Press release, 21 May 2014

# ARION BANK'S FINANCIAL RESULTS FOR THE FIRST QUARTER OF 2014

Arion Bank reported net earnings of ISK 2.9 billion for the first three months of 2014, compared with ISK 1.4 billion for the same period in 2013. Return on equity was 7.8%, compared with 4.3% in the same period of 2013. Return on equity based on core operations was 5.9%, compared with 7.6% in the same period of 2013. Total assets amounted to ISK 933.1 billion, compared with ISK 938.9 billion at the end of 2013.

The Bank's capital ratio at the end of the period was 22.5%, compared with 23.6% at the end of 2013.

**Highlights of the Interim Financial Statements:**

- Net earnings of ISK 2.9 billion, compared with ISK 1.4 billion during the same period of 2013.
- Income tax and the bank levy amounted to ISK 2.0 billion, compared with ISK 0.7 billion during the same period of 2013.
- Earnings from core operations of ISK 1.6 billion, compared with ISK 2.1 billion in the same period of 2013.
- Operating income of ISK 9.0 billion, compared with ISK 9.1 billion during the same period of 2013.
- Net interest income of ISK 5.5 billion, compared with ISK 6.3 billion during the same period of 2013. The decrease is largely due to lower inflation.
- Net commission income of ISK 3.1 billion, compared with ISK 2.4 billion during the same period of 2013. The increase is largely due to higher commission income from credit cards and asset management.
- Other operating expenses of ISK 2.7 billion, compared with ISK 3.3 billion during the same period of 2013.
- Positive net valuation change of ISK 2.0 billion, compared with a negative ISK 322 million in the same period last year. Net valuation change on corporate loans of ISK 2.0 billion during the first quarter and retail loan write-downs of ISK 0.8 billion. Valuation increase of other assets of ISK 0.7 billion.
- Return on equity was 7.8%, compared with 4.3% in the same period of 2013. Return on equity based on core operations was 5.9%, compared with 7.6% in the same period of 2013.
- The net interest margin as a percentage of the average interest-bearing assets was 2.6%, compared with 3.1% in the same period of 2013.
- The cost-to-income ratio was 69.0%, compared with 72.6% in the first quarter of 2013. The cost-to-income ratio on core operations was 66.8%, compared with 66.7% in the first quarter of 2013.
- Total assets amounted to ISK 933.1 billion at the end of 2013, compared with ISK 938.9 billion at the end of 2013.
- Shareholders' equity amounted to ISK 147.8 billion, compared with ISK 144.9 billion at the end of 2013.

*Höskuldur H. Ólafsson, CEO of Arion Bank:*

"Arion Bank's first quarter results are satisfactory. Net earnings increased compared with the same period in 2013, despite increased taxation, and return on equity was 7.8%. However, the Bank's income decreased, primarily as a result of the lower net interest margin as inflation was lower in the first quarter than during the same period last year. Furthermore, the market conditions have led to a reduction in the value of the Bank's assets in securities and foreign currency. We are satisfied with the growth in commission income compared with last year following targeted efforts to consolidate the Bank's sources of commission income. The increase is primarily generated by asset management and payment card transactions. Over the last year the Bank has also made good progress in reducing operating expenses, while the number of employees has also decreased between periods.

An important milestone was reached at the beginning of the year when Standard & Poor's assigned Arion Bank a credit rating of BB+, the first Icelandic bank to be rated by S&P since the financial crisis. A credit rating from an international agency will facilitate our access to the international credit markets. Arion Bank is, however, fully funded and has no refunding requirements in the next few years. Nevertheless, when the market conditions are right, we will seek to secure credit with the aim of improving the quality of the Bank's funding and reducing funding costs."

*For further information please contact Haraldur Gudni Eidsson head of Arion Bank's Corporate Communications at haraldur.eidsson@arionbanki.is, or tel. +354 856 7108.*

## Income statement - highlights

### Operating income

| Income Statement | | | | |
|---|---|---|---|---|
| *In ISK million* | **Q1 2014** | **Q1 2013** | **Diff.** | **Diff. %** |
| Net interest income | 5,483 | 6,288 | (805) | (13%) |
| Net commission income | 3,148 | 2,449 | 699 | 29% |
| Net financial income | (96) | 570 | (666) | (117%) |
| Net gain (loss) on foreign exchange | (476) | (1,397) | 921 | (66%) |
| Other income | 918 | 1,176 | (258) | (22%) |
| **Operating income** | **8,977** | **9,086** | **(109)** | **(1%)** |
| Salaries and related expense | (3,450) | (3,322) | (128) | 4% |
| Other operating expense | (2,747) | (3,277) | 530 | (16%) |
| Net impairment | 1,967 | (322) | 2,289 | (711%) |
| **Net earnings before taxes** | **4,747** | **2,165** | **2,582** | **119%** |
| Income tax | (1,315) | (586) | (729) | 124% |
| Bank levy | (660) | (91) | (569) | 625% |
| **Net earnings from continuing operation** | **2,772** | **1,488** | **1,284** | **86%** |
| Net gain/ -loss from discont. operation net of tax | 92 | (79) | 171 | (216%) |
| **Net earnings** | **2,864** | **1,409** | **1,455** | **103%** |

Operating income during the first quarter of 2014 amounted to ISK 8,977 million and is virtually unchanged from the same period of 2013.

