Arion Bank

# Interim Consolidated Financial Statements

## 1 January - 30 June 2013

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 Interim Consolidated Financial Statements of Arion Bank for the period ended 30 June 2013 include the Interim Consolidated 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.

**Operations during the period**

Net earnings amounted to ISK 5,911 million for the period ended 30 June 2013. The Group's equity amounted to ISK 136,788 million at the end of the period, 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 38% and 32% respectively at the end of the period, compared with the regulatory minimum of 20% and 5% respectively.

Operating results in the six months show stability in regular operations, however net earnings are affected by the volatility of the Icelandic Krona and one-time expenses. The Icelandic Krona strengthened during the period which contributes ISK 1.1 billion to the difference in net earnings compared to same period last year and an ISK 500 million fine set on Valitor by the Icelandic Competition Authority negatively affects Administration expenses. Valitor has appealed the fine to the Competition Appeals Committee. Other differences from last year are mainly lower net valuation changes of the loan book and loss from discontinued operations compared to gains in the first half of 2012. Higher net valuation changes in 2012 were the result of good progress in the restructure of loans to companies and sale of overtaken entities, while postive changes in valuation of loans in the first half of 2013 are evened out by increased impairment for uncertainties related to FX loans and other losses.

The Balance Sheet has grown by 3% from year end 2012. Total loans to customers are unchanged from year end 2012 despite considerable changes in valuation of loans. The amount of losses on loans and impairment due to recalculation of loans which are off-set by revaluation of loans where expected payments exceed previous estimates. Certainty regarding the valuation of the loan book continues to improve, even if minor volatility may remain in the near term, mainly due to continued legal uncertainty. Increased investments in associates are due to the takeover of a 38.2% share in Skipti.

The Bank completed its third non-indexed covered bonds offering in January by issuing ISK 1.8 billion worth of bonds. In February the Bank was the first Icelandic bank since 2007 to complete international bond offering, issuing NOK 500 million, equalling ISK 11 billion, of senior unsecured bonds that have now been listed on the Oslo Børs. In July the bank finished an offering of a new indexed Covered Bonds issuance for ISK 3 billion worth.

The international bond offering in February represented the first phase in raising international funding since the Bank was founded. As a follow up, steps have been taken to apply for a credit rating from an international rating agency. In July the Icelandic rating agency Reitun issued an updated rating for both Arion Bank as a debtor and covered bonds issued by the Bank. For the Bank the rating improved from B with stable outlook to B+ with positive outlook. For covered bonds the rating is unchanged at A, which is at par with the rating of the Icelandic State.

Assets under management increased considerably during the year 2012 and have continued to grow in 2013 with an increase of 6.6% in the first half of 2013. The Bank has in recent periods successfully attracted new customers and the market has contributed by positive progress.

**Outlook**

The Icelandic economy is expected to grow by 1.8% in 2013. Arion Bank is well positioned to grow and its strong balance sheet will enable it to be an active participant in the further strengthening of the Icelandic economy. As debt recovery cases decrease, traditional banking activities are becoming more characteristic of the Bank's operations. This provides opportunities for further streamlining, yet at the same time creates 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.

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

**Endorsement of the Board of Directors and the Chief Executive Officer**

The Interim Consolidated Financial Statements for the period ended 30 June 2013 have been prepared in accordance with International Financial Reporting Standards (IAS 34 *Interim Financial Reporting* ) as endorsed by the European Union.

It is our opinion that the Interim Consolidated Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 June 2013, its financial position as at 30 June 2013 and its cash flows for the period ended 30 June 2013.

Further, in our opinion the Interim 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 Interim Consolidated Financial Statements of Arion Bank for the period ended 30 June 2013 and confirm them by means of their signatures.

Reykjavík, 29 August 2013

**Board of Directors**

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Gudrún Johnsen

Måns Höglund

Björg Arnardóttir

Jón G. Briem

Thóra Hallgrímsdóttir

**Chief Executive Officer**

Höskuldur H. Ólafsson

# REPORT ON REVIEW OF INTERIM CONSOLIDATED FINANCIAL STATEME

To the Board of Directors and Shareholders of Arion Bank.

**Introduction**

We have reviewed the accompanying Interim Consolidated Financial Statements of Arion Bank and its subsidiaries (the "Group"), which comprise the Interim Consolidated Statement of Comprehensive Income, the Interim Consolidated Statement of Financial Position as at 30 June 2013, the Interim Consolidated Statement of Changes in Equity and the Condensed Interim Consolidated Statement of Cash Flows for the six-month period then ended, and explanatory notes. Management is responsible for the preparation and fair presentation of these Interim Consolidated Financial Statements in accordance with International Financial Reporting Standard IAS 34, "Interim Financial Reporting" as adopted by the EU. Our responsibility is to express a conclusion on these Interim Consolidated Financial Statements based on our review.

**Scope of review**

We conducted our review in accordance with the International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity". A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Interim Consolidated Financial Statements are not prepared, in all material respects, in accordance with IAS 34 "Interim Financial Reporting" as adopted by the EU.

Reykjavík, 29 August 2013

**Ernst & Young ehf.**

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

# INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2013

| | Notes | 2013 1.1.-30.6. | 2012 1.1.-30.6. | 2013 1.4.-30.6. | 2012 1.4.-30.6. |
|---|---|---|---|---|---|
| Interest income | | 30,049 | 32,153 | 13,577 | 16,855 |
| Interest expense | | (17,382) | (18,273) | (7,198) | (9,189) |
| **Net interest income** | 10 | 12,667 | 13,880 | 6,379 | 7,666 |
| Reversal of impairment (acquired and incurred) on loans and receivables | 11 | 6,798 | 7,168 | 4,425 | 7,049 |
| Impairment of loans and receivables | 12 | (6,664) | (4,636) | (3,969) | (4,441) |
| **Net interest income less net impairment change on loans and receivables** | | 12,801 | 16,412 | 6,835 | 10,274 |
| Fee and commission income | | 7,740 | 7,968 | 4,080 | 4,162 |
| Fee and commission expense | | (2,442) | (2,630) | (1,231) | (1,160) |
| **Net fee and commission income** | 13 | 5,298 | 5,338 | 2,849 | 3,002 |
| Net financial income (expense) | 14-17 | 1,544 | 330 | 974 | (16) |
| Net foreign exchange gain (loss) | 18 | (1,248) | (149) | 149 | (1,232) |
| Share of profit (loss) of associates | 36 | (12) | 7 | (12) | 2 |
| Other operating income | 19 | 2,437 | 2,999 | 1,261 | 2,052 |
| **Operating income** | | 20,820 | 24,937 | 12,056 | 14,082 |
| Salaries and related expense | 21 | (6,679) | (6,169) | (3,357) | (3,124) |
| Administration expense | | (4,869) | (4,147) | (2,264) | (2,042) |
| Depositors' and investors' guarantee fund | 47 | (379) | (445) | (192) | (207) |
| Depreciation and amortisation | | (550) | (463) | (288) | (246) |
| Other operating expense | 22 | (430) | (420) | (207) | (223) |
| **Earnings before tax** | | 7,913 | 13,293 | 5,748 | 8,240 |
| Income tax expense | 23 | (1,749) | (2,913) | (1,163) | (1,852) |
| Bank Levy | 24 | (188) | (510) | (97) | (242) |
| **Net earnings from continuing operations** | | 5,976 | 9,870 | 4,488 | 6,146 |
| Net gain (loss) from discontinued operations, net of tax | 25 | (65) | 1,379 | 14 | 652 |
| **Net earnings** | | 5,911 | 11,249 | 4,502 | 6,798 |
| **Attributable to:** | | | | | |
| Shareholders of Arion Bank | | 6,137 | 11,052 | 4,440 | 6,741 |
| Non-controlling interest | | (226) | 197 | 62 | 57 |
| **Net earnings** | | 5,911 | 11,249 | 4,502 | 6,798 |
| **Other comprehensive income:** | | | | | |
| Exchange difference on translating foreign subsidiaries | 45 | (1) | - | - | (2) |
| **Total comprehensive income for the period** | | 5,910 | 11,249 | 4,502 | 6,796 |
| **Earnings per share** | | | | | |
| Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) | 26 | 3.07 | 5.53 | 2.22 | 3.37 |

*The Q2 result (and implied Q1 result) were not audited or reviewed*

*The notes on pages 10 to 52 are an integral part of these Interim Consolidated Financial Statements.*

*Arion Bank Interim Consolidated Financial Statements 30 June 2013* 6 *Amounts are in ISK millions*

# INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 2013

| Assets | Notes | 30.6.2013 | 31.12.2012 | 30.6.2012 |
|---|---|---|---|---|
| Cash and balances with Central Bank | 27 | 25,717 | 29,746 | 16,280 |
| Loans and receivables to credit institutions | 28-29 | 109,732 | 101,011 | 71,769 |
| Loans and receivables to customers | 30-31 | 567,257 | 566,610 | 578,886 |
| Bonds and debt instruments | 32-33 | 132,744 | 117,730 | 128,853 |
| Shares and equity instruments with variable income | 32 | 16,735 | 16,844 | 15,408 |
| Derivatives | 32,43 | 832 | 788 | 1,363 |
| Securities used for hedging | 32 | 3,460 | 2,438 | 1,516 |
| Investment property | 35 | 28,911 | 28,919 | 28,379 |
| Investments in associates | 36 | 14,424 | 7,050 | 3,020 |
| Property and equipment | | 7,433 | 6,311 | 6,232 |
| Intangible assets | | 5,283 | 4,941 | 5,008 |
| Tax assets | 37 | 495 | 463 | 548 |
| Non-current assets and disposal groups held for sale | 38 | 10,086 | 11,923 | 16,303 |
| Other assets | 39 | 5,921 | 5,901 | 6,485 |
| **Total Assets** | | 929,030 | 900,675 | 880,050 |
| **Liabilities** | | | | |
| Due to credit institutions and Central Bank | 32 | 25,727 | 32,990 | 20,837 |
| Deposits | 32 | 466,834 | 448,683 | 445,249 |
| Financial liabilities at fair value | 32 | 10,005 | 13,465 | 10,439 |
| Tax liabilities | 37 | 4,049 | 3,237 | 4,028 |
| Non-current liabilities and disposal groups held for sale | 38 | 614 | 1,769 | 4,174 |
| Other liabilities | 40 | 49,410 | 40,348 | 45,052 |
| Borrowings | 32,41 | 203,100 | 195,085 | 192,953 |
| Subordinated liabilities | 32,41 | 32,503 | 34,220 | 32,175 |
| **Total Liabilities** | | 792,242 | 769,797 | 754,907 |
| **Equity** | | | | |
| Share capital | 44 | 2,000 | 2,000 | 2,000 |
| Share premium | 44 | 73,861 | 73,861 | 73,861 |
| Other reserves | 45 | 1,638 | 1,639 | 1,637 |
| Retained earnings | | 55,709 | 49,572 | 44,002 |
| **Total Shareholders' Equity** | | 133,208 | 127,072 | 121,500 |
| Non-controlling interest | | 3,580 | 3,806 | 3,643 |
| **Total Equity** | | 136,788 | 130,878 | 125,143 |
| **Total Liabilities and Equity** | | 929,030 | 900,675 | 880,050 |

*The notes on pages 10 to 52 are an integral part of these Interim Consolidated Financial Statements.*

*Arion Bank Interim Consolidated Financial Statements 30 June 2013* 7 *Amounts are in ISK millions*

# INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2013

| | Share capital and share premium | Other reserves | Retained earnings | **Total Share-holders' equity** | Non-controlling interest | **Total equity** |
|---|---|---|---|---|---|---|
| **Changes in equity from 1 January to 30 June 2013** | | | | | | |
| Equity 1 January 2013 | 75,861 | 1,639 | 49,572 | 127,072 | 3,806 | 130,878 |
| Total comprehensive income for the period | | (1) | 6,137 | 6,136 | (226) | 5,910 |
| **Equity 30 June 2013** | 75,861 | 1,638 | 55,709 | 133,208 | 3,580 | 136,788 |
| **Changes in equity from 1 January to 30 June 2012** | | | | | | |
| Equity 1 January 2012 | 75,861 | 1,637 | 32,950 | 110,448 | 4,110 | 114,558 |
| Total comprehensive income for the period | | | 11,052 | 11,052 | 197 | 11,249 |
| Acquisition of non-controlling interest | | | | | (664) | (664) |
| **Equity 30 June 2012** | 75,861 | 1,637 | 44,002 | 121,500 | 3,643 | 125,143 |

