Consolidated Financial Statements

for the year 2013

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

CONTENTS

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2013 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Operations during the year

Net earnings amounted to ISK 12,657 million for the year ended 31 December 2013. The Group's equity amounted to ISK 144,947 million at year end. The capital adequacy ratio of the Group, calculated according to the Financial Undertakings Act, was 23.6% and comfortably meets the requirements set by law and the Financial Supervisory Authority ("FME"). The liquidity position was strong at year end and well above the regulatory minimum. The Board of Directors proposes that 60% of Net earnings will be paid out as a dividend in 2014 for the financial year 2013.

The Group performed well during the year and operations were characterized by greater stability. The appreciation of the Icelandic króna had the effect of reducing interest income and the value of the loan portfolio. Another item which changed significantly from 2012 is that impairment on loans decreased, reflecting the success which has been achieved in restructuring the loan portfolio in recent years. However, there was a threefold increase in the bank levy compared with the previous year and the increase was ninefold when compared with the levy as it was initially presented for the year.

At the end of 2013 an agreement was reached between Arion Bank and ESÍ ehf., a subsidiary of the Central Bank of Iceland, on the settlement of the Drómi bond from 2009. The bond was paid with assets including three loan portfolios originating from two small failed banks, SPRON savings bank and Frjálsi Investment Bank. The transfer of these loan portfolios enables thousands of former customers of these banks to combine their business at Arion Bank as the deposits of those same customers had previously been transferred to the Bank. The effect of the agreement on the balance sheet and income statement can be seen in the transfer of assets from securities holdings over to loans to customers. The loans received by the Bank are only to individuals which increases the ratio of loans to individuals in the Bank's loan portfolio to 48.8% at the end of the year. This fits in well with the Bank's strategy of increasing the proportion of loans to individuals. At the same time it raises slightly the ratio of problem loans, as the quality of these loan portfolios is slightly less than that of similar loans already owned by the Bank. The agreement and its effects are discussed in more detail in Note 21.

The Bank has made concerted efforts to diversify its funding base in the short term and long term. To this end the Bank has issued bond series which have been sold and listed in Iceland and abroad. The Bank has also increased the term of its deposits. An important milestone in the Bank's funding was reached in January 2014 when Standard & Poor's assigned Arion Bank a credit rating of BB+ with a stable outlook which is just one notch below the rating of the Republic of Iceland.

Very good progress has been made in recent years in selling the companies that the Bank had to take over in debt restructuring, and during the year the sale of assets linked to the Fram Foods group was completed. However, the Bank acquired a 38% share in the telecommunications company Skipti hf. in the process of financially restructuring the company which increased the Group's assets in associate companies.

The Bank has strived to promote its intrinsic values called the Bank's cornerstones. The cornerstones are "We make a difference", "We say what we mean" and "We get things done". A great deal of effort has gone into the introduction of a lean management called A plus which is designed to ensure efficiency and strengthen customer relationships throughout the Bank with the ultimate goal of improving the level of service to customers.

In November the Banker magazine named Arion Bank as the Bank of the Year 2013 in Iceland. The magazine gave Arion Bank the award in recognition of the greater diversity in the Bank's funding, its reduced default ratio, the strong focus on product development, its efficient online bank and the Arion Bank app. Arion Bank is very proud of this international recognition of the effort and hard work that has been undertaken by the Bank's employees over recent years and the award only encourages the Bank to do even better.

The Group had 1,145 full-time equivalent positions at the end of the year, compared with 1,190 at the end of 2012. 911 of these positions were at the parent company Arion Bank hf., compared with 949 at the end of 2012.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Outlook

Arion Bank is a leading financial institution on the Icelandic market and enjoys a strong position in all its business segments. In recent years the Bank has reduced the risk in its loan portfolio by increasing the share of retail mortgage loans. The loan portfolio now comprises loans to individuals and companies in equal measure. The Bank has also greatly improved the quality of its funding. The Bank is financially robust in international comparisons and has a very good liquidity position.

The core of the Bank's business is traditional banking activities now that debt recovery work has largely been completed. The Bank sees great opportunity in strengthening the business relationship with the new customers from SPRON and Frjálsi Investment Bank and is confident that the issues which have been on hold for many of them can be quickly resolved. The focus in the near future will be to further improve operations and to take advantage of the foundations already in place to take the business forward. The Bank aims to continue reducing operating expenses, mainly through automation and further optimization in both back office functions as well as the branch network. The Bank will also concentrate on selling the remaining shareholdings acquired by the Bank as a result of the financial restructuring of some of its corporate clients. Arion Bank's financial position and risk distribution enables the Bank to support the expected growth in activities of individual and corporate clients over the coming years. The Bank's solid position, its rating from S&P and plans for new funding will enable it to support its customers in their operations and investment activities domestically as well as in their current operation and expansion internationally.

Risk Management

The Group faces various risks arising from its day-to-day operations as a financial institution. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure, policy and main risk factors are addressed in the notes, starting at Note 40.

Group ownership

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, investment banking and asset management. The Group includes subsidiaries in the real estate sector, card services and insurance.

Kaupskil ehf., a company owned by Kaupthing hf., holds 87% of the shares in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State Financial Investments on behalf of the Icelandic government.

Corporate governance

The Board of Directors of Arion Bank is committed to good corporate governance and endeavours to promote responsible behaviour and corporate culture within Arion Bank for the benefit of all the Bank's stakeholders.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2013 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance and cash flows of the Group for the year 2013 and its financial position as at 31 December 2013.

Further, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2013 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 26 February 2014

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Björgvin Skúli Sigurðsson

Måns Höglund

Benedikt Olgeirsson

Guðrún Johnsen

Þóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion Bank and its subsidiaries ("the Group"), which comprise the Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position as at 31 December 2013, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flow for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

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 judgement, 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 financial position of the Group as at 31 December 2013, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with the 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 requirement of Paragraph 2 Article 104 of the Icelandic Financial Statement 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 that is not disclosed elsewhere in the Consolidated Financial Statements.

Reykjavík, 26 February 2014

Ernst & Young ehf.

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR 2013

	Notes	2013	2012
Interest income		56,867	59,094
Interest expense		(33,067)	(31,952)
Net interest income	6	23,800	27,142
Fee and commission income		16,443	16,166
Fee and commission expense		(5,220)	(5,418)
Net fee and commission income	7	11,223	10,748
Net financial income	8	1,675	2,017
Other operating income	9	7,650	9,595
Operating income		44,348	49,502
Salaries and related expense	10	(13,537)	(12,459)
Other operating expense	11	(11,858)	(12,209)
Net impairment	12	(680)	(4,690)
Earnings before tax		18,273	20,144
Income tax expense	13	(3,143)	(3,633)
Bank levy	14	(2,872)	(1,062)
Net earnings from continuing operations		12,258	15,449
Net gain from discontinued operations, net of tax	15	399	1,607
Net earnings		12,657	17,056
Attributable to			
Shareholders of Arion Bank		13,019	16,622
Non-controlling interest		(362)	434
Net earnings		12,657	17,056
Other comprehensive income			
Exchange difference on translating foreign subsidiaries		(2)	2
Total comprehensive income for the year		12,655	17,058
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	6.31	7.51

The notes on pages 13 to 71 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2013 7 Amounts are in ISK millions

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2013

Assets	Notes	2013	2012
Cash and balances with Central Bank	17	37,999	29,746
Loans to credit institutions	18	102,307	101,011
Loans to customers	19	635,774	566,610
Financial instruments	20-22	86,541	137,800
Investment property	22	28,523	28,919
Investments in associates	24	17,929	7,050
Intangible assets	25	5,383	4,941
Tax assets	26	818	463
Other assets	27	23,576	24,135
Total Assets		938,850	900,675
Liabilities			
Due to credit institutions and Central Bank	21	28,000	32,990
Deposits	21	471,866	448,683
Financial liabilities at fair value	21	8,960	13,465
Tax liabilities	26	4,924	3,237
Other liabilities	28	43,667	42,117
Borrowings	21,29	204,568	195,085
Subordinated liabilities	21,30	31,918	34,220
Total Liabilities		793,903	769,797
Equity			
Share capital and share premium	32	75,861	75,861
Other reserves	32	1,637	1,639
Retained earnings		62,591	49,572
Total Shareholders' Equity		140,089	127,072
Non-controlling interest		4,858	3,806
Total Equity		144,947	130,878
Total Liabilities and Equity		938,850	900,675

The notes on pages 13 to 71 are an integral part of these Consolidated Financial Statements.

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CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR 2013

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
2013						
Equity 1 January 2013	75,861	1,639	49,572	127,072	3,806	130,878
Total comprehensive income for the year		(2)	13,019	13,017	(362)	12,655
Increase in non-controlling interests during the year					1,533	1,533
Decrease of non-controlling interest due to dividend payment from subsidiary					(119)	(119)
Equity 31 December 2013	75,861	1,637	62,591	140,089	4,858	144,947
2012						
Equity 1 January 2012	75,861	1,637	32,950	110,448	4,110	114,558
Total comprehensive income for the year		2	16,622	16,624	434	17,058
Decrease due to purchase of non-controlling interest					(738)	(738)
Equity 31 December 2012	75,861	1,639	49,572	127,072	3,806	130,878

The notes on pages 13 to 71 are an integral part of these Consolidated Financial Statements.

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CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR 2013

	2013	2012
Operating activities		
Net earnings	12,657	17,056
Non-cash items included in net earnings and other adjustments	(20,930)	(25,672)
Changes in operating assets and liabilities	(3,728)	8,063
Interest received	46,141	49,012
Interest paid*	(26,683)	(23,865)
Dividend received	46	25
Income tax and bank levy paid	(2,149)	(3,556)
Net cash from operating activities	5,354	21,063
Investing activities		
Investment in associated companies	(40)	(1,658)
Proceeds from sale of associated companies	-	396
Purchase of property and equipment and intangible assets	(3,022)	(1,674)
Proceeds from sale of property and equipment	185	30
Net cash used in investing activities	(2,877)	(2,906)
Financing activities		
Decrease in non-controlling interest	(119)	(738)
Net cash used in financing activities	(119)	(738)
Net increase in cash and cash equivalents	2,358	17,419
Cash and cash equivalents at beginning of the year	105,173	82,815
Effect of exchange rate changes on cash and cash equivalents	(7,848)	4,939
Cash and cash equivalents at the end of the year	99,683	105,173
Non-cash investing and financing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	9,017	2,051
Settlement of loans through foreclosure on collateral from customers with view to resale	(9,017)	(2,051)

* Interest paid includes interest credited to deposit accounts at the end of the year.

The notes on pages 13 to 71 are an integral part of these Consolidated Financial Statements.

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NOTES TO THE CONSOLIDATED STATEMENT OF CASH FLOW FOR THE YEAR 2013

	2013	2012
Non-cash items included in net earnings and other adjustments		
Net interest income	(23,799)	(27,142)
Net impairment	680	4,690
Income tax expense	3,143	3,633
Bank levy	2,872	1,062
Net foreign exchange loss (gain)	1,766	(1,434)
Net gain on financial instruments	(3,395)	(561)
Depreciation and amortisation	1,788	1,436
Share of profit of associates and fair value change	(1,986)	(2,405)
Investment property, fair value change	(1,219)	(1,584)
Net gain on disposal of investment in associates	-	(396)
Net gain on disposal of property and equipment	(9)	(8)
Net gain on disposal of investment property	(372)	(1,356)
Net gain from discontinued operations, net of tax	(399)	(1,607)
Non-cash items included in net earnings and other adjustments	(20,930)	(25,672)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(250)	(177)
Loans to credit institutions	(15,225)	(9,729)
Loans to customers	(31,027)	3,008
Financial instruments	(14,373)	30,000
Investment property	2,132	(44)
Other assets	3,363	12,775
Due to credit institutions and Central Bank	(4,569)	16,901
Deposits	44,551	(45,537)
Borrowings	11,633	422
Other liabilities	37	444
Changes in operating assets and liabilities	(3,728)	8,063

Cash and cash equivalents comprises		
Cash in hand and demand deposits	37,999	29,746
Due from credit institutions	70,671	84,164
Mandatory reserve with Central Bank	(8,987)	(8,737)
Cash and cash equivalents at the end of the year	99,683	105,173

The notes on pages 13 to 71 are an integral part of these Consolidated Financial Statements.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Financial Statements for the year ended 31 December 2013 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards, as endorsed by the European Union.

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 26 February 2014.

Basis of measurement

The Financial Statements are prepared on the historical cost basis except for the following:
- Financial assets and financial liabilities held for trading are measured at fair value;
- Investment properties are measured at fair value; and
- Non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated. At the end of the year the exchange rate of the ISK against the USD was 115.09 and 158.49 for the EUR (2012: USD 128.09 and EUR 168.89).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Financial Statements 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. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within:

- impairment losses and reversal of impairment losses on loans;
- the foreign currency loan portfolio caused by legal dispute and court judgements ;
- investment property; and
- assets classified as held for sale.

