Arion banki

Press release, 23 May 2013

ARION BANK'S FINANCIAL RESULTS FOR THE FIRST QUARTER OF 2013

Arion Bank reported net earnings of ISK 1.4 billion for the first quarter of 2013, compared with ISK 4.5 billion for the same period in 2012. Return on equity was 4.3%, compared with 16.5% in Q1 2012. Return on equity based on regular operations was 6.3%, compared with 12.5% in Q1 2012. Total assets amounted to ISK 907.5 billion, compared with ISK 900.7 billion at the end of 2012.

The Bank's capital ratio at the end of Q1 2013 was 24.1%, compared with 24.3% at the end of 2012.

Highlights of the Q1 2013 interim financial statement:

- Net earnings of ISK 1.4 billion in Q1 2013, compared with ISK 4.5 billion in Q1 2012.
- Earnings from regular operations of ISK 2.1 billion, compared with ISK 3.6 billion in Q1 2012.
- Operating income decreased between years on account of exchange rate losses to ISK 8.8 billion, compared with ISK 10.9 billion in Q1 2012.
- Net interest income of ISK 6.3 billion, virtually unchanged from Q1 2012.
- Net valuation change on loans of ISK 0.3 billion resulting from written down and written off loans of ISK 2.7 billion and a valuation increase of ISK 2.4 billion.
- Return on equity was 4.3%, compared with 16.5% in Q1 2012. Return on equity based on regular operations was 6.3%, compared with 12.5% in Q1 2012.
- The interest-rate differential as a percentage of the average interest-bearing assets was 3.1%, unchanged from Q1 2012.
- Cost-to-income ratio was 72.6%, compared with 53.1% in Q1 2012. The high ratio in this quarter is partly due to a provision for a fine imposed on Valitor by the Icelandic Competition Authority. The cost ratio on regular operations was 66.7%, compared with 51.4% in Q1 2012.
- Loans to customers of ISK 565.5 billion at the end of Q1 2013, virtually the same as at the end of 2012.
- Total assets of ISK 907.5 billion, compared with ISK 900.7 billion at the end of 2012.
- Shareholders' equity of ISK 132.3 billion, compared with ISK 130.9 billion at the end of 2012.

Höskuldur H. Ólafsson, CEO of Arion Bank:

"The first quarter results were below expectations. Although interest income and commission income are broadly in line with projections, changes in the value of loans and particularly in exchange rates have had a negative impact on these results. The ISK 500 million fine imposed on Valitor by the Competition Authority was expensed during the first quarter and this also adversely affected the Bank's profitability. However, it is important that the Bank's core activities and underlying financial position have remained stable. The Bank's capital ratio is more than 24%, well in excess of the FME's stipulated minimum, and this underlines the Bank's strong position.

During the first quarter we focused on diversifying the Bank's funding. We continued to issue non-indexed covered bonds in Iceland, and Arion Bank became the first Icelandic financial institution since 2007 to issue bonds on the international markets when it issued instruments denominated in Norwegian kroner. While it was not a large issue, it was of great significance. It is vital for the Icelandic business sector that the country's main financial institutions have access to international credit markets. This represented an important step in that direction. Since then we have sensed a greater interest among international lenders in the Bank and developments in Iceland, which can only be positive for us.

Information technology represents a significant part of the Bank's activities and its overall costs. Recently we completed an extensive upgrade of the Bank's SAP business software. It required the participation of around 40 employees and 20 external advisers, both from Iceland and overseas. We estimate that more than 6,000 working hours were expended on the project in the last few months and that the total cost will be approximately ISK 230 million. Part of this sum was expensed during the quarter. This upgrade makes the Bank's SAP systems better adapted to Arion Bank's activities, increases data security and boosts the efficiency of the systems."

