

APPLICABLE FINAL TERMS

16 September 2014

ÍSLANDBANKI HF.

Issue of ISK 1,140,000,000 Inflation linked Equal Principal Payment Covered Bonds including Covered Bonds with one payment of principal on maturity date under the ISK 100,000,000,000

Covered Bond Programme

PART A – CONTRACTUAL TERMS

Terms used herein shall be deemed to be defined as such for the purposes of the Terms and Conditions of the Covered Bonds (the **Terms and Conditions**) set forth in the Base Prospectus dated 2 October, 2013. This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5(4) of the Prospectus Directive and Article 45 of Act on Securities Transactions and must be read in conjunction with the Base Prospectus and any supplements if applicable which constitute a base prospectus for the purposes of the Prospectus Directive. Full information on the Issuer, and the offer of the Covered Bonds is only available on the basis of the combination of these Final Terms, the Base Prospectus and any supplements, if applicable. Copies of said Base Prospectus and any supplements, if applicable, are available for viewing on the Issuer's webpage, <http://www.islandsbanki.is/english/investor-relations/funding/covered-bonds/> and at the office of the Issuer at Kirkjusandur 2, 155 Reykjavík, Iceland.

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|---|---|
| 1. Issuer: | Íslandsbanki hf. |
| 2. | |
| i. Series Number: | 7 |
| ii. Tranche Number: | 2 |
| 3. Specified Currency or Currencies: | ISK |
| 4. Aggregate Nominal Amount: | |
| i. Series: | 20,000,000,000 |
| ii. Tranche: | 2,100,000,000 |
| 5. Issue Price: | 99.9962 per cent. of the Aggregate Nominal Amount |
| 6. Specified Denominations: | 20,000,000 |
| 7. | |
| i. Issue Date: | 22 September 2014 |
| ii. Interest Commencement Date: | 22 September 2014 |

- 8.**
- i. Maturity Date: 23 June 2020
 - ii. Extended Maturity Date: Applicable
The Extended Maturity Date is 23 June 2023
- 9.**
- i. Interest Basis to Maturity Date: Inflation Linked Interest
 - ii. Interest Basis from Maturity Date to Extended Maturity Date: Inflation Linked Interest
- If any partial redemption after the Maturity Date is not sufficient to redeem all outstanding Interest Payments, then the remainder of any Interest Payment shall be added to the principal amount of the Covered Bonds. See Condition 8.11
- 10. Redemption/Payment Basis:** One principal payment on maturity
- i. Payment Basis: Not Applicable
 - ii. Instalment Amounts: Not Applicable
 - iii. Instalment Dates: Not Applicable
- 11. Change of Interest Basis or Redemption/Payment Basis:** Not Applicable
- 12. Call Option:** Not Applicable
- If an Extended Maturity Date is specified and the Final Redemption Amount is not paid in full on the Maturity Date, payment of the unpaid amount will be automatically deferred until the Extended Maturity Date, provided that any amount representing the principal amount outstanding due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date occurring thereafter up to (and including) the relevant Extended Maturity Date. See Condition 8.11
- 13. Status of the Covered Bonds:** Senior.
- 14. Approval for issuance of the Covered Bonds:**
- Date of Board approval for issuance 23 March 2010 and 1 December 2010, respectively

of Covered Bonds obtained:

15. Method of distribution: Non-syndicated

PROVISIONS RELATING TO INFLATION LINKED ANNUITY COVERED BONDS

16. Inflation Linked Annuity Covered Bonds: Not Applicable

PROVISIONS RELATING TO INFLATION LINKED EQUAL PRINCIPAL PAYMENT COVERED BONDS INCLUDING COVERED BONDS WITH ONE PAYMENT OF PRINCIPAL ON MATURITY DATE

