ANNUAL REPORT 2013

Arion Bank

ANNUAL REPORT **2013**

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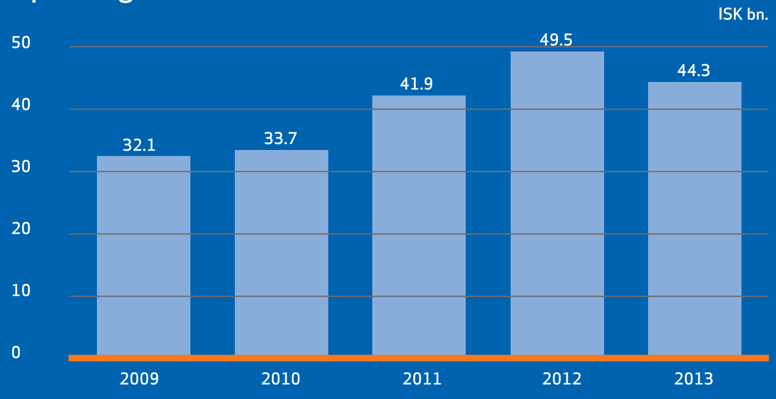
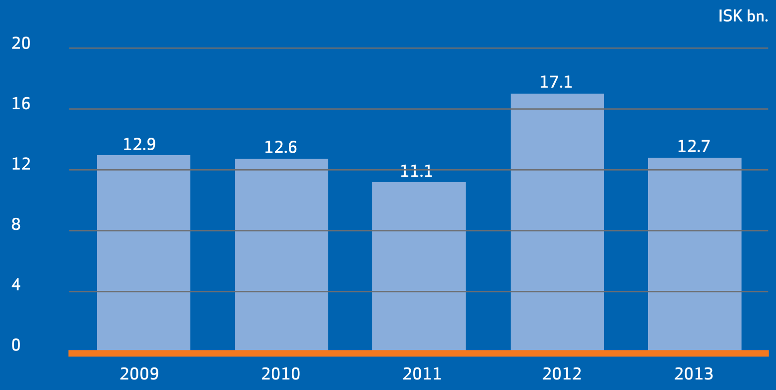
KEY FIGURES

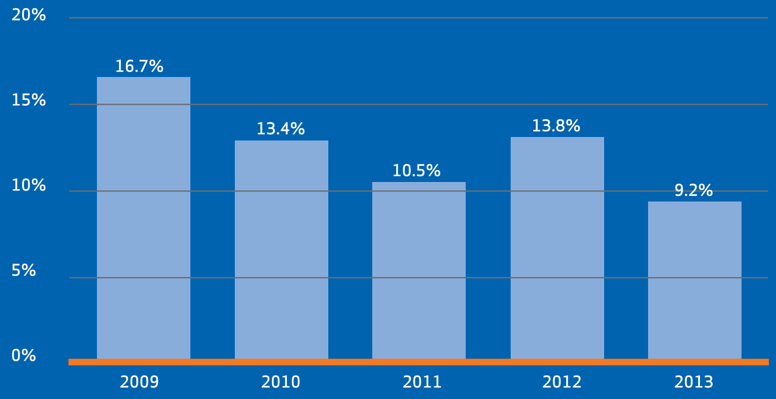
Operating income



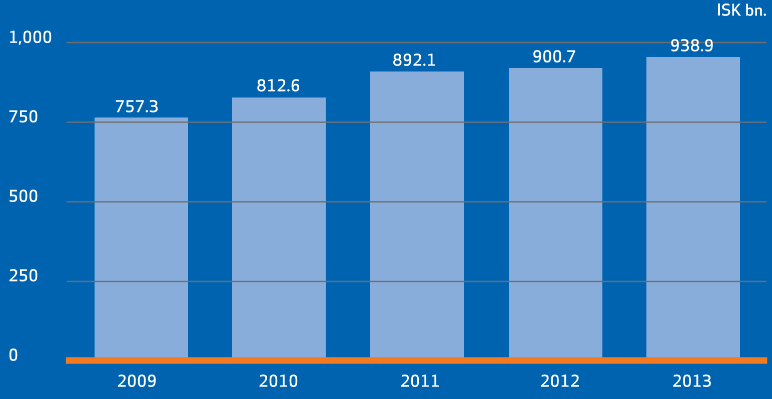
Net earnings



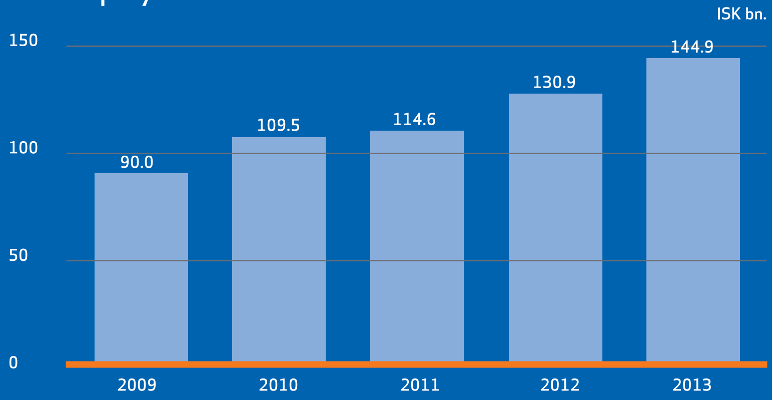
Return on equity



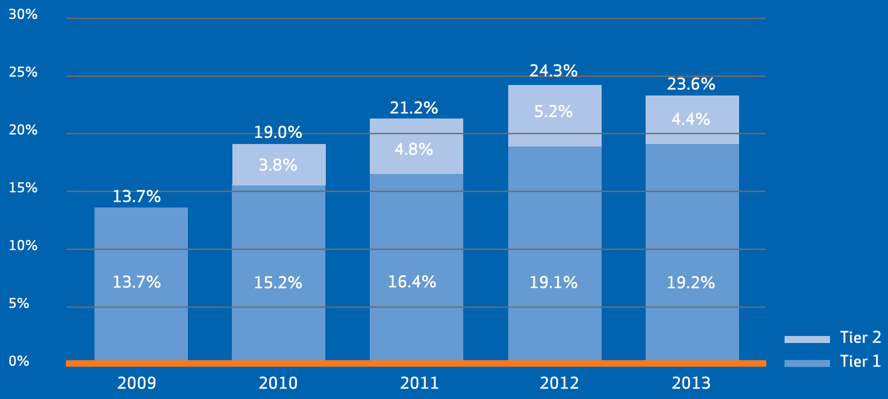
Total assets



Total equity



CAD ratio



CHAIRMAN'S ADDRESS

In many ways Iceland is in a good position. The country has a wealth of natural riches and possesses great human resources with its well-educated and dynamic populace. A great deal has been achieved in the last few years in terms of rebuilding the economy and the reconstruction of a solid financial system is critical in this respect as it fosters stability. Our goal has been to develop a bank which provides support to individual and corporate clients in whatever business they are engaged in. We are on the right track and Arion Bank's operations are now characterized by stability, further rebuilding and getting results in a challenging environment

Monica Caneman,
Chairman

ARION BANK LEADS THE WAY

Important milestones were reached in 2013 in the ongoing process of building the Bank's business. Crucial steps were taken in opening up international credit markets. Early in the year the Bank secured foreign funding by means of a successful unsecured bond offering denominated in Norwegian kroner. By doing so, Arion Bank became the first Icelandic bank to raise foreign funding since 2007. The issue was part of the Bank's strategy to diversify the Bank's funding and at the same time it made us better positioned to serve our customers. The Bank has also issued covered bonds in Iceland, both indexed and non-indexed instruments.

Recently Arion Bank was assigned the credit rating BB+ with stable outlook by Standard & Poor's (S&P). This will facilitate further access to the international credit markets. Once more Arion Bank is leading the way and we became the first Icelandic bank to receive such ratings since the economic crisis. These are important steps on the path laid out by the Bank in 2010 and they are all designed to help build a bank which is capable of serving industry and households in Iceland.

▶ CHAIRMAN'S ADDRESS

CHALLENGES IN THE OPERATING ENVIRONMENT

Economic policy has been successful in several areas in Iceland in recent years. Interest rates, inflation and unemployment have all been reduced. The main challenges remain to stimulate investment, both from within Iceland and from abroad, and to lift the capital controls. Unfortunately, progress has been too slow in these areas in my opinion. Lifting the capital controls is admittedly a huge and delicate undertaking and great caution must be exercised.

An important component of good economic management is stability and predictability. I believe that one of the key roles of the Icelandic authorities now is to create a stable operating environment for companies and investors. One positive development is that the uncertainty over illegal currency-linked loans has been reduced and related cases are being resolved.

However, many of the words and actions of the authorities recently have been insufficient to increase the confidence of Icelandic and foreign investors in the Icelandic economy. The operating environment of Icelandic companies, especially financial institutions, remains too volatile. The legal environment for financial institutions has undergone enormous change and the recent steep increase in the banking levy is a clear example of that. This represents a massive rise in taxes which are not calculated on revenue or earnings but on liabilities. If the authorities want Iceland to be home to robust financial institutions which are capable of supporting the Icelandic business sector, then they need to create greater stability in their operating environment.

RESTRICTIVE TAXATION

It is also important to remember that restrictive taxation of cost items such as liabilities and salaries, regardless of the type of company or where they are located, will always have an impact on the terms of business that companies can offer their customers. Higher costs do not reduce the required rate of return of the owners, irrespective of whether the increase is from taxation or due to other factors. Such high taxes also have more wide-reaching consequences. They impede the ongoing development and consolidation of the Bank's business. Taxation on this scale can reduce foreign investment in Iceland and could slow down the process of selling the Bank which its owners are currently preparing.

