Íslandsbanki

# CONSOLIDATED FINANCIAL STATEMENTS 2013

# Contents

# Endorsement and Statement by the Board of Directors and the CEO

The consolidated financial statements of Íslandsbanki hf. for the period ended 31 December 2013 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as “the Bank”.

## Operations and ownership

Íslandsbanki, with roots tracing back to 1884, is a universal bank offering comprehensive financial services to households, corporations and institutional investors. Íslandsbanki is one of Iceland's largest banking and financial services groups with total assets of ISK 866bn at the reporting date. The Bank has 20%-40% market share across all domestic franchise areas and operates an efficient branch network in Iceland. Building on a heritage of lending to Icelandic industry, the Bank has developed specific expertise in selected industry sectors; tourism, seafood, municipalities, energy and offshore service vessels.

The Bank is divided into six business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury and Subsidiaries & Equity Investments. At the reporting date there were 1,240 full-time employees at the Bank, thereof 1,028 were employees of the parent company.

Íslandsbanki has two owners; ISB Holding ehf., which owns 95% of the Bank ' s share capital, and the Icelandic State Treasury which owns 5% through Icelandic State Financial Investments (ISFI – Bankasýsla ríkisins). ISB Holding ehf. is 100% owned by a subsidiary of Glitnir hf. (GLB Holding ehf.).

At a shareholder´s meeting in September 2013 it was decided to increase the number of Board Members from seven to nine and thereby adding two new Board Members. This decision was made to conform to a legislation stipulating that corporate entities with more than 50 employees must ensure that the proportion of each gender on their Board of Directors is not lower than 40%. Two board members are appointed by the ISFI and the remaining seven are appointed by ISB Holding ehf.

## Risk Management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies. The Bank's risk management framework and policies are discussed under Notes 60-84.

## The reporting period

Íslandsbanki made good progress in 2013. The restructuring work that was required to be done on the loan portfolio acquired in 2008 has largely been completed, and the uncertainty surrounding foreign currency linked loans reduced. Since the Bank's establishment 35,500 individuals and 4,100 companies have received write-offs, debt forgiveness or some form of debt correction totalling ISK 543bn. Furthermore, demand for new lending to households and companies has continued to increase.

VÍB, the Bank's wealth management division, has continued to consolidate its position as a leading player in its market. VÍB was the recipient of the Investment Management Award for 2013 as the best investment management company in Iceland by the British financial magazine World Finance This is an important recognition for VÍB which has focused on providing professional, high-quality services, and offering effective educational programmes both for large investors and the general public.

VÍB and Íslandssjóðir founded Akur, a new private equity company, which will be an active owner of stakes in unlisted companies. The new company will have approximately ISK 7bn investment capacity. Akur will focus on investments in companies which have the potential to grow further and companies which have good near-term listing potential.

In January 2014, the Bank's asset management services, VÍB, signed a distribution agreement with the world's largest asset management company BlackRock, which has operations in 30 countries. The partnership increases the wide variety of products and services supplied by VÍB in the field of asset management services in foreign markets.

The financial markets are gaining momentum and the Bank has continued to play a leading role in managing bond offerings and overseeing listings on the NASDAQ OMX Iceland Stock Exchange. In 2013, the Bank managed the listing of one of the country's largest petrol stations operator, N1 hf., and is working on listings of other large Icelandic companies, including the insurance company Sjóvá Almennar hf. The Bank had the highest turnover in the equities market in 2013 with a 27.8% market share, and was second in turnover in the fixed income market in 2013 with a 21.0% share.

The Bank continued the development of its branch services and in 2013 three branches were merged into a new modernised branch serving the eastern part of Reykjavik.

# Endorsement and Statement by the Board of Directors and the CEO

The Bank continued with its funding diversification strategy by issuing covered bonds, bringing the total issued to ISK 23.3bn. The Bank was the first bank in Iceland since 2008 to issue covered bonds and has already established itself as the largest issuer in that market. The Bank was also the first bank to list commercial paper on the Icelandic Stock Exchange in February 2013, and has issued ISK 8.5bn to date.

In December 2013, Íslandsbanki issued its first international bond. More than 40 investors from Sweden, Norway and Finland subscribed to the issue, which was listed on the Irish Stock Exchange. The bond was launched under Íslandsbanki's USD 250m Global Medium Term Note (GMTN) Programme, which enables the Bank to issue bonds in a broad range of currencies at fixed or floating interest rates. The participation of international investors is a welcome sign of confidence in the direction that the Icelandic economy is taking.

The financial magazine Euromoney awarded Íslandsbanki Awards for Excellence as the best bank in Iceland. The magazine bases its selection on various factors such as return on equity, balance sheet growth and strong equity and deposit ratios.

## Outlook

Since Islandsbanki establishment in 2008 the Bank´s main focus has been on restructuring of loans to individuals and corporates and thereby providing a sustainable basis for the future operations of the Bank. At the same time the Bank has put material resources into improving internal processes and corporate governance practices based on a revised regulatory structure. After 2010 the Bank has been in the forefront of rebuilding the financial market in Iceland, initiated diversification in funding for the Bank and has promoted cost efficiency after the merger with BYR, one of the biggest savings banks in Iceland.

At the end of 2013 the restructuring of loans is mostly finished, financial markets have started to gain momentum and the economic environment in Iceland in general is improving. Core operations of the Bank are stable and liquidity and capital ratios are very strong. This will enable the Bank to meet future challenges.

A variety of hindrances still remain. Chief among them are the capital controls in place in Iceland which, although providing stability in the foreign exchange market at a critical time, will most likely slow growth in the long-term. The large amount of foreign capital currently tied up in Icelandic krónur is the single largest obstacle to the start of lifting the capital controls. The authorities have not issued a clear timeline for lifting the capital controls, nor have they declared an exchange rate policy that might take effect afterwards.

## Corporate Governance

Good governance promotes good work habits and communication, which in turn enhances confidence among shareholders, board of directors, management, employees and other stakeholders. One of the main objectives of the Board of Directors of Íslandsbanki is to continuously develop and strengthen its governance framework reflecting compliance with the best corporate governance practices in the financial market at all times.

Íslandsbanki's management structure consists of the CEO and the Board of Directors, comprising nine non-executive directors and two alternates (the Board). The Board has ultimate authority over the Bank's affairs subject to shareholder's meetings. There are four Board subcommittees comprised of members of the Board; Board Audit Committee; Board Risk Committee; Board Strategy Committee; and Board Corporate Governance, Compensation and Human Resource Committee.

The Board is responsible for the formulation of the Bank's general strategy and instructs the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations and good business practices.

The Chief Executive Officer is responsible for the day-to-day operations of the Bank pursuant to the policy and resolutions of the Board of Directors. Moreover it is the task of the CEO to ensure that the Bank's operations are at all times consistent with the Bank's Articles of Association and applicable legislation. An Executive Board is appointed by the CEO, consisting of 8 members, including the CEO. The Executive Board sets the Bank's policy for operational risk at group level.

The Board shall moreover monitor the execution of its policies, the sound control of accounting and financial management, and ensure that Group Internal Audit, Compliance and Risk Management are effective at all times.

Group Internal Audit operates independently from other departments. The Chief Audit Executive is appointed by the Board and is responsible for internal audit on group basis and monitoring adequacy of the Bank's risk management, control and governance processes.

The Board confirms the CEO's appointment of the Compliance Officer who is responsible for monitoring and assessing on a regular basis whether the Bank's operations, regarding securities transactions, are in compliance with applicable law. The Compliance Officer is moreover responsible for compliance with Act No. 64/2006, on measures against money laundering and terrorist financing.

# Endorsement and Statement by the Board of Directors and the CEO

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable law and regulations, including those imposed by the FME and the NASDAQ OMX Nordic Exchange in Iceland. The applicable law includes inter alia the Act on Financial Undertakings No. 161/2002 and the Act on Securities Transactions 108/2007, the Act on Public Limited Companies No. 2/1995 and the Act on Competition No. 44/2005, available on the Icelandic legislature's website.[1]

The Bank follows the Corporate Governance Guidelines issued in March 2012 (4th ed.) by the Iceland Chamber of Commerce, NASDAQ OMX Iceland and Confederation of Icelandic Employers (hereinafter the Guidelines), available on the website of Icelandic Chamber of Commerce.[2] The Bank's practices are in compliance with the Guidelines except for certain items in Articles 1.2., 2.5., 2.10., 5.1., 5.C.3., 6.1. and 6.2 of the Guidelines.

Íslandsbanki's governance framework and associated practices are described in further detail, as well as a discussion on deviations from the Guidelines, in the Corporate Governance Statement contained in the unaudited Appendix.

1 www.althingi.is
2 www.vi.is

## Accounting convention

The consolidated financial statements for the year ended 31 December 2013 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union (EU).

Profit from the Bank's operations for the year ended 31 December 2013 amounted to ISK 23,069m, which corresponds to a 14.7% return on equity. The Board of Directors proposes that up to 40% of net profit will be paid in dividends to shareholders, but otherwise the profit will be added to the Bank's equity.The Board may convene a special shareholder meeting later in the year where a proposal regarding payment of dividends of profit for the previous fiscal years could be suggested. Bank equity, according to the consolidated statement of financial position, amounted to ISK 167,318m at year end. The Bank's total capital ratio, calculated according to the Act on Financial Undertakings, was 28.4%. The Board of Directors refers to Note 83 for further understanding of the capital requirements of the Bank. The Bank's total assets amounted to ISK 866,009m at year end 2013.

The Board of Directors draws special attention to the risks relating to the political and legal environment in Iceland where capital controls are still in place. The Bank has made appropriate provisions to reflect the risk associated with court rulings. The Board also notes that the Bank maintains a strong capital base and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 4 and 58 for the principal risks and uncertainties currently faced by the Bank.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Bank's operating profits and its financial position at 31 December 2013. It also describes the principal risks and uncertainties currently faced by the Bank.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's consolidated financial statements for the period 1 January to 31 December 2013 by means of their signatures.

Reykjavík, 19 February 2014

**Board of Directors:**

**Chief Executive Officer:**

# Independent Auditors' Report

**To the Board of Directors and Shareholders of Íslandsbanki hf.**

We have audited the accompanying consolidated financial statements of Íslandsbanki hf., which comprise the consolidated statement of financial position as at 31 December 2013, consolidated income statement and consolidated statement of comprehensive income for the year 2013, consolidated statement of changes in equity and consolidated statement of cash flow for the year 2013, and a summary of significant accounting policies and other explanatory information.

**Management's and the Board of directors Responsibility for the Consolidated Financial Statements**

Management and the board of directors are responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the 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 misstatement, 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 ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated 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 consolidated financial statements.

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

**Opinion**

In our opinion, the Consolidated Financial Statements give a true and fair view, of the consolidated financial position of Íslandsbanki hf. as of 31 December 2013, and its consolidated financial performance and its consolidated cash flows for the period then ended in accordance with International Financial Reporting Standards as adopted by the EU.

**Confirmation of Endorsement and Statement by the Board of Directors and the CEO**

Pursuant to the requirements of Article 104 of the Icelandic Financial Statements Act No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act.

Kópavogur 19 February 2014

**Deloitte ehf.**

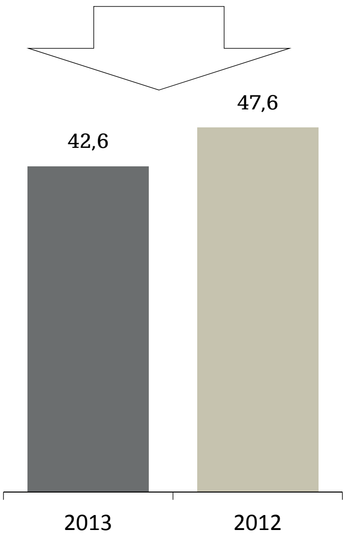
Pálína Árnadóttir
State Authorised Public Accountant

Gunnar Þorvarðarson
State Authorised Public Accountant

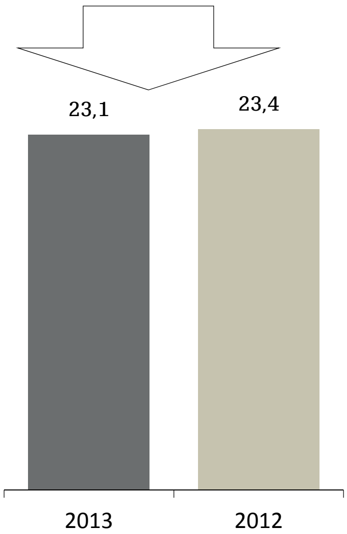
# Financial Highlights 2013

Amounts on this page are in ISK billion

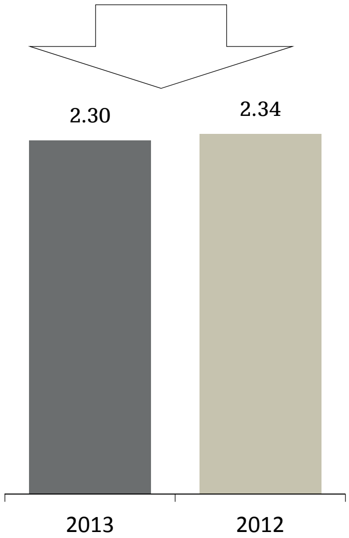
### Operating income



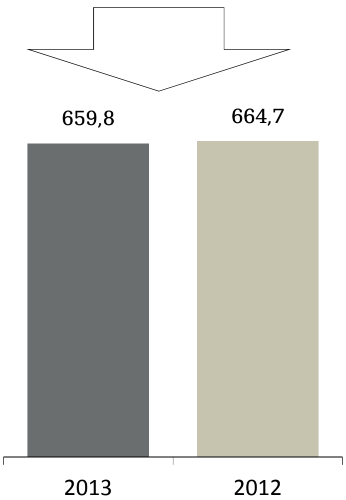

### Profit after tax



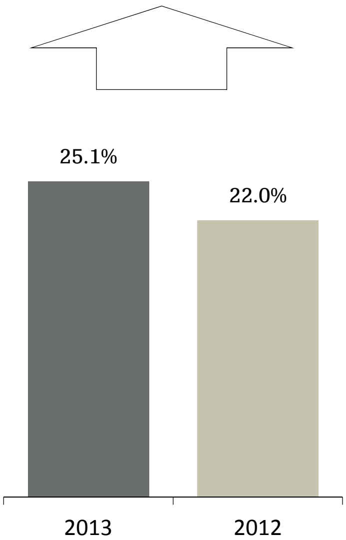

### Earnings per share



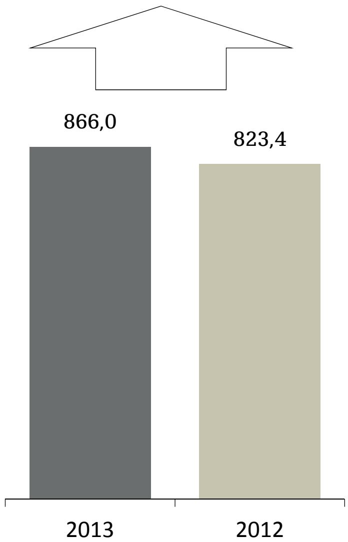

### Risk Weighted Assets



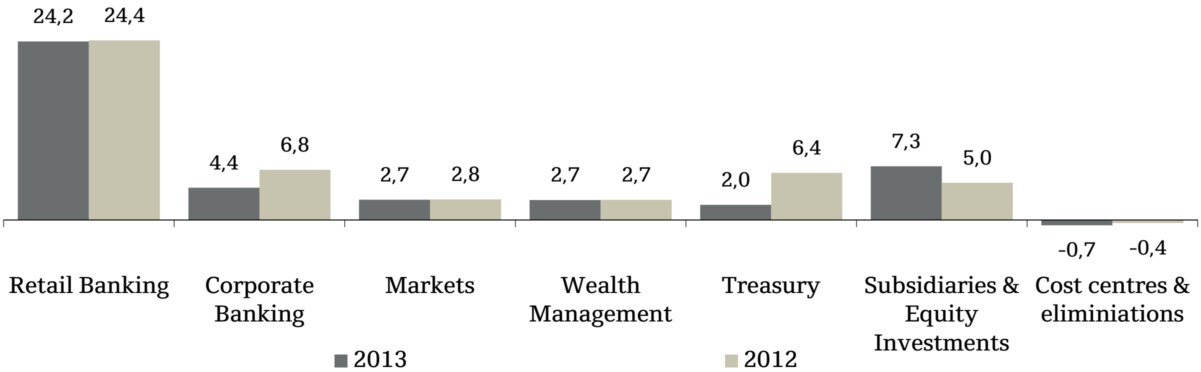

### Tier 1 Capital




### Total Assets




### Operating income by segment



# Consolidated Income Statement for the year 2013

| | Notes | 2013 | 2012 |
|---|---|---|---|
| Interest income | 12 | 54,333 | 59,419 |
| Interest expense | 12 | ( 25,903) | ( 26,479) |
| **Net interest income** | | 28,430 | 32,940 |
| Fee and commission income | 13 | 16,695 | 14,812 |
| Fee and commission expense | 13 | ( 6,262) | ( 5,353) |
| **Net fee and commission income** | | 10,433 | 9,459 |
| Net financial income | 14-16 | 4,612 | 1,517 |
| Net foreign exchange (loss) gain | 17 | ( 2,423) | 2,737 |
| Share of profit or loss of associates | 35 | 3 | - |
| Other net operating income | 18 | 1,542 | 996 |
| **Other net operating income** | | 3,734 | 5,250 |
| **Total operating income** | | 42,597 | 47,649 |
| Administrative expenses | 19-23 | ( 25,551) | ( 24,589) |
| Impairment of goodwill | 40 | - | ( 425) |
| Contribution to the Depositors' and Investors' Guarantee Fund | | ( 1,016) | ( 1,055) |
| Bank tax | | ( 2,321) | ( 858) |
| **Total operating expenses** | | ( 28,888) | ( 26,927) |
| **Profit before loan impairment charges and net valuation changes** | | 13,709 | 20,722 |
| Loan impairment charges and net valuation changes | 24 | 16,299 | 5,710 |
| **Profit before tax** | | 30,008 | 26,432 |
| Income tax | 26 | ( 7,866) | ( 6,253) |
| **Profit for the year from continuing operations** | | 22,142 | 20,179 |
| Profit from discontinued operations, net of income tax | 25 | 927 | 3,239 |
| **Profit for the year** | | 23,069 | 23,418 |

The notes on pages 15 to 93 are an integral part of these consolidated financial statements.

Amounts are in ISK million

# Consolidated Statement of Comprehensive Income for the year 2013

| | Notes | 2013 | 2012 |
|---|---|---|---|
| **Profit for the year** | | 23,069 | 23,418 |
| **Other comprehensive income** | | | |
| Foreign currency translation differences for foreign operations | 54 | ( 363) | 173 |
| **Other comprehensive income for the year (net of tax)** | | ( 363) | 173 |
| **Total comprehensive income for the year** | | 22,706 | 23,591 |
| | | | |
| **Profit attributable to:** | | | |
| Equity holders of Íslandsbanki hf. | | 22,977 | 23,438 |
| Non-controlling interests | | 92 | ( 20) |
| **Profit for the year** | | 23,069 | 23,418 |
| | | | |
| **Total comprehensive income attributable to:** | | | |
| Equity holders of Íslandsbanki hf. | | 22,614 | 23,611 |
| Non-controlling interests | | 92 | ( 20) |
| **Total comprehensive income for the year** | | 22,706 | 23,591 |
| | | | |
| **Basic earnings per share** | | | |
| **From profit for the year** | 27 | 2.30 | 2.34 |
| **Diluted earnings per share** | | | |
| **From profit for the year** | 27 | 2.30 | 2.34 |

The notes on pages 15 to 93 are an integral part of these consolidated financial statements.

Amounts are in ISK million

# Consolidated Statement of Financial Position as at 31 December 2013

| | Notes | 31.12.2013 | 31.12.2012 |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances with Central Bank | 28 | 111,779 | 85,500 |
| Derivatives | 30 | 843 | 127 |
| Bonds and debt instruments | 8 | 75,186 | 64,035 |
| Shares and equity instruments | 8 | 9,208 | 10,445 |
| Loans to credit institutions | 31 | 44,078 | 54,043 |
| Loans to customers | 32-33 | 554,741 | 557,857 |
| Investments in associates | 35-36 | 1,563 | 503 |
| Property and equipment | 39 | 8,772 | 5,579 |
| Intangible assets | 40 | 299 | 261 |
| Deferred tax assets | 48-51 | 1,275 | 864 |
| Non-current assets and disposal groups held for sale | 41 | 47,106 | 39,046 |
| Other assets | 42 | 11,159 | 5,115 |
| **Total Assets** | | 866,009 | 823,375 |
| **Liabilities** | | | |
| Derivative instruments and short positions | 30 | 11,176 | 18,435 |
| Deposits from Central Bank | 43 | 63 | 54 |
| Deposits from credit institutions | 43 | 29,626 | 38,218 |
| Deposits from customers | 44-45 | 489,331 | 471,156 |
| Debt issued and other borrowed funds | 46 | 89,193 | 66,571 |
| Subordinated loans | 47 | 21,890 | 23,450 |
| Current tax liabilities | 48-51 | 10,806 | 2,052 |
| Deferred tax liabilities | 48-51 | 20 | 20 |
| Non-current liabilities and disposal groups held for sale | 41 | 9,456 | 6,805 |
| Other liabilities | 52 | 37,130 | 48,954 |
| **Total Liabilities** | | 698,691 | 675,715 |
| **Equity** | | | |
| Share capital | 53 | 10,000 | 10,000 |
| Share premium | 53 | 55,000 | 55,000 |
| Other reserves | 54 | 2,471 | 2,834 |
| Retained earnings | | 98,548 | 78,571 |
| **Total equity attributable to the equity holders of Íslandsbanki hf.** | | 166,019 | 146,405 |
| Non-controlling interests | | 1,299 | 1,255 |
| **Total Equity** | | 167,318 | 147,660 |
| **Total Liabilities and Equity** | | 866,009 | 823,375 |

The notes on pages 15 to 93 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2013 10 Amounts are in ISK million

# Consolidated Statement of Changes in Equity for the year 2013

| | Notes | Share capital | Share premium | Other reserves | Retained earnings | Total | Non-controlling interests | Total equity |
|---|---|---|---|---|---|---|---|---|
| | | Attributable to the equity holders of Íslandsbanki hf. | | | | | | |
| **Equity as at 31.12.2011** | | 10,000 | 55,000 | 2,661 | 55,133 | 122,794 | 909 | 123,703 |
| Translation differences for foreign operations | 54 | | | 173 | | 173 | | 173 |
| Net income recognised directly in equity | | - | - | 173 | - | 173 | - | 173 |
| Profit for the year | | | | | 23,438 | 23,438 | ( 20) | 23,418 |
| Total comprehensive income for the year | | - | - | 173 | 23,438 | 23,611 | ( 20) | 23,591 |
| Acquisition of subsidiary with non-controlling interests | | | | | | - | 366 | 366 |
| **Equity as at 31.12.2012** | 53 | 10,000 | 55,000 | 2,834 | 78,571 | 146,405 | 1,255 | 147,660 |
| Translation differences for foreign operations | 54 | | | ( 363) | | ( 363) | | ( 363) |
| Net income recognised directly in equity | | - | - | ( 363) | - | ( 363) | - | ( 363) |
| Profit for the year | | | | | 22,977 | 22,977 | 92 | 23,069 |
| Total comprehensive income for the year | | - | - | ( 363) | 22,977 | 22,614 | 92 | 22,706 |
| Dividends paid | | | | | (3,000) | (3,000) | | (3,000) |
| Change in non-controlling interests | | | | | | 0 | (148) | (148) |
| Acquisition of subsidiary with non-controlling interests | | | | | | | 100 | 100 |
| **Equity as at 31.12.2013** | 53 | 10,000 | 55,000 | 2,471 | 98,548 | 166,019 | 1,299 | 167,318 |

The notes on pages 15 to 93 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2013 11 Amounts are in ISK million

# Consolidated Statement of Cash Flows for the year 2013

| | Notes | 2013 | 2012 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Profit for the year | | 23,069 | 23,418 |
| **Adjustments to reconcile profit for the year to cash flows provided by operating activities:** | | | |
| Non-cash items included in profit for the year and other adjustments | | ( 2,902) | ( 2,396) |
| Changes in operating assets and liabilities | | ( 9,038) | 17,896 |
| Income tax paid | | ( 2,000) | ( 6,144) |
| **Net cash provided by operating activities** | | 9,129 | 32,774 |
| **Cash flows from investing activities:** | | | |
| Investments in associated companies | | ( 37) | 533 |
| Proceeds from sale of property and equipment | | 1,241 | 178 |
| Purchase of property and equipment | 39 | ( 858) | ( 1,381) |
| Purchase of intangible assets | 40 | ( 164) | ( 126) |
| **Net cash provided by (used in) investing activities** | | 182 | ( 796) |
| **Cash flows from financing activities:** | | | |
| Proceeds from borrowings | | 35,535 | 9,120 |
| Repayment of borrowings | | ( 15,715) | ( 6,919) |
| Dividends paid | | (3,000) | - |
| **Net cash provided by financing activities** | | 16,820 | 2,201 |
| Net increase in cash and cash equivalents | | 26,131 | 34,179 |
| Effects of foreign exchange rate changes | | ( 508) | 60 |
| Cash and cash equivalents at the beginning of the year | | 112,810 | 78,571 |
| **Cash and cash equivalents at year end** | | 138,433 | 112,810 |

| | | | |
|---|---|---|---|
| **Reconciliation of cash and cash equivalents:** | | | |
| Cash on hand | 28 | 2,472 | 2,008 |
| Cash balances with Central Bank | 28 | 105,704 | 74,340 |
| Bank accounts | 31 | 30,257 | 36,462 |
| **Total cash and cash equivalents** | | 138,433 | 112,810 |

The Bank has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year. Cash and cash equivalents consist of highly liquid assets that are readily convertible into cash and which are subject to an insignificant risk of change in value. These are cash on hand, unrestricted balances with Central Bank and demand deposits with credit institutions.

Interest received in 2013 was ISK 47,781 million (2012: ISK 41,470 million) and interest paid in 2013 was ISK 23,515 million (2012: ISK 25,560 million). Interest paid is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 15 to 93 are an integral part of these consolidated financial statements

Íslandsbanki hf. Consolidated Financial Statements 2013 12 Amounts are in ISK million

# Consolidated Statement of Cash Flows for the year 2013

| Non-cash items included in net profit and other adjustments: | 2013 | 2012 |
|---|---|---|
| Depreciation and impairment | 979 | 903 |
| Amortisation of intangible assets | 126 | 425 |
| Share of (gain) loss of associates | ( 3) | 5 |
| Indexation and foreign exchange gain on debt issued | 2,802 | 2,775 |
| Impairment on loans | 8,378 | 19,029 |
| Income due to revised estimated cash flows from loans | ( 24,677) | ( 24,739) |
| Foreign exchange loss (gain) | 2,423 | ( 3,304) |
| (Gain) loss on sale of property and equipment | ( 456) | 180 |
| Unrealised fair value gains through profit and loss | ( 1,734) | ( 1,542) |
| Net profit on non-current assets classified as held for sale | ( 927) | ( 3,239) |
| Bank tax | 2,321 | 858 |
| Income tax | 7,866 | 6,253 |
| **Non-cash items included in net profit and other adjustments** | ( 2,902) | ( 2,396) |

| Changes in operating assets and liabilities: | | |
|---|---|---|
| Mandatory reserve with Central Bank | 5,549 | ( 2,782) |
| Loans and receivables to credit institutions | ( 2,133) | 2,955 |
| Loans and receivables to customers | 701 | 18,482 |
| Trading assets | ( 6,679) | ( 2,202) |
| Other operating assets | ( 6,013) | 1,975 |
| Non-current assets and liabilities held for sale | 2,080 | 5,237 |
| Deposits with credit institutions and Central Bank | ( 8,159) | ( 24,892) |
| Deposits from customers | 25,333 | 2,022 |
| Trading financial liabilities | ( 2,528) | 2,645 |
| Derivatives | ( 5,447) | 2,629 |
| Other operating liabilities | ( 11,742) | 11,827 |
| **Changes in operating assets and liabilities** | ( 9,038) | 17,896 |

### Non-cash transactions 2013

During 2013 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Bank reclassified shareholding in Atorka of ISK 1 bn from shares and equity instruments to investment in associates. This had no cash effect on the Bank.

b) The Bank sold part of its shareholding in an associate company which was held for sale and as a result lost significant influence over the entity. The remaining equity shares of ISK 1bn were subsequently reclassifed from Non-current assets and disposal groups held for sale to Shares and equity instruments. This transaction had no cash effect on the Bank.

c) The Bank acquired four subsidiaries EFF1 ehf., EFF2 ehf., EFF4 ehf. and Fergin ehf. in 2013 and as a result, the Bank reclassified ISK 9.9bn from Loans to customers, ISK 4.2bn to Property and equipment and ISK 5.7bn to Non-current assets held for sale. This transaction had no cash effect on the Bank.

### Non-cash transactions 2012

During 2012 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Bank recognised fair value changes of ISK 1.5 billion in 2012 which had no cash effect on the Bank.

The notes on pages 15 to 93 are an integral part of these consolidated financial statements

Íslandsbanki hf. Consolidated Financial Statements 2013 13 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

# Notes to the Consolidated Financial Statements

## 1. Reporting entity

Íslandsbanki hf. is a limited liability company incorporated and domiciled in Iceland. The address of its registered office is Kirkjusandur 2, 155 Reykjavík, Iceland.

The consolidated financial statements for the year ended 31 December 2013 were prepared on a going concern basis and comprise Íslandsbanki hf. (the parent company) and its subsidiaries (together referred to as "the Bank"). Comparative information refers to the year ended 31 December 2012.

The Bank was incorporated on 8 October 2008 and commenced trading on 15 October 2008 when it acquired assets and liabilities relating to the domestic operations of Glitnir Banki hf. ("Glitnir").

Ownership of Íslandsbanki hf. is divided between ISB Holding ehf., a private limited liability company owned 100% by GLB Holding ehf. which is a private limited liability company owned 100% by Glitnir hf., which wields 95% of the voting rights and the Icelandic State Treasury, which wields 5% of the voting rights. The Icelandic State Treasury's holdings in financial undertakings are managed by The Icelandic State Financial Investments (ISFI - Bankasýsla Ríkisins) which reports to the Minister of Finance.

