Arion Bank

Press release, 18 November 2014

ARION BANK'S 9 MONTHS 2014 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 22.6 billion for the first nine months of 2014, compared with ISK 10.1 billion for the same period of 2013. Return on equity was 19.9%, compared with 10.0% in the same period of 2013. Total assets amounted to ISK 942.2 billion, compared with ISK 938.9 billion at the end of 2013.

The Bank's capital ratio at the end of the period was 24.6%, compared with 23.6% at the end of 2013.

Highlights of the interim financial statement:

- Net earnings of ISK 22.6 billion, compared with ISK 10.1 billion during the same period of 2013.
- Earnings during the third quarter of 2014 of ISK 5.2 billion, compared with ISK 4.2 billion during the third quarter of 2013.
- Operating income increased between years to ISK 38.3 billion, compared with ISK 31.6 billion in the same period of 2013. The largest increase was in net financial income.
- Net interest income of ISK 18.3 billion, the same amount as for the first nine months of 2013.
- Net commission income of ISK 10.1 billion, compared with ISK 8.3 billion during the same period of 2013. The increase is largely attributable to higher commission income on cards and to activities in Investment Banking.
- Income tax and the bank levy amounted to ISK 6.5 billion, compared with ISK 3.1 billion during the same period of 2013.
- Earnings from discontinued operations of ISK 6.6 billion, compared with a loss of ISK 3 million in the same period of 2013. These earnings relate almost entirely to the sale of the Bank's 18.8% shareholding in HB Grandi hf. in the second quarter of 2014.
- Operating expenses of ISK 18.6 billion, compared with ISK 18.2 billion during the same period of 2013.
- The net valuation change during the period is positive, amounting to ISK 2.9 billion, compared with a negative figure of ISK 119 million in the same period last year. The net valuation change on loans to companies totalled ISK 2.2 billion during the first nine months and retail loan write-downs amounted to ISK 0.2 billion. The valuation increase of other assets totalled ISK 0.7 billion.
- Return on equity was 19.9%, compared with 10.0% in the same period of 2013.
- The net interest margin as a percentage of the average interest-bearing assets was 2.9%, the same as for the first nine months of 2013.
- The cost-to-income ratio was 48.7%, compared with 57.6% in the same period of 2013, mainly because of an increase in operating income compared with last year.
- Total assets of ISK 942.2 billion, compared with ISK 938.9 billion at the end of 2013.
- Total equity amounted to ISK 159.8 billion, compared with ISK 144.9 billion at the end of 2013. The Bank paid a dividend of ISK 7.8 billion to its shareholders during the period.
- The capital ratio was 24.6% at the end of the period, compared with 23.6% at the end of 2013.

Höskuldur H. Ólafsson, CEO of Arion Bank:

The Bank's financial results for the first nine months of 2014 are strong, and return on equity is around 20%. Irregular items have had a positive influence on these results, particularly the Bank's sale of some of its shareholding in HB Grandi and the subsequent stock market flotation of the company in April. We are pleased to see continued stability in the Bank's core operations and all income generating business segments have yielded satisfactory results. We particularly welcome the growth in commission income, up 22% from last year and moving closer to our target. Looking ahead we still have challenges on the cost side.

The Bank's capital ratio remains robust, something we consider important when our operating environment is still subject to uncertainty.

We have been successful in reducing the ratio of non-performing loans and expect this to continue further during the year. Problem loans have been increasing in many areas of the world, while the trend in Iceland in recent years has been the reverse, as household and corporate debt decreases. In fact corporate debt as a percentage of GDP is at its lowest level since late 2004.

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Income statement – highlights

Income statement				
In ISK millions	**9M 2014**	**9M 2013**	**Diff**	**Diff%**
Net interest income	18,309	18,313	(4)	(0%)
Net commission income	10,119	8,284	1,835	22%
Net financial income	5,297	1,989	3,308	166%
Net foreign exchange gain (loss)	564	(1,035)	1,599	(154%)
Other income	3,963	4,035	(72)	(2%)
Operating income	**38,252**	**31,586**	**6,666**	**21%**
Salaries and related cost	(10,026)	(9,439)	(587)	6%
Other operating expenses	(8,598)	(8,744)	146	(2%)
Net change in valuation	2,877	(119)	2,996	(2,518%)
Net earnings before taxes	**22,505**	**13,284**	**9,221**	**69%**
Income tax	(4,456)	(2,851)	(1,605)	56%
Bank Levy	(2,008)	(300)	(1,708)	569%
Net earnings from continuing operation	**16,041**	**10,133**	**5,908**	**58%**
Net gain (loss) from disc. operations	6,592	(3)	6,595	-
Net earnings	**22,633**	**10,130**	**12,503**	**123%**

Operating income

Operating income has increased considerably between years, up ISK 6,666 million. Operating income amounted to ISK 38,252 million during the first nine months of 2014, compared with ISK 31,586 million during the same period of 2013. This increase is primarily due to increases of ISK 3,308 million in net financial income, ISK 1,835 million in net commission income and a shift of ISK 1,599 million in net gain on foreign exchange.