CHAIRMAN'S ADDRESS

SEPARATE ICELANDIC REGULATORY FRAMEWORK MUST BE AVOIDED

More changes to the legislation governing financial institutions are also on the horizon. It is important that care is taken and that any changes to the law are well founded and will contribute to a better economy and society in Iceland. I'm aware of the good will of the current government and its willingness for cooperation and partnership, a willingness to provide strong support to the Icelandic business sector. As for the legal environment for financial institutions, it is important to look at our neighbouring countries and draw from their experience. A separate Icelandic regulatory framework is not desirable and undermines the competitiveness of Icelandic financial institutions and the entire business sector.

In this respect it must be said that Icelandic banks appear to be subject to greater restrictions than similar companies in the Nordic region in terms of cooperation, e.g. infrastructure. By doing this we are missing an opportunity to reduce the costs of the entire financial system without compromising the necessary competition between companies. Such restrictions are a cause for concern because reducing costs is a critical task for Icelandic banks and it is in everybody's interests that they manage to do so.

RIGHT ATTITUDE THE KEY TO SUCCESS

Banks perform a key role in all societies. The Board of Directors and employees of Arion Bank have worked hard to create a bank which does its job competently and responsibly. A great deal has been achieved but the process never ends. We are continuing to work diligently to change the Bank, making us better able to serve our customers. Change is not always easy. Change can be challenging but it is a great pleasure to experience the positive attitude of people at the Bank, both in the past when the tasks at hand were at times overwhelming, and today when changes chiefly involve adapting the Bank and its business to the ever-evolving needs of our customers.

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CHAIRMAN'S ADDRESS

INTERNATIONAL RECOGNITION

Towards the end of 2013 The Banker magazine, which is published by The Financial Times, named Arion Bank the bank of the year in Iceland. It is noteworthy that this is the first time since 2007 that an Icelandic bank has received such an award. It underlines what has been achieved and illustrates where Arion Bank and other Icelandic banks now find themselves. Arion Bank was chosen for its solid results in recent years and also for its leading role in Iceland in terms of funding, its range of mortgages, debt recovery work and innovative service offering.

OUTSTANDING RESULTS

The employees deserve praise for what they have accomplished in the last few years. In 2013 our objectives have been met and key performance indicators developed as predicted. Following Arion Bank's acquisition of the loan portfolios of Drómi, Hilda and Frjálsi towards the end of the year, the loan portfolio is well distributed and loans to individual borrowers now constitute half of the loan book. The Bank's funding mix is healthier than ever after a concerted effort was made to increase the stickiness of deposits and to diversify funding. Efforts to better distribute income have met with success and commission income now represents a larger proportion of the Bank's income. The Bank's capital ratio of 23.6% bears clear testament to the Bank's financial strength.

CEO'S ADDRESS

The year 2013 was a good year for Arion Bank. It was a year of operational stability, not least in the Bank's regular operations. Return on equity was 9.2% which is satisfactory in light of the sharp increase in the bank tax, which amounted to ISK 2.9 billion in 2013. Return on equity from regular operations was 10.5%. The Bank reported net earnings of ISK 12.7 billion. There was a significant increase in demand for the Bank's basic services. New loans grew by 60% from the previous year to almost ISK 120 billion.

Höskuldur H. Ólafsson, CEO

Loans to customers increased by 12% between years, particularly in connection with the Bank's acquisition of loan portfolios from the Drómi transaction, and totalled ISK 636 billion at the end of 2013. Arion Bank has reduced the risk in its operation by increasing long-term funding and raising the proportion of retail loans to almost 49% of total loans to customers by the end of the year. Total assets amounted to ISK 938.9 billion at the end of 2013, compared with ISK 900.7 billion at the end of 2012.

BUILDING THE BUSINESS STEADILY AND SURELY

October 2013 marked the fifth anniversary of the founding of Arion Bank, although the Bank has roots dating further back, something we appreciate more every day. We have had to deal with numerous tasks during this time, many presenting a serious challenge. But they have all been important because the objective has been to create a good bank; a bank which is financially robust and can meet its obligations to customers and society responsibly. Arion Bank has posted a profit every year during this period and has gone from strength to strength. It was therefore welcome recognition of what the Bank and its employees have achieved when The Banker magazine named Arion Bank as bank of the year in Iceland for 2013.

We are proud of the achievements of the last few years. Arion Bank stands on a firm footing, staffed by a team of dedicated employees who strive to be good partners to the Bank's customers. It has been a long, and at times, demanding journey. The first complete year of operations, 2009, was characterized by a struggle for survival from one day to the next. The Bank and its environment were racked by uncertainty. Key milestones were reached in 2010 when the Bank's ownership structure was clarified and a new board of directors and executive management took the helm. Later that year we set out a strategy for the Bank – one we have closely followed ever since.

We had to tackle complex debt recovery cases with their origins in the past and this left its mark on 2011. We focused our efforts on resolving the problem debts of the Bank's corporate and retail customers. The steps taken in reducing loans were without precedent. However, these actions were necessary as many homes and companies had unmanageable levels of debt. By taking these measures, which were designed to improve the situation of a large proportion of our customers, the Bank's balance sheet became far more transparent and healthier. As a result of meticulously going through their loan portfolios in recent years Icelandic banks now know exactly what is on their balance sheets.

CEO'S ADDRESS

In the last two years we have been able to turn our attention to regular banking activities and provide traditional services to our customers. We have shown ambition and endeavoured to show initiative and be at the cutting edge in terms of product development and the services we offer. We have taken a leading role on the mortgage market, offering several innovations in this area. Our competitors have often followed our lead, and the mortgage market has been revolutionized with the profusion of new loan options, both non-indexed and indexed. Most importantly, our customers have welcomed these changes.

WE KNOW WHERE WE ARE HEADING AND HOW TO GET THERE

A clear strategy and vision of the future are central to our efforts to create a good bank. What we have achieved in building up Arion Bank is to a large extent down to the clear strategy we set out with in 2010 and which we have followed ever since. It is a strategy based on the relationship banking model – Arion Bank is a relationship bank – a bank which offers its customers a broad range of financial services, customized to their needs, a bank which wants to forge durable links with its customers in the long term. Since adopting the strategy we have sharpened its focus and added more depth to it, setting quantifiable targets on how we can get to where we want to go – how we can become a good relationship bank. We have embarked on and completed around two hundred projects to implement our strategy. Some of these larger projects are still in progress, projects which will transform the Bank – a process which cannot be measured in months but rather in years. Such tasks require commitment and dedication.

One example of such a project is the implementation of the Bank's operating strategy which we set out in 2011. It is a strategy based on efficiency and results. We are creating a bank which not only intends to gives its customers quality and personal service but does so effectively – more efficiently than our competitors. The key to this is in no small part due to our clear strategy. We know where we are heading and our operating strategy helps us get there. Our operating strategy builds on the methodology of lean management and we have called it A Plus. It involves eliminating all waste and thus improving efficiency. Our objective is not just to lower costs but also to enhance our services. Currently a team of employees is working on implementing the operating strategy throughout the Bank and we expect it to have been completed in two years' time.

KNOWING OUR CUSTOMERS

The way to attain results is to know our customers and their widely differing requirements. Meet the customers on their own terms, where it suits them best. What our customers actually want and need varies greatly from one individual to another. A broad range of products and services is therefore vital. We are currently working on standardizing and increasing the availability of self-service transactions wherever possible. At the same time we are adding to the range of personal and customized services in other areas. This is the core to our strategy, building on our knowledge of the circumstances and needs of our customers and adapting our services to suit them. This is the core as our aim is to be a relationship bank which knows its customer and forges strong ties with them in the long term.

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CEO'S ADDRESS

TAKING THE RIGHT APPROACH

The prevailing culture within the Bank is essential for its ongoing development. We are lucky to have the people we have. A dedicated team of ambitious people who want to do a good job – to make a difference. Surveys have shown that our employees are proud to work for Arion Bank – this is important to us and our customers. In 2013 we established a set of values for the Bank. We kept things simple and took inspiration from what we felt characterized the mind-set and work of the Bank's employees. The values are we make a difference, we get things done, and we say what we mean. We know that people at the Bank are pleased with these values; we can all relate to them and they provide simple and useful guidance when making decisions. An important part of creating a good bank is to make decisions responsibly.

In my opinion it is a fundamental duty to ourselves, our customers and the society in which we work to create a good bank which takes its decisions responsibly. Financial institutions perform a critical role in all societies and are essential to the economic independence of all countries. As a bank we are an important link between people with money who are looking for a financial return and those who lack the funds to realize their ideas, whether this involves putting a roof over their heads or founding or expanding a business, thus stimulating economic growth. It is therefore important that we go about things the right way.

MAKING A CONTRIBUTION

We are active participants in the society in which we work in many ways. We proudly support good causes and cultural and sporting events throughout Iceland because we think it matters. We place a special emphasis on financial education; we look on it as our duty. We have the expertise and the human resources in this area to share our specialist knowledge with the community. We provide generous support to the important work done by the Institute for Financial Literacy, which is based at Reykjavík University.