3. The Group

Shares in main subsidiaries in which Arion Bank held a direct interest at the end of the year

			Equity interest	
	Country	Currency	2013	2012
AFL - sparisjóður, Aðalgata 34, Siglufjörður	Iceland	ISK	99.3%	99.3%
Arion Bank Mortgages Institutional Investor Fund, Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%
BG12 slhf., Borgartún 19, Reykjavík	Iceland	ISK	62.0%	-
EAB 1 ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%
Eignabjarg ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Hátún 2b, Reykjavík	Iceland	ISK	100.0%	100.0%
Landfestar ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100.0%	100.0%
Okkar líftryggingar hf., Sóltún 26, Reykjavík	Iceland	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður	Iceland	ISK	60.8%	60.8%

In addition the Bank holds subsidiaries classified as Non-current assets and disposal groups held for sale, see Note 27.

Changes within the Group

Arion Bank hf. established BG12 slhf. in partnership with others to manage the shareholding of Bakkavör Group Ltd.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

Segment information is presented in respect of the Group's operating segments based on the Group´s management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

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

Operating segments

The Group comprises six main operating segments:

Corporate Banking provides services to the Bank’s larger corporate clients. Its role is to provide comprehensive financial services and tailored services to meet the needs of each company.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund and AFL Sparisjóður, provide a comprehensive range of services. That includes among other advice on deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 25 branches all around Iceland are over 100,000.

The Asset Management division comprises Institutional Asset Management, Private Banking and Investment Services. Asset Management manages financial assets on behalf of its clients according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Investment Banking is divided into Corporate Advisory, Capital Markets and Research. Corporate Advisory advises clients on securities offerings and the admission of securities for trading on regulated securities markets and also provides M&A advisory services. Capital Markets handles securities brokerage and foreign exchange trading for the Bank’s clients. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking’s clients are private individuals, companies and institutions.

Treasury is responsible for the Bank’s liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency and liaison with other financial institutions.

Other divisions and Subsidiaries include market making in domestic securities and currencies. The subsidiaries are Eignabjarg ehf., Eignarhaldsfélagið Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

Headquarters: Overhead, Risk Management, Accounting, Legal, Operations and Corporate Development.

4. The Group's business segments

2013	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other divisions and Subsidiaries	Headquarters and Elimination	Total
Net interest income	8,630	12,058	560	120	3,813	(1,473)	92	23,800
Other income	685	2,507	3,141	4,302	(1,103)	10,264	752	20,548
Operating income	9,315	14,565	3,701	4,422	2,710	8,791	844	44,348
Operating expense	(658)	(5,518)	(774)	(596)	(244)	(5,409)	(12,196)	(25,395)
Net impairment	3,789	(5,694)	(3)	1,738	420	(311)	(619)	(680)
Earnings before tax	12,446	3,353	2,924	5,564	2,886	3,071	(11,971)	18,273
Net seg. rev. from ext. customers	16,780	24,805	1,462	4,087	(13,995)	11,616	(407)	44,348
Net seg. rev. from other segments	(7,465)	(10,240)	2,239	335	16,705	(2,825)	1,251	-
Operating income	9,315	14,565	3,701	4,422	2,710	8,791	844	44,348
Depreciation and amortisation	-	166	-	-	-	281	1,341	1,788
Total assets	248,082	397,721	4,840	34,799	168,334	77,150	7,924	938,850
Total liabilities	208,389	356,086	1,781	29,231	148,696	42,746	6,974	793,903
Allocated equity	39,693	41,635	3,059	5,568	19,638	34,404	950	144,947

2012	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other divisions and Subsidiaries	Headquarters and Elimination	Total
Net interest income	10,300	11,437	1,814	(6)	4,857	(1,218)	(42)	27,142
Other income	1,134	2,837	2,356	4,516	(196)	10,804	909	22,360
Operating income	11,434	14,274	4,170	4,510	4,661	9,586	867	49,502
Operating expense	(605)	(5,448)	(1,651)	(599)	(191)	(4,755)	(11,419)	(24,668)
Net impairment	(270)	(5,516)	9	1,095	164	(81)	(91)	(4,690)
Earnings before tax	10,559	3,310	2,528	5,006	4,634	4,750	(10,643)	20,144
Net seg. rev. from ext. customers	20,600	23,553	489	4,243	(11,477)	11,292	802	49,502
Net seg. rev. from other segments	(9,166)	(9,279)	3,681	267	16,138	(1,706)	65	-
Operating income	11,434	14,274	4,170	4,510	4,661	9,586	867	49,502
Depreciation and amortisation	-	170	-	-	-	198	1,068	1,436
Total assets	251,384	318,700	4,597	26,000	212,315	80,057	7,622	900,675
Total liabilities	211,444	291,701	1,497	22,784	185,326	50,338	6,707	769,797
Allocated equity	39,940	26,999	3,100	3,216	26,989	29,719	915	130,878

The vast majority of the revenues from external customers is attributable to customers in Iceland.

Discontinued operations are excluded from the profit and loss segment information.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

QUARTERLY STATEMENTS

5. Operations by quarters

2013	Q4	Q3	Q2	Q1	Total
Net interest income	5,487	5,646	6,379	6,288	23,800
Net fee and commission income	2,939	2,986	2,849	2,449	11,223
Net financial income (expense)	721	658	1,123	(827)	1,675
Other operating income	3,615	1,610	1,249	1,176	7,650
Operating income	12,762	10,900	11,600	9,086	44,348
Salaries and related expense	(4,098)	(2,760)	(3,357)	(3,322)	(13,537)
Other operating expense	(3,114)	(2,516)	(2,951)	(3,277)	(11,858)
Net impairment	(561)	(253)	456	(322)	(680)
Earnings before tax	4,989	5,371	5,748	2,165	18,273
Tax expense	(2,864)	(1,214)	(1,260)	(677)	(6,015)
Net earnings from continuing operations	2,125	4,157	4,488	1,488	12,258
Net gain (loss) from discontinued operations, net of tax	402	62	14	(79)	399
Net earnings	2,527	4,219	4,502	1,409	12,657

2012	Q4	Q3	Q2	Q1	Total
Net interest income	7,008	6,254	7,666	6,214	27,142
Net fee and commission income	2,695	2,715	3,002	2,336	10,748
Net financial income (expense)	967	869	(1,248)	1,429	2,017
Other operating income	4,952	1,637	2,054	952	9,595
Operating income	15,622	11,475	11,474	10,931	49,502
Salaries and related expense	(3,646)	(2,644)	(3,124)	(3,045)	(12,459)
Other expense	(4,148)	(2,586)	(2,718)	(2,757)	(12,209)
Net impairment	(5,169)	(2,053)	2,608	(76)	(4,690)
Earnings before tax	2,659	4,192	8,240	5,053	20,144
Tax expense	(549)	(723)	(2,094)	(1,329)	(4,695)
Net earnings from continuing operations	2,110	3,469	6,146	3,724	15,449
Net gain (loss) from discontinued operations, net of tax	409	(181)	652	727	1,607
Net earnings	2,519	3,288	6,798	4,451	17,056

The half-year results were reviewed by the Bank's auditor. The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditor.

Arion Bank Consolidated Financial Statements 2013 17 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2013	2012
Cash and balances with Central Bank	628	650
Loans	48,932	49,112
Securities	6,630	8,790
Other	677	542
Interest income	56,867	59,094
Deposits	(19,108)	(17,769)
Borrowings	(12,568)	(12,572)
Subordinated liabilities	(1,334)	(1,520)
Other	(57)	(91)
Interest expense	(33,067)	(31,952)
Net interest income	23,800	27,142
Net interest income from assets and liabilities at fair value	6,630	8,790
Interest income from assets not at fair value	50,237	50,304
Interest expense from liabilities not at fair value	(33,067)	(31,952)
Net interest income	23,800	27,142

7. Net fee and commission income

	2013	2012
Fee and commission income		
Asset management	3,388	2,715
Cards	7,895	8,951
Collection and payment services	1,157	871
Investment banking	1,266	722
Interbank clearing	707	706
Lending and guarantees	986	1,098
Other fee and commission income	1,044	1,103
Fee and commission income	16,443	16,166
Fee and commission expense		
Asset management	(138)	(192)
Cards	(3,648)	(3,956)
Collection and payment services	(56)	(17)
Investment banking	(175)	(40)
Interbank clearing	(704)	(723)
Other fee and commission expense	(499)	(490)
Fee and commission expense	(5,220)	(5,418)
Net fee and commission income	11,223	10,748

Asset management fees are earned by the Group on trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

Arion Bank Consolidated Financial Statements 2013 18 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

8. Net financial income

	2013	2012
Dividend income	46	25
Net gain (loss) on financial assets and financial liabilities classified as held for trading	475	(298)
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	2,920	856
Net foreign exchange gain (loss)	(1,766)	1,434
Net financial income	1,675	2,017

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

	2013	2012
Net gain (loss) on equity instruments and related derivatives	690	456
Net gain (loss) on interest rate instruments and related derivatives	(61)	(502)
Net gain (loss) on other derivatives	(154)	(252)
Net gain (loss) on financial assets and financial liabilities held for trading	475	(298)

Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss

	2013	2012
Net gain (loss) on equity instruments designated at fair value	2,232	776
Net gain (loss) on interest rate instruments designated at fair value	688	80
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	2,920	856

9. Other operating income

	2013	2012
Share of profit of associates	1,986	2,405
Rental income from investment property	2,303	2,184
Fair value changes on investment property	1,219	1,584
Realised gain on investment property	372	1,356
Earned premiums, net of reinsurance	1,073	918
Net gain on disposals of assets other than held for sale	9	396
Other income	688	752
Other operating income	7,650	9,595

Earned premiums, net of reinsurance

	2013	2012
Premium written	1,235	1,075
Outward reinsurance premiums	(118)	(99)
Change in the gross provision for unearned premiums	(44)	(58)
Earned premiums, net of reinsurance	1,073	918

10. Personnel and salaries

The Group's total number of employees

	2013	2012
Average number of full time equivalent positions during year	1,159	1,166
Full time equivalent positions at the end of the year	1,145	1,190

The Bank's total number of employees

	2013	2012
Average number of full time equivalent positions during the year	923	927
Full time equivalent positions at the end of the year	911	949

Amounts are in ISK millions

10. Personnel and salaries, continued

Salaries and related expense	2013	2012
Salaries	10,289	9,562
Defined contribution pension plans	1,436	1,288
Salary related expense	1,812	1,609
Salaries and related expense	13,537	12,459

Salaries and related expense for the Bank		
Salaries	8,117	7,127
Defined contribution pension plans	1,133	960
Salary related expense	1,406	1,592
Salaries and related expense	10,656	9,679

In 2013 the Group made a provision of ISK 494 million (2012: ISK 78 million) for performance plan payments, including salary related expense. Forty per cent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. In 2013 the Bank made a provision of ISK 452 million (2012: nil).

	2013			2012		
Compensation of key management personnel	Fixed remuneration[1]	Additional remuneration[2]	Total	Fixed remuneration[1]	Additional remuneration[2]	Total
Monica Caneman, Chairman of the Board	16.8	1.8	18.6	16.8	1.8	18.6
Guðrún Johnsen, Vice-Chairman of the Board	6.3	3.6	9.9	6.3	3.6	9.9
Agnar Kofoed-Hansen, Director	4.2	3.6	7.8	4.2	3.2	7.4
Freyr Þórðarson, Director (1.1.-13.5.2013)	1.6	0.9	2.5	3.5	1.5	5.0
Jón G. Briem, Director	4.2	2.3	6.5	4.2	4.1	8.3
Måns Höglund, Director	8.4	3.6	12.0	8.4	3.6	12.0
Þóra Hallgrímsdóttir, Director	3.5	1.1	4.6	-	-	-
Björg Arnardóttir, alternate director	3.0	1.0	4.0	0.7	-	0.7
Other alternate directors of the Board	5.2	2.5	7.7	3.9	0.5	4.4
Total remuneration	53.2	20.4	73.6	48.0	18.3	66.3

	2013	2012
Höskuldur H. Ólafsson, CEO	50.7	44.5
Nine managing directors of the Bank's divisions being members of the Bank's Executive Committee	219.9	227.6

Board Members receive remuneration for their involvement in board committees. In addition to 13 Board meetings (2012: 14), during the year 14 Board Credit Committee meetings (2012: 20), 6 Board Audit and Risk Committee meetings (2012: 10) and 5 Board Remuneration Committee meetings (2012: 6) were held. Five committee meetings with alternate directors of the Board were held in 2013.

The 2013 Annual General Meeting of the Bank held on 21 March 2013 approved the monthly salaries for 2013 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 700,000, ISK 525,000 and ISK 350,000 (2012: ISK 700,000; 525,000; 350,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 175,000 (2012: ISK 175,000) per meeting, up to a maximum of ISK 350,000 (2012: ISK 350,000) per month. For Board Members resident abroad, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 150,000 (2012: ISK 150,000) per month for each committee they serve on.

1. Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.
2. Additional remuneration represents Board Member compensation for their participation in Board Committees.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

11. Other operating expense

	2013	2012
Administration expense	8,398	9,142
Depositors' and investors' guarantee fund	791	899
Depreciation of property and equipment	1,228	899
Amortisation of intangible assets	560	537
Direct operating expense derived from rental-earning investment properties	547	499
Claims incurred, net of reinsurance	323	233
Other expense	11	-
Other operating expense	11,858	12,209

Claims incurred, net of reinsurance

	2013	2012
Claims paid	368	324
Change in the provision for claims	40	(38)
Claims paid, net of reinsurers' share	(118)	(63)
Change in the provision for claims, reinsurers' share	33	10
Claims incurred, net of reinsurance	323	233

Auditor's fee

2013	EY	KPMG	Total
Audit and review of the Financial Statements	141	7	148
Other audit related services	27	-	27
Auditor's fee	168	7	175

2012			
Audit and review of the Financial Statements	137	16	153
Other audit related services	33	9	42
Other service	-	2	2
Auditor's fee	170	27	197

12. Net impairment

	2013	2012
Reversal of impairment of loans to corporates	7,769	12,098
Reversal of impairment of loans to individuals	1,330	726
Impairment of loans to corporates	(3,093)	(12,074)
Impairment of loans to credit institutions	-	(70)
Impairment of loans to individuals	(4,900)	(5,956)
Collective (impairment) reversal	(947)	586
Impairment of intangible assets	(839)	-
Net impairment	(680)	(4,690)

Arion Bank Consolidated Financial Statements 2013 21 Amounts are in ISK millions

13. Income tax expense

	2013	2012
Current tax expense	3,627	3,160
Deferred tax expense	(484)	473
Income tax expense	3,143	3,633

Reconciliation of effective tax rate

	2013		2012	
Earnings before tax		18,273		20,144
Income tax using the Icelandic corporation tax rate	20.0%	3,655	20.0%	4,030
Additional 6% tax on financial institutions	4.7%	865	3.1%	621
Non-deductible expenses	1.7%	305	0.1%	25
Tax exempt revenue	(6.5%)	(1,183)	(6.5%)	(1,318)
Recognition of previously unrecognised tax losses	(3.5%)	(641)	(2.9%)	(578)
Other changes	0.8%	142	4.2%	853
Effective tax rate	17.2%	3,143	18.0%	3,633

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1.0 billion.

14. Bank levy

Bank levy is calculated according to law. The levy for the year 2013 is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions, at end of the year. Non-financial subsidiaries are exempt from this tax. The total rate for this tax was 0.1285% for the year 2012 on debt excluding tax liabilities. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

15. Net gain from discontinued operations, net of tax

	2013	2012
Net gain (loss) from legal entities	10	836
Net gain (loss) from associated companies	250	1,376
Net gain (loss) from real estate	60	(577)
Net gain (loss) from other assets	79	(28)
Net gain from discontinued operations, net of tax	399	1,607

Net gain (loss) from legal entities comprises the Group's share of net profit after tax from operations of legal entities that were classified as held for sale during the year.

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2013	2012	2013	2012
Net earnings attributable to the shareholders of Arion Bank	12,620	15,015	13,019	16,622
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	6.31	7.51	6.51	8.31

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2012: none).

Arion Bank Consolidated Financial Statements 2013 22 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank

	2013	2012
Cash on hand	4,099	3,495
Cash with Central Bank	24,912	17,514
Mandatory reserve deposit with Central Bank	8,987	8,737
Cash and balances with Central Bank	37,999	29,746

The mandatory reserve deposit with Central Bank is not available for the Group to use in its daily operations.

18. Loans to credit institutions

Loans to credit institutions

	2013	2012
Bank accounts	70,671	84,164
Money market loans	26,197	13,763
Other loans	5,439	3,888
Provision on loans	-	(804)
Loans to credit institutions	102,307	101,011

Changes in the provision for losses on loans to credit institutions

	2013	2012
Balance at the beginning of the year	804	774
Provision for losses (reversal)	-	70
Write-offs	(804)	(40)
Provision for losses on loans to credit institutions at the end of the year	-	804

19. Loans to customers

	Individuals	Corporates	Total
2013			
Overdrafts	18,205	19,669	37,874
Credit cards	11,296	878	12,174
Mortgage loans	258,065	8,103	266,168
Subordinated loans	-	531	531
Other loans	36,133	312,120	348,253
Provision on loans	(13,208)	(16,018)	(29,226)
Loans to customers	310,491	325,283	635,774
2012			
Overdrafts	17,236	18,470	35,706
Credit cards	10,302	769	11,071
Mortgage loans	190,897	4,376	195,273
Subordinated loans	-	573	573
Other loans	43,560	340,208	383,768
Provision on loans	(19,222)	(40,559)	(59,781)
Loans to customers	242,773	323,837	566,610

The total book value of pledged loans that were pledged against amounts borrowed was ISK 173 billion at the end of the year (31.12.2012: ISK 167 billion). Pledged loans comprised mortgage loans to individuals, loans to municipals and loans to state related entities.

Further analysis of loans is provided in Risk Management Disclosures.

Arion Bank Consolidated Financial Statements 2013 23 Amounts are in ISK millions

19. Loans to customers, continued

Changes in the provision for losses on loans to customers

	Specific	FX rulings	Collective	Total
2013				
Balance at the beginning of the year	41,498	14,942	3,341	59,781
Provision for losses during the year	6,041	1,952	947	8,940
Write-offs during the year	(24,228)	(12,008)	(188)	(36,424)
Transferred to liabilities	-	(3,984)	-	(3,984)
Payment of loans previously written off	914	-	-	914
Balance at the end of the year	24,224	902	4,100	29,226
2012				
Balance at the beginning of the year	32,953	13,823	9,513	56,289
Provision for losses during the year	11,818	5,744	(118)	17,444
Write-offs during the year	(3,830)	-	(6,054)	(9,884)
Transferred to liabilities	-	(4,625)	-	(4,625)
Payment of loans previously written off	557	-	-	557
Balance at the end of the year	41,498	14,942	3,341	59,781

The Bank made good progress in restructuring large loans to corporates which resulted in a write-off. Consequently the provision for losses on those loans decreased in the Statement of Financial Position. The Bank settled a great part of the recalculated foreign currency loans that had been provisioned for in prior years following court rulings that such loans were illegal. This resulted in a decrease in the provision for FX rulings between years.

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans and the valuation of foreign currency-linked loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

For the foreign loan portfolio the Group estimates the impact of Court judgements that have dealt with the legality of foreign currency-linked loans on the cash flows recoverable from the portfolios. The Group remains exposed to uncertainty regarding the foreign loan portfolio arising from firstly, the Group's interpretation of judgments made, and secondly, the outcome of future legal decisions and new or amended government legislation. Management judgment is required in the determination of the loans that require recalculation, and the estimated loss is based on assumptions that may be revised by future court decisions. In addition, the outcome of future legal decisions and new or amended government legislation may require recalculation of other categories of foreign loan portfolio that the Group has not previously considered vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

20. Financial instruments

	2013	2012
Bonds and debt instruments	62,171	117,730
Shares and equity instruments with variable income	17,449	16,844
Derivatives	1,070	788
Securities used for hedging	5,851	2,438
Financial instruments	86,541	137,800

Arion Bank Consolidated Financial Statements 2013 24 Amounts are in ISK millions

21. Financial assets and financial liabilities

2013	Amortised cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers	635,774	-	-	635,774
Loans	776,080	-	-	776,080
Bonds and debt instruments				
Listed	-	4,708	55,625	60,333
Unlisted	-	49	1,789	1,838
Bonds and debt instruments	-	4,757	57,414	62,171
Shares and equity instruments with variable income				
Listed	-	1,420	2,858	4,278
Unlisted	-	1,387	9,553	10,940
Bond funds with variable income	-	906	1,325	2,231
Shares and equity instruments with variable income	-	3,713	13,736	17,449
Derivatives				
OTC derivatives	-	1,070	-	1,070
Derivatives	-	1,070	-	1,070
Securities used for hedging				
Bonds and debt instruments	-	490	-	490
Shares and equity instruments with variable income	-	5,361	-	5,361
Securities used for hedging	-	5,851	-	5,851
Other financial assets	5,746	-	-	5,746
Financial assets	781,826	15,391	71,150	868,367
Liabilities at amortised cost				
Due to credit institutions and Central Bank	28,000	-	-	28,000
Deposits	471,866	-	-	471,866
Borrowings	204,568	-	-	204,568
Subordinated liabilities	31,918	-	-	31,918
Liabilities at amortised cost	736,352	-	-	736,352
Financial liabilities at fair value				
Short position in bonds	-	8,199	-	8,199
Derivatives	-	761	-	761
Financial liabilities at fair value	-	8,960	-	8,960
Other financial liabilities	36,747	-	-	36,747
Financial liabilities	773,099	8,960	-	782,059

Arion Bank Consolidated Financial Statements 2013 25 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

2012	Amortised cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	29,746	-	-	29,746
Loans to credit institutions	101,011	-	-	101,011
Loans to customers	566,610	-	-	566,610
Loans	697,367	-	-	697,367
Bonds and debt instruments				
Listed	-	2,132	42,441	44,573
Unlisted	-	3,515	69,642	73,157
Bonds and debt instruments	-	5,647	112,083	117,730
Shares and equity instruments with variable income				
Listed	-	374	2,446	2,820
Unlisted	-	1,037	8,682	9,719
Bond funds with variable income	-	2,623	1,682	4,305
Shares and equity instruments with variable income	-	4,034	12,810	16,844
Derivatives				
OTC derivatives	-	788	-	788
Derivatives	-	788	-	788
Securities used for hedging				
Bonds and debt instruments	-	1,460	-	1,460
Shares and equity instruments with variable income	-	978	-	978
Securities used for hedging	-	2,438	-	2,438
Other financial assets	5,030	-	-	5,030
Financial assets	702,397	12,907	124,893	840,197
Liabilities at amortised cost				
Due to credit institutions and Central Bank	32,990	-	-	32,990
Deposits	448,683	-	-	448,683
Borrowings	195,085	-	-	195,085
Subordinated liabilities	34,220	-	-	34,220
Liabilities at amortised cost	710,978	-	-	710,978
Financial liabilities at fair value				
Short position in bonds	-	12,490	-	12,490
Derivatives	-	975	-	975
Financial liabilities at fair value	-	13,465	-	13,465
Other financial liabilities	35,141	-	-	35,141
Financial liabilities	746,119	13,465	-	759,584

Included in unlisted Bonds and debt instruments designated at fair value is the Drómi bond, which the Group received when acquiring deposits from SPRON hf. in March 2009 and was closed by contract at year end 2013.

Arion Bank Consolidated Financial Statements 2013 26 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value specified by issuer	2013	2012
Financial and insurance activities	1,363	70,142
Public administration, human health and social activities	55,007	40,679
Corporates	1,044	1,262
Bonds and debt instruments designated at fair value	57,414	112,083

The total amount of pledged bonds at the end of the year was ISK 18.4 billion (31.12.2012: ISK 35.7 billion). Pledged bonds comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

Settlement of Drómi Bond

At the end of 2013 the Bank reached an agreement with Eignasafn Seðlabanka Íslands ehf. (ESÍ) on the settlement of a bond issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. The bond was secured with all Drómi's assets and also with a hold harmless statement from the Ministry of Finance and Economic Affairs. The bond was due in June 2014 with a possible extension to 2015. The agreement stated that the Bank would acquire loans to individuals held by Drómi hf., Frjálsi hf. (subsidiary of Drómi hf.) and Hilda hf. (entity held by ESÍ). The Hilda loans transferred were previously owned by SPRON but pledged against liabilities with the Central Bank.

The bond, with a book value of approximately ISK 70 billion, will be fully settled through this agreement and the settlement of the potential value of business relationships attributable to the deposits transferred from SPRON in 2009. In respect of these transactions and the former customers of SPRON and Frjálsi fjárfestingarbankinn that became the customers of Arion Bank when their loans are transferred, business relationships worth ISK 1 billion were capitalized. The financial effect of this settlement was as follows:

	2013
Loans to customers	49,977
Financial instruments, bonds	(69,020)
Intangible assets	1,000
Other assets	1,675
Total effect on assets	(16,368)
Deposits	(15,374)
Tax liabilities	(234)
Other liabilities	178
Total effect on liabilities	(15,430)
Interest income on Drómi Bond	444
Net impairment on loans	(1,616)
Tax expense	234
Total effect on Net earnings	(938)

The remaining balance of 1.7 billion will be settled in March 2014 as well as any possible correction of the transfer valuation.

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22. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and
Level 3: valuation techniques which include significant inputs that are not based on observable market data.

For assets and liabilities that are recognised at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting year.