*The notes on pages 10 to 52 are an integral part of these Interim Consolidated Financial Statements.*

*Arion Bank Interim Consolidated Financial Statements 30 June 2013* 8 *Amounts are in ISK millions*

# CONDENSED INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2013

| | Notes | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. |
|---|---|---|---|
| **Cash flows from (used in) operating activities:** | | | |
| Earnings before tax | | 7,913 | 13,293 |
| 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 | 52 | (238) | (3,057) |
| Changes in operating assets and liabilities | 53 | (6,700) | (18,393) |
| Income tax and Bank Levy paid | | (969) | (2,129) |
| Net cash from (used in) operating activities | | 6 | (10,286) |
| Net cash from (used in) investing activities | | (2,185) | 3,228 |
| Net increase (decrease) in cash and cash equivalents | | (2,179) | (7,058) |
| Cash and cash equivalents at beginning of the period | | 105,173 | 82,815 |
| Effect of exchange rate changes on cash and cash equivalents | | (5,099) | 879 |
| **Cash and cash equivalents at the end of the period** | | 97,895 | 76,636 |
| | | | |
| **Cash and cash equivalents comprises:** | | | |
| Cash in hand and demand deposits | | 25,717 | 16,280 |
| Due from credit institutions | | 81,282 | 67,951 |
| Mandatory reserve with Central Bank | | (9,104) | (7,595) |
| Cash and cash equivalents at the end of the period | | 97,895 | 76,636 |
| | | | |
| **Non-cash investing and financing transactions:** | | | |
| Assets acquired through foreclosure on collateral from customers with view to resale | | 8,117 | 655 |
| Settlement of loans and receivables through foreclosure on collateral from customers with view to resale | | (8,117) | (655) |

*The notes on pages 10 to 52 are an integral part of these Interim Consolidated Financial Statements.*

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS
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# NOTES TO THE INTERIM 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 Interim Consolidated Financial Statements for the period ended 30 June 2013 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

The Interim Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 29 August 2013.

2. Basis of preparation

a) *Statement of compliance*
The Interim Consolidated Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standard IAS 34, Interim Financial Reporting as endorsed by the European Union. The Interim Consolidated Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Arion Bank´s annual Financial Statements for the year 2012. The statements are available at Arion Bank's website www.arionbanki.is.

b) *Basis of measurement*
The Interim Consolidated 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 Interim Consolidated 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 Interim Consolidated 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 Interim Consolidated 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 Interim Consolidated 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 Interim Consolidated Financial Statements and estimates with a risk of material adjustment within the next financial year are discussed in Note 4 in these Interim Consolidated Financial Statements and in the annual Consolidated Financial Statements for 2012.

**Significant accounting policies**

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

The Group has implemented International Financial Reporting Standards endorsed by the EU with effective dates in 2013. The adoption of these new and revised standards had no impact on the financial position and financial results of the Group.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

3. Going concern assumption

The Interim Consolidated Financial Statements are prepared on a going concern basis. 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 in the Group's Financial Statements for the year 2012.

4. Significant accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets, liabilities, revenues 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 Interim Consolidated 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 Interim Consolidated 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.

ii) Foreign loan portfolio

In 2011 the Group recognised the estimated 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 51 of these Interim Consolidated Financial Statements, the Group recognised impairment of the foreign loan portfolio at the end of the respective periods 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 above judgments, and secondly, the outcome of future legal decisions and new or amended government legislation.

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

4. cont.

As set out in Note 21 in the annual Consolidated Financial Statements for the year 2012, 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, 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. 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.

**The Group**

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

| | | | Equity interest in % | |
|---|---|---|---|---|
| Company: | Country | Currency | 30.06.2013 | 31.12.2012 |
| AFL - sparisjódur, Adalgata 34, Siglufjördur | Iceland | ISK | 99.3 | 99.3 |
| ALT ehf., Borgartún 19, Reykjavík | Iceland | ISK | 100.0 | 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 |
| Eignarhaldsfélagid Landey ehf., Hátún 2b, Reykjavík | Iceland | ISK | 100.0 | 100.0 |
| Einkaklúbburinn ehf., Borgartún 19, Reykjavík | Iceland | ISK | 100.0 | 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 |
| 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 |
| Stefnir hf., Borgartún 19, Reykjavík | Iceland | ISK | 100.0 | 100.0 |
| Tekjuvernd ehf., Hlídarsmári 17, Kópavogur | Iceland | ISK | 100.0 | 100.0 |
| Valitor Holding hf., Laugavegur 77, Reykjavík | Iceland | ISK | 60.8 | 60.8 |

In addition the Bank holds subsidiaries classified as a Non-current assets and disposal groups held for sale, see Note 38.

6. Changes within the Group

In March 2013 Fram Foods ehf. sold its subsidiary Fram Foods Ísland hf. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. Fram Foods Ísland hf. was classified as non-current assets and disposal groups held for sale at year-end 2012. The effects from the sale of this entity has minor effects on the Interim Consolidated Statement of Comprehensive Income.

In June 2013 GIR Fund Management Ltd. was dissolved and assets of the company transferred to Arion Bank hf. This transaction has minor effects on the Interim Consolidated Statement of Comprehensive Income.

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## OPERATING SEGMENT REPORTING

7. 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.

   Segment capital expenditure is the total cost incurred during the period to acquire property and equipment and intangible assets.

   **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 when necessary.

   **Retail Banking**, Arion Bank Mortgages Institutional Investor Fund and AFL - spairsjódur 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 market making in domestic securities and currencies. The subsidiaries are Eignabjarg ehf., Eignarhaldsfélagid Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

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

8. Summary of the Group's business segments:

| 1.1.-30.6.2013 | Corporate Banking | Retail Banking | Asset Management and Stefnir | Investment Banking | Treasury | Other divisions and Subsidiaries | Headquarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 4,508 | 5,644 | 310 | 80 | 2,837 | (817) | 105 | 12,667 |
| Other income | 668 | (964) | 1,494 | 3,362 | (512) | 3,706 | 399 | 8,153 |
| **Operating income** | 5,176 | 4,680 | 1,804 | 3,442 | 2,325 | 2,889 | 504 | 20,820 |
| Operating expense | (326) | (2,849) | (635) | (323) | (120) | (2,843) | (5,811) | (12,907) |
| **Earnings before tax** | 4,850 | 1,831 | 1,169 | 3,119 | 2,205 | 46 | (5,307) | 7,913 |
| Net seg. rev. from ext. customers | 9,439 | 9,480 | 534 | 3,378 | (6,212) | 4,212 | (11) | 20,820 |
| Net seg. rev. from other segments | (4,263) | (4,800) | 1,270 | 64 | 8,537 | (1,323) | 515 | - |
| **Operating income** | 5,176 | 4,680 | 1,804 | 3,442 | 2,325 | 2,889 | 504 | 20,820 |
| Depreciation and amortisation | - | 88 | - | - | - | 102 | 360 | 550 |
| **Total assets** | 241,404 | 332,237 | 4,180 | 32,080 | 238,412 | 80,717 | - | 929,030 |
| **Total liabilities** | 202,780 | 302,964 | 2,042 | 26,947 | 205,518 | 51,991 | - | 792,242 |
| **Allocated equity** | 38,624 | 29,273 | 2,138 | 5,133 | 32,894 | 28,726 | - | 136,788 |

| 1.1.-30.6.2012 | Corporate Banking | Retail Banking | Asset Management and Stefnir | Investment Banking | Treasury | Other divisions and Subsidiaries | Headquarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 5,493 | 5,083 | 1,031 | 100 | 3,132 | (908) | (51) | 13,880 |
| Other income | 2,808 | (581) | 1,087 | 3,313 | (90) | 4,358 | 162 | 11,057 |
| **Operating income** | 8,301 | 4,502 | 2,118 | 3,413 | 3,042 | 3,450 | 111 | 24,937 |
| Operating expense | (314) | (2,768) | (561) | (293) | (90) | (2,610) | (5,008) | (11,644) |
| **Earnings before tax** | 7,987 | 1,734 | 1,557 | 3,120 | 2,952 | 840 | (4,897) | 13,293 |
| Net seg. rev. from ext. customers | 13,455 | 11,068 | (414) | 3,477 | (7,708) | 4,352 | 707 | 24,937 |
| Net seg. rev. from other segments | (5,154) | (6,566) | 2,532 | (64) | 10,750 | (902) | (596) | - |
| **Operating income** | 8,301 | 4,502 | 2,118 | 3,413 | 3,042 | 3,450 | 111 | 24,937 |
| Depreciation and amortisation | - | 84 | - | - | - | 109 | 270 | 463 |
| **Total assets** | 269,326 | 314,155 | 3,603 | 19,709 | 180,141 | 93,116 | - | 880,050 |
| **Total liabilities** | 226,234 | 289,598 | 1,005 | 16,556 | 139,069 | 82,445 | - | 754,907 |
| **Allocated equity** | 43,092 | 24,557 | 2,598 | 3,153 | 41,072 | 10,671 | - | 125,143 |

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

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

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## QUARTERLY STATEMENTS

9. Operations by quarters

| 2013 | Q2 | Q1 | Total |
|---|---|---|---|
| Net interest income | 6,379 | 6,288 | 12,667 |
| Increase in book value of loans and receivables | 4,425 | 2,373 | 6,798 |
| Impairment of loans and receivables | (3,969) | (2,695) | (6,664) |
| Net fee and commission income | 2,849 | 2,449 | 5,298 |
| Net financial income (expense) | 974 | 570 | 1,544 |
| Net foreign exchange gain (loss) | 149 | (1,397) | (1,248) |
| Other income | 1,249 | 1,176 | 2,425 |
| **Operating income** | 12,056 | 8,764 | 20,820 |
| Salaries and related expense | (3,357) | (3,322) | (6,679) |
| Other expense | (2,951) | (3,277) | (6,228) |
| **Earnings before tax** | 5,748 | 2,165 | 7,913 |
| Income tax expense | (1,163) | (586) | (1,749) |
| Bank Levy | (97) | (91) | (188) |
| **Net earnings from continuing operations** | 4,488 | 1,488 | 5,976 |
| Net gain (loss) from discontinued operations, net of tax | 14 | (79) | (65) |
| **Net earnings** | 4,502 | 1,409 | 5,911 |

| 2012 | | | |
|---|---|---|---|
| Net interest income | 7,666 | 6,214 | 13,880 |
| Increase in book value of loans and receivables | 7,049 | 119 | 7,168 |
| Impairment of loans and receivables | (4,441) | (195) | (4,636) |
| Net fee and commission income | 3,002 | 2,336 | 5,338 |
| Net financial income (expense) | (16) | 346 | 330 |
| Net foreign exchange gain (loss) | (1,232) | 1,083 | (149) |
| Other income | 2,054 | 952 | 3,006 |
| **Operating income** | 14,082 | 10,855 | 24,937 |
| Salaries and related expense | (3,124) | (3,045) | (6,169) |
| Other expense | (2,718) | (2,757) | (5,475) |
| **Earnings before tax** | 8,240 | 5,053 | 13,293 |
| Income tax expense | (1,852) | (1,061) | (2,913) |
| Bank Levy | (242) | (268) | (510) |
| **Net earnings from continuing operations** | 6,146 | 3,724 | 9,870 |
| Net gain (loss) from discontinued operations, net of tax | 652 | 727 | 1,379 |
| **Net earnings** | 6,798 | 4,451 | 11,249 |

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 INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