Innovation is also particularly important to us. There are many reasons for this. Not least the fact that it is important to increase the number of ways of creating value in Iceland. The seed investment environment in Iceland is good in many ways but we have detected a lack of support and funding at the initial stages. That is why, in collaboration with Klak Innovit, we have set up Startup Reykjavík, a business accelerator based on an international template. It is therefore not merely symbolic support or empty words. In 2012 and 2013 we invested in a total of 20 seed projects and gave them assistance and guidance over a period of 10 weeks. We will continue along this path because it matters. Who knows, perhaps one of these companies will become the next Marel, Össur or CCP? There is only one way to find out and that is to provide solid support to new ideas and entrepreneurs who have the talent to realize their ideas.

STRONG EMPHASIS ON A DIVERSE SERVICE OFFERING

It is not just innovation at start-up companies which is important, but also innovation at well-established companies. We place great importance on developing our product offering and services. Technology is central to our business and our state-of-the-art online bank and the Arion Bank app are testament to that.

CEO'S ADDRESS

Our customers need to be able to choose how they want to use the Bank's basic services – whether from a branch, the call centre, ATM, Arion Online Bank, the app or by phone. The most costly way of providing a service is one which requires the direct involvement of an employee, such as at a branch or the call centre.

At Arion Bank we think it only fair that those using the most expensive services pay a fee which reflects the cost involved. This means that service from cashiers will be more expensive in the future than it is today. But it is also important that our customers have the choice to use service channels which cost less, and I am particularly referring to solutions online and via smart phones. This development is well established in our neighbouring countries. In Iceland this is partly needed to offset the decreasing net interest margin, a development that we expect to continue. The net interest margin at Arion Bank is one of the lowest in Iceland at 2.9% in 2013.

HUGE INCREASE IN TAXES PUSHES UP COSTS AND HAS IMPACT ON TERMS OF BUSINESS

We need to keep firm control of costs in order to allow us to offer our customers services at reasonable terms. The business environment does not make it easy for us, however. Heavy taxes are imposed on the Bank and towards the end of 2013 the authorities decided on a huge increase in the bank tax. This tax is calculated on the liabilities of financial institutions. Arion Bank, like other Icelandic banks, is primarily funded with deposits. Therefore this is primarily a tax on deposits. The tax in 2014 for the financial year 2013 is estimated at ISK 2.9 billion. It is clear from this that reducing the net interest margin has not been made any easier by these government measures.

The Banker magazine's choice of Arion Bank as Icelandic bank of the year for 2013 was welcome recognition of the achievements made in recent years.

PROUD OF GOOD ACHIEVEMENTS

The Banker magazine's choice of Arion Bank as Icelandic bank of the year for 2013 was welcome recognition of the achievements made in recent years. In justifying its decision the magazine referred to the Bank's enterprise in many areas, such as the mortgage market and its development of online and smart phone banking services. It also highlighted the fact that in early 2013 Arion Bank became the first Icelandic bank to raise funding on the international credit markets since 2007. Here we led the way and others have since followed our example. Now at the beginning of 2014 Arion Bank became the first Icelandic financial institution to gain a rating from an international ratings agency.

We are proud of the achievements of the last few years. We have been steadfast, adhering to the strategy we laid out at the end of 2010 and have attained our stated targets. As the 2013 financial results show, the Bank's operations are stable, the product range is diverse and we provide good service. It is important to us that market research has shown that satisfaction among our customers continues to increase and is in fact at an all-time high at the end of 2013. This provides the firm foundation we need to help us continue our work and to develop in the future.

112 ICELAND

NEW APP DESIGNED TO INCREASE SAFETY FOR TRAVELLERS

BUSINESS DEVELOPMENT

Innovation is important in all areas. Not just for entrepreneurs and start-ups but also for well-established companies. In 2013 we placed strong emphasis on the innovation carried out by our customers. Focused business development takes place at Icelandic companies and this creates more efficient business and delivers better goods and services to customers. This is worth celebrating.

Arion Bank

HIGHLIGHTS OF 2013

FIRST QUARTER

JANUARY

- The Bank completed its third non-indexed covered bond issue. The bonds were subsequently admitted to trading on NASDAQ OMX Iceland.
- The Arion Bank and Disney Reading Week was held for the third time, with 1,700 children taking part.
- The pension fund Lifeyrissjódur Rangæinga came under the management of Arion Bank Asset Management.

FEBRUARY

- New 30-day term account introduced.
- The Bank completed its first international bond offering in Norwegian kroner, arranged by Pareto Öhman. Bonds with a value of approximately NOK 500 million (ISK 11.2 billion) were placed with more than 60 international investors.
- Arion Bank reported its 2012 annual financial results – net earnings of ISK 17.1 billion.
- Arion Bank held an art exhibition on the theme of chess in Icelandic art. An international chess match between Iceland and China was also held at the Bank's headquarters.

MARCH

- Arion Bank was the main sponsor of Moustache March, a campaign to raise awareness of male-specific cancer organized by the Icelandic Cancer Society.
- Arion Bank sponsored the Iceland Geothermal Conference 2013 which has held at the Harpa Concert Hall. The Bank is one of the founders of the geothermal cluster.
- Arion Bank and the Icelandic Sports Association for the Disabled signed a partnership agreement whereby the Bank will continue to be one of the association's chief sponsors.
- The Bank sponsored the campaign Caring People which involved setting up a fund to provide support to chronically ill children.
- The Bank signed partnership agreements with the FBSH rescue team in Hella in southern Iceland, pledging ISK 900,000 to the team over three years.
- Annual General Meeting held.
- Private Banking conference held at the Bank's headquarters.

HIGHLIGHTS OF 2013

SECOND QUARTER

APRIL

- Startup Reykjavík attracted a great deal of interest. A total of 207 applications were received from 309 people.
- Arion Bank Stock Exchange Days were held at the Bank's headquarters.
- A meeting was held on investments by women in collaboration with the Association of Business Women in Iceland.
- Arion Research organized a seminar on the economic outlook and the lifting of the capital controls.
- Asset Management held an information meeting on payouts from pension savings and what should be considered in this respect.
- Publication of the Bank's Pillar 3 Risk Disclosures for 2012. Its objective is to provide information on risk and capital management at the Bank and also to meet the legal requirements on disclosure under the EU Capital Requirements Directive.
- The Bank held an opening meeting on business models, at which Alexander Osterwalder, bestselling author of the book Business Model Generation, gave a lecture on the template Business Model Canvas.
- Corporate Finance arranged the sale and stock market listing of VÍS.

MAY

- An art exhibition was held at the Bank of works by Kristján Davídsson, who died earlier in the year. All the exhibited works were owned by the Bank.
- The Bank's 3M results for 2013 were published – net earnings of ISK 1.4 billion.
- The Bank expanded its range of non-indexed mortgages. Firstly, the Bank offers a non-indexed mortgage based on Central Bank interest rates plus a premium of 0.95%. Secondly, the Bank offers non-indexed mortgages with fixed 3-year interest.
- The Bank started issuing a new credit card with travel-related benefits in partnership with Icelandair.
- The Bank acquired a property at Borgartún 18 in Reykjavík where a branch will be opened during the summer of 2014.

JUNE

- Ten teams chosen to participate in Startup Reykjavík 2013.
- Freyr Thórdarson appointed managing director of Corporate Banking at Arion Bank.
- Corporate Finance worked on the refinancing of Reitir. An important milestone was reached when Reitir signed a letter of intent with pension funds on the acquisition of new share capital and bonds issued by Reitir.

▶ HIGHLIGHTS OF 2013

THIRD QUARTER

JULY

- NOK denominated bonds issued by Arion Bank were admitted to trading on Oslo Stock Exchange.
- The Bank completed an offering of a new series of covered bonds, Arion CBI 19. They were subsequently admitted to trading on NASDAQ OMC Iceland.
- Reitun upgraded its credit rating of Arion Bank to B+ with a positive outlook. It also affirmed its rating of the Bank's covered bonds at A.

AUGUST

- The Bank organized a Street Exhibition during the 2013 Reykjavík Culture Night.
- The Arion Bank football tournament was held in Reykjavík. A total of 2,100 children took part.
- The Investment Day was held at the Bank's headquarters where participants in Startup Reykjavík presented their business ideas to investors.
- Arion Bank reported its 6M 2013 financial results – net earnings of ISK 5.9 billion.

SEPTEMBER

- Arion Bank, the owner of the holding company Landfestar hf, and the board of the real estate company Eik began discussions on a merger between Eik and Landfestar.
- The Bank was the main sponsor of the conference Mergermarket which was held in London to present investment opportunities in Iceland.
- Asset Management and Stefnir organized a seminar for pension funds under the title "Looking into the future".

HIGHLIGHTS OF 2013

FOURTH QUARTER

OCTOBER

- The Bank held a lecture and opened an exhibition by the photographer Ragnar Axelsson, RAX. The lecture was entitled "North" and was held at the Bank's headquarters.
- Pink flags were raised at the Bank's headquarters to mark the Pink Ribbon fundraising and awareness campaign of the Icelandic Cancer Society in the fight against cancer in women. The Bank supported the campaign by buying pink ribbons for its employees.
- Arion Bank distributed reflector badges to all six-year olds in Iceland.
- The Bank participated in a conference in Greenland at which specialists from the Bank discussed economic developments and the outlook in Iceland.
- Arion Bank granted 25 students grants to buy books worth ISK 30,000 each.
- Arion Bank Ladies Night held at the Bank's headquarters to raise funds in the fight against cancer in women. The employees raised ISK 1.5 million for the Icelandic Cancer Society.
- The Arion Bank and Disney Reading Week was held for the fourth time, with 2,200 children taking part.
- The Bank completed an offering of a new series of covered bonds, Arion CBI 19. They were subsequently admitted to trading on NASDAQ OMC Iceland.