The Bank provides a wide range of financial services such as retail banking, corporate banking, brokerage services, investment management and asset-based financing. The Bank operates in the Icelandic market.

## 2. Basis of preparation

*Statement of compliance*

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Information about new IFRS standards and amendments to standards are disclosed in Notes 87.34-87.37.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 19 February 2014.

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue in business for the foreseeable future. Therefore, these consolidated financial statements have been prepared on a going concern basis.

## 3. Functional and presentation currency

These consolidated financial statements are presented in Icelandic krona (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated.

## 4. Use of significant estimates and judgements in applying accounting policies

The preparation of the consolidated financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses recognised.

The accounting estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates. The accounting 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

The Bank's management discusses with the Audit Committee the development, selection and disclosure of the Bank's critical accounting policies and their application, and assumptions made relating to major estimation uncertainties. Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year and about critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the consolidated financial statements is disclosed below.

# Notes to the Consolidated Financial Statements

**4. Cont'd**

a) *Uncertainties relating to court rulings, pending court cases and investigations by regulators*

Two court cases have been filed against Íslandsbanki and Landsbankinn, challenging the legality of fixing the principal of a mortgage to the consumer price index (CPI). Such indexation has been the industry standard for at least 30 years. However, the method of calculating the index has changed over the years, with the most recent change introduced in 1995. The possible effect on the Bank has not been estimated, but clearly, any downgrading of the indexation would affect the Bank and other home mortgage lenders in Iceland.

Several rulings of the Supreme Court of Iceland during the years 2010 to 2013 in relation to foreign currency-linked loans have affected the Bank. Most important of these rulings was a ruling in June 2010 on the illegality of a principal of loans in ISK being linked to foreign currencies. The Bank consequently made an announcement to the effect that it would recalculate illegally foreign currency-linked loans, outstanding as well as paid-up loans, in line with the instructions given by the rulings. This process is in its final stages. The court rulings combined have effectively reduced the uncertainty regarding which foreign currency loans are illegal and how they should be recalculated. The uncertainty that still exists is more or less embedded in two court cases where final judgement is expected in the fourth quarter of 2014.

The Icelandic Competition Authority ("ICA") has initiated an investigation concerning alleged violations of the Competition law by Íslandsbanki where significant sanctions may come into consideration. Details of the investigation remain confidential. The Bank has presented its observations on the opposition document and will further cooperate with the ICA to resolve the case.

The Bank has recognised provisions in the consolidated financial statements 2013 relating to court rulings and sanctions which are presented under Note 52. Uncertainties are further discussed under Note 58.

b) *Impairment of loans and receivables measured at amortised cost*

There were uncertainties in input parameters and assumptions used in the valuation of the loans and receivables acquired at a deep discount from Glitnir in 2008 and from Byr in 2011. Valuation estimates were based on the Bank's management's estimates for collateral values and a prudent risk premium, knowledge of the customers and the markets and official macroeconomic forecasts.

Factors that can affect the recovery value of the loans and receivables include macroeconomic parameters such as the unemployment rate, inflation and wage growth, as well as actions taken by the government to facilitate and ease debt service and legislation that lengthens the collection process or increases taxation and the extent of customer participation in flexible maturity and payment equalisation programmes.

At 31 December 2013 some of the uncertainties surrounding the initial valuation of the loans and receivables acquired at a deep discount and the economic environment were still present. The Bank's management is, however, confident that the Bank's capital base is robust enough to absorb reasonable variances in applied assumptions.

The Bank's management reviews its loan portfolios on a quarterly basis to assess whether there is any objective evidence of impairment. In determining whether an impairment loss should be recognised in the income statement, the Bank's management makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from loans and receivables. 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.

When scheduling its future cash flows the Bank's management uses estimates based on loans and receivables with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio. 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. Impairment of loans and receivables is disclosed in more detail in Note 87.28.

c) *Impairment of foreign exchange gains for loans acquired at a deep discount*

Since the acquisition of the deep discount loan portfolio, the foreign currency part of the loan portfolio has been divided into loans to customers with revenue and cash flows in foreign currency and loans to customers with revenue and cash flows in ISK. The foreign exchange gain or loss on these loans was recognised in profit or loss as net foreign exchange gain. However, as the Bank did not expect to recover foreign exchange gain relating to loans to customers with revenue and cash flows in ISK, the respective foreign exchange gain was recognised immediately in full as an impairment loss in profit or loss in the line item net valuation changes.

At year end 2013, the foreign currency loans to customers with revenue and cash flows in ISK have either been, or are on the verge of being, converted to ISK loans or have been categorised as foreign currency loans to customers with revenue and cash flows in foreign currency. The foreign currency loan portfolio will therefore no longer be divided as described above and impairment of foreign exchange gain to customers with revenue and cash flows in ISK will not be applicable in the year 2014.

# Notes to the Consolidated Financial Statements

4 **Cont'd**

d) *Determination of fair value of financial assets and financial liabilities*

The Bank determines the fair value of financial assets and financial liabilities that are not quoted in active markets by using valuation techniques as described in accounting policy Notes 87.5, 9-10. To the extent that it is practical, models use only observable data. However, for financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument, such as credit risk (both own and counterparty).

e) *The application of the effective interest method*

The application of the effective interest method when calculating the amortised cost of financial assets and financial liabilities requires management to estimate future cash payments or receipts through the expected life of the financial instrument, considering all contractual terms of the financial instrument (for example, prepayment, call and similar options). Revisions to estimates of future cash flows, other than those arising from changes in market variables, generally result in the Bank having to adjust the carrying amount of the financial asset or financial liability to reflect actual and revised estimated cash flows. In such cases the adjustment is recognised as income or expense in profit or loss in the period in which the estimate is revised.

f) *Restructuring and forbearance*

Restructuring of customers' debt has been one of the Bank's main tasks since October 2008. This has been a challenging task as such a large part of the customers needed forbearance measures. The Bank has offered several debt relief measures and set in place processes and resources to undertake the restructuring work. This has been done without a significant loss to the Bank because the loan portfolio was acquired at a deep discount. Legal issues, political environment and the general economy have further contributed in ways of uncertainty and complications. The Bank's management team has been kept well informed on the status of restructuring and forbearance on a regular basis.

Further details on forbearance and the restructuring of customers' debt can be seen under Note 67 and in the Íslandsbanki Risk Report published concurrent to the annual report.

g) *Liquidity*

The Bank manages its liquidity by maintaining an adequate portfolio of liquid assets against liabilities. Internal liquidity limits assume that liquid assets cover all liabilities expected to mature within the next 12 month period, even under stressed market conditions.

The expected maturity profile of the Bank's liabilities is based on analysis of the historical behaviour and other characteristics of the deposit base. The contractual maturity profile is set out in the liquidity risk disclosure in Note 70. The table requires judgement with respect to whether assets can be considered liquid and when deposits will be withdrawn.

# Notes to the Consolidated Financial Statements

## Business combination

### 5. Acquisition of group undertakings

### 5.1 Acquisition of subsidiaries

a) *Identification of the business*

On 24 January 2013, the Bank acquired 100% shareholding in the real estate companies EFF 1 ehf. and EFF 2 ehf. EFF1 ehf. subsequently merged with the Bank's real estate company D1 ehf. on 1 April 2013.

b) *Identification of the acquired assets and liabilities*

The fair value of the identifiable assets and liabilities acquired in EFF1 ehf. and EFF2 ehf. is as follows:

| | EFF1 ehf. | EFF2 ehf |
|---|---|---|
| | Fair value at the date of acquisition | Fair value at the date of acquisition |
| Property | 3,452 | 648 |
| Other assets | 63 | - |
| **Assets** | 3,515 | 648 |
| Debt issued and other borrowed funds | 3,515 | 648 |
| **Liabilities** | 3,515 | 648 |
| **Net identifiable assets and liabilities** | - | - |

c) *Identification of the cost of the business combination*

The cost arising from the acquisition was immaterial and no goodwill arose from the transaction.

### 5.2 Acquisition of subsidiaries held exclusively with a view to disposal

On 24 January 2013, the Bank acquired 100% shareholding in the real estate company EFF 4 ehf. The entity EFF 4 ehf. qualifies as being held for sale in accordance with IFRS 5 and has therefore been classified as disposal groups held for sale.

On 20 December 2013, the Bank acquired 80% shareholding in the car inspection company Frumherji hf. and its holding company Fergin ehf. The entities qualify as being held for sale in accordance with IFRS 5 and have therefore been classified as disposal groups held for sale.

Íslandsbanki hf. Consolidated Financial Statements 2013 18 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Business segments

6. A business segment is a distinguishable component of the Bank that is engaged in providing products or services that are subject to risks and rewards that may be different from those of other business segments. Transactions between the business segments are on normal commercial terms and conditions. No single customer generates 10% or more of the combined revenue of the Bank.

The accounting policies for the reportable segments are in line with the Bank's accounting policies. The segment profit presented is the profit reported to the chief operating decision maker (CEO) and the Board of Directors for the purpose of resource allocation and assessment of segment performance.

The Bank is organised into six main business segments based on products and services:

a) Retail Banking operates 19 branches and asset based financing under the brand name Ergo. The branches provide services to individuals and small and medium-sized enterprises. In addition, the Retail Banking division operates Kreditkort, which is a special credit card branch, call centre and centralised cash centre.

b) Corporate Banking provides lending and tailor-made financial services to larger companies and professional investors. Building on experience and industry expertise Corporate Banking offers universal banking services to customers through cross-selling and by connecting customers to other business units of the bank. Furthermore, Corporate Banking overseas the Bank's international business in the North Atlantic region where the focus is on the seafood, the offshore supply vessel and the energy industries.

c) Markets incorporates brokerage services in securities, foreign currencies and derivatives as well as providing money market lending and interbank services. The division further offers an extensive range of corporate finance services.

d) Wealth Management offers a range of wealth and asset management products and services for individuals, corporations and institutional investors. The Wealth Management unit consists of VÍB which offers a broad range of asset management products and services and the fund management company Íslandssjódir.

e) Treasury is responsible for the management of liquidity risk, foreign exchange risk and interest rate risk within regulatory requirements and internal limits established by the Board of Directors. Treasury is also responsible for funding the Bank´s operations and managing an internal pricing framework.

f) Subsidiaries and equity investments include equity investments in the banking book and subsidiaries, the most significant being:
• Midengi, an asset management company managing commercial real estate and businesses which the Bank has acquired through repossessions following loan defaults, debt restructuring and bankruptcies of its customers
• Borgun, a credit card settlement company
• HTO (Höfdatorg), a property investment company (sold in 2014)
• Allianz Ísland hf., an agent for the German insurance company Allianz and its holding company Hringur eignarhaldsfélag ehf.

g) Cost centres comprise Head Office, Human Resources, Credit and Risk, Legal, Finance and Operations & IT.

On the following page is an overview showing the Bank's performance with a breakdown by business segments.

# Notes to the Consolidated Financial Statements

6. Cont'd

The year 2013

| Operations | Retail Banking | Corporate Banking | Markets | Wealth Manage-ment | Treasury | Subsidiaries & Equity Investments | Cost Centres & Eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 20,674 | 4,294 | 541 | 781 | 4,647 | ( 572) | ( 1,935) | 28,430 |
| Net fee and commission income | 3,468 | 163 | 1,723 | 1,814 | ( 222) | 3,241 | 246 | 10,433 |
| Other net operating income (exps.) | 51 | ( 95) | 478 | 103 | ( 2,389) | 4,615 | 971 | 3,734 |
| Total operating income | 24,193 | 4,362 | 2,742 | 2,698 | 2,036 | 7,284 | ( 718) | 42,597 |
| Administrative expenses | ( 7,889) | ( 623) | ( 1,016) | ( 931) | ( 278) | ( 3,269) | ( 11,545) | ( 25,551) |
| Impairment of goodwill | - | - | - | - | - | - | - | - |
| Insurance fund | ( 886) | ( 8) | ( 0) | ( 75) | ( 47) | - | - | ( 1,016) |
| Bank tax | - | - | - | - | ( 2,321) | - | - | ( 2,321) |
| Impairment and net valuation changes on loans | 5,559 | 9,951 | 2 | 1,158 | ( 51) | 78 | ( 398) | 16,299 |
| Profit (loss) before cost allocation & tax | 20,977 | 13,682 | 1,728 | 2,850 | ( 661) | 4,093 | ( 12,661) | 30,008 |
| Net segment revenue from external customers | 31,558 | 21,779 | 2,691 | 1,071 | ( 6,078) | 8,435 | ( 559) | 58,896 |
| Net segment revenue from other segments | ( 1,806) | ( 7,466) | 53 | 2,785 | 8,063 | ( 1,072) | ( 557) | 0 |
| **At 31 December 2013** | | | | | | | | |
| Total segment assets | 395,292 | 182,184 | 261 | 2,823 | 223,219 | 120,815 | ( 58,585) | 866,009 |
| Total segment liabilities | 395,236 | 8,986 | 215 | 50,542 | 219,283 | 63,797 | ( 39,368) | 698,691 |

The year 2012

| Operations | Retail Banking | Corporate Banking | Markets | Wealth Manage-ment | Treasury | Subsidiaries & Equity Investments | Cost Centres & Eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 21,334 | 6,821 | 254 | 1,080 | 5,065 | (243) | (1,371) | 32,940 |
| Net fee and commission income | 3,393 | 112 | 1,865 | 1,574 | (203) | 2,549 | 169 | 9,459 |
| Other net operating income (exps.) | ( 376) | ( 144) | 666 | 64 | 1,520 | 2,740 | 780 | 5,250 |
| Total operating income | 24,351 | 6,789 | 2,785 | 2,718 | 6,382 | 5,046 | ( 422) | 47,649 |
| Administrative expenses | ( 7,056) | ( 561) | ( 1,108) | ( 959) | ( 186) | ( 2,747) | ( 11,972) | ( 24,589) |
| Impairment of goodwill | - | - | - | ( 135) | - | - | ( 290) | ( 425) |
| Insurance fund | ( 913) | ( 0) | ( 0) | ( 74) | ( 68) | - | - | ( 1,055) |
| Bank tax | - | - | - | - | ( 858) | - | - | ( 858) |
| Impairment and net valuation changes on loans | ( 1,444) | 5,375 | 0 | 966 | ( 0) | 537 | 276 | 5,710 |
| Profit (loss) before cost allocation & tax | 14,938 | 11,603 | 1,677 | 2,516 | 5,270 | 2,836 | ( 12,408) | 26,432 |
| Net segment revenue from external customers | 25,674 | 20,341 | 2,597 | 1,396 | ( 3,084) | 5,583 | 852 | 53,359 |
| Net segment revenue from other segments | ( 2,767) | ( 8,177) | 187 | 2,288 | 9,468 | - | ( 999) | 0 |
| **At 31 December 2012** | | | | | | | | |
| Total segment assets | 379,450 | 199,948 | 954 | 5,808 | 195,005 | 101,945 | ( 59,735) | 823,375 |
| Total segment liabilities | 398,628 | 5,777 | 500 | 44,770 | 213,107 | 57,453 | ( 44,520) | 675,715 |

Íslandsbanki hf. Consolidated Financial Statements 2013 20 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Quarterly statements

7. Operations by quarters:

| 2013 | Q4* | Q3* | Q2* | Q1* | Total |
|---|---|---|---|---|---|
| Net interest income | 6,547 | 7,365 | 7,045 | 7,473 | 28,430 |
| Net fee and commission income | 2,849 | 2,462 | 2,670 | 2,452 | 10,433 |
| Net financial income | 2,747 | 315 | 669 | 881 | 4,612 |
| Net foreign exchange (loss) gain | ( 1,117) | 409 | ( 152) | ( 1,563) | ( 2,423) |
| Share of profit of associates | - | - | - | 3 | 3 |
| Other net operating income | 100 | 314 | 716 | 412 | 1,542 |
| Administrative expenses | ( 7,928) | ( 5,208) | ( 6,179) | ( 6,236) | ( 25,551) |
| Impairment of goodwill | - | - | - | - | - |
| Contribution to the Depositors' and Investors' Guarantee Fund | ( 262) | ( 252) | ( 256) | ( 246) | ( 1,016) |
| Bank tax | ( 2,113) | ( 76) | ( 65) | ( 67) | ( 2,321) |
| Loan impairment charges and net valuation changes | 7,894 | 555 | 4,857 | 2,993 | 16,299 |
| Profit before tax | 8,717 | 5,884 | 9,305 | 6,102 | 30,008 |
| Income tax | ( 2,501) | ( 1,570) | ( 2,347) | ( 1,448) | ( 7,866) |
| Profit for the period from continuing operations | 6,216 | 4,314 | 6,958 | 4,654 | 22,142 |
| Profit (loss) for the period from discontinued operations | 1,456 | ( 125) | ( 335) | ( 69) | 927 |
| **Profit for the period** | 7,672 | 4,189 | 6,623 | 4,585 | 23,069 |

* The half year results were reviewed by the Bank's auditors, but the splits between quarters were not audited.

| 2012 | Q4* | Q3* | Q2* | Q1* | Total |
|---|---|---|---|---|---|
| Net interest income | 8,560 | 7,785 | 7,585 | 9,010 | 32,940 |
| Net fee and commission income | 2,755 | 2,278 | 2,324 | 2,102 | 9,459 |
| Net financial income | 199 | 213 | 191 | 914 | 1,517 |
| Net foreign exchange gain (loss) | 1,507 | 491 | ( 452) | 1,191 | 2,737 |
| Share of profit of associates | - | - | - | - | - |
| Other net operating income | 181 | 226 | 294 | 295 | 996 |
| Administrative expenses | ( 6,701) | ( 5,271) | ( 6,395) | ( 6,222) | ( 24,589) |
| Impairment of goodwill | ( 425) | - | - | - | ( 425) |
| Contribution to the Depositors' and Investors' Guarantee Fund | ( 257) | ( 272) | ( 201) | ( 325) | ( 1,055) |
| Bank tax | ( 227) | ( 224) | ( 200) | ( 207) | ( 858) |
| Loan impairment charges and net valuation changes | 3,507 | 404 | 3,464 | ( 1,665) | 5,710 |
| Profit before tax | 9,099 | 5,630 | 6,610 | 5,093 | 26,432 |
| Income tax | ( 1,790) | ( 1,465) | ( 1,546) | ( 1,452) | ( 6,253) |
| Profit for the period from continuing operations | 7,309 | 4,165 | 5,064 | 3,641 | 20,179 |
| (Loss) profit for the period from discontinuing operations | ( 112) | 432 | 954 | 1,965 | 3,239 |
| **Profit for the period** | 7,197 | 4,597 | 6,018 | 5,606 | 23,418 |

* The half year results were reviewed by the Bank's auditors, but the splits between quarters were not audited.

Íslandsbanki hf. Consolidated Financial Statements 2013 21 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Financial assets and liabilities

8. The following tables show the carrying value of financial assets and financial liabilities according to their IAS 39 classification.

| At 31 December 2013 | Notes | Held for trading | Designated at fair value through P&L | Loans & receivables | Liabilities at amortised cost | Total carrying amount |
|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 28 | - | - | 111,779 | - | 111,779 |
| *Loans and receivables* | | | | | | |
| Loans to credit institutions | 31 | - | - | 44,078 | - | 44,078 |
| Loans to customers | 32-33 | - | - | 554,741 | - | 554,741 |
| **Loans and receivables** | | - | - | 710,598 | - | 710,598 |
| *Bonds and debt instruments* | | | | | | |
| Listed | | 41,311 | 31,598 | - | - | 72,909 |
| Unlisted | | | 2,277 | - | - | 2,277 |
| **Bonds and debt instruments** | | 41,311 | 33,875 | - | - | 75,186 |
| *Shares and equity instruments* | | | | | | |
| Listed | | 3,095 | 3,322 | - | - | 6,417 |
| Unlisted | | - | 2,791 | - | - | 2,791 |
| **Shares and equity instruments** | | 3,095 | 6,113 | - | - | 9,208 |
| Derivatives | 30 | 843 | - | - | - | 843 |
| Other financial assets | | - | - | 9,036 | - | 9,036 |
| **Total financial assets** | | 45,249 | 39,988 | 719,634 | - | 804,871 |
| | | | | | | |
| Derivative instruments and short positions | 30 | 11,176 | - | - | - | 11,176 |
| Deposits from Central Bank | 43 | - | - | - | 63 | 63 |
| Deposits from credit institutions | 43 | - | - | - | 29,626 | 29,626 |
| Deposits from customers | 44-45 | - | - | - | 489,331 | 489,331 |
| Debt issued and other borrowed funds | 46 | - | - | - | 89,193 | 89,193 |
| Subordinated loans | 47 | - | - | - | 21,890 | 21,890 |
| Other financial liabilities | | - | - | - | 22,561 | 22,561 |
| **Total financial liabilities** | | 11,176 | - | - | 652,664 | 663,840 |

Íslandsbanki hf. Consolidated Financial Statements 2013 22 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

8. Cont'd

| At 31 December 2012 | Notes | Held for trading | Designated at fair value through P&L | Loans & receivables | Liabilities at amortised cost | Total carrying amount |
|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 28 | - | - | 85,500 | - | 85,500 |
| *Loans and receivables* | | | | | | |
| Loans to credit institutions | 31 | - | - | 54,043 | - | 54,043 |
| Loans to customers | 32-33 | - | - | 557,857 | - | 557,857 |
| **Loans and receivables** | | - | - | 697,400 | - | 697,400 |
| *Bonds and debt instruments* | | | | | | |
| Listed | | 28,400 | 31,661 | - | - | 60,061 |
| Unlisted | | - | 3,974 | - | - | 3,974 |
| **Bonds and debt instruments** | | 28,400 | 35,635 | - | - | 64,035 |
| *Shares and equity instruments* | | | | | | |
| Listed | | 2,835 | 3,681 | - | - | 6,516 |
| Unlisted | | - | 3,929 | - | - | 3,929 |
| **Shares and equity instruments** | | 2,835 | 7,610 | - | - | 10,445 |
| Derivatives | 30 | 127 | - | - | - | 127 |
| Other financial assets | | - | - | 1,259 | - | 1,259 |
| **Total financial assets** | | 31,362 | 43,245 | 698,659 | - | 773,266 |
| Derivative instruments and short positions | 30 | 18,435 | - | - | - | 18,435 |
| Deposits from Central Bank | 43 | - | - | - | 54 | 54 |
| Deposits from credit institutions | 43 | - | - | - | 38,218 | 38,218 |
| Deposits from customers | 44-45 | - | - | - | 471,156 | 471,156 |
| Debt issued and other borrowed funds | 46 | - | - | - | 66,571 | 66,571 |
| Subordinated loans | 47 | - | - | - | 23,450 | 23,450 |
| Other financial liabilities | | - | - | - | 23,494 | 23,494 |
| **Total financial liabilities** | | 18,435 | - | - | 622,943 | 641,378 |

Íslandsbanki hf. Consolidated Financial Statements 2013 23 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Fair value information for financial instruments

9. The fair value of a financial instrument is the transaction price that would have been received in selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Where a market price is not readily available, the Bank applies valuation techniques based on estimates and assumptions that are consistent with that which market participants would use in setting a price for the financial instrument. In some instances the Bank uses approximation methods. These approximation methods are explained in more detail below.

The fair value of a financial liability with a demand feature, such as a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

### Financial instruments at amortised cost

*Assets*

Loans on the Bank's balance sheet that are carried at amortised cost consist of two types:

1) Loans whose carrying amount is less than their claim value, due to either impairments or deep discount.
2) Loans whose carrying amount equals the claim value.

Loans in category 1) are specifically valued each quarter and therefore their fair value is fully represented by their carrying amount. The fair value of the loans in category 2) may differ from their carrying amount because the interest rate they carry may not reflect the interest rate that similar new loans would carry. This difference stems from two sources:

a) Credit migration: The debtors may not have the same credit-worthiness they had when the loans' interest rates were last reset and the collateralisation of the loan may have changed.
b) Fixed rate loans: The interest rate level used as a base for pricing fixed rate loans may have shifted.

The Bank calculates the fair value of loans in category 2) by discounting from the carrying amount the resulting interest rate difference from 31 December 2013 to the loan's next interest reset or maturity.

For "Cash and balances with Central Bank" and "Loans to credit institutions" the carrying value is very well approximated by the carrying amount since they are short term in nature.

*Liabilities*

On the liabilities side most deposits are on demand or carry floating interest rates and as such their fair value equals their carrying amount. For longer term, fixed rate deposits the Bank calculates the fair value with a duration approach, using the difference in each liability´s current rate from the rate that a similar deposit would carry today. For the fair value of "Debt issued and other borrowed funds" the Bank uses an observed market value where it is available. If there is no observable market value the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate and is estimated by comparing the debt's margin with the Bank's current funding premium on similar debt if it is based on a floating rate. The Bank estimates its funding premium based on the interest margin on its issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

The fair value of liabilities in "Subordinated loans" is estimated by comparing the contractual interest margin with the interest margin in the market on the Bank's issuance in foreign currency plus a margin to account for the fact that the subordinated liabilities are junior to the market traded debt.

The following table shows the fair value for the Bank's assets and liabilities recognised at amortised cost.

| | Carrying amount 2013 | Fair value 2013 | Carrying amount 2012 | Fair Value 2012 |
|---|---|---|---|---|
| **Financial assets:** | | | | |
| Cash and balances with Central Bank | 111,779 | 111,779 | 85,500 | 85,500 |
| Loans to credit institutions | 44,078 | 44,078 | 54,043 | 54,043 |
| Loans to customers | 554,741 | 556,068 | 557,857 | 557,857 |
| **Total financial assets** | 710,598 | 711,925 | 697,400 | 697,400 |
| **Financial liabilities:** | | | | |
| Deposits from Central Bank | 63 | 63 | 54 | 54 |
| Deposits from credit institutions | 29,626 | 29,626 | 38,218 | 38,218 |
| Deposits from customers | 489,331 | 489,430 | 471,156 | 471,402 |
| Debt issued and other borrowed funds | 89,193 | 89,723 | 66,571 | 67,100 |
| Subordinated loans | 21,890 | 21,880 | 23,450 | 23,450 |
| **Total financial liabilities** | 630,103 | 630,722 | 599,449 | 600,224 |

Íslandsbanki hf. Consolidated Financial Statements 2013 24 Amounts are in ISK million

## 10. Financial instruments at fair value

The table below categorises financial instruments carried at fair value, by valuation method used. The different levels have been defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Bank can access at the measurement date.

Level 2: Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Inputs for the assets or liabilities that are not based on observable market data (unobservable inputs, e.g. internal assumptions).

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities carried at fair value in the consolidated balance sheet are categorised as at 31 December 2013:

### At 31 December 2013

| Financial assets: | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 42,071 | 31,836 | 1,279 | 75,186 |
| Shares and equity instruments | 6,417 | - | 2,791 | 9,208 |
| Derivative instruments | - | 843 | - | 843 |
| **Total financial assets** | 48,488 | 32,679 | 4,070 | 85,237 |
| **Financial liabilities:** | | | | |
| Short positions | 9,252 | 210 | - | 9,462 |
| Derivative instruments | - | 1,629 | 85 | 1,714 |
| **Total financial liabilities** | 9,252 | 1,839 | 85 | 11,176 |

The following table shows financial instruments carried at fair value, by valuation method, as categorised at 31 December 2012.

### At 31 December 2012

| Financial assets: | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 59,542 | 795 | 3,698 | 64,035 |
| Shares and equity instruments | 6,516 | - | 3,929 | 10,445 |
| Derivative instruments | - | 107 | 20 | 127 |
| **Total financial assets** | 66,058 | 902 | 7,647 | 74,607 |
| **Financial liabilities:** | | | | |
| Short positions | 11,991 | - | - | 11,991 |
| Derivative instruments | - | 1,270 | 5,174 | 6,444 |
| **Total financial liabilities** | 11,991 | 1,270 | 5,174 | 18,435 |

Comparable information in fair value information for financial instruments has not been changed to conform to changes adopted for the current year based on new requirements according to IFRS 13 Fair Value Measurement.

Íslandsbanki hf. Consolidated Financial Statements 2013 25 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**10.** Cont'd

### Reconciliation of financial instruments in level 3

| | Bonds and debt instruments | Shares and equity instruments | Derivatives |
|---|---|---|---|
| Recorded value as at 31 December 2012 | 3,698 | 3,929 | ( 5,154) |
| Additions/Purchases | - | 1,237 | - |
| Sales | - | ( 1,052) | - |
| Recategorised as an affiliate | - | ( 1,021) | - |
| Settled | ( 759) | - | - |
| Net gains on financial instruments | ( 437) | ( 164) | ( 5) |
| Transfers from level 1 or 2 | - | 52 | - |
| Transfers to level 1 or 2 | ( 1,223) | ( 190) | 5,074 |
| **Recorded value at 31 December 2013** | 1,279 | 2,791 | ( 85) |

The responsibility for the valuation of financial instruments at fair value lies within the relevant business units. The business units are required to assess the valuation of their assets quarterly and present them for the Investment Committee which must give its approval of these valuations. Risk Management is responsible for reviewing the valuations, assessing the extent of market data used and categorising the valuation methods.

Level 3 assets contain primarily unlisted and illiquid equities and bonds and one bond option.

The valuation of level-3 assets is done on a case-by-case basis when the book value exceeds ISK 50 million. The valuation methods are presented in the table below.

Following a review of valuation methods in 2013 a number of transfers between levels were made: ISK 5,074 million of derivatives and ISK 190 million of equities were transferred from level 3 to level 2 and ISK 1,223 million of bonds were then transferred from level 3 to level 1 because the underlying bonds, previously unlisted, were listed on the domestic market in Q1 2013. Transfers of assets from level 3 to level 1 or 2 is done at the price at 31 December 2012.