Assets and liabilities recorded at fair value by level of the fair value hierarchy

	Level 1	Level 2	Level 3	Total
2013				
Assets at fair value				
Bonds and debt instruments	21,411	39,531	1,229	62,171
Shares and equity instruments with variable income	3,570	13,441	438	17,449
Derivatives	-	1,070	-	1,070
Securities used for hedging	4,495	1,355	-	5,850
Investment property	-	-	28,523	28,523
Assets at fair value	29,476	55,397	30,190	115,063
Liabilities at fair value				
Short position in bonds	8,199	-	-	8,199
Derivatives	-	761	-	761
Liabilities at fair value	8,199	761	-	8,960
2012				
Assets at fair value				
Bonds and debt instruments	4,397	111,914	1,420	117,731
Shares and equity instruments with variable income	1,799	14,530	515	16,844
Derivatives	-	788	-	788
Securities used for hedging	1,733	706	-	2,438
Investment property	-	-	28,919	28,919
Assets at fair value	7,929	127,937	30,854	166,720
Liabilities at fair value				
Short position in bonds	12,490	-	-	12,490
Derivatives	-	975	-	975
Liabilities at fair value	12,490	975	-	13,465

There have been no transfers between Level 1 and Level 2 in 2013 (2012: none).

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22. Fair value hierarchy, continued

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

Methods for establishing fair value

Level 1: Fair value established from quoted market prices
The best evidence of the fair value of a asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of a asset in Note 21 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information
For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

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

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

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

Level 3: Fair value established using valuation techniques with significant unobservable market information
In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

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

When determining the fair value of rental earning investment property net present value of future cash flow is calculated. When determining the cash flow, general accepted valuation techniques are applied, such as international valuation standard, IVS no. 1 Market Value Basis of Valuation. Vast majority of the rental earning investment properties are valued based on aforementioned valuation technique but when preconditions are not available the Group uses management valuation.

The Group applies management valuation for determining fair value of investment properties under construction at the end of the year. Management valuation is based on recent transactions and offers for similar assets.

22. Fair value hierarchy, continued

The level of the fair value hierarchy of assets is determined at the end of each reporting year.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	2013	2012	2013	2012	2013	2012
Balance at the beginning of the year	28,919	27,100	1,935	2,021	30,854	29,121
Fair value adjustments	1,219	1,584	231	191	1,450	1,775
Additions	1,804	3,729	-	105	1,804	3,834
Disposal	(3,419)	(3,494)	(407)	(391)	(3,826)	(3,885)
Transfers into Level 3	-	-	-	9	-	9
Transfers out of Level 3	-	-	(92)	-	(92)	-
Balance at the end of the year	28,523	28,919	1,667	1,935	30,190	30,854

Within line items in the Consolidated Statement of Comprehensive Income where gain (loss) related to fair value measurements in Level 3 is recognised

	2013	2012
Net interest income	82	151
Net financial income	149	40
Other operating income	1,219	1,584
Gain (loss) recognised in the Consolidated Statement of Comprehensive Income	1,450	1,775

Significant unobservable inputs to valuation in Level 3

	Valuation technique	Significant unobservable inputs	Range	Sensitivity of the input to fair value
Rental earning investment properties	DCF method	Weighted average cost of capital	4.4-6.3%	+ / - 0.5% change in WACC would result in increase / decrease in FV by ISK 2,072 / ISK1,735 million.
Investment properties under construction	Management Valuation	Years in NPV calculations	1/2-4 yrs	+ / - 1 year change would result in increase / decrease in FV by ISK 439 / ISK 493 million.

Significant accounting estimates and judgements

As the fair value measurement of Level 3 assets is based on valuation techniques with significant unobservable inputs there is uncertainty about the actual fair value of the assets.

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22. Fair value hierarchy, continued

Carrying amounts and fair values of financial assets and financial liabilities that are not carried at fair value in the Consolidated Financial Statements. The table does not include the fair values of non-financial assets and non-financial liabilities.

2013	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	37,999	37,999	-
Loans to credit institutions	102,307	102,307	-
Loans to customers	635,774	626,825	(8,949)
Other financial assets	5,746	5,746	-
Financial assets not carried at fair value	781,826	772,877	(8,949)
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	28,000	28,000	-
Deposits	471,866	472,063	(197)
Borrowings	204,568	196,981	7,587
Subordinated loans	31,918	31,918	-
Other financial liabilities	36,747	36,747	-
Financial liabilities not carried at fair value	773,099	765,709	7,390
Net unrealised gain (loss) not recognised in the Consolidated Statement of Comprehensive Income			(1,559)

2012	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	29,746	29,746	-
Loans to credit institutions	101,011	101,011	-
Loans to customers	566,610	555,468	(11,142)
Other financial assets	5,030	5,030	-
Financial assets not carried at fair value	702,397	691,255	(11,142)
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	32,990	32,990	-
Deposits	448,683	449,047	(364)
Borrowings	195,085	195,562	(478)
Subordinated loans	34,220	34,220	-
Other financial liabilities	35,141	35,141	-
Financial liabilities not carried at fair value	746,119	746,960	(842)
Net unrealised gain (loss) not recognised in the Consolidated Statement of Comprehensive Income			(11,984)

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Arion Bank Consolidated Financial Statements 2013 31 Amounts are in ISK millions

22. Fair value hierarchy, continued

Derivatives

	Fair value	
	Assets	Liabilities
2013		
Forward exchange rate agreements, unlisted	68	20
Interest rate and exchange rate agreements, unlisted	518	42
Bond swap agreements, unlisted	4	54
Share swap agreements, unlisted	33	632
Options - purchased agreements, unlisted	447	13
Derivatives	1,070	761
2012		
Forward exchange rate agreements, unlisted	250	92
Interest rate and exchange rate agreements, unlisted	71	792
Bond swap agreements, unlisted	17	42
Share swap agreements, unlisted	16	49
Options - purchased agreements, unlisted	434	-
Derivatives	788	975

Arion Bank Consolidated Financial Statements 2013 32 Amounts are in ISK millions

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet				
2013	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognised on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets re-cognised on balance sheet
Reverse repurchase agreements	10,381	-	10,381	(8,199)	-	2,182	-	10,381
Derivatives	389	-	389	(22)	-	367	681	1,070
Other assets netted by deposits	17,049	(15,374)	1,675	-	-	1,675	-	1,675
Total assets	27,819	(15,374)	12,445	(8,221)	-	4,224	681	13,126
2012								
Reverse repurchase agreements	13,095	-	13,095	(12,350)	-	745	-	13,095
Derivatives	170	-	170	(8)	-	162	618	788
Total assets	13,265	-	13,265	(12,358)	-	907	618	13,883

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
2013	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognised on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognised on balance sheet
Repurchase agreements	8,199	-	8,199	(8,199)	-	-	-	8,199
Derivatives	39	-	39	(22)	-	17	722	761
Deposits netted against other assets	15,374	(15,374)	-	-	-	-	-	-
Total liabilities	23,612	(15,374)	8,238	(8,221)	-	17	722	8,960
2012								
Repurchase agreements	12,350	-	12,350	(12,350)	-	-	-	12,350
Derivatives	806	-	806	(8)	-	798	169	975
Total liabilities	13,156	-	13,156	(12,358)	-	798	169	13,325

Accounting policies for offsetting are provided in Note 53.

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24. Investments in associates

The Group´s interest in its principal associates	2013	2012
Auðkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	45.8%	30.1%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	39.3%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúðir, Iceland	30.0%	30.0%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	31.8%	36.3%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	21.7%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmiðjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	23.6%
Skipti hf., Ármúla 25, 108 Reykjavík, Iceland	38.3%	-
SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland	-	39.1%

Investments in associates		
Carrying amount at the beginning of the year	7,050	2,987
Additions	8,903	1,658
Dividend	(10)	-
Share of profit (loss) of associates and reversal of impairment	1,986	2,405
Investment in associates	17,929	7,050

On 30 April 2013 creditors of Skipti hf. reached an agreement on financial restructuring of Skipti hf. Arion bank hf., the largest creditor, converted claims to shares and holds 38.3% share in Skipti hf.

*Summarised financial information in respect of the Group´s associates**	2013	2012
Total assets	457,202	560,268
Total liabilities	(316,762)	(446,287)
Net assets	140,441	113,981
Total revenue of associates	263,365	396,201
Net earnings of associates	9,595	(11,200)

This value is based on book value of net assets in each company and does not reflect the Bank's view of its value.

*These information were not audited or reviewed by the Bank's auditor.

25. Intangible assets

Intangible assets comprise three categories: Infrastructure, Customer Relationship and Related Agreements and Software. Infrastructure and Customer Relationship and Related Agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

Infrastructure, which is capitalized as an intangible asset, is connected to two business segments at the Bank, namely Asset Management within the Bank and within the Bank's subsidiary Stefnir hf. and Credit card operation at the Bank's subsidiary Valitor Holding hf. In both cases the business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as is described below.

Customer Relationship and Related Agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries bought in 2008-2009. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are those of the subsidiaries Okkar líftryggingar, Ekort and Tekjuvernd. Every year existing agreements are examined and compared with agreements which were valid at the time of acquisition. Impairment is made if agreements are closed and recognized impairment in 2013 was ISK 0.5 million (2012: nil).

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25. Intangible assets, continued

At the end of 2013 an agreement was reached to settle the bond issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. Included in this agreement was the settlement of any potential value of business relationships attributable to the deposits transferred from SPRON in 2009 and the loans transferred to Arion Bank as a payment for the bond. The Bank valued the business relationships at ISK 1 billion and will amortize this asset over a period of 5-7 years.

Software is acquired computer software licenses and is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3 - 5 years.

2013	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	3,914	144	883	4,941
Additions	-	1,000	841	1,841
Impairment	(839)	-	-	(839)
Amortisation	-	-	(560)	(560)
Intangible assets	3,075	1,144	1,164	5,383
2012				
Balance at the beginning of the year	3,886	144	735	4,765
Additions	28	-	685	713
Amortisation	-	-	(537)	(537)
Intangible assets	3,914	144	883	4,941

Impairment testing

The methodology for impairment testing on the Infrastructure which is part of intangible assets is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment was recognized for Credit card operation in 2013 ISK 839 million (2012: nil).

	2013		2012	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	13.1%	2.5%	12.4%	2.5%
Credit card operation	15.1%	4-10%	13.9%	4.3%

26. Tax assets and tax liabilities

	2013		2012	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,698	17	1,899
Deferred tax	818	1,226	446	1,338
Tax assets and tax liabilities	818	4,924	463	3,237

Deferred tax assets and tax liabilities are attributable to the following:

Foreign currency denominated assets and liabilities	25	(212)	-	(694)
Investment property and property and equipment	144	(1,770)	-	(215)
Financial assets	580	-	11	(1,343)
Other assets and liabilities	514	(90)	550	(47)
Deferred tax related to foreign exchange gain	79	-	168	(81)
Tax loss carry forward	322	-	759	-
	1,664	(2,072)	1,488	(2,380)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(846)	846	(1,042)	1,042
Deferred tax assets and tax liabilities	818	(1,226)	446	(1,338)

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26. Tax assets and tax liabilities, continued

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 728 million (31.12.2012: ISK 1,371 million) that is not recognised in the Financial Statements, due to uncertainty about the utilisation possibilities of the loss.

Changes in deferred tax assets and tax liabilities

2013	At 1 Jan.	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(248)	61	(187)
Investment property and property and equipment	(1,275)	(351)	(1,626)
Financial assets	565	15	580
Other assets and liabilities	11	413	424
Deferred foreign exchange differences	(696)	775	79
Tax loss carry forward	751	(429)	322
Change in deferred tax assets and tax liabilities	(892)	484	(408)

2012			
Foreign currency denominated assets and liabilities	(222)	(26)	(248)
Investment property and property and equipment	(529)	(746)	(1,275)
Financial assets	611	(46)	565
Other assets and liabilities	(42)	53	11
Deferred foreign exchange differences	(897)	201	(696)
Tax loss carry forward	660	91	751
Change in deferred tax assets and tax liabilities	(419)	(473)	(892)

27. Other assets

	2013	2012
Non-current assets and disposal groups held for sale	10,046	11,923
Property and equipment	6,943	6,311
Accounts receivable	4,610	4,084
Prepaid expenses	690	687
Accrued income	619	456
Unsettled securities trading	255	125
Sundry assets	413	549
Other assets	23,576	24,135

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27. Other assets, continued

Non-current assets and disposal groups held for sale	2013	2012
Legal entities	300	1,733
Associates	5,457	6,384
Real estates	4,150	3,275
Other assets	139	531
Non-current assets and disposal groups held for sale	10,046	11,923

The legal entities are subsidiaries that were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5.

The main associate classified as disposal groups held for sale in accordance with IFRS 5 is HB Grandi hf. (31% share).

Real estates and other assets classified as non-current assets are generally the result of foreclosures on companies and individuals.

	2013	2012
Liabilities associated with the legal entities held for sale	567	1,769

Significant accounting estimates and judgements

Associates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. For the most part, fair value at the date of classification of these legal entities was calculated using valuation models based on discounted future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), could have impact on the fair value of these disposal groups.

Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. Fair value at the date of classification is based on independent property valuers or management valuation. As the fair value measurement of real estates is based on valuation techniques there is uncertainty about the actual fair value of the assets.