NOVEMBER

- Preparations began for the listing of HB Grandi hf. on the main list of NASDAQ OMX Iceland. Arion Bank owns 1/3 of the company.
- Frjalsi Pension Fund was named the best pension fund in countries with fewer than one million inhabitants by Investment Pension Europe.
- Arion Bank reported its 9M 2013 financial results – net earnings of ISK 10.1 billion.
- Work on the recalculation of currency-linked loans from Arion Bank came to a conclusion. It involved the recalculation of 3,700 loans where a clear legal precedent had been set.

DECEMBER

- Corporate Finance arranged the listing of N1 on NASDAQ OMX Iceland.
- Arion Bank named bank of the year in Iceland for 2013 by The Banker magazine, published by The Financial Times.
- Arion Research held a presentation discussing the outlook on the property market until 2015 and at the same time published a report on the property market.
- A company owned by Stefnir, SF IV slhf, acquired the entire share capital of Skeljungur and the Faroese oil company P/F Magn.

HIGHLIGHTS OF 2013

- The founding of a new business accelerator for projects and companies in the energy sector, Startup Energy Reykjavík, was announced. Arion Bank is one of the founders of the business accelerator.
- Benedikt Olgeirsson and Björgvin Skúli Sigurdsson replaced Jón G. Briem and Björg Arnardóttir as Board Directors. Björg was an Alternate for Freyr Thórdarson who left the Board earlier in the year when he took up a position as a managing director at Arion Bank.
- Arion Bank sponsored the Christmas aid distribution organized by Icelandic Church Aid, Mædrastyrksnefnd and the Icelandic Red Cross. Each organization received a donation of ISK 2 million and employees also gave Christmas presents to be distributed by Mædrastyrksnefnd.
- Eik and Arion Bank signed an agreement on the acquisition by Eik of all share capital in Landfestar ehf. Eik financed the acquisition with new share capital and Arion Bank thereby became the largest shareholder in Eik.
- Settlement agreements were reached between Drómi, ESÍ and Arion Bank, whereby Arion Bank took over the retail loans of Drómi, Frjálsi and Hilda.

THE ECONOMIC ENVIRONMENT

The Icelandic economy continued on the road to recovery in 2013. Economic growth gained pace, while inflation and unemployment continued to decrease. The financial circumstances of households and companies also improved to some degree. The treasury deficit kept shrinking and the treasury is set to be deficit free in 2014. Tourism has been a key force behind the growth in foreign trade in 2013 and is one of the main motors driving the economy. This industry is likely to remain a major source of growth over the next few years and the outlook is for sustained economic recovery. The asset markets are showing various signs of progress, with both the property and stock markets performing well during the year. However, several areas of risk remain, particularly the lifting of the capital controls, the difficult maturity profile of private debt and settlements with the failed banks and to some extent, the economic growth outlook of Iceland's main trade partners.

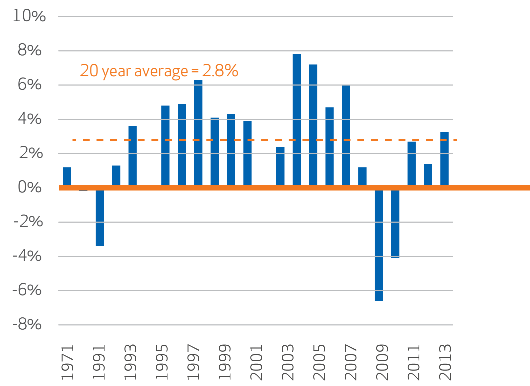
ECONOMIC GROWTH TAKES OFF

The economic recovery continued in 2013 with the economy performing considerably better than forecast after a period of weak growth the previous year. Private consumption continued to rise and foreign trade was a positive contributor to economic growth once more. Investment (excluding ships and aircraft) increased again after having been in a depressed state since the economic crisis and there are clear signs of a willingness to invest in the economy. Domestic product, however, is still well below the previous levels and production levels are currently almost 4% lower than when the financial crisis hit towards the end of 2008.

The labour market rallied and gathered momentum as the year went by. The employment rate increased alongside a rise in the total hours worked. At the beginning of 2013 unemployment measured 5.8% but had fallen to 4.4% by the end of the year. The main indicators on the labour market suggest a sustained recovery, with an increase in total working hours and falling unemployment as economic activity intensifies.

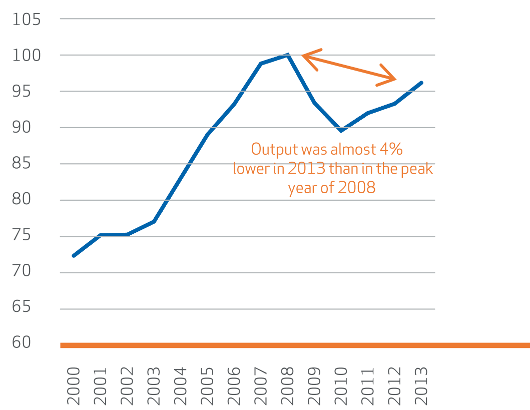
The positive thing about the drop in unemployment is that is not caused by people leaving the labour market. The number of people not participating in the labour market has decreased and more people are moving to Iceland than leaving the country. The explanation appears to be that people are moving into paid employment. The figure below shows that unemployment in Iceland is relatively low in international comparisons.

GDP Growth
YoY %



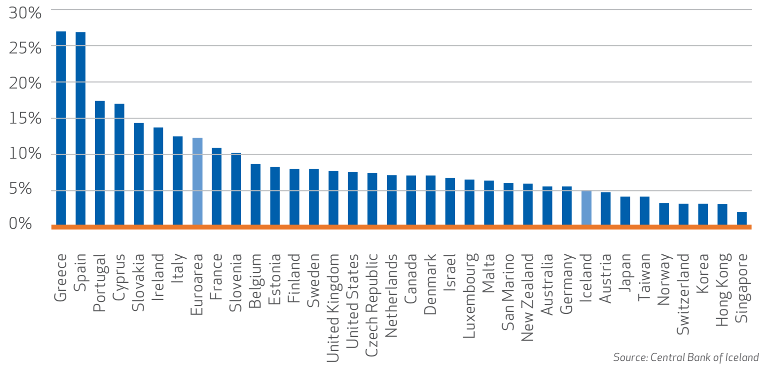
Source: Statice

GDP
Constant prices; index, 2008 = 100



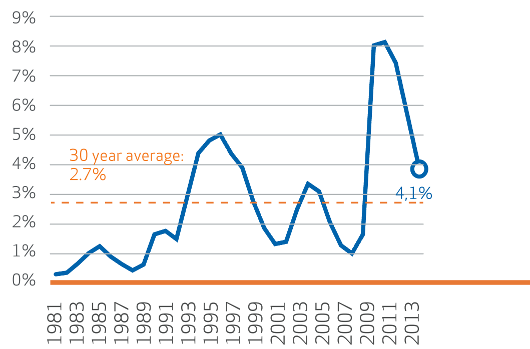
Source: Statice

Unemployment in 2013
average for the year



Source: Central Bank of Iceland

Unemployment

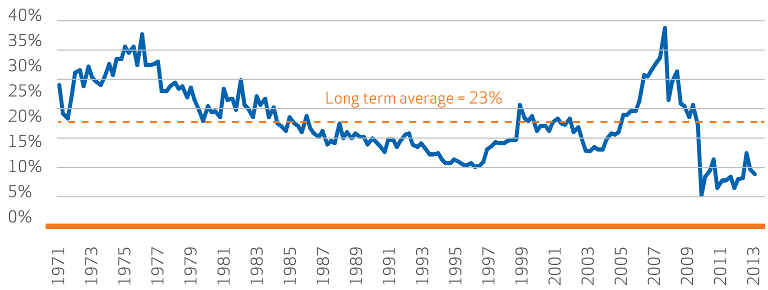


Source: Central Bank of Iceland

INVESTMENT ON THE WAY UP

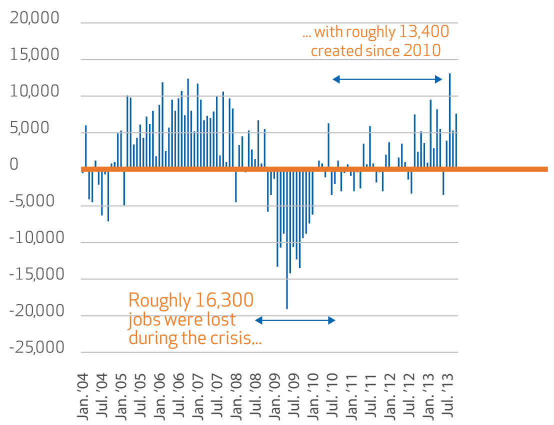
Investment has been at a historical low level in Iceland in recent years and has been far below the long-term average. The situation appears to have got brighter in 2013 and business investment was one of the reasons that economic growth was greater than had been generally forecast during the year. Surveys conducted during the second half of the year also indicated that there was a greater willingness among companies to invest than there was in the first half of the year. However, there is still a long way to go before investment regains the level of the long-term average. It is vital that investment receives a boost if economic growth is to gain momentum over the next few years. It is also important to stimulate investment which generates foreign currency so further steps can be taken to lift the capital controls.