**Net interest income**

| 10. Interest income and interest expense is specified as follows: | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.4.-30.6. | 2012<br>1.4.-30.6. |
|---|---|---|---|---|
| Cash and balances with Central Bank | 463 | 301 | 144 | 130 |
| Loans and receivables | 24,718 | 27,478 | 10,998 | 14,594 |
| Securities | 4,484 | 4,164 | 2,206 | 2,017 |
| Other | 384 | 210 | 229 | 114 |
| **Interest income** | 30,049 | 32,153 | 13,577 | 16,855 |
| Deposits | (9,906) | (9,621) | (4,346) | (4,686) |
| Borrowings | (6,772) | (7,751) | (2,507) | (4,105) |
| Subordinated liabilities | (662) | (811) | (327) | (381) |
| Other | (42) | (90) | (18) | (17) |
| **Interest expense** | (17,382) | (18,273) | (7,198) | (9,189) |
| **Net interest income** | 12,667 | 13,880 | 6,379 | 7,666 |
| Net interest income from assets and liabilities at fair value | 4,484 | 4,164 | 2,206 | 2,017 |
| Interest income from assets not at fair value | 25,565 | 27,989 | 11,371 | 14,838 |
| Interest expense from liabilities not at fair value | (17,382) | (18,273) | (7,198) | (9,189) |
| **Net interest income** | 12,667 | 13,880 | 6,379 | 7,666 |

**Reversal of impairment (acquired and incurred) on loans and receivables**

11. Reversal of impairment (acquired and incurred) on loans and receivables:

| | | | | |
|---|---|---|---|---|
| Reversal of impairment on loans and receivables to corporates | 6,482 | 6,975 | 4,247 | 6,914 |
| Reversal of impairment on loans and receivables to individuals | 316 | 193 | 178 | 135 |
| **Reversal of Impairment (acquired and incurred) on loans and receivables** | 6,798 | 7,168 | 4,425 | 7,049 |

**Impairment of loans and receivables**

| 12. Impairment of loans and receivables is specified as follows: | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.4.-30.6. | 2012<br>1.4.-30.6. |
|---|---|---|---|---|
| Impairment (reversal) of loans and receivables to credit institutions | (23) | (2) | 8 | (31) |
| Impairment of loans and receivables to customers | 6,687 | 4,638 | 3,961 | 4,472 |
| **Impairment of loans and receivables** | 6,664 | 4,636 | 3,969 | 4,441 |

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**Net fee and commission income**

13. Fee and commission income and expense is specified as follows:

| | 2013 | 2012 | 2013 | 2012 |
|---|---|---|---|---|
| **Fee and commission income** | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Asset management | 1,720 | 1,214 | 847 | 691 |
| Cards | 3,556 | 4,477 | 1,871 | 2,231 |
| Collection and payment services | 552 | 494 | 302 | 260 |
| Investment banking | 631 | 467 | 417 | 344 |
| Interbank clearing | 352 | 349 | 179 | 174 |
| Lending and guarantees | 388 | 452 | 202 | 203 |
| Other fee and commission income | 541 | 515 | 262 | 259 |
| **Fee and commission income** | 7,740 | 7,968 | 4,080 | 4,162 |
| **Fee and commission expense** | | | | |
| Asset management | (96) | (101) | (49) | (44) |
| Cards | (1,720) | (1,910) | (857) | (848) |
| Collection and payment services | (9) | (9) | (5) | (4) |
| Investment banking | (22) | (27) | (10) | (9) |
| Interbank clearing | (352) | (360) | (179) | (180) |
| Other fee and commission expense | (243) | (224) | (131) | (76) |
| **Fee and commission expense** | (2,442) | (2,630) | (1,231) | (1,160) |
| **Net fee and commission income** | 5,298 | 5,338 | 2,849 | 3,002 |

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.

**Net financial income (expense)**

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

| | 2013 | 2012 | 2013 | 2012 |
|---|---|---|---|---|
| | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Dividend income | 46 | 21 | 42 | 19 |
| Net gain (loss) on financial assets and financial liabilities classified as held for trading | 197 | (307) | 75 | (254) |
| Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss | 1,301 | 616 | 857 | 219 |
| **Net financial income (expense)** | 1,544 | 330 | 974 | (16) |

15. Dividend income is specified as follows:

| | | | | |
|---|---|---|---|---|
| Dividend income on trading assets | 9 | 15 | 5 | 13 |
| Dividend income on financial assets designated at fair value through profit or loss | 37 | 6 | 37 | 6 |
| **Dividend income** | 46 | 21 | 42 | 19 |

16. 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 | 329 | 86 | 113 | (12) |
| Net gain (loss) on interest rate instruments and related derivatives | (16) | (454) | (18) | (177) |
| Net gain (loss) on other derivatives | (116) | 61 | (20) | (65) |
| **Net gain (loss) on financial assets and financial liabilities held for trading** | 197 | (307) | 75 | (254) |

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

| | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.4.-30.6. | 2012<br>1.4.-30.6. |
|---|---|---|---|---|
| Net gain (loss) on interest rate instruments designated at fair value | 537 | 373 | 430 | (30) |
| Net gain (loss) on equity instruments designated at fair value | 764 | 243 | 427 | 249 |
| **Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss** | 1,301 | 616 | 857 | 219 |

**Net foreign exchange gain (loss)**

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

| | | | | |
|---|---|---|---|---|
| From loans and receivables | (6,702) | 324 | 787 | (5,132) |
| From cash and cash equivalents | (5,099) | 879 | 231 | (1,468) |
| From deposits and borrowings | 8,393 | (1,359) | (284) | 4,349 |
| From subordinated liabilities | 1,729 | (65) | (465) | 1,876 |
| On bonds, equity instruments and derivatives | 753 | 113 | (81) | (676) |
| On other assets and liabilities | (322) | (41) | (39) | (181) |
| **Net foreign exchange gain (loss)** | (1,248) | (149) | 149 | (1,232) |

**Other operating income**

19. Other operating income is specified as follows:

| | | | | |
|---|---|---|---|---|
| Rental income from investment properties | 1,113 | 1,004 | 554 | 516 |
| Fair value changes on investment property | 307 | 719 | 307 | 686 |
| Realised gain (loss) on investment property | 108 | 97 | (25) | 80 |
| Earned premiums, net of reinsurance | 533 | 421 | 278 | 207 |
| Net gain on disposals of assets other than held for sale | 5 | 385 | - | 367 |
| Other income | 371 | 373 | 147 | 196 |
| **Other operating income** | 2,437 | 2,999 | 1,261 | 2,052 |

**Personnel and salaries**

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

| | | | | |
|---|---|---|---|---|
| Average number of full time equivalent positions during the period | 1,177 | 1,159 | 1,182 | 1,161 |
| Full time equivalent positions at the end of the period | 1,153 | 1,173 | 1,153 | 1,173 |

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

| | | | | |
|---|---|---|---|---|
| Average number of full time equivalent positions during the period | 939 | 912 | 929 | 914 |
| Full time equivalent positions at the end of the period | 918 | 920 | 918 | 920 |

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Salaries and related expense are specified as follows:

| | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.4.-30.6. | 2012<br>1.4.-30.6. |
|---|---|---|---|---|
| Salaries | 5,095 | 4,710 | 2,557 | 2,361 |
| Defined contribution pension plans | 664 | 645 | 322 | 322 |
| Salary related expense | 920 | 814 | 478 | 441 |
| **Salaries and related expense** | 6,679 | 6,169 | 3,357 | 3,124 |

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

| | | | | |
|---|---|---|---|---|
| Salaries | 4,043 | 3,754 | 2,034 | 1,878 |
| Defined contribution pension plans | 527 | 507 | 256 | 254 |
| Salary related expense | 735 | 559 | 374 | 299 |
| **Salaries and related expense** | 5,305 | 4,820 | 2,664 | 2,430 |

**Other operating expense**

22. Other operating expense is specified as follows:

| | | | | |
|---|---|---|---|---|
| Direct operating expense derived from rental-earning investment properties | 256 | 247 | 115 | 132 |
| Claims incurred, net of reinsurance | 171 | 173 | 89 | 91 |
| Other expense | 3 | - | 3 | - |
| **Other operating expense** | 430 | 420 | 207 | 223 |

**Tax expense**

23. Income tax recognised in the Interim Consolidated Statement of Comprehensive Income is specified as follows:

| | | | | |
|---|---|---|---|---|
| *Current tax expense* | | | | |
| Current period | 2,109 | 2,996 | 1,215 | 2,164 |
| *Deferred tax expense* | | | | |
| Changes in temporary differences | (360) | (83) | (52) | (312) |
| **Total income tax expense** | 1,749 | 2,913 | 1,163 | 1,852 |

The Icelandic corporation tax rate is 20%. Effective tax rate of the Group is 22.1% and reconciles as follows:

| | 1.1.-30.6.2013 | | 1.1.-30.6.2012 | |
|---|---|---|---|---|
| Earnings before tax | | 7,913 | | 13,293 |
| Income tax using the Icelandic corporation tax rate | 20.0% | 1,583 | 20.0% | 2,658 |
| Additional 6% tax on financial institutions | 6.0% | 478 | 5.2% | 696 |
| Non-deductible expense | 1.7% | 135 | 0.1% | 14 |
| Tax exempt revenues | (3.7%) | (296) | (0.6%) | (78) |
| Tax incentives not recognised in the Statement of Comprehensive Income | (1.9%) | (154) | (2.7%) | (365) |
| Non-deductible taxes | 0.0% | - | 0.7% | 98 |
| Other changes | 0.0% | 3 | (0.8%) | (110) |
| **Effective tax rate** | 22.1% | 1,749 | 21.9% | 2,913 |

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1,0 billion.

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24. Bank Levy

Bank levy is calculated according to law. The levy is 0.041% on total debt excluding tax liabilities at end of the period. 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**

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

| | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.4.-30.6. | 2012<br>1.4.-30.6. |
|---|---|---|---|---|
| Net gain (loss) from legal entities | 11 | 900 | (1) | 97 |
| Net gain (loss) from associated companies | - | 868 | - | 868 |
| Net gain (loss) from real estate | (76) | (86) | 15 | (43) |
| Net gain (loss) from other assets | - | (303) | - | (270) |
| **Net gain (loss) from discontinued operations, net of tax** | (65) | 1,379 | 14 | 652 |

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

**Earnings per share**

26. Earnings per share are specified as follows:

| | Discontinued operations | | | |
|---|---|---|---|---|
| | Excluded | | Included | |
| | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. |
| Net earnings attributable to the shareholders of Arion Bank | 6,202 | 9,673 | 6,137 | 11,052 |
| Weighted average share capital: | | | | |
| Weighted average number of outstanding shares for the period, million | 2,000 | 2,000 | 2,000 | 2,000 |
| Basic earnings per share | 3.10 | 4.84 | 3.07 | 5.53 |
| Number of outstanding shares at the end of the period, million | 2,000 | 2,000 | 2,000 | 2,000 |

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

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

**Cash and balances with Central Bank**

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Cash on hand | 3,558 | 3,495 | 3,975 |
| Cash with Central Bank | 13,055 | 17,514 | 4,710 |
| Mandatory reserve deposit with Central Bank | 9,104 | 8,737 | 7,595 |
| **Cash and balances with Central Bank** | 25,717 | 29,746 | 16,280 |

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**

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Bank accounts | 81,282 | 84,164 | 67,951 |
| Money market loans | 25,409 | 13,763 | 822 |
| Other loans | 3,822 | 3,888 | 3,768 |
| Provision on loans and receivables | (781) | (804) | (772) |
| **Loans and receivables to credit institutions** | 109,732 | 101,011 | 71,769 |

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Balance at the beginning of the period | 804 | 774 | 774 |
| Provision for losses (reversal) during the period | (23) | 70 | (2) |
| Write-offs during the period | - | (40) | - |
| **Provision for losses on loans and receivables to credit institutions** | 781 | 804 | 772 |

**Loans and receivables to customers**

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

| 30.06.2013 | Individuals | Corporates | Total |
|---|---|---|---|
| Overdrafts | 17,927 | 18,771 | 36,698 |
| Credit cards | 10,421 | 855 | 11,276 |
| Mortgage loans | 201,381 | 5,932 | 207,313 |
| Subordinated loans | - | 545 | 545 |
| Other loans and receivables | 38,636 | 316,133 | 354,769 |
| Provision on loans and receivables | (14,497) | (28,847) | (43,344) |
| **Loans and receivables to customers** | 253,868 | 313,389 | 567,257 |

| 31.12.2012 | 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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30. cont.

| 30.06.2012 | Individuals | Corporates | Total |
|---|---|---|---|
| Overdrafts | 16,602 | 16,827 | 33,429 |
| Credit cards | 10,210 | 814 | 11,024 |
| Mortgage loans | 194,931 | 4,106 | 199,037 |
| Subordinated loans | - | 544 | 544 |
| Other loans and receivables | 37,787 | 354,217 | 392,004 |
| Provision on loans and receivables | (21,386) | (35,766) | (57,152) |
| **Loans and receivables to customers** | 238,144 | 340,742 | 578,886 |

The total book value of pledged loans at the end of the period was ISK 172 billion (31.12.2012: ISK 167 billion and 30.6.2012: ISK 172 billion). Pledged loans 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.