### Valuation techniques used in the fair value measurement of level 3 assets and liabilities

| **Valuation method** | Bonds and debt instru-ments | Shares and equity instruments | Derivatives | Significant unobservable input | Range of estimates (weighted average) for unobservable inputs | Fair value measurement sensitivity to unobservable inputs |
|---|---|---|---|---|---|---|
| Expected recovery | 1,279 | 728 | - | Value of assets | Bonds: 0-78% (29%) | An increase or decrease in the expected recovery would result in a similar change in the fair value |
| Dividend discount model | - | 760 | - | Weighted average cost of capital (WACC) | 12% (12%) | An increase in the WACC would result in a lower fair value and a decrease would result in a higher fair value |
| Discounted cash flow model | - | 1,117 | - | Weighted average cost of capital (WACC) | 6-13% | An increase in the WACC would result in a lower fair value and a decrease would result in a higher fair value |
| Multipliers | - | 186 | - | Original investment multiplier | 2 | An increase in the multiplier would result in a higher fair value and a decrease would result in a lower fair value |
| Other | - | - | ( 85) | Bond price volatility | 6% (6%) | An increase in the volatility would result in a higher fair value and a decrease would result in a lower fair value |
| **Total** | 1,279 | 2,791 | ( 85) | | | |

## Offsetting financial assets and financial liabilities

**11.** Offsetting financial assets and financial liabilities

The table below provides a summary of the financial assets and financial liabilities which are subject to enforceable master netting agreements of similar arrangements, even if they have not been offset in the balance sheet.

a) Financial assets subject to offsetting, enforceable netting arrangements and similar agreements

| | Financial assets subject to netting arrangements | | | Amounts not set off but subject to master netting arrangements and similar agreements | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2013** | Gross recognised financial assets before balance sheet netting | Balance sheet netting with gross recog-nised financial liabilities | Financial assets recognis-ed on the balance sheet, net | Recognised financial liabilities | Cash collateral received | Financial instruments collateral received | Net amount after consideration of potential effect of netting arrangements | Assets outside the scope of offsetting disclosure requirements | Total assets recognised on the balance sheet |
| Derivatives ......................... | 843 | - | 843 | ( 60) | ( 98) | ( 152) | 534 | - | 843 |
| **Total assets** | 843 | - | 843 | ( 60) | ( 98) | ( 152) | 534 | - | 843 |
| **At 31 December 2012** | | | | | | | | | |
| Derivatives ......................... | 127 | - | 127 | ( 97) | ( 30) | - | - | - | 127 |
| **Total assets** | 127 | - | 127 | ( 97) | ( 30) | - | - | - | 127 |

b) Financial liabilities subject to offsetting, enforceable netting arrangements and similar agreements

| | Financial liabilities subject to netting arrangements | | | Amounts not set off but subject to master netting arrangements and similar agreements | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2013** | Gross recognised financial liabilities before balance sheet netting | Balance sheet netting with gross recog-nised financial assets | Financial liabilities recognis-ed on the balance sheet, net | Recognised financial assets | Cash collateral pledged | Financial instruments collateral pledged | Net amount after consideration of potential effect of netting arrangements | Liabilities outside the scope of offsetting disclosure requirements | Total liabilities recognised on the balance sheet |
| Derivative instruments and short position ..................... | 1,714 | - | 1,714 | ( 60) | - | - | 1,654 | 9,462 | 11,176 |
| **Total liabilities** | 1,714 | - | 1,714 | ( 60) | - | - | 1,654 | 9,462 | 11,176 |
| **At 31 December 2012** | | | | | | | | | |
| Derivative instruments and short position ..................... | 6,444 | - | 6,444 | ( 97) | ( 33) | ( 5,044) | 1,270 | 11,991 | 18,435 |
| **Total liabilities** | 6,444 | - | 6,444 | ( 97) | ( 33) | ( 5,044) | 1,270 | 11,991 | 18,435 |

Íslandsbanki hf. Consolidated Financial Statements 2013 27 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Net interest income

12. Net interest income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| **Interest income:** | | |
| Cash and balances with Central Bank | 4,639 | 3,467 |
| Loans and receivables | 46,764 | 52,571 |
| Financial assets held for trading | 948 | 1,521 |
| Financial assets designated at fair value through profit or loss | 1,790 | 1,742 |
| Other assets | 192 | 118 |
| **Total interest income** | 54,333 | 59,419 |
| **Interest expense:** | | |
| Deposits from credit institutions and Central Bank | ( 505) | ( 1,204) |
| Deposits from customers | ( 18,174) | ( 17,739) |
| Borrowings | ( 5,753) | ( 5,629) |
| Subordinated loans | ( 951) | ( 1,098) |
| Other financial liabilities | ( 367) | ( 546) |
| Other interest expense | ( 153) | ( 263) |
| **Total interest expense** | ( 25,903) | ( 26,479) |
| **Net interest income** | 28,430 | 32,940 |
| Interest spread (as the ratio of net interest income to the average carrying amount of total assets) | 3.4% | 3.9% |

## Net fee and commission income

13. Net fee and commission income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| **Fee and commission income:** | | |
| Asset management | 1,564 | 1,490 |
| Investment Banking and brokerage | 2,005 | 2,071 |
| Payment processing | 10,484 | 8,546 |
| Loans and guarantees | 1,141 | 1,104 |
| Other fees and commissions income | 1,501 | 1,601 |
| **Total fees and commission income** | 16,695 | 14,812 |
| **Commission expenses:** | | |
| Interbank charges | ( 331) | ( 232) |
| Brokerage | ( 126) | ( 165) |
| Clearing and settlement | ( 5,702) | ( 4,878) |
| Other commission expenses | ( 103) | ( 78) |
| **Total commission expenses** | ( 6,262) | ( 5,353) |
| **Net fee and commission income** | 10,433 | 9,459 |

Íslandsbanki hf. Consolidated Financial Statements 2013 28 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Net financial income

**14.** Net financial income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Net gain (loss) on financial assets and liabilities held for trading | 891 | ( 297) |
| Net gain on financial assets designated at fair value through profit or loss | 3,721 | 1,814 |
| **Net financial income** | 4,612 | 1,517 |

## Net gain (loss) on financial assets and liabilities held for trading

**15.** Net gain (loss) on financial assets and liabilities held for trading are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Shares and related derivatives | 498 | 68 |
| Dividend income on shares held for trading | 115 | 210 |
| Bonds and related derivatives | ( 71) | 368 |
| Other derivatives | 349 | ( 943) |
| **Net gain (loss) on financial assets and liabilities held for trading** | 891 | ( 297) |

## Net gain on financial assets designated at fair value through profit or loss

**16.** Net gain on financial assets designated at fair value through profit or loss are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Shares | 3,799 | 2,150 |
| Bonds | ( 78) | ( 336) |
| **Net gain on financial assets designated at fair value through profit or loss** | 3,721 | 1,814 |

## Net foreign exchange (loss) gain

**17.** Net foreign exchange (loss) gain is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| **Assets:** | | |
| Cash and balances with Central Bank | ( 145) | 60 |
| Financial assets held for trading | 3,246 | 400 |
| Loans to credit institutions | ( 5,893) | 4,043 |
| Loans to customers | ( 9,428) | 7,278 |
| Other assets | ( 32) | 280 |
| **Total** | ( 12,252) | 12,061 |
| **Liabilities:** | | |
| Deposits from credit institutions | 424 | ( 319) |
| Deposits from customers | 7,158 | ( 6,191) |
| Subordinated loan | 1,576 | ( 1,514) |
| Other liabilities | 114 | ( 256) |
| **Total** | 9,272 | ( 8,280) |
| **Unadjusted net foreign exchange (loss) gain** | ( 2,980) | 3,781 |
| Foreign exchange gain (loss) reversal on loans to customers with ISK cash flow* | 557 | ( 1,044) |
| **Net foreign exchange (loss) gain** | ( 2,423) | 2,737 |

*Further discussed under Note 4 (c)

Íslandsbanki hf. Consolidated Financial Statements 2013 29 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Other net operating income

**18.** Other net operating income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Agency fees and service level agreement fees | 338 | 316 |
| Rental income from real estate | 145 | 76 |
| Rental income from foreclosed assets | 349 | 336 |
| Legal cost and fees | 192 | 101 |
| Realised gain on property and equipment | 556 | 4 |
| Other net operating (expenses) income | ( 38) | 163 |
| **Other net operating income** | 1,542 | 996 |

## Administrative expenses

**19.** Administrative expenses are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Salaries and related expenses | 13,361 | 13,080 |
| Other administrative expenses | 11,118 | 10,606 |
| Depreciation | 946 | 784 |
| Amortisation | 126 | 119 |
| **Administrative expenses** | 25,551 | 24,589 |

## Salaries and related expenses

**20.** Salaries and related expenses are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Salaries | 10,187 | 10,118 |
| Pension | 1,409 | 1,379 |
| Social security charges and financial activities tax | 1,589 | 1,397 |
| Other | 176 | 186 |
| **Salaries and related expenses** | 13,361 | 13,080 |

The Bank made a provision of ISK 271 million for potential performance plan payments. In accordance with the FME rules 700/2011, part of the payment is deferred for a minimum of 3 years see Note 22. Salary related expenses are included in the amount.

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

| | At 31 December 2013 | | At 31 December 2012 | |
|---|---|---|---|---|
| | Parent Company | The Bank | Parent Company | The Bank |
| Average number of employees | 1,056 | 1,265 | 1,119 | 1,357 |
| Positions at the end of the year | 1,028 | 1,240 | 1,079 | 1,287 |

Average number of employees for the Bank in 2013 includes 84 employees (2012: 113 employees) in disposal groups held for sale, whose salaries are not included in the salaries and related expenses.

Íslandsbanki hf. Consolidated Financial Statements 2013 30 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Employment terms for the Board of Directors, the CEO and Management Board

**22.** Employment terms for the Board of Directors, the CEO and Management Board are specified as follows:

| 2013 | Salaries |
|---|---|
| Fridrik Sophusson, Chairman of the Board | 7.5 |
| Árni Tómasson, member of the Board | 5.4 |
| Daniel Levin, member of the Board | 5.7 |
| Helga Valfells, member of the Board | 1.4 |
| John E. Mack, member of the Board | 5.8 |
| Marianne Økland, member of the Board | 5.7 |
| María E. Ingvadóttir, member of the Board | 5.4 |
| Neil Graeme Brown, member of the Board | 5.7 |
| Þóranna Jónsdóttir, member of the Board | 1.4 |
| Alternate board members | 0.2 |
| **Total** | 44.2 |

| 2013 | Salaries | Performance based payments |
|---|---|---|
| Birna Einarsdóttir, CEO | 36.4 | 3.6 |
| 7 Managing Directors | 180.7 | 18.2 |

| 2012 | Salaries |
|---|---|
| Fridrik Sophusson, Chairman of the Board | 7.2 |
| Árni Tómasson, member of the Board | 5.1 |
| Daniel Levin, member of the Board | 5.6 |
| John E. Mack, member of the Board | 5.7 |
| Marianne Økland, member of the Board | 5.6 |
| María E. Ingvadóttir, member of the Board | 3.8 |
| Neil Graeme Brown, member of the Board | 5.6 |
| Kolbrún Jónsdóttir, former member of the Board | 1.9 |
| Alternate board members | 1.0 |
| **Total** | 41.5 |

| 2012 | Salaries | Performance based payments |
|---|---|---|
| Birna Einarsdóttir, CEO | 31.5 | 0 |
| 7 Managing Directors | 171.7 | 0 |

The employer's contribution to pension funds and other benefits for the Board, CEO and Management Board amounted to ISK 51.8 million in 2013 (2012: ISK 44.3million). There were no share based payments in the years 2013 and 2012.

The performance based salaries are based on FME rules on renumeration policy for financial undertakings (700/2011). The rules reflect a conservative framework for remuneration schemes within the financial sector. The remuneration policy shall not encourage unreasonable risk taking, nor contravene the long-term interests of the under taking and the stability of the financial system. The policy shall conform to viewpoints related to the protection of the under taking´s customers, its creditors and shareholders or guarantee capital owners and in other respects conform to proper and sound business practices.The rules state that the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. Risk management, compliance and internal audit shall review and analyse whether variable remuneration complies with the under taking's remuneration policy and the FME rules.

Íslandsbanki hf. Consolidated Financial Statements 2013 31 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Auditors' fees

**23.** Auditors' fees are as follows:

| | 2013 | 2012 |
|---|---|---|
| Audit of the annual accounts | 104 | 84 |
| Review of interim accounts | 33 | 25 |
| Other services | 31 | 22 |
| **Auditors' fees** | 168 | 131 |
| Thereof remuneration to others than the auditors of the parent company | 33 | 31 |

## Loan impairment charges and net valuation changes

**24.** Loan impairment charges and net valuation changes:

| | 2013 | 2012 |
|---|---|---|
| **Impairment charged to the income statement:** | | |
| Specific impairment losses on financial assets | ( 6,438) | ( 18,253) |
| Impairment of foreign exchange gain | 557 | ( 1,044) |
| Net specific impairment losses on financial assets | ( 5,881) | ( 19,297) |
| Provision for latent impairment | ( 1,940) | ( 776) |
| Total impairment charged to the income statement (see Note 34) | ( 7,821) | ( 20,073) |
| **Net valuation changes on loans:** | | |
| Income due to revised estimated future cash flow from loans | 24,677 | 24,739 |
| Net specific impairment losses on financial assets | ( 5,881) | ( 19,297) |
| Foreign exchange (loss) gain (see Note 17) | ( 557) | 1,044 |
| **Net valuation changes on loans** | 18,239 | 6,486 |
| Provision for latent impairment | ( 1,940) | ( 776) |
| **Loan impairment charges and net valuation changes** | 16,299 | 5,710 |

Foreign exchange gain on foreign currency loans to customers with revenue and cash flows in ISK is impaired and offset against total foreign exchange gain as per Note 17. When previously impaired foreign exchange gain is recovered a foreign exchange loss is recognised. Further discussed under Note 4 (c).

## Profit from discontinued operations

**25.** Profit from discontinued operations are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Net profit from sale of foreclosed mortgages | 785 | 590 |
| Net share of loss from disposal groups held for sale | ( 822) | ( 155) |
| Net profit from sale of subsidiaries and associates | 964 | 2,804 |
| **Profit from discontinued operations** | 927 | 3,239 |

Íslandsbanki hf. Consolidated Financial Statements 2013 32 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Effective income tax

**26.** Income tax for the year 2013 is calculated at 20%. Special financial activities tax (FAT) is calculated as 6% of taxable profits above ISK 1 billion. The effective income tax rate in the Bank's income statement for 2013 is 26,2%. The difference is specified as follows:

| | 2013 | | 2012 | |
|---|---|---|---|---|
| Profit before tax | 30,008 | | 26,432 | |
| 20% income tax calculated on the profit of the year | 6,002 | 20.0% | 5,286 | 20.0% |
| Special financial activities tax | 1,833 | 6.1% | 954 | 3.6% |
| Effect of different tax rate in other countries | - | 0.0% | ( 13) | (0.0%) |
| Income not subject to tax | ( 938) | (3.1%) | ( 459) | (1.7%) |
| Non-deductable expenses | 667 | 2.2% | 206 | 0.8% |
| Other differences | 302 | 1.0% | 279 | 1.0% |
| **Effective income tax** | 7,866 | 26.2% | 6,253 | 23.7% |

The Bank is taxed jointly with its subsidiary Íslandssjódir hf. whereby the taxable income of the subsidiary is added to the taxable income of the parent and taxed as one. Joint taxation is only applicable for calculation of income taxes. Tax losses brought forward which originate before the permission for a joint taxation was issued by the tax authorities cannot be used except to offset taxes of the entity where they originated.

## Earnings per share

**27.** Earnings per share are specified as follows:

| **Basic earnings per share, ISK** | | |
|---|---|---|
| Profit attributable to ordinary shareholders | 2013 | 2012 |
| Net profit to the equity holders of the parent, according to the statement of comprehensive income | 22,977 | 23,438 |
| Average outstanding shares: | | |
| Weighted average number of outstanding shares for the period, million | 10,000 | 10,000 |
| From profit for the year | 2.30 | 2.34 |
| **Diluted earnings per share, ISK** | | |
| Profit attributable to ordinary shareholders (diluted) | | |
| Average outstanding shares for the calculation of diluted earnings per share | 10,000 | 10,000 |
| Number of total shares at the end of the period, million, diluted | 10,000 | 10,000 |
| From profit for the year | 2.30 | 2.34 |

There have been no transactions involving ordinary shares or potential ordinary shares between the reporting date and the date of the completion of these consolidated financial statements which would require the restatement of earnings per share.

## Cash and balances with Central Bank

**28.** Specification of cash and balances with Central Bank:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Cash on hand | 2,472 | 2,008 |
| Balances with Central Bank other than mandatory reserve deposits | 6,619 | 16,221 |
| Certificates of deposit | 99,085 | 58,119 |
| **Included in cash and cash equivalents** | 108,176 | 76,348 |
| Mandatory reserve deposits with Central Bank | 3,603 | 9,152 |
| **Cash and balances with Central Bank** | 111,779 | 85,500 |

The average balance of the Central bank current account for each month must be equivalent to at least mandatory reserve deposits, which amounted to ISK 8,153 million (December 2012: ISK 9,152 million).

Íslandsbanki hf. Consolidated Financial Statements 2013 33 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**28.** Cont'd

Certificates of deposit (CDs) are a 28-day promissory notes issued by the Central Bank at fixed rates. The CD auction process is only for financial institutions with accounts at the Central Bank. The CDs may be used as collateral in collateralised lending transactions with the Central Bank.

## Pledged assets

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| **29.** Financial assets which have been pledged as collaterals for liabilities | 106,062 | 95,034 |

The Bank has issued covered bonds under Icelandic law, with maturities of up to 12 years, which are pledged on a pool of consumer mortgage loans. The underlying cover pool must withstand a weekly stress test with regards to interest rates and exchange rates. The Bank also pledged a pool of customer loans as collateral for an asset-backed bond issued to the Central Bank. Furthermore, the Bank pledged a pool of customer loans as collateral in a currency swap agreement with the Central Bank in order to reduce the Bank's foreign exchange imbalance and has also pledged cash collateral in foreign currency for International Swaps and Derivatives Association (ISDA) agreements with foreign financial institutions.

## Derivative instruments and short positions

**30.** Derivative instruments and short positions:

| **At 31 December 2013** | Assets | Notional values related to assets | Liabilities | Notional values related to liabilities |
|---|---|---|---|---|
| Interest rate swaps | 21 | 2,000 | 1,364 | 19,500 |
| Cross currency interest rate swaps | 525 | 28,240 | 28 | 6,585 |
| Equity forwards | 21 | 7 | 182 | 104 |
| Foreign exchange forwards | 197 | 6,498 | 34 | 712 |
| Foreign exchange swaps | 42 | 1,176 | 7 | 3,193 |
| Bond forwards | 37 | 1,987 | 14 | 2,065 |
| Bond options | - | - | 85 | 25,000 |
| **Derivatives** | 843 | 39,908 | 1,714 | 57,159 |
| Short positions in listed bonds | - | - | 9,462 | - |
| **Total** | 843 | 39,908 | 11,176 | 57,159 |

| **At 31 December 2012** | Assets | Notional values related to assets | Liabilities | Notional values related to liabilities |
|---|---|---|---|---|
| Interest rate swaps | 5 | 500 | 1,142 | 19,900 |
| Cross currency interest rate swaps | 20 | 7,199 | 5,094 | 55,351 |
| Equity forwards | - | - | 89 | 95 |
| Foreign exchange forwards | 8 | 1,503 | 8 | 219 |
| Foreign exchange swaps | 33 | 1,154 | 9 | 2,492 |
| Bond forwards | 61 | 2,250 | 22 | 1,325 |
| Bond options | - | - | 80 | 25,000 |
| **Derivatives** | 127 | 12,606 | 6,444 | 104,382 |
| Short positions in listed bonds | - | - | 11,991 | - |
| **Total** | 127 | 12,606 | 18,435 | 104,382 |

Íslandsbanki hf. Consolidated Financial Statements 2013 34 Amounts are in ISK million

**30.** Cont'd

The Bank uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. The Bank carries relatively low indirect exposure due to margin trading with clients and the Bank holds collaterals for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

Short positions are in institution with government guaranty . As a primary dealer the Bank has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

## Loans

**31.** Loans to credit institutions:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Money market loans | 13,821 | 17,581 |
| Bank accounts | 30,257 | 36,462 |
| **Loans to credit institutions** | 44,078 | 54,043 |

**32.** Loans to customers:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Loans and advances to customers at amortised cost | 554,741 | 557,857 |
| **Loans to customers** | 554,741 | 557,857 |

**33.** Loans to customers at amortised cost:

**At 31 December 2013**

| | Gross amount | Individually assessed impairment allowance | Collectively assessed impairment allowance | Loans less impairment allowance |
|---|---|---|---|---|
| Loans to customers: | | | | |
| Individuals | 263,446 | ( 8,402) | - | 255,044 |
| Commerce and services | 85,340 | ( 3,818) | - | 81,522 |
| Construction | 20,656 | ( 2,016) | - | 18,640 |
| Energy | 3,614 | - | - | 3,614 |
| Financial services | 34 | - | - | 34 |
| Industrials and transportation | 48,224 | ( 1,791) | - | 46,433 |
| Investment companies | 13,839 | ( 3,533) | - | 10,306 |
| Public sector and non-profit organisations | 6,943 | ( 49) | - | 6,894 |
| Real estate | 69,732 | ( 3,085) | - | 66,647 |
| Seafood | 70,829 | ( 1,540) | - | 69,289 |
| Loans to customers before latent impairment allowance | | | | 558,423 |
| Latent impairment allowance | | | | ( 3,682) |
| **Loans to customers** | 582,657 | ( 24,234) | - | 554,741 |

The balance of collectively assessed impairment allowance is presented as zero at year end 2013 since the FX-ISK loans that contributed to that impairment allowance are now immaterial (see Note 4c). The homogeneous pools of loans will no longer be kept at an average deep discount which leads to a one-off significant increase in latent impairment in Q4 2013. The latent impairment is not expected to continue to increase at this rate in 2014.

Íslandsbanki hf. Consolidated Financial Statements 2013 35 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**33.** Cont'd

### At 31 December 2012

| | Gross amount | Individually assessed impairment allowance | Collectively assessed impairment allowance | Loans less impairment allowance |
|---|---|---|---|---|
| Loans to customers: | | | | |
| Individuals | 254,461 | ( 7,896) | ( 2,139) | 244,426 |
| Commerce and services | 75,130 | ( 5,761) | ( 564) | 68,805 |
| Construction | 18,954 | ( 1,576) | ( 913) | 16,465 |
| Energy | 4,945 | - | ( 3) | 4,942 |
| Financial services | 282 | ( 27) | ( 1) | 254 |
| Industrials and transportation | 46,773 | ( 2,406) | ( 707) | 43,660 |
| Investment companies | 21,943 | ( 5,920) | - | 16,023 |
| Public sector and non-profit organisations | 11,307 | ( 329) | ( 44) | 10,934 |
| Real estate | 86,849 | ( 12,686) | ( 1,222) | 72,941 |
| Seafood | 84,142 | ( 2,959) | ( 38) | 81,145 |
| Loans to customers before latent impairment allowance | | | | 559,595 |
| Latent impairment allowance | | | | ( 1,738) |
| **Loans to customers** | 604,786 | ( 39,560) | ( 5,631) | 557,857 |

**34.** Financial assets - impairments

The following table shows the movement in the provision for impairment losses for loans and receivables.

| | Individually assessed | Collectively assessed | Latent | Total |
|---|---|---|---|---|
| At 1 January 2013 | 39,560 | 5,631 | 1,738 | 46,929 |
| Merger with Kreditkort | - | - | - | - |
| Amounts written-off | ( 19,252) | ( 2) | 4 | ( 19,251) |
| Recoveries of amounts previously written-off | 1,240 | - | - | 1,240 |
| Principal credit adjustment | ( 8,824) | - | - | ( 8,824) |
| Charged to the income statement | 11,510 | ( 5,629) | 1,940 | 7,821 |
| **At 31 December 2013** | 24,234 | - | 3,682 | 27,915 |

| | Individually assessed | Collectively assessed | Latent | Total |
|---|---|---|---|---|
| At 1 January 2012 | 32,735 | 8,508 | 915 | 42,158 |
| Merger with Kreditkort | 205 | ( 252) | 47 | - |
| Amounts written-off | ( 12,643) | ( 46) | - | ( 12,689) |
| Recoveries of amounts previously written-off | 2,136 | - | - | 2,136 |
| Principal credit adjustment | ( 3,998) | ( 751) | - | ( 4,749) |
| Charged to the income statement | 21,125 | ( 1,828) | 776 | 20,073 |
| **At 31 December 2012** | 39,560 | 5,631 | 1,738 | 46,929 |

| | 2013 | 2012 |
|---|---|---|
| **Impairment losses charged to the income statement:** | | |
| Loans to customers | 7,821 | 20,073 |
| **Impairment losses charged to the income statement** | 7,821 | 20,073 |

Íslandsbanki hf. Consolidated Financial Statements 2013 36 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Investment in associates

**35.** Changes in investment in associates:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Investments in associates at the beginning of the year | 503 | 1,070 |
| Additions during the period | 37 | - |
| Sales of shares in associates | - | ( 567) |
| Transfers | 1,020 | - |
| Share of results | 3 | - |
| **Investment in associates** | 1,563 | 503 |

**36.** The Bank's interest in its principal associates are as follows:

| | Ownership at year end |
|---|---|
| FAST GP ehf., Kirkjusandi 2, 155 Reykjavík | 35.0% |
| Atorka Group hf., Túngötu 14, 101 Reykjavík | 29.7% |
| Reiknistofa bankanna hf., Kalkofnsvegi 1, 150 Reykjavík | 30.7% |
| Audkenni hf., Borgartúni 31, 105 Reykjavík | 20.0% |

Summarised financial information in respect of the Bank's associates is set out below:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Total assets | 12,046 | 55,629 |
| Total liabilities | ( 7,517) | ( 67,497) |
| Net assets | 4,529 | ( 11,868) |
| **Bank's share of net assets of associates** | 1,563 | 503 |

| | 2013 | 2012 |
|---|---|---|
| Total revenue | 3,979 | 6,774 |
| **Total loss in associates for the year** | ( 78) | ( 17,476) |

When the Bank's share of losses in an associate exceeds its interest in the associate, the carrying amount of the investment is reduced to zero and the recognition of further losses is discontinued, except to the extent that the Bank has an obligation or has made payments on behalf of the associate.

Íslandsbanki hf. Consolidated Financial Statements 2013 37 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Investment in subsidiaries

**37.** Significant subsidiaries:

| | Location | Ownership |
|---|---|---|
| Borgun hf., Ármúla 30, 108 Reykjavík | Iceland | 62.2% |
| Íslandssjódir hf., Kirkjusandi 2, 155 Reykjavík | Iceland | 100% |
| Midengi ehf., Lækjargötu 12, 155 Reykjavík | Iceland | 100% |
| HTO ehf. formerly Höfdatorg ehf., Skúlagötu 63, 105 Reykjavík | Iceland | 72.5% |
| Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur | Iceland | 100% |
| Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur | Iceland | 100% |
| D-1 ehf., Kirkjusandi 2, 105 Reykjavík | Iceland | 100% |
| EFF 4 ehf., Kirkjusandi 2, 105 Reykjavík | Iceland | 100% |
| Geysir Green Investment Fund slhf., Kirkjusandi 2, 105 Reykjavík | Iceland | 100% |
| Fergin ehf., Hesthálsi 6-8, 110 Reykjavík | Iceland | 80% |
| Frumherji hf., Hesthálsi 6-8, 110 Reykjavík | Iceland | 80% |
| 32 other subsidiaries (SME) | | |

## Related party disclosures

**38.** Ultimate controlling party

The Bank has determined that ISB Holding ehf. is the ultimate controlling party of the Bank with GLB Holding ehf. having significant influence. This is reflected in related party transactions.

Entities which are controlled, jointly controlled or significantly influenced by the government (state-controlled entities) are not considered as being a related party if neither entity actually influenced the other and if the state did not actually influence either entity with regards to transactions between them. The Bank's transactions with state-controlled entities during the year were based on general business terms of the Bank.

Related party transactions

The Bank has a related party relationship with its associates, the Board of Directors of the parent company and the ulitmate controlling party, the executive vice presidents of the Bank, close family members of individuals referred to herein and entities with significant influence as the largest shareholders of the Bank.

All loans to employees are provided on general business terms of the Bank. Included in assets are loans to key management.

Related parties have transacted with the Bank during the period as follows:

| | | | 31.12.2013 | | | 31.12.2012 |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Total | Assets | Liabilities | Total |
| CEO and Man. Directors (incl. comp. owned by them) | 178 | ( 285) | ( 107) | 164 | ( 246) | ( 82) |
| Members of the Board (incl. comp. owned by them) | 462 | ( 2,393) | ( 1,931) | 391 | ( 250) | 141 |
| Associated companies and other related parties | 288 | ( 3,824) | ( 3,536) | 11,462 | ( 8,649) | 2,813 |
| **Total** | 928 | ( 6,502) | ( 5,574) | 12,017 | ( 9,145) | 2,872 |

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Guarantees | 478 | 363 |
| Loan commitments, overdrafts and credit card commitments | 124 | 3,195 |

Impairment allowances of ISK 70 million (2012: ISK 790 million) were recognised during the year against balances outstanding with associated companies. No share option programmes were operated during 2013. For related party remuneration see Note 22.