Property and equipment	Real estate	Equip-ment	Total 2013	Total 2012
Gross carrying amount at the beginning of the year	5,104	4,013	9,117	8,197
Additions	1,104	1,077	2,181	961
Disposals	(189)	(39)	(228)	(41)
Transfers to investment property	(166)	-	(166)	-
Gross carrying amount at the end of the year	5,853	5,051	10,904	9,117
Accumulated depreciation at the beginning of the year	(654)	(2,152)	(2,806)	(1,926)
Depreciation	(389)	(839)	(1,228)	(899)
Disposals	24	28	52	19
Transfers to investment property	21	-	21	-
Accumulated depreciation at the end of the year	(998)	(2,963)	(3,961)	(2,806)
Property and equipment	4,855	2,088	6,943	6,311

The official real estate value (Registers Iceland) amounts to ISK 5,025 million at the end of the year (2012: ISK 4,954 million) and the insurance value amounts to ISK 9,466 million (2012: ISK 9,633 million).

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28. Other liabilities

	2013	2012
Accounts payable	19,264	19,318
Provision for settled FX loans	4,524	4,625
Unsettled securities trading	144	842
Depositors' and investors' guarantee fund	2,886	2,919
Insurance claim	2,266	2,138
Withholding tax	1,552	1,926
Non-current liabilities and disposal groups held for sale	567	1,769
Bank levy	2,835	357
Sundry liabilities	9,629	8,223
Other liabilities	43,667	42,117

29. Borrowings

	Issued	Maturity	Maturity type	Currency	Terms of interest	2013	2012
Covered bond	2013	2019	At maturity	ISK	Fixed, CPI linked, 2.50%	4,453	-
Covered bond	2012	2015	At maturity	ISK	Fixed, 6.50%	4,378	2,540
Covered bond	2012	2034	Amortizing	ISK	Fixed, CPI linked, 3.60%	2,603	2,592
Covered bond	2008	2045	Amortizing	ISK	Fixed, CPI linked, 4.00%	21,361	20,922
Covered bond	2008	2031	Amortizing	ISK	Fixed, CPI linked, 4.00%	4,934	4,948
Covered bond	2006	2048	Amortizing	ISK	Fixed, CPI linked, 3.75%	77,894	76,169
Covered bond	2005	2033	Amortizing	ISK	Fixed, CPI linked, 3.75%	17,873	17,819
Covered bonds						133,497	124,991
Senior unsecured bond	2013	2016	At maturity	NOK	Floating, NIBOR + 5.00%	9,356	-
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1.00%	2,662	3,192
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1.00%	2,202	2,815
Secured bond, Landfestar	2010	2044	Amortizing	ISK	Fixed, CPI linked, 4.70%	2,932	2,902
Bonds issued						17,152	8,909
Central Bank, secured	2010	2022	At maturity	Various	Floating, LIBOR + 3.00%	52,998	60,056
Other						922	1,129
Other loans						53,920	61,185
Borrowings						204,568	195,085

Book value of listed bonds was ISK 23,770 million (31.12.2012: ISK 8,034 million) at the end of the year. Market value of those bonds was ISK 24,472 million (31.12.2012: ISK 8,512 million).

The Group did not repurchase any own debts in 2013 (2012: nil).

30. Subordinated liabilities

	Issued	Maturity	Maturity type	Currency	Terms of interest	2013	2012
Tier II capital	2010	2020	At maturity	Various	Floating, LIBOR + 4.00%*	31,918	34,220
Subordinated liabilities						31,918	34,220

* In 2015 and thereafter 3 month EURIBOR/LIBOR +500 basis points.

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31. Pledged assets

Pledged assets against liabilities	2013	2012
Assets which have been pledged as collateral against borrowings	258,762	248,864
Assets which have been pledged as collateral against loans from credit institutions and short positions	18,440	35,701
Pledged assets against liabilities	277,202	284,565

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 259 billion at the end of the year (31.12.2012: ISK 249 billion). Those assets were mainly pool of mortgage loans to individuals, loans to municipals and loans to state related entities. The book value of those borrowings was ISK 189 billion at the end of the year (31.12.2012: ISK 188 billion).

Assets are primarily pledged against borrowings associated with the acquisition of the pledged assets. Two major events are most significant. Assets were acquired from the Central Bank of Iceland in conjunction with the recapitalization of Arion Bank on 8 January 2010 and a portfolio of mortgages was acquired from Kaupthing hf. and is pledged against a structured covered bond that Arion Bank took over as issuer of from Kaupthing hf. at the end of 2011.

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

32. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	2013	Number (million)	2012
Issued share capital	2,000	75,861	2,000	75,861
	2,000	75,861	2,000	75,861

Share premium represents excess of payment above nominal value that Shareholders have paid for shares issued by Arion banki hf.

Other reserves	2013	2012
Statutory reserve	1,637	1,637
Foreign currency translation reserve	-	2
Other reserves	1,637	1,639

OFF BALANCE SHEET INFORMATION

33. Obligations

Guarantees, unused overdraft and loan commitments the Group has granted its customers

	2013	2012
Guarantees	9,922	9,185
Unused overdrafts	37,371	34,545
Loan commitments	48,585	36,001

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

34. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 22 years. The majority of the contracts include renewal options for various periods of time.

	2013	2012
Less than one year	272	339
Over 1 year and up to 5 years	960	1,173
Over 5 years	800	1,115
Future minimum lease payments under non-cancellable leases	2,032	2,627

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 17 years, with majority being non-cancellable agreements.

	2013	2012
Less than one year	2,353	2,084
Over 1 year and up to 5 years	5,086	5,898
Over 5 years	1,480	1,968
Future minimum lease payments under non-cancellable leases	8,919	9,950

35. Assets under management and under custody

Assets under management	895,457	819,684
Assets under custody	1,490,888	1,378,454

36. Legal matters

The Group has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects which the claims may have on its financial standing. At the end of the year, the Group had several unresolved legal claims.

i) Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into practices of all card issuers in Iceland, including the Bank, and by two card payment acquirers, including Valitor. The investigation was initiated by a complaint by Kortaþjónustan hf., a card payment acquirer, in 2009. The case concerns alleged concerted practices through associations of undertakings connected to decisions on multilateral interchange fees and alleged anti-competitive practices towards competitors in the field of acquiring.

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36. Legal matters, continued

The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The complaints from BYR hf. and MP banki hf. concern the terms of the Banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition.

The ICA received a complaint from Tryggingamiðstöðin hf. in 2010. The complaint concerns the banks' alleged tying of banking services and insurances.

The extent of the investigations and outcome of the cases before the ICA is still uncertain as well as any effect on the Group. However, if the Bank or Valitor will be deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor for abusing its dominant position on the payment card market and violating conditions set in an earlier decision of the Authority. Valitor appealed the decision to the Competition Appeals Committee. In October 2013 the Committee confirmed the decision of the Competition Authority. Valitor may decide to file a motion and appeal this administrative decision to the courts.

In 2012 Kortaþjónustan hf. filed a suit against Valitor claiming damages for the alleged loss suffered by Kortaþjónustan hf. due to alleged breaches of competition law based on a settlement made by Valitor with the ICA, published in ICA decision No 4/2008. The case is still being contested before the District Court of Reykjavík. In July 2013 Kortaþjónustan hf. filed another suit, now against the Bank and Valitor, claiming damages for the alleged loss suffered by Kortaþjónustan hf. in relation to the alleged breaches of competition law based on the complaint to the ICA in 2009, stated above. The case is being contested before the District Court of Reykjavík.

Legal proceedings regarding the Bank's variable interest rate

Two borrowers have issued summons against the Group where they claim that a clause in their mortgage loan (in foreign currency), where it is stated that the bond shall bear a variable interest rate, which the Bank was authorised to change, is illegal and unbinding. The borrowers make e.g. the claim that it will be recognised by the court that said clause on interest rates is illegal. The Bank defended against the borrowers' summons and with a judgment on 20 December 2013 the Group was acquitted. The case has not yet been appealed to the Supreme Court of Iceland but if the borrowers appeal and the Supreme Court sides with the borrowers, it could have a negative effect on the Bank's loan portfolio with variable interest rates in foreign currency (i.e. foreign currency-linked loans in ISK) and also in ISK.

ii) Other legal matters

Legal proceedings regarding CPI loans

Recently, there has been discussion in the media where it has been claimed that the indexation of the principal of mortgage loans to consumers to the Consumer Price Index (CPI) is possibly illegal and therefore the appreciation of the principal of each loan, due to the rise of the CPI, should be annulled. Reportedly, there are two court cases in motion regarding this issue, but the Bank is not a party to those cases. Recently, the Supreme Court requested Advisory Opinions from the EFTA Court in two separate cases on the interpretation of certain provisions of an EC directive, in cases where the disagreement is whether the CPI-indexation of a loan is in accordance with certain provisions of Icelandic law on contracts. If successful in a court case, one possible outcome is that a debtor would receive a part or all of the CPI-indexation of his loan annulled. The Group considers the possibility of this happening unlikely, and has therefore made no provision due to this.

iii) Legal matters concluded

Legal proceedings regarding Stefnir hf.

In October 2011 the winding-up committee of Landsbanki Íslands brought legal action against Stefnir hf. demanding the annulment and repayment of payments made by Landsbanki Íslands of money market deposits which matured in early October 2008 to two funds managed by Stefnir. The amount involved was ISK 450 million plus interest. As a result of this judgment by Reykjavík District Court, Stefnir, on behalf of the two funds, was ordered to repay the amounts. The company made provision in respect of this case in 2012. The case was appealed to the Supreme Court of Iceland where Stefnir was acquitted on 16 January 2014 and the provision has been revised in the accounts for 2013.

36. Legal matters, continued

Legal proceedings regarding FX loans

With a summons, presented to the Bank on 14 November 2012, Hagar hf., a listed company, claimed from the Bank ISK 1,152 million plus interest from 19 October 2009 until the date of payment, minus a payment of ISK 515 million made on 19 December 2011. The summons followed Hagar's announcement on the Icelandic Stock Exchange from 21 March 2012, whereby Hagar announced that it had decided to take legal action against the Bank regarding Hagar's foreign currency linked loans, which it had reimbursed in full to the Bank in October 2009. Hagar's foreign currency linked loans were recalculated by the Bank in accordance with the Bank's notification of 15 June 2011. The outcome of the recalculation showed that the Bank owed Hagar ISK 515 million, which the Bank subsequently paid to Hagar. After the Supreme Court of Iceland had passed its judgment of 15 February 2012 (in case no. 600/2011), Hagar expressed its view to the Bank that, in light of the above judgment, Hagar believed it had a further claim against the Bank regarding said foreign currency linked loans. The Bank rejected Hagar's claim and defended the case in court. With a judgement of the District Court pronounced on 28 May 2013 the Bank was acquitted of Hagar's claim. Hagar appealed the judgement to the Supreme Court and with a judgement on 12 December 2013 the Supreme Court confirmed the judgement of the District Court and the Bank was acquitted. The effect of this judgement has been calculated in the Groups provision for foreign currency loans.

37. The uncertainty regarding the book value of foreign currency loans

In recent years there has been considerable uncertainty over the legality of foreign currency loans to individuals and companies and the recalculation of those loans which are clearly currency-linked loans in Icelandic krona. Firstly, there has been uncertainty over which loans are considered legal foreign currency loans and which loans are considered currency-linked loans in Icelandic krona, and secondly over how loans in the latter category should be recalculated. The Bank has been required to recalculate numerous loans which are considered currency-linked loans in Icelandic krona on the basis of the Interest and Indexation Act No. 38/2001 and after examining the judgments passed by the Supreme Court which were considered to set a precedent for the Bank's loans.

The uncertainty of legality of FX loans has continued in 2013 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. After consideration of such judgments, the Group provisioned ISK 1.5 billion in 2013 in addition to ISK 19.6 billion impaired in 2011 and 2012.

Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in three respects:

Firstly, the estimation uncertainty associated with the Group's interpretation of the impact of several judgments of the Supreme Court of Iceland regarding the method of recalculation of illegal currency-linked loans. This uncertainty is somewhat mitigated by the use of FME prescribed methodology. In the event the Group's interpretation of the judgments were to change, the total loss could be greater or less than the current provision in the accounts of ISK 5.4 billion.

Secondly, there have been claims that currency-linked loans to consumers should, from the date they have been recalculated and until the loans are repaid, bear their contractual interest rates, and not the non-indexed interest rate for the Icelandic Krona posted by the Central Bank of Iceland, as stipulated in Act No. 151/2010. This will probably be determined by future court rulings, for which it is currently not possible to predict the outcome.

Thirdly, the legal uncertainty over the outcome of future legal decisions and new or amended government legislation that may require the recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome. Some uncertainty still exists over the impact of the above matters on the carrying value of the Group's portfolio of foreign currency linked loans at the end of the year.

Nevertheless, the Group considers its portfolio of foreign currency linked loans fully provisioned for the most likely outcome.