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

1.1.-30.6.2013

| | Specific | FX rulings | Collective | Total |
|---|---|---|---|---|
| Balance at the beginning of the period | 41,499 | 14,942 | 3,341 | 59,782 |
| Provision for losses during the period | 3,130 | 3,897 | (340) | 6,687 |
| Write-offs during the period | (10,661) | (9,674) | (17) | (20,352) |
| Transferred to liabilities | - | (2,974) | - | (2,974) |
| Payment of loans previously written off | 201 | - | - | 201 |
| **Balance at the end of the period** | 34,169 | 6,191 | 2,984 | 43,344 |

1.1.-31.12.2012

| | | | | |
|---|---|---|---|---|
| Balance at the beginning of the year | 32,953 | 13,823 | 9,513 | 56,289 |
| Provision for losses during the year | 11,818 | 5,744 | (118) | 17,444 |
| Write-offs during the year | (3,830) | - | (6,054) | (9,884) |
| Transferred to liabilities | - | (4,625) | - | (4,625) |
| Payment of loans previously written off | 557 | - | - | 557 |
| **Balance at the end of the year** | 41,498 | 14,942 | 3,341 | 59,781 |

1.1.-30.6.2012

| | | | | |
|---|---|---|---|---|
| Balance at the beginning of the period | 32,953 | 13,823 | 9,513 | 56,289 |
| Provision for losses during the period | 7,402 | 640 | (3,404) | 4,638 |
| Write-offs during the period | (1,174) | - | (2,792) | (3,966) |
| Payment of loans previously written off | 191 | - | - | 191 |
| **Balance at the end of the period** | 39,372 | 14,463 | 3,317 | 57,152 |

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**Financial assets and financial liabilities**

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

| 30.6.2013 | Amortised cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans and receivables* | | | | |
| Cash and balances with Central Bank | 25,717 | - | - | 25,717 |
| Loans and receivables to credit institutions | 109,732 | - | - | 109,732 |
| Loans and receivables to customers | 567,257 | - | - | 567,257 |
| **Loans and receivables** | 702,706 | - | - | 702,706 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 4,418 | 41,372 | 45,790 |
| Unlisted | - | 143 | 86,811 | 86,954 |
| **Bonds and debt instruments** | - | 4,561 | 128,183 | 132,744 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 1,062 | 2,562 | 3,624 |
| Unlisted | - | 1,226 | 8,329 | 9,555 |
| Bond funds with variable income | - | 2,018 | 1,538 | 3,556 |
| **Shares and equity instruments** | - | 4,306 | 12,429 | 16,735 |
| *Derivatives* | | | | |
| OTC derivatives | - | 832 | - | 832 |
| **Derivatives** | - | 832 | - | 832 |
| *Securities used for hedging* | | | | |
| Bonds and debt instruments | - | 526 | - | 526 |
| Shares and equity instruments | - | 2,934 | - | 2,934 |
| **Securities used for hedging** | - | 3,460 | - | 3,460 |
| Other financial assets | 4,459 | - | - | 4,459 |
| **Financial assets** | 707,165 | 13,159 | 140,612 | 860,936 |
| *Liabilities at amortised cost* | | | | |
| Due to credit institutions and Central Bank | 25,727 | - | - | 25,727 |
| Deposits | 466,834 | - | - | 466,834 |
| Borrowings | 203,100 | - | - | 203,100 |
| Subordinated liabilities | 32,503 | - | - | 32,503 |
| **Liabilities at amortised cost** | 728,164 | - | - | 728,164 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 9,150 | - | 9,150 |
| Derivatives | - | 855 | - | 855 |
| **Financial liabilities at fair value** | - | 10,005 | - | 10,005 |
| Other financial liabilities | 43,187 | - | - | 43,187 |
| **Financial liabilities** | 771,351 | 10,005 | - | 781,356 |

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32. cont.

| 31.12.2012 | 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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32. cont.

| 30.06.2012 | Amortised cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans and receivables* | | | | |
| Cash and balances with Central Bank | 16,280 | - | - | 16,280 |
| Loans and receivables to credit institutions | 71,769 | - | - | 71,769 |
| Loans and receivables to customers | 578,886 | - | - | 578,886 |
| **Loans and receivables** | 666,935 | - | - | 666,935 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 5,070 | 53,170 | 58,240 |
| Unlisted | - | 62 | 70,551 | 70,613 |
| **Bonds and debt instruments** | - | 5,132 | 123,721 | 128,853 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 1,643 | 1,340 | 2,983 |
| Unlisted | - | 714 | 8,000 | 8,714 |
| Bond funds with variable income | - | 1,976 | 1,735 | 3,711 |
| **Shares and equity instruments** | - | 4,333 | 11,075 | 15,408 |
| *Derivatives* | | | | |
| OTC derivatives | - | 1,363 | - | 1,363 |
| **Derivatives** | - | 1,363 | - | 1,363 |
| *Securities used for hedging* | | | | |
| Bonds and debt instruments | - | 418 | - | 418 |
| Shares and equity instruments | - | 1,098 | - | 1,098 |
| **Securities used for hedging** | - | 1,516 | - | 1,516 |
| Other financial assets | 5,440 | - | - | 5,440 |
| **Financial assets** | 672,375 | 12,344 | 134,796 | 819,515 |
| *Liabilities at amortised cost* | | | | |
| Due to credit institutions and Central Bank | 20,837 | - | - | 20,837 |
| Deposits | 445,249 | - | - | 445,249 |
| Borrowings | 192,953 | - | - | 192,953 |
| Subordinated liabilities | 32,175 | - | - | 32,175 |
| **Liabilities at amortised cost** | 691,214 | - | - | 691,214 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 10,008 | - | 10,008 |
| Derivatives | - | 431 | - | 431 |
| **Financial liabilities at fair value** | - | 10,439 | - | 10,439 |
| Other financial liabilities | 39,230 | - | - | 39,230 |
| **Financial liabilities** | 730,444 | 10,439 | - | 740,883 |

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Financial and insurance services | 70,238 | 70,142 | 68,981 |
| Governments | 56,862 | 40,679 | 46,317 |
| Corporates | 1,083 | 1,262 | 8,423 |
| **Bonds and debt instruments designated at fair value** | 128,183 | 112,083 | 123,721 |

The total amount of pledged bonds at the end of the period was ISK 19.1 billion (31.12.2012: ISK 35.7 billion and 30.6.2012: ISK 21.3billion). Pledged bonds comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

34. 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.

Further information regarding fair value measurement are set out in Note 71 in the annual Consolidated Financial Statements for the year 2012.

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

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

| 30.06.2013 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Financial assets designated at FV through P/L | | | | |
| Bonds and debt instruments | 2,969 | 124,056 | 1,158 | 128,183 |
| Shares and equity instruments with variable income | 1,835 | 10,238 | 356 | 12,429 |
| | 4,804 | 134,294 | 1,514 | 140,612 |
| Financial assets held for trading | | | | |
| Bonds and debt instruments | 2,778 | 1,762 | 21 | 4,561 |
| Shares and equity instruments with variable income | 1,062 | 3,244 | - | 4,306 |
| Derivatives | - | 832 | - | 832 |
| Securities used for hedging | 2,305 | 1,155 | - | 3,460 |
| | 6,145 | 6,993 | 21 | 13,159 |
| | 10,949 | 141,287 | 1,535 | 153,771 |
| Financial liabilities held for trading | | | | |
| Short position in bonds | 9,150 | - | - | 9,150 |
| Derivatives | - | 855 | - | 855 |
| | 9,150 | 855 | - | 10,005 |

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34. cont.

| 31.12.2012 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Financial assets designated at FV through P/L | | | | |
| Bonds and debt instruments | 2,277 | 108,408 | 1,398 | 112,083 |
| Shares and equity instruments with variable income | 1,425 | 10,870 | 515 | 12,810 |
| | 3,702 | 119,278 | 1,914 | 124,893 |
| Financial assets held for trading | | | | |
| Bonds and debt instruments | 2,120 | 3,506 | 21 | 5,647 |
| Shares and equity instruments with variable income | 374 | 3,660 | - | 4,034 |
| Derivatives | - | 788 | - | 788 |
| Securities used for hedging | 1,732 | 706 | - | 2,438 |
| | 4,226 | 8,660 | 21 | 12,907 |
| | 7,928 | 127,938 | 1,935 | 137,800 |
| Financial liabilities held for trading | | | | |
| Short position in bonds | 12,490 | - | - | 12,490 |
| Derivatives | - | 975 | - | 975 |
| | 12,490 | 975 | - | 13,465 |

| 30.06.2012 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Financial assets designated at FV through P/L | | | | |
| Bonds and debt instruments | 5,957 | 116,432 | 1,332 | 123,721 |
| Shares and equity instruments with variable income | 174 | 10,412 | 490 | 11,075 |
| | 6,130 | 126,843 | 1,822 | 134,796 |
| Financial assets held for trading | | | | |
| Bonds and debt instruments | 5,059 | 51 | 22 | 5,132 |
| Shares and equity instruments with variable income | 1,643 | 2,690 | - | 4,333 |
| Derivatives | - | 1,363 | - | 1,363 |
| Securities used for hedging | 1,516 | - | - | 1,516 |
| | 8,218 | 4,104 | 22 | 12,344 |
| | 14,348 | 130,947 | 1,844 | 147,140 |
| Financial liabilities held for trading | | | | |
| Short position in bonds | 10,008 | - | - | 10,008 |
| Derivatives | - | 431 | - | 431 |
| | 10,008 | 431 | - | 10,439 |

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2013 is consistent with the classification used in 2012.

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34. cont.

There have been no transfers between Level 1 and Level 2 in 2013 and 2012.

*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 period. The following table shows the movements of Level 3 financial assets and financial liabilities:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Balance at the beginning of the period | 1,935 | 2,021 | 2,021 |
| Gain (loss) recognised in Statement of Comprehensive Income | 62 | 191 | 114 |
| Acquisition | - | 105 | 88 |
| Disposal | (369) | (391) | (388) |
| Transfers into Level 3 | - | 9 | 9 |
| Transfers out of Level 3 | (92) | - | - |
| **Balance at the end of the period** | 1,536 | 1,935 | 1,844 |

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

| | 2013<br>1.1.-30.6. | 2012<br>1.1.-31.12. | 2012<br>1.1.-30.6. |
|---|---|---|---|
| Net interest income | 50 | 151 | 88 |
| Net financial income (expense) | 30 | 3 | (1) |
| Net foreign exchange gain (loss) | (18) | 37 | 27 |
| **Gain (loss) recognised in the Interim Consolidated Statement of Comprehensive Income** | 62 | 191 | 114 |

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 Interim Consolidated Financial Statements. The table does not include the fair values of non-financial assets and non-financial liabilities.