Íslandsbanki hf. Consolidated Financial Statements 2013 38 Amounts are in ISK million

## Property and equipment

39. Property and equipment are specified as follows:

| At 31 December 2013 | Land and buildings | Fixtures, equipment & vehicles | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 3,198 | 4,117 | 7,315 |
| Change from previous year | 1,004 | - | 1,004 |
| Additions during the year | 233 | 625 | 858 |
| Net acquisition through business combinations | 4,100 | - | 4,100 |
| Disposals during the year (write-offs) | ( 692) | ( 340) | ( 1,032) |
| **Balance at 31.12.2013** | 7,843 | 4,402 | 12,245 |
| **Accumulated depreciation** | | | |
| Balance at the beginning of the year | ( 51) | ( 1,685) | ( 1,736) |
| Change from previous year | ( 1,004) | - | ( 1,004) |
| Depreciation during the year | ( 135) | ( 630) | ( 765) |
| Impairment during the year | ( 214) | - | ( 214) |
| Disposals during the year | 18 | 228 | 246 |
| **Balance at 31.12.2013** | ( 1,386) | ( 2,087) | ( 3,473) |
| **Carrying amount at 31.12.2013** | 6,457 | 2,315 | 8,772 |
| Depreciation rates | 2% | 8-33% | |

| | |
|---|---|
| Official real estate value of buildings and leased land | 4,383 |
| Insurance value of buildings as at 31.12.2013 | 7,523 |
| Insurance value of fixtures, equipment and vehicles as at 31.12.2013 | 2,086 |

| At 31 December 2012 | Land and buildings | Fixtures, equipment & vehicles | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 2,941 | 4,176 | 7,117 |
| Additions during the year | 367 | 1,014 | 1,381 |
| Additions from acquired companies | 66 | - | 66 |
| Disposals during the year (write-offs) | ( 176) | ( 1,073) | ( 1,249) |
| **Balance at 31.12.2012** | 3,198 | 4,117 | 7,315 |
| **Accumulated depreciation** | | | |
| Balance at the beginning of the year | ( 14) | ( 1,827) | ( 1,841) |
| Depreciation during the year | ( 42) | ( 742) | ( 784) |
| Disposals during the year | 5 | 884 | 889 |
| **Balance at 31.12.2012** | ( 51) | ( 1,685) | ( 1,736) |
| **Carrying amount at 31.12.2012** | 3,147 | 2,432 | 5,579 |
| Depreciation rates | 0-2% | 8-33% | |

| | |
|---|---|
| Official real estate value of buildings and leased land | 2,419 |
| Insurance value of buildings as at 31.12.2012 | 4,156 |
| Insurance value of fixtures, equipment and vehicles as at 31.12.2012 | 3,061 |

Íslandsbanki hf. Consolidated Financial Statements 2013 39 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Intangible assets

**40.** Intangible assets are specified as follows:

| At 31 December 2013 | Goodwill | Purchased software | Developed software | Total |
|---|---|---|---|---|
| **Historical cost** | | | | |
| Balance at the beginning of the year | - | 314 | 200 | 514 |
| Additions during the year | - | 164 | - | 164 |
| **Balance at 31.12.2013** | - | 478 | 200 | 678 |
| **Accumulated amortisation and impairment losses** | | | | |
| Balance at the beginning of the year | - | ( 170) | ( 83) | ( 253) |
| Amortisation during the year | - | ( 76) | ( 50) | ( 126) |
| Impairment of goodwill | - | - | - | - |
| **Balance at 31.12.2013** | - | ( 246) | ( 133) | ( 379) |
| **Carrying amount at 31.12.2013** | - | 232 | 67 | 299 |
| Amortisation rates | | 25% | 25% | |

| At 31 December 2012 | Goodwill | Purchased software | Developed software | Total |
|---|---|---|---|---|
| **Historical cost** | | | | |
| Balance at the beginning of the year | 290 | 188 | 200 | 678 |
| Additions during the year | - | 126 | - | 126 |
| Acquisition through business combinations | 135 | - | - | 135 |
| **Balance at 31.12.2012** | 425 | 314 | 200 | 939 |
| **Accumulated amortisation and impairment losses** | | | | |
| Balance at the beginning of the year | - | ( 101) | ( 33) | ( 134) |
| Amortisation during the year | - | ( 69) | ( 50) | ( 119) |
| Impairment of goodwill | ( 425) | - | - | ( 425) |
| **Balance at 31.12.2012** | ( 425) | ( 170) | ( 83) | ( 678) |
| **Carrying amount at 31.12.2012** | - | 144 | 117 | 261 |
| Amortisation rates | | 25% | 25% | |

Íslandsbanki hf. Consolidated Financial Statements 2013 40 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Non-current assets and disposal groups held for sale

**41.** Specification of non-current assets and disposal groups held for sale:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Repossessed collateral | 10,722 | 10,161 |
| Assets of disposal groups classified as held for sale | 36,384 | 28,885 |
| **Total** | 47,106 | 39,046 |

Repossessed collateral:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Land and property | 8,544 | 8,225 |
| Industrial equipment and vehicles | 34 | 234 |
| Shares and equity instruments | 2,144 | 1,702 |
| **Total** | 10,722 | 10,161 |

The Bank classified the assets and liabilities of its subsidiaries HTO ehf., Fastengi ehf., Hafnargata 7 ehf., Bláfugl ehf., IG Invest ehf., Lava Capital ehf., Fjárvari ehf., Básbryggja ehf., Bréfabær ehf., Smyrlaheidi ehf., LT lódir ehf., GREF hf., Geysir Green Investment Fund slhf., EFF 4 ehf., Gráhella ehf., Fergin ehf., Frumherji hf., Manston Properties Ltd. and Lava Capital Ltd. as assets and liabilities of disposal groups held for sale.

Shares and equity instruments comprise shares in the Bank's associates Skeljungur hf., Nýr Norðurturn hf. and Íslensk verdbréf hf. are classfied as non-current assets held for sale.

Assets of disposal groups classified as held for sale:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Cash | 535 | 1,069 |
| Equity instruments | 775 | 1,037 |
| Receivables | 785 | 1,513 |
| Tax assets | 225 | 231 |
| Properties | 15,890 | 16,081 |
| Assets classified as held for sale | 13,745 | 4,937 |
| Other assets | 4,429 | 4,017 |
| **Total** | 36,384 | 28,885 |

Liabilities associated with assets classified as held for sale:

| | | |
|---|---|---|
| Payables | 502 | 634 |
| Deferred tax liabilities | 644 | 676 |
| Income tax payables | 416 | 48 |
| Borrowings | 7,148 | 3,588 |
| Other liabilities | 746 | 1,859 |
| **Total** | 9,456 | 6,805 |

## Other assets

**42.** Other assets are specified as follows:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Receivables | 4,816 | 2,740 |
| Unsettled securities transactions | 5,099 | 1,259 |
| Accruals | 731 | 562 |
| Prepaid expenses | 200 | 271 |
| Other assets | 313 | 283 |
| **Other assets** | 11,159 | 5,115 |

Inventory consists of real estate valued at the lower of cost and net realisable value.

Íslandsbanki hf. Consolidated Financial Statements 2013 41 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Deposits from Central Bank and credit institutions

**43.** Deposits from Central Bank and credit institutions are specified as follows:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Repurchase agreements with Central Bank | 63 | 54 |
| Deposits from credit institutions | 29,626 | 38,218 |
| **Deposits from Central Bank and credit institutions** | 29,689 | 38,272 |

## Deposits from customers

**44.** Deposits from customers are specified by type as follows:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Demand deposits | 394,345 | 379,257 |
| Time deposits | 94,986 | 91,899 |
| **Deposits from customers** | 489,331 | 471,156 |

Demand deposits include deposits with maturity of up to 3 months.

**45.** Deposits from customers are specified by owners as follows:

| | | 31.12.2013 | | 31.12.2012 |
|---|---|---|---|---|
| | Amount | % of total | Amount | % of total |
| Central government and state-owned enterprises | 5,086 | 1% | 4,963 | 1% |
| Municipalities | 4,193 | 1% | 5,671 | 1% |
| Other companies | 292,792 | 60% | 276,168 | 59% |
| Individuals | 187,260 | 38% | 184,354 | 39% |
| **Deposits from customers** | 489,331 | 100% | 471,156 | 100% |

## Debt issued and other borrowed funds

**46.** Specification of debt issued and other borrowed funds:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Non-listed issued bonds | 46,758 | 51,335 |
| Listed issued bonds | 41,006 | 13,713 |
| Loans from credit institutions | 2 | 8 |
| Other debt securities | 1,427 | 1,515 |
| **Debt issued and other borrowed funds** | 89,193 | 66,571 |

Non-listed bonds include an asset-backed bond issued to the Central Bank which matures in July 2019 and is pledged on a pool of loans to customers. Listed bonds are covered bonds pledged on a pool of mortgage loans, short-term unsecured bonds (commercial paper) and bonds issued under the Bank's GMTN programme. The Bank did not repurchase any of its own debt during 2013.

In the beginning of 2013, the Bank had four outstanding listed covered bond series, three CPI-linked and one non-indexed. Two of the CPI-linked issues, ISLA CBI 19 and ISLA CBI 24, were tapped into quarterly. At year end the total amount issued had reached ISK 6,630 million and ISK 8,470 million respectively. The tap issues of ISLA CBI 19 were sold at real yields of 2.35% - 2.82% whereas the real yield for ISLA CBI 24 was from 2.72% - 3.00%. The non-index linked series, ISLA CB 15, was tapped into in the first and second quarter at nominal yields of 6.30% - 6.50%. The total amount issued at year end was ISK 2,520 million. In the third quarter the Bank issued a new 3-year non-index linked series, ISLA CB 16, at a nominal yield of 6.35%. Neither of the non-index linked covered bonds were tapped in the fourth quarter.

Short-term listed unsecured bonds (commercial paper) were issued in 2013 at nominal yields between 5.90% - 6.30%. The total outstanding amount of commercial paper at year end was ISK 8.350 million.

In December 2013, the Bank issued SEK 500 million listed unsecured bonds under the Bank´s GMTN programme. The issue has a coupon rate of 3-month STIBOR + 400 bps and maturity of four years.

Íslandsbanki hf. Consolidated Financial Statements 2013 42 Amounts are in ISK million

## Subordinated loans

**47.** Specification of subordinated loans:

| | Currency | Interest | Maturity date | Book value 31.12.2013 |
|---|---|---|---|---|
| **Loans which qualify as Tier 2 capital:** | | | | |
| Subordinated loans - unlisted | EUR | 4.2% | 31.12.2019 | 21,890 |
| **Tier 2** | | | | 21,890 |
| **Subordinated loans** | | | | 21,890 |

| | Currency | Interest | Maturity date | Book value 31.12.2012 |
|---|---|---|---|---|
| **Loans which qualify as Tier 2 capital:** | | | | |
| Subordinated loans - unlisted | EUR | 4.2% | 31.12.2019 | 23,450 |
| **Tier 2** | | | | 23,450 |
| **Subordinated loans** | | | | 23,450 |

Subordinated loans consist of a Tier 2 government bond of EUR 138 million.

Subordinated loans are financial liabilities of the Bank which consist of liabilities in the form of subordinated loan 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 subordinated loans are included within Tier II. Subordinated loans usually have a maturity of a minimum of 10 years. To ensure that the amount of capital outstanding doesn't fall sharply, once a Tier II issue matures, the regulator demands that the subordinated issue is subjected to a progressive discount, of 20% per annum, during the last five years of its maturity.

## Tax assets and tax liabilities

**48.** Tax in the balance sheet:

| | 31.12.2013 | | 31.12.2012 | |
|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities |
| Current tax | - | 10,806 | - | 2,052 |
| Deferred tax | 1,275 | 20 | 864 | 20 |
| **Tax in the balance sheet** | 1,275 | 10,826 | 864 | 2,072 |

The deferred tax assets are mainly due to the write-off of goodwill in relation to the acquisition of Byr in December 2011. The goodwill is deductible for tax purposes over a period of 5 years.

**49.** Changes in the deferred tax assets and the tax liabilities during the year are as follows:

| | Assets | Liabilities |
|---|---|---|
| Deferred tax assets and tax liabilities 1.1.2012 | 2,629 | 17 |
| Calculated income tax for 2012 | ( 4,972) | 232 |
| Income tax payable in 2013 | 3,380 | ( 229) |
| Prior year income tax adjustment | ( 173) | - |
| **Deferred tax assets and tax liabilities 31.12.2012** | 864 | 20 |
| Transferred deferred tax liabilities to deferred tax assets 1.1.2013 | (20) | (20) |
| Calculated income tax for 2013 | ( 6,170) | 46 |
| Income tax payable in 2014 | 6,626 | ( 26) |
| Prior year income tax adjustment | ( 25) | - |
| **Deferred tax assets and tax liabilities 31.12.2013** | 1,275 | 20 |

Íslandsbanki hf. Consolidated Financial Statements 2013 43 Amounts are in ISK million

50. The Bank's deferred tax assets and tax liabilities are attributable to the following balance sheet items:

| | | | 31.12.2013 | | | 31.12.2012 |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Net | Assets | Liabilities | Net |
| Property and equipment | - | ( 212) | ( 212) | - | ( 225) | ( 225) |
| Assets and liabilities denominated in foreign curr. | - | ( 156) | ( 156) | - | ( 159) | ( 159) |
| Other intangible assets | 1,433 | - | 1,433 | 2,154 | - | 2,154 |
| Deferred foreign exchange difference | 134 | ( 7) | 127 | - | ( 973) | ( 973) |
| Tax loss carry forwards | 63 | - | 63 | 47 | - | 47 |
| | 1,630 | ( 375) | 1,255 | 2,201 | ( 1,357) | 844 |
| Set-off of deferred tax assets together with liabilities of the same taxable entities | ( 355) | 355 | - | ( 1,337) | 1,337 | - |
| **Total** | 1,275 | ( 20) | 1,255 | 864 | ( 20) | 844 |

51. Movements in temporary differences during the year were as follows:

| **2013** | Balance at 1.1. | Recognised in profit or loss | Changes from prior year | Balance at 31.12. |
|---|---|---|---|---|
| Property and equipment | ( 225) | 13 | - | ( 212) |
| Assets and liabilities denominated in foreign curr. | ( 159) | 3 | - | ( 156) |
| Other intangible assets | 2,154 | ( 721) | - | 1,433 |
| Deferred foreign exchange difference | ( 973) | 1,100 | - | 127 |
| Tax loss carry forwards | 47 | 16 | - | 63 |
| **Total** | 844 | 411 | - | 1,255 |

| **2012** | Balance at 1.1. | Recognised in profit or loss | Changes from prior year | Balance at 31.12. |
|---|---|---|---|---|
| Property and equipment | ( 190) | ( 35) | - | ( 225) |
| Shares in other companies | 5 | ( 5) | - | - |
| Assets and liabilities denominated in foreign currencies | ( 150) | ( 9) | - | ( 159) |
| Other intangible assets | 2,844 | ( 690) | - | 2,154 |
| Deferred foreign exchange difference | ( 218) | ( 755) | - | ( 973) |
| Other items | 4 | ( 4) | - | - |
| Tax loss carry forwards | 317 | ( 245) | ( 25) | 47 |
| **Total** | 2,612 | ( 1,743) | ( 25) | 844 |

Íslandsbanki hf. Consolidated Financial Statements 2013 44 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Other liabilities

**52.** Specification of other liabilities:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Accruals | 3,163 | 3,117 |
| Liabilities to retailers for credit card provision | 20,563 | 17,404 |
| Provision for effects of court rulings* | 4,699 | 14,736 |
| Provision for estimated losses from guarantees and others** | 2,211 | 868 |
| Provision for reimbursement of interest*** | - | 2,493 |
| Capital gains tax | 1,816 | 1,896 |
| Unsettled securities transactions | 840 | 5,222 |
| Deferred income | 206 | 197 |
| Sundry liabilities | 3,632 | 3,021 |
| **Other liabilities** | 37,130 | 48,954 |

| Provision: | Provision for effects of court rulings* | Provision for estimated losses from guarantees and others** | Provision for reimbursement of interest*** | Total |
|---|---|---|---|---|
| Balance 1 January 2013 | 14,736 | 868 | 2,493 | 18,097 |
| Reclass 1 January 2013 | ( 650) | 650 | - | - |
| Provision used during the year | ( 6,807) | - | ( 2,493) | ( 9,300) |
| New provisions and reversed provisions during the year | ( 2,580) | 693 | - | ( 1,887) |
| **Balance at 31.12.2013** | 4,699 | 2,211 | - | 6,910 |

## Equity

**53.** Share capital

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2013 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank.

Issued share capital

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Ordinary fully paid shares of ISK 1 krona each | 10,000 | 10,000 |
| **Share capital** | 10,000 | 10,000 |

The Bank has one class of ordinary shares which carry no right to fixed income.

Share premium account

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Premium arising on issue of equity shares | 55,000 | 55,000 |
| **Share premium account** | 55,000 | 55,000 |

Total share capital

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Ordinary share capital | 10,000 | 10,000 |
| Share premium account | 55,000 | 55,000 |
| **Total share capital** | 65,000 | 65,000 |

Íslandsbanki hf. Consolidated Financial Statements 2013 45 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

54. Other reserves are specified as follows:

| | Other reserves |
|---|---|
| Other reserves as at 1.1.2012 | 2,661 |
| Translation differences | 173 |
| **Other reserves as at 31.12.2012** | 2,834 |
| Translation differences | ( 363) |
| **Other reserves as at 31.12.2013** | 2,471 |

## Off-balance sheet items

55. *The Depositors' and Investors' Guarantee Fund*

Following an amendment in June 2012 to Law no. 98/1999 on the Depositors' and Investors' Guarantee Fund, the annual premium payable was decreased from 0.3% to 0.225% of all eligible deposits. In addition, there is a variable premium payable based on equity, funding and a loan portfolio analysis (LPA) calculated as a ratio provided by the FME.

Under the previous legislation, the Bank was required to grant the fund a declaration of guarantee in case the fund's assets did not meet the required minimum amount. Accordingly, in 2010, the Bank issued a declaration of guarantee for future obligations amounting to ISK 3,724 million. The Bank did not recognise a liability in its statement of financial position in respect of this declaration which is now considered void. The amended legislation does not stipulate a requirement for such declaration of guarantee. However, there remains some uncertainty as to its validity in relation to losses originated in the period from October 2008 to June 2012.

## Operating lease commitments

56. Future non-cancellable minimum operating lease payments, where the Bank is the lessee, are due as follows:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Up to 1 year | 199 | 559 |
| 1-5 years | 828 | 2,618 |
| Later than 5 years | 365 | 4,933 |
| **Operating lease commitments** | 1,392 | 8,110 |

The Bank leases a number of branch and office premises under operating leases. The typical lease period is 20 years with a continuation clause. In some leases the rent is based on the consumer price index and changes accordingly.

The drop between years derives from the Bank's acquisition of two subsidiaries, real estate companies EFF1 ehf. and EFF2 ehf., from a former associate.

## Balance of custody assets

57. Balance of custody assets:

| | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Custody assets | 754,166 | 762,568 |

Custody assets are under custody, but not managed by the Bank.

Íslandsbanki hf. Consolidated Financial Statements 2013 46 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Contingencies

58. **Litigation threats**

Several former customers of Glitnir private banking services have threatened litigation against the Bank in order to claim compensation for alleged mistakes made by former employees of Glitnir. A few of those customers have already filed lawsuits against the Bank with the Reykjavík District Court. The Bank has not accepted liability and will challenge these lawsuits on the grounds that these claims relate to events that happened prior to the incorporation of the Bank and the assignment of related liabilities and assets and are therefore not the responsibility of the Bank. The District Court has now ruled in favour of the Bank in one of these cases stating that the Bank cannot be held responsible for a mistake made by a former employee of Glitnir. This ruling was not appealed. The Bank estimates the total amount of compensation liabilities currently claimed by customers of Glitnir to be ISK 5.5 billion.

**Netting agreement**

When certain assets and obligations were transferred from Glitnir to the Bank, the FME (Financial Supervisory Authority) ruled that customers would, upon liquidation of Glitnir, maintain their right to claim netting of assets and liabilities held by Glitnir prior to the Bank's acquisition.

The Bank made an agreement with Glitnir that the latter will compensate the Bank for any losses incurred as a result of netting of assets and liabilities. The claims in question are priority claims on the liquidated assets of Glitnir and the netting exercise is therefore unlikely to affect either the net asset value or the earnings of the Bank.

Following the Bank's acquisition of Byr hf. the Bank may also be in the position of having to honour a clients' right to claim netting of assets and liabilities held by Byr sparisjóður, prior to the founding of Byr hf., as later acquired by the Bank. Arrangements, comparable to the agreement between the Bank and Glitnir, have been made between Byr sparisjóður and the Bank.

**Allocation of liens, guarantees and comparable rights**

When certain assets and obligations were transferred from Glitnir to the Bank, the FME ruled that the Bank would take over all rights used to secure the performance of obligations of the debtors of Glitnir, including all liens, guarantees and other comparable rights connected to the claims of the Bank.

The Bank should, however, be accountable to Glitnir for specific collateral of its customers, as applicable, due to claims and derivatives which were not transferred to the Bank. The Bank has, in accordance with this decision, transferred to Glitnir certain collateralised obligations of customers. One customer filed a lawsuit against the Bank with the Reykjavík District Court challenging the Bank's decision to transfer the customer's money market deposit to Glitnir which the Bank, in good faith, identified as collateral for a foreign exchange future contract. The claim was for approximately ISK 450 million. The District Court ruled in favour of the Bank and the ruling was confirmed by the Iceland Supreme Court after appeal. Any future allocation of collaterals will be made under an agreement with Glitnir, whereby Glitnir indemnifies the Bank against any future claims arising from the transfer of such rights.

**Indexed loans**

Two court cases have been filed against the Bank and Landsbankinn, challenging the legality of fixing the principal of a mortgage to the consumer price index (CPI). Such indexation has been the industry standard for at least 30 years. However, the method of calculating the index has changed over the years, with the most recent change introduced in 1995.

The Bank's case is based on the indexation being in violation of the EU directive 93/13/EU on unfair terms in consumer loan contracts. The directive does not prohibit the use of price indexation, mainly to the effect that the consumer is adequately informed about the method by which prices vary. Thus, the case does not challenge the indexation as such, but only the context in which it is deployed. It will not affect corporate customers. Being a directive that does not require full harmonisation, the directive was not adopted by Iceland in its entirety. Instead, the existing contract law was amended by adding 4 articles. In this context, the Supreme Court accepted the motion introduced by the plaintiff on seeking the opinion of the EFTA court on the implications of the differences between the directive and the local law. The opinion is expected late in the first quarter of next year. Icelandic courts are not obliged to accept an opinion of the EFTA court.

The possible effect on the Bank has not been estimated, but clearly, any downgrading of the indexation would affect the Bank and other home mortgage lenders in Iceland.

The Landsbanki case is based on the argument that CPI indexation makes a mortgage a complex financial instrument as defined in the Act on Securities Transactions no. 108/2007 (MiFid Directive) and therefore unsuitable for retail customers. However, the Supreme Court has recently sustained a motion previously mentioned on seeking the opinion of the EFTA court on several issues relating to the implementation of both the directive on consumer loans (90/88/EBE) and on unfair terms in consumer loan contracts. The court also commented on the MiFID argument stating that the loan instrument could not be categorised as a derivative. Thus the courts have more or less dismissed the original argument, making the case very similar to the one the Bank is defending.

**Foreign currency loans**

Several rulings of the Supreme Court of Iceland during the years 2010 to 2013 in relation to foreign currency-linked loans have affected the Bank. Most important of these rulings was a ruling in June 2010 on the illegality of the principal of loans in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates.

**58.** Cont'd

The effects of these rulings and the subsequent corrections to the recalculations of illegal foreign currency-linked loans are reflected in the value of the loans in the Bank's consolidated financial statements. The amount owed to customers with regards to paid-up loans is reflected in the Bank's provisions, see Note 52.

The court rulings combined have effectively reduced the uncertainty regarding which foreign currency loans are illegal and how they should be recalculated. The Bank made an announcement to the effect that it would recalculate illegally foreign currency-linked loans, outstanding as well as paid-up loans, in line with the instructions given by the rulings. This process is in its final stages. However the rulings are based on the Bank being the dominant and expert party in the contractual relationship. Another ruling dictates that former rulings do not necessarily apply to other financial institutions or large companies as counterparties, especially if those conduct their business in part abroad or deal in foreign currency contracts on a regular basis. Moreover, the Supreme Court found in favour of a bank in a case in which a customer did not pay instalments on a regular basis and deviated significantly from the original payment schedule. Consequently, the Bank revised its categorisation on which loans should be recalculated. The result did only slightly differ from the previous categorisation.

The uncertainty that still exist is more or less embedded in two court cases in which the plaintiffs contest the legality of 3 corporate Glitnir/Íslandsbanki loan contracts. Although such contracts are not great in number, several are the instruments that carry the greatest sums. Thus, the value of the precedent is significant (approx. 3-5 billion ISK in the two cases) The Bank argues that the contracts differ from those previously ruled on by way of the method the loan was disbursed. If the contract says that the debtor can explicitly request payment in any currency and the contract is fulfilled in that manner, the maximum contract amount can be presented in ISK without offsetting the foreign currency loan validity of the contract. Final judgement on the cases is expected in the fourth quarter of 2014.

### Settlement of the 2011 Byr acquisition

The Bank acquired Byr (a former Savings Bank) in 2011 from the Bank's Winding-up Committee (the "Committee") and the Icelandic Ministry of Finance and Economic Affairs (the "Ministry"). According to standard practice, the Bank retained the right to re-evaluate the value of the assets acquired and subsequently to demand a refund if the assets did not live up to expectations. A claim was filed with the Committee in June 2013 amounting to ISK 6,943 million plus interest. The claim is filed as a priority claim, according to Article 110 of Law 21/1991, to be set off against the bond the Bank owes Byr amounting to ISK 5,834 million (due in November 2014 and 2015). The Committee rejected the claim with a letter dated 30 September. It was decided at a creditors meeting in December of 2013, that the Committee would refer the dispute to the District Court of Reykjavík. A formal claim amounting to ISK 911 million plus interest was filed with the Ministry on 24 September. The claim on the Ministry will be filed with the District Court of Reykjavík early in February 2014. Furthermore, a request for court appointed evaluators, for formal evaluation of the Bank's claim has been filed with the District Court. Any possible revenues relating to this claim have as yet not been incorporated into the Bank's current financial statements.

### Formal investigation by the Icelandic Competition Authority regarding alleged violation of competition law by Íslandsbanki

The Icelandic Competition Authority ("ICA") has initiated an investigation concerning alleged violations of the Competition law by the Bank. Details of the investigation remain confidential.

The ICA has requested and received information from Íslandsbanki and have, following their review, sent the Bank an opposition document. It is alleged that the Bank has violated Articles 10, 11 and 12 of the Competition Act, i.e. Act no. 44/2005 and Articles 53 and 54 of the EEA Agreement. The ICA considers the violations to be extensive, to have been in existence for a considerable period of time and to concern important markets. The opposition document is one stage in the processing of the case and does not comprise a final administrative decision.

The Bank has presented its observations on the opposition document and will further cooperate with the ICA to resolve the case. However, should the ICA's findings be final, significant sanctions may come into consideration, as per Article 37 of the Competition Act. The Bank has made appropriate provision for the ICA's sanctions as a result of the alleged violations of the Competition Act.

### Formal request for information by the EFTA Surveillance Authority into alleged unlawful state aid to Íslandsbanki hf.

On 22 October 2013 the EFTA Surveillance Authority ("ESA"), following a complaint dated 23 September 2013, formally requested information on alleged unlawful state aid granted to Íslandsbanki hf. through long term funding at favourable interest rates by the Central Bank of Iceland.

The Icelandic authorities are requested to submit all information and relevant observations to ESA, in order to determine whether or not the measures complained of involve state aid in the meaning of Article 61 of the EEA Agreement or qualify for an exemption under Article 61(2) or (3) of the EEA Agreement.

**58.** Cont'd

The Icelandic authorities and the Bank have sent all relevant information and their observations as per the ESA request. Both parties state that the measures, which are the topic of the complaint, cannot be considered to be state aid within the meaning of Article 61 (1) of the EEA Agreement, as the funding in question was provided at what has to be considered market rates at the time and where indeed favourable to the Central Bank. However, should ESA disagree, then the measures must be considered state aid compatible with the functioning of the EEA Agreement under Article 61(3) (b) of the EEA Agreement.

The possible effect on the bank, should ESA decide that the measures constitute unlawful state aid, has not been determined. At date, no timeframe has been given as to when the Icelandic authorities may expect ESA's decision.

## Events after the balance sheet date

**59.** On 10 January 2014, the Bank signed a sale agreement for the sale of 100% of its shareholding in Bláfugl ehf. The sale is subject to approval by the Icelandic Competition Authorities and is due to complete in the first quarter of 2014.

On 7 February 2014, the Bank signed a sale agreement for the sale of 100% of its shareholding in HTO ehf. (Höfdatorg). The sale is subject to approval by the Icelandic Competition Authorities and is expected to complete in the first quarter of 2014.

# Notes to the Consolidated Financial Statements

## Risk management

### 60. Risk governance

The Bank is exposed to various risk factors. Managing these risk factors is an integral part of the Bank's operations.

Íslandsbanki's management body has a dual structure, meaning that the Board of Directors has a supervising role and the CEO has responsibility for daily operations.

The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk appetite statement and the risk management policies.

The Chief Executive Officer (CEO) is responsible for developing and maintaining adequate and effective risk management and internal control functions within Íslandsbanki. In addition, the CEO appoints the Chief Risk Officer (CRO) as well as other members of the Executive Board, the Risk Committee, the Asset and Liability Committee and the Investment Committee.

Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

The Compliance function is responsible for monitoring that Íslandsbanki maintains adequate policies and procedures to ensure that the Board and employees of the Bank comply with its obligations according to law, regulations and internal policies and operate in accordance with proper and sound business practices and customs on the financial market.

The Chief Risk Officer (CRO) is a member of the Executive Board and is responsible for the risk management organisation within Íslandsbanki. The CRO heads the Risk Management department and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for organising risk management within Íslandsbanki in order to ensure that Íslandsbanki has the right resources and an appropriate organisation to manage its risks efficiently. This includes risk management functions in branches and subsidiaries.

The Risk Management department is responsible for maintaining and developing internal directives and frameworks regarding risk management and internal control. The department is also responsible for setting competency standards, for training staff on the Bank's policies, internal directives and frameworks related to risk management and internal control and for assisting heads of business units in risk management and internal control issues as well as to provide information and guidance.

The Risk Management advises on risk and risk assessment. It develops, maintains and tests risk models and provides other forms of support within its expertise.

Risk management reports on risk and compliance to limits to internal and external stakeholders and ensures an appropriate escalation in the event of limit breaches.

The Risk Management department is independent from business lines and legal entities but provides strategic support aligned with business objectives. The existence of an independent Risk Management department does not absolve management from its responsibility to manage all risks arising in their business and function.

### 61. Management committees

The implementation of the risk management practises and internal monitoring in accordance with Board authorisation is delegated to the management committees: the Executive Board, the Risk Committee, the Asset and Liability Committee, and the Investment Committee. Under this authorisation, these management committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite. The members of the management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter approved by the Board.

The Executive Board is responsible for the operational risk framework. The operational risk framework covers how operational risk is identified, assessed, measured, monitored, controlled and mitigated at the Bank. In addition, the Executive Board supervises reputational risk, business risk and strategic risk. The Executive Board governs the Bank's Operational Risk Policy.