Net interest income during the period amounted to ISK 18,309 million, virtually unchanged from the same period of 2013. The net interest margin as a percentage of average interest-bearing assets was 2.9% during the period, the same as for the first nine months of 2013.

Net commission income increased by 22% between years to ISK 10,119 million, compared with ISK 8,284 million during the first nine months of 2013. The increase is largely due to higher commission income from cards and higher income generated by Investment Banking.

Net financial income increased sharply between years to ISK 5,297 million during the first nine months of 2014, compared with ISK 1,989 million during the same period of 2013. The main difference is the change in the value of the shareholding in HB Grandi hf. which was listed on the Main List of NASDAQ OMX Iceland in April 2014. With the exception of HB Grandi hf. and Hagar hf., the conditions on the Icelandic securities market have had a negative impact on the Group's holdings in equities and bonds. Dividend income was over ISK 800 million higher in the first nine months of 2014 than the same period of 2013.

Net exchange rate gain amounted to ISK 564 million, compared with a loss of ISK 1,035 million in the same period of 2013. The Bank's net foreign exchange imbalance was ISK 16.6 billion at the end of the period, meaning 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 its net foreign exchange position. The foreign exchange balance of the parent company is well within the 15% limit stipulated by the Central Bank of Iceland.

Other operating income amounted to ISK 3,963 million, compared with ISK 4,035 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 ehf. (subsidiary sold in June 2014) and Landey, and income from insurance premiums at OKKAR Life

Insurance hf. The increase over last year is primarily a result of higher valuation changes on investment properties and profits from the sale of the Bank's shareholding in Landfestar ehf.

Operating expenses

Operating expenses totalled ISK 18,624 million and increased slightly from the same period last year. The cost-to-income ratio decreased to 48.7% from 57.6% in the first nine months of 2013. The cost-to-assets ratio was 2.6%, unchanged from the same period of 2013.

Salaries and related expenses amounted to ISK 10,026 million, compared with ISK 9,439 million during the same period of 2013, an increase of 6.2%. The increase is partly explained by contractual salary increases of 2.8% and the estimated cost of the incentive scheme which was not in place in 2013. There were on average 1,130 full-time equivalent positions at the Group during the period, compared with 1,164 in the same period of 2013.

Other operating expenses amounted to ISK 8,598 million, compared with ISK 8,744 million in the same period of 2013. The decrease is explained by the fine imposed on the subsidiary Valitor hf. by the Competition Authority in the first quarter of 2013. Other operating expenses are in line with expectations.

Net valuation change

Net valuation change amounted to ISK 2,877 million and is broadly divided into three types. Firstly, net valuation increases on loans to corporates of ISK 2,262 million. Secondly, net loan impairment on retail loans amounted to ISK 193 million during the period. Thirdly, the net valuation increase of other assets totalled ISK 683 million.

Taxes

Income tax amounted to ISK 4,456 million, compared with ISK 2,851 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% financial tax which is levied on the earnings of financial institutions in excess of ISK 1 billion. The effective income tax rate was 19.8% for the first nine months of 2014, compared with 21.5% during the same period of 2013.

The bank levy amounted to ISK 2,008 million, compared with ISK 300 million during the same period of 2013. The tax rate increased from 0.041% to 0.376% at the end of 2013.

Earnings from discontinued operations

Earnings from discontinued operations amounted to ISK 6,592 million, compared with a loss of ISK 3 million during the same period of 2013. In April the Bank sold 18.8% in HB Grandi hf. (previously held 31%) and the majority of these earnings originate from this sale. Following this transaction and the company’s stock market listing the Bank’s remaining shareholding was classed as a financial asset and it changes in value in accordance with the listed price. These valuation changes are categorized under net financial income in the income statement.

Third quarter of 2014

The financial results for the third quarter of 2014 were good. Return on equity was 13.3%, compared with 12.2% in the same period of 2013.

