Consolidated Financial Statements

for the year 2012

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

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ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2012 include the Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Arion Bank is a group of undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate and retail banking, investment banking and asset management. Within the Group are subsidiaries in investment property management, credit card and insurance services.

Kaupskil ehf., a company owned by Kaupthing hf. (formerly Kaupthing Bank 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.

The number of full-time equivalent positions at the Group at the end of the year was 1,190, compared with 1,158 at the end of 2011. At the end of the year 949 of these positions were at the parent company, Arion Bank, compared with 858 at the end of 2011. The increase is largely explained by the mergers of Verdis hf. and Sparisjódur Ólafsfjardar with the parent company.

Operations in 2012

Net earnings amounted to ISK 17,056 million for the year ended 31 December 2012. The Board of Directors proposes that earnings will be added to equity and that no dividend will be paid out in 2013 for the fiscal year 2012. The Group's equity amounted to ISK 130,878 million at the end of the year, including share capital of ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 24.3%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") makes more stringent requirements. The Bank comfortably meets these requirements. The Bank's liquidity position was strong with the liquidity ratio and cash ratio being 33% and 31% respectively at the end of the year, compared with the regulatory minimum of 20% and 5% respectively.

Arion Bank performed well during the year and reported satisfactory earnings from its core activities. The Bank's subsidiaries, both financial companies and non-financial businesses, also produced satisfactory results. The Group's focus in the future is to increase commission income as a proportion of total income. The way to achieve this goal is to add more weight to services which bring greater stability to commission income and to provide funding-based services, either through loans or via the market. In the current economic climate, reining in the costs of financial companies is clearly necessary and the Bank will focus on operating efficiency. In recent years a great deal of effort, work and financial resources has been spent on various debt recovery tasks and official supervision of the Bank's activities. As more of those tasks are completed, there is more scope for cutting costs and for expanding the Bank's business on the financial market.

Bank deposits in Iceland have been decreasing and this trend is likely to continue in the near future, particularly as the equities market grows and offers more investment opportunities for private investors, companies and institutional investors. Arion Bank is responding to this expected development by seeking to diversify its long-term and short-term funding. To this end, the Bank issued the first tranche of a covered bond issue in February which could amount up to EUR 1 billion. The issue of indexed bonds amounted to ISK 2.5 billion and matures in 2034. It was sold to Icelandic institutional investors. Arion Bank was the first bank to issue non-indexed fixed-interest bonds. In May and June the Bank issued a total of ISK 2.5 billion in covered bonds with 6.5% interest which mature in 2015.

One key objective has been to sell those entities which the Bank took over in the process of recovering debts. The Group's holding in Hagar hf. was sold during the year and the Bank now only owns shares in the company in its trading book. Between May and August the Bank completed the sales of its holdings in B.M. Vallá ehf., N1 ehf. and Penninn á Íslandi ehf. once the deals had been authorized by the competition authorities. The Bank also sold its 20% interest in Ölgerdin Egill Skallagrímsson ehf. and the major part of the Fram Foods Group.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Group structure has been simplified by merging some of the Bank's subsidiaries and by winding-up other companies which had completed their assigned roles. The largest companies to be merged with the Bank were Verdis ehf. and Sparisjódur Ólafsfjardar which were both wholly owned by the Bank. Work is underway to merge AFL sparisjódur, which is almost entirely owned by the Bank, with Arion Bank hf. in the next few months.

The quality of the Group's asset portfolio increased during the year. The sale of foreclosure assets in the form of real estate and legal entities has some impact in this respect and headway has been made in the Group's loan portfolio. The financial restructuring of the Group's largest corporate customers has largely been completed and good progress has been made in the case of smaller companies and private customers. In February the Supreme Court of Iceland pronounced a judgement which led to uncertainty over the interest terms and book value of currency-linked loans which had previously been deemed illegal. The judgment was considered to be too tied to specific events to set a precedent for all types of loans and terms which it could affect, and it was thus thought necessary for other cases to go to court. Judgments which were pronounced later in the year have removed much of the uncertainty and the Group has recalculated certain categories of currency-linked loans with reference to judgment pronounced in October. In respect of these judgments the Group has expensed ISK 19.6 billion in 2011 and 2012 to meet future settlements. For further details on the legality of FX loans, see Note 96.

In November the FME published the results of its examination of the Bank's assessment of its loan portfolio. Approximately 43% of the Bank's loans to larger companies were examined and the main conclusion was that there was no indication that the loan portfolio was overvalued.

Risk Management

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 Group's risk management structure, strategy and risk exposures are addressed in the notes, starting at Note 101.

Outlook

The Bank is well positioned to grow and its strong balance sheet will enable it to be an active participant in the regeneration of the Icelandic economy. As debt recovery cases decrease, traditional banking activities are becoming more characteristic for the Bank's operations. This creates opportunities for further streamlining yet at the same time greater potential for generating earnings. The Bank aims to be a relationship bank and a fundamental aspect of this is to know the needs of the customers and how to respond to them.

Loans to customers are beginning to grow and this is expected to continue over the next few years. The property market has begun to recover with a greater demand for funding as a result. While loans are not expected to grow significantly in 2013, an increase is projected from 2014.

In January 2013 Arion Bank hf. completed its third non-indexed fixed rate covered bond offering by issuing ISK 1.8 billion worth of bonds. Following successful bond offerings on the Icelandic market, the Bank was in February 2013 the first Icelandic bank since 2007 to sell bonds to international investors. The bonds are senior unsecured, worth NOK 500 million and will be traded on the Oslo exchange. This represents the first phase in raising international funding since the Bank was founded and the next step is to apply for a credit rating from an international rating agency.

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. Further information about corporate governance can be found in Arion Bank's corporate governance statement for 2013 which is published in the Group's Annual Report.

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 for the year ended 31 December 2012 have been prepared in accordance with International Financial Reporting Standards as endorsed by the European Union.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance of the Group for the year 2012, its financial position as at 31 December 2012 and its cash flows in 2012.

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 2012 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, 28 February 2013

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Guðrún Johnsen

Måns Höglund

Freyr Thórdarson

Jón G. Briem

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 2012, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flows 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 2012, of its financial performance and its cash flows for the year then ended in accordance with the International Financial Reporting Standards as endorsed by the EU.

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

Pursuant to the requirement of Item 5, Paragraph 1 Article 106 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, 28 February 2013

Ernst & Young ehf.

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR 2012

	Notes	2012	2011
Interest income		59,094	46,433
Interest expense		(31,952)	(23,045)
Net interest income	42	27,142	23,388
Increase in book value of loans and receivables	43	12,824	38,368
Impairment of loans and receivables	44	(17,514)	(27,424)
Changes in compensation instrument	45	-	(19,593)
Net interest income less valuation changes on loans and receivables		22,452	14,739
Fee and commission income		16,166	16,862
Fee and commission expense		(5,418)	(6,177)
Net fee and commission income	46	10,748	10,685
Net financial income (expense)	47-50	583	511
Net foreign exchange gain (loss)	51	1,434	1,836
Share of profit (loss) of associates	73	2,405	8
Other operating income	52	7,190	5,497
Operating income		44,812	33,276
Salaries and related expense	55	(12,459)	(11,254)
Administration expense		(9,142)	(7,810)
Depositors' and investors' guarantee fund	90	(899)	(1,200)
Depreciation and amortisation	75	(1,436)	(956)
Other operating expense	58	(732)	(796)
Earnings before tax		20,144	11,260
Income tax expense	60	(3,633)	(1,912)
Bank Levy	61	(1,062)	(1,046)
Net earnings from continuing operations		15,449	8,302
Net gain (loss) from discontinued operations, net of tax	62	1,607	2,792
Net earnings		17,056	11,094
Attributable to:			
Shareholders of Arion Bank		16,622	10,493
Non-controlling interest		434	601
Net earnings		17,056	11,094
Other comprehensive income:			
Exchange difference on translating foreign subsidiaries	88	2	112
Total comprehensive income for the year		17,058	11,206
Earnings per share			
Basic and diluted earnings per share from continuing operations attributable to the shareholders of Arion Bank (ISK)	63	8.31	5.25

The notes on pages 11 to 79 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2012 7 Amounts are in ISK millions

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2012

Assets	Notes	2012	2011
Cash and balances with Central Bank	64	29,746	29,200
Loans and receivables to credit institutions	65-66	101,011	69,103
Loans and receivables to customers	67-68	566,610	561,550
Bonds and debt instruments	69-70	117,730	140,568
Shares and equity instruments with variable income	69	16,844	14,045
Derivatives	69,86	788	674
Securities used for hedging	69	2,438	2,372
Investment property	72	28,919	27,100
Investments in associates	73	7,050	2,987
Property and equipment	74-75	6,311	6,271
Intangible assets	76	4,941	4,765
Tax assets	77-80	463	724
Non-current assets and disposal groups held for sale	81	11,923	23,886
Other assets	82	5,901	8,876
Total Assets		900,675	892,121

Liabilities	Notes	2012	2011
Due to credit institutions and Central Bank	69	32,990	16,160
Deposits	69	448,683	489,995
Financial liabilities at fair value	69	13,465	4,907
Tax liabilities	77-80	3,237	3,421
Non-current liabilities and disposal groups held for sale	81	1,769	4,950
Other liabilities	83	40,348	38,822
Borrowings	69,84	195,085	187,203
Subordinated liabilities	69,85	34,220	32,105
Total Liabilities		769,797	777,563

Equity	Notes	2012	2011
Share capital	87	2,000	2,000
Share premium	87	73,861	73,861
Other reserves	88	1,639	1,637
Retained earnings		49,572	32,950
Total Shareholders' Equity		127,072	110,448
Non-controlling interest		3,806	4,110
Total Equity		130,878	114,558
Total Liabilities and Equity		900,675	892,121

The notes on pages 11 to 79 are an integral part of these Consolidated Financial Statements.

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CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR 2012

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
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
2011						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Dividend paid			(6,074)	(6,074)		(6,074)
Total comprehensive income for the year		112	10,493	10,605	601	11,206
Decrease due to sale of subsidiary					(110)	(110)
Equity 31 December 2011	75,861	1,637	32,950	110,448	4,110	114,558

The notes on pages 11 to 79 are an integral part of these Consolidated Financial Statements.

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CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR 2012

	Notes	2012	2011
Cash flows from (used in) operating activities:			
Earnings before tax		20,144	11,260
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments	98	(1,618)	(1,623)
Changes in operating assets and liabilities	99	(2,432)	(13,443)
Income taxes paid		(3,556)	(3,232)
Net cash from (used in) operating activities		12,538	(7,038)
Cash flows from (used in) investing activities:			
Purchase of investment property		(3,728)	(2,160)
Investment in minority share of subsidiary		(738)	-
Investment in associated companies		(1,658)	(177)
Proceeds from sale of investment property		3,684	5,999
Proceeds from sale of associated companies		396	-
Purchase of intangible assets		(713)	(518)
Purchase of property and equipment		(961)	(667)
Proceeds from sale of property and equipment		30	158
Proceeds from the sale of individual properties included in discontinued operations		8,569	11,028
Net cash from (used in) investing activities		4,881	13,663
Net increase (decrease) in cash and cash equivalents		17,419	6,625
Cash and cash equivalents at beginning of the year		82,815	72,797
Cash and cash equivalents acquired through business combinations		-	11
Effect of exchange rate changes on cash and cash equivalents		4,939	3,382
Cash and cash equivalents at the end of the year	100	105,173	82,815
Non-cash investing and financing transactions:			
Tier II subordinated notes issued in settlement of dividend		-	(6,074)
Change in retained earnings for settlement of dividend with Icelandic State Financial Investments		-	6,074
Assets acquired through foreclosure on collateral from customers with view to resale		2,051	10,549
Settlement of loans and receivables through foreclosure on collateral from customers with view to resale		(2,051)	(10,549)

The notes on pages 11 to 79 are an integral part of these Consolidated Financial Statements.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

ACCOUNTING POLICIES

General information

1. Reporting entity

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 2012 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 28 February 2013.

2. Basis of preparation

a) *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.

b) *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; and
- Investment properties are measured at fair value.

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. Immediately before the initial classification, or where the assets and liabilities are not within the scope of IFRS 5, the carrying amounts are measured in accordance with applicable IFRS.

c) *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.

d) *Use of estimates and judgements*

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, contingent liabilities as well as income and expenses in the Financial Statements presented. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the differences may affect the Financial Statements.

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

Judgements made by management that have an effect on the Financial Statements and estimates with a risk of material adjustment within the next financial year are discussed in Notes 33, 71, 101, 110 and 121.

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 2011.

3. 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.

4. Principles underlying the consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Group holds more than 50% of the voting power of the entity. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The Financial Statements of subsidiaries are included in the 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.

The acquisition method of accounting is used to account for the acquisition of businesses and subsidiaries by the Group. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the Group measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree’s identifiable net assets. Acquisition costs incurred are expensed and included in administrative expenses. If the business combination is achieved in stages, the acquisition date fair value of the acquirer’s previously held equity interest in the acquiree is remeasured to fair value at the acquisition date through profit or loss. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in the Statement of Comprehensive Income. After initial recognition, goodwill is measured at cost less any accumulated impairment losses.

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 an disposal groups held for sale from the date of classification.

b) *Non-controlling interest*

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. Losses within a subsidiary are attributed to the non-controlling interest even if that results in a deficit balance. Changes in the Group's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

c) *Funds management*

The Group manages and administers assets held in 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.

5. 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.

5. cont.

