Acceptable collateral for margin accounts is in the front of very liquid assets, e.g. cash or traded stocks. In case the net negative position of the contract falls below a certain level a call for added collateral is made. If extra collateral is not supplied the contract is closed.

101. cont.

d) Master netting agreements

Frequently, exposure to credit losses is reduced by entering into master netting agreements with clients that counterparties have significant and/or diverse credit related business with the Bank. Master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by these types of agreements since in the case of default all amounts of the counterparty are terminated and settled on a net basis.

Loan provisioning

An allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the balance sheet, whereas for an off-balance sheet item such as a commitment a provision for credit loss is reported in Other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans. Allowances and provisions for credit losses are evaluated at a counterparty-specific level and collectively based on the following principles:

a) Counterparty-specific

A claim is considered impaired when there is an object evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual credit exposures are evaluated based upon the borrower's character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, where applicable, the realisable value of any collateral.

The estimated recoverable amount is the present value, using the loan's original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount.

Upon impairment, the accrual of interest income based on the original terms of the claim is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

All impaired claims are reviewed and analysed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of timely collection of principal and interest in accordance with the original contractual terms of the claim agreement.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim. Recoveries in part or in full of amounts previously written off are credited to credit loss expense.

b) Collectively

All loans for which no impairment is identified on a counterparty-specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognised as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

Market Risk Strategy

Kaupthing's strategy is to invest its own capital on a limited and carefully selected basis in transactions, underwritings and other activities that involve market risk. The main types of market risk are price risk of listed and unlisted securities, both shares and bonds, interest rate risk, currency risk or other market variables influenced by market forces.

These investments are either taken as a service to clients for example as an underwriting commitment, a co-investment in an acquisition, market making in capital markets etc. – or the investments are made with the strategy of the bank in mind and then primarily in financial service companies.

The Bank should keep firm track of the market risk embedded in market investments at Group level and make sure that the total estimated market risk does not exceed the market risk allowance set by the Bank's Board of Directors. The aim is to monitor the market risk in real time so that market risk operations can take the best investment opportunities available at each time without violating their risk limits. Additional provisions are imposed depending on the type of market risk operation.

Derivatives

102. The Bank's use of derivatives is mainly through derivative sales, but derivatives are also in trading portfolios. The types of derivatives used by the Bank include swaps, futures, forwards, options, credit derivatives, and other similar types of contracts.

102. cont.

Derivative sales offer companies and institutional investors foreign exchange and a range of interest rate and currency derivatives for position taking and risk management. The market risk associated with derivatives sales is hedged on a portfolio basis and on a back-to-back basis.

The Bank's trading portfolios take positions in traded and over-the-counter instruments, including derivatives, to take advantage of short-term market movements in equities and bonds and in currency prices and interest rates, and they also use derivatives to hedge certain market exposures. The level of exposure is controlled using individual trading limits as with other market risk.

Interest rate risk

103. Interest-rate risk increased quite significantly at year-end 2004 following the introduction of fixed-interest mortgage products, but it remains closely monitored. The table below shows the interest rate risk by currency and maturity. Trading interest rate risk refers to exposures in trading book where positions are marked-to-market and profit or loss is recognised immediately but banking interest rate risk refers to exposure in banking book where profit or loss is realised over the lifetime of the exposure.

The total amount of indexed assets of the Bank amounted to ISK 325,845 million (2005: ISK 237,218 million), and the total amount of indexed liabilities amounted to ISK 180,241 million (2005: 129,917 million), respectively, at year-end.

The Bank's operations are subject to the risk of interest rate fluctuations to the extent that interest-earning assets (including investments) and interest-bearing liabilities mature or reprice at different times or in differing amounts. In the case of floating rate assets and liabilities the Bank is also exposed to basis risk, which is the difference in repricing characteristics of the various floating rate indices, such as the savings rate and six months LIBOR and different types of interest. Risk management activities are aimed at optimising net interest income, given market interest rate levels consistent with the Bank's business strategies. Interest rate risk is monitored centrally with duration reports and yield curve stress testing for each currency.

Interest rate risk by currency and duration. Interest rate risk is measured by shifting all yield curves by 100 bp simultanously. The table lists the resulting profit and loss broken down by currency and duration buckets for both banking and trading book.