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks. The Risk Committee governs the Bank's Credit Risk Policy and other credit rules and procedures. The Risk Committee can delegate authorisation power to subcommittees and decides on credit authorisation limits to individuals.

The Risk Committee and each of its subcommittees have the authority to decide on credit proposals, credit risk and counterparty credit risk within defined limits. Decisions on exposures that exceed committee limits shall be referred to a more senior committee. In turn, credit decisions exceeding the limits of the Risk Committee need to be referred to the Board for confirmation.

# Notes to the Consolidated Financial Statements

61. Cont'd

The Risk Committee is also responsible for approving products and services according to a formal product approval process within the Bank.

The Asset and Liability Committee (ALCO) supervises other financial risks, including market risk, liquidity risk and interest rate risk in the banking book (non-trading portfolio). ALCO decides on and sets limits for these risks and governs the Bank's Market Risk Policy and Liquidity Risk Policy. ALCO also oversees the Bank's capital allocation framework and transfer pricing mechanism.

The Investment Committee makes decisions pertaining to the purchase or sale of equity stakes in companies as well as other types of investments such as investment funds and real estate.

## Credit risk

62. Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or to otherwise fail to perform as agreed.

This risk comprises default risk, recovery risk, country risk, settlement risk and credit concentration risk.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Credit risk arises principally from the Bank's loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as guarantees, loan commitments and derivatives.

The Bank has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Bank's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Bank measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

63. Maximum credit exposure

The Bank's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position before the latent impairment allowance is subtracted, see Note 33. The maximum exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. The maximum credit exposure for a derivative contract is calculated by adding future credit exposure to the market value of the contract as described in Annex III of the European Parliament directive 2006/48/EC (Basel II).

The industry breakdown shows the Bank's credit exposure by industry classification. The breakdown follows an internal industry classification which is based on the Icelandic ISAT2008 that derives from the European NACE Rev. 2 classification standard.

The Bank's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

## Credit risk exposure

63. Cont'd

Maximum credit exposure 31.12.2013

| | Individuals | Central governments | Commerce and services | Construction | Energy | Financial services | Industrials and transporta-tion | Investment companies | Public sector and non-profit organisations | Real estate | Seafood | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | - | 111,779 | - | - | - | - | - | - | - | - | - | 111,779 |
| Derivatives | 10 | 1,036 | 53 | - | 520 | 434 | 131 | 43 | - | 4 | 137 | 2,368 |
| Bonds and debt instruments | - | 67,268 | - | - | 58 | 6,326 | - | 967 | 116 | 451 | - | 75,186 |
| Loans to credit institutions | - | - | - | - | - | 44,078 | - | - | - | - | - | 44,078 |
| Loans to customers: | 255,044 | - | 81,522 | 18,640 | 3,614 | 34 | 46,433 | 10,306 | 6,894 | 66,647 | 69,289 | 558,423 |
| Overdrafts | 14,885 | - | 9,862 | 4,109 | 1 | 20 | 4,000 | 290 | 1,746 | 2,208 | 2,318 | 39,439 |
| Credit cards | 16,008 | - | 1,265 | 154 | 4 | 14 | 369 | 28 | 140 | 51 | 47 | 18,080 |
| Mortgages | 176,421 | - | - | - | - | - | - | - | - | - | - | 176,421 |
| Leases | 9,586 | - | 14,244 | 2,451 | 8 | - | 5,227 | 213 | 304 | 1,475 | 228 | 33,736 |
| Other loans | 38,144 | - | 56,151 | 11,926 | 3,601 | - | 36,837 | 9,775 | 4,704 | 62,913 | 66,696 | 290,747 |
| Off-balance sheet items: | | | | | | | | | | | | |
| Financial guarantees | 1,299 | - | 2,559 | 2,343 | - | 1,500 | 1,298 | 24 | 11 | 48 | 492 | 9,574 |
| Undrawn loan commitments | - | - | 392 | 879 | 9,069 | - | 3,880 | - | - | 4,995 | 186 | 19,401 |
| Undrawn overdrafts | 9,646 | - | 5,634 | 1,013 | 202 | 1,102 | 2,125 | 195 | 1,704 | 726 | 1,324 | 23,671 |
| Credit card commitments | 22,594 | - | 3,267 | 408 | 12 | 91 | 800 | 124 | 887 | 160 | 144 | 28,487 |
| **Total maximum credit exposure** | 288,593 | 180,083 | 93,427 | 23,283 | 13,475 | 53,565 | 54,667 | 11,659 | 9,612 | 73,031 | 71,572 | 872,967 |

Íslandsbanki hf. Consolidated Financial Statements 2013 52 Amounts are in ISK million

63. Cont'd

Maximum credit exposure 31.12.2012

| | Individuals | Central governments | Commerce and services | Construction | Energy | Financial services | Industrials and transporta-tion | Investment companies | Public sector and non-profit organisations | Real estate | Seafood | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | - | 85,500 | - | - | - | - | - | - | - | - | - | 85,500 |
| Derivatives | 8 | 132 | 51 | 30 | - | 1,292 | 12 | 70 | - | 8 | 36 | 1,639 |
| Bonds and debt instruments | - | 58,141 | 316 | - | - | 2,174 | - | 2,162 | 19 | 1,223 | - | 64,035 |
| Loans to credit institutions | - | - | - | - | - | 54,043 | - | - | - | - | - | 54,043 |
| Loans to customers: | 244,426 | - | 68,805 | 16,465 | 4,942 | 254 | 43,660 | 16,023 | 10,934 | 72,941 | 81,145 | 559,595 |
| Overdrafts | 14,871 | - | 6,487 | 2,705 | 3 | 94 | 3,508 | 418 | 1,756 | 1,616 | 1,898 | 33,356 |
| Credit cards | 15,825 | - | 1,243 | 138 | 2 | 26 | 333 | 34 | 182 | 45 | 41 | 17,869 |
| Mortgages | 164,416 | - | - | - | - | - | - | - | - | - | - | 164,416 |
| Leases | 9,763 | - | 14,187 | 2,266 | 14 | 13 | 4,181 | 176 | 408 | 1,492 | 413 | 32,913 |
| Other loans | 39,551 | - | 46,888 | 11,356 | 4,923 | 121 | 35,638 | 15,395 | 8,588 | 69,788 | 78,793 | 311,041 |
| Off-balance sheet items: | | | | | | | | | | | | |
| Financial guarantees | 1,307 | - | 2,242 | 1,858 | 4 | 1,001 | 873 | 360 | 55 | 152 | 519 | 8,371 |
| Undrawn loan commitments | - | - | 3,308 | 422 | 5,436 | - | 2,798 | 1 | - | - | 833 | 12,798 |
| Undrawn overdrafts | 9,502 | - | 4,330 | 1,141 | 229 | 1,318 | 3,117 | 279 | 1,146 | 471 | 879 | 22,412 |
| Credit card commitments | 21,893 | 10 | 2,990 | 426 | 17 | 93 | 796 | 123 | 1,096 | 154 | 112 | 27,710 |
| **Total maximum credit exposure** | 277,136 | 143,783 | 82,042 | 20,342 | 10,628 | 60,175 | 51,256 | 19,018 | 13,250 | 74,949 | 83,524 | 836,103 |

Íslandsbanki hf. Consolidated Financial Statements 2013 53 Amounts are in ISK million

**64.** Credit exposure covered by collateral

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. In the case of corporate entities the Bank takes a charge over assets such as real estate, fishing vessels, cash and securities and as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured. Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

In some cases the Bank uses guarantees as a credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in maximum exposure to credit risk. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

Valuation of collateral is based on market price, official valuation from the Iceland Property Registry or expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation. Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Bank's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. An estimate of the collateral held by the Bank against credit exposure is shown below:

| At 31 December 2013 | Real estate | Fishing vessels | Cash & securities | Vehicles & equipment | Other collateral | Credit exposure covered by collateral |
|---|---|---|---|---|---|---|
| Derivatives | - | - | 1,820 | - | - | 1,820 |
| Loans and commitments to customers: | 321,247 | 59,488 | 6,895 | 31,053 | 14,603 | 433,286 |
| Individuals | 202,593 | 26 | 1,410 | 8,791 | 5 | 212,825 |
| Commerce and services | 30,764 | 217 | 1,098 | 12,998 | 5,193 | 50,270 |
| Construction | 8,912 | 143 | 84 | 3,961 | 1,418 | 14,518 |
| Energy | 3,242 | - | 87 | - | 122 | 3,451 |
| Financial services | 4 | - | - | - | - | 4 |
| Industrial and transportation | 18,161 | - | 98 | 4,682 | 5,029 | 27,970 |
| Investment companies | 4,108 | - | 2,783 | 44 | 55 | 6,990 |
| Public sector and non-profit organisations | 1,438 | 3 | 3 | 223 | - | 1,667 |
| Real estate | 47,377 | 25 | 445 | 155 | 21 | 48,023 |
| Seafood | 4,648 | 59,074 | 887 | 199 | 2,760 | 67,568 |
| **Total** | 321,247 | 59,488 | 8,715 | 31,053 | 14,603 | 435,106 |

| At 31 December 2012 | Real estate | Fishing vessels | Cash & securities | Vehicles & equipment | Other collateral | Credit exposure covered by collateral |
|---|---|---|---|---|---|---|
| Derivatives | - | - | 640 | - | - | 640 |
| Loans and commitments to customers: | 314,242 | 68,349 | 15,682 | 17,790 | 14,231 | 430,294 |
| Individuals | 197,187 | 89 | 2,918 | 8,145 | - | 208,339 |
| Commerce and services | 27,477 | - | 913 | 8,471 | 3,083 | 39,944 |
| Construction | 7,622 | 186 | 121 | 287 | 3,662 | 11,878 |
| Energy | 2,601 | - | 6 | 3 | 146 | 2,756 |
| Financial services | 69 | - | 8 | 11 | - | 88 |
| Industrial and transportation | 13,036 | - | 724 | 674 | 5,793 | 20,227 |
| Investment companies | 3,493 | - | 10,150 | 17 | 397 | 14,057 |
| Public sector and non-profit organisations | 3,645 | - | 10 | 59 | 194 | 3,908 |
| Real estate | 54,596 | 139 | 233 | 76 | - | 55,044 |
| Seafood | 4,516 | 67,935 | 599 | 47 | 956 | 74,053 |
| **Total** | 314,242 | 68,349 | 16,322 | 17,790 | 14,231 | 430,934 |

Íslandsbanki hf. Consolidated Financial Statements 2013 54 Amounts are in ISK million

**65.** Credit quality of financial assets

Loans are classified as impaired loans if contractual cash payments are not expected to be fulfilled and if financial restructuring of the obligor is expected to lead to a loss on that particular loan. In most cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio.

Loans are also classified as impaired if the Bank has made impairments to offset currency movements. This impairment does not signal a loss from the deep discount.

The full carrying amount of all loans which give rise to individual impairment or collective impairment is included in impaired loans, even if parts are covered by collateral. The latent impairment has not been subtracted from the carrying amount here.

| At 31 December 2013 | Neither past due nor impaired | Past due but not impaired | Classified as impaired | Total carrying amount |
|---|---|---|---|---|
| Cash and balances with Central Bank | 111,779 | - | - | 111,779 |
| Derivatives | 2,368 | - | - | 2,368 |
| Bonds and debt instruments | 75,186 | - | - | 75,186 |
| Loans to credit institutions | 44,078 | - | - | 44,078 |
| Loans to customers: | 496,705 | 34,618 | 27,100 | 558,423 |
| Individuals | 222,791 | 23,944 | 8,309 | 255,044 |
| Commerce and services | 71,177 | 3,759 | 6,586 | 81,522 |
| Construction | 16,780 | 1,005 | 855 | 18,640 |
| Energy | 3,614 | - | - | 3,614 |
| Financial services | 34 | - | - | 34 |
| Industrial and transportation | 43,175 | 1,318 | 1,940 | 46,433 |
| Investment companies | 9,293 | 506 | 507 | 10,306 |
| Public sector and non-profit organisations | 6,818 | 52 | 24 | 6,894 |
| Real estate | 58,694 | 2,356 | 5,597 | 66,647 |
| Seafood | 64,329 | 1,678 | 3,282 | 69,289 |
| **Total** | 730,116 | 34,618 | 27,100 | 791,834 |

| At 31 December 2012 | Neither past due nor impaired | Past due but not impaired | Classified as impaired | Total carrying amount |
|---|---|---|---|---|
| Cash and balances with Central Bank | 85,500 | - | - | 85,500 |
| Derivatives | 1,639 | - | - | 1,639 |
| Bonds and debt instruments | 64,035 | - | - | 64,035 |
| Loans to credit institutions | 54,043 | - | - | 54,043 |
| Loans to customers: | 469,435 | 42,205 | 47,955 | 559,595 |
| Individuals | 206,255 | 29,714 | 8,457 | 244,426 |
| Commerce and services | 55,908 | 3,330 | 9,567 | 68,805 |
| Construction | 13,411 | 1,717 | 1,337 | 16,465 |
| Energy | 4,941 | - | 1 | 4,942 |
| Financial services | 197 | 16 | 41 | 254 |
| Industrial and transportation | 39,531 | 1,454 | 2,675 | 43,660 |
| Investment companies | 11,736 | 631 | 3,656 | 16,023 |
| Public sector and non-profit organisations | 10,425 | 101 | 408 | 10,934 |
| Real estate | 51,351 | 4,598 | 16,992 | 72,941 |
| Seafood | 75,680 | 644 | 4,821 | 81,145 |
| **Total** | 674,652 | 42,205 | 47,955 | 764,812 |

Íslandsbanki hf. Consolidated Financial Statements 2013 55 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**66.** Neither past due nor impaired loans

The Bank uses internal rating models to assess the default probability of corporate and retail customers. The models assign each customer to one of ten risk classes. One risk class is for customers in default (risk class 10), and nine risk classes are for performing customers (risk classes 1-9). Risk classes are assigned on customer level and not facility level.

The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its management, market position and industry sector.

For retail customers the Bank uses two different statistical rating models. One model is for individuals and the other is for small companies with a total exposure to the Bank of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits, and demographic variables to assess the probability that a customer will default on any of his obligations within 12 months of the rating assessment.

The table below shows loans that are neither past due nor impaired aggregated in five customer groups based on the default probability. Group 1-4 represents low risk, group 5-6 moderate risk, group 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers in default.

Note that the same customer can have loans that are more than 90 days past or impaired, and at the same time other loans that are neither past due nor impaired. Those customers will be in risk class 10 and their loans that are neither past due nor impaired are included in the table below.

| At 31 December 2013 | Risk class 1-4 | Risk class 5-6 | Risk class 7-8 | Risk class 9 | Risk class 10 | Total |
|---|---|---|---|---|---|---|
| Loans to customers - total | | | | | | |
| Individuals | 8,502 | 78,311 | 83,314 | 44,952 | 7,712 | 222,791 |
| Commerce and services | 14,674 | 21,170 | 27,751 | 4,789 | 2,793 | 71,177 |
| Construction | - | 4,279 | 10,863 | 1,037 | 601 | 16,780 |
| Energy | 2,150 | 1,445 | 19 | 0 | - | 3,614 |
| Financial services | 6 | 1 | 19 | 8 | - | 34 |
| Industrial and transportation | 13,910 | 16,432 | 8,796 | 3,627 | 410 | 43,175 |
| Investment companies | 837 | 3,220 | 3,654 | 1,440 | 142 | 9,293 |
| Public sector and non-profit organisations | 1,756 | 3,060 | 1,804 | 195 | 3 | 6,818 |
| Real estate | 127 | 35,019 | 11,140 | 4,315 | 8,093 | 58,694 |
| Seafood | 21,363 | 29,347 | 11,719 | 561 | 1,339 | 64,329 |
| **Total** | 63,325 | 192,284 | 159,079 | 60,924 | 21,093 | 496,705 |

| At 31 December 2012 | Risk class 1-4 | Risk class 5-6 | Risk class 7-8 | Risk class 9 | Risk class 10 | Total |
|---|---|---|---|---|---|---|
| Loans to customers - total | | | | | | |
| Individuals | 8,215 | 71,069 | 66,147 | 49,650 | 11,174 | 206,255 |
| Commerce and services | 3,737 | 14,624 | 21,225 | 10,326 | 5,996 | 55,908 |
| Construction | - | 1,511 | 9,062 | 2,117 | 721 | 13,411 |
| Energy | 2 | 2,882 | 24 | 2,033 | - | 4,941 |
| Financial services | 5 | 16 | 99 | 77 | - | 197 |
| Industrial and transportation | 10,494 | 18,062 | 7,432 | 2,937 | 606 | 39,531 |
| Investment companies | 661 | 7,092 | 1,358 | 1,812 | 813 | 11,736 |
| Public sector and non-profit organisations | 639 | 4,994 | 2,000 | 2,774 | 18 | 10,425 |
| Real estate | 4,443 | 15,369 | 10,643 | 4,553 | 16,343 | 51,351 |
| Seafood | 31,949 | 34,605 | 5,638 | 705 | 2,783 | 75,680 |
| **Total** | 60,145 | 170,224 | 123,628 | 76,984 | 38,454 | 469,435 |

Íslandsbanki hf. Consolidated Financial Statements 2013 56 Amounts are in ISK million

**67.** Restructuring and forbearance

Restructuring of customers' debt has been one of the Bank's main tasks since October 2008. This has been a challenge as such a large part of customers have needed forbearance measures. Legal issues, political environment and the general economy have contributed in ways of uncertainty and complications. The Bank has set in place processes and resources to take on this task. The Bank's management team is kept well informed on the status of restructuring on a regular basis.

The Bank has offered several debt relief measures and restructuring frameworks for its customers since its establishment. These restructuring frameworks include principal adjustment and recalculation of currency linked loans, debt adjustment for companies and individuals, 110% adjustment of mortgages, write-offs and tailor made solutions in complicated cases where general solutions do not suffice.

Other forbearance measures which the Bank can make available include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In many cases these measures are precursors to the more formal restructuring process.

The table below shows the carrying amount of loans to customers that are neither past due nor impaired broken down by restructuring and forbearance status.

| | 31.12.2013 |
|---|---|
| Loans discharged from restructuring in 2013 | 6,046 |
| Loans where forbearance agreements were made in 2013 | 7,174 |
| Other loans neither past due nor impaired | 483,485 |
| **Loans to customers neither past due nor impaired** | 496,705 |

Comparative figures not available.

Íslandsbanki hf. Consolidated Financial Statements 2013 57 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**68.** Past due but not impaired loans

Past due but not impaired loans are loans where contractual interest or principal payments have passed due date without the obligor making full payment, but where specific impairment is not appropriate. The reason is usually that contractual payments are eventually expected to be fulfilled or these loans are expected to be restructured without any loss to the Bank. In some cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio. In other cases, there is sufficient collateral.

Amounts reported as loans past due refer to the total loan exposure and not only the payment or sum of payments that are past due. Payments three days in arrears or less are not considered to be past due and the corresponding loans are therefore omitted here. Past due but not impaired loans are as follows:

| At 31 December 2013 | Past due 4-30 days | Past due 31-60 days | Past due 61-90 days | Past due more than 90 days | Total past due loans |
|---|---|---|---|---|---|
| Loans to customers: | | | | | |
| Individuals | 8,615 | 4,181 | 786 | 10,362 | 23,944 |
| Commerce and services | 1,349 | 1,000 | 335 | 1,075 | 3,759 |
| Construction | 330 | 279 | 24 | 372 | 1,005 |
| Energy | - | - | - | - | - |
| Financial services | - | - | - | - | - |
| Industrials and transportation | 375 | 203 | 45 | 695 | 1,318 |
| Investment companies | 181 | 35 | 137 | 153 | 506 |
| Public sector and non-profit organisations | 38 | 6 | 1 | 7 | 52 |
| Real estate | 1,040 | 460 | 109 | 747 | 2,356 |
| Seafood | 790 | 107 | 78 | 703 | 1,678 |
| **Total** | 12,718 | 6,271 | 1,515 | 14,114 | 34,618 |

| At 31 December 2012 | Past due 4-30 days | Past due 31-60 days | Past due 61-90 days | Past due more than 90 days | Total past due loans |
|---|---|---|---|---|---|
| Loans to customers: | | | | | |
| Individuals | 8,567 | 4,652 | 1,107 | 15,388 | 29,714 |
| Commerce and services | 1,023 | 502 | 101 | 1,704 | 3,330 |
| Construction | 323 | 82 | 97 | 1,215 | 1,717 |
| Energy | - | - | - | - | - |
| Financial services | 1 | 1 | 1 | 13 | 16 |
| Government secured customer loan | - | - | - | - | - |
| Industrials and transportation | 299 | 269 | 72 | 814 | 1,454 |
| Investment companies | 73 | 30 | 38 | 490 | 631 |
| Public sector and non-profit organisations | 42 | 19 | - | 40 | 101 |
| Real estate | 580 | 1,528 | 133 | 2,357 | 4,598 |
| Seafood | 45 | 30 | 34 | 535 | 644 |
| **Total** | 10,953 | 7,113 | 1,583 | 22,556 | 42,205 |

Íslandsbanki hf. Consolidated Financial Statements 2013 58 Amounts are in ISK million

**69.** Large exposure disclosure

When the Bank's total exposure to a group of connected clients is 10% or higher of the Bank's capital base it is considered a large exposure. Both on-balance sheet and off-balance sheet items from all types of financial instruments are included in the exposure as defined by FME rules 625/2013. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) of law 161/2002 on Financial Undertakings, where groups of connected clients are defined.

The exposure is evaluated both gross and net of credit risk mitigating effects eligible according to the FME rules. Net of mitigating effects, the Bank has currently no large exposure above 10% of capital base. In particular, the Bank is below the maximum 25% single large exposure limit set by the law.

The following tables show the Bank's large exposures as a percentage of the Bank's capital base, gross and net of eligible credit risk mitigating effects. Note that group references might change between reporting periods, i.e. Group 1 might not be the same group in the two tables.

| | | 31.12.2013 |
|---|---|---|
| **Client groups** | Gross | Net |
| Group 1 | 78% | 0% |

| | | 31.12.2012 |
|---|---|---|
| **Client groups** | Gross | Net |
| Group 1 | 53% | 0% |
| Group 2 | 15% | 15% |

Íslandsbanki hf. Consolidated Financial Statements 2013 59 Amounts are in ISK million

## Liquidity risk

**70.** The Bank defines liquidity risk as the risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

### Liquidity risk management

The Bank's main source of funding is customer deposits. The Bank's Treasury is responsible for the Bank's funding and liquidity management within the limits approved by the Board and the Asset and Liability Committee. The Interbank desk manages the Bank's intraday liquidity.

Risk management is responsible for measuring, monitoring and reporting on the Bank's liquidity position.

The Bank's liquidity risk policy assumes that the Bank has back-up liquidity resources to meet all maturing liabilities and other obligations for at least twelve months.

The tables below show the contractual payments of principal and interest for the Bank´s financial liabilities. Thus, the total figures for each liability class are higher than the respective balance sheet amount. Cash flows for payments of unknown nature, such as for floating rate, CPI linked or foreign currency denominated instruments, are estimated based on official yield curves and internal forecasts.
For dated financial liabilities the amounts are grouped into maturity buckets according to contractual maturities of principal and estimated contractual payments of interest. For demand deposits or other non-dated liabilities, the figures are grouped according to the first possible required payment date.

In the table below the total amount for loans to customers is shown before latent impairment allowance and is therefore higher than the total amount shown in the financial statement. The tables showing the cash flow of assets only include principal payments whereas for the financial liabilities the cash flow includes both principal and interest.

### Maturity analysis 31 December 2013

| Financial liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Short positions | 9,462 | - | - | - | - | - | 9,462 |
| Deposits from Central Bank | 63 | - | - | - | - | - | 63 |
| Deposits from credit institutions | 26,804 | 2,457 | 413 | - | - | - | 29,674 |
| Deposits from customers | 346,352 | 47,265 | 52,685 | 29,918 | 29,429 | - | 505,649 |
| Debt issued and other borrowed funds | 2 | 6,765 | 15,988 | 52,993 | 28,397 | - | 104,145 |
| Subordinated loans | - | - | 749 | 6,869 | 24,919 | - | 32,537 |
| Other financial liabilities | 33,576 | 4,874 | 9,196 | - | 74 | - | 47,720 |
| **Total** | 416,259 | 61,361 | 79,031 | 89,780 | 82,819 | - | 729,250 |

Off-balance sheet liabilities show the amount of contractual obligations that the Bank has taken towards customers, either by committing to lend out money in the future or as third party guarantees. The amounts shown reflect the maximum amount, not taking into account the Bank's ability to reduce overdraft or credit card limits before the current undrawn amount is fully utilised by the customer. These obligations all fall into the first time bucket since contractually, on a case by case basis, the Bank could be required to fulfil these obligations instantaneously.

| Off-balance sheet liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Financial guarantees | 9,574 | - | - | - | - | - | 9,574 |
| Undrawn loan commitments | 19,401 | - | - | - | - | - | 19,401 |
| Undrawn overdrafts | 23,671 | - | - | - | - | - | 23,671 |
| Credit card commitments | 28,487 | - | - | - | - | - | 28,487 |
| **Total** | 81,133 | - | - | - | - | - | 81,133 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Total non-derivative financial liabilities and off-balance sheet liabilities | 497,392 | 61,361 | 79,031 | 89,780 | 82,819 | - | 810,383 |

Íslandsbanki hf. Consolidated Financial Statements 2013 60 Amounts are in ISK million

**70.** Cont'd

The table below shows the contractual cash flow of the Bank's derivative liabilities, i.e. derivatives that have a negative carrying amount at the date of reporting. Derivatives with a positive carrying amount are detailed separately. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

| Derivative financial liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 3,865 | 8,742 | 65,955 | - | - | 78,562 |
| Outflow | - | ( 3,906) | ( 8,321) | ( 71,328) | - | - | ( 83,555) |
| Total | - | ( 41) | 421 | ( 5,373) | - | - | ( 4,993) |
| Net settled derivatives | - | ( 195) | - | - | - | - | ( 195) |
| **Total** | - | ( 236) | 421 | ( 5,373) | - | - | ( 5,188) |

Maturity classification of assets is based on contractual maturity. For loans that were acquired at a deep discount and have not yet been restructured, the contractual amount is scaled to reflect the carrying amount of the claim. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity dates while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

| Financial assets | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 12,695 | 99,084 | - | - | - | - | 111,779 |
| Bonds and debt instruments | 5,503 | 35,250 | 67 | 26 | 31,805 | 2,535 | 75,186 |
| Shares and equity instruments | 46 | - | 9 | 344 | - | 8,986 | 9,385 |
| Loans to credit institutions | 29,420 | 14,497 | 161 | - | - | - | 44,078 |
| Loans to customers | 932 | 75,481 | 42,852 | 150,591 | 289,067 | - | 558,923 |
| Other financial assets | 7,102 | 1,541 | 102 | 1,658 | - | 3,169 | 13,572 |
| **Total financial assets** | 55,698 | 225,853 | 43,191 | 152,619 | 320,872 | 14,690 | 812,923 |
| **Derivative financial assets** | | | | | | | |
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 4,793 | 3,732 | 10,508 | 2,523 | - | 21,556 |
| Outflow | - | ( 4,605) | ( 3,584) | ( 10,265) | ( 2,813) | - | ( 21,267) |
| Total | - | 188 | 148 | 243 | ( 290) | - | 289 |
| Net settled derivatives | - | 58 | - | - | - | - | 58 |
| **Total** | - | 246 | 148 | 243 | ( 290) | - | 347 |

The tables below show the comparative amounts for financial assets and liabilities at the end of 2012.

**Maturity analysis 31 December 2012**

| Financial liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Short positions | 11,991 | - | - | - | - | - | 11,991 |
| Deposits from Central Bank | 54 | - | - | - | - | - | 54 |
| Deposits from credit institutions | 29,726 | 8,119 | 401 | - | - | - | 38,246 |
| Deposits from customers | 338,464 | 46,390 | 41,059 | 27,590 | 23,969 | - | 477,472 |
| Debt issued and other borrowed funds | 8 | 2,449 | 7,304 | 44,288 | 23,085 | 983 | 78,117 |
| Subordinated loans | - | 236 | 523 | 6,337 | 28,919 | - | 36,015 |
| Other financial liabilities | 42,190 | 5,957 | 2,154 | - | 291 | - | 50,592 |
| **Total financial liabilities** | 422,433 | 63,151 | 51,441 | 78,215 | 76,264 | 983 | 692,487 |

Íslandsbanki hf. Consolidated Financial Statements 2013 61 Amounts are in ISK million

70. Cont'd

| Off-balance sheet liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Financial guarantees | 8,371 | - | - | - | - | - | 8,371 |
| Undrawn loan commitments | 12,798 | - | - | - | - | - | 12,798 |
| Undrawn overdraft | 22,412 | - | - | - | - | - | 22,412 |
| Credit card commitments | 27,710 | - | - | - | - | - | 27,710 |
| **Total** | 71,291 | - | - | - | - | - | 71,291 |
| Total non-derivative financial liabilities and off-balance sheet liabilities | 493,724 | 63,151 | 51,441 | 78,215 | 76,264 | 983 | 763,778 |

| Derivative financial | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 6,074 | 1,872 | 75,987 | 25,000 | - | 108,933 |
| Outflow | - | ( 5,849) | ( 1,944) | ( 93,004) | ( 25,080) | - | ( 125,877) |
| Total | - | 225 | ( 72) | ( 17,017) | ( 80) | - | ( 16,944) |
| Net settled derivatives | - | ( 115) | - | - | - | - | ( 115) |
| **Total** | - | 110 | ( 72) | ( 17,017) | ( 80) | - | ( 17,059) |

| Financial assets | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 27,380 | 58,120 | - | - | - | - | 85,500 |
| Bonds and debt instruments | 1,281 | 26,730 | - | - | 31,120 | 4,904 | 64,035 |
| Shares and equity instruments | - | - | 13 | 326 | - | 10,106 | 10,445 |
| Loans to credit institutions | 34,665 | 19,227 | 151 | - | - | - | 54,043 |
| Loans to customers | 578 | 70,346 | 50,267 | 149,005 | 289,399 | - | 559,595 |
| Other financial assets | 1,640 | 1,007 | 209 | 1,201 | - | 1,998 | 6,055 |
| **Total financial assets** | 65,544 | 175,430 | 50,640 | 150,532 | 320,519 | 17,008 | 779,673 |
| **Derivative financial assets** | | | | | | | |
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 1,805 | 909 | 8,284 | - | - | 10,998 |
| Outflow | - | ( 1,755) | ( 860) | ( 8,189) | - | - | ( 10,804) |
| Total | - | 50 | 49 | 95 | - | - | 194 |
| Net settled derivatives | - | 61 | - | - | - | - | 61 |
| **Total** | - | 111 | 49 | 95 | - | - | 255 |

As a part of managing liquidity risk, the Bank holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Bank's liquidity back-up at the end of 2013 and end of 2012.

| Composition and amount of liquidity back-up | 31.12.2013 | 31.12.2012 |
|---|---|---|
| Cash and balances with Central Bank | 111,779 | 85,500 |
| Domestic bonds eligible as collateral against borrowing at the Central Bank | 20,873 | 12,704 |
| Foreign government bonds | 34,618 | 26,730 |
| Short-term placements with credit institutions | 41,192 | 49,264 |
| **Composition and amount of liquidity back-up** | 208,462 | 174,198 |

Íslandsbanki hf. Consolidated Financial Statements 2013 62 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

## Market risk

**71.** The Bank defines market risk as the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices, commodity prices and foreign exchange rates.