30.06.2013

| Financial assets not carried at fair value | Carrying value | Fair value | Unrealised gain (loss) |
|---|---|---|---|
| Cash and balances with Central bank | 25,717 | 25,717 | - |
| Loans and receivables to credit institutions | 109,732 | 109,732 | - |
| Loans and receivables to customers | 567,257 | 555,774 | (11,483) |
| Other financial assets | 4,459 | 4,459 | - |
| **Financial assets not carried at fair value** | 707,165 | 695,682 | (11,483) |

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34. cont.

| Financial liabilities not carried at fair value | Carrying value | Fair value | Unrealised gain (loss) |
|---|---|---|---|
| Due to credit institutions and Central bank | 25,727 | 25,727 | - |
| Deposits | 466,834 | 466,575 | 259 |
| Borrowings | 203,100 | 197,231 | 5,869 |
| Subordinated loans | 32,503 | 32,503 | - |
| Other financial liabilities | 43,187 | 43,187 | - |
| **Financial liabilities not carried at fair value** | 771,351 | 765,223 | 6,128 |

**Net unrealised gain (loss) not recognised in the Interim Consolidated Statement of Comprehensive Income** (5,355)

31.12.2012

| Financial assets not carried at fair value | Carrying value | Fair value | Unrealised 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 | 192,222 | 2,863 |
| Subordinated loans | 34,220 | 34,220 | - |
| Other financial liabilities | 35,141 | 35,141 | - |
| **Financial liabilities not carried at fair value** | 746,119 | 743,620 | 2,499 |

**Net unrealised gain (loss) not recognised in the Interim Consolidated Statement of Comprehensive Income** (8,643)

Comparative information for 30 June 2012 is not available.

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

**Investment property**

35. Investment property is specified as follows:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Balance at the beginning of the period | 28,919 | 27,100 | 27,100 |
| Additions during the period | 971 | 3,729 | 2,322 |
| Disposals during the period | (1,432) | (3,494) | (1,762) |
| Transferred from property and equipment | 146 | - | - |
| Fair value adjustments | 307 | 1,584 | 719 |
| **Investment property** | 28,911 | 28,919 | 28,379 |

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**Investments in associates**

| 36. The Group´s interest in its principal associates are as follows: | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland | 20.0% | 20.0% | 20.0% |
| Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom | 30.1% | 30.1% | 31.3% |
| Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland | 43.5% | 43.5% | 43.5% |
| GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland | 30.0% | 30.0% | 30.0% |
| Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland | 36.3% | 36.3% | 36.3% |
| Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland | - | - | 25.0% |
| Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland | 23.3% | 23.3% | 23.3% |
| Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland | 42.7% | 42.7% | 42.7% |
| Sementsverksmidjan ehf., Mánabraut 20, 300 Akranes, Iceland | 23.6% | 23.6% | 23.6% |
| Skipti hf., Ármúla 25, 108 Reykjavík, Iceland | 38.2% | - | - |
| SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland | 39.1% | 39.1% | 39.1% |

Investments in associates are specified as follows:

| | | | |
|---|---|---|---|
| Carrying amount at the beginning of the period | 7,050 | 2,987 | 2,987 |
| Additions during the period | 7,386 | 1,658 | 26 |
| Share of profit (loss) of associates and reversal of impairment | (12) | 2,405 | 7 |
| **Investment in associates** | 14,424 | 7,050 | 3,020 |

On 30 April 2013 creditors of Skipti hf. reached an agreement on financial restructuring of Skipti hf. Arion bank hf., the largest creditor, converted claims to shares and holds 38.2% of shares in Skipti hf. The shareholders of Skipti hf. aim to list the company at NASDAQ OMX Iceland.

The carrying value of investments in associates is significantly below the net asset values disclosed in financial reports of associates. Note 73 in the annual Consolidated Financial Statements for 2012 discloses summarised financial information in respect of this gap as at 31 December 2012.

**Tax assets and tax liabilities**

| 37. Tax assets and tax liabilities are specified as follows: | 30.06.2013 | | 31.12.2012 | | 30.06.2012 | |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities |
| Current tax | - | 3,022 | 17 | 1,899 | 13 | 2,992 |
| Deferred tax | 495 | 1,027 | 446 | 1,338 | 535 | 1,036 |
| **Tax assets and tax liabilities** | 495 | 4,049 | 463 | 3,237 | 548 | 4,028 |

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

| 38. Non-current assets and disposal groups held for sale are specified as follows: | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Legal entities | 302 | 1,733 | 6,810 |
| Associates | 5,820 | 6,384 | 6,023 |
| Real estates | 3,727 | 3,275 | 2,740 |
| Other assets | 237 | 531 | 730 |
| **Non-current assets and disposal groups held for sale** | 10,086 | 11,923 | 16,303 |

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

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

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

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38. cont.

| Liabilities associated with the legal entities held for sale are as follows: | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Legal entities, total liabilities | 614 | 1,769 | 4,174 |

**Other assets**

39. Other assets are specified as follows:

| | | | |
|---|---|---|---|
| Accounts receivable | 2,676 | 4,084 | 2,805 |
| Prepaid expenses | 1,283 | 687 | 839 |
| Accrued income | 563 | 456 | 654 |
| Unsettled securities trading | 757 | 125 | 1,135 |
| Sundry assets | 642 | 549 | 1,052 |
| **Other assets** | 5,921 | 5,901 | 6,485 |

**Other liabilities**

40. Other liabilities are specified as follows:

| | | | |
|---|---|---|---|
| Accounts payable | 18,949 | 19,318 | 20,392 |
| Provision for settled FX loans | 7,600 | 4,625 | - |
| Depositors' and investors' guarantee fund | 2,874 | 2,919 | 3,126 |
| Insurance claim | 2,208 | 2,138 | 2,120 |
| Withholding tax | 450 | 1,926 | 487 |
| Unsettled securities trading | 7,787 | 842 | 3,539 |
| Sundry liabilities | 9,542 | 8,580 | 15,388 |
| **Other liabilities** | 49,410 | 40,348 | 45,052 |

**Borrowings**

41. Borrowings are specified as follows:

| | | | |
|---|---|---|---|
| Covered bonds | 128,566 | 124,992 | 124,772 |
| Bonds issued | 18,291 | 8,909 | 9,204 |
| Other loans | 56,243 | 61,184 | 58,977 |
| **Borrowings** | 203,100 | 195,085 | 192,953 |

The Group did not repurchase any own debts during the first half of 2013 (2012: nil).

In January 2013 Arion Bank issued non-indexed fixed rate covered bonds from its EUR 1.0 billion covered bond programme. The bond issue is nominated in Icelandic Krona, the amount issued was ISK 1.8 billion in the Series ARION CBI 15. The Bank had previously issued ISK 2.5 billion and the series were admitted for trading on NASDAQ OMX Iceland on 22 February 2012. The bonds bear 6.50% interest and mature in 2015. The Bank has issued total ISK 6.7 billion from this EUR 1.0 billion covered bond programme, ISK 4.2 billion non-indexed with fixed 6.50% interest rate and ISK 2.5 billion inflation indexed with fixed 3.60% interest.

In February 2013 Arion Bank completed its first international bond offering, issuing NOK 500 million of senior unsecured bonds, equalling ISK 11.2 billion. The series was admitted for trading on Oslo Börs on 2 July 2013. The bonds issued bear floating interest rate of 5.0% on NIBOR and mature in 2016.

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 121.7 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 1.6 billion a year and total payment including repayment of principal, indexation and interest is ISK 7.6 billion a year.

Book value of listed bonds was ISK 9,901 million at the end of the period. Market value of those bonds was ISK 10,126 million.

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

**Subordinated liabilities**

42. Subordinated liabilities are specified as follows:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Tier II capital | 32,503 | 34,220 | 32,175 |
| **Subordinated liabilities** | 32,503 | 34,220 | 32,175 |

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

**Derivatives**

43. Derivatives at fair value are specified as follows:

| | Fair value | |
|---|---|---|
| 30.06.2013 | Assets | Liabilities |
| Forward exchange rate agreements, unlisted | 119 | 53 |
| Interest rate and exchange rate agreements, unlisted | 200 | 484 |
| Bond swap agreements, unlisted | 26 | 309 |
| Share swap agreements, unlisted | 31 | 9 |
| Options - purchased agreements, unlisted | 456 | - |
| **Derivatives** | 832 | 855 |
| 31.12.2012 | | |
| Forward exchange rate agreements, unlisted | 250 | 92 |
| Interest rate and exchange rate agreements, unlisted | 71 | 792 |
| Bond swap agreements, unlisted | 17 | 42 |
| Share swap agreements, unlisted | 16 | 49 |
| Options - purchased agreements, unlisted | 434 | - |
| **Derivatives** | 788 | 975 |
| 30.06.2012 | | |
| Forward exchange rate agreements, unlisted | 322 | 18 |
| Interest rate and exchange rate agreements, unlisted | 588 | 338 |
| Bond swap agreements, unlisted | 69 | 75 |
| Options - sold agreements | 384 | 4 |
| **Derivatives** | 1,363 | 435 |

**Equity**

44. 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) | 30.06.2013 | Number (million) | 31.12.2012 | Number (million) | 30.06.2012 |
|---|---|---|---|---|---|---|
| Issued share capital | 2,000 | 75,861 | 2,000 | 75,861 | 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.

45. Other reserves are specified as follows:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Statutory reserve | 1,637 | 1,637 | 1,637 |
| Foreign currency translation reserve | 1 | 2 | - |
| **Other reserves** | 1,638 | 1,639 | 1,637 |

## OFF BALANCE SHEET INFORMATION

**Obligations**

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Guarantees | 10,515 | 9,185 | 8,402 |
| Unused overdrafts | 36,990 | 34,545 | 33,613 |
| Loan commitments | 41,566 | 36,001 | 27,878 |

47. Depositors' and Investors' Guarantee fund

The Group expensed ISK 379 million during the period 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**

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Assets which have been pledged as collateral against borrowings | 257,358 | 244,653 | 242,029 |
| Assets which have been pledged as collateral against loans from banks and short positions | 19,152 | 35,701 | 21,302 |
| **Pledged assets against liabilities** | 276,510 | 280,354 | 263,331 |

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 257 billion at the end of the period (31.12.2012: ISK 245 billion and 30.6.2012: ISK 242 billion). Those assets were mainly pool of mortgage loans to individuals, loans to municipals and loans to state related entities. The book value of those borrowings was ISK 184 billion at the end of the period (31.12.2012: ISK 185 billion and 30.6.2012: ISK 181 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.

**Assets under management and under custody**

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Assets under management | 873,802 | 819,684 | 748,951 |
| Assets under custody | 1,374,997 | 1,378,454 | 1,536,624 |

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**Legal Matters**

50. 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 an 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.

*Legal proceedings regarding the Bank's variable interest rate*

Two borrowers have issued summons against the Group where they claim that a clause in their mortgage loan, where it is stated that the bond shall bear a variable interest rate, which the Bank was authorised to change, is illegal and unbinding. The borrowers make e.g. the claim that it will be recognised by the court that said clause on interest rates is illegal. The Bank will defend against the borrowers' summons. If the courts side with the borrowers in the case, it could have a negative effect on the Bank's loan portfolio with variable interest rates in ISK and also in foreign currency (i.e. foreign currency-linked loans in ISK).

ii) Other legal disputes

*Legal proceedings regarding Drómi hf.*

As further discussed in Note 95 in the annual Consolidated Financial Statements for 2012 the Bank brought legal action against the FME and Drómi hf. in an attempt to annul the FME's decision of 4 February 2011 but with a judgement of the Supreme Court pronounced on 6 June 2013 FME and Drómi hf. were acquitted.

*Legal proceedings regarding Stefnir hf.*

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

50. cont.

*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. With a judgement of the District Court pronounced on 28 May 2013 the Bank was acquitted. Hagar hf. will appeal the judgement.

*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.

*Legal proceedings regarding Valitor hf.*

In a letter dated 18 June 2013 to the Bank's subsidiary Valitor hf., Datacell ehf. and Sunshine Press Productions demand damages from the company in relation to damage which they claim to have sustained following the termination by Valitor of a sale dealership agreement with Datacell, since in a judgment on 24 April 2013 in case no. 612/2012 the Supreme Court considered that Valitor had exceeded its authority to terminate the agreement. Valitor has already categorically turned down the demand for damages and it can be expected that Datacell and Sunshine Press Productions will bring an action for damages against Valitor whereby the court will appoint assessors and the final amount demanded in the action will take into account this assessment.