2006		Within 1	1-3	3-12	1-5	Over 5	
Currency:		month	months	months	years	years	Total
ISK	Trading	(712)	33	535	1,916	(254)	1,518
	Banking	(903)	(109)	(313)	(738)	(15,048)	(17,111)
DKK	Trading	106	1,120	134	103	(2,745)	(1,282)
	Banking	(10)	(37)	(30)	360	(3,673)	(3,390)
EUR	Trading	(40)	135	416	(529)	1,493	1,475
	Banking	55	50	(123)	518	(692)	(192)
GBP	Trading	2	503	(126)	(151)	(2)	226
	Banking	(19)	(87)	(644)	(120)	(853)	(1,723)
USD	Trading	1	(302)	83	828	2	612
	Banking	(8)	(34)	(86)	(72)	(133)	(333)
CHF	Trading	51	89	(56)	3	(0)	87
	Banking	(2)	(40)	(92)	(21)	(37)	(192)
Other	Trading	(762)	196	(44)	735	(15)	110
	Banking	(9)	(68)	(113)	72	(332)	(450)
2005							
ISK	Trading	(0)	(1)	(1)	(94)	(578)	(674)
	Banking	10	19	2	22	(13,446)	(13,393)
DKK	Trading	162	43	(106)	(865)	(768)	(1,534)
	Banking	(28)	(171)	(367)	(418)	(455)	(1,439)
EUR	Trading	(175)	(156)	(23)	(59)	19	(394)
	Banking	233	358	(25)	261	398	1,225
GBP	Trading	(29)	(33)	(1)	(6)	12	(57)
	Banking	41	251	(146)	(25)	(139)	(18)
USD	Trading	(1)	(33)	(16)	(1)	(1)	(52)
	Banking	39	55	(35)	(123)	(866)	(930)
CHF	Trading	7	2	(2)	(0)	0	7
	Banking	4	35	(87)	(6)	18	(36)
Other	Trading	0	(13)	(10)	(57)	29	(51)
	Banking	25	26	(27)	5	40	69

Table showing interest rate risk by currency and maturity in millions of ISK. Risk is measured by assuming a 1% simultaneous upward shift in all yields curves in the relevant maturity band.

Market price risk

104. Market price risk is the risk of loss due to changes in market prices. The Bank's main exposures are through equities and bonds, but the management of currency risk is handled separately. Market price risk is measured with Value-at-Risk, and the total Bank Value at Risk (99%, 10 days) was ISK 5.5 billion (2005: ISK 3.4 billion) at 31 December 2006.

The following table shows the calculated VaR (99% confidence interval 10 day holding period). Results are itemised by type of market risk and market location.

2006	Iceland	Scandi-navia	Other
Equity risk	989	4,374	10
Interest risk	306	697	
Total VaR	1,035	4,429	10
Total Group VaR			5,476

2005	Iceland	Scandi-navia	Other
Equity risk	1,571	2,130	5
Interest risk	232	589	
Total VaR	1,588	2,209	5
Total Group VaR			3,446

The following table shows high, low and average values for the calculated VaR (99% confidence interval 10 day holding period).

2006	High	Low	Average
Equity risk	6,261	2,150	3,637
Interest risk	585	596	814
Total	6,302	2,218	3,719

2005	High	Low	Average
Equity risk	4,022	1,146	2,868
Interest risk	809	373	560
Total	4,004	1,273	2,922

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to some FX risk, in particular regarding the repatriation of non-ISK results. The Bank hedges part of the equity base against adverse movements in foreign exchange rates. Net exposures per currency are monitored centrally in the Bank.

If the ISK exchange rate index drepciated by 25% from its year end 2006 level then it would affect the CAD-ratio of the Bank by 0%.

Breakdown of assets and liabilities by currency:
The total amount of assets in foreign currencies in the Banks Financial Statement is ISK 3,437 billion (2005: ISK 2,242 billion), and the total amount of liabilities amounted to ISK 3,307 billion (2005: ISK 2,198 billion), respectively, at year-end. Included in these assets and liabilities are forward contracts and interest rate swaps.

Kaupthing Bank hf. Financial Statements 2006 51 Amounts are in ISK millions

105. Breakdown of assets and liabilities by currency:

Assets	ISK	EUR	DKK	GBP	Other	Total
Cash and balances with central banks	964	5,986	34,516	65,007	488	106,961
Loans to credit institutions	31,897	128,141	92,504	129,696	103,096	485,334
Loans to customers	351,196	451,171	582,576	553,032	600,634	2,538,609
Bonds and debt instruments	19,330	73,180	158,251	25,198	42,305	318,264
Shares and equity instruments	54,056	40,409	16,609	10,034	37,912	159,020
Derivatives	14,151	19,899	7,560	5,876	17,968	65,454
Derivatives used for hedging	0	1,836	3,500	(0)	1,117	6,453
Securities used for hedging	101,279	2,429	2,539	803	8,888	115,938
Investments in associates	2,075	0	1,136	11	2,082	5,304
Intangible assets	6,694	173	32,009	28,551	875	68,301
Investment property	14,551	4,202	9,783	3,048	0	31,584
Property and equipment	5,996	686	651	22,594	538	30,466
Tax assets	(2,191)	184	0	6,060	1,781	5,834
Other assets	18,796	5,404	74,336	7,363	11,975	117,874
Total assets	618,794	733,700	1,015,971	857,273	829,659	4,055,395
Liabilities						
Due to credit institutions and central banks	11,533	65,411	2,120	6,754	24,637	110,456
Deposits	185,580	104,291	55,553	276,199	129,034	750,658
Borrowings	111,085	1,238,924	47,695	279,304	722,931	2,399,939
Subordinated loans	14,660	76,478	369	6,976	117,547	216,030
Financial liabilities measured at fair value	12,176	7,914	27,068	10,492	13,614	71,264
Tax liabilities	10,161	3,100	5,526	4,199	223	23,209
Other liabilities	13,736	17,082	68,597	22,682	26,852	148,948
Equity and minority interest	324,094	10,774	0	24	0	334,892
Total liabilities	683,024	1,523,974	206,929	606,631	1,034,838	4,055,396
Net on-balance sheet position	(64,230)	(790,274)	809,042	250,642	(205,179)	
Net off-balance sheet position	(108,554)	843,712	(749,479)	(206,904)	221,225	
Net position	(172,783)	53,438	59,563	43,738	16,045	