### Market risk management

The Bank's market risk appetite is determined by the Board of Directors. The Asset and Liability Committee (ALCO) decides on limits for portfolios and products in accordance with the market risk policy approved by the Board. Risk Management is responsible for monitoring and reporting on the Bank's overall market risk positions and compliance to limits. The objective of market risk management is to manage and control market risk exposures within acceptable parameters.

The Bank separates exposures to market risk into trading book and banking book (non-trading portfolios). The Bank's primary sources of market risk in the trading portfolio are shares, debt instruments and foreign currency positions. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. Market risk in the banking book is mainly due to mismatches in interest rate terms and denomination currency of assets and liabilities. These mismatches are reported to management and are subject to regulatory and internal limits.

## Interest rate risk

**72.** Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates.

The Bank uses sensitivity measures like Basis Point Value (BPV) to measure and manage risk arising from its fixed income exposures. The BPV measures the effect of a 0.01 percentage point upward parallel shift in the yield curve on the fair value of these exposures.

**73.** Interest rate risk in the trading portfolios

The fixed income trading unit invests mainly in government bonds and bonds issued by the Housing Financing Fund (HFF), which are guaranteed by the Icelandic government. These positions can include short positions. Government bonds are either indexed to the Icelandic Consumer Price Index (CPI) or non-indexed, with duration up to 9 years. HFF bonds are CPI linked and have duration up to 13 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day. In addition to BPV limits short and long positions in each instrument are subject to separate limits. Risk Management monitors these limits and reports all breaches to ALCO.

Note that in the table below the total market value of long and short positions may not be exactly the same as reported in note 8. The reason for this difference is that note 8 sums up the net positions in each security while the table below ignores both netting of long and short positions in specific securities between different portfolios and hedge positions against derivative contracts.

| **Trading bonds and debt instruments, long positions** | 31.12.2013 | | | 31.12.2012 | | |
|---|---|---|---|---|---|---|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | 3,282 | 7.41 | (2.43) | 1,589 | 11.01 | (1.75) |
| Non-Indexed | 35,848 | 0.32 | (1.13) | 26,933 | 0.18 | (0.50) |
| **Total** | 39,130 | 0.91 | (3.56) | 28,522 | 0.79 | (2.25) |

| **Trading bonds and debt instruments, short positions** | 31.12.2013 | | | 31.12.2012 | | |
|---|---|---|---|---|---|---|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | 291 | 6.39 | 0.19 | 521 | 10.65 | 0.55 |
| Non-Indexed | 2,878 | 2.23 | 0.64 | 1,592 | 2.21 | 0.35 |
| **Total** | 3,169 | 2.61 | 0.83 | 2,113 | 4.29 | 0.90 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Net position of trading bonds and debt instruments** | 35,961 | 0.76 | (2.73) | 26,409 | 0.50 | (1.35) |

Íslandsbanki hf. Consolidated Financial Statements 2013 63 Amounts are in ISK million

# Notes to the Consolidated Financial Statements

**73.** Cont'd

The Bank's liquidity management assumes that part of the liquidity portfolio in foreign currencies can be invested in highly liquid bills issued by foreign governments. The minimum rating criteria for such investments is Aa3 according to Moody's long-term issuer rating. At year-end 2013 the Bank held a significant amount of foreign Aa1 and Aaa credit rated government bills for liquidity management purposes. These bills have a duration ranging up to six months and the sensitivity measured in BPV was ISK -0.9 million (2012: ISK -0.4 million).

| Foreign government bills | 31.12.2013 | | 31.12.2012 | |
|---|---|---|---|---|
| Country | Market value | BPV | Market value | BPV |
| Denmark | 1,063 | (0.02) | - | - |
| France | 1,585 | (0.01) | 5,094 | (0.04) |
| Germany | 4,755 | (0.09) | 2,547 | (0.05) |
| Netherlands | 2,377 | (0.02) | 7,641 | (0.13) |
| Norway | 3,760 | (0.13) | 1,149 | (0.02) |
| Sweden | 5,375 | (0.13) | - | - |
| UK | 1,902 | (0.02) | - | - |
| USA | 14,433 | (0.44) | 10,298 | (0.17) |
| **Total** | 35,250 | (0.86) | 26,729 | (0.41) |

**74.** Sensitivity analysis for interest rate risk in the trading portfolios

For the sensitivity analysis in the trading portfolio the Bank applies a 100 bps shift in ISK, non-indexed and indexed interest rates. Shifts in rates in other currencies are scaled down in accordance with lower volatility. The following table demonstrates the sensitivity of the Bank's equity and income statement to a reasonable change in interest rates, all other risk factors held constant.

| Sensitivity analysis for trading bonds and debt instruments | | 31.12.2013 | | 31.12.2012 | |
|---|---|---|---|---|---|
| | | Profit or loss | | | |
| **Currency (ISK million)** | Parallel shift in yield curve (basis points) | Downward shift | Upward shift | Downward shift | Upward shift |
| ISK, indexed | 100 | 243 | ( 243) | 120 | ( 120) |
| ISK, non-indexed | 100 | 28 | ( 28) | ( 27) | 27 |
| CHF | 40 | - | - | - | - |
| EUR | 20 | 2 | ( 2) | 4 | ( 4) |
| GBP | 40 | 1 | ( 1) | - | - |
| JPY | 20 | - | - | - | - |
| USD | 40 | 18 | ( 18) | 7 | ( 7) |
| Other total | 40 | - | - | 1 | ( 1) |
| **Total** | | 292 | ( 292) | 105 | ( 105) |

# Notes to the Consolidated Financial Statements

**75.** Interest rate risk in the non-trading portfolio

Interest rate risk in the non-trading portfolios arises from the Bank's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as interest rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Bank holds a government bond designated at fair value amounting to ISK 30.8 billion (2012: ISK 30.9 billion). The bond pays floating rates and carries relatively low interest rate risk.

The Bank uses traditional measures for assessing the sensitivity of the Bank's financial assets, financial liabilities and earnings to changes in the underlying interest rates.

In the table below the total amount of loans to customers is shown before latent impairment allowance is subtracted and is therefore not the same as the total amount shown in the financial statement. Loans with specific impairment have been placed in the category 0-3 months since their valuation is based on the underlying collateral and as such not directly affected by changes in market interest rates.

Non-trading portfolio interest rate adjustment periods 31 December 2013

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|---|
| Balances with Central Bank | 111,779 | - | - | - | - | - | 111,779 |
| Bonds and debt instruments | 31,302 | 632 | 20 | 1,275 | 154 | 493 | 33,876 |
| Loans to credit institutions | 43,917 | 161 | - | - | - | - | 44,078 |
| Loans to customers | 397,719 | 46,565 | 57,552 | 38,803 | 1,586 | 12,516 | 554,741 |
| **Total assets** | 584,717 | 47,358 | 57,572 | 40,078 | 1,740 | 13,009 | 744,474 |
| Off-balance sheet items | 19,191 | 30,980 | 1,001 | 4,733 | - | - | 55,905 |
| **Liabilities** | | | | | | | |
| Short positions | 2,439 | 399 | - | 832 | - | - | 3,670 |
| Deposits from Central Bank | 63 | - | - | - | - | - | 63 |
| Deposits from credit institutions | 29,225 | 401 | - | - | - | - | 29,626 |
| Deposits from customers | 476,312 | 2,944 | - | 2,885 | 7,190 | - | 489,331 |
| Debt issued and other borrowed funds | 20,518 | 4,369 | 2,450 | 45,263 | 7,208 | 9,386 | 89,194 |
| Subordinated loans | 21,890 | - | - | - | - | - | 21,890 |
| **Total liabilities** | 550,447 | 8,113 | 2,450 | 48,980 | 14,398 | 9,386 | 633,774 |
| Off-balance sheet items | 20,046 | 23,638 | 5,338 | 8,195 | - | - | 57,217 |
| **Net interest gap on 31 December 2013** | 33,415 | 46,587 | 50,785 | ( 12,364) | ( 12,658) | 3,623 | 109,388 |

Íslandsbanki hf. Consolidated Financial Statements 2013 65 Amounts are in ISK million

**75.** Cont'd

Non-trading portfolio interest rate adjustment periods 31 December 2012

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|---|
| Balances with Central Bank | 83,493 | - | - | - | - | - | 83,493 |
| Bonds and debt instruments | 33,424 | 795 | 403 | 382 | 575 | 58 | 35,637 |
| Loans to credit institutions | 53,891 | 151 | - | - | - | - | 54,042 |
| Loans to customers | 422,980 | 48,961 | 27,250 | 46,196 | 1,314 | 12,893 | 559,594 |
| **Total assets** | 593,788 | 49,907 | 27,653 | 46,578 | 1,889 | 12,951 | 732,766 |
| Off-balance sheet items | 47,982 | 29,259 | - | - | 113 | - | 77,354 |
| **Liabilities** | | | | | | | |
| Short positions | - | 3,226 | 1,140 | 850 | - | - | 5,216 |
| Deposits from Central Bank | 54 | - | - | - | - | - | 54 |
| Deposits from credit institutions | 37,837 | 381 | - | - | - | - | 38,218 |
| Deposits from customers | 459,233 | 1,657 | 888 | 2,743 | 6,635 | - | 471,156 |
| Debt issued and other borrowed funds | 7,420 | - | - | 6,018 | 48,193 | 4,940 | 66,571 |
| Subordinated loans | 23,450 | - | - | - | - | - | 23,450 |
| **Total liabilities** | 527,994 | 5,264 | 2,028 | 9,611 | 54,828 | 4,940 | 604,665 |
| Off-balance sheet items | 52,896 | 9,479 | 10,552 | 9,753 | - | - | 82,680 |
| **Net interest gap on 31 December 2012** | 60,880 | 64,423 | 15,073 | 27,214 | ( 52,826) | 8,011 | 122,775 |

**76.** Sensitivity analysis for interest rate risk in the non-trading portfolios

For the sensitivity analysis in the non-trading portfolios a 100 bps shift is applied for non-indexed ISK interest rates. Shifts in other currencies are chosen using the same scaling factors as in the trading portfolio. CPI-linked ISK rate shifts are also scaled down to reflect significantly stronger mean reversion than for non-indexed rates. The table shows how applied shifts would affect the fair value of the Bank's non-trading portfolios.

**Sensitivity analysis for non-trading bonds and debt instruments**

| | | 31.12.2013 | | 31.12.2012 | |
|---|---|---|---|---|---|
| | | Profit or (loss) | | | |
| **Currency (ISK million)** | Parallel shift in yield curve (basis points) | Downward shift | Upward shift | Downward shift | Upward shift |
| ISK, indexed | 40 | 113 | ( 113) | 228 | ( 228) |
| ISK, non-indexed | 100 | 206 | ( 206) | 301 | ( 301) |
| CHF | 40 | ( 2) | 2 | ( 2) | 2 |
| EUR | 20 | ( 6) | 6 | ( 3) | 3 |
| GBP | 40 | 1 | ( 1) | 1 | ( 1) |
| JPY | 20 | 1 | ( 1) | 4 | ( 4) |
| USD | 40 | 14 | ( 14) | 4 | ( 4) |
| Other | 40 | ( 4) | 4 | ( 1) | 1 |
| **Total** | | 323 | ( 323) | 532 | ( 532) |

# Notes to the Consolidated Financial Statements

## Currency risk

77. Currency risk is the risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or due to a mismatch in the currency composition of assets or liabilities.

The analysis of the Bank's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements. The tables below summarise the Bank's exposure to currency risk at 31 December 2013 and 31 December 2012, based on contractual currencies, off-balance sheet items, but excluding assets categorised as held-for-sale.

The previous adjustment of the currency imbalance for loans in foreign currency to customers with revenue and cash flows in ISK is no longer applicable see Note 4.c.

### Currency analysis 31 December 2013

| Assets | EUR | USD | GBP | CHF | JPY | Other | Total |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ................ | 326 | 194 | 108 | 29 | 10 | 252 | 919 |
| Bonds and debt instruments ................................ | 8,757 | 14,779 | 1,902 | - | - | 10,206 | 35,644 |
| Shares and equity instruments ............................ | 377 | 261 | 11 | 1 | - | - | 650 |
| Loans to credit institutions ................................... | 5,494 | 18,566 | 817 | 2,967 | 267 | 13,869 | 41,980 |
| Loans to customers ................................................ | 56,060 | 10,813 | 4,661 | 6,486 | 6,834 | 4,665 | 89,519 |
| Investments in associates ..................................... | - | - | - | - | | - | - |
| Other assets ............................................................. | 4,261 | 1,801 | 152 | - | 33 | 66 | 6,313 |
| **Total assets** | 75,275 | 46,414 | 7,651 | 9,483 | 7,144 | 29,058 | 175,025 |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Deposits from credit institutions ......................... | 189 | 504 | - | - | 13 | - | 706 |
| Deposits from customers ...................................... | 38,627 | 28,978 | 5,153 | 1,419 | 876 | 9,483 | 84,536 |
| Debt issued and other borrowed funds .............. | - | - | - | - | - | 8,937 | 8,937 |
| Subordinated loans ................................................ | 21,890 | - | - | - | - | - | 21,890 |
| Other liabilities ....................................................... | 1,911 | 5,839 | 875 | 2 | 33 | 156 | 8,816 |
| **Total liabilities** | 62,617 | 35,321 | 6,028 | 1,421 | 922 | 18,576 | 124,885 |
| | | | | | | | |
| On-balance sheet imbalance ............................... | 12,658 | 11,093 | 1,623 | 8,062 | 6,222 | 10,482 | 50,140 |
| | | | | | | | |
| **Off-balance sheet items** | | | | | | | |
| Off-balance sheet assets ....................................... | 12,838 | 17,024 | 533 | - | 519 | 613 | 31,527 |
| Off-balance sheet liabilities .................................. | 17,022 | 24,558 | 437 | 7,582 | 4,651 | 3,689 | 57,939 |
| Net off-balance sheet items | ( 4,184) | ( 7,534) | 96 | ( 7,582) | ( 4,132) | ( 3,076) | ( 26,412) |
| | | | | | | | |
| Net currency imbalance on 31 December 2013 ........................................... | 8,474 | 3,559 | 1,719 | 480 | 2,090 | 7,406 | 23,728 |

Íslandsbanki hf. Consolidated Financial Statements 2013 67 Amounts are in ISK million

77. Cont'd

### Currency analysis 31 December 2012

| Assets | EUR | USD | GBP | CHF | JPY | Other | Total |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ................ | 355 | 187 | 101 | 30 | 11 | 248 | 932 |
| Bonds and debt instruments ................................ | 15,283 | 10,686 | - | - | - | 1,149 | 27,118 |
| Shares and equity instruments ............................ | 491 | 255 | 16 | 2 | - | - | 764 |
| Loans to credit institutions ................................... | 13,721 | 17,758 | 683 | 2,166 | 2,836 | 9,235 | 46,399 |
| Loans to customers ................................................ | 60,309 | 17,674 | 5,314 | 8,590 | 10,808 | 1,729 | 104,424 |
| Investments in associates ..................................... | 21 | 348 | - | - | - | - | 369 |
| Other assets ............................................................. | 358 | 1,096 | 138 | - | 4 | 30 | 1,626 |
| **Total assets** | 90,538 | 48,004 | 6,252 | 10,788 | 13,659 | 12,391 | 181,632 |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Deposits from credit institutions ......................... | 44 | 5 | - | - | - | - | 49 |
| Deposits from customers ...................................... | 28,752 | 26,484 | 3,960 | 1,025 | 720 | 5,937 | 66,878 |
| Debt issued and other borrowed funds .............. | - | - | - | - | - | 128 | 128 |
| Subordinated loans ................................................ | 23,450 | - | - | - | - | - | 23,450 |
| Other liabilities ....................................................... | 1,521 | 4,088 | 669 | 1 | 16 | 166 | 6,461 |
| **Total liabilities** | 53,767 | 30,577 | 4,629 | 1,026 | 736 | 6,231 | 96,966 |
| | | | | | | | |
| On-balance sheet imbalance ............................... | 36,771 | 17,427 | 1,623 | 9,762 | 12,923 | 6,160 | 84,666 |
| | | | | | | | |
| **Off-balance sheet items** | | | | | | | |
| Off-balance sheet assets ....................................... | 3,862 | 12,786 | 445 | - | 1,800 | 464 | 19,357 |
| Off-balance sheet liabilities .................................. | 24,610 | 26,826 | 722 | 9,818 | 13,394 | 795 | 76,165 |
| Net off-balance sheet items | ( 20,748) | ( 14,040) | ( 277) | ( 9,818) | ( 11,594) | ( 331) | ( 56,808) |
| | | | | | | | |
| Net currency imbalance on 31 December 2012 ........................................... | 16,023 | 3,387 | 1,346 | ( 56) | 1,329 | 5,829 | 27,858 |

Íslandsbanki hf. Consolidated Financial Statements 2013 68 Amounts are in ISK million

78. Sensitivity analysis for currency risk

The table below shows how the currency imbalance is affected by either depreciation or appreciation of each currency assuming other risk factors being held constant. The shift number is the 99% percentile of a 10-day return distribution for each currency for the previous 365 days. The adverse movement of each currency is applied for the impact of the shift and demonstrates how the Bank's equity and income statement would be affected by the shifts.

**Sensitivity analysis for currency risk 31 December 2013**

| Currency (shift) | Shift effect |
|---|---|
| EUR (6%) | ( 508) |
| USD (5%) | ( 178) |
| CHF (5%) | ( 24) |
| GBP (5%) | ( 86) |
| JPY (9%) | ( 188) |
| Other (6%) | ( 444) |
| **Total** | ( 1,428) |

**Sensitivity analysis for currency risk 31 December 2012**

| Currency (shift) | Shift effect |
|---|---|
| EUR (4%) | ( 641) |
| USD (5%) | ( 169) |
| CHF (4%) | ( 2) |
| GBP (4%) | ( 54) |
| JPY (5%) | ( 66) |
| Other (4%) | ( 233) |
| **Total** | ( 1,165) |

## Shares and equity instruments

79. The Bank's equity exposure in the trading book arises from flow trading, mainly in shares denominated in ISK. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the equity risk and concentration risk in the Bank's portfolio. Shares and equity instruments in the banking book are designated at fair value through profit or loss or are classified as held-for-sale.

80. Sensitivity analysis for shares and equity instruments
The following table demonstrates how reasonable shifts in the prices of trading and non-trading equities would affect the Bank's equity and net financial income. Shifts applied for the trading and non-trading portfolios are 20% and 40% respectively.

| Sensitivity analysis for equities | | 31.12.2013 | | 31.12.2012 | |
|---|---|---|---|---|---|
| | | Profit or loss | | | |
| Portfolio (ISK million) | Change in equity prices | Downward shift | Upward shift | Downward shift | Upward shift |
| Trading | 20% | ( 233) | 233 | ( 333) | 333 |
| Non-trading | 40% | ( 2,792) | 2,792 | ( 4,341) | 4,341 |
| **Total** | | ( 3,025) | 3,025 | ( 4,674) | 4,674 |

## Derivatives

81. The Bank uses derivatives to hedge currency risk, interest rate risk in the banking book as well as inflation risk. The Bank carries relatively low indirect exposure due to margin trading with clients and the Bank holds collaterals for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

## Inflation risk

82. The Bank is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 31 December 2013 the CPI gap amounted to ISK 6.4 billion (31 December 2012: ISK 1.3 billion). Thus, a 1% increase in the index would lead to an ISK 64 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

# Notes to the Consolidated Financial Statements

## Capital management

**83.** Risk exposure and capital base

At the end of 2013, the Bank's total capital ratio, calculated according to the Act on Financial Undertakings, was 28.4% and the Tier 1 ratio was 25.1%. As required in the Basel II rules, the Bank's Board of Directors sets a minimum capital target for the Bank. The current minimum capital target approved by the Board is 18% of RWA. The target is based on the Bank's internal capital adequacy assessment (ICAAP) and the views expressed by the regulator through the latest SREP results. The capital target is intended to support the Bank's business strategy and takes into account changes or uncertainties in the operating environment. Unlike the 8% regulatory minimum, the Bank's capital target can change over time reflecting changes in the Bank's risk profile, business strategy and external environment. Thus, falling below the capital target does not impose any direct regulatory actions but the Bank's dividend payments and remuneration can be impacted.

The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach.

The table below shows the capital base, risk weighted assets and capital ratios of the Bank at 31 December 2013 and 31 December 2012.

| | 2013 | 2012 |
|---|---|---|
| **Tier 1 capital** | | |
| Ordinary share capital | 10,000 | 10,000 |
| Share premium | 55,000 | 55,000 |
| Other reserves | 2,471 | 2,834 |
| Retained earnings | 98,548 | 78,571 |
| Non-controlling interests | 1,299 | 1,255 |
| Tax assets | ( 1,275) | ( 864) |
| Intangible assets | ( 299) | ( 261) |
| Other regulatory adjustments | ( 159) | ( 321) |
| **Total Tier 1 capital** | 165,585 | 146,214 |
| **Tier 2 capital** | | |
| Other regulatory adjustments | ( 160) | ( 322) |
| Qualifying subordinated liabilities | 21,890 | 23,450 |
| **Total regulatory capital** | 187,315 | 169,342 |
| **Risk weighted assets** | | |
| - due to credit risk | 551,938 | 549,535 |
| - due to market risk: | 28,849 | 33,940 |
| Market risk, trading book | 5,105 | 6,006 |
| Currency risk FX | 23,744 | 27,934 |
| - due to operational risk | 78,970 | 81,214 |
| **Total risk weighted assets** | 659,757 | 664,689 |
| **Capital ratios** | | |
| Tier 1 ratio | 25.1% | 22.0% |
| Total capital ratio | 28.4% | 25.5% |

Article 86 of the act on Financial Undertakings (161/2002) details the measures taken in the case of insufficient own funds of a financial undertaking. If the board or managing directors of a financial undertaking have reason to expect that its own funds will be less than the minimum required by law, they must immediately notify the Financial Supervisory Authority (FME) thereof. The FME may grant the financial undertaking concerned a time limit of up to six months to increase its own funds to the minimum provided. If the remedies are not satisfactory in the opinion of the FME, or if the time limit provided for expires, the operating licence of the financial undertaking shall be revoked.

Íslandsbanki hf. Consolidated Financial Statements 2013 70 Amounts are in ISK million

## Operational risk

**84.** The Bank has adopted the definition of operational risk from the Directive 2006/48/EC of the European Parliament and of the Council, where operational risk is defined "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". The Bank's definition of operational risk includes legal risk, compliance risk, and reputational risk.

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank and its subsidiaries. The policy outlines a framework for operational risk management in the Bank. The operational risk management framework is described in further detail in several subdocuments, such as the Business Continuity Management Framework, the Security Policy, and the Crisis Communication Policy, all of which are approved by the Executive Board.

According to the Operational Risk Management Policy, the Executive Board is responsible for the operational risk management framework, and the Risk Monitoring Unit within Risk Management is responsible for the implementation of the operational risk framework throughout the Bank.

The Bank uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for Pillar 1 operational risks, in accordance with Rules on the Capital Requirement and Risk Weighted Assets of Financial Undertakings no. 215/2007.

## 85. Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, short positions in listed bonds and derivative financial assets and liabilities.

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell.

## 86. Changes in presentation

The following comparative amounts have been changed due to adjustments between the years:

*a)* The Bank has changed its presentation in the consolidated income statement as follows:
•The line item Loan impairment charges and net valuation changes, previously presented as Net valuation changes on loans and receivable, has been moved down from being below Net interest income to being below the line item Profit before loan impairment charges and net valuation changes. Total operating income changed from 53,359 to 47,649.
•The line item Bank tax has been moved from being below Income tax to being part of Total operating expenses
Comparable figures have been adjusted accordingly.

*b)* Comparable information in Note 12, Net interest income, Note 14, Net financial income, and Note 17, Net foreign exchange (loss) gain, has been changed due to change in methodology. Note 12 from ISK (184) million to ISK 1,521 million for financial assets held for trading, Note 14 from ISK 841 million to ISK (297) million for net gain (loss) on financial instruments held for trading and Note 17 from ISK 967 million to ISK 400 million for financial assets held for trading. This also affects Note 4 Business segment, Note 7 Quarterly statements and Note 15 Net gain (loss) on financial assets and liabilities held for trading.

*c)* Following completion of restructuring of a large portion of the loan portfolio acquired from Glitnir and Byr, the Bank is in the process of changing its presentation of provision for impairment losses for loans and receivables. These are currently divided into three categories, individually assessed, collectively assessed and latent and are presented accordingly in the consolidated financial statements 2013. At year end 2013, the remaining balance of provision for collectively assessed loan portfolios was charged to the income statement in the line item "Loan impairment losses and net valuation changes" leaving the balance at year end as zero as presented in Note 34.

In 2014, the Bank will present provision for impairment losses for loans and receivables under two categories, individually assessed and collectively assessed, where individually assessed provision will comprise impairment for financial assets that are individually significant and collectively assessed provision will comprise estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics.

*d)* Comparable information in Note 77 Currency risk has been changed as the Bank no longer includes adjustment of currency imbalance for loans in foreign currency to customers with revenue and cash flows in ISK in arriving at its net currency imbalance. This is in accordance with changes in the Bank's regulatory reporting.

*e) IFRS 13 Fair Value Measurement*
The Bank has adopted IFRS 13 "Fair Value Measurement" which establishes a single source of guidance for fair value measurements under IFRS and introduces new and enhanced disclosure requirements. Disclosures of fair value measurement is provided in Notes 9-10.

*f) IFRS 7 Financial Instruments: Disclosures, Offsetting Financial Assets and Financial Liabilities*
The Bank has adopted revision to IFRS 7 "Disclosures, Offsetting Financial Assets and Financial Liabilites" requiring extended disclosures of new information in respect of an entity's use of enforcable netting arrangements. Disclosures of Offsetting are provided in Note 11.

# Notes to the Consolidated Financial Statements

## 87. Significant accounting policies

The accounting policies set out below have been applied consistently by all Bank entities to all periods presented in these consolidated financial statements.

Set out below is an index of the significant accounting policies, the details of which are available on the pages that follow.

*Contents* *Page*

87 Cont'd

*1. 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 50% or more of the voting power of the subsidiaries. In assessing control, the Bank takes into consideration any potential voting rights that are currently exercisable or convertible.

In preparing the consolidated financial statements, the parent company combines its financial statements with those of its subsidiaries, line by line by adding together like items of assets, liabilities, equity, income and expenses, and applies the required consolidation procedures. Intra-group balances and transactions, and any unrealised income and expenses arising from intra-bank transactions, are eliminated, except for foreign currency transaction gains or losses. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment. If a Bank entity uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, the Bank makes appropriate adjustments to that entity's financial statements when preparing the consolidated financial statements. The financial statements of subsidiaries are included in the consolidated financial statements of the Bank from the date that control commences until the date that control ceases.

Subsidiaries which the Bank acquires exclusively with a view to resale, often through restructuring or repossession following a customer default, when the Bank expects that their carrying amount to be recovered principally through a sale transaction are classified as Non-current assets and disposal groups held for sale and measured according to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations (see Note 87.14).

Subsidiaries are consolidated even if they are held exclusively with a view to subsequent disposal and classified as held-for-sale. Consolidation requires the application of acquisition accounting (see Note 87.1(b)).

b) *Business combinations*

Acquisitions of subsidiaries and other businesses are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Bank.

The following steps are applied for the acquisition method:
1. Identification of the 'acquirer' – the combining entity that obtains control of the acquiree;
2. Determination of the 'acquisition date' – the date on which the Bank obtains control of the acquiree;
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
4. Recognition and measurement of goodwill or a gain from a bargain purchase.

The Bank measures goodwill at the acquisition date as:
• the fair value of the consideration transferred; plus
• the recognised amount of any non-controlling interests in the acquiree; plus
• if the business combination is achieved in stages, the fair value of the Bank's previously held equity interest in the acquiree, less
• the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.
When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss.

The consideration transferred by the Bank is measured at fair value, which is calculated as the sum of the acquisition date fair values of the assets transferred by the Bank, the liabilities incurred by the Bank to former owners of the acquiree and the equity interests issued by the Bank, if any. The consideration transferred does not include amounts related to the settlement of pre-existing relationships. Such amounts are generally recognised in profit or loss. Where applicable, the consideration transferred includes any asset or liability resulting from a contingent consideration arrangement, measured at its acquisition date fair value. Subsequent changes in the fair value of contingent consideration classified as an asset or liability are accounted for in accordance with relevant IFRSs. Changes in the fair value of contingent consideration classified as equity are not recognised.

Where a business combination is achieved in stages, the Bank's previously held interests in the acquiree are remeasured to fair value at the acquisition date and the resulting gain or loss, if any, is recognised in profit or loss. Amounts arising from interests in the acquiree prior to the acquisition date that have previously been recognised in other comprehensive income are reclassified to profit or loss, where such treatment would be appropriate if that interest were disposed of.