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 recognising 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.

6. Foreign currency

a) *Functional currencies*

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

b) *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.

c) *Foreign operations*

The assets and liabilities of foreign operations are translated to Icelandic Krona, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic Krona at exchange rates approximating the exchange rates current at the dates of the transactions.

Foreign exchange differences arising on translation are recognised in the Statement of Comprehensive Income. When a foreign operation is disposed of, in part or in full, the cumulative amount of the exchange differences relating to that foreign operation which is recorded in comprehensive income and accumulated in the separate component of equity, is transferred to the Statement of Comprehensive Income when the gain or loss on disposal is recognised.

7. Income and Expense

a) *Interest income and expense*

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 liability and is not revised subsequently.

The calculation of the effective interest rate includes all fees paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or 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 on an accrual basis; and
- Interest on financial assets designated at fair value through profit or loss on an accrual basis.

Interest income on non-performing assets are recognised in the Statement of Comprehensive Income using the effective interest method. The Group recognises losses for impaired loans to offset the recognised interest income when appropriate.

b) *Fee and commission income and expense*

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.

7. cont.

c) *Net financial income*

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value through profit or loss, Net foreign exchange gain and Net gain on disposal of financial assets and liabilities not at fair value.

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

iii) Net foreign exchange gains 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 gains 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 gains and losses are also recognised in profit or loss.

iv) Net gain on financial assets and liabilities not at fair value through profit or loss relates to derecognition of certain financial assets and liabilities and comprises Net realised gain or loss on financial liabilities measured at amortised cost and other net realised gain or loss. It does not include either unrealised foreign exchange gains and losses or interest income and expense which are included in other line items.

d) *Income tax*

Income tax comprises current and deferred tax. Income tax is recognised in the Statement of Comprehensive Income except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised in other comprehensive income or equity.

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.

The deferred income tax asset and tax liability has been calculated and entered in the Statement of Financial Position. The calculation is based on the difference between Statement of Financial Position items as presented in the tax return on the one hand, and in the Financial Statements on the other. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Financial Statements, mostly because revenues and settlement is not expected at the same time. A deferred tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. 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. Tax assets and tax liabilities are calculated based on expected tax rates when the tax asset is realised or tax liability is paid according to current tax law.

8. Impairment of financial assets

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.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

a) *Impairment on loans and receivables*

The Group recognises losses for impaired loans when there is objective evidence that impairment of a loan or portfolio of loans has occurred. That is done on an unified basis according to internal guidance for the Group.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

8. cont.

Objective evidence of impairment includes observable data about the following loss events:

i) Significant financial difficulty of the borrower;

ii) A breach of contract, such as a default on instalments or on interest or principal payments;

iii) The Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;

iv) It becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;

v) Deterioration in collateral to loan ratio; or

vi) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:

- Adverse changes in the payment status of borrowers in the Group; or
- General national or local economic conditions connected with the assets in the Group.

Assessment of loans and receivables

When assessing impairment loss on loans and receivables the Group uses an internal classification of borrowers. Customers are classified according to financial position and collateral. The internal classification consists of four categories; green, yellow, orange and red. Customers classified as green or yellow are not subject to impairment. Orange and red customers are assessed for impairment loss but loans are classified as red if impairment is needed even if they are classified as orange at the beginning of the process. Impairment on loans and receivables for orange and red customers is based on individual assessment of loans. The Group assesses at each reporting date whether there is any objective evidence that the loan is impaired. In determining such impairment losses on individually assessed accounts, 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 security (or other credit mitigates) and likelihood of successful repossession; and
- The likely deduction of any costs involved in recovery of amounts outstanding.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Statement of Comprehensive Income. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan or receivable at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Loans and receivables in category green, yellow and orange are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans and reiceivables that are impaired at the reporting date but which will not be individually identified as such until some time in the future. The estimated collective impairment loss is recognised through the use of an allowance account.

The collective impairment loss is determined after taking into account:

- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the assets;
- Historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash; and
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

8. cont.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period, for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to minimise any differences between loss estimates and actual losses.

Loan write-offs

Loans are normally 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 security have been received.

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised or acquired impairment loss is reversed. The amount of any reversal is recognised in the Statement of Comprehensive Income.

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 and receivables in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

Assets acquired in exchange for loans

Assets acquired in exchange for loans are recorded as non-current assets and disposal groups held for sale in the Statement of Financial Position if its sale is highly probable and management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan have been initiated. The non-current assets and disposal groups held for sale is recorded at the lower of its fair value less costs to sell, and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Statement of Comprehensive Income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Statement of Comprehensive Income.

b) *Calculation of recoverable amount*

The recoverable amount of the Group's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate, i.e. the effective interest rate computed at initial recognition of these financial assets.

c) *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.

9. 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.

10. 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 Derivatives and derivatives with negative fair values are recognised as Financial liabilities at fair value.

The fair value of derivatives is determined in accordance with the accounting policy presented in Note 13.

11. 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.

12. Loans and receivables

Loans and receivables 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.

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.

Loans and receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

13. Financial assets measured at fair value through profit or loss

a) *Trading assets*

Trading assets 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.

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

The Group classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Statement of Comprehensive Income as Net financial income if doing so results in more relevant information because:

i) the assets are managed, evaluated and reported internally on a fair value basis;
ii) the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
iii) the assets contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

The assets classified according to the above mentioned conditions 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.

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

14. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation 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.

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.

15. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Group commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

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 recognised when the Group becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

16. Offsetting financial assets and financial liabilities

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.

17. Amortised cost measurement of financial assets and financial liabilities

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.

18. Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets are not capitalised and expenditure is reflected in the Statement of Comprehensive Income in the period in which the expenditure is incurred.

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

a) *Subsequent expenditure*

Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

b) *Amortisation*

Amortisation is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of intangible assets. Intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software .... 5 years

19. 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 stated at fair value. The Group has not engaged independent property valuers to appraise the values of investment properties at the end of the year as management believes the valuation techniques as described below provide a more reliable estimate of fair value.

When determining the fair value of the properties, net present value of future cash flow over 30 years 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. The valuation model is based on estimated free cash flow to the owners and assumptions applied that reflect the market conditions at the accounting date. The cash flow of the properties is based on estimation of rental income less estimated expenses.

Rental income is estimated based on valid lease agreements. In the valuation model estimated market lease at the end of the current lease agreement is taken into consideration. Assumptions on estimated utilisation of the properties in the future, estimated discounts and provisioning on receivables are applied when estimating future rental income.

All related expenses, e.g. maintenance, real estate tax and other operating and financial expenses, is deducted from the estimated rental income. Real estate tax and insurances are based on historical data and foreseen future changes. Financial expense is estimated based upon market interest and expected interest yield (interest margin).

The net present value of free cash flow to owners, for each property, is determined by calculating the net present value of the cash flow with a factor representing current market uncertainty on amount and timing of the cash flow, including expected inflation. The CAPM model is used and the required rate of return is based on the risk free real interest on the accounting date, the risk factor of the real estate market and specific risk factors of each lessee.

When estimating the fair value of the investment properties' assets like fixtures, are not accounted for separately as they are considered part of the fair value of the properties. The fair value of the properties does not reflect the possible future increase in the value due to further investments in the property.

Vast majority of the investment properties are valued based on the above mentioned valuation techniques but when preconditions are not available the Group uses management valuation.

20. Property and equipment

a) *Recognition and measurement*

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.

b) *Subsequent costs*

The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Group and its cost can be measured reliably. All other costs are recognised in the Statement of Comprehensive Income as an expense as incurred.

c) *Depreciation*

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.

21. 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.

22. Deposits

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

23. 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.

24. 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 125. 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.

25. Financial liabilities at fair value

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain (loss) on financial assets and financial liabilities classified as held for trading. Interest expenses on trading liabilities are included in Interest expenses.

Short positions

Trading liabilities primarily consist of short positions. Short positions are obligations of the Group to deliver financial assets borrowed by the Group and sold to third parties. These obligations are initially recognised at fair value in the statement of financial position, with transaction costs being recognised in the statement of comprehensive income. Subsequently, they are carried at fair value, with all fair value changes recognised in Net financial income (expense) in the Statement of Comprehensive Income.

Derivatives

Derivatives primarily consist of derivatives with negative fair values. Economic hedging derivatives not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

26. Other assets and other liabilities

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

27. Equity

Dividends on shares

Dividends on shares are recognised in equity in the period in which they are approved by the 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.

28. 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.

29. 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.

30. 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.

31. 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.

32. New standards and amendments to standards

a) *New standards and amendments to standards effective in 2012*

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 2012:

IFRS 7 Financial Instruments: Disclosures — Enhanced Derecognition Disclosure Requirements. The amendment requires additional disclosure about financial assets that have been transferred but not derecognised to enable the user of the Group's financial statements to understand the relationship with those assets that have not been derecognised and their associated liabilities. In addition, the amendment requires disclosures about continuing involvement in derecognised assets to enable the user to evaluate the nature of, and risks associated with, the entity's continuing involvement in those derecognised assets. The amendment becomes effective for annual periods beginning on or after 1 July 2011. The amendment affects disclosure only and has no impact on the Group's financial position or performance.

b) *New standards and amendments to standards not yet adopted*

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2012, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

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 would provide users with information that is useful in evaluating the effect of netting arrangements on an entity's financial position. The new 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 will not impact the Group's financial position or performance and will become effective for annual periods beginning on or after 1 January 2013.

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. If endorsed by the EU, the effective date for mandatory adoption is 1 January 2015.

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. The Group is currently assessing the impact of the new standard on its financial statements. This standard has been endorsed by the EU and becomes effective for annual periods beginning on or after 1 January 2014.

IFRS 11 Joint arrangements. IFRS 11 Joint arrangements will replace IAS 31 Joint ventures. Currently, the Group is not engaged in any joint arrangements.

32. cont.

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 becomes effective for annual periods beginning on or after 1 January 2014.

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 is not expected to have a material impact on the financial position or performance of the Group. This standard becomes effective for annual periods beginning on or after 1 January 2013.

IAS 1 Presentation of Items of Other Comprehensive Income – Amendments . The amendments to IAS 1 change the grouping of items presented in other comprehensive income (OCI). The amendment affects presentation only and has no impact on the Bank's financial position or performance. The amendment becomes effective for annual periods beginning on or after 1 July 2012.

IAS 19 Employee Benefits – Amendments. The amendments to IAS 19 remove the option to defer the recognition of actuarial gains and losses, i.e., the corridor mechanism. All changes in the value of defined benefit plans will be recognised in the Statement of Comprehensive Income. Adoption of the standard is not expected to have a material impact on the financial position or performance of the Group. The effective date of the standard is 1 January 2013.

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 become effective for annual periods beginning on or after 1 January 2014.

Annual improvements May 2012, relevant for the Group

IAS 1 Presentation of Financial Statements . This improvement clarifies the difference between voluntary additional comparative information and the minimum required comparative information. Generally, the minimum required comparative information is the previous period. This improvement becomes effective for annual periods beginning on or after 1 January 2013, but will not have an impact on the financial position or performance of the Group.

33. Significant accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets, liabilities, revenures and expenses. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

These disclosures supplement the risk management disclosures, provided elsewhere in these Financial Statements.

Key sources of estimation uncertainty

i) Impairment losses on loans and receivables
The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Statement of Comprehensive Income, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

33. cont.

ii) Foreign loan portfolio

In 2011 the Group estimated the impact of the Supreme Court judgement of 15 February 2012 on the foreign loan portfolio. In 2012 the Group has estimated the impacts of the Supreme Court judgements of 15 June, 18 October and 1 November 2012, dealing with foreign loans or currency linked loans.

As set out in Note 96 of these Financial Statements, the Group recognised impairment of the foreign loan portfolio at the end of the year for the estimated loss arising from the above judgments. The Group remains exposed to uncertainty regarding the foreign loan portfolio arising from firstly, the Group's interpretation of the judgments of 15 February and 18 October 2012, 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.

iii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could have impact on the reported fair value of financial instruments.

iv) Assets classified as held for sale

The Group classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. For the sale to be highly probable management must be committed to sell the assets and be actively looking for a buyer, the assets must be actively marketed at a price that is reasonable in relation to their fair value and the sale is expected to be completed within one year. An extension of the period required to complete a sale does not preclude an asset or disposal group from being classified as held for sale if the delay is caused by events or circumstances beyond the Group's control and there is sufficient evidence that the Group remains committed to its plan to sell the assets or disposal groups.

When classifying assets as held for sale the Group has determined that the requirements of IFRS 5 have been met.