Operational Risk Strategy

106. Operational Risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The bank aims to reduce the frequency and impact of operational risk events in a cost-effective manner. The Bank can reduce it's exposure to operational risk with selection of internal control and quality management, well educated and qualified staff. The Bank can choose to transfer operational risk through outsourcing the activity or to transfer the financial consequences through insurance programs.

The Bank should keep firm track of the operational risk that the bank is exposed to. Measurement should be done through Control and Risk Self Assessment, registration of loss events, near misses and quality deficiencies and through monitoring of potential risk indicators and other early-warning signals. Operational risk can be reduced through staff training, process re-design and enhancement of the control environment.

Risk Capital for Operational Risk is measured as a fixed percentage of gross income for each Business Unit, measured according to the Standardised approach outlined in the Capital Requirements Directive (CRD). The fixed percentage serves as a proxy for the likely scale of operational risk exposure within the business line. The fixed percentage is as follows:

Business lines:	
Corporate finance	18.0%
Trading and sales	18.0%
Payment and Settlement	18.0%
Commercial banking	15.0%
Agency services	15.0%
Asset Management	12.0%
Retail brokerage	12.0%

The Bank's business units are mapped onto above business lines.

Kaupthing Bank hf. Financial Statements 2006 52 Amounts are in ISK millions

Liquidity Risk Strategy

107. Liquidity risk is an unavoidable source of risk in Kaupthing's operations. 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 secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources. The funding liquidity risk limit is quantified by calculating liquidity ratios, including the number of days currently covered by expected cash flow.

The Bank calculates the Secured Liquidity from a pool of secured liquid assets (secured assets are: deposits, repo-able bonds, the securitisation pipeline, and unused revolvers with maturity above 360 days and no MAC clauses) against future liabilities. With the Secured Liquidity the bank has to be able to serve and repay all maturing debts for 360 days without any access to capital markets. Each of the subsidiaries quantifies the Secured Liquidity in the same way as the Secured Liquidity is consolidated on a Group level.

At the year end the number of days covered by the Secured Liquidity was 427.

Liquidity of Kaupthing Bank:	Up to 1 month	1-3 month	3-6 months	6-12 months	12-18 months	18-24 months
Secured liquidity	856,000	573,000	360,000	121,000	(136,000)	(237,000)

108. The breakdown by contractual maturity of assets and liabilities.

Assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
Cash and balances with central banks	106,961	0	0	0	0	106,961
Loans to credit institutions	87,284	320,642	23,672	47,597	6,139	485,334
Loans to customers	202,564	437,861	326,551	796,445	775,189	2,538,609
Bonds and debt instruments	1,097	53,114	4,861	157,506	101,685	318,264
Shares and equity instruments	88,944	69,912	0	164	0	159,020
Derivatives	4	18,517	12,190	25,176	9,567	65,454
Derivatives used for hedging	0	623	146	1,185	4,499	6,453
Securities used for hedging	115,938	0	0	0	0	115,938
Investments in associates	0	0	0	0	5,304	5,304
Intangible assets	0	0	0	0	68,301	68,301
Investment property	0	0	0	0	31,584	31,584
Property and equipment	0	0	0	0	30,466	30,466
Tax assets	0	0	26	5,808	0	5,834
Other assets	0	0	117,874	0	0	117,874
Total 31.12.2006	602,792	900,668	485,320	1,033,881	1,032,735	4,055,396
Total 31.12.2005	484,756	575,861	210,311	602,215	667,668	2,540,811

Liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
Due to credit institutions and central banks	10,384	90,269	4,045	3,605	2,152	110,456
Deposits	226,966	409,317	86,755	21,459	6,161	750,658
Borrowings	3,569	489,330	442,860	1,105,436	358,744	2,399,939
Subordinated loans	0	0	0	3,437	212,593	216,030
Financial liabilities measured at fair value	3,503	15,658	7,684	32,277	12,143	71,264
Tax liabilities	0	0	10,180	13,029	0	23,209
Other liabilities	91,661	0	57,287	0	0	148,948
Total 31.12.2006	336,083	1,004,573	608,811	1,179,242	591,794	3,720,504
Total 31.12.2005	189,965	616,536	294,778	936,184	300,836	2,338,299
Assets - liabilities 31.12.2006	266,709	(103,905)	(123,491)	(145,361)	440,941	334,892
Assets - liabilities 31.12.2005	294,791	(40,675)	(84,467)	(333,969)	366,832	202,512

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Fair Value of financial instruments

109. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Bank to measure financial assets and financial liabilities. If quoted prices for a financial instrument fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

The following table presents the fair value of financial instruments, including those not reflected in the Financial Statements at fair value. It is accompanied by a discussion of the methods used to determine fair value for financial instruments.

Assets	Carrying value 2006	Fair value 2006	Unrealised gain (loss) 2006
Cash and balances with central banks	106,961	106,961	0
Loans	3,023,943	3,028,923	4,980
Financial assets measured at fair value	664,965	664,965	0
Financial assets available-for-sale	164	164	0
Liabilities			
Due to credit institutions and central banks	110,456	110,456	0
Deposits	750,658	750,292	365
Borrowings	2,399,939	2,397,319	2,620
Subordinated loans	216,030	217,850	(1,820)
Financial liabilities measured at fair value	71,264	71,264	0
Net unrealised gains not recognised in the Income Statement			6,147

Methods for establishing fair value

a) *Fair value established from quoted market prices*

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of the financial instrument is as in note 65 used as an approximation for the fair value of the instrument. This is straight-forward for cash and cash equivalents but is also used for short-term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that carry interests close to or equal to market rates and expose the Bank to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed in following balance sheet items; Trading assets and Trading liabilities.

For financial instruments, for which the market is not active, the Bank applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuations techniques used by market participants to price the instrument.

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109. cont.

b) Fair value established using valuation techniques

For financial instruments for which quoted prices on active markets are not available, the fair values are derived using various valuation techniques. This applies in particular to OTC-derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation are based on theoretical financial models, such as the Black-Scholes models or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

Furthermore, in many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of financial instruments with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers - which is added to the current and suitable interest rate to arrive at an appropriate discount rate - is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The fair value for deposits with stated maturities was calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Balance Sheet.

Although the Bank follows market standards and relies on well accepted methods there is still wide room for choice, both in the models themselves and the assumptions that must be supplied and cannot be derived from market data. Consequently, different assumptions and choices could lead to different estimates.

Subsidiaries

110. Shares in main subsidiaries are specified as follows:

Company:	Country	Currency	Business Group[1]	Share Capital in millions	Equity interest accum. %
Arion Custody Service hf.	Iceland	ISK	OD	115	100.0
Eik fasteignafélag hf.	Iceland	ISK	OD	707	100.0
FI-Holding A/S	Denmark	DKK	CM, IB, Tr, Ba	842	100.0
Kaupthing Bank Luxembourg S.A.	Luxembourg	EUR	CM, Tr, Ba, AM & PB	16,611	100.0
Kaupthing Bank Oyj	Finland	EUR	IB, CM, Tr, Ba, AM & PB	1,670	100.0
Kaupthing Føroyar Virdisbrævameklarafelag P/F	Faroe Islands	DKK	IB, CM, AM & PB	112	100.0
Kaupthing Holding UK Ltd. (KTSF)	UK	GBP	IB, CM, Tr, Ba, AM & PB	31,839	100.0
Kaupthing New York Inc.	USA	USD	CM	432	100.0
Kaupthing Norge AS	Norway	NOK	IB, CM, AM & PB	1,433	100.0
Kaupthing Sverige AB	Sweden	SEK	IB, CM, Tr, Ba, AM & PB	2,807	100.0
Kaupthing Líf hf.	Iceland	ISK	Ba	17	100.0
Kirna ehf.	Iceland	ISK	IB, Tr	31,770	100.0
New Bond Street Asset Management LLP	UK	GBP	Tr	-	100.0
Norvestia Oyj	Finland	EUR	CM	4,455	30.6
Rekstrarfélag Kaupthings banka hf.	Iceland	ISK	AM & PB	44	100.0
Vidjar ehf.	Iceland	ISK	Ba	1	100.0
Sparisjódur Kaupthings hf.	Iceland	ISK	Ba	100	100.0

1. IB: Investment Banking, CM: Capital Markets, Tr: Treasury, Ba: Banking, AM & PB: Asset Management and Private Banking, O: Other Divisions

The Bank wields 54.4% of the votes in Norvestia Oyj and the company is thus considered to be a subsidiary of the Bank.