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Income statement – highlights

Income Statement				
In ISK million	**3M '13**	**3M '12**	**Diff.**	**Diff. %**
Net interest income	6,288	6,214	74	1%
Net change in valuation on loans	-322	-76	-246	324%
Net interest income less val. on loans	5,966	6,138	-172	-3%
Net commission income	2,449	2,336	113	5%
Net financial income	570	346	224	65%
Net gain/ -loss on foreign exchange	-1,397	1,083	-2,480	-229%
Other income	1,176	952	224	24%
Operating income	**8,764**	**10,855**	**-2,091**	**-19%**
Salaries and related expense	-3,322	-3,045	-277	9%
Other operating expense	-3,277	-2,757	-520	19%
Net earnings before taxes	**2,165**	**5,053**	**-2,888**	**-57%**
Income tax	-586	-1,061	475	-45%
Bank Levy	-91	-268	177	-66%
Net earnings from continuing operation	**1,488**	**3,724**	**-2,236**	**-60%**
Net gain/ -loss from discont. operation net of tax	-79	727	-806	-
Net earnings	**1,409**	**4,451**	**-3,042**	**-68%**

Operating income

Operating income during the first quarter of 2013 amounted to ISK 8,764 million, which is ISK 2,091 million lower than in Q1 2012. The decrease is primarily due to exchange rate losses of ISK 1.4 billion, compared with exchange rate gains of ISK 1.1 billion during Q1 2012.

Net interest income during the period amounted to ISK 6,288 million, compared with ISK 6,214 million in Q1 2012. This represents a year-on-year change of 1.2% and reflects the stability of the loan portfolio during the period. The interest-rate differential as a percentage of the average interest-bearing assets was 3.1% in both periods.

Net valuation changes on loans and receivables amounted to ISK 322 million, compared with ISK 76 million in Q1 2012. The valuation of a proportion of the group's loans is still subject to some uncertainty. Write-downs during the period totalled ISK 2.7 billion, which are partly related to illegal currency-linked loans. Valuation changes on loans are positive by ISK 2.4 billion as it is likely that recoveries of loans to larger companies will be better than previously estimated.

Net commission income increased by 5% to ISK 2,449 million, compared with ISK 2,336 million in Q1 2012. The main reason behind this increase is the growth in assets under management in the Bank's Asset Management division.

Net financial income amounted to ISK 570 million, compared with ISK 346 million in Q1 2012. The Bank's securities portfolio was valued at ISK 145.5 billion at the end of the period, and the above valuation changes were thus relatively insignificant.

Net exchange rate loss amounted to ISK 1,397 million, compared with a net exchange rate gain of ISK 1,083 million in Q1 2012. The Bank's net foreign exchange balance was ISK 18.8 billion at the end of the period which meant that high volatility in the exchange rate had a significant impact on operating income. The foreign exchange balance is well within the 15% limit imposed by the Central Bank of Iceland. It is the Bank's policy to have good liquidity in foreign currencies but developments in the exchange rate during the quarter meant that this policy resulted in exchange rate losses.

Other operating income amounted to ISK 1,176 million, compared with ISK 952 million in Q1 2012. The main types of income included in other operating income are lease income from commercial property owned by Landfestar and Landey and income from insurance premiums at OKKAR Life Insurance, all of which are subsidiaries of the Bank. Also included are capital gains relating to properties owned by the Bank's real estate companies; this explains the majority of the increase between years.

Operating expenses

Operating expenses increased by ISK 797 million, or 13.7%, between years to ISK 6,599 million. Operating expenses include a fine of ISK 500 million imposed on Valitor by the Icelandic Competition Authority. Valitor has appealed the decision to the Competition Authority Appeals Committee. Excluding the fine, operating expenses increased by ISK 296 million or 5.1%. The cost-to-income ratio increased to 72.6%, compared with 53.1% in Q1 2012. The cost-to-assets ratio was 3.0%, compared with 2.6% in Q1 2012. The cost-to-income ratio is significantly affected by the decrease in operating income relating to net foreign exchange losses and the aforementioned fine imposed on Valitor.

Salaries and related expenses amounted to ISK 3,322 million, compared with ISK 3,045 million in Q1 2012. There were on average 1,187 full-time equivalent positions at Arion Bank during the period, compared with 1,157 in Q1 2012. The average salary has risen by 5.3% which is in line with the increase in the salary index between periods; 3.25% relate to contractual salary increases.