As set out in these Financial Statements, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair values less costs to sell. For the most part, fair values at the date of classification of these legal entities were 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.

v) Fair value of Investment Property

As the property market in Iceland is relatively inactive and assets are often quite dissimilar it is difficult to obtain reliable estimates of fair values of investment properties. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to use prices from recent market transactions in order to determine values of comparable properties. This being the case there is uncertainty about the actual fair value of the properties.

vi) Intangible assets

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

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The Group

34. Shares in subsidiaries in which Arion Bank held a direct interest at the end of the year were as follows:

			Equity interest in %	
Company:	Country	Currency	2012	2011
AB-fjárfestingar ehf., Borgartún 19, Reykjavík	Iceland	ISK	-	100,0
AFL - sparisjódur, Adalgata 34, Siglufjördur	Iceland	ISK	99,3	94,5
ALT ehf., Borgartún 19, Reykjavík	Iceland	ISK	100,0	-
Arion Bank Mortgages Institutional Investor Fund, Borgartún 19, Reykjavík	Iceland	ISK	100,0	100,0
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
Einkaklúbburinn ehf., Borgartún 19, Reykjavík	Iceland	ISK	100,0	-
Ekort ehf., Gardatorg 5, Gardabær	Iceland	ISK	-	100,0
ENK 1 ehf., Borgartún 19, Reykjavík	Iceland	ISK	-	100,0
Gen hf., Borgartún 19, Reykjavík	Iceland	ISK	100,0	100,0
GIR Fund Management Ltd., Walker House Mary Street, George Town.	Cayman Isl.	ISK	100,0	100,0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	100,0	100,0
Landfestar ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100,0	100,0
NS1 ehf., Borgarbraut 14, Borgarnes	Iceland	ISK	100,0	100,0
Okkar líftryggingar hf., Sóltún 26, Reykjavík	Iceland	ISK	100,0	100,0
Sparisjódur Ólafsfjardar, Adalgata 14, Ólafsfjördur	Iceland	ISK	-	100,0
Stefnir hf., Borgartún 19, Reykjavík	Iceland	ISK	100,0	100,0
Tekjuvernd ehf., Hlídarsmári 17, Kópavogur (former KB Rádgjöf ehf.)	Iceland	ISK	100,0	100,0
Valitor Holding hf., Laugavegur 77, Reykjavík	Iceland	ISK	60,8	53,6
Verdis hf., Ármúli 13, Reykjavik	Iceland	ISK	-	100,0
Vesturland hf., Borgartún 19, Reykjavík	Iceland	ISK	-	100,0

In addition the Bank holds subsidiaries classified as a Non-current assets and disposal groups held for sale, see Note 81.

35. Merger of entities

In 2012 the boards of Arion Bank and the Bank´s wholly owned subsidiary Verdis hf. approved the merger of these two entities. On 29 June 2012 FME approved the merger. The merger took effect from 1 January 2012.

In 2012 the boards of Arion Bank and the Bank´s wholly owned subsidiary Sparisjódur Ólafsfjardar approved the merger of these two entities. On 14 September 2012 FME approved the merger. The merger took effect from 1 January 2012.

The subsidiary Ekort ehf. was merged into Arion Bank 1 January 2012. Prior to the merger part of the operation of Ekort ehf. was transferred to Einkaklúbburinn ehf. which is a new subsidiary of the Bank.

36. Equity holding in subsidiaries

In April 2012 the Group acquired a further 7.2% share in Valitor Holding hf. After the acquisition the Group holds 60.8% share in Valitor Holding hf.

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37. Disposal of subsidiaries

In October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf., which was approved by the Icelandic Competition Authority in April 2012. B.M. Vallá ehf. was classified as non-current assets and disposal groups classified as held for sale at the end of the year 2011. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income.

In June 2012 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. Approval from the Icelandic Competition Authority was obtained in August 2012. Penninn á Íslandi ehf. was classified as non-current assets and disposal groups held for sale at the end of the year 2011. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income.

In July 2012 Fram Foods ehf. sold its subsidiary Boyfood Oy in Finland and in October 2012 it sold its subsidiary Fram Foods AB in Sweden. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. Fram Foods ehf. was classified as non-current assets and disposal groups held for sale at the end of the year 2011. The sales has minor effects on the assets valuation of Fram Foods.

The subsidiaries AB-fjárfestingar ehf., ENK 1 ehf. and Vesturland ehf. were liquidated in the first quarter of 2012.

38. Acquisition of mortgage portfolio in 2011

At the end of the year 2011 Arion Bank and Kaupthing hf. reached agreement for Arion Bank to acquire a mortgage portfolio which is managed in a special fund. The agreement also specifies that the deal is funded by the assumption of covered bonds by Arion Bank.

Under the agreement Arion Bank replaced Kaupthing hf. as issuer of the covered bonds. The Bank is in the process of listing the covered bonds on NASDAQ OMX Iceland.

Through this acquisition total assets of the Group increased by ISK 94.4 billion and total liabilities increased by ISK 96.7 billion in 2011. The acquisition of the mortgage portfolio resulted in a impairment loss on loans and receivables amounting to ISK 2.3 billion, net of tax.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

39. 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. Corporate Banking offers diverse solutions relating to loans and other services required by companies. The division is also responsible for the financial restructuring of companies which need it.

Retail Banking, Arion Bank Mortgages Institutional Investor Fund and AFL Spairsjodur provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven 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 is the fund distributor for Stefnir, an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds. Asset Management offers investment options suited to every investor's needs, including pension savings, other regular savings, investments or asset management. Asset Management also offers funds from other leading global fund management companies.

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 Proprietary trading and 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.

40. Summary of the Group's business segments:

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	864	(2,679)	2,365	5,611	(32)	10,723	818	17,670
Operating income	11,164	8,758	4,179	5,605	4,825	9,505	776	44,812
Operating expense	(605)	(5,448)	(1,651)	(599)	(191)	(4,755)	(11,419)	(24,668)
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	20,330	18,037	498	5,338	(11,313)	11,211	711	44,812
Net seg. rev. from other segments	(9,166)	(9,279)	3,681	267	16,138	(1,706)	65	-
Operating income	11,164	8,758	4,179	5,605	4,825	9,505	776	44,812
Depreciation and amortisation	-	170	-	-	-	198	1,068	1,436
Total assets	251,384	318,700	4,597	26,000	212,315	87,679	-	900,675
Total liabilities	211,444	291,701	1,497	22,784	185,326	57,045	-	769,797
Allocated equity	39,940	26,999	3,100	3,216	26,989	30,634	-	130,878

2011	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other divisions and Subsidiaries	Headquarters and Elimination	Total
Net interest income	10,433	12,759	1,409	322	901	(2,530)	94	23,388
Other income	12,859	(14,310)	2,322	765	(2,872)	10,935	189	9,888
Operating income	23,292	(1,551)	3,731	1,087	(1,971)	8,405	283	33,276
Operating expense	(540)	(5,601)	(1,057)	(679)	(170)	(5,023)	(8,947)	(22,016)
Earnings before tax	22,752	(7,152)	2,674	408	(2,141)	3,382	(8,664)	11,260
Net seg. rev. from ext. customers	28,044	(5,958)	427	1,085	(2,818)	11,724	772	33,276
Net seg. rev. from other segments	(4,752)	4,407	3,304	2	847	(3,319)	(489)	-
Operating income	23,292	(1,551)	3,731	1,087	(1,971)	8,405	283	33,276
Depreciation and amortisation	-	222	-	1	-	213	520	956
Total assets	271,207	299,208	3,621	16,477	207,099	94,509	-	892,121
Total liabilities	227,910	266,628	948	15,208	189,037	77,832	-	777,563
Allocated equity	43,297	32,580	2,673	1,269	18,062	16,677	-	114,558

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

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QUARTERLY STATEMENTS

41. Operations by quarters

2012	Q4	Q3	Q2	Q1	Total
Net interest income	7,008	6,254	7,666	6,214	27,142
Increase in book value of loans and receivables	4,751	905	7,049	119	12,824
Impairment on loans and receivables	(9,920)	(2,958)	(4,441)	(195)	(17,514)
Net fee and commission income	2,695	2,715	3,002	2,336	10,748
Net financial income (expense)	92	161	(16)	346	583
Net foreign exchange gain (loss)	875	708	(1,232)	1,083	1,434
Other income	4,952	1,637	2,054	952	9,595
Operating income	10,453	9,422	14,082	10,855	44,812
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)
Earnings before tax	2,659	4,192	8,240	5,053	20,144
Income tax expense	(258)	(462)	(1,852)	(1,061)	(3,633)
Bank Levy	(291)	(261)	(242)	(268)	(1,062)
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

2011					
Net interest income	6,552	5,676	5,274	5,886	23,388
Increase in book value of loans and receivables	8,573	457	27,281	2,057	38,368
Impairment on loans and receivables	(20,981)	(642)	(6,241)	440	(27,424)
Changes in compensation instrument	-	-	(16,683)	(2,910)	(19,593)
Net fee and commission income	3,111	2,475	2,607	2,492	10,685
Net financial income (expense)	163	386	(767)	729	511
Net foreign exchange gain (loss)	(143)	2	2,289	(312)	1,836
Other income	2,028	1,127	1,251	1,099	5,505
Operating income	(697)	9,481	15,011	9,481	33,276
Salaries and related expense	(3,033)	(2,705)	(2,858)	(2,658)	(11,254)
Other expense	(3,208)	(2,301)	(2,790)	(2,463)	(10,762)
Earnings before tax	(6,938)	4,475	9,363	4,360	11,260
Income tax expense	1,167	(562)	(1,472)	(1,045)	(1,912)
Bank Levy	(362)	(238)	(379)	(67)	(1,046)
Net earnings from continuing operations	(6,133)	3,675	7,512	3,248	8,302
Net gain (loss) from discontinued operations, net of tax	3,579	(219)	(286)	(282)	2,792
Net earnings	(2,554)	3,456	7,226	2,966	11,094

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Net interest income

42. Interest income and interest expense is specified as follows:

	2012	2011
Cash and balances with Central Bank	650	486
Loans and receivables	49,112	37,410
Securities	8,790	7,690
Compensation instrument	-	322
Other	542	525
Interest income	59,094	46,433
Deposits	(17,769)	(18,338)
Borrowings	(12,572)	(2,597)
Subordinated liabilities	(1,520)	(1,830)
Other	(91)	(280)
Interest expense	(31,952)	(23,045)
Net interest income	27,142	23,388
Net interest income from assets and liabilities at fair value	8,790	7,690
Interest income from assets not at fair value	50,304	38,743
Interest expense from liabilities not at fair value	(31,952)	(23,045)
Net interest income	27,142	23,388

Increase in book value of loans and receivables

43. The increase in book value of loans and receivables is determined in accordance with the accounting policy presented in Note 8 a). Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment of loans and receivables

44. Impairment of loans and receivables is specified as follows:

	2012	2011
Impairment of loans and receivables to credit institutions	70	199
Impairment of loans and receivables to customers	17,444	27,225
Impairment of loans and receivables	17,514	27,424

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Changes in compensation instrument

45. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing hf. to Arion Bank in 2008. On 30 June 2011 a Settlement and release of claims agreement was signed by Arion Bank and Kaupthing hf. to finalize a settlement of the compensation instrument and various other claims lodged against Kaupthing hf. by Arion Bank. By signing the agreement the compensation instrument was terminated and neither party has any payment obligations towards the other under the instrument.

Changes in compensation instrument are specified as follows:	2011
Balance at the beginning of the year	24,188
Changes due to valuation changes in underlying assets in:	
Continuing operations	(19,593)
Discontinued operations	1,578
Accrued interest	322
Net foreign exchange gain (loss)	325
Assets and liabilities upon settlement	(6,820)
Balance at the end of the year	-

Net fee and commission income

46. Fee and commission income and expense is specified as follows:	2012	2011
Fee and commission income		
Asset management	2,715	2,716
Cards	8,951	10,031
Collection and payment services	1,036	1,164
Derivatives	169	179
Interbank clearing	706	682
Lending and guarantees	932	667
Security trading	162	250
Other fee and commission income	1,495	1,173
Fee and commission income	16,166	16,862
Fee and commission expense		
Asset management	(192)	(105)
Cards	(3,956)	(4,892)
Collection and payment services	(17)	(32)
Interbank clearing	(723)	(708)
Security trading	(40)	(44)
Other fee and commission expense	(490)	(396)
Fee and commission expense	(5,418)	(6,177)
Net fee and commission income	10,748	10,685

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Net financial income (expense)

47. Net financial income (expense) is specified as follows:

	2012	2011
Dividend income	25	7
Net gain (loss) on financial assets and financial liabilities classified as held for trading	(298)	(959)
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	856	1,463
Net financial income (expense)	583	511

48. Dividend income is specified as follows:

Dividend income on trading assets	15	4
Dividend income on financial assets designated at fair value through profit or loss	10	3
Dividend income	25	7

49. Net gain (loss) on financial assets and financial liabilities held for trading is specified as follows:

Net gain (loss) on equity instruments and related derivatives	456	250
Net gain (loss) on interest rate instruments and related derivatives	(502)	(668)
Net gain (loss) on other derivatives	(252)	(541)
Net gain (loss) on financial assets and financial liabilities held for trading	(298)	(959)

50. Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss is specified as follows:

Net gain (loss) on interest rate instruments designated at fair value	80	930
Net gain (loss) on equity instruments designated at fair value	776	533
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	856	1,463

Net foreign exchange gain (loss)

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

From loans and receivables	6,193	9,118
From Cash and cash equivalents	4,939	3,382
From deposits and borrowings	(6,585)	(8,751)
From subordinated liabilities	(2,134)	(955)
On bonds, equity and derivatives	(1,017)	(1,284)
From compensation instrument	-	325
On other assets and liabilities	38	1
Net foreign exchange gain (loss)	1,434	1,836

Other operating income

52. Other operating income is specified as follows:

Rental income from investment properties	2,184	2,146
Fair value changes on investment property	1,584	916
Realised gain on investment property	1,356	485
Earned premiums, net of reinsurance	918	864
Net gain (loss) on disposals of assets other than held for sale	396	293
Other income	752	793
Other operating income	7,190	5,497

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53. Earned premiums, net of reinsurance:

	2012	2011
Premium written	1,075	987
Outward reinsurance premiums	(99)	(93)
Change in the gross provision for unearned premiums	(58)	(30)
Earned premiums, net of reinsurance	918	864

Personnel and salaries

54. The Group's total number of employees is as follows:

	2012	2011
Average number of full time equivalent positions during the year	1,166	1,217
Full time equivalent positions at the end of the year	1,190	1,158

The Parent company's total number of employees is as follow:

	2012	2011
Average number of full time equivalent positions during the year	927	928
Full time equivalent positions at the end of the year	949	858

Former employees of Verdis hf. and Sparisjódur Ólafsfjardar are included in Parent company's numbers in 2012.