Investment in Iceland since 1970
% of GDP



Source: Central Bank of Iceland

Number employed
change YoY



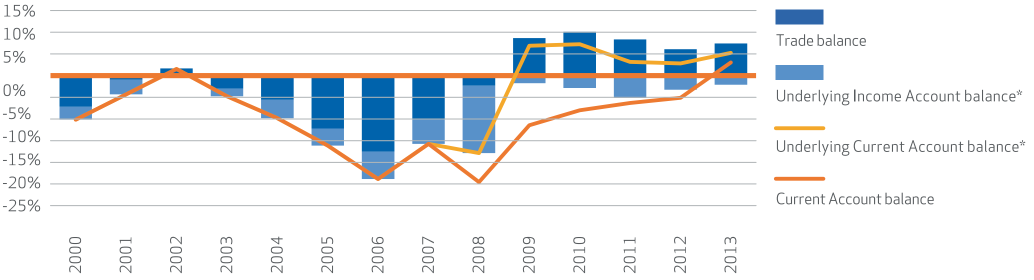
Source: Central Bank of Iceland

CONTINUED CURRENT ACCOUNT SURPLUS

The underlying current account balance has improved dramatically since 2008 and there has been a surplus of an average of over 5% of GDP.

Current Account

% of GDP



* Excludes DMBs being wound up and excludes Actavis until 2012.

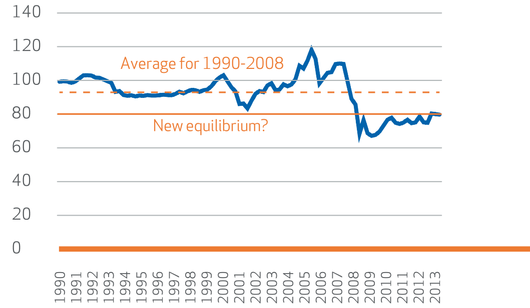
Source: Central Bank of Iceland

The low real exchange rate has benefitted the export sector in recent years and the real exchange rate today is approximately 16% lower than the average real exchange rate of recent decades. Although exports grew faster than imports in 2013, the current account surplus did not increase significantly as terms of trade continued to deteriorate. Aluminium and fisheries products account for almost half of Iceland's total exports and prices of both aluminium and marine products dropped sharply in 2013. Terms of trade deteriorated further and were 17% poorer in 2013 than they were before starting to deteriorate in 2007.

Service exports have changed substantially in recent years and have grown steadily as the number of tourists to Iceland has risen - since 2000 there has been a 100% increase in the number of tourists. Yet another record was broken in 2013 in terms of the number of tourists visiting Iceland and service exports represented more than 40% of total exports, up from 35% in 2010. Revenue from tourism is 29% of total exports, rising from 19% in 2010.

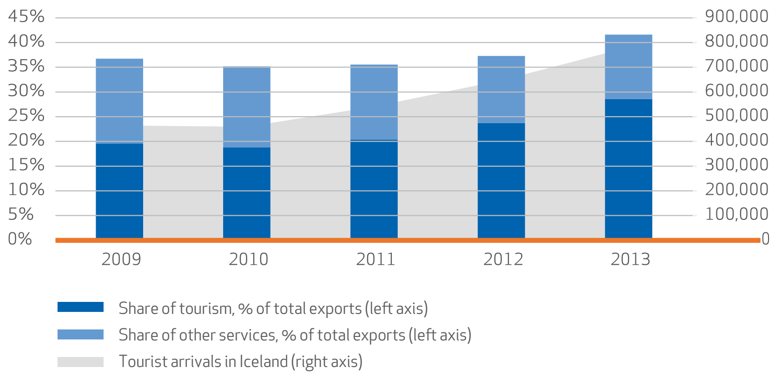
Real Exchange Rate

Relative CPI



Source: Central Bank of Iceland

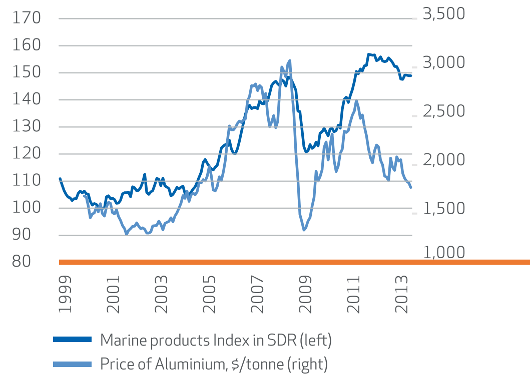
Increase in tourism and exported services



Sources: Icelandic Tourist Board, Statice

Prices of marine exports and aluminium

Marine products price index, Sept 2000 = 100



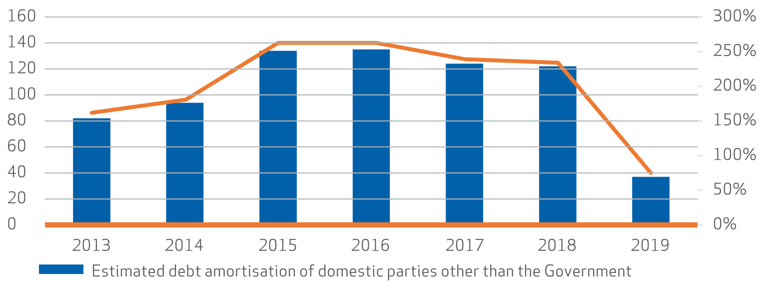
Sources: Central Bank of Iceland, StatIce

CHALLENGING MATURITY PROFILE IN FOREIGN CURRENCIES

Companies and the public sectors are facing challenging repayment schedules in foreign currencies. Since the collapse of the banking system, access to international credit markets by Icelandic borrowers other than the treasury has been highly restricted. Only a moderate current account surplus is expected over the next few years and therefore it will be insufficient to cover maturing debt over the next few years. If Icelandic investors are unable to access international credit markets at better terms, it is going to prove necessary to refinance their debts, especially the repayment of the Landsbanki bond, from the new bank to the old one. The repayment profile of other companies and the public sector (other than the treasury and the old Landsbanki) is declining and will continue to decline in coming years, hence, reducing the pressure on the króna. Otherwise there will be a significant pressure on the exchange rate of the ISK in the next few years to meet scheduled loan repayments.

Estimated debt amortization profile of domestic parties other than the Government

SK bn. and as a % of 2013 CA



Source: Central Bank of Iceland

Icelandic króna (TWI)

Source: Central Bank of Iceland

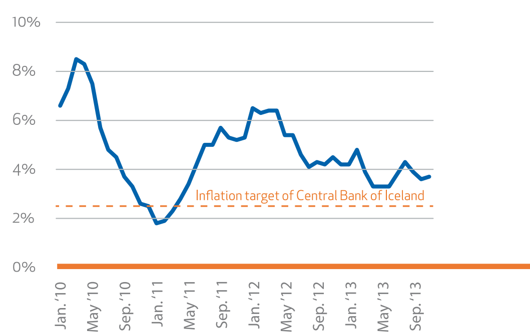
INFLATION HAS DROPPED SUBSTANTIALLY

Inflation dropped sharply during the year and the Central Bank of Iceland kept its policy interest rate unchanged throughout the year. Inflation was nevertheless above the Central Bank's inflation target all year, and the 12-month rate of inflation measured 4.2% at the end of the year. There is considerable uncertainty over future developments, particularly with regard to the effect of a debt relief programme announced by the government, but also due to longer term union wage agreements that need to be approved next year. The Central Bank has repeatedly hinted at raising interest rates if revised union wage agreements are not conducive to the Bank's efforts to reduce inflation and it has pointed out the importance of maintaining a tight fiscal stance. The Central Bank has also said that ways to reduce inflation pressure stemming from debt relief for inflation-indexed housing mortgages must also be considered.

Various factors will generate inflation pressure in the coming months. There is likely to be pressure from the labour market while prices on the real estate market will continue to increase, thus making this market play an even more dominant role in the measuring of inflation in the coming months.

Inflation

change from previous year



Source: Central Bank of Iceland

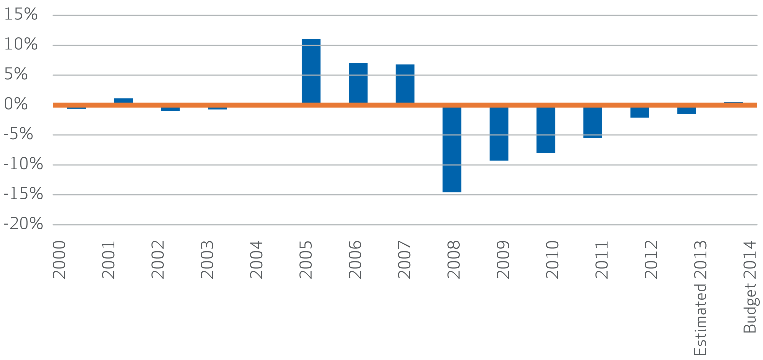
THE ECONOMIC ENVIRONMENT

UNCERTAINTY OVER 2014 BUDGET ASSUMPTIONS

The ratings agencies Fitch, Moody's and S&P affirmed Iceland's credit rating during the year 2013. Moody's rates Iceland at Baa3 and the outlook was upgraded from negative to stable in February 2013 as the ruling by the EFTA court in January was seen to reduce risk. S&P rates Iceland at BBB- and the outlook was downgraded from stable to negative in July 2013 on account of risk linked to fiscal policy. Fitch maintained a stable outlook and its rating for foreign long-term liabilities is BBB and for domestic liabilities BBB+. Both Fitch and Moody's issued press releases after the government had announced its plans on debt relief for mortgage loans and both agencies agreed that it would not have a significant effect on government finances.