17. Inflation Linked Equal Principal Payment Covered Bonds:

Applicable

- i. Rate(s) of Interest to Maturity Date: 3.4699 per cent. per annum payable semi-annually in arrear
- ii. Rate(s) of Interest from Maturity Date to Extended Maturity Date: 3.9699 per cent. per annum payable semi-annually in arrear
- iii. Number of Interest Payment Dates: 12
- iv. Interest Payment Date(s): The 23rd day in the months of June and December in each year up to and including the Maturity Date. First Interest Payment Date being 23 December 2014.
- v. Number of Principal Payment Dates: 1
- vi. Principal Payment Date(s): Maturity Date
- vii. Day Count Fraction: 30E/360
- viii. Principal Repayment(s): An amount calculated by the Issuer on each Principal Payment Date by multiplying the Principal Amount Outstanding on the Issue Date with the Index Ratio and dividing with the number of principal Payment Dates.
- ix. Interest Payment(s): Interest is calculated on each Interest Payment date as the Principal Amount Outstanding on each Interest Payment Date multiplied with the Rate of Interest and, the appropriate Day Count Fraction.

- x. Payments(s): On each Interest Payment Date the sum of the relevant Principal Repayment and the Interest Payment.
- xi. Calculation Agent: Issuer
- xii. Principal Amount Outstanding: On the relevant Interest Payment Date, the Principal Amount Outstanding is calculated based on the following formula:

$$PAO_t = (PAO_{t-1} - PR_{t-1}) \frac{IR_t}{IR_{t-1}}$$

where:

PAO_t means the Principal Amount Outstanding on the relevant Interest Payment Date.

PAO_{t-1} means the Principal Amount Outstanding on the preceding Interest Payment Date.

PR_{t-1} means the Principal Repayment on the preceding Interest Payment Date.

IR_t means the Index Ratio on the relevant Interest Payment Date.

IR_{t-1} means the Index Ratio on the preceding Interest Payment Date (Issue Date for the first Interest Payment Date).

The value of the Index Ratio (**IR**) on the relevant Interest Payment Date shall be the value of the Reference Index (**RI**) applicable to the relevant Interest Payment Date divided by the value of the Base Index (**BI**) as calculated by the Issuer:

- xiii. Index Ratio:

$$IR = \frac{RI_t}{BI}$$

where:

Reference Index or **RI_t** means on each Interest Payment Date:

For each day in the calendar month and number RI rounded to 5 decimals:

$$RI = CP_{M-2} + \left[\frac{d-1}{D} * (CP_{M-1} - CP_{M-2}) \right]$$

where:

CP_{M-1} = CPI value published by Statistic Iceland in the month preceding month M

CP_{M-2} = CPI value published by Statistic Iceland 2 months prior to month M

d = the relevant calendar date

D = number of calendar days in the relevant calendar month

Provided that if the Reference Index in i) or ii) is lower than the Base Index, the Reference Index shall equal the Base Index.

And

Base Index means 421.22, being the value of the CPI on 23 June 2014.

If at any time a new index is substituted for the CPI, as of the calendar month from and including that in which such substitution takes effect:

(i) the Reference Index shall be deemed to refer to the new index; and

(ii) the new Base Index shall be the product of the existing Base Index and the Reference Index immediately following such substitution, divided by the Reference Index immediately prior to such substitution.

PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE

18. Fixed Rate Covered Bond Provisions:	Not Applicable
19. Floating Rate Covered Bond Provisions:	Not Applicable
20. Zero Coupon Covered Bond Provisions:	Not Applicable

PROVISIONS RELATING TO REDEMPTION

21. **Issuer Call:** Not Applicable
22. **Final Redemption Amount of each Covered Bond:** Not Applicable

GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS

23. **New Global Covered Bond:** No
24. **Form of Covered Bonds:** VS System Covered Bonds
25. **Additional Financial Centre(s) or other special provisions relating to Payment Days:** Not Applicable
26. **Talons for future Coupons or Receipts to be attached to definitive Covered Bonds (and dates on which such Talons mature):** No
27. **Details relating to Partly Paid Covered Bonds: amount of each payment comprising the Issue Price and date on which each payment is to be made and consequences of failure to pay, including any right of the Issuer to forfeit the Covered Bonds and interest due on late payment:** Not Applicable
28. **Details relating to Instalment Covered Bonds:**
- i. **Instalment Amount(s):** Not Applicable
 - ii. **Instalment Date(s):** Not Applicable
29. **Redenomination applicable:** Redenomination not applicable
30. **Other final terms:** Not Applicable