55. Salaries and related expense are specified as follows:

	2012	2011
Salaries	9,562	9,065
Defined contribution pension plans	1,288	1,241
Salary related expense	1,609	948
Salaries and related expense	12,459	11,254

Salaries and related expense for the Parent company are specified as follows:

	2012	2011
Salaries	7,127	6,546
Defined contribution pension plans	960	884
Salary related expense	1,592	975
Salaries and related expense	9,679	8,405

Salaries and related expense from Verdis hf. and Sparisjódur Ólafsfjardar are included in Parent company's numbers in 2012.

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56. Compensation of the key management personnel:

	Fixed remuner-ation[1]	Additional remuner-ation[2]	2012 Total	Fixed remuner-ation[1]	Additional remuner-ation[2]	2011 Total
Monica Caneman, Chairman of the Board	16.8	1.8	18.6	14.7	1.4	16.1
Gudrún Johnsen, Vice-Chairman of the Board	6.3	3.6	9.9	6.3	2.7	9.0
Agnar Kofoed-Hansen, Director	4.2	3.2	7.4	3.3	1.4	4.7
Freyr Thórdarson, Director	3.5	1.5	5.0	-	-	-
Jón G. Briem, Director	4.2	4.1	8.3	3.9	4.0	7.9
Måns Höglund, Director	8.4	3.6	12.0	6.3	2.7	9.0
Gudrún Björnsdóttir, Alternate Director	-	-	-	1.6	-	1.6
Kristján Jóhannsson, Director	-	-	-	1.0	-	1.0
Theodór S. Sigurbergsson, Director	-	-	-	3.2	1.8	5.0
Other alternate directors of the Board	4.6	0.5	5.1	1.3	-	1.3
Total remuneration	48.0	18.3	66.3	41.6	14.0	55.6

	2012	2011
Höskuldur H. Ólafsson, CEO	44.5	37.1
Nine managing directors of the Bank's divisions being members of the Bank's Executive Committee	227.6	210.2

Board Members receive remuneration for their involvement in board committees. In addition to 14 Board meetings (2011: 17), during the year 20 Board Credit Committee meetings (2011: 15), 10 Board Audit and Risk Committee meetings (2011: 8) and 6 Board Remuneration committee meetings (2011: 8) were held.

The 2012 Annual General Meeting of the Bank held on 22 March 2012 approved the monthly salaries for 2012 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 700,000, ISK 525,000 and ISK 350,000 (2011: ISK 700,000; 525,000; 350,000) respectively. It was also approved that the salary of Alternative Board Members would be ISK 175,000 (2011: ISK 175,000) per meeting, up to a maximum of ISK 350,000 (2011: 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 (2011: 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.

Arion Bank Consolidated Financial Statements 2012 35 Amounts are in ISK millions

Auditor's fee

57. Auditor's fee is specified as follows:

2012	Ernst & Young	KPMG	Total
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

2011	Ernst & Young	KPMG	Total
Audit and review of the Financial Statements	151	28	179
Other audit related services	28	11	39
Other service	-	20	20
Auditor's fee	179	59	238

Other operating expense

58. Other operating expense:

	2012	2011
Direct operating expense derived from rental-earning investment properties	499	497
Claims incurred, net of reinsurance	233	298
Other expense	-	1
Other operating expense	732	796

59. Claims incurred, net of reinsurance:

	2012	2011
Claims paid	324	346
Change in the provision for claims	(38)	21
Claims paid, net of reinsurers' share	(63)	(60)
Change in the provision for claims, reinsurers' share	10	(9)
Claims incurred, net of reinsurance	233	298

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Tax expense

60. Income tax recognised in the Statement of Comprehensive Income is specified as follows:

	2012	2011
Current tax expense		
Current year	3,160	1,683
Deferred tax expense		
Changes in temporary differences	473	229
Total income tax expense	3,633	1,912

The Icelandic corporation tax rate is 20%. Effective tax rate of the Group is 18.0% and reconciles as follows:

	2012		2011	
Earnings before tax		20,144		11,260
Income tax using the Icelandic corporation tax rate	20.0%	4,030	20.0%	2,252
Additional 6% tax on financial institutions	3.1%	621	0.0%	-
Effect of tax rates in foreign jurisdictions	0.0%	-	(0.9%)	(103)
Non-deductible expense	0.1%	25	(0.1%)	(13)
Tax exempt revenues	(6.5%)	(1,318)	0.0%	-
Tax incentives not recognised in the Statement of Comprehensive Income	(2.9%)	(578)	(0.7%)	(73)
Non-deductible taxes	0.0%	-	(1.9%)	(214)
Other changes	4.2%	853	0.6%	63
Effective tax rate	18.0%	3,633	17.0%	1,912

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1,0 billion. It is presumed that the tax rates remain unchanged for the next year.

61. Bank Levy

Bank levy is calculated according to law. The levy is 0.041% on total debt excluding tax liabilities at end of year. Non-financial subsidiaries are exempt from this tax. Additional temporary levy of 0.0875% is assessed for the years 2012 and 2013 to meet the funding of a special interest relief provided to individual tax payers.

Net gain (loss) from discontinued operations, net of tax

62. Net gain (loss) from discontinued operations, net of tax is specified as follows:

	2012	2011
Net gain (loss) from legal entities	836	3,867
Net gain (loss) from associated companies	1,376	-
Net loss on revaluation and disposal of real estate	(577)	(207)
Other assets	(28)	(103)
Impairment loss on remeasurement to fair value of legal entities	-	(2,027)
Effect of compensation instrument	-	1,262
Net gain (loss) from discontinued operations, net of tax	1,607	2,792

In 2012 the Group sold 15.7% effective share in Hagar hf. The gain resulting from the transaction was ISK 875 million and is recognised in the Statement of Comprehensive Income.

In 2012 the Group sold its associate N1 hf. The gain resulting from the sale was ISK 1,376 million and is recognised in the Statement of Comprehensive Income.

Net gain from legal entities in 2011 predominantly comprises a gain of ISK 3,635 million arising on the sale 75.4% of the Group's held for sale subsidiary Hagar hf. Included in this amount is a gain of ISK 1,256 million arising on the recognition at fair value of the investment retained in Hagar hf. at the date it became an associate of the Group in December 2011.

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Earnings per share

63. Earnings per share are specified as follows:

	Discontinued operations			
	Excluded		Included	
	2012	2011	2012	2011
Net earnings attributable to the shareholders of Arion Bank	15,015	7,701	16,622	10,493
Weighted average share capital:				
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	7.51	3.85	8.31	5.25
Diluted earnings per share	7.51	3.85	8.31	5.25
Number of outstanding shares at the end of the year, million	2,000	2,000	2,000	2,000
Number of total shares at the end of the year, million, diluted	2,000	2,000	2,000	2,000

There were no instruments at the end of the year that could potentially dilute basic earnings per share.

Arion Bank Consolidated Financial Statements 2012 38 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Cash and balances with Central Bank

64. Cash and balances with Central Bank are specified as follows:

	2012	2011
Cash on hand	3,495	2,954
Cash with Central Bank	17,514	17,686
Mandatory reserve deposit with Central Bank	8,737	8,560
Cash and balances with Central Bank	29,746	29,200

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

Loans and receivables to credit institutions

65. Loans and receivables to credit institutions specified by types of loans:

	2012	2011
Bank accounts	84,164	62,175
Money market loans	13,763	4,720
Overdrafts	-	19
Other loans	3,888	2,963
Provision on loans and receivables	(804)	(774)
Loans and receivables to credit institutions	101,011	69,103

66. Changes in the provision for losses on loans and receivables to credit institutions are specified as follows:

	2012	2011
Balance at the beginning of the year	774	1,359
Provision for losses during the year	70	199
Write-offs during the year	(40)	(784)
Provision for losses on loans and receivables to credit institutions	804	774

Loans and receivables to customers

67. Loans and receivables to customers specified by types of loans:

2012	Individuals	Corporates	Total
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 and receivables	43,560	340,208	383,768
Provision on loans and receivables	(19,222)	(40,559)	(59,781)
Loans and receivables to customers	242,773	323,837	566,610

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67. cont.

2011	Individuals	Corporates	Total
Overdrafts	16,353	11,375	27,728
Credit cards	14,679	771	15,450
Mortgage loans	192,869	3,603	196,472
Subordinated loans	-	550	550
Other loans and receivables	28,208	349,431	377,639
Provision on loans and receivables	(12,821)	(43,468)	(56,289)
Loans and receivables to customers	239,288	322,262	561,550

The total book value of pledged loans at the end of the year was ISK 167 billion (2011: ISK 171 billion). Pledged loans at the end of the year comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

Further analysis of loans and receivables is provided in Risk Management Disclosures.

68. Changes in the provision for losses on loans and receivables to customers are specified as follows:

2012

	Specific	FX rulings	Collective	Total
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

2011

Balance at the beginning of the year	39,083	-	2,760	41,843
Provision for losses during the year	6,649	13,823	6,753	27,225
Write-offs during the year	(13,230)	-	-	(13,230)
Payment of loans previously written off	451	-	-	451
Balance at the end of the year	32,953	13,823	9,513	56,289

Arion Bank Consolidated Financial Statements 2012 40 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Financial assets and financial liabilities

69. Financial assets and financial liabilities are specified as follows:

2012	Amortised cost	Trading	Designated at fair value	Total
Loans and receivables				
Cash and balances with Central Bank	29,746	-	-	29,746
Loans and receivables to credit institutions	101,011	-	-	101,011
Loans and receivables to customers	566,610	-	-	566,610
Loans and receivables	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	-	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	-	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

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69. cont.

2011	Amortised cost	Trading	Designated at fair value	Total
Loans and receivables				
Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers	561,550	-	-	561,550
Loans and receivables	659,853	-	-	659,853
Bonds and debt instruments				
Listed	-	2,919	52,688	55,607
Unlisted	-	44	84,917	84,961
Bonds and debt instruments	-	2,963	137,605	140,568
Shares and equity instruments with variable income				
Listed	-	153	1,163	1,316
Unlisted	-	657	8,382	9,039
Bond funds with variable income	-	1,774	1,916	3,690
Shares and equity instruments	-	2,584	11,461	14,045
Derivatives				
OTC derivatives	-	674	-	674
Derivatives	-	674	-	674
Securities used for hedging				
Bonds and debt instruments	-	1,922	-	1,922
Shares and equity instruments	-	450	-	450
Securities used for hedging	-	2,372	-	2,372
Other financial assets	8,004	-	-	8,004
Financial assets	667,857	8,593	149,066	825,516
Liabilities at amortised cost				
Due to credit institutions and Central Bank	16,160	-	-	16,160
Deposits	489,995	-	-	489,995
Borrowings	187,203	-	-	187,203
Subordinated liabilities	32,105	-	-	32,105
Liabilities at amortised cost	725,463	-	-	725,463
Financial liabilities at fair value				
Short position in bonds	-	3,711	-	3,711
Derivatives	-	1,196	-	1,196
Financial liabilities at fair value	-	4,907	-	4,907
Other financial liabilities	33,764	-	-	33,764
Financial liabilities	759,227	4,907	-	764,134

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.

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70. Bonds and debt instruments designated at fair value specified by issuer:

	2012	2011
Financial and insurance services	70,142	70,674
Governments	40,679	59,368
Corporates	1,262	7,563
Bonds and debt instruments designated at fair value	112,083	137,605

The total amount of pledged bonds at the end of the year was ISK 35.7 billion (2011: ISK nil). Pledged bonds at the end of the year 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.

71. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments 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.

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

2012	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	3,702	119,277	1,914	124,893
Financial assets held for trading	4,226	8,660	21	12,907
	7,928	127,937	1,935	137,800
Financial liabilities held for trading	12,490	975	-	13,465
2011				
Financial assets designated at FV through PL	6,222	140,844	2,000	149,066
Financial assets held for trading	5,391	3,181	21	8,593
	11,613	144,025	2,021	157,659
Financial liabilities held for trading	3,710	1,197	-	4,907

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2012 is consistent with the classification used in 2011.

The following table shows transfers from Level 1 to Level 2 on the fair value hierarchy for financial assets and financial liabilities which are recorded at fair value:

	2012	2011
Financial assets designated at FV through PL	-	886

The financial assets were transferred from Level 1 to Level 2 in 2011 as they have ceased to be actively traded during the year and fair values were consequently obtained using valuation techniques using observable market inputs.

There have been no transfers from Level 2 to Level 1 in 2012 and 2011.

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71. cont.

The fair value of a financial instrument is the amount at which the instrument 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 financial assets and financial liabilities. If quoted prices for a financial instrument 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 financial instrument 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 financial instrument in Note 69 is used as an approximation for the fair value of the instrument. 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, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed under Bonds, Shares, Derivatives 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 financial instruments, 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 financial instruments for which quoted prices on active markets are not available, the fair values are 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 was 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 financial instruments 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.

71. cont.