Other operating expenses amounted to ISK 3,277 million, compared with ISK 2,757 million in Q1 2012. This increase of ISK 520 million is almost entirely related to the fine imposed on Valitor by the Competition Authority. In other respects other operating expenses are virtually unchanged between years.

Taxes

Income tax amounted to ISK 586 million, compared with ISK 1,061 million in Q1 2012. The effective income tax rate was 27.1% during the period, compared with 21.0% in Q1 2012. This increase is mainly due to the transfer of exchange rate difference between periods in compliance with Icelandic tax legislation.

Special tax on financial companies amounted to ISK 91 million, compared with ISK 268 million in Q1 2012. The decrease is due to a lower tax rate in 2013 than in the previous two years.

Discontinued operations

Net expenses from discontinued operations amounted to ISK 79 million, compared with net income of ISK 727 million in Q1 2012. During the first quarter of 2012 the Bank generated capital gains from the sale of a major shareholding in Hagar. The sale of assets during the first quarter of 2013 had an insignificant effect and there was a loss on other discontinued operations and foreclosure assets owned by the Bank.

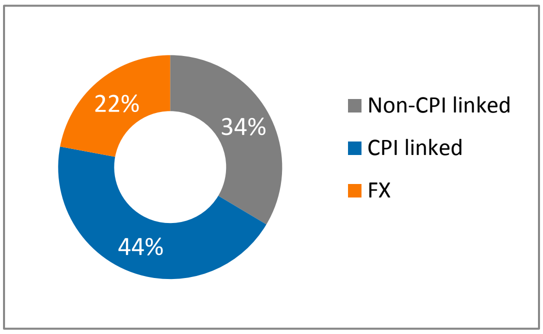
Balance sheet – highlights

Assets					
In ISK million	**31.03.2013**	**31.12.2012**	**Diff.%**	**31.03.2012**	**Diff.%**
Cash & balances with CB	28,099	29,746	-6%	18,030	56%
Loans to credit institutions	103,444	101,011	2%	65,955	57%
Loans to customers	565,526	566,610	0%	584,154	-3%
Financial assets	145,533	137,800	6%	161,004	-10%
Investment properties	28,112	28,919	-3%	25,867	9%
Non-current assets & disp.groups HFS	10,877	11,923	-9%	21,852	-50%
Other assets	25,874	24,666	5%	22,510	15%
Total assets	**907,465**	**900,675**	**1%**	**899,372**	**1%**

Arion Bank had *total assets* of ISK 907,465 million at the end of Q1 2013, compared with ISK 900,675 million at the end of 2012. Changes during the period are insignificant and can largely be attributed to changes in liquidity management. The Bank's financial strength remains virtually unchanged from the end of 2012 - the liquidity ratio is 35.3% and the cash ratio is 27.4%, compared with 32.9% and 30.8% respectively at the end of 2012. The statutory minimums for these ratios are 20% and 5%.

Loans to customers

Loans to customers amounted to ISK 565,526 million at the end of March 2013, compared with ISK 566,610 million at the end of 2012. The diagram to the side shows the division of the loan book between indexed, non-indexed and loans in foreign currencies. The ratio of loans in foreign currencies has fallen sharply following the restructuring of corporate and private debt and the recalculation of loans to private customers and smaller companies in the wake of recent court rulings. The ratio of indexed loans has increased substantially, particularly following the Bank's acquisition of a mortgage portfolio from Kaupthing at the end of 2011.



Securities

Securities holdings amounted to ISK 145,533 million at the end of Q1 2013, compared with ISK 137,800 million at the end of 2012.

Securities					
In ISK million	**31.03.2013**	**31.12.2012**	**Diff.%**	**31.03.2012**	**Diff.%**
Bonds	125,526	117,730	7%	142,493	-12%
Shares and instruments w. variable income	16,975	16,844	1%	15,096	12%
Derivatives	1,179	788	50%	1,313	-10%
Securities used for hedging	1,853	2,438	-24%	2,102	-12%
Securities total	**145,533**	**137,800**	**6%**	**161,004**	**-10%**

Arion Bank uses cash to invest in liquid bonds, which explains the fluctuations in bondholdings between years.