The treasury deficit has decreased in recent years and if the government keeps to its budget, there will be a surplus on the primary balance in 2014. It is also assumed that there will be a surplus on an accrual basis which would be an important step towards lowering government debt. It would in fact be the first time for six years that there was no treasury deficit.

Central Government Total Balance
as % of GDP



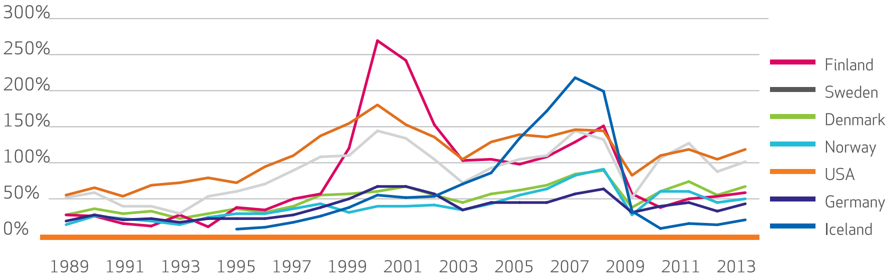
Source: Ministry of Finance and Economic Affairs

There is considerable uncertainty which could influence the assumptions used in the government's budget and it would not take much to derail expectations of a primary surplus. Such uncertainty includes the government's plans to extend a 5-year bond which it submitted to the Central Bank at the beginning of the financial crisis. There is also uncertainty over an increase in revenue from the banking tax which has been imposed on the estates of banks in the process of being wound up and over how much capital will be put into the Housing Financing Fund. On the other hand, the dividends paid by the three banks, Íslandsbanki, Landsbanki and Arion Bank because of the financial year 2013 are substantially larger than expected in the government's budget.

ASSET MARKETS GIVE CAUSE FOR GREATER OPTIMISM

The equities market rallied strongly in 2013. Three new companies were listed on the equities market and the market value of listed shares increased by approximately ISK 130 billion. The total market capitalization of listed companies on the Icelandic stock market is equivalent to 29% of Iceland's GDP. Further IPOs are expected in 2014. Although the market has grown rapidly over the last two years it is still far smaller in relation to GDP than comparable markets abroad. In contrast, the bond market was more sluggish and turnover remained similar to the previous year.

Market value of listed stocks
% of GDP

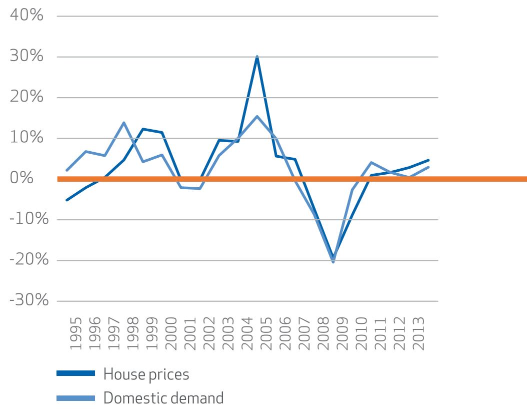


Sources: IMF, Arion Research

The real estate market continued to gain strength. Increased economic activity, growing purchasing power, falling unemployment, low real interest rates and higher demographic demand are factors which boost the market and will continue to do so in the years to come. The financial position of private households has also improved with shrinking debts and increasing asset prices.

In the long term the capital controls have a negative effect on economic growth and distort the financial markets and asset prices in Iceland. Following the financial crisis, an enormous amount of capital has been trapped in the economy yet there have been few available investment options. This capital has found its way mainly into government-backed assets (deposits and bonds), both because investors are risk averse at present and also because there has been a greater supply of lower risk assets than other types of investments. The consequence of this is low interest on bonds under the protection of the capital controls.

Interaction between the Economy and House Prices
YoY change in real values



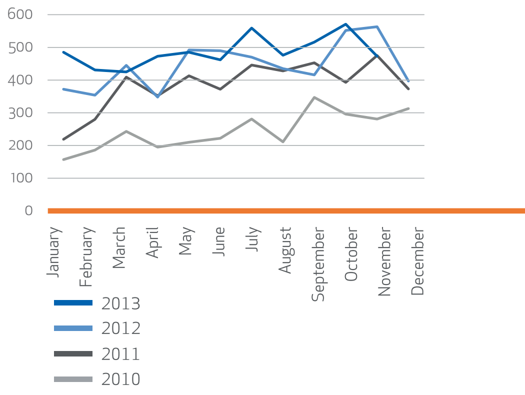
Sources: Registers Iceland, Statice, Arion Research

THE ECONOMIC ENVIRONMENT

Although the capital controls have had an obvious influence on the government bond market in recent years, the effect has not been noticed on the other asset markets (equities and property). Gains on the market recently can be explained by a general improvement in the economy. The longer the capital controls become rooted, the greater the danger of a bubble forming in other asset markets. However, towards the end of the year the Central Bank announced the sale of assets from its asset portfolio (ESÍ) which could have a profound effect on the supply of investment options and liquidity on the market and consequently interest rates and inflation in Iceland. In the long term it reduces the likelihood of an unsustainable spiralling of asset prices by lessening surplus liquidity on the financial markets. Inflation pressure will therefore decrease, if other factors remain unchanged.

Activity is increasing year by year

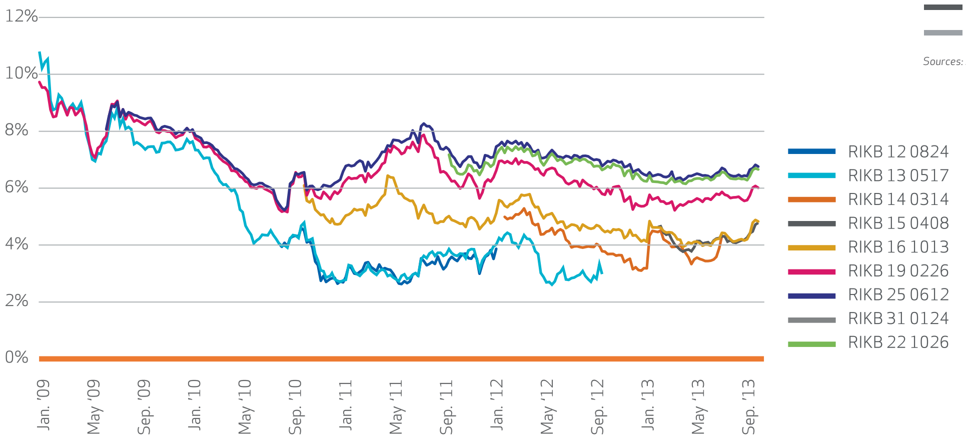
number of registered purchase agreements in the Reykjavik area



Sources: Statice, Registers Iceland, Arion Research

Yields on nominal Treasury bonds

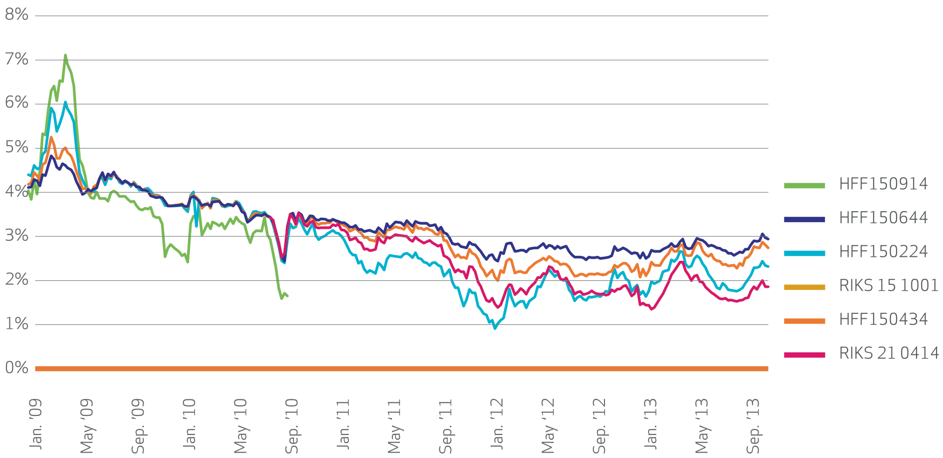
2 January 2009 - 27 December 2013



Source: Central Bank of Iceland

Yields on indexed bonds

2 January 2009 - 27 December 2013



Source: Central Bank of Iceland

1 IN 20 PEOPLE
HAVE SAVED FOR A BIKE

SAVINGS

It makes sense to save money and Arion Bank offers you many ways of doing this. In order to show you how you can save money, we decided to look at the main reasons for saving. We conducted a survey in which people were asked what they were saving for. The results were then used to illustrate all the different ways of saving and how beneficial it is to save.

Arion Bank

BOARD OF DIRECTORS
AND CORPORATE GOVERNANCE

CORPORATE GOVERNANCE STATEMENT OF ARION BANK HF.

This Corporate Governance Statement is designed to help foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Corporate governance provides a basis for responsible management and decision-making, with the objective of generating lasting value.

The Corporate Governance Statement of Arion Bank hf. (Arion Bank or the Bank) is based on legislation, regulations and recognized guidelines which are in force at the time the Bank's financial statement is approved by the Board of Directors. This statement has been prepared in accordance with Article 19 (3) of the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 4th edition, issued by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland hf. and the Confederation of Icelandic Employers in March 2012.