*Net interest income* amounted to ISK 5,483 million during the period, compared with ISK 6,288 million during the same period of 2013. This represents a decrease of ISK 800 million between years and is largely due to lower inflation than during the first quarter of 2013. Longer funding maturities also have an impact on interest expenses on deposits and borrowing. The net interest margin as a percentage of average interest-bearing assets was 2.6% during the period, compared with 3.1% during the same period of 2013.

*Net commission income* increased by 29% between years to ISK 3,148 million, compared with ISK 2,449 million during the same period of 2013. The increase is largely due to higher commission income from credit cards and asset management.

*Net financial income* decreased considerably between years from ISK 570 million in the first quarter of 2013 to an expense of ISK 96 million in the first quarter 2014. Dividend income was almost ISK 600 million higher in the first three months of 2014 than the same period of 2013. This is offset by the significantly weaker performance of the Group's equities and bonds portfolios. Negative conditions on the Icelandic securities market in the first quarter are the main reasons for the significant change between years.

*Net exchange rate loss* amounted to ISK 476 million, compared with a loss of ISK 1,397 million in the same period of 2013. The Bank's net foreign exchange imbalance was ISK 21.3 billion at the end of the period, which means that volatility in the exchange rate has a significant impact on operating income. The net foreign exchange imbalance was ISK 31.6 billion at the end of 2013 and the Bank has made a targeted effort to reduce the imbalance. The net foreign exchange imbalance of the parent company is well within the 15% target set by the Central Bank of Iceland.

*Other operating income* amounted to ISK 918 million, compared with ISK 1,176 million in the same period of 2013. The main types of income included in other operating income are lease income, valuation changes and profits from the sale of commercial property owned by Landfestar and Landey and income from insurance premiums at OKKAR Life Insurance, all of which are subsidiaries of the

Bank. The decrease from the previous year is largely due to profit from the sale of an investment asset during the same period of 2013, whereas no such sale was made in 2014.

**Operating expenses**

Operating expenses amounted to ISK 6,197 million and decreased between years by ISK 402 million, or 6.1%. The decrease is largely explained by a one-off expense item in the first quarter of 2013. The cost-to-income ratio decreased to 69.0% from 72.6% in the first quarter of 2013. The cost-to-total-assets ratio was 2.7%, compared with 3.0% in the first quarter of 2013.

*Salaries and related expenses* amounted to ISK 3,450 million, compared with ISK 3,332 million during the same period of 2013. The increase is partly explained by estimated cost of the incentive scheme which was not in place in 2013. There were on average 1,144 full-time equivalent positions at Arion Bank during the period, compared with 1,187 in the same period of 2013.

*Other operating expenses* amounted to ISK 2,747 million, compared with ISK 3,322 million in the same period of 2013. This represents a decrease of ISK 530 million and is largely explained by the fine imposed on the subsidiary Valitor by the Competition Authority in the first quarter of 2013. In other respects other operating expenses were as expected.

*Net valuation change* amounted to ISK 1,967 million and is broadly divided into three types. Firstly, net valuation increases on loans of ISK 2,308 million, mainly relating to loans to large companies. Secondly, net loan impairment on retail loans of ISK 1,024 million during the period. Thirdly, the net valuation increase of other assets totalled ISK 683 million.

**Taxes**

*Income tax* amounted to ISK 1,315 million, compared with ISK 586 million during the same period of 2013. Income tax, as reported in the interim financial statement, comprises 20% income tax on earnings and a special 6% tax on financial companies which is levied on earnings in excess of ISK 1 billion. The effective income tax rate was 27.7% for the first three months of 2014, compared with 27.1% during the same period of 2013.

*The bank levy* amounted to ISK 660 million, compared with ISK 91 million during the same period of 2013. The tax rate increased from 0.1285% to 0.376% at the end of 2013.