38. Events after Balance Sheet date

In January 2014 the shareholders of Eik fasteignafélag hf. approved an agreement signed by Arion Bank hf. and Eik fasteignafélag hf. in December 2013 on the purchase of all of issued shares of Landfestar hf. After the acquisition Arion Bank hf. will be the largest shareholder of Eik fasteignafélag hf. The agreement was signed subject to due diligence and approval by the Icelandic Competition Authority.

RELATED PARTY

39. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

The Board of Directors of Arion Bank, key Management personnel of the Bank and the Group's associates are defined as related parties, as well as close family members of individuals referred to above and legal entities controlled by them.

No unusual transactions took place with related parties during the year. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

2013 *Balances with related parties*	Assets	Liabilities	Net balance
Shareholders with control over the Group	554	(63,949)	(63,395)
Shareholders with influence over the Group	19	(2,003)	(1,984)
Board of Directors and key Management personnel	228	(68)	160
Associates and other related parties	36,546	(19,015)	17,531
Balances with related parties	37,347	(85,035)	(47,688)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(1,206)	76	-
Shareholders with influence over the Group	33	-	2	(11)
Board of Directors and key Management personnel	7	(3)	27	-
Associates and other related parties	4,237	(704)	1,233	(196)
Transactions with related parties	4,277	(1,912)	1,337	(207)

2012 *Balances with related parties*	Assets	Liabilities	Net balance
Shareholders with control over the Group	704	(61,095)	(60,391)
Shareholders with influence over the Group	-	(1,960)	(1,960)
Board of Directors and key Management personnel	129	(128)	1
Associates and other related parties	53,737	(16,379)	37,358
Balances with related parties	54,570	(79,562)	(24,992)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(1,207)	57	-
Shareholders with influence over the Group	-	(18)	-	-
Board of Directors and key Management personnel	10	(3)	-	-
Associates and other related parties	4,118	(279)	771	(173)
Transactions with related parties	4,128	(1,507)	828	(173)

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RISK MANAGEMENT DISCLOSURES

The Group faces various risks arising from its day to day operations. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, policies and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital adequacy assessment process (ICAAP). The Asset and Liability Committee (ALCO), chaired by the CEO or his deputy, is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes, policies and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BARC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into five units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Economic Capital, which is responsible for the Bank's ICAAP; Portfolio Risk, which monitors liquidity risk and risks in the Bank's assets and liabilities at the portfolio level; and Operational Risk which monitors risks associated with the daily operation of the Bank.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk and legal risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The Group is to some extent exposed to risks through the loan portfolio that are related to assumptions about asset valuation and asset performance. Provisions have in some cases been made to meet possible losses. Concentration in the Group's loan portfolio is relatively high; the total sum of large exposures net of eligible collateral at the end of the year 2013 was 45% of the capital base, down from 60% in the previous year.

The Group is exposed to currency risk. The Bank has met the legal limits on currency imbalance since 2012. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, approximately half of which is on demand.

The Group faces legal risk related to previous court judgments on foreign currency loans, see Note 37.

Further information on risk management and capital adequacy is provided in the annual Consolidated Financial Statements for 2013 and in the Pillar 3 Risk Disclosures for 2013. The Pillar 3 Risk Disclosures 2013 will be published in March 2014 and be available on the Bank's website, www.arionbanki.is. The disclosures have not been subject to external audit.

40. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

Managing and analysing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

40. Credit risk, continued

Maximum exposure to credit risk and credit concentration by industry sectors

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2013

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	37,999	-	-	-	-	-	37,999
Loans to credit institutions	-	-	-	-	-	102,307	-	-	-	-	-	102,307
Loans to customers	310,491	83,002	60,906	24,025	55,061	27,535	22,661	18,966	19,793	8,682	4,652	635,774
Financial instruments	3	26	1	7	42	2,960	1,336	6	514	58,836	-	63,731
Other assets with credit risk	295	312	78	15	835	3,636	23	1	506	45	-	5,746
Total on balance sheet maximum exposure to credit risk	310,789	83,340	60,985	24,047	55,938	174,437	24,020	18,973	20,813	67,563	4,652	845,557

Maximum exposure to credit risk related to off-balance sheet items

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	387	1,781	534	769	1,328	1,183	2,539	500	833	60	8	9,922
Unused overdrafts	22,282	1,433	395	591	4,095	1,951	1,653	298	2,005	2,298	371	37,371
Loan commitments	205	6,651	2,895	2,617	12,517	5,536	16,529	837	778	20	-	48,585
Total off balance sheet maximum exposure to credit risk	22,874	9,865	3,824	3,977	17,940	8,670	20,721	1,635	3,616	2,378	379	95,878
Maximum exposure to credit risk	333,663	93,205	64,809	28,024	73,878	183,107	44,741	20,608	24,429	69,941	5,031	941,435

Amounts are in ISK millions

40. Credit risk, continued

2012

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and com- munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu- facturing	Transpor- tation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	29,746	-	-	-	-	-	29,746
Loans to credit institutions	-	-	-	-	-	101,011	-	-	-	-	-	101,011
Loans to customers	242,775	68,834	67,752	28,754	55,621	24,693	22,794	21,692	18,745	9,952	4,998	566,610
Financial instruments	-	25	-	28	-	74,630	1,210	7	1,233	42,845	-	119,978
Other assets with credit risk	316	1,569	15	83	80	2,388	47	1	501	19	11	5,030
Total on balance sheet maximum exposure to credit risk	243,091	70,428	67,767	28,865	55,701	232,468	24,051	21,700	20,479	52,816	5,009	822,375

Maximum exposure to credit risk related to off-balance sheet items

	Individuals	Real estate activities and construction	Fishing industry	Information and com- munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu- facturing	Transpor- tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	388	919	348	592	1,879	1,510	2,294	466	677	95	17	9,185
Unused overdrafts	21,499	1,143	295	463	3,548	1,666	1,555	305	1,606	2,209	256	34,545
Loan commitments	118	2,214	5,298	215	10,300	5,634	11,375	837	-	-	10	36,001
Total off balance sheet maximum exposure to credit risk	22,005	4,276	5,941	1,270	15,727	8,810	15,224	1,608	2,283	2,304	283	79,731
Maximum exposure to credit risk	265,096	74,704	73,708	30,135	71,428	241,278	39,275	23,308	22,762	55,120	5,292	902,106

Amounts are in ISK millions

40. Credit risk, continued

Loans to customers specified by sectors	2013	2012
Individuals	48.8%	42.8%
Real estate activities and construction	13.1%	12.1%
Fishing industry	9.6%	12.0%
Information and communication technology	3.8%	5.1%
Wholesale and retail trade	8.7%	9.8%
Financial and insurance activities	4.3%	4.4%
Industry, energy and manufacturing	3.5%	4.0%
Transportation	3.0%	3.8%
Services	3.1%	3.3%
Public administration, human health and social activities	1.4%	1.8%
Agriculture and forestry	0.7%	0.9%
	100.0%	100.0%

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages in residential properties.
- Corporate loans: Charges over real estate properties, fishing vessels and other fixed and current assets, inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

Collateral held by the Bank against different types of financial assets

2013	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	659	269,700	49	362	270,770
Real estate activities and construction	3,887	55,427	12	1,053	60,379
Fishing industry	89	3,039	52,878	2,361	58,367
Information and communication technology	26	1,842	-	20,452	22,320
Wholesale and retail trade	6,664	10,095	5	28,447	45,211
Financial and insurance activities	12,416	441	-	9,116	21,973
Industry, energy and manufacturing	180	8,645	46	10,719	19,590
Transportation	69	563	51	2,310	2,993
Services	285	3,314	98	2,994	6,691
Public administration, human health and social activities	22	3,190	-	170	3,382
Agriculture and forestry	5	2,331	-	136	2,472
Financial instruments	2,867	-	-	-	2,867
Collateral held against different types of financial assets	27,169	358,587	53,139	78,120	517,015

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40. Credit risk, continued

2012	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	560	208,967	39	84	209,650
Real estate activities and construction	677	46,229	5	267	47,178
Fishing industry	642	2,311	50,528	6,020	59,502
Information and communication technology	78	625	-	17,981	18,684
Wholesale and retail trade	1,900	13,793	-	17,489	33,181
Financial and insurance activities	11,141	526	-	884	12,551
Industry, energy and manufacturing	222	7,014	50	1,058	8,344
Transportation	65	493	76	688	1,322
Services	249	2,911	57	1,215	4,432
Public administration, human health and social activities	28	3,263	-	91	3,382
Agriculture and forestry	10	1,858	-	9	1,876
Financial instruments	1,219			68,628	69,847
Collateral held against different types of financial assets	16,792	287,991	50,754	114,414	469,950

The information is for loans and collateral at the Bank only.

In the tables above, collateral is allocated based on the claim value of loans. In the 2012 financial statement, collateral was allocated based on book value. The 2012 figures have been restated to reflect this change in methodology.

Credit quality by class of financial assets

2013	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired*	Total
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers				
Loans to corporates	304,880	9,789	10,614	325,283
Loans to individuals	268,485	34,607	7,399	310,491
Financial instruments	63,731	-	-	63,731
Other assets with credit risk	5,746	-	-	5,746
Credit quality of loans	783,148	44,396	18,013	845,557

2012	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired*	Total
Cash and balances with Central Bank	29,746	-	-	29,746
Loans to credit institutions	101,011	-	-	101,011
Loans to customers				
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Financial instruments	119,978	-	-	119,978
Other assets with credit risk	5,030	-	-	5,030
Credit quality of loans	731,682	40,696	49,997	822,375

* The figures for individually impaired reflects both impairment due to legal uncertainty related to foreign currency loans as well as impairment due to a deterioration in the borrower's credit quality.

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40. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive.

The table below shows loans to customers which are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

	Risk classification						
2013	1	2	3	4	5	Not rated	Total
Individuals	12,201	68,291	120,751	53,841	9,978	3,422	268,484
Real estate activities and construction	1,889	4,924	37,703	6,848	708	27,612	79,684
Fishing industry	26,962	6,070	7,193	10,865	3,162	3,707	57,959
Information and communication technology	19,242	2,802	1,065	294	2	1,011	24,416
Wholesale and retail trade	12,130	9,550	18,057	3,384	1,644	6,395	51,160
Financial and insurance activities	102	9,178	1,429	211	-	12,721	23,641
Industry, energy and manufacturing	4,610	12,193	2,979	580	550	758	21,670
Transportation	197	17,404	573	458	87	244	18,963
Services	117	10,198	3,288	914	110	442	15,069
Public sector	85	3,335	917	178	38	4,052	8,605
Agriculture and forestry	162	480	1,636	769	11	656	3,714
Neither past due nor impaired loans	77,697	144,425	195,591	78,342	16,290	61,020	573,365
2012							
Individuals	10,411	56,716	85,813	37,534	8,110	6,949	205,533
Real estate activities and construction	27	1,341	25,099	17,636	9,635	3,185	56,923
Fishing industry	2,580	18,566	8,080	9,306	3,210	14,474	56,217
Information and communication technology	139	2,920	514	276	20,146	1,414	25,409
Wholesale and retail trade	12,535	7,001	15,840	2,710	1,706	7,248	47,040
Financial and insurance activities	546	223	1,342	225	6,508	7,430	16,274
Industry, energy and manufacturing	1,316	3,069	2,370	821	3,201	10,713	21,490
Transportation	144	20,062	214	535	1	482	21,439
Services	758	2,000	9,741	471	82	1,113	14,166
Public sector	264	3,006	620	103	112	4,471	8,577
Agriculture and forestry	2	311	1,357	345	48	788	2,851
Neither past due nor impaired loans	28,724	115,215	150,992	69,962	52,759	58,266	475,918

Exposures that are 'Not Rated' are primarily due to newly formed entities and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and some holding companies.

Past due but not impaired loans by class of loans

2013	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,100	923	111	2,655	9,789
Loans to individuals	11,224	3,751	543	19,089	34,607
Past due but not impaired loans	17,325	4,673	655	21,744	44,396
2012					
Loans to corporates	6,285	951	322	10,293	17,851
Loans to individuals	8,719	3,558	287	10,281	22,845
Past due but not impaired loans	15,004	4,509	609	20,574	40,696

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40. Credit risk, continued

The majority of the past due but not impaired loans have been acquired at discount. These loans are not considered to be impaired unless the specific allowance exceeds the discount received.

Collateral repossessed

During the year, the Group took possession of real estates with the carrying value of ISK 1,692 million and other assets with the value of ISK 5 million, all which the Group is in the process of selling, see Note 27.