**The uncertainty regarding the book value of foreign currency loans**

51. As summarized in Note 96 to the 2012 annual financial statements, the book value of foreign currency loans has been subject to uncertainty arising from various court cases and changes in law since the Group's formation in 2008. This uncertainty continues in 2013 and the group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans.

After consideration of such judgments, the Group has provisioned a total amount of ISK 23.5 billion of which ISK 9.7 billion have been written-off in the first half of 2013.

Although there is more clarity in the matters of foreign currency loans, due to the judgments pronounced by the Supreme Court of Iceland in 2013, there still remains uncertainty regarding those loans, e.g. what interest rate foreign currency-linked loans should bear from the date they are recalculated and until their final maturity. Nevertheless, the Group considers its portfolio of foreign currency-linked loans fully provisioned for the most likely outcome.

## NOTES TO THE CONDENSED INTERIM CONSOLIDATED STATEMENT OF CASH FLOW

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

| | 2013<br>1.1.-30.6. | 2012<br>1.1.-30.6. |
|---|---|---|
| Increase in book value of loans and receivables | (6,798) | (7,168) |
| Impairment of loans and receivables | 6,664 | 4,636 |
| Depreciation and amortisation | 550 | 463 |
| Share of loss (profit) of associates and fair value change | 12 | (7) |
| Investment property, fair value change | (307) | (719) |
| Net foreign exchange loss (gain) | 1,248 | 149 |
| Net loss (gain) on financial assets and liabilities at fair value through profit or loss | (1,498) | (309) |
| Net loss (gain) on disposal of property and equipment | (1) | (5) |
| Net loss (gain) on disposal of investment property | (108) | (97) |
| | (238) | (3,057) |

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

| | | |
|---|---|---|
| Mandatory reserve with Central Bank | (367) | 965 |
| Loans and receivables to credit institutions | (11,888) | 3,017 |
| Loans and receivables to customers | (15,048) | (14,676) |
| Bonds and debt instruments | (15,539) | 12,858 |
| Shares and equity instruments | 1,043 | (548) |
| Derivatives and financial liabilities at fair value | (2,684) | 5,062 |
| Investment property | 569 | (560) |
| Non-current assets and liabilities and disposals group held for sale | 1,373 | 3,168 |
| Other assets | (328) | 7,144 |
| Due to credit institutions and Central Bank of Iceland | (7,263) | 4,677 |
| Deposits | 21,403 | (44,663) |
| Borrowings | 13,156 | 1,080 |
| Other liabilities | 8,873 | 4,083 |
| | (6,700) | (18,393) |

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## RISK MANAGEMENT DISCLOSURES

**Introduction**

54. 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.

    Further information regarding risk management is available in the annual Consolidated Financial Statements for 2012 and in the Pillar 3 Risk Disclosures for 2012, published on the Bank's website, www.arionbanki.is. The Pillar 3 risk disclosures are not audited.

**Credit risk**

55. 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.

56. Maximum exposure to credit risk

    The following table shows the maximum exposure to credit risk for the components of the Interim Consolidated Statement of Financial Position, at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements.

Maximum exposure to credit risk related to on-balance sheet items:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Cash and balances with Central Bank | 25,717 | 29,746 | 16,280 |
| Loans and receivables to credit institutions | 109,732 | 101,011 | 71,769 |
| Loans and receivables to customers | 567,257 | 566,610 | 578,886 |
| Bonds and debt instruments | 132,744 | 117,730 | 128,853 |
| Derivatives | 832 | 788 | 1,363 |
| Bonds and debt instruments, hedging | 526 | 1,460 | 418 |
| Other assets with credit risk | 4,459 | 5,030 | 5,440 |
| **Total on-balance sheet maximum exposure to credit risk** | 841,267 | 822,375 | 803,009 |

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

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Financial guarantees | 10,515 | 9,185 | 11,847 |
| Unused overdrafts | 36,990 | 34,545 | 35,019 |
| Loan commitments | 41,566 | 36,001 | 30,412 |
| **Total off-balance sheet maximum exposure to credit risk** | 89,071 | 79,731 | 77,278 |
| | | | |
| **Maximum exposure to credit risk** | 930,338 | 902,106 | 880,287 |

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57. Loans and receivables to customers specified by sectors:

| | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Individuals | 44.5% | 42.8% | 41.1% |
| Real estate activities and construction | 13.1% | 12.1% | 13.1% |
| Fishing industry | 11.2% | 12.0% | 12.9% |
| Information and communication technology | 4.4% | 5.1% | 4.6% |
| Wholesale and retail trade | 9.0% | 9.8% | 9.8% |
| Financial and insurance activities | 4.5% | 4.4% | 4.2% |
| Industry, energy and manufacturing | 4.0% | 4.0% | 5.0% |
| Transportation | 3.5% | 3.8% | 3.5% |
| Services | 3.3% | 3.3% | 3.0% |
| Public sector | 1.6% | 1.8% | 1.6% |
| Agriculture and forestry | 0.9% | 0.9% | 1.2% |
| | 100.0% | 100.0% | 100.0% |

58. Collateral and other credit enhancements

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

- Retail loans to individuals: Mortgages in residential properties.
- Corporate loans: Charges over real estate properties, fishing vessels and other fixed and current assets, inventory and trade receivables, cash and securities.
- Derivative exposures: Cash 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:

| 30.06.2013 | Cash and securities | Real estates | Fishing vessels | Other collateral | Total collateral |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | - | - | - |
| Loans and receivables to credit institutions | - | - | - | - | - |
| Loans and receivables to customers: | | | | | |
| Individuals | 595 | 213,165 | 48 | 805 | 214,613 |
| Real estate activities and construction | 815 | 51,641 | 5 | 415 | 52,876 |
| Fishing industry | 1,933 | 2,496 | 53,063 | 5,798 | 63,290 |
| Information and communication technology | 26 | 816 | - | 22,017 | 22,859 |
| Wholesale and retail trade | 2,357 | 14,092 | 7 | 26,040 | 42,496 |
| Financial and insurance activities | 17,462 | 1,588 | - | 966 | 20,016 |
| Industry, energy and manufacturing | 177 | 7,283 | 1 | 10,584 | 18,045 |
| Transportation | 69 | 523 | 51 | 4,020 | 4,663 |
| Services | 275 | 3,173 | 71 | 2,686 | 6,205 |
| Public sector | 32 | 3,663 | - | 146 | 3,841 |
| Agriculture and forestry | 10 | 2,230 | - | 153 | 2,393 |
| Bond, debt instruments and derivatives | 1,779 | - | - | 68,987 | 70,766 |
| **Collateral held against different types of financial assets** | 25,530 | 300,670 | 53,246 | 142,617 | 522,063 |

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58. cont.

| 31.12.2012 | Cash and securities | Real estates | Fishing vessels | Other collateral | Total collateral |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | - | - | - |
| Loans and receivables to credit institutions | - | - | - | - | - |
| Loans and receivables to customers: | | | | | |
| Individuals | 556 | 212,357 | 40 | 219 | 213,172 |
| Real estate activities and construction | 675 | 49,416 | 6 | 702 | 50,799 |
| Fishing industry | 1,877 | 2,325 | 58,274 | 6,222 | 68,698 |
| Information and communication technology | 78 | 547 | - | 18,312 | 18,937 |
| Wholesale and retail trade | 1,909 | 12,705 | - | 8,550 | 23,164 |
| Financial and insurance activities | 9,924 | 532 | - | 8,876 | 19,332 |
| Industry, energy and manufacturing | 140 | 6,659 | 1 | 1,189 | 7,989 |
| Transportation | 71 | 503 | 19 | 904 | 1,497 |
| Services | 252 | 2,785 | 57 | 1,973 | 5,067 |
| Public sector | 29 | 3,261 | - | 91 | 3,381 |
| Agriculture and forestry | 10 | 1,569 | - | 12 | 1,591 |
| Bond, debt instruments and derivatives | 1,219 | - | - | 68,628 | 69,847 |
| **Collateral held against different types of financial assets** | 16,740 | 292,659 | 58,397 | 115,678 | 483,474 |

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

Comparative information for 30 June 2012 is not available.

59. Credit quality by class of financial assets is specified as follows:

| 30.06.2013 | Neither past due nor impaired | Past due but not impaired | Individually impaired* | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | 25,717 | - | - | 25,717 |
| Loans and receivables to credit institutions | 109,732 | - | - | 109,732 |
| Loans and receivables to customers: | | | | |
| Loans to corporates | 272,853 | 18,358 | 22,178 | 313,389 |
| Loans to individuals | 218,833 | 25,658 | 9,377 | 253,868 |
| Bonds and debt instruments | 132,744 | - | - | 132,744 |
| Derivatives | 832 | - | - | 832 |
| Bonds and debt instruments used for hedging | 526 | - | - | 526 |
| Other assets with credit risk | 4,459 | - | - | 4,459 |
| **Credit quality of loans and receivables** | 765,696 | 44,016 | 31,555 | 841,267 |

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59. cont.

| 31.12.2012 | 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 |

| 30.06.2012 | | | | |
|---|---|---|---|---|
| Cash and balances with Central Bank | 16,280 | - | - | 16,280 |
| Loans and receivables to credit institutions | 71,769 | - | - | 71,769 |
| Loans and receivables to customers: | | | | |
| Loans to corporates | 280,699 | 29,156 | 42,597 | 352,452 |
| Loans to individuals | 176,910 | 23,428 | 26,096 | 226,434 |
| Bonds and debt instruments | 128,853 | - | - | 128,853 |
| Derivatives | 1,363 | - | - | 1,363 |
| Bonds and debt instruments used for hedging | 418 | - | - | 418 |
| Other assets with credit risk | 5,440 | - | - | 5,440 |
| **Credit quality of loans and receivables** | 681,732 | 52,584 | 68,693 | 803,009 |

* 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.

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

| 30.06.2013 | Up to 30 days | 31 to 60 days | 61 to 90 days | More than 90 days | Total |
|---|---|---|---|---|---|
| Loans and receivables to corporates | 7,026 | 1,314 | 1,071 | 8,947 | 18,358 |
| Loans and receivables to individuals | 11,583 | 4,562 | 1,713 | 7,800 | 25,658 |
| **Past due but not impaired loans and receivables** | 18,609 | 5,876 | 2,784 | 16,747 | 44,016 |
| 31.12.2012 | | | | | |
| 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 |
| 30.06.2012 | | | | | |
| Loans and receivables to corporates | 12,998 | 5,026 | 639 | 10,493 | 29,156 |
| Loans and receivables to individuals | 8,942 | 672 | 3,246 | 10,568 | 23,428 |
| **Past due but not impaired loans and receivables** | 21,940 | 5,698 | 3,885 | 21,061 | 52,584 |

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60. cont.

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.

61. Collateral repossessed

During the period, the Group took possession of real estates with the carrying value of ISK 756 million and other assets with the value of ISK 5 million, all which the Group is in the process of selling, see Note 38.