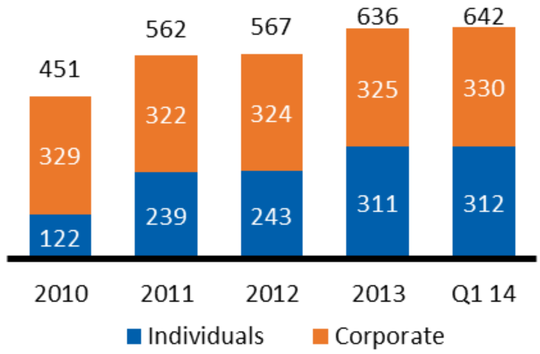
## Balance sheet – highlights

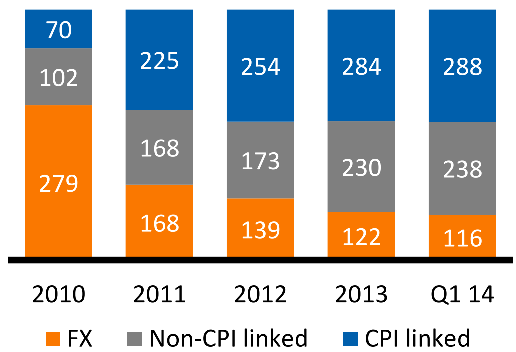
| Assets | | | | | |
|---|---|---|---|---|---|
| *In ISK million* | **31.03.2014** | **31.12.2013** | **Diff.%** | **31.03.2013** | **Diff.%** |
| Cash & balances with CB | 18,744 | 37,999 | (51%) | 28,099 | (33%) |
| Loans to credit institutions | 95,158 | 102,307 | (7%) | 103,444 | (8%) |
| Loans to customers | 642,341 | 635,774 | 1% | 565,526 | 14% |
| Financial assets | 99,710 | 86,541 | 15% | 145,533 | (31%) |
| Investment properties | 28,503 | 28,523 | (0%) | 28,112 | 1% |
| Non-current assets & disp.groups HFS | 10,217 | 10,046 | 2% | 10,877 | (6%) |
| Other assets | 38,472 | 37,660 | 2% | 25,874 | 49% |
| **Total assets** | **933,145** | **938,850** | **(1%)** | **907,465** | **3%** |

Arion Bank had *total assets* of ISK 933,145 million at the end of the period, compared with ISK 938,850 million at the end of 2013. Changes to individual asset classes during the period are mainly due to changes in the Bank's liquidity management, which results in lower deposits at the Central Bank of Iceland and increased securities holdings.

### Loans to customers

*Loans to customers* amounted to ISK 642,341 million at the end of March 2014, compared with ISK 635,774 million at the end of 2013. Since 2010 the structure of the Group's loan book has undergone substantial change. This applies to both the division between corporate and retail loans and whether the loans are indexed, non-indexed or in foreign currency. The diagram shows the development of the loan book, with two events being prominent: firstly the Bank's acquisition of Arion Bank Mortgages Institutional Investor Fund, which was Kaupthing's mortgage fund, at the end of 2010, and secondly the settlement of the Drómi bond where the Bank took over retail loans of a value of more than ISK 50 billion at the end of 2013. Retail loans now represent almost 50% of the Bank's loans to customers, which is in line with the Bank's strategy.



## Securities

*Securities holdings* amounted to ISK 99,710 million at the end of the period, compared with ISK 86,541 million at the end of 2013.

| Securities | | | | | |
|---|---|---|---|---|---|
| *In ISK million* | **31.03.2014** | **31.12.2013** | **Diff.%** | **31.03.2013** | **Diff.%** |
| Bonds | 71,858 | 62,171 | 16% | 125,526 | (43%) |
| Shares and instruments w. variable income | 19,277 | 17,449 | 10% | 16,975 | 14% |
| Derivatives | 1,040 | 1,070 | (3%) | 1,179 | (12%) |
| Securities used for hedging | 7,535 | 5,851 | 29% | 1,853 | 307% |
| **Securities total** | **99,710** | **86,541** | **15%** | **145,533** | **(31%)** |

This increase is particularly attributable to changes in the Bank's liquidity management.

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

*Non-current assets and disposal groups held for sale* amounted to ISK 10,217 million at the end of March 2014, compared with ISK 10,046 million at the end of 2013. The main assets in this category are real estate and shareholdings in companies which have been acquired by the Bank in connection with the settlement of customers' loans. Most significant in this respect is the Bank's 31% shareholding in HB Grandi hf., which the Bank held at the end of March. In April the Bank sold 18.8% of the company when HB Grandi hf. was listed on the Icelandic stock exchange. After the sale the Bank's shareholding in HB Grandi hf. is 12%.