DISTRIBUTION

31.

i. If syndicated, names of Managers : Not Applicable

ii. Stabilising Manager (if any): Not applicable

32. If non-syndicated, name of relevant Dealer: Íslandsbanki hf.

33. Additional selling restrictions: Not Applicable

LISTING AND ADMISSION TO TRADING APPLICATION

These Final Terms comprise the final terms required to list and have admitted to trading the issue of Covered Bonds described herein pursuant to the ISK 100,000,000,000 Covered Bond Programme of Íslandsbanki hf.

RESPONSIBILITY

The Issuer accepts responsibility for the information contained in these Final Terms. The information contained in paragraph 8 of Part B of these Final Terms has been extracted from the website of Iceland Statistics www.hagstofa.is. The Issuer confirms that such information has been accurately reproduced and that, so far as it is aware and is able to ascertain from information published by Iceland Statistics, no facts have been omitted which would render the reproduced information inaccurate or misleading.

Signed on behalf of the Issuer:

By:

Duly authorised

PART B – OTHER INFORMATION

1. LISTING

- | | | |
|-----|-----------------------|---|
| i. | Listing: | NASDAQ OMX Iceland |
| ii. | Admission to trading: | Application has been made for the Covered Bonds to be admitted to trading on Nasdaq OMX Iceland with effect from 22 September 2014. |

2. RATING

Not Applicable

3. NOTIFICATION

The Financial Supervisory Authority, Iceland has provided the Nasdaq OMX Iceland with a certificate of approval attesting that the Base Prospectus has been drawn up in accordance with the Prospectus Directive.

4. INTERESTS OF NATURAL AND LEGAL PERSONS INVOLVED IN THE ISSUE

Save for any fees payable to the Dealer, so far as the Issuer is aware, no person involved in the issue of the Covered Bonds has an interest material to the issue.

5. USE OF PROCEEDS, ESTIMATED NET PROCEEDS AND TOTAL EXPENSES

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|------|---------------------------|--|
| i. | Use of proceeds: | For general funding purposes of the Issuer |
| ii. | Estimated net proceeds: | ISK 1,139,606,680 |
| iii. | Estimated total expenses: | ISK 350,000 |

6. YIELD (*Fixed Rate Covered Bonds only*)

Indication of yield: Not Applicable

7. HISTORIC INTEREST RATES (*Floating Rate Covered Bonds Only*)

Not Applicable

8. PERFORMANCE OF CPI, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING (*Inflation Linked Annuity Covered Bonds and Inflation Linked Equal Principal Payment Covered Bonds Only*)

The general cash-flow of the Covered Bonds is determined in real terms on the Issue Date. The nominal value of each future payment depends on the development of the CPI as demonstrated by the formula in paragraph 16 and 17 of Part A of this Final Terms.

Based on data from Statistics Iceland, the year to year inflation, measured as changes in the CPI, has been positive for the last 30 years ranging from 1.3 per cent in 1998 to 67.7 per cent in 1982. The average value over

the period is 20 per cent with standard deviation of 21.4 per cent. The same statistics for the last 10 years is an average inflation rate of 3.6 per cent. and standard deviation of 2.5 per cent.

The development of the CPI over the past eight years is set out in the table below:

	2007	2008	2009	2010	2011	2012	2013	2014
January	266.9	282.3	334.8	356.8	363.4	387.1	403.3	415.9
February	268.0	286.2	336.5	360.9	367.7	391.0	409.9	418.7
March	267.1	290.4	334.5	362.9	371.2	395.1	410.7	419.7
April	268.7	300.3	336.0	363.8	374.1	398.2	411.5	421.0
May	271.0	304.4	339.8	365.3	377.6	398.1	411.3	421.3
June	272.4	307.1	344.5	364.1	379.5	400.1	413.5	422.8
July	273.0	310.0	345.1	361.7	379.9	397.2	412.4	422.1
August	273.1	312.8	346.9	362.6	380.9	396.6	413.8	423.1
September	276.7	315.5	349.6	362.6	383.3	399.6	415.2	
October	278.1	322.3	353.6	365.3	384.6	400.7	415.2	
November	279.9	327.9	356.2	365.5	384.6	402.0	416.7	
December	281.8	332.9	357.9	366.7	386.0	402.2	418.9	