62. Impaired loans and receivables to customers specified by sector:

| | Loans impaired due to borrower credit quality | | Loans impaired due to FX-loan court rulings | | | |
|---|---|---|---|---|---|---|
| 30.06.2013 | Impair-ment amount | Loan carrying amount | Impair-ment amount | Loan carrying amount | Total im-pairment amount | Total loan carrying amount |
| Individuals | 12,172 | 18,995 | 901 | 3,455 | 13,073 | 22,450 |
| Real estate activities and construction | 4,627 | 9,593 | 870 | 1,773 | 5,497 | 11,366 |
| Fishing industry | 2,400 | 4,486 | 1,717 | 4,134 | 4,117 | 8,620 |
| Information and communication technology | 42 | 55 | 48 | 56 | 90 | 111 |
| Wholesale and retail trade | 5,188 | 8,700 | 855 | 1,819 | 6,043 | 10,519 |
| Financial and insurance activities | 7,044 | 10,029 | 999 | 1,377 | 8,043 | 11,406 |
| Industry, energy and manufacturing | 693 | 1,408 | 77 | 223 | 770 | 1,631 |
| Transportation | 23 | 24 | 331 | 2,201 | 354 | 2,225 |
| Services | 1,219 | 1,625 | 204 | 394 | 1,423 | 2,019 |
| Public sector | 29 | 38 | 102 | 138 | 131 | 176 |
| Agriculture and forestry | 732 | 1,142 | 87 | 250 | 819 | 1,392 |
| | 34,169 | 56,095 | 6,191 | 15,820 | 40,360 | 71,915 |
| 31.12.2012 | | | | | | |
| Individuals | 13,143 | 19,397 | 5,032 | 18,626 | 18,175 | 38,023 |
| Real estate activities and construction | 4,684 | 10,091 | 1,586 | 4,139 | 6,270 | 14,230 |
| Fishing industry | 2,361 | 4,343 | 2,648 | 6,913 | 5,009 | 11,256 |
| Information and communication technology | 7,561 | 11,192 | 187 | 307 | 7,748 | 11,499 |
| Wholesale and retail trade | 5,295 | 8,399 | 2,639 | 5,638 | 7,934 | 14,037 |
| Financial and insurance activities | 6,405 | 8,363 | 1,142 | 1,492 | 7,547 | 9,855 |
| Industry, energy and manufacturing | 604 | 1,152 | 483 | 999 | 1,087 | 2,151 |
| Transportation | 35 | 40 | 36 | 120 | 71 | 160 |
| Services | 744 | 1,168 | 505 | 1,328 | 1,249 | 2,496 |
| Public 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 |

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62. cont.

| 30.06.2012 | Loans impaired due to borrower credit quality | | Loans impaired due to FX-loan court rulings | | | |
|---|---|---|---|---|---|---|
| | Impair-ment amount | Loan carrying amount | Impair-ment amount | Loan carrying amount | Total im-pairment amount | Total loan carrying amount |
| Individuals | 12,635 | 22,485 | 6,525 | 22,771 | 19,160 | 45,256 |
| Real estate activities and construction | 3,941 | 12,233 | 1,597 | 2,815 | 5,538 | 15,048 |
| Fishing industry | 1,404 | 9,195 | 2,889 | 3,247 | 4,293 | 12,442 |
| Information and communication technology | 7,518 | 7,940 | 171 | 274 | 7,689 | 8,214 |
| Wholesale and retail trade | 3,260 | 9,292 | 2,774 | 8,475 | 6,034 | 17,767 |
| Financial and insurance activities | 5,408 | 9,028 | 57 | 130 | 5,465 | 9,158 |
| Industry, energy and manufacturing | 513 | 2,541 | 407 | 2,977 | 920 | 5,518 |
| Transportation | 26 | 60 | 54 | 68 | 80 | 128 |
| Services | 650 | 2,766 | 553 | 794 | 1,203 | 3,560 |
| Public sector | 412 | 1,128 | 79 | 120 | 491 | 1,248 |
| Agriculture and forestry | 619 | 936 | 483 | 1,393 | 1,102 | 2,329 |
| | 36,386 | 77,604 | 15,589 | 43,064 | 51,975 | 120,668 |

This note refines the presentation of impairments by separating those that are due to the uncertainty related to foreign currency loans from impairments that are due to deteriorating borrower credit quality. At 30 June 2013, a provision of ISK 13,790 million had been made for losses due to court rulings for illegal FX loans, in addition to the ISK 9,674 million previously written of for this reason. ISK 6,191 million of provisions are due to loans with a carrying value of ISK 15,820 million that are still on the Group's balance sheet. The balance of ISK 7,599 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 the calculation of the loans.

63. 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 period was ISK 29 billion (31.12.2012: ISK 29 billion and 30.6.2012: ISK 31 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has four large exposures at the end of the period (31.12.2012: four exposures and 30.6.2012: four exposures) net of eligible collateral.

| | 30.06.2013 | | 31.12.2012 | | 30.06.2012 | |
|---|---|---|---|---|---|---|
| no. | Gross | Net | Gross | Net | Gross | Net |
| 1 Drómi | 42% | 0% | 43% | 0% | 45% | 0% |
| 2 | 18% | 18% | 18% | 18% | 18% | 18% |
| 3 | 16% | 16% | 18% | 17% | 20% | 20% |
| 4 | 14% | 14% | 14% | 14% | 14% | 14% |
| 5 | 11% | 11% | 11% | 11% | 12% | 12% |
| **Sum of exposure gross > 10%** | 101% | 59% | 104% | 60% | 109% | 64% |

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period. 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 99% of the Group's capital base before collateral mitigation or 57% net of eligible collateral, which is well below the 400% legal maximum.

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**Market risk**

64. 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.

65. 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.

| 30.06.2013 | | 0-1Y | 1-5Y | 5-10Y | 10-20Y | >20Y |
|---|---|---|---|---|---|---|
| CPI Indexed linked ........ | ISK | (18) | (804) | (93) | (2,066) | 1,441 |
| Non Indexed linked ........ | ISK | (164) | (418) | (34) | (27) | (17) |
| | EUR | 75 | (2) | - | - | - |
| | Other | 11 | (4) | - | - | - |
| 31.12.2012 | | | | | | |
| 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) | - | - |

Comparative information for 30 June 2012 is not available.

66. 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.

| 30.06.2013 | | 0-1Y | 1-5Y | 5-10Y | 10-20Y | >20Y |
|---|---|---|---|---|---|---|
| CPI Indexed linked ........ | ISK | - | (11) | (38) | (26) | (241) |
| Non Indexed linked ........ | ISK | (37) | 17 | (26) | 16 | - |
| | EUR | 1 | - | - | - | - |
| | Other | (1) | - | - | - | - |
| 31.12.2012 | | | | | | |
| CPI Indexed linked ........ | ISK | - | (19) | (80) | (5) | (270) |
| Non Indexed linked ........ | ISK | (50) | (17) | (8) | (36) | - |
| | EUR | (5) | - | - | - | - |
| | Other | (2) | - | - | - | - |

Comparative information for 30 June 2012 is not available.

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

| 30.06.2013 | 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 | 25,717 | 16,613 | - | 9,104 | - | - | - |
| Loans and receivables to credit institutions | 109,732 | 81,085 | 28,401 | - | 246 | - | - |
| Loans and receivables to customers | 567,257 | 11,002 | 34,951 | 107,562 | 199,789 | 213,953 | - |
| Bonds and debt instruments | 132,744 | 5,714 | 8 | 16,032 | 69,480 | 41,510 | - |
| Shares and equity instruments | 16,735 | - | - | - | - | - | 16,735 |
| Derivatives | 832 | 455 | 177 | - | 200 | - | - |
| *Assets leg* | 12,813 | 455 | 10,235 | 13 | 2,110 | - | - |
| *Liabilities leg* | (11,980) | - | (10,057) | (13) | (1,910) | - | - |
| Securities used for hedging | 3,460 | 527 | - | - | - | - | 2,933 |
| Investment property | 28,911 | - | - | - | - | - | 28,911 |
| Investments in associates | 14,424 | - | - | - | - | - | 14,424 |
| Property and equipment | 7,433 | - | - | - | - | - | 7,433 |
| Intangible assets | 5,283 | - | - | - | - | - | 5,283 |
| Tax assets | 495 | - | - | - | 495 | - | - |
| Non-current assets held for sale | 10,086 | - | - | - | - | - | 10,086 |
| Other assets | 5,921 | 60 | 2,605 | 843 | 936 | 14 | 1,463 |
| **Assets 30.06.2013** | 929,030 | 115,456 | 66,142 | 133,541 | 271,146 | 255,477 | 87,268 |
| Liabilities | | | | | | | |
| Due to credit institutions and Central Bank | 25,727 | 14,671 | 5,129 | - | 5,927 | - | - |
| Deposits | 466,834 | 240,009 | 156,349 | 34,679 | 27,525 | 8,272 | - |
| Financial liabilities at fair value | 10,005 | - | 9,407 | 183 | 415 | - | - |
| *Assets leg* | (25,763) | - | (11,375) | (2,426) | (11,962) | - | - |
| *Liabilities leg* | 26,618 | - | 11,632 | 2,609 | 12,377 | - | - |
| *Short position bonds and derivatives* | 4,174 | - | 4,174 | - | - | - | - |
| *Short position bonds used for hedging* | 4,976 | - | 4,976 | - | - | - | - |
| Tax liabilities | 4,049 | - | 756 | 2,266 | 1,027 | - | - |
| Non-current liabilities held for sale | 614 | - | - | - | - | - | 614 |
| Other liabilities | 49,410 | 515 | 39,076 | 201 | 3,184 | 211 | 6,223 |
| Borrowings | 203,100 | - | 1,578 | 2,868 | 28,975 | 169,679 | - |
| Subordinated liabilities | 32,503 | - | - | - | - | 32,503 | - |
| **Liabilities 30.06.2013** | 792,242 | 255,195 | 212,295 | 40,197 | 67,053 | 210,665 | 6,837 |
| Off-balance sheet items: | | | | | | | |
| Guarantees | 10,515 | 2,239 | 1,859 | 4,077 | 1,083 | 1,257 | - |
| Unused overdraft | 36,990 | 702 | 9,128 | 15,956 | 11,127 | 77 | - |
| Loan commitments | 41,566 | 2,928 | 17,342 | 11,923 | 9,373 | - | - |
| **Off-balance sheet items** | 89,071 | 5,869 | 28,329 | 31,956 | 21,583 | 1,334 | - |
| **Net interest sensitivity gap** | 47,717 | (145,608) | (174,482) | 61,388 | 182,510 | 43,478 | 80,431 |

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67. cont.

| 31.12.2012 | 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 bonds and derivatives* | *5,163* | - | *5,163* | - | - | - | - |
| *Short position bonds used for hedging* | *7,327* | - | *7,327* | - | - | - | - |
| 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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67. cont.

| 30.06.2012 Assets | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 16,280 | 8,685 | - | 7,595 | - | - | - |
| Loans and receivables to credit institutions | 71,769 | 68,346 | 3,178 | - | 245 | - | - |
| Loans and receivables to customers | 578,886 | 11,570 | 53,625 | 79,247 | 220,849 | 213,595 | - |
| Bonds and debt instruments | 128,853 | 6,445 | 104 | 2,034 | 78,956 | 41,314 | - |
| Shares and equity instruments | 15,408 | - | - | - | - | - | 15,408 |
| *Derivatives* | 1,363 | - | 756 | 1 | 560 | 46 | - |
| *Assets leg* | *30,311* | - | *16,434* | *164* | *7,972* | *5,741* | - |
| *Liabilities leg* | *(28,948)* | - | *(15,678)* | *(163)* | *(7,412)* | *(5,695)* | - |
| Securities used for hedging | 1,516 | 418 | - | - | - | - | 1,098 |
| Investment property | 28,379 | - | - | - | - | - | 28,379 |
| Investments in associates | 3,020 | - | - | - | - | - | 3,020 |
| Property and equipment | 6,232 | - | - | - | - | - | 6,232 |
| Intangible assets | 5,008 | - | - | - | - | - | 5,008 |
| Tax assets | 548 | - | - | - | - | - | 548 |
| Non-current assets held for sale | 16,303 | - | - | - | - | - | 16,303 |
| Other assets | 6,485 | 163 | 2,351 | 2,428 | 403 | 96 | 1,044 |
| **Assets 30.06.2012** | 880,050 | 95,627 | 60,014 | 91,305 | 301,013 | 255,051 | 77,040 |
| Liabilities | | | | | | | |
| Due to credit institutions and Central Bank | 20,837 | 13,016 | 5,178 | 2,643 | - | - | - |
| Deposits | 445,249 | 288,224 | 89,967 | 34,540 | 29,730 | 2,788 | - |
| Financial liabilities at fair value | 10,439 | - | 10,101 | - | 297 | 41 | - |
| *Assets leg* | *(12,235)* | - | *(7,271)* | - | *(141)* | *(4,823)* | - |
| *Liabilities leg* | *12,666* | - | *7,364* | - | *438* | *4,864* | - |
| *Short position bonds and derivatives* | *3,969* | - | *3,969* | - | - | - | - |
| *Short position bonds used for hedging* | *6,039* | - | *6,039* | - | - | - | - |
| Tax liabilities | 4,028 | - | - | 4,034 | - | - | (6) |
| Non-current liabilities held for sale | 4,174 | - | - | - | - | - | 4,174 |
| Other liabilities | 45,052 | 7,326 | 6,585 | 21,923 | 3,163 | 231 | 5,824 |
| Borrowings | 192,953 | - | 1,432 | 3,397 | 17,377 | 170,747 | - |
| Subordinated liabilities | 32,175 | - | - | - | - | 32,175 | - |
| **Liabilities 30.06.2012** | 754,907 | 308,567 | 113,263 | 66,537 | 50,567 | 205,981 | 9,992 |
| Off-balance sheet items: | | | | | | | |
| Guarantees | 11,847 | 3,092 | 1,195 | 3,465 | 2,556 | 1,539 | - |
| Unused overdraft | 35,019 | 985 | 7,100 | 13,197 | 13,710 | 27 | - |
| Loan commitments | 30,412 | 2 | 12,566 | 7,493 | 9,993 | 358 | - |
| **Off-balance sheet items** | 77,278 | 4,079 | 20,860 | 24,155 | 26,259 | 1,924 | - |
| **Net interest sensitivity gap** | 47,865 | (217,017) | (74,111) | 612 | 224,188 | 47,144 | 67,049 |