Movements in Level 3 financial instruments measured at fair value

The level of the fair value hierarchy of financial instruments is determined at the beginning of each reporting year. The following table shows the movements of Level 3 financial assets and financial liabilities:

	2012	2011
Balance at the beginning of the year	2,021	1,688
Gain (loss) recognised in Statement of Comprehensive Income	191	771
Acquisition	105	160
Disposal	(391)	(598)
Transfers into Level 3	9	-
Balance at the end of the year	1,935	2,021

The following table shows the line items in the Statement of Comprehensive Income where gain (loss) related to fair value measurements in Level 3 is recognised:

	2012	2011
Net interest income	151	176
Net financial income (expense)	3	520
Net foreign exchange gain (loss)	37	75
Gain (loss) recognised in the Statement of Comprehensive Income	191	771

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

2012 Financial assets not carried at fair value	Carrying value	Fair value	Un-realised gain (loss)
Cash and balances with Central Bank	29,746	29,746	-
Loans and receivables to credit institutions	101,011	101,011	-
Loans and receivables 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 liabilities	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 Statement of Comprehensive Income			(11,984)

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71. cont.

2011 Financial assets not carried at fair value	Carrying value	Fair value	Un-realised gain (loss)
Cash and balances with Central Bank	29,200	29,200	-
Loans and receivables to credit institutions	69,103	69,103	-
Loans and receivables to customers	561,550	562,940	1,390
Other financial assets	8,004	8,004	-
Financial assets not carried at fair value	667,857	669,247	1,390
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	16,160	16,160	-
Deposits	489,995	489,995	-
Borrowings	187,203	187,067	136
Subordinated loans	32,105	32,105	-
Other financial liabilities	33,764	33,764	-
Financial liabilities not carried at fair value	759,227	759,091	136
Net unrealised gain (loss) not recognised in the Statement of Comprehensive Income			1,526

As financial assets and financial liabilities predominantly bear interest at floating rates, the difference between book value and fair value of financial assets and financial liabilities is deemed to be immaterial.

Investment property

72. Investment property is specified as follows:	2012	2011
Balance at the beginning of the year	27,100	27,642
Additions during the year	3,729	3,527
Disposals during the year	(3,494)	(5,760)
Transferred from property and equipment	-	775
Fair value adjustments	1,584	916
Investment property	28,919	27,100

The official real estate value (Registers Iceland) amounts to ISK 19,062 million at the end of the year (2011: ISK 18,380 million). The insurance value of real estate amounts to ISK 23,130 million at the end of the year (2011: ISK 20,130 million). Methods used for those valuation are different from what the Group uses and finds more appropriate.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Investments in associates

73. The Group´s interest in its principal associates are as follows:

	2012	2011
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	30.1%	-
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43.5%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland	30.0%	30.0%
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	-	20.6%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	36.3%	44.9%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	-	25.0%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	23.3%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmidjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	23.6%
SMI ehf., Smáratorg 3, 210 Kópavogur, Iceland	39.1%	39.1%
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	-	20.0%

Investments in associates are specified as follows:

Carrying amount at the beginning of the year	2,987	2,713
Additions during the year	1,658	2,854
Transferred to held for sale assets	-	(2,525)
Transferred from associates due to step acquisition	-	(9)
Share of profit (loss) of associates and reversal of impairment	2,405	8
Other changes	-	(54)
Investment in associates	7,050	2,987

In May 2012 the Bank acquired 31.3% share in Bakkavör Group ehf. as a result of the conversion of the Bank´s convertible loans to equity. In the last quarter of 2012 the shares in Bakkavör Group ehf. were exchanged for shares in Bakkavör Group Ltd with the effect that the Group´s interest is 30.1% at the end of the year.

In March the Bank sold its 20.6% shareholding in Hótel Borgarnes hf. The effects from the sale has minor impact on the Statement of Comprehensive Income.

In June the Bank sold its 20,0% shareholding in Ölgerdin Egill Skallagrímsson ehf. The effects from the sale is recognised in the Statement of Comprehensive Income.

Kríuvarp ehf. was liquidated in 2012.

The Group's equity interest in Klakki ehf. has been diluted from 44.9% to 36.3% following the conversion of further creditor claims on Klakki ehf. to equity shareholdings.

Summarised financial information in respect of the Group´s associates is set out below:

	2012	2011
Total assets	560,268	209,229
Total liabilities	(446,287)	(170,788)
Net assets	113,981	38,441
Total revenue of associates	396,201	15,114
Net earnings of associates	(11,200)	4,491

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Property and equipment

74. Property and equipment are specified as follows:

	Real estate	Equip-ment	Total 2012	Total 2011
Gross carrying amount at the beginning of the year	4,826	3,371	8,197	8,572
Acquisitions through business combination	-	-	-	2
Additions during the year	280	681	961	667
Disposals during the year	(2)	(39)	(41)	(189)
Disposals through the sale of a subsidiary	-	-	-	(16)
Transfers to investment property	-	-	-	(839)
Gross carrying amount at the end of the year	5,104	4,013	9,117	8,197
Accumulated depreciation at the beginning of the year	424	1,502	1,926	1,207
Depreciation during the year	230	669	899	832
Disposals during the year	-	(19)	(19)	(49)
Transfers to investment property	-	-	-	(64)
Accumulated depreciation at the end of the year	654	2,152	2,806	1,926
Property and equipment	4,450	1,861	6,311	6,271

The official real estate value (Registers Iceland) amounts to ISK 4,954 million at the end of the year (2011: ISK 4,561 million). The insurance value of real estate amounts to ISK 9,633 million at the end of the year (2011: ISK 8,518 million).

75. Depreciation and amortisation in the Statement of Comprehensive Income is specified as follows:

	2012	2011
Depreciation of property and equipment	899	832
Amortisation of intangible assets	537	124
Depreciation and amortisation	1,436	956

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Intangible assets

76. 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 and this is described in more detail 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, but no agreements were closed in 2012 but impairment of ISK 6 million was expensed in 2011.

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.

Intangible assets are specified as follows:

2012	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	3,886	144	735	4,765
Additions during the year	28	-	685	713
Amortisation	-	-	(537)	(537)
Intangible assets	3,914	144	883	4,941

2011	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	3,824	149	379	4,352
Additions during the year	62	-	481	543
Impairment	-	(6)	-	(6)
Amortisation	-	-	(124)	(124)
Intangible assets	3,886	143	736	4,765

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 no impairment was recognized for Asset Management and Credit card operation in 2012 (2011: nil).

The table below shows the discount and growth rates used for the calculation:

	2012		2011	
	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	12.4%	2.5%	10.8%	2.5%
Credit card operation	13.9%	4.3%	15.5%	4.5%

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Tax assets and tax liabilities

77. Tax assets and tax liabilities are specified as follows:

	2012		2011	
	Assets	Liabilities	Assets	Liabilities
Current tax	17	1,899	6	2,284
Deferred tax	446	1,338	718	1,137
Tax assets and tax liabilities	463	3,237	724	3,421

78. Deferred tax assets and tax liabilities are specified as follows:

2012

	Assets	Liabilities	Net
Balance at the beginning of the year	718	(1,137)	(419)
Income tax recognised in profit or loss	(272)	(201)	(473)
Deferred tax assets and tax liabilities	446	(1,338)	(892)

2011

	Assets	Liabilities	Net
Balance at the beginning of the year	295	(633)	(338)
Acquisition through business combination	149	(1)	148
Income tax recognised in profit or loss	274	(503)	(229)
Deferred tax assets and tax liabilities	718	(1,137)	(419)

Companies in the Group own tax loss carry forward with asset value of the amount of ISK 1,371 million that is not recognised in the Financial Statements, due to uncertainty about the utilisation possibilities of the loss.

79. Changes in deferred tax assets and tax liabilities are specified as follows:

2012	At 1 Jan.	Addition (disposal)	Recognised in profit or loss	At 31 Dec.
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)

2011

	At 1 Jan.	Addition (disposal)	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(249)	-	27	(222)
Investment property and property and equipment	(139)	149	(539)	(529)
Financial assets	-	-	611	611
Other assets and liabilities	(37)	-	(5)	(42)
Deferred foreign exchange differences	(538)	(1)	(358)	(897)
Tax loss carry forward	625	-	35	660
Change in deferred tax assets and tax liabilities	(338)	148	(229)	(419)

Arion Bank Consolidated Financial Statements 2012 50 Amounts are in ISK millions

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

	2012		2011	
	Assets	Liabilities	Assets	Liabilities
Deferred tax related to foreign exchange gain	-	(694)	-	(897)
Foreign currency denominated assets and liabilities	-	(215)	-	(221)
Investment property and property and equipment	11	(1,343)	5	(534)
Financial assets	550	(47)	611	-
Other assets and liabilities	168	(81)	174	(217)
Tax loss carry forward	759	-	388	272
	1,488	(2,380)	1,178	(1,597)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(1,042)	1,042	(460)	460
Deferred tax assets and tax liabilities	446	(1,338)	718	(1,137)

Non-current assets and disposal groups held for sale

81. Non-current assets and disposal groups held for sale are specified as follows:

	2012	2011
Legal entities	1,733	8,458
Associates	6,384	12,073
Real estates	3,275	2,875
Other assets	531	480
Non-current assets and disposal groups held for sale	11,923	23,886

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. At the end of the year the largest entity is Fram Foods ehf. held by the Group's holding company Eignabjarg ehf.

On 15 June 2012 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. A condition precedent for the sale was approval by the Icelandic Competition Authority, which was obtained in August 2012. The effects from the sale of this entity has minor effects on the Statement of Comprehensive Income.

On 28 September 2011 an agreement to sell the Groups 38.9% shareholding in its associate N1 hf. was signed. A condition precedent for the sale was approval by the Icelandic Competition Authority. Approval was obtained in June 2012. The gain resulting from this transaction was ISK 1,376 million and is recognised in the Statement of Comprehensive Income.

On 3 July 2012 Fram Foods ehf. sold its subsidiary Boyfood Oy in Finland and on 30 October it sold its subsidiary Fram Foods AB in Sweden. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. The sale of these entities has minor effects on the Statement of Comprehensive Income.

On 4 October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf. A condition precedent for the sale was approval by the Icelandic Competition Authority, which was obtained in April 2012. The sale of this entity has minor effects on the Statement of Comprehensive Income.

The associate classified as disposal groups held for sale in accordance with IFRS 5 is HB Grandi hf.

At end of 2011 the Group held 20.9% effective share in Hagar hf. During the year the Group sold 15.7% effective share in Hagar hf. The gain resulting from this transaction was ISK 875 million and is recognised in the Statement of Comprehensive Income.

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

Liabilities associated with the legal entities held for sale are as follows:	2012	2011
Legal entities, total liabilities	1,769	4,950

Arion Bank Consolidated Financial Statements 2012 51 Amounts are in ISK millions

Other assets

82. Other assets are specified as follows:

	2012	2011
Accounts receivable	4,084	6,511
Prepaid expenses	687	678
Accrued income	456	455
Unsettled securities trading	125	708
Sundry assets	549	524
Other assets	5,901	8,876

Unsettled securities trading was settled in less than three days from the reporting date.

Other liabilities

83. Other liabilities are specified as follows:

Accounts payable	19,318	18,944
Provision for paid-up FX loans	4,625	-
Depositors' and investors' guarantee fund	2,919	3,018
Insurance claim	2,138	2,023
Withholding tax	1,926	2,186
Unsettled securities trading	842	132
Kaupthing hf. due to investment in ABMIIF	-	3,048
Sundry liabilities	8,580	9,471
Other liabilities	40,348	38,822

Unsettled securities trading was settled in less than three days from the reporting date.

Borrowings

84. Borrowings are specified as follows:

Covered bonds	124,992	117,915
Bonds issued	8,909	8,881
Other loans	61,184	60,407
Borrowings	195,085	187,203

The Group did not repurchase any own debts in 2012 (2011: ISK 442 million).

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006 to 2008. The bonds in question are covered bonds amounting to ISK 119.8 billion, net outstanding, with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund. It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Currently repayment of principal is approximately ISK 1.5 billion a year and total payment including repayment of principal, indexation and interest is ISK 7.4 billion a year.

In February 2012 Arion Bank issued covered bonds from its EUR 1.0 billion covered bond programme. The bond issue is nominated in Icelandic Krona, the amount issued was ISK 2.5 billion in the Series ARION CBI 34 and was admitted for trading on NASDAQ OMX Iceland 22 February 2012. The covered bond issue matures in February 2034 and is inflation indexed with fixed 3.60% interest.

In May 2012 Arion Bank completed its first non-indexed fixed rate covered bond offering, issuing ISK 1,220 million worth of bonds in the Series ARION CB 15. In June 2012 Arion Bank completed its second offering, issuing ISK 1,200 billion worth of bonds in the same series. The series was part of the EUR 1.0 billion covered bond programme and was admitted for trading on NASDAQ OMX Iceland on 21 May 2012. The bonds bear 6.50% interest and mature in 2015.

Book value of listed bonds was ISK 8,034 million at end the end of the year. Market value of those bonds was ISK 8,512 million.

Interest of other loans is 3 month Euribor/Libor +300 bps until the loans expires in 2016. The loan can be extended up to 2022 with same terms.

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Subordinated liabilities

85. Subordinated liabilities are specified as follows:

	2012	2011
Tier II capital	34,220	32,105
Subordinated liabilities	34,220	32,105

The interest on the loan is 3 month Euribor/Libor +400 bps to the year 2015 and thereafter 3 month Euribor/Libor +500 bps.