**87 Cont'd**

The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 are recognised at their fair value at the acquisition date, except that:

• Deferred tax assets and liabilities are recognised and measured in accordance with IAS 12 Income Taxes;

• Assets and liabilities related to employee benefit arrangements are recognised and measured in accordance with IAS 19 Employee Benefits;

• Liabilities or equity instruments related to the replacement by the Bank of an acquiree's share-based payment awards are measured in accordance with IFRS 2 Share-based Payment;

• Assets (or disposal groups) that are classified as held for sale at the acquisition date in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations are measured in accordance with that standard.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Bank reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period, or additional assets or liabilities are recognised, to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the amounts recognised as of that date. The measurement period is the period from the date of acquisition to the date the Bank obtains complete information about facts and circumstances that existed as at the acquisition date, subject to a maximum of one year.

Transaction costs, other than those associated with the issue of debt or equity securities, that the Bank incurs in connection with a business combination are expensed as incurred.

c) *Non-controlling interests*

Non-controlling interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Bank. Non-controlling interests are presented separately in the income statement and within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of the Bank.

Non-controlling interests in the net assets consist of the amount of those non-controlling interests at the date of the original combination and the non-controlling interests' share of changes in equity since the date of the combination.

For each business combination, the Bank measures at the acquisition date components of non-controlling interests in the acquiree, that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either:

• fair value; or

• the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

Changes in the Bank's interest in a subsidiary that do not result in loss of control are accounted for as transactions with owners in their capacity as owners. Adjustments to non-controlling interests are based on a proportionate amount of the net assets of the subsidiary. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

d) *Loss of control*

When the Bank is committed to a sale plan involving the loss of control of a subsidiary it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements when the criteria for classification as held for sale are met (see Note 87.14). This is regardless of whether the Bank will retain a non-controlling interest in the subsidiary after the sale.

On the loss of control, the Bank derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item “Net financial income (expenses)”. If the Bank retains any interest in the previous subsidiary, then such interest is measured at fair value at the date that control is lost. Subsequently, that retained interest is accounted for as an equity-accounted investee or in accordance with the Bank´s accounting policy for financial instruments, depending on the level of influence retained.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 87.30), the Bank presents the gain or loss from disposal in the income statement in the line item “Profit (loss) from discontinued operations, net of income tax”.

e) *Funds management*

The Bank manages and administers assets held in unit trusts 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.

87 Cont'd

2 *Foreign currencies*

a) *Foreign currency transactions*

Items included in the financial statements of each of the Bank's entities are measured using the functional currency of the respective entity. Transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into functional currencies at the spot 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 year, adjusted for effective interest and payments during the year, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the year.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the functional currency at the spot exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognised in profit or loss (see Note 87.24).

b) *Foreign operations*

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into the presentation currency, Icelandic krona (ISK), at spot exchange rates at the reporting date. The income and expenses of foreign operations are translated into ISK at rates approximating the spot exchange rates at the dates of the transactions.

Foreign currency differences arising on translation are recognised in other comprehensive income and accumulated directly in the translation reserve in equity. However, if the foreign operation is a non-wholly owned subsidiary, the relevant proportion of the translation difference is allocated to non-controlling interest. When a foreign operation is disposed of in such a way that control is lost, the cumulative amount in the translation reserve related to that foreign operation is reclassified from equity to profit or loss as part of the gain or loss on sale. When the Bank disposes of only part of its interest in a subsidiary that includes a foreign operation while retaining control, the relevant proportion of the cumulative amount is reattributed to non-controlling interests.

3 *Financial assets*

For the purpose of measuring its financial assets, the Bank classifies them at inception in one of the following categories (see also Note 8):

• Loans and receivables; or
• Financial assets at fair value through profit or loss, either as:
  - held for trading; or
  - designated as at fair value through profit or loss.

a) *Loans and receivables*

Loans and receivables 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, other than those that the Bank designates upon initial recognition as financial assets at fair value through profit or loss. Loans and receivables include loans originated by the Bank to its customers and credit institutions, acquired loans, participations in loans from other lenders and finance lease receivables (see Note 87.10 (b)).

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 repurchase transactions), the arrangement is accounted for as a loan or receivable, and the underlying asset is not recognised in the consolidated financial statements of the Bank.

Loans and receivables are recognised when cash is advanced to borrowers. On initial recognition they are measured at fair value plus incremental direct transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the loans and receivables are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment (see Note 87.28). Accrued interest is included in the carrying amount of the loans and receivables in the statement of financial position.

## 87 Cont'd

Gains and losses on loans and receivables are recognised in profit or loss in the line item "Interest income" when the loans and receivables are derecognised and in the line item "Net foreign exchange gain (loss)" when the loans and receivables are re-measured for foreign exchange differences. The losses arising from impairment are recognised in profit or loss in the line item "Loan impairment charges and net valuation changes", except for impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK, which are recognised in profit or loss in the line item "Net foreign exchange gain (loss)" (see Notes 4 (c), 87.27 and 87.24).

A large proportion of the Bank's current loans and receivables were acquired at a deep discount. Credit losses already incurred were reflected in the purchase price and included in the estimated future cash flows when computing the effective interest rates of the loans and receivables. A loan and receivable is defined as having been acquired at a deep discount when the fair value on acquisition is considerably lower than the balance according to the terms of the loan. The difference is explained by severe financial difficulties of the debtor which manifests itself in a higher credit spread when estimating the fair value of the loan and not because of changes in business environment since the terms of the loan were agreed, i.e. market interest rates.

Discounts arising at the initial recognition of the acquired loans and receivables and resulting from the difference between market interest rates and nominal interest rates of the loans and receivables are amortised over the expected life of the financial asset. However, a shorter period is used if this is the period to which the discounts relate.

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

The Bank designates certain financial assets upon their initial recognition as financial assets at fair value through profit or loss when doing so results in more relevant information because:

• 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 from them on different bases; or

• 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; or

• The financial assets and/or financial liabilities contain an embedded derivative that significantly modifies the cash flows that would otherwise have been required under the contract.

Assets classified according to the above-mentioned conditions consist of:

• Fixed interest rate loans originated by the Bank whose fixed interest has been swapped into floating by entering into corresponding interest rate swaps;

• Debt and equity 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.

Financial assets designated by the Bank as at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest earned, which is recognised in the line item "Interest income" on an accrual basis.

*c) Financial assets held for trading*

Financial assets held for trading are financial assets acquired principally for the purpose of selling or repurchasing in the near term, or for holding as part of a portfolio that is managed together for short-term profit or position taking. Financial assets held for trading consist of bonds and debt instruments, shares and equity instruments, and derivatives with positive fair value which are not designated as hedging instruments.

Financial assets held for trading are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest earned, which is recognised in the line item "Interest income" on an accrual basis.

### *4 Financial liabilities*

Except for financial guarantees (see Note 87.15) and loan commitments (see Note 87.16), for the purpose of measuring its financial liabilities, the Bank classifies them in one of the following categories (see also Note 8):

• Financial liabilities held for trading; or

• Financial liabilities measured at amortised cost.

The Bank does not designate financial liabilities as at fair value through profit or loss.

# Notes to the Consolidated Financial Statements

**87 Cont'd**

a) *Financial liabilities held for trading*

Financial liabilities held for trading are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities held for trading consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities held for trading are initially recognised and subsequently measured at fair value in the statement of financial position with transaction costs taken directly to profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis.

b) *Financial liabilities measured at amortised cost*

Financial liabilities measured at amortised cost are non-derivative financial liabilities which are not classified by the Bank as financial liabilities held for trading. Financial liabilities measured at amortised cost include deposits, debt issued and other borrowed funds and subordinated loans.

Financial liabilities measured at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums and fees and costs that are an integral part of the effective interest rate). Accrued interest is included in the carrying amount of the liabilities in the statement of financial position.

## *5 Determination of fair value of financial assets and financial liabilities*

A number of the Bank's accounting policies and disclosures require the determination of fair value for measurement and/or disclosure purposes. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price).

When available, the Bank measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the balance sheet date. For all other financial instruments, the Bank determines fair value using other valuation techniques.

If a market for a financial instrument is not active, the Bank establishes its fair value using a valuation technique. The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Bank entity and the counterparty where appropriate. Periodically, the Bank calibrates the valuation techniques and tests them for validity using prices from observable current market transactions for the same instrument, without modification or repackaging, or based on other available observable market data.

All long and short positions are measured at the latest closing price as obtained from the relevant securities market. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Bank recognises the difference between the transaction price and fair value in profit or loss in the line item Net financial income (expenses) on initial recognition of the financial instrument. In cases where use is made of data which is not from observable markets, the difference between the transaction price and the value produced by the valuation technique, if any, is recognised in profit or loss in the line item Net financial income (expenses), depending upon individual facts and circumstances of each transaction and not later than when the data becomes observable or when the instrument is redeemed, transferred or sold.

a) *Valuation models*

The Bank measures fair values using a fair value hierarchy, which reflects the significance of the inputs used in making the measurements. Further discussion on the fair value hierarchy can be found in Note 9-10.

Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations.

**87 Cont'd**

The Bank uses widely recognised valuation models for determining the fair value of common and more simple financial instruments, such as interest rate and currency swaps that use only observable market data and require little management judgement and estimation. Observable prices or model inputs are usually available in the market for listed debt and equity securities, exchange-traded derivatives and simple over-the-counter derivatives such as interest rate swaps. Availability of observable market prices and model inputs reduces the need for management judgement and estimation and also reduces the uncertainty associated with determining fair values. Availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

For more complex financial 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, in which case the inputs are derived from market prices or rates or estimated based on assumptions. 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, to the extent that the Bank believes a third-party market participant would take them into account in pricing a transaction. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the statement of financial position.

Management judgement and estimation are usually required for selection of the appropriate valuation model to be used, determination of expected future cash flows of the financial instrument being valued, determination of the probability of counterparty default and prepayments and selection of appropriate discount rates.

Fair value estimates obtained from models are adjusted for any other factors, such as liquidity risk or model uncertainties, to the extent that the Bank believes that a third party market participant would take them into account in pricing a transaction. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Bank and the counterparty where appropriate. For measuring derivatives that might change classification from being an asset to a liability or vice versa such as interest rate swaps, fair values take into account both credit valuation adjustment (CVA) and debit valuation adjustment (DVA) when market participants take this into consideration in pricing the derivatives.

Model inputs and values are calibrated against historical data and published forecasts and, where possible, against current or recent observed transactions in different instruments and against broker quotes. This calibration process is inherently subjective and it yields ranges of possible inputs and estimates of fair value, and management judgement is required to select the most appropriate point in the range.

*b) Valuation framework*

The Bank has an established control framework with respect to the measurement of fair values. This framework includes the Bank's market risk function, which is independent of front office management and reports to the Chief Risk Officer, and which has overall responsibility for independently verifying the results of trading and investment operations and all significant fair value measurements. Specific controls include, model validation and review of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's investment committee.

## *6 Recognition and derecognition of financial assets and financial liabilities*

The Bank uses trade date accounting to recognise purchases and sales of financial assets, 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 on the date when cash is advanced by the Bank to the borrowers. For a financial asset purchased, the Bank recognises on the trade date a financial asset to be received and a financial liability to pay. For a financial asset sold, the Bank derecognises the asset on the trade date, recognises any gains or losses on disposal and recognises a receivable from the buyer.

The Bank recognises financial liabilities held for trading on the trade date, i.e. on the date at which the Bank becomes a party to the contractual provisions of the financial instrument. The Bank recognises financial liabilities measured at amortised cost on the date when they originated. The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

The Bank derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Bank transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Bank transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Bank neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

87 Cont'd

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Bank is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

The Bank enters into transactions whereby it transfers assets recognised in its statement of financial position, but retains either all or substantially all risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognised from the statement of financial position of the Bank. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Bank does not derecognise from its statement of financial position securities which the Bank sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Bank recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Bank neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Bank continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Bank derecognising the original financial assets and recognising new financial assets at fair value. (See also Note 87.28(a)) with respect to renegotiated loans.

7 *Offsetting financial assets and financial liabilities*

Financial assets and liabilities are offset and the net amount presented in theconsolidated statement of financial position when, and only when, the Bank has a legal right to set off the amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

8 *Derivative financial instruments*

Derivatives entered into by the Bank may be in the form of stand-alone contracts or embedded in other contracts, in which case the Bank assesses whether it is required to separate and account for the embedded derivatives as if they were stand-alone contracts. That would be the case when the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host contracts; stand-alone contracts with the same terms as the embedded derivatives would meet the definition of a derivative for accounting purposes; and the combined contracts are not classified by the Bank as financial assets or financial liabilities held for trading or designated by the Bank as at fair value through profit or loss.

Derivatives which do not classify as equity instruments of the Bank are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities). When the Bank is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Bank presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Bank presents the related host contracts.

The Bank did not apply hedge accounting during the year ended 31 December 2013, nor during the comparative period. Accordingly, the Bank accounted for all its derivative financial assets and liabilities as financial assets or financial liabilities held for trading in accordance with Notes 87.3(b) and 87.4(a).

9 *Investments in associates*

Associates are those entities over which the Bank has significant influence, which is the power to participate in the financial and operating policy decisions of the entity but is 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 that are currently exercisable or convertible, if any.

87 Cont'd

Investments in associates are accounted for using the equity method and are initially recognised at cost. The investments include goodwill identified on acquisition. The carrying amount of the investments is adjusted for post-acquisition changes in the Bank's share of net assets of the associates and for impairment losses, if any (see Note 87.28(b)). Therefore, the consolidated financial statements include the Bank's share of the total recognised gains and losses of associates, 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 the associate, the carrying amount of that associate 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 Bank resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

Investments in associates which are classified as held for sale are not accounted for using the equity method but in accordance with the accounting policy disclosed in Note 87.14.

### *10 Leases*

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

a) *Bank as a lessee*

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.

b) *Bank as a lessor*

When the Bank is the lessor in a finance lease, the Bank recognises a finance lease receivable equal to the net investment in the lease and presents it in the line item “Loans to customers” in the statement of financial position. The Bank applies its accounting policies for derecognition and impairment of loans and receivables also to its finance lease receivables. The Bank recognises the finance income from finance lease receivables in profit or loss in the line item “Interest revenue” over the period of the lease so as to give a constant periodic rate of return on the net investment in the lease.

When the Bank is lessor in arrangements which involve the legal form of leases, but which in substance do not involve leases, the Bank does not apply lease accounting to those arrangements and instead the Bank accounts for them as loans and receivables.

### *11 Investment property*

When the Bank holds certain properties, i.e. land or a building or part of a building or both, to earn rental income or for capital appreciation or both, the property is classified as an investment property and is measured initially at cost, including transaction costs. Subsequently, investment property is measured at fair value, which reflects market conditions at the reporting date. Changes in the fair values are included in the income statement in the line item "Other net operating income". The Bank did not hold any investment properties during the year ended 31 December 2013, nor during the comparative period.

Properties that are leased to its parent or another subsidiary do not qualify as investment property in consolidated financial statements, because the property is owner-occupied from the perspective of the group although from the perspective of the entity that owns it, the property is treated as an investment property in the lessor's individual financial statements.

When the Bank takes possession of a property that was originally pledged as security in full and final settlement of a mortgage loan, the property is classified based on its intended use. When the property is acquired exclusively with a view to subsequent disposal in the near future it is measured at the lower of cost or net realisable value.

### *12 Property and equipment*

a) *Recognition and measurement*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses.

Where parts of an item of property and equipment have different useful lives, those components are accounted for as separate items of property and equipment.

**87 Cont'd**

*b) Subsequent costs*

The Bank recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Bank and the cost of the item can be measured reliably. The decision if subsequent costs are added to the acquisition cost of the property or equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are recognised in profit or loss as incurred.

*c) Depreciation*

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. Each part of a depreciable item of property and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The depreciable amount of each significant item of property and equipment is determined after deducting its residual value. Depreciation is expensed in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives for the current and comparative periods of significant items of property and equipment are as follows:

| | |
|---|---|
| Buildings | 50 years |
| Fixtures | 6 - 12 years |
| Equipment | 4 years |
| Vehicles | 3 years |

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

## *13 Intangible assets*

*a) Goodwill*

The Bank recognises goodwill as an asset only when it results from a business combination. Goodwill relating to acquisition of associates is not recognised separately as an asset but it is included in the carrying amount of investments in associates in the statement of financial position. For the measurement of goodwill at initial recognition, (see Note 87.1(b)).

Goodwill is allocated from the acquisition date to cash-generating units (CGUs) and it is subsequently measured at cost less accumulated impairment losses. Goodwill is tested by the Bank for impairment annually or whenever there is an indication that the CGUs may be impaired.

*b) Software*

Software acquired by the Bank is measured at cost less accumulated amortisation and impairment losses.

Expenditure on internally developed software is recognised as an asset when the Bank is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and impairment.

Subsequent expenditure on software 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.

Software is amortised on a straight-line basis in profit or loss over its estimated useful live, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is four years.

## *14 Non-current assets and disposal groups held for sale*

Non-current assets and disposal groups (comprising groups of assets and liabilities associated with those assets, including non-current assets) are classified as held for sale and presented in separate line items on the face of the statement of financial position if the Bank expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable.

Immediately before classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable IFRSs. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets and investment properties, which are measured in accordance with the accounting policies of the Bank applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment is no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Bank applicable to those liabilities.

87 Cont'd

Non-current assets and the assets and liabilities of a disposal group classified as held-for-sale are presented separately from other assets and liabilities in the statement of financial position. Non-controlling interests in a disposal group classified as held-for-sale are presented within equity consistent with the requirements of IAS27 and are not reclassified as a liability.

Any impairment loss on a disposal group is allocated first to any goodwill included in the disposal group, and then to the remaining assets and liabilities on a pro rata basis, except for that no loss is allocated to inventories, financial assets, deferred tax assets and investment property.

Impairment losses on initial classification of non-current assets and disposal groups as held for sale and subsequent gains and losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

Income earned and expenses incurred on assets and disposal groups held for sale continue to be recognised in the appropriate line items in profit or loss until the transaction is complete. However, income and expenses on assets and liabilities of subsidiaries acquired by the Bank exclusively with a view to resale are recognised in profit or loss in the line item “Profit (loss) from discontinued operations, net of income tax” (see Note 87.30).

### *15 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 payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Bank to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities. Liabilities arising from financial guarantees issued by the Bank are initially measured at their fair value, being the premium received, and the initial fair value is amortised on a straight line basis over the life of the guarantee. The liabilities are subsequently carried at the higher of the unamortised premium and the best estimate of the expenditure required to settle the liability when a payment under the contracts has become probable. The estimates are determined based on experience of similar transactions and history of past losses, supplemented by a judgement by the management.

Any increase in the liabilities arising from financial guarantees is recognised in profit or loss. The premium received is recognised as revenue in profit or loss in the line item "Fee and commission income".

### *16 Loan commitments*

Loan commitments are firm commitments of the Bank to provide credit under pre-specified terms and conditions. All loan commitments issued by the Bank are outside the scope of IAS 39. As such, the Bank recognises a provision for loan commitments in the statement of financial position, in the line item “Other liabilities”, only when the Bank is committed to making a loan that would be considered to be impaired or when the commitment becomes onerous. The related expense is then recognised in profit or loss. Loan commitment fees received by the Bank are recognised in accordance with the accounting policy disclosed in Note 87.22.

### *17 Provisions*

Provisions are recognised when the Bank has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Bank will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the balance sheet date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that the reimbursement will be received and the amount of the receivable can be measured reliably.

The Bank recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

87 Cont'd

## 18 *Employee benefits*

All Bank entities are required to pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Bank has no further payment obligations once these contributions have been paid by the Bank. The Bank recognises these contributions as salary related expenses when they become due. The Bank does not have a defined benefit pension plan.

Termination benefits are recognised by the Bank as a salary expense when the Bank is demonstrably committed, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognised as an expense if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

Short-term employee benefits include salaries, short-term cash bonuses, social security contributions, short-term compensated absences and non-monetary benefits for current employees. Short-term employee benefit obligations are expensed by the Bank as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Bank has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

## 19 *Share capital*

a) *Share capital*

The share capital disclosed in the consolidated financial statement represents the total nominal value of ordinary shares issued by the parent company and outstanding at the reporting date. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

b) *Dividends on shares*

Dividends payable to shareholders of the parent company are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders in the parent company's annual general meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

## 20 *Cash and cash equivalents*

Cash and cash equivalents in the consolidated statement of cash flows consist of cash on hand, treasury bills, demand deposits with the Central Bank and with other credit institutions, short-term loans to credit institutions and other liquid debt securities at floating interest rates. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, that are subject to an insignificant risk of changes in their fair value and which are used by the Bank in the management of its short-term cash commitments.

## 21 *Interest income and expense*

For all financial assets and financial liabilities measured at amortised cost interest income and expense is recognised in profit or loss using the effective interest method. For all financial assets and financial liabilities held for trading and for all financial assets designated at fair value through profit or loss, interest income and expense is recognised through profit or loss on an accrual basis.

The effective interest 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 a shorter period, when appropriate, 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.

87 Cont'd

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or expense. For floating rate instruments, interest income or expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate. Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

Interest income and expense include gains and losses on derecognition of loans and receivables and financial liabilities measured at amortised cost.

## *22 Net fee and commission income*

Net fee and commission income comprises fees and commission income and expenses. Fees and commissions are generally recognised on an accrual basis when the service has been provided.

Fees and commission income and expense that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised in profit or loss on a straight-line basis over the commitment period.

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Bank has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses, are recognised on completion of the underlying transaction.
Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria is fulfilled.

## *23 Net financial income (expenses)*

Net financial income (expenses) consist of net gains on financial assets and liabilities held for trading, net gain on financial assets designated at fair value through profit or loss and net gain on loss of control over subsidiaries.

a) *Net gain (loss) on financial assets and liabilities held for trading*

Net gain (loss) on financial assets and liabilities held for trading includes all realised and unrealised fair value changes of financial assets and liabilities classified by the Bank as held for trading, except for interest income and interest expense (which are included in the line items “Interest income” and “Interest expense”, (see Note 87.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, (see Note 87.24). Dividend income from financial assets held for trading is recognised in profit or loss when the Bank's right to receive payment is established.

Changes in fair value of derivatives that are classified as held for trading but which are economic hedges of financial assets designated at fair value through profit or loss are presented in the notes to the consolidated financial statements as an offset to net gains on financial assets designated at fair value through profit or loss (see Note 16).

b) *Net gain (loss) on financial assets designated at fair value through profit or loss*

Net gain (loss) on financial assets designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets designated by the Bank as at fair value through profit or loss, except for interest income and interest expense (which are included in the line items “Interest income” and “Interest expense”, see Note 87.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, see Note 87.24 ). Dividend income from financial assets designated at fair value through profit or loss is recognised in profit or loss when the Bank's right to receive payment is established.

87 Cont'd

Net gain on financial assets designated at fair value through profit or loss also include changes in fair value of derivatives that are classified by the Bank as held for trading but which are economic hedges of financial assets designated by the Bank as at fair value through profit or loss.

### 24 *Net foreign exchange gain (loss)*

Net foreign exchange gain (loss) disclosed as a separate line item in the income statement comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in previous financial statements.

Net foreign exchange gain (loss) also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured by the Bank at fair value in foreign currencies and whose other gains and losses are also recognised in profit or loss.

On the face of the income statement, net foreign exchange gain (loss) is offset by impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK, as the Bank does not expect to recover the foreign exchange gain on these loans.

### 25 *Administrative expenses*

Administrative expenses consist of salaries and related expenses, depreciation of property and equipment, amortisation of intangible assets and other administrative expenses, such as housing costs, advertising expenses and IT-related expenses.

### 26 *Bank tax*

Bank tax is a tax on credit institutions whose stated purpose is to create revenue for the Icelandic government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, the tax is intended as a deterrent to increased risk appetite. Following the Icelandic governments debt relief initiatives introduced last autumn, the bank tax will increase from 0.1285% to 0.376% from the beginning of 2013, calculated from total liabilities in excess of ISK 50bn. The Bank tax is shown in a separate line in the income statement.

### 27 *Loan impairment charges and net valuation changes*

Loan impairment charges and net valuation changes is the net amount recognised in profit or loss following a revision of estimates of receipts from loans and receivables. It is made up of income due to revision of estimated future cash flows and expenses due to individually and collectively assessed impairment losses on loans and receivables (see Note 87.28), but excludes impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK (see Notes 4 (c) and 87.24).

a) *Revised estimated future cash flows*

At each reporting date, the Bank assesses the current status of loans and advances and whether there is any objective evidence of changes in expected cash flows, for example due to differences in estimated and actual payments, changes in the value of collaterals and improvement in the financial situation of debtors. 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 or acquired, the previously recognised impairment loss is reversed. The amount of any reversal is recognised in profit or loss in the line item “Net valuation changes on loans and receivables”.

The Bank acquired part of the loans and advances at a deep discount that reflects incurred credit losses. The Bank includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Bank revises its estimate of payments or receipts, the Bank adjusts the carrying amount of the loans and advances, to reflect actual and revised estimated cash flows. If there is any change in expected cash flows, the Bank recalculates the carrying amount of these loans and advances as the present value of the revised estimated future cash flows, using their effective interest rate method. The difference between the revised carrying amount of the loans and their current carrying amount, which includes accrued interest, indexation, foreign exchange differences and actual payments received by the Bank, is recognised in profit or loss in the line item “Net valuation changes on loans and receivables”.

The Bank recognises interest and indexation on these loans and advances based on their carrying amount and only to the extent that the interest and indexation are deemed to be collectible. The interest and indexation are recognised in profit or loss in the line item "Interest income".

# Notes to the Consolidated Financial Statements

87 **Cont'd**

b) *Provision for latent impairment*

Provision for latent impairment losses reflects estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics. In 2014, the Bank will no longer use the term Provision for latent impairment losses but will present provision for impairment losses for loans and receivables under two categories, individually assessed and collectively assessed, where collectively assessed provision will comprise estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics.

## *28 Impairment*

The carrying amounts of the Bank's assets, other than tax assets and financial assets measured at fair value with changes recognised through profit or loss, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised in profit or loss whenever the carrying amount of a tangible or intangible asset or of a cash-generating unit exceeds its recoverable amount.

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

*a) Impairment of loans and receivables*

If there is objective evidence that an impairment loss has been incurred on loans and receivables, their carrying amount is reduced through the use of an allowance account to the present value of expected future cash flows, discounted at their original effective interest rate.

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:
• Delinquency in contractual payments of principal or interest;
• Cash flow difficulties experienced by the borrower (for example, equity ratio, net income, percentage of sales);
• Breach of loan covenants or conditions;
• Initiation of bankruptcy proceedings;
• Deterioration of the customer's competitive position;
• Deterioration in the value of collateral;
• Downgrading of an asset;
• Restructuring and forbearance.

The Bank's management first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Loans and receivables that are not impaired individually become a part of a portfolio which is assessed for impairment. Collective assessment based on a portfolio assumes that loans and receivables have similar credit risk characteristics. Objective evidence of impairment of a group of loans and receivables exists if objective data indicates a decrease in expected future cash flows from a portfolio of loans and the decrease can be measured reliably but cannot be identified with the individual loans in the portfolio.

Interest income on impaired loans and receivables is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring impairment losses.

*Calculation of recoverable amount*

The recoverable amount of the Bank's loans and receivables is calculated as the present value of estimated future cash flows. The discount rate used for fixed rate loans and receivables is the effective interest rate computed at initial recognition. For variable rate loans and receivables the discount rate is the current effective interest rate.

The recoverable amount of other assets or cash generating units (CGUs) is the greater of their value in use and 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 or CGU. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the CGU to which the asset belongs.

*Loan write-offs:*

When a loan is uncollectible, it is written-off against the related allowance for impairment. Such loans are written-off after all the necessary procedures have been completed and the amount of the loss has been determined.

87 Cont'd

*Reversals of impairment*

An impairment loss in respect of loans and receivables is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

When loans and receivables are acquired at a deep discount, credit losses have already occurred and are reflected in the purchase price. Such incurred credit losses are included in the estimated cash flows when computing the effective interest rate. Any adjustments arising from revisions to estimated cash flows subsequent to initial recognition are recognised as part of the carrying amount of the loans and receivables with a corresponding amount recognised in profit or loss under the line item “Loan impairment charges and net valuation changes”. Upwards changes in estimated future cash flows are first recognised as a reversal of previously recognised impairment losses. The remaining balance is recognised in profit or loss as income from revised estimated future cash flows from loans. Downwards revisions to estimated future cash flows are recognised in profit or loss.

An impairment loss in respect of goodwill is never reversed.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. 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.

*Renegotiated loans*

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment.

If the terms of a financial asset are renegotiated or modified or an existing financial asset is replaced with a new one due to financial difficulties of the customer then an assessment is made whether the financial asset should be derecognised. If the cash flows of the renegotiated asset are substantially different, then the contractual rights to the cash flows from the original financial asset are deemed to have expired. In this case the original financial asset is derecognised and the new financial asset is recognised at fair value. The impairment loss is measured as follows:

- If the expected restructuring does not result in derecognition of the existing asset, the estimated cash flows arising from the modified financial asset are included in the measurement of the existing asset based on their expected timing and amounts discounted at the original effective interest rate of the existing financial asset.
- If the expected restructuring results in derecognition of the existing asset, then the expected fair value of the new asset is treated as the final cash flow from the existing financial asset at the time of derecognition. This amount is discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset.

b) *Impairment of associates*

Whenever there is an objective evidence that an investment in associates may be impaired, the entire carrying amount of the investment is tested for impairment by comparing its recoverable amount with its carrying amount, goodwill included in the carrying amount of an investment in an associate is not recognised separately and is therefore not tested separately for impairment according to the requirements for impairment testing of goodwill

c) *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. For goodwill and intangible assets that have indefinite useful lives or that are not yet available for use, the recoverable amount is estimated each year at the same time. An impairment loss is recognised if the carrying amount of an asset or cash-generating unit (CGU) exceeds its estimated recoverable amount. Impairment losses on goodwill are recognised in profit or loss under the line item “Impairment of goodwill”.

# Notes to the Consolidated Financial Statements

87 Cont'd

*29 Income tax*

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations, excluding the Bank's share of income tax of the Bank's equity-accounted associates. Income tax from discontinued operations is included in the line item "Profit (loss) from discontinued operations, net of income tax" in the income statement (see Note 87.30).