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68. 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 256.7 billion (31.12.2012: ISK 262.0 billion and 30.06.2012: ISK 267.4 billion) and the total amount of indexed liabilities amount to ISK 215.8 billion (31.12.2012: 216.8 billion and 30.06.2012 ISK 223.6 billion).

| 30.06.2013 | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| Assets, CPI indexed linked | | | | |
| Loans and receivables to customers | 2,535 | 57,882 | 187,788 | 248,205 |
| Bonds and debt instruments | 38 | 194 | 3,161 | 3,393 |
| Off-balance sheet position | - | 5,096 | - | 5,096 |
| **Assets, CPI indexed linked** | 2,573 | 63,172 | 190,949 | 256,694 |
| | | | | |
| Liabilities, CPI indexed linked | | | | |
| Deposits | 61,141 | 21,826 | 5,329 | 88,296 |
| Borrowings | 44 | 507 | 126,940 | 127,491 |
| **Liabilities, CPI indexed linked** | 61,185 | 22,333 | 132,269 | 215,787 |
| | | | | |
| Net on-balance sheet position | (58,612) | 35,743 | 58,680 | 35,811 |
| Net off-balance sheet position | - | 5,096 | - | 5,096 |
| **CPI Balance 30.06.2013** | (58,612) | 40,839 | 58,680 | 40,907 |
| | | | | |
| CPI Balance 31.12.2012 | (60,232) | 18,321 | 87,051 | 45,140 |
| | | | | |
| CPI Balance 30.06.2012 | (64,948) | 28,577 | 85,003 | 48,632 |

69. 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 reporting period. Note that net real position is not relevant for 30 June 2013 and 31 December 2012.

| Assets | ISK | EUR | USD | CHF | GBP | JPY | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 17,229 | 5,899 | 212 | 362 | 372 | 1,300 | 343 | 25,717 |
| Loans to credit institutions | 22,537 | 25,708 | 12,501 | 1,639 | 18,917 | 2,967 | 25,463 | 109,732 |
| Loans and receivables to customers | 440,516 | 50,228 | 22,970 | 17,563 | 5,941 | 10,071 | 19,968 | 567,257 |
| Bonds and debt instruments | 132,139 | - | 605 | - | - | - | - | 132,744 |
| Shares and equity instruments | 9,772 | 5,798 | 919 | - | 211 | - | 35 | 16,735 |
| Derivatives | 306 | 458 | 39 | 6 | 20 | 3 | - | 832 |
| Securities used for hedging | 3,460 | - | - | - | - | - | - | 3,460 |
| Investment property | 28,911 | - | - | - | - | - | - | 28,911 |
| Investments in associates | 14,424 | - | - | - | - | - | - | 14,424 |
| Property and equipment | 7,433 | - | - | - | - | - | - | 7,433 |
| Intangible assets | 5,283 | - | - | - | - | - | - | 5,283 |
| Tax assets | 495 | - | - | - | - | - | - | 495 |
| Non-current assets held for sale | 10,086 | - | - | - | - | - | - | 10,086 |
| Other assets | 4,443 | 587 | 782 | - | 32 | - | 77 | 5,921 |
| **Assets 30.06.2013** | 697,034 | 88,678 | 38,028 | 19,570 | 25,493 | 14,341 | 45,886 | 929,030 |

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69. cont.

| Liabilities | ISK | EUR | USD | CHF | GBP | JPY | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Due to credit inst. and Central Bank .. | 21,676 | 2,034 | 323 | 435 | 1 | 1,258 | - | 25,727 |
| Deposits .......................................... | 390,265 | 24,333 | 10,802 | 612 | 10,530 | 1,395 | 28,897 | 466,834 |
| Financial liabilities at fair value ......... | 9,476 | 505 | 7 | - | - | - | 17 | 10,005 |
| Tax liabilities .................................... | 4,049 | - | - | - | - | - | - | 4,049 |
| Non-current liabilities held for sale ... | 614 | - | - | - | - | - | - | 614 |
| Other liabilities ................................ | 37,184 | 1,396 | 1,165 | 112 | 7,810 | 471 | 1,272 | 49,410 |
| Borrowings ....................................... | 134,954 | 2,463 | 20,109 | 20,326 | 6,644 | 8,613 | 9,991 | 203,100 |
| Subordinated liabilities ..................... | - | 26,271 | 2,481 | - | 3,751 | - | - | 32,503 |
| Equity .............................................. | 136,788 | - | - | - | - | - | - | 136,788 |
| **Liabilities 30.06.2013 .......................** | 735,006 | 57,002 | 34,887 | 21,485 | 28,736 | 11,737 | 40,177 | 929,030 |
| | | | | | | | | |
| Net on-balance sheet position .......... | (37,972) | 31,676 | 3,141 | (1,915) | (3,243) | 2,604 | 5,709 | |
| Net off-balance sheet position .......... | 13,716 | (15,062) | 2,179 | 747 | 5,423 | (972) | (6,031) | |
| Net position 30.06.2013 ................... | (24,256) | 16,614 | 5,320 | (1,168) | 2,180 | 1,632 | (322) | |
| | | | | | | | | |
| 31.12.2012 | | | | | | | | |
| 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 | 1,233 | 3,595 | (284) | 3,561 | |
| | | | | | | | | |
| 30.06.2012 | | | | | | | | |
| Net on-balance sheet position .......... | (42,488) | 12,885 | 10,832 | 4,442 | (101) | 10,148 | 4,282 | |
| Net off-balance sheet position .......... | 14,716 | (12,024) | (5,229) | - | 3,971 | (3,243) | 1,809 | |
| Net position 30.06.2012 ................... | (27,772) | 861 | 5,603 | 4,442 | 3,870 | 6,905 | 6,091 | |
| Loans to customers with ISK income . | 10,740 | (2,063) | (560) | (4,909) | (109) | (2,925) | (174) | |
| Net real position 30.06.2012 ............ | (17,032) | (1,202) | 5,043 | (467) | 3,761 | 3,980 | 5,917 | |

**Liquidity risk**

70. An important source of funding for the Group is deposits from individuals, corporations and institutional investors. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits.

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.

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70. cont.

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 period were as follows, compared to last year:

| | 30.06.2013 | | 31.12.2012 | | 30.06.2012 | |
|---|---|---|---|---|---|---|
| | Liquidity ratio | Cash ratio | Liquidity ratio | Cash ratio | Liquidity ratio | Cash ratio |
| Period-end | 38% | 32% | 33% | 31% | 32% | 14% |
| Maximum | 42% | 38% | 37% | 31% | 37% | 23% |
| Minimum | 32% | 20% | 28% | 10% | 28% | 10% |
| Average | 36% | 29% | 32% | 17% | 32% | 14% |

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.

– Due to Central Bank: Excluded from stickiness categorisation;
– 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.

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

% of deposit base:

| | 30.06.2013 | | 31.12.2012 | | 30.06.2012 | |
|---|---|---|---|---|---|---|
| Stickiness rating | | | | | | |
| Due to Central Bank | | - | | 12,358 | | - |
| 1 Capital controls | 2% | 8,321 | 2% | 8,746 | 2% | 10,961 |
| 2 Resolution process | 17% | 86,438 | 18% | 82,338 | 15% | 69,225 |
| 3 Investors | 26% | 129,968 | 21% | 101,827 | 25% | 118,099 |
| 4 Deposits - legal entities | 14% | 67,484 | 14% | 63,445 | 11% | 52,529 |
| 5 Deposits - retail individuals | 11% | 52,382 | 11% | 53,239 | 12% | 55,171 |
| 6 Deposits - legal entities with business relationship | 12% | 61,482 | 16% | 73,098 | 18% | 78,053 |
| 7 Deposits - retail individuals with business relationship | 18% | 86,486 | 18% | 86,622 | 18% | 82,048 |
| Total | 100% | 492,561 | 100% | 481,673 | 100% | 466,086 |

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**Capital management**

71. The capital base at 30 June 2013 amounts to ISK 163,252 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 (2012: the same).

A reclassification of securities was made in 2012, from the trading book into the banking book in precise compliance with the Basel II standard. Now only securities in the Bank's proprietary trading book are classified in the trading book, while other securities are classified in the banking book.

| The table shows the Group's RWA calculations: | 30.06.2013 | 31.12.2012 | 30.06.2012 |
|---|---|---|---|
| Capital Base | | | |
| Share capital | 2,000 | 2,000 | 2,000 |
| Share premium | 73,861 | 73,861 | 73,861 |
| Other reserves | 1,638 | 1,639 | 1,637 |
| Retained earnings | 55,709 | 49,572 | 44,002 |
| Non-controlling interests | 3,580 | 3,806 | 3,643 |
| **Total Equity** | 136,788 | 130,878 | 125,143 |
| Intangible assets | (5,283) | (4,941) | (5,008) |
| Tax assets | (495) | (463) | (548) |
| Other statutory deductions | (136) | - | - |
| **Total Tier 1 capital** | 130,874 | 125,474 | 119,587 |
| Subordinated liabilities | 32,503 | 34,220 | 32,175 |
| Other statutory deductions | (125) | - | - |
| **Total Capital base** | 163,252 | 159,694 | 151,762 |
| | | | |
| Risk weighted assets | | | |
| Credit risk | 563,702 | 557,964 | 560,283 |
| Market risk FX | 28,472 | 20,063 | 28,936 |
| Market Risk Other | 6,339 | 7,407 | 33,348 |
| Operational risk | 72,329 | 72,329 | 58,976 |
| **Total Risk weighted assets** | 670,842 | 657,763 | 681,543 |
| Tier 1 ratio | 19.5% | 19.1% | 17.5% |
| Capital adequacy ratio | 24.3% | 24.3% | 22.3% |

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## OTHER INFORMATION

**Related parties**

72. 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 period. 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.

30.06.2013

| Balances with related parties: | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with significant influence over the Group | - | (9,501) | (9,501) |
| Shareholders with control over the Group | 567 | (62,918) | (62,351) |
| Board of Directors and key Management personnel | 174 | (94) | 80 |
| Associates and other related parties | 49,153 | (22,077) | 27,076 |
| | 49,894 | (94,590) | (44,696) |

31.12.2012

| 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) |

30.06.2012

| Balances with related parties: | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with significant influence over the Group | - | (1,789) | (1,789) |
| Shareholders with control over the Group | 473 | (61,286) | (60,813) |
| Board of Directors and key Management personnel | 202 | (98) | 104 |
| Associates and other related parties | 56,805 | (16,263) | 40,542 |
| | 57,480 | (79,436) | (21,956) |

**Events after Balance Sheet date**

73. Events after Balance Sheet date

In July 2013 Arion Bank completed ISK 3.0 billion covered bond offering in new serie, Arion CBI 19. The aim is to list the bonds at NASDAQ OMX Iceland. The bonds are inflation indexed with 2.50% fixed interest and mature in 2019.

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