Derivatives

86. Derivatives at fair value are specified as follows:

	Fair value	
2012	Assets	Liabilities
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
2011		
Forward exchange rate agreements, unlisted	193	671
Interest rate and exchange rate agreements, unlisted	463	415
Bond swap agreements, unlisted	18	110
Derivatives	674	1,196

Equity

87. Share capital and share premium

According to the Parent Company'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)	2012	Number (million)	2011
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.

88. Other reserves are specified as follows:

	2012	2011
Statutory reserve	1,637	1,637
Foreign currency translation reserve	2	-
Other reserves	1,639	1,637

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

OFF BALANCE SHEET INFORMATION

Obligations

89. The Group has granted its customers guarantees, unused overdraft and loan commitments. These items are specified as follows:

	2012	2011
Guarantees	9,185	8,662
Unused overdrafts	34,545	34,258
Loan commitments	36,001	17,687

90. Depositors' and Investors' Guarantee fund

The Group expensed ISK 892 million in 2012 to meet payments requirements to the Depositors' and Investors' Guarantee fund according to act no 98/1999 as amended in 2012.

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.

Pledged assets

91. The Group has pledged assets against liabilities as follows:

	2012	2011
Assets which have been pledged as a collateral against borrowings	244,653	210,412
Assets which have been pledged as a collatteral against loans from banks and short positions	35,701	-
Pledged assets against liabilities	280,354	210,412

The Group has pledged assets, such as loans , bank accounts and other assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 244 billion at the end of the year (2011: ISK 210 billion). Those assets were mainly pool of mortgage loans to individuals, loans to municipalities and loans to state related entities. The book value of those borrowings was ISK 185 billion at the end of the year (2011: ISK 176 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.

Operating lease commitments

92. 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 23 years. The majority of the contracts include renewal options for various periods of time. The future minimum lease payments under non-cancellable leases are as follows:

	2012	2011
Less than one year	339	243
Over 1 year and up to 5 years	1,173	787
Over 5 years	1,115	714
Minimum lease payments under non-cancellable leases	2,627	1,744

Arion Bank Consolidated Financial Statements 2012 54 Amounts are in ISK millions

93. 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 18 years, with majority being non-cancellable agreements. The future minimum lease payments under non-cancellable leases are as follows:

	2012	2011
Less than one year	2,084	2,100
Over 1 year and up to 5 years	5,898	5,713
Over 5 years	1,968	2,605
Minimum lease payments under non-cancellable leases	9,950	10,418

Assets under management and under custody

94. Assets under management and assets under custody are specified as follows:

	2012	2011
Assets under management	819,684	659,024
Assets under custody	1,378,454	1,716,230

Legal Matters

95. Due to the current economic climate in Iceland litigation against the Group has been uncommonly frequent. 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 by the Icelandic Competition Authority

The Icelandic Competition Authority (ICA) has opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Group, following a complaint by Kortathjónustan hf., a credit card payment acquirer, made in 2009. The ICA has also opened a formal investigation into the alleged abuse of their alleged collective dominant position by the three largest retail banks, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The ICA received a similar complaint from Tryggingamidstödin hf. 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 complaint from Tryggingamidstödin hf. concerns the banks' alleged tying of banking services and insurances. The Group has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Group. However, if the Group will be deemed to have violated the competition law, it could result in a fine or restrictions set on the Bank by the ICA.

Legal proceedings regarding FX loans

The Bank has received a letter from a company stating that the company suffered significant damage, both directly and indirectly, on account of the Bank's actions to satisfy a debt, which resulted in the forced sale of the company's pledged assets. This action was taken as a result of the defaulting of currency-linked loans. In the letter it is requested that the Bank state its position to its liability for damages in the aforementioned circumstances. The Bank is now examining this matter but preliminary estimate is that if the Bank is considered liable for the damage, it will not be material for the Bank.

Claims related to Asset Management clients

A legal entity has brought legal action against the Bank and the Bank's subsidiary Stefnir hf. and is claiming damages for alleged illegal handling by Kaupthing Bank hf. of financial assets which Kaupthing Bank hf. was instructed to manage for the legal entity. The Bank and Stefnir hf. are defending this case and reject the claims of the legal entity. Any damages will not be material for the Bank.

Arion Bank Consolidated Financial Statements 2012 55 Amounts are in ISK millions

95. cont.

ii) Other legal disputes

Legal proceedings regarding Drómi hf.

One significant court case is a case between Drómi hf. and the Bank. Following a decision issued by the Icelandic Financial Supervisory Authority (FME) on 21 March 2009, the Bank acquired the deposits of SPRON hf. According to the decision the resolution committee of SPRON hf. is supposed to establish a specific limited liability company owned by SPRON hf., later Drómi hf., designed to receive all the assets of SPRON hf. and all security interests, including all liens, guarantees and other comparable interests linked to SPRON hf.'s claims. The subsidiary was then supposed to take over all SPRON hf.'s obligations to the Bank relating to the acquisition of SPRON hf.'s deposit obligations and was supposed to issue a bond to the Bank as compensation for the deposit obligations. This obligation to the Bank was documented with an agreement on repaying the debt. The agreement states that the interest rate on the debt principal shall be determined by the FME at any given time. The FME decided that the debt should bear a given annual interest rate plus an interest premium until the debt has been paid in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months. In a letter dated 2 December 2009 Drómi hf. insisted that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear an annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Bank has brought legal action against the FME and Drómi hf. in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011 Drómi hf. brought legal action against the FME and the Bank. Drómi hf. principally demands the annulment of all decisions by the FME on interest rates, and secondly demands a different interest rate from the outset. In two judgments pronounced on 7 November 2012, the District Court acquitted Drómi hf. and the FME of the Bank's claims in its case, and also acquitted the Bank and the FME of Drómi hf's. claims in its case. The Bank has appealed the former judgment to the Supreme Court of Iceland.

Legal proceedings regarding Stefnir hf.

The winding-up committee of Landsbanki Íslands hf. has brought legal action against Stefnir hf. in Reykjavík District Court. The legal action is based on the winding-up committee's demand to rescind Landsbankinn's payment of money market deposits which matured early in October 2008 to two funds managed by Stefnir hf. The amount involved is ISK 450 million plus interest. Stefnir hf. has previously stated its opinion that the winding-up committee's claims are baseless. Given the fact that court rulings in similar cases have not been unanimous it is now considered appropriate to provision for these cases. Court hearings are expected to take place in the first quarter of 2013.

Investigation by the EFTA Surveillance Authority

Two formal investigations involving the Bank and one subsidiary were launched by the EFTA Surveillance Authority (ESA) in 2010, which have now both been concluded with no financial effect for the Group. The first investigation related to whether or not the purchases by each of the new banks, i.e. Arion Bank hf., Íslandsbanki hf. and Landsbankinn hf., of assets of money market funds in the autumn of 2008 should be considered state aid under the Agreement on the European Economic Area (EEA Agreement). The second investigation related to the state aid granted in the restoration of certain operation of Kaupthing hf. and the establishment and capitalisation of the Bank. Similar investigations were launched in relation to the restoration and capitalisation of Íslandsbanki hf. and Landsbankinn hf.

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 hf.'s announcement on the Icelandic Stock Exchange from 21 March 2012, whereby Hagar hf. announced that it had decided to take legal action against the Bank regarding Hagar hf.'s foreign currency linked loans, which it had reimbursed in full to the Bank in October 2009. Hagar hf.'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 hf. ISK 515 million, which the Bank subsequently paid to Hagar hf. After the Supreme Court of Iceland had passed its judgment of 15 February 2012 (in case no. 600/2011), Hagar hf. expressed its view to the Bank that, in light of the above judgment, Hagar hf. believed it had a further claim against the Bank regarding said foreign currency linked loans. The Bank has rejected Hagar hf.'s claim and will defend the case in court.

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. 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 remote, and has therefore made no provision due to this.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The uncertainty regarding the book value of foreign currency lending

96. In two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic Krona indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents. In a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic Krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic Krona interest rate posted by the Central Bank of Iceland.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic Krona indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic Krona posted by the Central Bank of Iceland. Furthermore, the law required that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed. In accordance with the act, the Group recalculated all mortgage loans for personal residents in foreign currency to individuals.

In two similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans to small SMEs were in fact loans in Icelandic Krona and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. The Supreme Court passed another two similar judgments on 8 March 2011 dealing with foreign currency loans. In a ruling on 9 June 2011, the Supreme Court, by a 4-3 vote, stated that a foreign currency loan to a corporate entity was in fact a loan in Icelandic Krona and indexed to a foreign currency exchange rate.

The Group announced on 15 June 2011 that recent rulings made by the Supreme Court provide a precedent for the Group to follow, and that the loans that fall under the conditions set forth by the Supreme Court in its rulings would be recalculated. The Group recalculated around 2,000 loans, to both individuals and corporates. The recalculation came in addition to the recalculation of foreign currency linked mortgage loans which was done in 2010. Therefore, the lion's share of the Group's foreign currency linked loans to individuals has been recalculated into ISK denominated loans.

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingarbankinn hf. (Frjálsi). In the judgment, it was stated that loans, which are deemed to be illegal foreign currency-linked loans, can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland, however Frjálsi could not claim from the borrower a higher payment of interest of the loan than the interest the borrower actually paid, if the borrower has paid according to Frjálsi´s payment slips. As the judgment dealt with a dispute which rose from special circumstances the Group considered, at the time, that its precedent was not entirely clear. However, the Group estimated that the loss to the Group's foreign loan portfolio arising from the judgment was ISK 13.8 billion. In calculating this estimate, the Group elected to follow the methodology prescribed in an impact analysis conducted by the FME. From the four scenarios prescribed in the FME's analysis, the Group has selected the one considered to be the most plausible interpretation of the judgment.

On 18 October 2012, the Supreme Court pronounced a judgment in the case Borgarbyggd v Arion Bank. The case tested some of the questions raised by the court's judgment of 15 February 2012, including whether the principle of that case applied to legal entities. In this case the Supreme Court applied the same principle as in the judgment from February, i.e. that a financial institution could not demand from the borrower higher interest than the borrower actually paid according to payment slips. This applied irrespective of whether it involved a legal entity or not. It can therefore be said that the legal uncertainty relating to the judgment from February has been significantly reduced.

The Group issued a press release on 2 November 2012 announcing that the Group had decided to recalculate foreign currency-linked loans, which were similar to the loan disputed in the judgment of 18 October 2012. The loans in question were loans to individuals and smaller companies where there was a payment slip for payment of interest and capital in accordance with each loan's original terms.

96. cont.

The first Supreme Court of Iceland judgment which discussed the legality of a loan owned by Arion Bank hf. was pronounced on 15 June 2012, in the case the Bank v Háttur ehf. The case concerned the legality of the company’s loan agreement where the loan amount is specified as “the equivalent to” a certain amount in Icelandic Krona; the loan amount was disbursed to the borrower in foreign currency and the majority of the loan was repaid in foreign currency. The majority of the Supreme Court concluded that it was a legitimate FX loan, particularly with reference to the name of the loan agreement, the specification of the loan amount and interest and the way in which the loan was paid out and how repayments and interest were repaid, as it was considered that both parties had discharged their duties with amounts in foreign currencies having changed hands. The Supreme Court came to the same conclusion in a judgment pronounced on 1 November 2012, in the case of Arion Bank v P. Arnason fasteignir ehf. In that case, the loan amount is specified as “the equivalent to” a certain amount in Icelandic Krona; the loan amount was disbursed to the borrower in foreign currency, but the loan had been repaid in Icelandic Krona. In its reasoning the Supreme Court stated that according to the loan agreement between the parties, the borrower was intended to repay the loan in foreign currencies, irrespective of whether he actually did. As both parties had or were intended to discharge their duties with foreign currency changing hands, the Supreme Court considered the loan to be a legitimate loan in foreign currencies. The Group believes that comparable loan agreements with companies and individuals at the Group are subject to the precedent set by both these judgments. It is therefore clear that a decision has been reached by the courts on the legality or, in some circumstances, illegality of the majority of the Group's FX loans to companies and individuals. However, although the courts have not ruled on all types of the Group's FX loans, the aforementioned rulings, and e.g. the ruling of the Supreme Court in case no 524/2011 (pronounced on 7 June 2012), have demonstrated that the vast majority of the Group‘s ISK 139,573 million of FX loans to customers are legitimate loans.

In light of the aforementioned judgments, the Group has decided to increase its provision of ISK 13.8 billion to ISK 19.6 billion.