Income statement				
In ISK millions	**Q3 2014**	**Q3 2013**	**Diff**	**Diff%**
Net interest income	6,343	5,646	697	12%
Net commission income	3,526	2,986	540	18%
Net financial income	1,582	445	1,137	256%
Net foreign exchange gain	412	213	199	93%
Other income	686	1,610	(924)	(57%)
Operating income	**12,552**	**10,900**	**1,649**	**15%**
Salaries and related cost	(2,862)	(2,760)	(102)	4%
Other operating expenses	(2,787)	(2,516)	(271)	11%
Net change in valuation	876	(253)	1,129	(446%)
Net earnings before taxes	**7,779**	**5,371**	**2,408**	**45%**
Income tax	(1,989)	(1,102)	(887)	80%
Bank levy	(633)	(112)	(521)	465%
Net earnings from continuing operation	**5,157**	**4,157**	**1,000**	**24%**
Net gain (loss) from disc. operations	67	62	5	8%
Net earnings	**5,224**	**4,219**	**1,005**	**24%**

Operating income in the third quarter increased between years, up 15%, with the largest rise being in net financial income, mainly as a result of the increase in the market value of the Bank's holding in HB Grandi hf. Net interest income and net commission income increased between years. Other income decreased as a result of the sale of Landfestar ehf. in June.

Operating expenses were overall slightly higher in the third quarter of 2014 than the same period of 2013. Despite the rise in salary expenses relating to a new incentive scheme at the Bank and contractual salary increases salaries are similar compared with the same period of 2013. The average number of full-time equivalent positions at the Group in the third quarter is 20 less than in the same period of 2013.

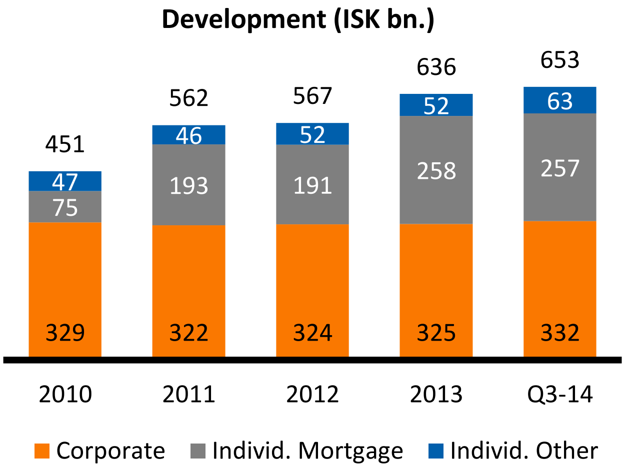
Balance sheet – highlights

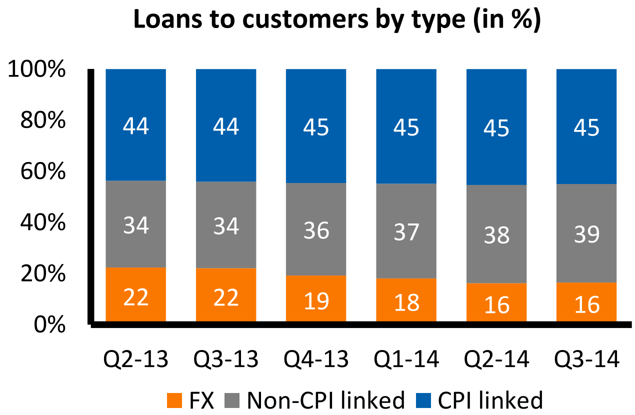
Assets					
In ISK millions	**30.09.2014**	**31.12.2013**	**Diff%**	**30.09.2013**	**Diff%**
Cash & balances with CB	33,335	37,999	(12%)	20,116	66%
Loans to credit institutions	108,621	102,307	6%	113,202	(4%)
Loans to customers	652,598	635,774	3%	576,204	13%
Financial assets	99,223	86,541	15%	154,387	(36%)
Investment property	2,901	28,523	(90%)	29,382	(90%)
Investments in associates	22,025	17,929	23%	14,856	48%
Non-current assets & disposal Groups HFS	4,210	10,046	(58%)	9,931	(58%)
Other assets	19,257	19,731	(2%)	18,866	2%
Total assets	**942,171**	**938,850**	**0%**	**936,944**	**1%**

Arion Bank had *total assets* of ISK 942,171 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, higher loans at credit institutions and increased securities holdings. Loans to customers increased due to new lending to individuals and corporates in seafood, real-estate and industry.

Loans to customers

Loans to customers amounted to ISK 652,598 million at the end of September 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, both in terms of the split between corporate and retail loans and whether the loans are indexed, non-indexed or in foreign currency. The diagrams show this development, with two events being prominent. Firstly, the Bank's acquisition of Arion Bank Mortgage Institutional Investor Fund, Kaupthing Bank's mortgage fund, at the end of 2011, 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 target. Mortgage loans represent a large proportion of loans to individuals and a substantial percentage of these are high quality, low-risk loans with strong collateral.





Securities

Securities holdings amounted to ISK 99,223 million at the end of the period, compared with ISK 86,541 million at the end of 2013.