Income tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the Bank recognises it in other comprehensive income or directly in equity, consistent with the recognition of the underlying item to which it relates.

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.

Deferred tax is calculated based on temporary differences between the carrying amounts of assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration any tax loss carry forwards. 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 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. A deferred tax asset is reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantially enacted at the reporting date.

Tax assets and tax liabilities are presented separately from other assets and liabilities in the statement of financial position, whereby current tax liabilities are distinguished from deferred tax assets and deferred tax liabilities. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 87.14) are included in the line items "Non-current assets and disposal groups held for sale" and „Non-current liabilities and disposal groups held for sale", respectively, in the statement of financial position.

Current tax assets and current tax liabilities are offset in the statement of financial position if the Bank has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset in the statement of financial position if the Bank has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

*30 Discontinued operations*

The Bank presents in a separate line in the income statement the profit or loss from discontinued operations, net of income tax. Discontinued operations consist of subsidiaries acquired by the Bank exclusively with a view to resale that meet the criteria to be classified as held for sale (see Note 87.14) from acquisition date.

The profit or loss from discontinued operations consists of (a) the post-tax profit or loss of the subsidiaries acquired by the Bank exclusively with a view to resale, (b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell and on the disposal of the subsidiaries acquired by the Bank exclusively with a view to resale and (c) the post-tax profit or loss from the sale of foreclosed assets held for sale.

*31 Offsetting income and expenses*

The Bank presents income and expenses on a net basis in the income statement only when required or permitted under IFRSs.

# Notes to the Consolidated Financial Statements

87 Cont'd

### 32 *Earnings per share*

The Bank presents basic and diluted earnings per share (EPS) for its ordinary shares. Basic EPS are calculated by dividing the profit or loss attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period. Diluted EPS are determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

### 33 *Segment reporting*

A business segment is a component of the Bank that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Bank's other components. Each business segment is engaged in providing products or services which are subject to risk and return that are different from those of other business segments, and which are subject to regular review by the Bank's Board of Directors and Chief Executive Officer for the purpose of allocating resources and assessing performance.

### 34 *Initial application of new standards and amendments to standards which had an effect on the consolidated financial statements of the Bank*

The initial application of the following new standards and amendments to standards which became effective for the Bank on 1 January 2013 affected the consolidated financial statements of the Bank as follows:

*a)* IFRS 13 Fair value measurement changed the definition of fair value, established a single comprehensive framework for measuring fair value and requires more extensive disclosures with respect to fair value measurements. In accordance with the transitional provisions of IFRS 13, the Bank has applied IFRS 13 prospectively from 1 January 2013. The initial adoption of IFRS 13 did not have a material impact on the fair value measurements of the Bank's assets and liabilities but has resulted in new disclosures provided by the Bank in its consolidated financial statements, mainly in Notes 9 and 10. The Bank has disclosed comparative information in respect of fair value measurements only to the extent that such disclosures were required by other standards in the consolidated financial statements of the Bank for the year 2012, in which case the Bank has provided the relevant comparative disclosures under those standards.

*b)* Amendments to IFRS 7 – Offsetting Financial Assets and Financial Liabilities added new requirements for disclosure of information that would enable users of financial statements to evaluate the effect or potential effect on an entity's financial position resulting from netting arrangements, including rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities. The initial adoption of these amendments has resulted in new disclosures provided by the Bank in its consolidated financial statements, (see Note 11).

### 35 *New standards and amendments to standards which became effective for the Bank on 1 January 2013 but had no effect on the consolidated financial statements of the Bank*

The following new standards and amendments to standards which became effective on 1 January 2013 had no effect on the consolidated financial statements of the Bank:

*a)* Amendments to IAS 1 – Presentation of Items of Other Comprehensive Income;

*b)* IAS 19 Employee Benefits (as amended in 2011);

*c)* Annual Improvements to IFRSs (issued in May 2012).

### 36 New standards and amendments to standards adopted in advance by the Bank

The Bank did not early adopt any standards or amendments to standards which become effective after 1 January 2013.

## 37 *New standards and amendments to standards which become effective for the Bank for annual periods beginning on or after 1 January 2014 and which have not been adopted in advance by the Bank*

The following new standards and amendments to standards become effective for annual periods beginning on or after 1 January 2014 and have not been early adopted by the Bank:

*a)* IFRS 10 Consolidated Financial Statements, which supersedes the requirements in IAS 27 Consolidated and Separate Financial Statements (as amended in 2008) relating to consolidated financial statements and SIC-12 Consolidation – Special Purpose Entities. IFRS 10 includes a revised definition of control that contains three elements: (a) power over an investee, (b) exposure, or rights, to variable returns from its involvement with the investee, and (c) the ability to use its power over the investee to affect the amount of the investor's returns. Extensive application guidance has been included in IFRS 10 to deal with complex circumstances, including guidance on how to determine when an investor holding less than a majority of the voting rights has de facto power over an investee. IFRS 10 carries forward the consolidation procedures from IAS 27 (2008). However, IFRS 10 requires parent companies which are investment entities to measure investments in particular subsidiaries at fair value through profit or loss instead of consolidating those subsidiaries. IFRS 10 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank does not expect the initial application of IFRS 10 to have a material impact on its consolidated financial statements.

*b)* IFRS 11 Joint Arrangements, which supersedes IAS 31 Interests in Joint Ventures and establishes principles for financial reporting by all entities that have interests in arrangements that are controlled jointly. Under IFRS 11, joint arrangements must be classified and accounted for either as joint operations or joint ventures. In contrast, under IAS 31, there are three types of joint arrangements: jointly controlled entities, jointly controlled assets and jointly controlled operations. In addition, joint ventures under IFRS 11 are required to be accounted for using the equity method of accounting, whereas jointly controlled entities under IAS 31 can be accounted for using either the equity method of accounting or proportionate accounting. Under IFRS 11, joint arrangements are classified depending on the rights and obligations of the parties to the arrangements. Joint operations arise where a joint operator has rights to the assets and obligations relating to the arrangement and hence accounts for its interest in assets, liabilities, revenue and expenses. Joint ventures arise where the joint operator has rights to the net assets of the arrangement and hence equity accounts for its interest. IFRS 11 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank does not expect the initial application of IFRS 11 to have a material impact on its consolidated financial statements.

*c)* IFRS 12 Disclosure of Interests in Other Entities, which includes all the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. In general, the disclosure requirements in IFRS 12 are more extensive than those in the currently effective standards. The disclosures required by IFRS 12 must enable users of an entity's financial statements to evaluate (a) the nature of, and risks associated with, the entity's interests in other entities; and (b) the effects of those interests on the entity's financial position, financial performance and cash flows. IFRS 12 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank expects the initial application of IFRS 12 to result in the Bank having to provide more disclosures in its consolidated financial statements.

*d)* IAS 28 Investments in Associates and Joint Ventures (as amended in 2011), which supersedes IAS 28 Investments in Associates (as revised in 2003) and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. The majority of the amendments made to IAS 28 in 2011 result from the incorporation of the requirements for joint ventures into the standard. The fundamental approach to accounting for equity-accounted investments has not been changed. Accordingly, IAS 28 (2011) requires an entity with significant influence over, or joint control of, an investee to account for the investment in the associate or joint venture using the equity method, except when the investment qualifies for certain exemptions. IAS 28 (2011) clarifies that either the entire investment in an associate or a portion of it may be measured by the investor at fair value through profit or loss in accordance with IAS 39 Financial Instruments: Recognition and Measurement (or IFRS 9 Financial Instruments if adopted) if certain criteria are met. IAS 28 (2011) contains more specific provisions with respect to investments in associates and joint ventures which meet the criteria to be classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. IAS 28 (2011) will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not expect the initial application of IAS 28 (2011) to have a material impact on its consolidated financial statements.

87 **Cont'd**

*e)* IFRIC 21 Levies, which provides guidance on when to recognise in financial statements liabilities to pay levies imposed by governments, other than income taxes. IFRIC 21 clarifies that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the relevant legislation. As such, a liability to pay a levy must be recognised progressively if the obligating event occurs over a period of time. However, if the obligating event is the reaching of a minimum activity threshold then the corresponding liability must be recognised when that minimum activity threshold is reached. IFRIC 21 clarifies that an entity does not have a present obligation to pay a levy that will be triggered by the entity operating in a future period. If endorsed by the EU, IFRIC 21 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not expect the initial application of IFRIC 21 to have a material impact on its consolidated financial statements.

*f)* Amendments to IAS 32 – Offsetting Financial Assets and Financial Liabilities, which clarify that an entity currently has a legally enforceable right to set-off if that right is (a) not contingent on a future event; and (b) enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all counterparties. The amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not expect the initial application of the amendments to have a material impact on its consolidated financial statements.

*g)* Amendments to IAS 36 – Recoverable Amount Disclosures for Non-Financial Assets, which address the disclosure of information about the recoverable amount of impaired assets if that amount is based on fair value less costs of disposal. The amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not expect the initial application of the amendments to have a material impact on its consolidated financial statements.

*h)* Amendments to IAS 39 – Novation of Derivatives and Continuation of Hedge Accounting, which provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria. The amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not expect the initial application of the amendments to have an impact on its consolidated financial statements as the Bank does not apply hedge accounting.

*i)* Amendments to IAS 19 - Defined Benefit Plans: Employee Contributions, which address contributions from employees or third parties to defined benefit plans. The objective of the amendments is to simplify the accounting for contributions that are independent of the number of years of employee service, for example, employee contributions that are calculated according to a fixed percentage of salary. If endorsed by the EU, the amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2015, with retrospective application required. The Bank does not expect the initial application of the amendments to have an impact on its consolidated financial statements as the Bank does not have any post-employment defined benefit plans for its employees.

*j)* Annual Improvements to IFRSs (2010-2012 and 2011-2013 cycles), which consist of various non-urgent but necessary amendments to nine international financial reporting standards. If endorsed by the EU, the amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2015, with prospective application generally required. The Bank does not expect the initial application of the amendments to have a material impact on its consolidated financial statements.

*k)* IFRS 9 Financial Instruments replaces those parts of IAS 39 Financial Instruments: Recognition and Measurement relating to the classification and measurement of financial assets and financial liabilities and to hedge accounting. The key features of IFRS 9 are the following:

• Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.

• An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest. All other debt instruments are to be measured at fair value through profit or loss.

• All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There will be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

87 **Cont'd**

• Derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not to be separated; instead the hybrid financial instrument is to be assessed in its entirety as to whether it should be measured at amortised cost or fair value.

• In general, the amount of change in fair value attributable to changes in the credit risk of liabilities designated by an entity as at fair value through profit or loss must be presented in other comprehensive income, with only the remaining amount of the total gain or loss being included in profit or loss. The amounts presented in other comprehensive income may not be subsequently reclassified to profit or loss but may be transferred within equity. However, if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, then the whole fair value change must be presented in profit or loss. Additionally, all fair value gains and losses continue to be included in profit or loss for loan commitments and financial guarantee contracts designated as fair value through profit or loss.

• Hedge accounting rules are more closely aligned with risk management, which enables entities to better reflect their risk management activities in the financial statements. As a result, users of financial statements are provided with better information about risk management and about the effect of hedge accounting on the financial statements. The rules in IFRS 9 establish a more principle-based approach to hedge accounting and address inconsistencies and weaknesses in the hedge accounting rules in IAS 39. However, IFRS 9 allows entities to apply the hedge accounting rules in IAS 39 instead of those in IFRS 9.

The International Accounting Standards Board (IASB) decided to remove 1 January 2015 as the mandatory effective date of IFRS 9 and tentatively decided that it would be no earlier than 1 January 2017. However, the Bank will be allowed to adopt IFRS 9 entirely or partially, in accordance with the various options currently available in the standard, only if EU will endorse the standard in the future. Upon initial application of IFRS 9 the Bank would have a choice as to whether it restates prior periods or not and it would need to provide certain disclosures about the transition from IAS 39 to IFRS 9. The Bank does not plan to early adopt IFRS 9 and it is currently in the process of evaluating the potential effect of the standard on its consolidated financial statements. Given the nature of the Bank's operations, if endorsed by the EU, the standard is expected to have a pervasive impact on the consolidated financial statements of the Bank in the period of initial application.

# Appendix unaudited: Corporate Governance Statement

**The Board of Directors of Íslandsbanki is committed to leadership in governance complying with the applicable regulatory standards and international best practice in the field of corporate governance.**

Íslandsbanki's governance practises are consistent with general corporate governance guidelines for entities regulated by official supervisors and regulatory instruments. The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable law and regulations, including those imposed by the FME and the NASDAQ OMX Nordic Exchange in Iceland, available at their websites.[1] The applicable law includes, inter alia, the Act on Financial Undertakings No. 161/2002 and the Act on Securities Transactions 108/2007, the Act on Competition No. 44/2005 and the Act on Public Limited Companies No. 2/1995, which along with the Íslandsbanki's Articles of Association lay the foundation for the Bank's existence and activities. The relevant law is available on the Icelandic legislature's website.[2]

## Recognition as Exemplary in Corporate Governance

Íslandsbanki is committed to maintaining high standards of governance complying with best governance practices that are in the interest of the organisation. To this end Íslandsbanki engaged an independent party to review the Banks' corporate governance practices. Subsequently, a formal review was undertaken by the Centre of Corporate Governance, at the Institute for Business Research at the University of Iceland (hereinafter CGC) including a comprehensive review of the practices of the Board, Board subcommittees and management. Following CGC's review Íslandsbanki was recognized as "*Exemplary in Corporate Governance*" in February 2014.

## Compliance to Guidelines on Corporate Governance

In accordance with Paragraph 3 of Article 19 of the Act on Financial Undertakings No. 161/2002, the Bank is required to observe accepted guidelines on the governance of financial undertakings. The Board of Directors (the Board) follows the Corporate Governance guidelines issued in March 2012 (4th ed.) by the Iceland Chamber of Commerce, NASDAQ OMX Iceland and Confederation of Icelandic Employers (hereinafter the Guidelines). The Guidelines are available on the website of Icelandic Chamber of Commerce.[3]

Governance practices of the Bank are consistent with the Guidelines. Íslandsbanki complies with the Guidelines in all respects except for certain items in Articles 1.2., 2.5., 2.10., 5.1., 5.C.3. and 6.2 of the Guidelines. The following discussion explains the reasons behind these exceptions as well as measures taken in relation to them:

In accordance with Article 1.2. of the Guidelines the Chairman of the Board and a required majority of the Board should preferably be present at a shareholders' meeting, together with the CEO. According to the said Article it is also preferable that auditors and not less than one member of the Bank's subcommittees be present, when appropriate. Íslandsbanki has followed this in detail in regards to the Annual General Meeting (AGM), but not in other shareholders' meetings because the bank has not considered it necessary since there are only two shareholders.

According to Article 2.5. of the Guidelines the Board shall evaluate the independence of new Directors before the AGM and make the result of such evaluation available to its shareholders. The Board assesses the independence of Board members after they take their seat on the Board. The Board has been carrying out this assessment of independence of new directors joining the Board at its first meeting after the AGM. The Board will be performing this assessment before the AGM for future members of the Board.

According to Article 2.10. of the Guidelines it is preferred that the Board establishes a policy of social responsibility and Ethical Guidelines. The Executive Board of the Bank adopted Ethical Guidelines for the Bank in January 2011. The Bank has always sought to work in harmony with the communities in which operates and delivered support to its immediate environment in the areas of culture, sports, community affairs as well as entrepreneurship and innovation. The Bank has e.g. for the last six years been a signatory to the UN Global Compact on social responsibility. The Bank produces an annual report, Íslandsbanki in the Community: Global Compact, which can be accessed on the Íslandsbanki website. The Board expects to adopt a formal Social Responsibility Policy.

According to Article 5.1. of the Guidelines the rules of procedure of all of the Board's subcommittees shall be posted on the Bank's website. Each subcommittee of the Board of Íslandsbanki operates under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board which are available on the Bank's website. A description of the role and responsibilities of the Board's subcommittees is provided on the Bank's website which the Board has considered sufficient in this respect.

In accordance to Article 5.C.1 the Board may decide to establish a Nomination Committee. Íslandsbanki's Board has not deemed it necessary to appoint a nomination committee.

Further to material already made public on the Bank's website, Article 6.2. of the Guidelines outlines what should be made available online: a corporate governance statement for the past three years; information on Board candidacy and agenda of shareholders meetings. Annual reports and annual accounts of the Bank are available on the Bank's website containing the corporate governance statements of preceding years. Íslandsbanki has not deemed it necessary to republish the corporate governance statement separately. Information on Board candidacy and the agenda of shareholders' meetings have not been published online as the Bank's the shareholders are only two and the Bank has deemed it more appropriate that they be informed directly.

[1] www.fme.is www and nasdaqomxnordic.com
[2] www.althingi.is
[3] www.vi.is

## Main aspects of Internal Controls and Risk Management

The Board monitors the execution of its policies, the sound control of accounting and financial management and ensures that Internal Audit, Compliance and Risk Management are effective at all times.

The Executive Board, Risk Committee, Asset and Liability Committee and Investment Committee are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation. Under this authorisation, these committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite.

In accordance with Article 16 of the Act on Financial Undertakings No. 161/2002 Íslandsbanki operates an internal audit division independent from other departments. Group Internal Audit provides the Bank with independent, impartial confirmation and consultancy as to whether the procedures employed by the Bank for risk management, monitoring, and governance as decided and presented by management is satisfactory. The Chief Audit Executive is appointed by the Board and is responsible for internal audit on a group basis.

As a financial undertaking licensed to conduct securities trading and an issuer of listed financial instruments, Íslandsbanki operates a compliance department. The Bank's Compliance Officer is appointed by the CEO, subject to Board confirmation, conferring the department's mandate, in accordance with Article 130 of the Act on Securities Transactions No. 108/2007. Compliance officer maintains an independent position within the Bank's organisation and is responsible for monitoring and assessing regularly whether the Bank's operations, regarding securities transactions, are in compliance with applicable law.

As provided for in the Bank's Articles of Association and the Act on Financial Undertakings, the Bank's audit firm shall be elected at the AGM for a term of five years. Deloitte hf. was elected to serve as Íslandsbanki's independent external auditing firm at the 2010 AGM.

Íslandsbanki has not been determined to have been in violation of any laws or regulations by the appropriate supervisory or ruling bodies in the year 2013.

## Decision Making Matrix

Íslandsbanki's Good Governance Policy, the Decision Making Matrix, was adopted by the Board in 2012 containing a map of major decisions that the Bank may wish to take under given circumstances.
The Decision Making Matrix sets specific conditions to all major decision making, and a requirement that all such decisions are taken with the input of the best qualified parties within the Bank and that they are taken on the basis of the best available information at all times.

## Íslandsbanki Values, Ethical Guidelines and Social Responsibility

Íslandsbanki's values are the pillars of the Bank's corporate culture, shaping the conduct, thinking and attitudes of its employees. Íslandsbanki's values insist on employees being professional, disciplined in their working procedures, and following matters through – professional, positive and progressive.

In order to maintain and strengthen the credibility and the reputation of the Bank, all employees were involved in formulating the Bank's Ethical Guidelines. The aim of the Ethical Guidelines is to promote good operational and business practices, increase trust and guide employees in their daily work. The Ethical Guidelines were approved by the Executive Board in January 2011 and are available on the Bank's website.

Íslandsbanki seeks to work in harmony with the communities in which it operates, delivering support for its immediate environment in the areas of culture, sports, community affairs as well as entrepreneurship and innovation. This participation in community programmes rests on Íslandsbanki's Corporate Social Responsibility Policy. The policy covers four key areas: Business, human capital, community and the environment. The Bank produces an annual report, Íslandsbanki in the Community: Global Compact, which can be accessed on the Íslandsbanki website. For the last six years Íslandsbanki has been a signatory to the UN Global Compact on social responsibility. The compact is a guide for companies on how to be socially responsible in practice. The Board expects to adopt a formal Social Responsibility Policy.

## Board of Directors

The Board of Directors comprises nine non-executive directors, and two alternates, elected at each AGM for a term of one year. The Chairman of the Board is elected at a shareholders' meeting. There are no limitations on duration of Board membership.

The Board has ultimate authority over the Bank's affairs subject to shareholders' meetings unless otherwise provided by law or the Articles of Association. The Board is responsible for the formulation of the Bank's general strategy and instructs the CEO on its further implementation and execution. The Board has a supervisory role in that it oversees that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations and good business practices. The Board appoints the CEO and Internal Auditor of the Bank.

The Rules of Procedure of the Board are adopted in accordance with Article 70 of the Act on Public Limited Companies No 2/1995 and Article 54 of the Act on Financial Undertakings No 161/2002. The Board's current rules of Procedure, adopted August 27 2013, are available on the website of the Bank.

According to its Rules of Procedure, at meetings of the Board the presence of at least five members of the Board is required to constitute a quorum. The Board met 14 times in the year 2013, constituting a quorum each time.

In accordance with the rules governing its activities, the Board appoints subcommittees. Each subcommittee operates under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The operation of the Board Special Credit Committee was ceased in August 2013.  There are four Board appointed subcommittees:

*The Board Audit Committee*, comprising four Board members, assists the Board in overseeing accounting and auditing of major accounting and financial reporting matters, effectiveness of internal monitoring within the Bank, and the risk management and compliance structure. Board Audit Committee met 9 times in the year 2013, all of which were valid.

*The Board Risk Committee,* which comprises four Board members, is responsible for reviewing the risk management practises followed by Bank management and presenting to the Board a description of the chief risks facing the Bank. It is also responsible for reviewing the risk management rules set by the Board. Board Risk Committee met 7 times in the year 2013, all of which were valid.

*The Strategy Committee,* which comprises of five Board members, oversees and approves key issues related to the strategy of the Bank and formulates general policies to effectively implement that strategy. The Committee sets out strategic and financial targets and priorities and monitors their progress. Board Risk Committee met 3 times in the year 2013, all of which were valid.

*The Board Corporate Governance, Compensation and Human Resource Committee* which comprises five Board members, assists the Board in overseeing the development and the regular assessment of the Bank's approach to corporate governance issues and assessing of board effectiveness. Board Corporate Governance, Compensation and Human Resource Committee met 6 times in the year 2013, all of which were valid.

Structure of Board subcommittees

| | The Board Audit Committee | The Board Risk Management Committee | The Board Strategy Committee | The Board Corporate Governance, Compensation and HR Committee |
|---|---|---|---|---|
| Friðrik Sophusson | | | Member | Chair |
| John E. Mack | | | Chair | Member |
| Árni Tómasson | Member | | Member | |
| Dr. Daniel Levin | | Member | | Member |
| Marianne Økland | Member | Chair | | |
| María E. Ingvadóttir | | Member | | Member |
| Neil Graeme Brown | Chair | | Member | |
| Helga Valfells | | Member | | Member |
| Þóranna Jónsdóttir | Member | | Member | |

Member Chair

## Performance Assessment

At least once a year, as provided for in the Board's Rules of Procedure, the Board shall assess its work, procedures and practices. This performance assessment is intended to improve working methods and increase efficiency of the Board. The assessment entails the evaluation of the strengths and weaknesses of the Board's work and practices. This is i.a. based on Board members' self-assessment on whether the Board rules of procedure have been complied with in all respects, status taken of the specific priorities set by the Board regarding risk management and internal control within the Bank as well as a follow up on how certain decisions of the Board have been implemented.

## Information about members of the Board

*Friðrik Sophusson, chairman of the Board,* born in 1943 and is an Icelandic national. He has a Cand. Jur. degree in Law from the University of Iceland. He joined the Board in January 2010. He also serves as board chairman of Hlíðarendi ses. and Úlfljótsvatn sf., and as an alternative board member of Fondament ehf.

*John E. Mack, vice-chairman of the Board,* born in 1947 and is a United States national. He has a MBA degree from the University of Virginia, Darden School of business and a B.A. degree in economics from Davidson College. He joined the Board in January 2010. He also serves as board member of Flowers National Bank, Incapital Holdings, Medley Capital Corporation, and Search Light Minerals (SRCH).

*Neil Graeme Brown,* born in 1959 and is a British national. He has an M.A. degree in classics from Emmanuel College, Cambridge and is an associate at of the Institute of Chartered Accountants (ACA). He joined the Board in January 2010. He is a founding partner of Subito Partners, a London based board advisory and investment business, specialising in private investments and restructuring, also serves as board member of Gate D3 Group AG, Magma Finance, AVC NEXT- GEN and Euro Car Parts Limited.

*Dr. Daniel Levin,* born in 1963 and is a US and Swiss national. He has a J.D. and Ph.D. degree in law from the University of Zurich and LL.M. degree in law from Columbia University. He joined the Board in May 2011. He is an independent consultant to governments and development agencies globally in the development of financial and capital markets, and has been working closely with supervisory agencies and regulators on the implementation of ethical and corporate governance standards for financial institutions. He also serves as a board member of CMD Group LLC, Corporation Maldana AG, Liechtenstein Foundation for State Governance, Make Foundation Inc, Securoseal Global Ltd. and Securoseal USA LLC.

*Árni Tómasson,* born in 1955 and is an Icelandic national. He has a Cand. Oecon degree in business from the University of Iceland and is an certified public accountant. He joined the Board in January 2010. He runs his own consulting firm, AT ráðgjöf ehf. and serves as board chairman of Gullberg ehf., board member of AT Ráðgjöf ehf., Skjaldborg kröfuhafafélag 15 ehf., Skjaldborg Kröfuhafafélag 10 ehf. and Kaffitár hf.

***Marianne Økland,*** born in 1962 and is a Norwegian national. She has a M.Sc. degree in finance and economics from the Norwegian School of Economics and Business Administration. She is the managing director of Avista Partners. She joined the Board in January 2010. She also serves as board member of IDFC and Scorpio Tankers Inc.

***María E. Ingvadóttir,*** born in 1946 and is an Icelandic national. She has a Cand. Oecon degree in business administration from the University of Iceland. Owner and managing director of Beggja hagur ehf., an advisory service company in the field of financial accounting and management. She joined the Board in September 2012. She also serves as board member of Storice ehf., Beggja hagur ehf., Ranna ehf., Olíulindin ehf. and Fjölblendir ehf.

***Dr. Þóranna Jónsdóttir*** born in 1968 and is an Icelandic national. She has a Doctorate Degree in Business Administration from Cranfield University, United Kingdom, an MBA degree from from IESE Barcelona and a MSc degree in Pharmaceuticals, and is chartered stockbroker. She joined the Board in September 2013. She is the Dean of Reykjavík University's School of Business, managing director and board member of Kaliber ehf., Ísarn ehf., and an alternate board member of Klak Innovit ehf.

***Helga Valfells*** born in 1964. Has an MBA degree from London Business School, UK, A.B. degree in English and economics from Harvard University. She joined the Board in September 2013. She is managing director of NSA Ventures, owner and managing director of Árhólmi ehf., owner and alternate board member of Uggi ehf. Board member of Mentor ehf., Klak Innovit ehf., Transmit ehf., Gagnavarslan hf., Vesturgarður ehf., and Frumtak GP hf. An alternate board member of AMP ehf., Tölvuský ehf., InfoMentor ehf., Norrænar myndir ehf., Akthelia ehf., Árhólmi ehf., and Íslensk nýsköpun ehf.

Alternate members of the Board are ***Gunnar Fjalar Helgason, since September 2013,*** and ***Jón Eiríksson since January 2011***.

All members of the Board are considered independent from the Bank and large shareholders of the Bank except for Árni Tómasson who is not considered independent from the largest shareholder in the Bank on account of his seat, as Chairman, on Glitni's Resolution Committee from September 2008 until September 30th 2011.

## Management Structure

The Chief Executive Officer (CEO) is responsible for overseeing the Bank's operations in accordance with set policy and Board decisions. The CEO is also to ensure that the Bank's operations are in compliance with the law and the Articles of Association at all times. The CEO appoints the Bank's Compliance Officer, members of the Executive Board and members of other management committees.

Together with the CEO, the Executive Board manages the daily activities of the Bank according to the strategy set out by the Board. It consists of 8 people, including the CEO: Birna Einarsdóttir since October 2008, CEO, Jón Guðni Ómarsson, Chief Financial Officer since October 2011, Sigríður Olgeirsdóttir, Chief Operating Officer since September 2010, Stefán Sigurðsson, Managing Director of Asset Management since October 2008, Sverrir Örn Þorvaldsson, Chief Risk Officersince November 2010, Tryggvi Björn Davíðsson, Managing Director of Markets since September 2011, Una Steinsdóttir, Managing Director of Retail Banking since October 2008 and Vilhelm Már Þorsteinsson Managing Director of Corporate Banking since October 2008.

The CEO and management committees are responsible for implementing risk management practices and internal monitoring in accordance with Board authorization. Under this authorization, these committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite.

The committees are appointed by the CEO, and their letters of mandate and rules of procedure are approved by the Board:

- The Executive Board sets the Bank's policy for operational risk at the group level.
- The Risk Committee manages and supervises lending issues and other counterparty risk, in accordance with the Bank's credit policy and lending rules.
- The Asset and Liability Committee monitors other financial risks, such as market risk, liquidity risk, and interest rate risk in the Bank's non-trading portfolio.
- The Investment Committee makes decisions on the purchase or sale of equity holdings in companies, as well as other types of investments, including investment funds and real estate.

Further to this four other departments report directly to the CEO; Legal department, Human Resources, Marketing and Compliance.

## Arrangement of communications between shareholders and the Board

Glitnir Bank hf. holds 95% of the share capital in Íslandsbanki through its subsidiary ISB Holding ehf.. The remaining 5% is held by the Icelandic government and is administered by Icelandic State Financial Investments.

The Board communicates with shareholders in accordance with the relevant laws, the Bank's Articles of Association and the Board's Rules of Procedure. Members of the Board of Directors shall, in their duties and decision-making, safeguard the interests of the Bank and shareholders in accordance with the provisions of Act No. 2/1995, on Public Limited Companies, Act No. 161/2002, on Financial Undertakings, and current rules and guidelines about the activities of financial undertakings.

Shareholder meetings are the general forum for informing and communicating with shareholders. In between meetings of the Bank's shareholders the Chairman of the Board is responsible for communications, on behalf of the Board of directors, with shareholders.

Shareholders can at any time express their views in relation to the operations of the Bank to the Board of Directors and submit queries to the Board for discussion.