Conclusion

Although there is more clarity in the matters of FX loans, due to the judgements pronounced by the Supreme Court of Iceland since the Group's last annual Financial Statements 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 the Supreme Court of Iceland judgments of 15 February and 18 October 2012. Uncertainty exists with regard to, firstly, the Group’s preliminary determination of the specific loans that require recalculation and, secondly, uncertainty with regard to assumptions used in the method of recalculation of loans to customers that were determined to fall within the scope of the judgment. As noted above, this uncertainty is somewhat mitigated by the use of FME prescribed methodology. In the event the Group’s interpretation of the judgments of 15 February and 18 October 2012 were to change, the loss could be greater or less than the current estimate of ISK 19.6 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 porfolio of foreign currency linked loans fully provisioned for the most likely outcome.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE CONSOLIDATED STATEMENT OF CASH FLOW

97. Operational cash flows from interest and dividends:

	2012	2011
Interest paid	(23,865)	(22,364)
Interest received	49,012	39,653
Dividend received	25	7

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

98. Non-cash items included in net earnings before income tax and other adjustments:

	2012	2011
Increase in book value of loans and receivables	(12,824)	(38,368)
Impairment of loans and receivables	17,514	27,424
Changes in compensation instrument	-	17,693
Depreciation and amortisation	1,436	957
Impairment of other assets	-	60
Share of loss (profit) of associates and fair value change	(2,405)	(8)
Investment property, fair value change	(1,584)	(916)
Net foreign exchange loss (gain)	(1,434)	(1,837)
Net loss (gain) on financial assets and liabilities at fair value through profit or loss	(561)	(1,463)
Net loss (gain) on disposal of investment in associates	(396)	-
Net loss (gain) on disposal of property and equipment	(8)	(16)
Net loss (gain) on disposal of investment property	(1,356)	-
Impairment loss on remeasurement to fair value of HFS legal entities	-	2,027
Net loss (gain) on non-current assets classified as held for sale	-	(7,176)
	(1,618)	(1,623)

99. Changes in operating assets and liabilities are specified as follows:

	2012	2011
Mandatory reserve with Central Bank of Iceland	(177)	(791)
Loans and receivables to credit institutions	(9,729)	10,928
Loans and receivables to customers	(3,498)	16,280
Bonds and debt instruments	22,387	(18,845)
Shares and equity instruments	(366)	(762)
Derivatives and financial liabilities at fair value	7,514	3,302
Other assets	4,179	11,431
Due to credit institutions and Central Bank of Iceland	16,901	(33,282)
Deposits	(45,537)	4,993
Borrowings	5,451	(107)
Subordinated liabilities	(19)	(1,181)
Other liabilities	462	(5,409)
	(2,432)	(13,443)

100. Cash and cash equivalents at the end of the year:

	2012	2011
Cash in hand and demand deposits	29,746	29,200
Due from credit institutions	84,164	62,175
Mandatory reserve with Central Bank	(8,737)	(8,560)
Cash and cash equivalents at the end of the year	**105,173**	**82,815**

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

RISK MANAGEMENT DISCLOSURES

Introduction

As a financial institution, 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 risk 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 2012 was 60% of capital base, down from 87% at the end of the year 2011.

The Group is still exposed to currency risk although much progress was made in curtailing the currency imbalance during the year. The Bank now meets the legal limits on currency imbalance. The Group’s operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

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, the majority of which is on demand.

The Group faces legal risk related to previous court judgments on foreign currency loans, see Note 96.

The Group will disclose information on the Group's risk management and capital adequacy in the Pillar 3 risk disclosure on the Bank's website following the annual general meeting. The Pillar 3 disclosures are unaudited.

Credit risk

101. 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. The main sources of credit risk are the Group's loan portfolio, commitments and guarantees and derivatives trading.

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's main asset is its loan portfolio. Therefore managing and analysing the 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 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. For additional information see Note 109.

The pricing of each new credit granted and the credits arising from the impaired loan restructuring process should reflect the risk taken. The customer's interests must be protected at all times and there must be a high likelihood that the customers will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

102. 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 has changed its industry classification compared to last year. 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. Due to this change, numbers in corresponding notes in the 2011 Financial Statement are not comparable.

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 & receivables to credit institutions ..	-	-	-	-	-	101.011	-	-	-	-	-	101.011
Loans & receivables 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
Bonds and debt instruments	-	25	-	28	-	73.865	1.210	7	1	42.594	-	117.730
Derivatives	-	-	-	-	-	765	-	-	23	-	-	788
Bonds & debt instruments, hedging	-	-	-	-	-	-	-	-	1.209	251	-	1.460
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

102. cont.

2011

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	-	-	-	-	-	29.200	-	-	-	-	-	29.200
Loans & receivables to credit institutions ..	-	-	-	-	-	69.103	-	-	-	-	-	69.103
Loans & receivables to customers	239.289	71.579	76.673	26.753	50.582	19.853	26.969	20.384	17.197	7.613	4.658	561.550
Bonds and debt instruments	-	10	-	54	-	70.953	7.501	8	-	62.042	-	140.568
Derivatives	8	92	-		39	87	7	-	3	438	-	674
Bonds & debt instruments, hedging	-	-	-	-	-	-	-	-	-	1.922	-	1.922
Other assets with credit risk	283	4.192	5	139	82	1.860	65	2	1.323	52	1	8.004
Total on balance sheet maximum exposure to credit risk	239.580	75.873	76.678	26.946	50.703	191.056	34.542	20.394	18.523	72.067	4.659	811.021

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	418	1.717	367	746	617	1.568	276	432	690	1.821	10	8.662
Unused overdrafts	21.553	1.128	148	288	2.200	2.977	1.511	290	1.521	2.412	230	34.258
Loan commitments	113	118	7.127	55	1.903	5.545	1.985	838	-	-	3	17.687
Total off balance sheet maximum exposure to credit risk	22.084	2.963	7.642	1.089	4.720	10.090	3.772	1.560	2.211	4.233	243	60.607
Maximum exposure to credit risk	261.664	78.836	84.320	28.035	55.423	201.146	38.314	21.954	20.734	76.300	4.902	871.628

Amounts are in ISK millions

103. Loans and receivables to customers specified by sectors:

	2012	2011
Individuals	42.8%	42.6%
Real estate activities and construction	12.1%	12.7%
Fishing industry	12.0%	13.7%
Information and communication technology	5.1%	4.8%
Wholesale and retail trade	9.8%	9.0%
Financial and insurance activities	4.4%	3.5%
Industry, energy and manufacturing	4.0%	4.8%
Transportation	3.8%	3.6%
Services	3.3%	3.1%
Public sector	1.8%	1.4%
Agriculture and forestry	0.9%	0.8%
	100.0%	100.0%

The Group has changed its industry classification compared to last year. The Group uses and internal industry classification, which is based on the ISAT 08 Standard classification. Comparison figures in 2011 have been changed accordingly.

104. 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:

For retail lending: Mortgages over residential properties;

For corporate: Charges over real estate properties, fishing vessels and other fixed and current assets, inventory and trade receivables and cash and securities;

For derivative exposure: Cash or Treasury bills.

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 is specified as follows:

2012	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral	Unsecured ratio %
Cash and balances with Central Bank	-	-	-	-	-	100.0%
Loans and receivables to credit institutions	-	-	-	-	-	100.0%
Loans and receivables to customers:						
Individuals	556	212,357	40	219	213,172	0
Real estate activities and construction	675	49,416	6	702	50,799	0
Fishing industry	1,877	2,325	58,274	6,222	68,698	-
Information and communication technology	78	547	-	18,312	18,937	0
Wholesale and retail trade	1,909	12,705	-	8,550	23,164	1
Financial and insurance activities	9,924	532	-	8,876	19,332	-
Industry, energy and manufacturing	140	6,659	1	1,189	7,989	1
Transportation	71	503	19	904	1,497	1
Services	252	2,785	57	1,973	5,067	1
Public sector	29	3,261	-	91	3,381	1
Agriculture and forestry	10	1,569	-	12	1,591	1
Bond, debt instruments and derivatives	1,219	-	-	68,628	69,847	42.0%
Collateral held against different types of financial assets	16,740	292,659	58,397	115,678	483,474	40.1%

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

Comparative information for the year 2011 is not available.

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105. Credit quality by class of financial assets

Credit quality is specified as follows:

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 and receivables to credit institutions	101,011	-	-	101,011
Loans and receivables to customers :				
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Bonds and debt instruments	117,730	-	-	117,730
Derivatives	788	-	-	788
Bonds and debt instruments used for hedging	1,460	-	-	1,460
Other assets with credit risk	5,030	-	-	5,030
Credit quality of loans and receivables	731,682	40,696	49,997	822,375

2011				
Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers :				
Loans to corporates	274,604	17,758	46,252	338,614
Loans to individuals	182,089	23,117	17,730	222,936
Bonds and debt instruments	140,568	-	-	140,568
Derivatives	674	-	-	674
Bonds and debt instruments used for hedging	1,922	-	-	1,922
Other assets with credit risk	8,004	-	-	8,004
Credit quality of loans and receivables	706,164	40,875	63,982	811,021

* 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.

106. Past due but not impaired loans by class of loans and receivables:

2012	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans and receivables to corporates	6,285	951	322	10,293	17,851
Loans and receivables to individuals	8,719	3,558	287	10,281	22,845
Past due but not impaired loans and receivables	15,004	4,509	609	20,574	40,696

2011					
Loans and receivables to corporates	5,649	824	834	10,451	17,758
Loans and receivables to individuals	2,950	3,422	2,512	14,233	23,117
Past due but not impaired loans and receivables	8,599	4,246	3,346	24,684	40,875

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

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107. Collateral repossessed

During the year, the Group took possession of real estates with the carrying value of ISK 2,051 million and other assets with the value of ISK 0.7 million, all which the Group is in the process of selling, see Note 81.

108. Impaired loans and receivables to customers by sector:

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
2012	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
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 sector	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
2011						
Individuals	6,901	7,114	5,761	23,278	12,662	30,392
Real estate activities and construction	6,171	12,836	1,407	3,980	7,578	16,816
Fishing industry	2,218	10,073	2,339	3,318	4,557	13,391
Information and communication technology	7,344	7,619	151	453	7,495	8,072
Wholesale and retail trade	3,121	8,285	2,173	9,981	5,294	18,266
Financial and insurance activities	4,706	9,013	50	111	4,756	9,124
Industry, energy and manufacturing	636	3,356	359	2,919	995	6,275
Transportation	35	99	47	121	82	220
Services	906	3,194	488	1,001	1,394	4,195
Public sector	154	876	610	970	764	1,846
Agriculture and forestry	761	673	438	1,488	1,199	2,161
	32,953	63,138	13,823	47,620	46,776	110,758

This note refines the presentation of impairments that are due to the uncertainty related to foreign currency loans from impairments that are due to deteriorating borrower credit quality. At the end of the year, a provision of ISK 19,567 million had been made for losses due to court rulings for illegal FX loans, out of which ISK 14,942 million are due to loans with a carrying value of ISK 41,359 million that are still on the Group's balance sheet. The balance of ISK 4,625 million is due to loans which have been paid up and is accounted for in the Statement of Financial Position as other liabilities. This balance will be paid out following a recalculation of the loans.

In prior financial years, loans where the impairment did not exceed the remaining acquisition discount were not classified as impaired loans as the Group's management wanted to disclose impaired loan information reflecting the deterioration in loan quality subsequent to acquisition. As the Group's restructuring of acquired loans in 2008 is nearing completion, the Group's management has reclassified the remaining acquisition discount to an impairment provision.

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109. 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 216/2007.

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 year was ISK 29 billion (2011: ISK 33 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has four large exposures at end of the year (2011: five exposures) net of eligible collateral.

	2012		2011	
no.	Gross	Net	Gross	Net
1. Drómi	43%	0%	49%	0%
2	18%	18%	20%	20%
3	18%	17%	23%	23%
4	14%	14%	19%	19%
5	11%	11%	14%	14%
6	<10%	<10%	11%	11%
Sum of exposure gross > 10%	104%	60%	137%	87%

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the year. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi. The FME has ruled that the Group can use the hold harmless statement as a credit enhancement towards the claim on Drómi. Consequently, the Group finds that the net exposure on Drómi is zero.

The sum of all large exposures is 104% of the Group's capital base before collateral mitigation or 60% net of eligible collateral, which is well below the 400% legal maximum.

Market risk

110. 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 2012 67 Amounts are in ISK millions

111. 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.

112. 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 liablities, 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.

2012		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	(35)	(603)	(282)	(1,980)	811
Non Indexed linked	ISK	(102)	(433)	57	-	(10)
	EUR	71	(3)	-	-	-
	Other	(35)	(6)	(50)	-	-
2011						
CPI Indexed linked	ISK	(101)	(145)	(84)	107	(189)
Non Indexed linked	ISK	40	(102)	(268)	(622)	459
	EUR	11	(3)	-	-	-
	Other	62	(177)	-	-	-

113. 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.

2012		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	-	(19)	(80)	(5)	(270)
Non Indexed linked	ISK	(50)	(17)	(8)	(36)	-
	EUR	(5)	-	-	-	-
	Other	(2)	-	-	-	-
2011						
CPI Indexed linked	ISK	-	(80)	(20)	(22)	5
Non Indexed linked	ISK	(66)	53	(42)	(85)	-
	EUR	1	-	-	-	-
	Other	213	9	-	-	-

114. The table below analyses the Group's assets and liabilities at carrying amount by residual maturity.

2012	Carrying	On	Up to 3	3-12	1-5	Over 5	With no
Assets	amount	demand	months	months	years	years	maturity
Cash and balances with Central Bank	29,746	21,121	-	8,625	-	-	-
Loans and receivables to credit institutions	101,011	84,033	16,721	-	257	-	-
Loans and receivables to customers	566,610	3,000	47,511	92,258	208,232	215,609	-
Bonds and debt instruments	117,730	7,034	-	25	69,087	41,584	-
Shares and equity instruments	16,844	-	-	-	-	-	16,844
Derivatives	788	-	693	23	72	-	-
Assets leg	*18,737*	-	*16,739*	*444*	*1,554*	-	-
Liabilities leg	*(17,949)*	-	*(16,046)*	*(421)*	*(1,482)*	-	-
Securities used for hedging	2,438	1,460	-	-	-	-	978
Investment property	28,919	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	7,050
Property and equipment	6,311	-	-	-	-	-	6,311
Intangible assets	4,941	-	-	-	-	-	4,941
Tax assets	463	-	-	17	446	-	-
Non-current assets held for sale	11,923	-	-	-	-	-	11,923
Other assets	5,901	64	2,500	2,047	401	18	871
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	*26,652*	-	*6,122*	*4,631*	*10,126*	*5,773*	-
Short position on bonds	*12,490*	-	*12,490*	-	-	-	-
Tax liabilities	3,237	-	474	1,425	1,338	-	-
Non-current liabilities held for sale	1,769	-	-	-	-	-	1,769
Other liabilities	40,348	492	25,952	5,180	3,207	308	5,209
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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114. cont.