Source: Iceland Statistics (Icelandic Hagstofa Íslands). No facts have been omitted which would render the reproduced information inaccurate or misleading.

The development of the 12 month inflation (in percentage terms) over the past eight years is set out in the table below:

	2007	2008	2009	2010	2011	2012	2013	2014
January	6.9%	5.8%	18.6%	6.6%	1.8%	6.5%	4.2%	3.1%
February	7.4%	6.8%	17.6%	7.3%	1.9%	6.3%	4.8%	2.1%
March	5.9%	8.7%	15.2%	8.5%	2.3%	6.4%	3.9%	2.2%
April	5.3%	11.8%	11.9%	8.3%	2.8%	6.4%	3.3%	2.3%
May	4.7%	12.3%	11.6%	7.5%	3.4%	5.4%	3.3%	2.4%
June	4.0%	12.7%	12.2%	5.7%	4.2%	5.4%	3.3%	2.2%
July	3.8%	13.6%	11.3%	4.8%	5.0%	4.6%	3.8%	2.4%
August	3.4%	14.5%	10.9%	4.5%	5.0%	4.1%	4.3%	2.2%
September	4.2%	14.0%	10.8%	3.7%	5.7%	4.3%	3.9%	
October	4.5%	15.9%	9.7%	3.3%	5.3%	4.2%	3.6%	
November	5.2%	17.1%	8.6%	2.6%	5.2%	4.5%	3.7%	
December	5.9%	18.1%	7.5%	2.5%	5.3%	4.2%	4.2%	

Source: Iceland Statistics (Icelandic Hagstofa Íslands). No facts have been omitted which would render the reproduced information inaccurate or misleading.

The main target of monetary policy is price stability. A formal inflation target was adopted on March 27, 2001¹.

- The Central Bank of Iceland aims to maintain an average rate of inflation, measured as the annual 12-month increase in the CPI, of as close to 2,5% as possible.
- If inflation deviates by more than $\pm 1,5$ percentage point from the target, the Central Bank of Iceland is obliged to submit a report to the Government of Iceland explaining the reasons for the deviations from the target, how the Central Bank of Iceland intends to react and how long it will take to reach the inflation target again in the bank's assessment. The report shall be made public. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

¹ <http://www.cb.is/monetary-policy/>

- The Central Bank of Iceland shall publish an inflation forecast, projecting inflation two years into the future, which will be outlined in its Monetary Bulletin.

Since monetary policy aims at maintaining price stability, it will not be applied to achieve other economic targets such as a balanced current account or a high level of employment, except insofar as these are compatible with the Central Bank's inflation target.

If policy changes or if the Icelandic economy runs into long-term stagnation it is possible that the level of the CPI will go down over time resulting in individual future payments on the Covered Bonds being reduced in nominal terms and can become lower than the real value of the same payment on the Issue Date.

Information about the CPI can be obtained from <http://www.statice.is/Statistics/Prices-and-consumption/Consumer-price-index>

9. OPERATIONAL INFORMATION

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|------|---|---------------------------------|
| i. | ISIN Code: | IS0000024917 |
| ii. | Common Code: | 000002491 |
| iii. | Any clearing system(s) other than Euroclear Bank S.A./N.V. or Clearstream Banking, société anonyme and the relevant identification number(s): | Icelandic Securities Depository |
| iv. | Delivery: | Delivery against payment |
| v. | Names and addresses of additional Paying Agent(s) (if any): | Not Applicable |
| vi. | Intended to be held in a manner which would allow Eurosystem eligibility: | i. No |