Securities					
In ISK millions	**30.09.2014**	**31.12.2013**	**Diff%**	**30.09.2013**	**Diff%**
Bonds	65,699	62,171	6%	131,511	(50%)
Shares and instruments w. variable income	25,277	17,449	45%	17,748	42%
Derivatives	1,306	1,070	22%	1,080	21%
Securities used for hedging	6,942	5,851	19%	4,048	71%
Securities total	**99,223**	**86,541**	**15%**	**154,387**	**(36%)**

This increase is particularly attributable to changes in the Bank's liquidity management and the growth in the Bank's equities holdings following the listing and re-categorization of the holding in HB Grandi hf. in the Bank's accounts.

Non-current assets and disposal groups held for sale

Non-current assets and disposal groups held for sale amounted to ISK 4,210 million at the end of September 2014, compared with ISK 10,046 million at the end of 2013. The main assets in this category are now almost entirely real estate properties. The decrease from the end of 2013 is due to sale and listing of shares in HB Grandi hf. At the end of 2013 the Bank owned 31% of the company and sold 18.8% at the end of April when it was listed on the Main Market of NASDAQ OMX Iceland. The Bank's shareholding at the end of September is now classed under financial assets.

Liabilities and equity

Liabilities and equity					
In ISK millions	**30.09.2014**	**31.12.2013**	**Diff%**	**30.09.2013**	**Diff%**
Due to credit institutions & CB	21,131	28,000	(25%)	28,548	(26%)
Deposits from customers	482,518	471,866	2%	471,768	2%
Financial liabilities at fair value	6,038	8,960	(33%)	9,834	(39%)
Other liabilities	49,567	48,591	2%	47,033	5%
Borrowings	191,947	204,568	(6%)	206,065	(7%)
Subordinated loans	31,205	31,918	(2%)	32,809	(5%)
Equity	159,765	144,947	10%	140,887	13%
Total liabilities and equity	**942,171**	**938,850**	**0%**	**936,944**	**1%**

Total liabilities amounted to ISK 782,406 million at the end of September 2014, compared with ISK 793,903 million at the end of 2013.

Deposits

Total deposits amounted to ISK 503,649 million at the end of September 2014, compared with ISK 499,866 million at the end of 2013. The Bank has managed to retain its market share in total deposits in a competitive environment.

Borrowings

Borrowings amounted to ISK 191,947 million at the end of September 2014, compared with ISK 204,568 million at the end of 2013. The decrease is mainly due to the repurchase of the Bank's own covered bonds of ISK 20 billion in June and the issuance of new covered bonds of ISK 10 billion, which mature in 2015. Borrowings also decreased as a result of the sale of the real estate company Landfestar hf. which has issued listed bonds of almost ISK 3 billion. In early 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's rating of BB+ was affirmed by the rating agency in October and the outlook was upgraded from stable to positive. This rating 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 31,205 million at the end of September 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.

Equity

Total equity amounted to ISK 159,765 million at the end of September 2014, compared with ISK 144,947 million at the end of 2013. During the second quarter the Bank paid a dividend to shareholders of ISK 7,811 million. Other changes in total equity are attributed to the financial results during the period. The capital ratio calculated in accordance with the rules of the FME was 24.6% at the end of the period, but the statutory minimum is 8%.

Key performance indicators

Key performance indicators	9M 2014	2013	9M 2013
Return on equity (ROE)	19.9%	9.2%	10.0%
Return on total assets (ROA)	3.2%	1.4%	1.5%
Net interest margin (int. bearing assets)	2.9%	2.9%	2.9%
Net interest margin (total assets)	2.6%	2.6%	2.7%
Cost-to-income ratio	48.7%	57.3%	57.6%
Cost-to-total assets ratio	2.6%	2.8%	2.6%
Effective tax rate	19.8%	17.2%	21.5%
CAD-ratio	24.6%	23.6%	23.6%
CET 1 ratio	20.3%	19.2%	19.5%
Problem loans	4.6%	6.3%	8.2%
RWA/Total assets	77.4%	76.8%	73.7%
Loans to deposit ratio	135.2%	134.7%	122.1%
The Group's average number of employees	1,130	1,159	1,164
The Group's employees at the end of the period	1,135	1,145	1,139
The Parent's average number of employees	898	923	927
The Parent's employees at the end of the period	899	911	906

Financial calendar

The Bank's financial statements are scheduled for publication on the dates stated below.

Annual financial statement for 2014	24 February 2015
Annual general meeting 2015	19 March 2015
First quarter 2015	12 May 2015
Second quarter 2015	26 August 2015
Third quarter 2015	18 November 2015

This calendar may be subject to change.