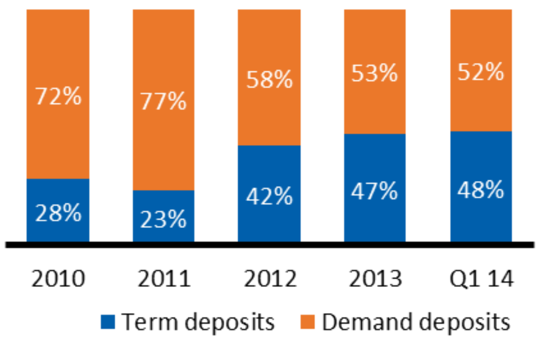
## Liabilities and equity

| Liabilities and equity | | | | | |
|---|---|---|---|---|---|
| *In ISK million* | **31.03.2014** | **31.12.2013** | **Diff.%** | **31.03.2013** | **Diff.%** |
| Due to credit institutions & CB | 25,915 | 28,000 | (7%) | 21,617 | 20% |
| Deposits from customers | 470,665 | 471,866 | (0%) | 462,255 | 2% |
| Non current liab. & disp.groups HFS | 560 | 567 | (1%) | 758 | (26%) |
| Financial liabilities at fair value | 9,145 | 8,960 | 2% | 11,298 | (19%) |
| Other liabilities | 44,524 | 48,024 | (7%) | 42,805 | 4% |
| Borrowings | 203,226 | 204,568 | (1%) | 204,394 | (1%) |
| Subordinated loans | 31,297 | 31,918 | (2%) | 32,052 | (2%) |
| Equity | 147,813 | 144,947 | 2% | 132,286 | 12% |
| **Total liabilities and equity** | **933,145** | **938,850** | **(1%)** | **907,465** | **3%** |

*Total liabilities* amounted to ISK 785,332 million at the end of March 2014, compared with ISK 793,903 million at the end of 2013.

## Deposits

*Total deposits* amounted to ISK 496,580 million at the end of March 2014, compared with ISK 499,866 million at the end of 2013. The Bank has made targeted efforts to increase the proportion of term deposits at the Bank in order to ensure more secure funding. At the end of March 2014 48% of total deposits were term deposits.



### Borrowings

*Borrowings* amounted to ISK 203,226 million at the end of March 2014, compared with ISK 204,568 million at the end of 2013. The decrease is owing to the appreciation of the Icelandic króna against foreign currencies. At the beginning of 2014 the Bank was assigned a rating by the international ratings agency Standard & Poor's, the first Icelandic bank to obtain a rating for more than five years. The Bank was rated BB+ and this will increase Arion Bank's opportunities on the credit markets both in Iceland and abroad in the coming years.

### Subordinated liabilities

*Subordinated liabilities* amounted to ISK 31,297 million at the end of March 2014, compared with ISK 31,918 million at the end of 2013. The change is solely related to changes in the exchange rate of foreign currencies to which the loans are linked.

### Total equity

*Total equity* amounted to ISK 147,813 million at the end of March 2014, compared with ISK 144,947 million at the end of 2013. The change is explained by the financial results for this quarter. The capital ratio calculated in accordance with the rules of the FME was 22.5% at the end of the period, compared with the statutory minimum of 8%.

### Key performance indicators

**Key performance indicators**

| | Q1 2014 | 2013 | Q1 2013 |
|---|---|---|---|
| Return on equity (ROE) | 7.8% | 9.2% | 4.3% |
| Return on total assets (ROA) | 1.3% | 1.4% | 0.6% |
| | | | |
| Net interest margin (int.bearing assets) | 2.6% | 2.9% | 3.1% |
| Net interest margin (total assets) | 2.3% | 2.6% | 2.8% |
| | | | |
| Cost-to-income ratio | 69.0% | 57.3% | 72.6% |
| Cost-to-Total assets ratio | 2.7% | 2.8% | 3.0% |
| Effective tax rate | 27.7% | 17.2% | 27.1% |
| | | | |
| CAD-ratio | 22.5% | 23.6% | 23.7% |
| Tier 1 ratio | 18.2% | 19.2% | 18.9% |
| | | | |
| Problem loans | 6.1% | 6.3% | 10.2% |
| RWA/Total Assets | 77.3% | 76.8% | 73.0% |
| | | | |
| Loans to deposit ratio | 136.5% | 134.7% | 122.3% |
| | | | |
| The Group's average number of employees | 1,144 | 1,159 | 1,187 |
| The Group's employees at the end of the period | 1,140 | 1,145 | 1,187 |
| The parent's average numer of employees | 913 | 923 | 950 |
| The parent's empl. at the end of the period | 908 | 911 | 950 |

**Financial calendar for 2014**

The Bank's Financial Statements are scheduled for publication as stated below. This calendar may be subject to change.

| | |
|---|---|
| Second quarter 2014 | 27 August 2014 |
| Third quarter 2014 | 20 November 2014 |
| Annual financial results | Week 8 2015 |
| Annual general meeting 2015 | Week 12 2015 |