Non-current assets and disposal groups held for sale

Non-current assets and disposal groups held for sale amounted to ISK 10,877 million at the end of the period, compared with ISK 11,923 million at the end of 2012. The decrease is largely due to the sale of Fram Foods Ísland hf. The majority of these assets are expected to be sold in 2013.

Liabilities and equity

Total liabilities amounted to ISK 775,179 million at the end Q1 2013, compared with ISK 769,797 million at the end of 2012. The increase is primarily attributable to bond issues in Iceland and abroad during the period.

Liabilities and equity

In ISK million	**31.03.2013**	**31.12.2012**	**Diff.%**	**31.03.2012**	**Diff.%**
Due to credit institutions & CB	21,617	32,990	-34%	37,032	-42%
Deposits from customers	462,255	448,683	3%	462,193	0%
Non-current liab. & disp.groups HFS	758	1,769	-57%	4,444	-83%
Financial liabilities at fair value	11,298	13,465	-16%	8,098	40%
Other liabilities	42,805	43,585	-2%	42,438	1%
Borrowings	204,394	195,085	5%	192,109	6%
Subordinated loans	32,052	34,220	-6%	34,047	-6%
Equity	132,286	130,878	1%	119,011	11%
Total liabilities and equity	**907,465**	**900,675**	**1%**	**899,372**	**1%**

Deposits

Total deposits amounted to ISK 483,872 million, compared with ISK 481,673 million at the end of 2012. Despite the growth in deposits during the quarter, deposits have decreased overall during the last few periods. Nevertheless the Bank has maintained its share in most categories on the domestic market. It is expected that capital will continue to be moved from deposits to other investment options as opportunities become available.

Borrowings

Borrowings amounted to ISK 204,394 million at the end of Q1 2013, compared with ISK 195,085 million at the end of 2012. This increase is explained by the Bank's issue of ISK 1.8 billion in covered bonds, which are listed on NASDAQ OMX Iceland, and NOK 500 million (approx. ISK 11 billion) in bonds which were sold to international investors and will be listed on the Oslo Stock Exchange.

Subordinated liabilities

Subordinated liabilities amounted to ISK 32,052 million at the end of Q1 2013, compared with ISK 34,220 million at the end of 2012. The change is solely related to changes in the exchange rate of foreign currencies linked to the loans.

Shareholders’ equity

Shareholders’ equity amounted to ISK 132,286 million at the end of Q1 2013, compared with ISK 130,878 million at the end of 2012. The change relates entirely to earnings generated during the period. The capital ratio calculated in accordance with the rules of the FME was 24.1% at the end of the period, compared with the statutory minimum of 8%.

Key performance indicators

	3M 2013	2012	3M 2012
Return on equity (ROE)	4.3%	13.8%	16.5%
Return on total assets (ROA)	0.6%	1.9%	2.0%
Net interest margin (int. bearing assets)	3.1%	3.4%	3.1%
Net interest margin (total assets)	2.8%	3.1%	2.8%
Cost-to-income ratio	72.6%	49.8%	53.1%
Cost-to-Total assets ratio	3.0%	2.8%	2.6%
Effective tax rate	27.1%	18.0%	21.0%
CAD-ratio	24.1%	24.3%	20.8%
Tier 1 ratio	19.2%	19.1%	16.0%
Problem loans	10.2%	12.5%	16.5%
RWA/Total Assets	72.5%	73.0%	78.7%
Loans to deposit ratio	122.3%	126.3%	126.4%
Secured liquidity ratio	35.3%	32.9%	30.2%
Cash ratio	27.4%	30.8%	13.9%
The Group's average number of employees	1,187	1,166	1,157
The Group’s employees at period end	1,187	1,190	1,179
The parent’s average number of employees	950	927	918
The parent’s employees at period end	950	949	930

Financial calendar 2013

The Bank’s interim financial statements are scheduled for publication in the weeks stated below.

Second quarter 2013	Week 35
Third quarter 2013	Week 48
Annual Financial Statements for 2013	February 2014

This calendar may be subject to change.