Impaired loans to customers specified by sector

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
2013	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
Individuals	11,538	18,496	173	614	11,711	19,110
Real estate activities and construction	1,726	3,755	37	113	1,763	3,868
Fishing industry	617	1,899	612	1,870	1,229	3,769
Information and communication technology	164	190	-	-	164	190
Wholesale and retail trade	4,020	5,941	14	44	4,034	5,985
Financial and insurance activities	4,513	6,080	-	-	4,513	6,080
Industry, energy and manufacturing	446	996	17	33	463	1,029
Transportation	65	356	6	9	71	365
Services	775	1,865	43	53	818	1,918
Public administration, human health and social activities	8	35	-	-	8	35
Agriculture and forestry	352	790	-	-	352	790
	24,224	40,403	902	2,736	25,126	43,139
2012						
Individuals	13,143	19,397	5,032	18,626	18,175	38,023
Real estate activities and construction	4,684	10,091	1,586	4,139	6,270	14,230
Fishing industry	2,361	4,343	2,648	6,913	5,009	11,256
Information and communication technology	7,561	11,192	187	307	7,748	11,499
Wholesale and retail trade	5,295	8,399	2,639	5,638	7,934	14,037
Financial and insurance activities	6,405	8,363	1,142	1,492	7,547	9,855
Industry, energy and manufacturing	604	1,152	483	999	1,087	2,151
Transportation	35	40	36	120	71	160
Services	744	1,168	505	1,328	1,249	2,496
Public administration, human health and social activities	30	38	262	406	292	444
Agriculture and forestry	636	895	422	1,391	1,058	2,286
	41,498	65,078	14,942	41,359	56,440	106,437

This note separates impairments that are due to the uncertainty related to foreign currency loans from impairments that are due to borrower credit quality. At year end 2012, a provision of ISK 14,942 million had been made for losses due to court rulings for illegal FX loans, in addition to the ISK 4,625 million transferred to liabilities. The provision is reduced to ISK 902 million at year end 2013 which reflects that the process of recalculating illegal FX loans is nearing completion. Recalculation in 2013 resulted in an additional ISK 1,952 million impairment and ISK 15,992 write-off or repayments. Provisions due to borrower credit quality have been similarly reduced, year on year – largely due to progress in corporate-loan restructuring during the period.

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40. Credit risk, continued

The Group made good progress in restructuring large loans to corporates resulting in a write-off. Consequently the impairment related to borrowers credit quality decreased in the Statement of Financial position. The Group settled great part of the recalculated foreign currency loans that had been provisioned for in prior years following court rulings about their illegality. That resulted in a decrease in the impairment amount for FX rulings between years.

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base net of eligible collateral according to FME rules No 625/2013.

The legal maximum for individual large exposures is 25% of capital base and the sum of all large exposures cannot exceed 400% of capital base.

The largest exposure to a group of connected clients at the end of the period was ISK 29 billion (31.12.2012: ISK 29 billion) before taking account of eligible collateral. The Group has three large exposures at the end of the period (31.12.2012: four exposures) net of eligible collateral.

	2013		2012	
no.	Gross	Net	Gross	Net
Drómi*	-	-	43%	-
1	17%	17%	18%	17%
2	16%	16%	18%	18%
3	12%	12%	14%	14%
4	10%	<10%	11%	11%
5	10%	<10%	<10%	<10%
Sum of large exposure gross and net > 10%	65%	45%	104%	60%

*See note 21 for information regarding the settlement of the Drómi bond.

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period.

The sum of exposures exceeding 10% of capital base is 65% of the Group's capital base before collateral mitigation or 45% net of eligible collateral, which is well below the 400% legal maximum.

41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

The Group keeps firm track of the market risk and separates its exposure to market risk into trading book and non-trading book i.e. banking book. The market risk in the trading book arises from proprietary trading activities. Market risk in the non-trading book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. The market risk in the trading book and in the non-trading book is managed separately by Treasury.

Market risk allowance is set by the Board in the Bank's risk appetite and the CEO decides on the limit framework for each trading desk and sets individual limits. The Asset and Liability Committee is responsible for managing the Bank's overall market risk. Risk management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

Arion Bank Consolidated Financial Statements 2013 52 Amounts are in ISK millions

41. Market risk, continued

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a large gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are generally fixed for a long period, resulting in a yield curve risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies, of which the largest one is EUR.

The Group's strategy for managing its interest rate risk is to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

Interest rate risk in the non-trading book

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rates by currency and interest fixing period in million of ISK in the Group. Risk is quantified as the net change in value of interest bearing assets and liabilities, when assuming a simultaneous parallel shift upwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income.

2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(44)	(823)	32	(557)	(1,129)
ISK, Non Indexed linked	(103)	(480)	(28)	(29)	(17)
EUR	63	(1)	-	-	-
Other	(36)	-	-	-	-

2012					
ISK, CPI Indexed linked	(35)	(603)	(282)	(1,980)	811
ISK, Non Indexed linked	(102)	(433)	57	-	(10)
EUR	71	(3)	-	-	-
Other	(35)	(6)	(50)	-	-

Interest rate risk in the trading book

Interest rate risk in the trading book is quantified in the same way as that of the non-trading book.

2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(11)	2	(0)	(34)	(92)
ISK, Non Indexed linked	(1)	(8)	(61)	(92)	-
EUR	1	-	-	-	-
Other	1	-	-	-	-

2012					
ISK, CPI Indexed linked	-	(19)	(80)	(5)	(270)
ISK, Non Indexed linked	(50)	(17)	(8)	(36)	-
EUR	(5)	-	-	-	-
Other	(2)	-	-	-	-

41. Market risk, continued

Group's assets and liabilities at carrying amount by residual maturity

2013 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	37,999	28,666	-	9,333	-	-	-
Loans to credit institutions	102,307	47,197	55,110	-	-	-	-
Loans to customers	635,774	2,151	56,696	85,340	221,979	269,608	-
Financial instruments	86,541	6,889	1,240	13,349	38,569	3,684	22,810
Derivatives - assets leg	23,567	447	8,008	4,094	11,018	-	-
Derivatives - liabilities leg	(22,497)	-	(7,918)	(3,893)	(10,686)	-	-
Investment property	28,523	-	-	-	-	-	28,523
Investments in associates	17,929	-	-	-	-	-	17,929
Intangible assets	5,383	-	-	-	-	-	5,383
Tax assets	818	-	-	-	-	818	-
Other assets	23,576	53	4,014	693	973	13	17,830
Assets 31.12.2013	938,850	84,956	117,060	108,715	261,521	274,123	92,475
Liabilities							
Due to credit institutions and Central Bank	28,000	17,692	3,622	6,636	50	-	-
Deposits	471,866	246,160	126,784	74,426	21,693	2,803	-
Financial liabilities at fair value	8,960	-	8,757	161	42	-	-
Assets leg	(18,830)	-	(16,322)	(911)	(1,597)	-	-
Liabilities leg	19,592	-	16,881	1,072	1,639	-	-
Short position bonds and derivatives	2,837	-	2,837	-	-	-	-
Short position bonds used for hedging	5,362	-	5,362	-	-	-	-
Tax liabilities	4,924	-	924	2,774	1,226	-	-
Other liabilities	43,667	371	28,344	5,098	2,671	263	6,919
Borrowings	204,568	-	1,868	2,319	27,779	172,602	-
Subordinated liabilities	31,918	-	-	-	-	31,918	-
Liabilities 31.12.2013	793,903	264,223	170,299	91,414	53,461	207,586	6,919
Off-balance sheet items:							
Guarantees	9,922	2,216	2,698	2,650	1,106	1,252	-
Unused overdraft	37,371	949	8,909	16,108	11,345	60	-
Loan commitments	48,585	3,301	25,011	14,198	6,075	-	-
Off-balance sheet items	95,878	6,466	36,618	32,956	18,526	1,312	-
Net interest sensitivity gap	49,069	(185,733)	(89,857)	(15,655)	189,534	65,225	85,556

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41. Market risk, continued

2012 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	29,746	21,121	-	8,625	-	-	-
Loans to credit institutions	101,011	84,033	16,721	-	257	-	-
Loans to customers	566,610	3,000	47,511	92,258	208,232	215,609	-
Financial instruments	137,800	8,494	693	48	69,159	41,584	17,822
Derivatives - assets leg	18,737	-	16,739	444	1,554	-	-
Derivatives - liabilities leg	(17,949)	-	(16,046)	(421)	(1,482)	-	-
Investment property	28,919	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	7,050
Intangible assets	4,941	-	-	-	-	-	4,941
Tax assets	463	-	-	17	446	-	-
Other assets	24,135	64	2,500	2,047	401	18	19,105
Assets 31.12.2012	900,675	116,712	67,425	102,995	278,495	257,211	77,837
Liabilities							
Due to credit institutions and Central Bank	32,990	12,742	12,360	7,659	229	-	-
Deposits	448,683	268,016	118,584	34,890	24,947	2,246	-
Financial liabilities at fair value	13,465	-	12,575	98	480	312	-
Assets leg	(25,677)	-	(6,037)	(4,533)	(9,646)	(5,461)	-
Liabilities leg	26,653	-	6,122	4,631	10,126	5,773	-
Short position bonds and derivatives	5,162	-	5,162	-	-	-	-
Short position bonds used for hedging	7,327	-	7,327	-	-	-	-
Tax liabilities	3,237	-	474	1,425	1,338	-	-
Other liabilities	42,117	492	25,952	5,180	3,207	308	6,978
Borrowings	195,085	601	1,865	2,858	31,686	158,075	-
Subordinated liabilities	34,220	-	-	-	-	34,220	-
Liabilities 31.12.2012	769,797	281,851	171,810	52,110	61,887	195,161	6,978
Off-balance sheet items:							
Guarantees	9,185	1,806	3,639	1,462	939	1,339	-
Unused overdraft	34,545	691	8,971	11,768	13,035	80	-
Loan commitments	36,001	1,051	19,201	5,816	9,932	1	-
Off-balance sheet items	79,731	3,548	31,811	19,046	23,906	1,420	-
Net interest sensitivity gap	51,147	(168,687)	(136,196)	31,839	192,702	60,630	70,859

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41. Market risk, continued

Inflation risk

The Group is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 291.6 billion (31.12.2012: ISK 262.0 billion) and the total amount of indexed liabilities amount to ISK 223.7 billion (31.12.2012: 216.8 billion).

The following table shows the transaction maturity profile of indexed assets and liabilities. In previous statements, the profile was based on residual maturity. The 2012 figures have therefore been updated to cash flow basis for accurate comparison. Financial instruments held for proprietary trading or for liquidity purposes are assumed to be on demand.

2013 Assets, CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	13,894	78,509	192,001	284,404
Financial instruments	2,305	-	-	2,305
Off-balance sheet position	2,478	2,394	-	4,872
Assets, CPI indexed linked	18,677	80,903	192,001	291,581
Liabilities, CPI indexed linked				
Deposits	67,044	21,585	2,707	91,336
Borrowings	2,830	12,625	116,914	132,369
Liabilities, CPI indexed linked	69,874	34,210	119,621	223,705
Net on-balance sheet position	(53,675)	44,299	72,380	63,004
Net off-balance sheet position	2,478	2,394	-	4,872
CPI Balance 31.12.2013	(51,197)	46,693	72,380	67,876
CPI Balance 31.12.2012	(40,402)	40,989	44,553	45,140

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Group are predominantly ISK denominated deposits whereas a substantial part of the Group's assets consist of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

Breakdown of assets and liabilities by currency at the end of the year

2013

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	30,745	4,971	731	693	376	254	229	37,999
Loans to credit institutions	25,156	17,490	10,064	5,856	15,071	4,475	24,195	102,307
Loans to customers	514,206	50,739	27,080	12,296	7,241	6,382	17,830	635,774
Financial instruments	65,025	13,754	4,860	7	73	2	2,820	86,541
Investment property	28,523	-	-	-	-	-	-	28,523
Investments in associates	12,253	-	-	-	5,676	-	-	17,929
Intangible assets	5,383	-	-	-	-	-	-	5,383
Tax assets	818	-	-	-	-	-	-	818
Other assets	22,903	486	104	-	46	-	37	23,576
Assets 31.12.2013	705,012	87,440	42,839	18,852	28,483	11,113	45,111	938,850

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41. Market risk, continued

Liabilities	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	23,189	1,832	622	839	4	1,514	-	28,000
Deposits	390,397	27,457	13,751	222	10,940	926	28,173	471,866
Financial liabilities at fair value	8,921	32	2	-	-	-	5	8,960
Tax liabilities	4,924	-	-	-	-	-	-	4,924
Other liabilities	38,508	1,120	2,114	75	59	410	1,381	43,667
Borrowings	140,012	2,202	18,669	20,043	6,728	7,557	9,357	204,568
Subordinated liabilities	-	25,818	2,303	-	3,797	-	-	31,918
Equity	144,947	-	-	-	-	-	-	144,947
Liabilities 31.12.2013	750,898	58,461	37,461	21,179	21,528	10,407	38,916	938,850
Net on-balance sheet position	(45,886)	28,979	5,378	(2,327)	6,955	706	6,195	
Net off-balance sheet position	14,256	(17,076)	924	3,569	1,069	792	(3,534)	
Net position 31.12.2013	(31,630)	11,903	6,302	1,242	8,024	1,498	2,661	

2012

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	24,874	3,353	729	155	403	4	228	29,746
Loans to credit institutions	26,176	21,098	17,521	2,538	15,462	1,794	16,422	101,011
Loans to customers	427,037	50,966	20,396	21,121	6,670	14,835	25,585	566,610
Financial instruments	132,298	3,278	1,675	7	244	4	294	137,800
Investment property	28,919	-	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	-	7,050
Intangible assets	4,941	-	-	-	-	-	-	4,941
Tax assets	463	-	-	-	-	-	-	463
Other assets	22,254	1,592	245	-	4	-	40	24,135
Assets 31.12.2012	674,012	80,287	40,566	23,821	22,783	16,637	42,569	900,675

Liabilities	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	31,060	1,486	201	-	24	218	1	32,990
Deposits	362,384	28,663	13,893	1,831	10,185	1,374	30,353	448,683
Financial liabilities at fair value	12,665	791	-	-	-	-	9	13,465
Tax liabilities	3,237	-	-	-	-	-	-	3,237
Other liabilities	34,084	2,786	1,866	298	808	1,430	845	42,117
Borrowings	132,214	2,815	20,785	21,698	7,346	10,227	-	195,085
Subordinated liabilities	-	27,511	2,563	-	4,146	-	-	34,220
Equity	130,878	-	-	-	-	-	-	130,878
Liabilities 31.12.2012	706,522	64,052	39,308	23,827	22,509	13,249	31,208	900,675
Net on-balance sheet position	(32,510)	16,235	1,258	(6)	274	3,388	11,361	
Net off-balance sheet position	14,347	(8,624)	3,667	(1,239)	3,321	(3,672)	(7,800)	
Net position 31.12.2012	(18,163)	7,611	4,925	(1,245)	3,595	(284)	3,561	

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41. Market risk, continued

Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at 31 December 2013. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the income statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

	2013		2012	
Currency	-10%	+10%	-10%	+10%
EUR	(1,190)	1,190	(761)	761
USD	(630)	630	(493)	493
CHF	(124)	124	125	(125)
GBP	(802)	802	(360)	360
JPY	(150)	150	28	(28)
Other	(266)	266	(356)	356

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Group's assets i.e. restructuring of troubled companies which the Group has taken over. For information on assets seized and held for sale and equity exposures, see notes 27 and 21 respectively.