2011 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	29,200	20,640	-	8,560	-	-	-
Loans and receivables to credit institutions	69,103	62,155	6,703	-	245	-	-
Loans and receivables to customers	561,550	13,694	49,872	71,108	230,773	196,103	-
Bonds and debt instruments	140,568	3,994	515	15,256	80,125	40,678	-
Shares and equity instruments	14,045	-	-	-	-	-	14,045
Derivatives	674	-	188	3	483	-	-
Assets leg	*9,589*	-	*5,603*	*299*	*3,687*	-	-
Liabilities leg	*(8,915)*	-	*(5,415)*	*(296)*	*(3,204)*	-	-
Securities used for hedging	2,372	1,922	-	-	-	-	450
Investment property	27,100	-	-	-	-	-	27,100
Investments in associates	2,987	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	23,886
Other assets	8,876	598	5,446	492	843	68	1,429
Assets 31.12.2011	892,121	103,003	62,724	95,419	312,469	236,849	81,657
Liabilities							
Due to credit institutions and Central Bank	16,160	10,341	231	5,588	-	-	-
Deposits	489,995	377,063	58,708	24,371	27,117	2,736	-
Financial liabilities at fair value	4,907	-	4,492	-	415	-	-
Assets leg	*(35,374)*	-	*(34,697)*	-	*(677)*	-	-
Liabilities leg	*36,571*	-	*35,479*	-	*1,092*	-	-
Short position bonds	*3,710*	-	*3,710*	-	-	-	-
Tax liabilities	3,421	-	-	2,284	-	-	1,137
Non-current liabilities held for sale	4,950	-	-	-	-	-	4,950
Other liabilities	38,822	2,020	8,235	20,157	2,686	219	5,505
Borrowings	187,203	-	3,885	2,595	13,297	167,426	-
Subordinated liabilities	32,105	-	-	-	-	32,105	-
Liabilities 31.12.2011	777,563	389,424	75,551	54,995	43,515	202,486	11,592
Off balance sheet items:							
Guarantees	8,662	343	420	1,273	5,108	1,518	-
Unused overdraft	34,258	808	7,685	12,465	13,272	28	-
Loan commitments	17,687	1	2,892	8,385	4,409	2,000	-
Off balance sheet items	60,607	1,152	10,997	22,123	22,789	3,546	-
Net interest sensitivity gap	53,951	(287,573)	(23,824)	18,301	246,165	30,817	70,065

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115. 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 262.0 billion (2011: ISK 230.7 billion) and the total amount of indexed liabilities amount to ISK 216.8 billion (2011: ISK 218.5 billion).

2012	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI indexed linked				
Loans and receivables to customers	583	55,601	197,506	253,690
Bonds and debt instruments	-	482	2,253	2,735
Off balance sheet position	-	1,085	4,478	5,563
Assets, CPI indexed linked	583	57,168	204,237	261,988
Liabilities, CPI indexed linked				
Deposits	59,738	26,041	5,815	91,594
Borrowings	1,077	12,806	111,371	125,254
Liabilities, CPI indexed linked	60,815	38,847	117,186	216,848
Net on balance sheet position	(60,232)	17,236	82,573	39,577
Net off balance sheet position	-	1,085	4,478	5,563
CPI Balance 31.12.2012	(60,232)	18,321	87,051	45,140
CPI Balance 31.12.2011	(58,423)	(1,448)	72,027	12,156

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116. 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 the Group's assets consist largely of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

The following table shows the breakdown of assets and liabilities by currency at the end of the year.

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 and receivables to customers	427,037	50,966	20,396	21,121	6,670	14,835	25,585	566,610
Bonds and debt instruments	117,058	-	672	-	-	-	-	117,730
Shares and equity instruments	12,649	2,718	949	-	234	-	294	16,844
Derivatives	153	560	54	7	10	4	-	788
Securities used for hedging	2,438	-	-	-	-	-	-	2,438
Investment property	28,919	-	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	-	7,050
Property and equipment	6,311	-	-	-	-	-	-	6,311
Intangible assets	4,941	-	-	-	-	-	-	4,941
Tax assets	463	-	-	-	-	-	-	463
Non-current assets held for sale	10,706	1,217	-	-	-	-	-	11,923
Other assets	5,237	375	245	-	4	-	40	5,901
Assets 31.12.2012	674,012	80,287	40,566	23,821	22,783	16,637	42,569	900,675
Liabilities								
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
Non-current liabilities held for sale	489	1,280	-	-	-	-	-	1,769
Other liabilities	33,595	1,506	1,866	298	808	1,430	845	40,348
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	

A natural hedge for currency is no longer relevant for the Group.

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116. cont.

2011

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	12,238	317	10,678	828	3,670	574	895	29,200
Loans to credit institutions	23,725	9,288	10,813	1,010	8,055	3,249	12,963	69,103
Loans and receivables to customers	393,093	48,344	20,998	34,298	10,957	27,824	26,036	561,550
Bonds and debt instruments	128,853	352	11,363	-	-	-	-	140,568
Shares and equity instruments	9,931	2,534	899	-	276	-	405	14,045
Derivatives	458	8	1	8	14	185	-	674
Securities used for hedging	2,372	-	-	-	-	-	-	2,372
Investment property	27,100	-	-	-	-	-	-	27,100
Investments in associates	2,986	1	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	-	23,886
Other assets	8,469	245	68	-	12	-	82	8,876
Assets 31.12.2011	644,871	61,089	54,820	36,144	22,984	31,832	40,381	892,121
Liabilities								
Due to credit inst. and Central Bank	15,188	261	69	-	304	11	327	16,160
Deposits	399,616	26,869	16,880	6,664	7,464	5,253	27,249	489,995
Financial liabilities at fair value	3,856	23	430	2	113	378	105	4,907
Tax liabilities	3,421	-	-	-	-	-	-	3,421
Non-current liabilities held for sale	4,950	-	-	-	-	-	-	4,950
Other liabilities	34,339	1,027	2,587	8	397	-	464	38,822
Borrowings	126,311	3,090	19,833	20,281	6,720	10,968	-	187,203
Subordinated liabilities	-	25,869	2,446	-	3,790	-	-	32,105
Equity	114,558	-	-	-	-	-	-	114,558
Liabilities 31.12.2011	702,239	57,139	42,245	26,955	18,788	16,610	28,145	892,121
Net on balance sheet position	(57,368)	3,950	12,575	9,189	4,196	15,222	12,236	
Net off balance sheet position	14,737	4,660	(3,075)	-	(1,312)	(9,437)	(5,573)	
Net position 31.12.2011	(42,631)	8,610	9,500	9,189	2,884	5,785	6,663	
Loans to customers with ISK income	18,440	(2,822)	(1,224)	(8,164)	(91)	(5,907)	(232)	
Net real position 31.12.2011	(24,191)	5,788	8,276	1,025	2,793	(122)	6,431	

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117. Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at 31 December 2012. 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).

	2012		2011	
Currency	-10%	+10%	-10%	+10%
EUR	(761)	761	(579)	579
USD	(493)	493	(828)	828
CHF	125	(125)	(103)	103
GBP	(360)	360	(279)	279
JPY	28	(28)	12	(12)
Other	(356)	356	(643)	643

118. Equity price risk

Equity price 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, see Note 81. The Group's trading book is to a very limited extent exposed to listed equities.

119. Derivatives

The Group's use of derivatives is through derivative sales and trading portfolios. The types of derivative currently offered by the Group are interest rate swaps, options and forwards on Treasury notes and Housing Financing Fund bonds. The Group is not materially exposed to derivative instruments at the end of the year 2012.

120. 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 2012.

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Liquidity risk

121. 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, the majority 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.

The liquidity risk limit is quantified by liquidity and cash ratios as well as by applying stress tests to identify scenarios of possible liquidity strain.

122. Secured liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balances with the Central Bank of Iceland, Treasury notes and Housing Financing Fund bonds which are held specifically as liquidity reserves and other eligible assets for repo transactions with the Central Bank and compare it with the total interest bearing liabilities.

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The Bank's ratios during the year were as follows:

	Liquidity ratio	Cash ratio
Year-end	33%	31%
Maximum	37%	31%
Minimum	28%	10%
Average	32%	17%

123. Deposit stickiness

The Group's deposit base has been split into seven different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described as being sticky if it has shown to be a stable funding for the Group in the past and is expected to remain stable in the future. Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Group and the maturity of the deposit. These criteria's are based both on qualitative and quantitative methods.

– Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls;
– Resolution process: Deposits from customers in a resolution process;
– Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate;
– Deposits - legal entities: Deposits from legal entities with no other business relationship with the Group and not quantified as an active investor;
– Deposits - retail individual: Deposits from retail individual with no other business relationship with the Group and not quantified as an active investor;
– Deposits - legal entities with business relationship: Deposits from legal entities with business relationship with the Group; and
– Deposits - retail individual with business relationship: Deposits from retail individual with business relationship with the Group.

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123. cont.

The table below shows the split between different levels of the Group's deposit stickiness at the end of the year, according to the Groups's classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky.

% of deposit base:

		2012		2011
Stickiness rating				
Due to Central Bank (excluded from stickiness categorisation)		12,358		-
1 Capital controls	2%	8,746	9%	43,977
2 Resolution process	18%	82,338	11%	58,315
3 Investors	21%	101,827	25%	124,596
4 Deposits - legal entities	14%	63,445	16%	80,494
5 Deposits - retail individuals	11%	53,239	11%	57,559
6 Deposits - legal entities with business relationship	16%	73,098	11%	57,664
7 Deposits - retail individuals with business relationship	18%	86,622	17%	83,550
Total	100%	481,673	100%	506,155

The fall in Capital Controls is primarily due to a single client's transaction.

Operational risk

124. Operational risk is the risk of direct or indirect loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Group's operations. Reputational risk and legal risk are among others, considered sub-categories of operational risk. Operational risk is inherent in all activities within the Group.

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, but manages it in accordance with the standardised approach.

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Capital management

125. The capital base at 31 December 2012 amounts to ISK 159,694 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 24.3%, 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 (ICAAP) 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 (2011: the same).

It should be noted that the effect of risk mitigation in the form of natural hedge, due to FX loans to borrowers with ISK income, is no longer reflected in the RWA for market risk whereas 31.12.2011 a 37% effective contribution of the corresponding portion of the FX imbalance was accounted for.

A reclassification of securities has been made from the trading book in to the banking book in precise compliance with the Basel II standard. The result is a transfer of 23,350 million of RWA from Market Risk into Credit Risk at 31 December 2012.

The table shows the Group's RWA calculations:	2012	2011
Capital Base		
Share capital	2,000	2,000
Share premium	73,861	73,861
Other reserves	1,639	1,637
Retained earnings	49,572	32,950
Non-controlling interests	3,806	4,110
Total Equity	130,878	114,558
Deduction from Tier 1 capital	(5,404)	(5,489)
Total Tier 1 capital	125,474	109,069
Tier 2 capital	34,220	32,105
Total Capital base	159,694	141,174
Risk weighted assets		
Credit risk	557,964	543,233
Market risk FX	20,063	31,990
Market Risk Other	7,407	30,757
Operational risk	72,329	58,976
Total Risk weighted assets	657,763	664,956
Tier 1 ratio	19.1%	16.4%
Capital adequacy ratio	24.3%	21.2%

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OTHER INFORMATION

Related parties

126. The Group has a related party relationship with Kaupskil ehf., Kaupthing hf., the Group's associates, the Board of Directors of Arion Bank, management personnel of the Bank and close family members of individuals referred to above.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank. ISFI and related entities are defined as related parties and balances and transactions with these entities are included in the tables below under Shareholders with significant influence over the Group.

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.

2012

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

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

2011

Balances with related parties:	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	(1,730)	(1,730)
Shareholders with control over the Group	493	(41,376)	(40,883)
Board of Directors and key Management personnel	104	(367)	(263)
Associates and other related parties	74,135	(29,088)	45,047
	74,732	(72,561)	2,171

Transactions with related parties:	Interest income	Interest expense	Other income	Other expense	Change in compens. instrum.
Shareholders with significant influence over the Group	-	28	-	-	-
Shareholders with control over the Group	322	887	47	-	18,015
Board of Directors and key Management personnel	6	12	31	-	-
Associates and other related parties	3,273	352	1,359	25	-
	3,601	1,279	1,437	25	18,015

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Events after Balance Sheet date

127. Events after Balance Sheet date

a) In January 2013 Arion Bank completed its third non-indexed fixed rate covered bond offering, issuing ISK 1.8 billion worth of bonds in the Series Arion CB 15. The bonds bear 6.5% interest and mature in 2015.

b) In February 2013 Arion Bank completed its first international bond offering, issuing NOK 500 million of senior unsecured bonds. That equals ISK 11.2 billions. The issuer has undertaken to list the bonds on Oslo Börs no later than one year from the issue date. The bonds issued bear floating interest rate of 5.0% on NIBOR and mature in 2016.