LEGAL AND REGULATORY FRAMEWORK

Arion Bank is a financial institution which operates in accordance with the Financial Undertakings Act No. 161/2002. The Bank is a universal bank which provides a comprehensive range of financial services relating to savings, loans, asset management, corporate finance and capital markets. The Bank has issued financial instruments which have been admitted for trading on regulated securities markets in Iceland, Norway and Luxembourg, and is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act No. 108/2007 and the rules of the relevant stock exchanges.

The Icelandic Financial Supervisory Authority (FME) supervises the operations of Arion Bank in accordance with Act No. 87/1998 on the Official Supervision of Financial Operations. Further information on the FME and an overview of the applicable legal and regulatory framework can be seen on the FME's website, www.fme.is. Numerous other pieces of legislation apply to the Bank's operations.

INTERNAL CONTROLS, AUDITING AND ACCOUNTING

Internal Audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter which lays out the responsibilities associated with the position and the scope of the work. The mission of the Internal Auditor is to provide independent and objective assurance and advice designed to add value and improve the Bank's operations. The scope of the audit is the Bank, its subsidiaries and pension funds serviced by Arion Bank.

The audit is governed by the audit charter, general guidelines No. 3/2008 issued by the FME on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by the Internal Audit every quarter. Internal Audit had nine employees at the end of 2013.

Compliance and measures against money laundering and terrorist financing

Arion Bank seeks to detect any risk of failure to fulfil its legal obligations and has taken appropriate measures to minimize such risks.

The Bank employs an independent Compliance Officer in accordance with a charter from the Board of Directors. The role of the Compliance Officer includes:

- To monitor and regularly assess the adequacy and effectiveness of measures and actions designed to minimize the risk of failure to fulfil the Bank's obligations under the Securities Transactions Act No. 108/2007 and the Act on Measures against Money Laundering and Terrorist Financing No. 64/2006.
- To provide the employees of the Bank with the necessary training, advice and assistance to enable them to fulfil the Bank's obligations under the Securities Transactions Act and the Act on Measures against Money Laundering and Terrorist Financing and the Competition Act.
- To investigate and notify the police of any suspicion of money laundering or terrorist financing and notify the FME of any suspicion of market abuse. The Compliance Officer also conducts independent investigations if there is any suspicion of a violation of the Competition Act.

The Compliance Officer reports directly to the CEO and provides the CEO with regular reports about his work. The Compliance Officer gives the Board of Directors an annual report and also reports to the Board Audit and Risk Committee on a quarterly basis. The Compliance Officer may refer cases directly to the Board if deemed necessary. Compliance had six employees at the end of 2013.

Risk Management

A central feature of the activities of all financial companies is carefully calculated risk-taking according to a predetermined strategy. Arion Bank manages its risk according to internal risk policies and processes that are reviewed and approved by the Board of Directors. The Bank's risk appetite, set by the Board, is translated into exposure limits and targets that are monitored by the Risk Management division. The Board is responsible for Arion Bank's internal capital adequacy assessment process, the main objective of which is to ensure that Arion Bank understands its risk profile and has systems in place to assess, quantify and monitor its total risk exposure.

Risk Management is managed by the Chief Risk Officer. The division is an independent unit and reports directly to the CEO. Risk Management comprises five departments whose role is to analyze, monitor and regularly report to the CEO and Board of Directors on the risks faced by the Bank.

Further information on risk management and capital management is contained in the Bank's annual Pillar 3 Risk Disclosures which is published on its website. Risk Management had 28 employees at the end of 2013.

▶ BOARD OF DIRECTORS AND CORPORATE GOVERNANCE

Auditing and accounting

The Bank's Finance division is responsible for preparing the accounts and this is done in accordance with the International Financial Reporting Standards (IFRS). The Bank publishes its financial statement on a quarterly basis and management statements are generally submitted to the Board ten times a year. The Board Audit and Risk Committee examines the annual and interim financial statements, while the external auditors review and audit the accounts twice a year. The Board Audit and Risk Committee gives its opinion on the accounts to the Board of Directors, which then approves and endorses the accounts.

CUSTOMERS' OMBUDSMAN

The Customers' Ombudsman is appointed by the Chief Executive Officer. The role of the Ombudsman is to ensure fairness and objectivity, prevent discrimination against the customer and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 186 cases in 2013, compared with 268 cases in 2012.

CORNERSTONES, CODE OF ETHICS AND CSR

Arion Bank's cornerstones are names used to describe its core values. They are designed to provide guidance when making decisions and in everything else employees say and do. They refer to the Bank's role, attitude and conduct. The cornerstones are: We make a difference. We get things done. We say what we mean.

The management and employees of Arion Bank are conscious of the fact that the Bank's activities affect different stakeholders and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. The code of ethics is applied by the Board of Directors, the CEO, the Bank's management and other employees of the Bank.

One of the fundamental principles of corporate social responsibility is to align the interests of companies with those of the wider community. Arion Bank is a responsible member of Icelandic society and as such takes an active role in its construction and future development. Corporate social responsibility means that the Bank must perform its role conscientiously, ensuring that its customers receive first-rate services and get the support they need. In addition Arion Bank supports a select number of causes which it believes benefit and improve the community, such as: innovation, environmental issues,financial education, sports, charities, and cultural issues. Many of these projects require the active participation of employees, which is the key to achieving results.

BOARD OF DIRECTORS AND COMMITTEES

The main duties of the Board of Directors of Arion Bank are to manage the Bank between shareholders' meetings as further described in the law, regulations and articles of association. The Board tends to those operations which are not considered part of day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. One of the Board's main duties is to supervise the Bank's activities. The Board meets at least ten times a year. The rules of procedure of the Board of Directors and its subcommittees take into account the law and the aforementioned Guidelines on Corporate Governance. The rules of procedure of the Board of Directors can be found on the Bank's website. In other respects the Board works in accordance with the laws and regulations in effect and its role is defined in detail in the rules of procedure of the Board of Directors, which have been established on the basis of Article 54 (2) of the Financial Undertakings Act, Article 70 (5) of the Public Limited Companies Act No. 2/1995, FME Guidelines No. 1/2010, and the articles of association of the Bank.

One of the main duties of the Board of Directors is to appoint a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The Board of Directors and the CEO shall carry out their duties with integrity and ensure that the Bank is run in a healthy and normal manner with the interests of the customers, the community, the shareholders and the Bank itself as a key consideration, cf. Article 1 (1) of the Financial Undertakings Act. The CEO shall ensure that he provides sufficient support to the Board to carry out its duties.

The Board of Directors is elected for a term of one year at the company's annual general meeting. At Arion Bank's last AGM on 21 March 2013, seven directors and seven alternates were elected to the Board of Directors. The elected Directors have diverse backgrounds and extensive skills, experience and expertise. On 13 May Freyr Thórdarson stepped down from the Board. He is now managing director of Corporate Banking. On 18 December Jón G. Briem stepped down from the Board of Directors. Freyr and Jón were replaced at a shareholders' meeting on 18 December by Benedikt Olgeirsson and Björgvin Skúli Sigurdsson.

Information on the independence of Directors was not published on the Bank's website before the AGM on 21 March 2013 because the candidacies were announced late. This information was published on the Bank's website after the meeting. The minutes of the AGM and shareholders' meetings are sent to the shareholders following the meeting but have not been published on the Bank's website because of the current shareholder structure.

In 2013 the Board met on 13 occasions. There were three meetings which certain members were unable to attend. On one occasion a Director announced at short notice that he was unable to attend but he voted at the meeting by e-mail and therefore it was not necessary to summon an Alternate. On another occasion a Director was unable to attend and an Alternate was called in instead.

The Chairman directs and is responsible for the work of the Board. The Chairman chairs Board meetings and ensures that there is enough time allocated to the discussion of important issues and that strategy issues are discussed thoroughly. The Chairman is not permitted to undertake any other work for the Bank unless part of the normal duties of the Chairman.

At the first scheduled meeting of the new Board following the AGM the Board appoints members to each of its sub-committees and assesses whether it is necessary to appoint external members to certain committees in order to bring in a greater level of expertise. One of the committee members in the Board Audit and Risk Committee, Gudjón Gústafsson, is not a Board Director and is independent of the Bank and its shareholders. The Board sub-committees are as follows:

- Board Audit and Risk Committee: Its main task is to examine issues concerning auditing and risk which the Board needs to make a decision on. Its regular tasks include examining reports from internal control divisions, reviewing the risk appetite, examining the annual and interim financial statements to ensure the quality of the information and the independence of the company's auditors.
- Board Credit Committee: Its main task is to attend to credit, investment and underwriting issues which exceed the credit limits of its sub-committees.
- Board Remuneration Committee: Its main task is to advise the Board on the terms of remuneration to the CEO and other employees hired by the Board. Regular tasks at committee meetings are to review the remuneration policy, the HR policy, salary distribution and the incentive system if one is in place.

The Board has decided to go further than stipulated in the Guidelines on Corporate Governance with respect to the disclosure requirements of sub-committees. At every meeting the Board receives the minutes of the previous meeting of each sub-committee and is given access to all the information from the meetings of the sub-committees.