Sensitivity analysis on equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the income statement. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase.

	2013		2012	
Equity	-10%	+10%	-10%	+10%
Trading book - Listed	(120)	120	(37)	37
Banking book - Listed	(307)	307	(245)	245
Banking book - Unlisted	(1,094)	1,094	(972)	972

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are FX swaps and forwards, interest rate swaps, cross-currency swaps, as well as options and forwards on equities, Treasury notes and bonds with Government guarantee. Limits on exposures and collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. The Group's exposure to derivative instruments has increased in the year 2013 but is not considered a material risk.

Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at the end of the year 2013.

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42. Liquidity risk

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

The Group's primary source of funding is deposits from individuals, businesses and financial institutions. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, approximately half of which is on demand.

Liquidity risk is one of the Group's most important risk factors and great deal of emphasis is placed on managing it. The Asset and Liability Committee is responsible for managing liquidity risk within the risk appetite the Board sets. The Bank's Treasury manage liquidity positions on a day-to day basis. Risk management measures, monitors and reports the Bank's liquidity risk.

The Icelandic economy has been subject to capital controls since late 2008. The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. The lifting of the capital controls remain uncertain.

Liquidity coverage ratio

On 1 December 2013 new liquidity rules issued by the Central Bank of Iceland took effect, overriding rules on liquidity and cash ratios that have previously been reported by the Group. The new rules are based on liquidity standards introduced in the Basel III Accord which are to be implemented in 2015 on a global level. The standard defines the Liquidity Coverage Ratio (LCR), which is the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

The criteria for liquid assets used to meet unexpected outflow is stricter for the new liquidity measure. The assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set a guideline for minimum Liquidity Coverage Ratio. As at 1 January 2014, the LCR requirement is 100% in foreign currency and 70% in total (ISK and foreign currency). The latter benchmark increases by 10% every year until a 100% requirement is implemented in 2017.

The Liquidity Coverage Ratio as at year end 2013 is shown below. No comparison is made to 2012 figures as the new LCR rules took effect shortly prior to year end 2013.

Liquidity coverage ratio	2013
FX	274%
Total	123%

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

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42. Liquidity risk, continued

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days				Term
	Less Stable	Weight (%)	Stable	Weight (%)	deposits*
Retail	75,385	10%	33,971	5%	30,224
SME	32,496	10%	3,723	5%	6,675
Operational relationship	847	25%	-	5%	530
Corporations	49,841	40%	742	20%	12,977
Sovereigns, central-banks and PSE	19,104	40%	-	-	7,206
Financial entities being wound up	17,616	100%	-	-	59,675
Deposit pension funds	4,346	100%	-	-	20,639
Pension funds	46,420	100%	-	-	20,299
Domestic financial entities	26,652	100%	-	-	13,636
Foreign financial entities	2,135	100%	-	-	495
Other foreign parties	3,830	100%	626	25%	250
Total	278,672		39,062		172,606

*No outflow assumed from term deposits.

43. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group’s operational risk.

The Group uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk.

Arion Bank Consolidated Financial Statements 2013 60 Amounts are in ISK millions

44. Capital management

The capital base at 31 December 2013 amounts to ISK 170,439 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 23.6%, exceeding the minimum legal requirement of 8%.

The Group uses the standardised approach to calculate the capital requirements for credit risk and market risk and basic indicator approach for operational risk.

The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank’s total risk exposure. The ICAAP is aimed at identifying and measuring the Group’s risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole.

The Group is subject to capital requirements which are specified by the FME following the Supervisory Review and Evaluation Process (SREP). The Group‘s capital base exceeds the FME‘s SREP requirements (2012: the same).

Group's RWA calculations

Capital Base	2013	2012
Share capital and share premium	75,861	75,861
Other reserves	1,637	1,639
Retained earnings	62,591	49,572
Non-controlling interests	4,858	3,806
Total Equity	144,947	130,878
Intangible assets	(5,383)	(4,941)
Tax assets	(818)	(463)
Other statutory deductions	(119)	-
Total Tier 1 capital	138,627	125,474
Subordinated liabilities	31,918	34,220
Other statutory deductions	(106)	-
Total Capital base	170,439	159,694

Risk weighted assets	2013	2012
Credit risk	608,029	557,964
Market risk FX	31,703	20,063
Market risk other	4,993	7,407
Operational risk	76,097	72,329
Total risk weighted assets	720,822	657,763
Tier 1 ratio	19.2%	19.1%
Capital adequacy ratio	23.6%	24.3%

Arion Bank Consolidated Financial Statements 2013 61 Amounts are in ISK millions

SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Financial Statements are consistent with those followed in the preparation of the Group's annual Financial Statements for the year ended 31 December 2012.

45. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment, management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures. The Financial Statements are prepared on a going concern basis.

46. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control the Group takes into consideration potential voting rights that are currently exercisable.

The Group 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; less
- if the business combination is achieved in stages, the fair value of the pre-existing 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.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:
- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Loss of control

On the loss of control, the Group 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.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in subsidiary is classified as held for sale the investment is accounted for, as non-current asset and disposal groups held for sale from the date of classification.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Financial Statements except when the Group controls the entity.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

47. Associates

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

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

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current assets and disposal groups held for sale. In instances where control of a subsidiary is lost and the Group retains an associate investment, a portion of the recognised gain or loss on sale is attributable to the investment retained in the former subsidiary at its fair value at the date when control is lost. This gain or loss is recognised as either Other operating income (expense) or Net gain (loss) from discontinued operations in the Statement of Comprehensive Income.

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognised in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

48. Foreign currency

Items included in the Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

49. Interest

Interest income and expense are recognised in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- Interest on financial assets and liabilities held for trading; and
- Interest on financial assets designated at fair value through profit or loss.

50. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance, Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled.

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

51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognised when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realised and unrealised fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise 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 year or in previous Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

52. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognised in the consolidated financial statements.

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 recognised in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

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 substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they 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.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

53. Financial assets and financial liabilities

Recognition

The Group initially recognises loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognised on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognised on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

Classification

The Group classifies its financial assets in one of the following categories:
- loans;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost or fair value through profit or loss.

Derecognition

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

Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

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

Disclosures on offsetting are provided in Note 23.

Amortised cost measurement

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

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

53. Financial assets and financial liabilities, continued

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

Identification and measurement of impairment

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

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment. All loans under ISK 1 million get general provisions only.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Bank uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses standard values.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument´s original effective interest rate. The adjustment is recognised as increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

53. Financial assets and financial liabilities, continued

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of collateral have been received.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

– the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
– the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
– the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

54. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortised cost in the Statement of Financial position.

55. Loans

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

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a finance lease and a receivable equal to the net investment in the lease is recognised and presented within loans.

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

56. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer’s margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognised in profit or loss. All changes in fair value are recognised as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

57. Derivatives

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

Derivatives are recognised at fair value. Fair value changes are recognised in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Financial instruments and derivatives with negative fair values are recognised as Financial liabilities at fair value.

58. Intangible assets

Goodwill
Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

Software

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

Subsequent expenditure on software 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.

Amortisation of software is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is five years.

59. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

60. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in profit or loss.

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

An impairment loss in respect of other assets, where impairment losses have been recognised in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable 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.

61. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

62. Borrowings

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

63. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group'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, they are included within Tier II, as shown in Note 44. The subordinated liabilities have no maturity date and the Group may only retire them with the permission of the Icelandic Financial Supervisory Authority.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognised in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

64. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalised only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

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

Buildings	33-50 years
Equipment	3-7 years

The depreciation methods, useful lives and residual values are reassessed annually.

Non-current assets and disposal groups held for sale

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

65. Equity

Dividends

Dividends on shares are recognised in equity in the period in which they are approved by Arion Bank´s shareholders.

Statutory reserve

According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Financial Statements of foreign operations.

66. Earnings per share

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

67. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognised in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

68. Fiduciary activities

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

69. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

70. New standards and amendments to standards

New standards and amendments to standards effective in 2013

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS effective as of 1 January 2013:

IFRS 7 Disclosures — Offsetting Financial Assets and Financial Liabilities — Amendments to IFRS 7. These amendments require an entity to disclose information about rights to set-off and related arrangements (e.g., collateral agreements). The disclosures provide users with information that is useful in evaluating the effect of netting arrangements on an entity's financial position. The disclosures are required for all recognised financial instruments that are set off in accordance with IAS 32 Financial Instruments: Presentation. The disclosures also apply to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are set off in accordance with IAS 32. These amendments do not impact the Group's financial position or performance.

IFRS 13 Fair Value Measurement. IFRS 13 establishes a single source of guidance under IFRS for all fair value measurements. IFRS 13 does not change when an entity is required to use fair value, but rather provides guidance on how to measure fair value under IFRS when fair value is required or permitted. There are also additional disclosure requirements. Adoption of the standard does not have a material impact on the financial position or performance of the Group.

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2013, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments: Classification and Measurement. In November 2009, the IASB issued IFRS 9 Financial instruments, which includes new classification and measurement criteria for financial assets. The publication of IFRS 9 represents the completion of the first part of a multi-stage project to replace IAS 39 Financial instruments: recognition and measurement. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Group is currently assessing the impact of the new standard on its Financial Statements. An effective date for the application of IFRS 9 has not yet been decided.

IFRS 10 Consolidated Financial Statements. IFRS 10 replaces the portion of IAS 27 Consolidated and Separate Financial Statements that addresses the accounting for consolidated financial statements. It also includes the issues raised in SIC-12 Consolidation — Special Purpose Entities. IFRS 10 establishes a single control model that applies to all entities including special purpose entities. The changes introduced by IFRS 10 will require management to exercise significant judgement to determine which entities are controlled, and therefore, are required to be consolidated by a parent, compared with the requirements that were in IAS 27. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014.

IFRS 12 Disclosure of Interests in Other Entities. IFRS 12 includes all of the disclosures that were previously in IAS 27 related to consolidated financial statements, as well as all of the disclosures that were previously included in IAS 31 and IAS 28. These disclosures relate to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. A number of new disclosures are also required. The standard will not have any impact on the financial position or performance of the Group. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014.

IAS 32 Offsetting Financial Assets and Financial Liabilities — Amendments to IAS 32. These amendments clarify the meaning of "currently has a legally enforceable right to set-off". It will be necessary to assess the impact to the Group by reviewing settlement procedures and legal documentation to ensure that offsetting is still possible in cases where it has been achieved in the past. In certain cases, offsetting may no longer be achieved. In other cases, contracts may have to be renegotiated. The requirement that the right of set-off be available for all counterparties to the netting agreement may prove to be a challenge for contracts where only one party has the right to offset in the event of default. Adoption of the standard is not expected to have a material impact on the financial position or performance of the Group. These amendments became effective for annual periods beginning on or after 1 January 2014.

IFRIC 21 defines a levy as an outflow from an entity imposed by a government in accordance with legislation. It confirms that an entity recognises a liability for a levy when the triggering event specified in the legislation occurs. IFRIC 21 is not expected to have a material impact on the financial position or performance of the Group. IFRIC 21 became effective for annual periods beginning on or after 1 January 2014.