In 2013 the Board Credit Committee met on 14 occasions. The Board Audit and Risk Committee met on six occasions. The Board Remuneration Committee met on five occasions. Below is an overview of the attendance of individual Directors:

Director	Period	Board	BARC	BCC	BRC
Monica Caneman	1 Jan - 31 Dec	13		14	
Gudrún Johnsen	1 Jan - 31 Dec	13	6		5
Agnar Kofoed-Hansen	1 Jan - 31 Dec	13		14	5
Benedikt Olgeirsson*	18 Dec - 31 Dec				
Björg Arnardóttir**	23 May - 18 Dec	8		8	
Björgvin Skúli Sigurdsson*	18 Dec - 31 Dec				
Freyr Thórdarson***	1 Jan - 13 May	5		5	
Jón G. Briem	1 Jan - 18 Dec	11	2		5
Måns Höglund	1 Jan - 31 Dec	12	6	12	
Thóra Hallgrímsdóttir****	14 Mar - 31 Dec	10	4		
Ólafur Örn Svansson*****	26 Sep / 22 Oct	2			
Gudjón Gústafsson******	1 Jan - 31 Dec		5		

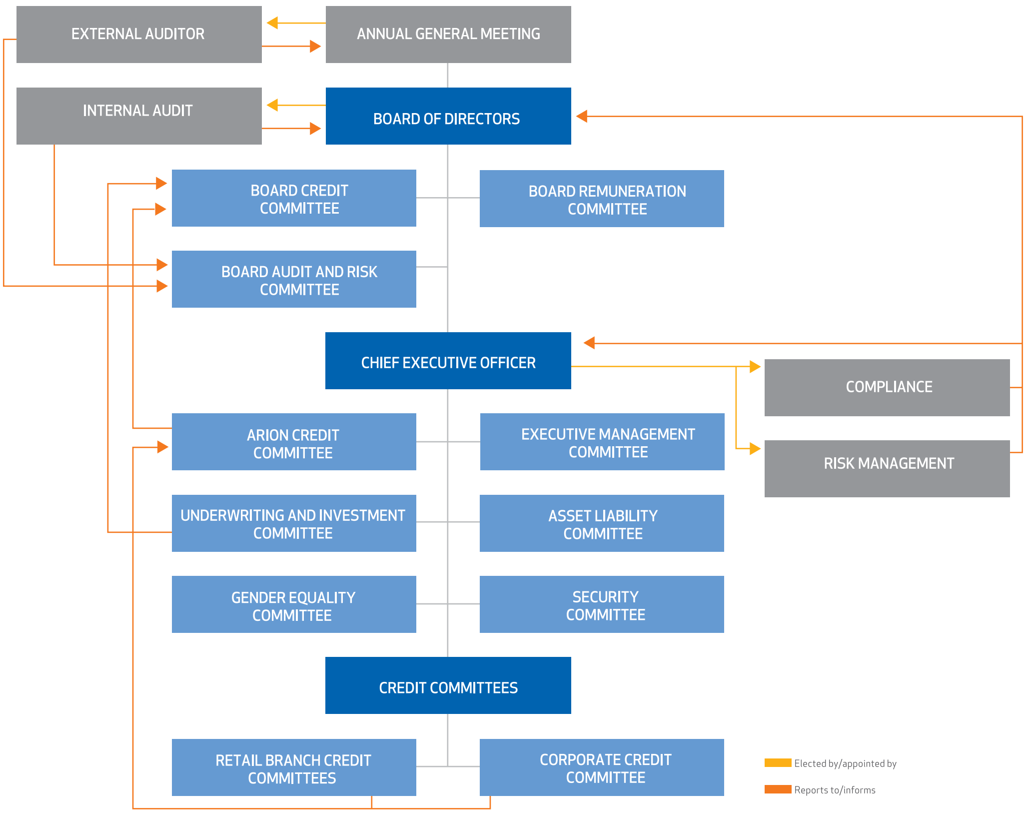
*Benedikt and Björgvin were elected on to the Board at a shareholders' meeting on 18 December 2013. No Board meetings were held in 2013 after 18 December.
**Björg was an Alternate from 1 Jan. She was brought in for Freyr Thórdarson who resigned from the Board on 13 May 2013. She is continuing to perform her duties as an Alternate following a shareholders' meeting on 18 Dec 2013.
***Freyr resigned from the Board on 13 May 2013. He is now managing director of Corporate Banking at Arion Bank.
****Thóra was an Alternate from 1 Jan. She was elected as a Director at the AGM on 21 March 2013.
*****Ólafur was an Alternate for Jón G. Briem who was unable to attend two meetings.
******Gudjón is a member of the Board Audit and Risk Commitee. He is not a Director.

The Board carries out an annual performance evaluation, at which it assesses its work, the necessary number of Board Directors, the Board structure, achievements and work of the sub-committees with respect to the aforementioned. This evaluation was last performed by the Board at its meetings and between meetings during the period 22 October to 11 December. The main conclusion of the evaluation was that the Board agreed that the Board and the CEO were doing a good job, and that the flow of information from the management to the Board was exemplary and that the relationship with the CEO was excellent.

BOARD OF DIRECTORS AND CORPORATE GOVERNANCE

The Board of Directors from left to right, back row: Benedikt Olgeirsson, Agnar Kofoed-Hansen, Måns Höglund, Thóra Hallgrímsdóttir and Björgvin Skúli Sigurdsson. Front row, left to right: Monica Caneman, Chairman, and Gudrún Johnsen Vice Chairman.

CORPORATE GOVERNANCE STRUCTURE



BOARD OF DIRECTORS AND CORPORATE GOVERNANCE

THE BOARD OF DIRECTORS

MONICA CANEMAN, CHAIRMAN

Monica was born in 1954. She is Swedish and lives in Sweden. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder of Arion Bank and is an independent Director. Monica is also Chairman of the Board Credit Committee.

She graduated with a BSc in business and economics from the Stockholm School of Economics in 1976.

Monica currently sits on the board of numerous companies and non-profit organizations and is the chairman of several of them. She worked at Skandinaviska Enskilda Banken (now SEB) from 1977 to 2001. Monica held various positions at SEB in marketing and commercial banking. She became a member of the Group Executive Committee and Group Management in 1995 and became deputy CEO in 1997. She became an alternate member of the board of directors at the same time. Monica left SEB in 2001. Since then she has built a career around board assignments.

GUDRÚN JOHNSEN,VICE CHAIRMAN

Gudrún was born in 1973. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder of Arion Bank. Gudrún is Chairman of the Board Remuneration Committee and a member of the Board Audit and Risk Committee.

Gudrún completed an MA in applied economics at the University of Michigan, Ann Arbor in the United States in 2002 and gained an MA in statistics from the same university the following year. She graduated with a BA in economics from the University of Iceland in 1999.

Gudrún is currently a lecturer in finance in the faculty of business administration at the University of Iceland. In 2009 and 2010 Gudrún worked as a senior researcher for the Parliamentary Special Investigation Commission looking into the causes and events leading up to the fall of the Icelandic banking system in 2008. She was assistant professor at Reykjavík University from 2006 to 2013. Between 2004 and 2006 Gudrún worked as a specialist in the Financial Systems Department of the International Monetary Fund (IMF) in Washington DC. She was a teaching and research assistant at the University of Michigan, Ann Arbor from 2002 to 2003. Gudrún worked as a securities broker at the Icelandic Investment Bank (FBA) hf.between 1999 and 2001. She has served on the board of a fund management company of MP Bank hf. and is the current chairman of the research and development company THOR ehf.

AGNAR KOFOED-HANSEN

Agnar was born in 1956. He was first elected as an Alternate at a shareholders' meeting on 18 March 2010. He was then elected as a Director at a shareholders' meeting on 24 March 2011. He is not a shareholder of Arion Bank and is an independent Director. Agnar is a member of the Board Remuneration Committee and the Board Credit Committee.

Agnar received a BSc in mechanical and industrial engineering from the University of Iceland in 1981. He completed a master's in management engineering from the Technical University of Denmark in 1983. He then did a master's program from MIT Sloan in the United States, including financial analysis, the presentation of management information and marketing. Agnar completed a degree in mechanical and industrial engineering from the University of Iceland in 1981. He is also an authorized securities dealer. In addition he has completed numerous training courses in management and business.

Agnar is now a business and management consultant at Intellecta ehf. He was managing director of finance and IT at HRV ehf. from 2008 to 2013. Between 2000 and 2007 he was managing director of SPRON Factoring hf. From 1989 to 2000 he was manager of capital markets at Kaupthing hf., managing director at Information Iceland ehf. and was later a board member and head of the credit reporting department at Creditinfo Lánstraust hf. He worked for Industrial Bank of Iceland hf. as head of the credit department from 1987 to 1989 and was head of sales and marketing at Thróun hf. from 1983 to 1987.

BENEDIKT OLGEIRSSON

Benedikt was born in 1961. He was first elected as a Director at a shareholders' meeting on 18 December 2013. He is not a shareholder of Arion Bank and is an independent Director.

He gained an MSc in construction engineering and project management at the University of Washington in Seattle in 1987. He has also completed courses in management, business and finance at Wharton Business School and Harvard Business School. Benedikt completed a degree in civil engineering from the University of Iceland in 1986.

Benedikt has been Deputy CEO of Landspítali University Hospital since 2010. Between 2005 and 2009 Benedikt he was managing director of Atorka hf. He was managing director of Parlogis ehf. from 2004 to 2005. He was a manager at Eimskip hf. between 1993 and 2004, most recently as head of Eimskip's hf. operations in Hamburg. Between 1988 and 1992 Benedikt worked as a project manager in civil engineering. He was a board director at Promens hf. from 2005 to 2010. He was also a board director at InterBulk Group, which is listed on the London Stock Exchange, from 2007 to 2010. Benedikt was also chairman of Icepharma hf. and Parlogis ehf. from 2005 to 2007.

BJÖRGVIN SKÚLI SIGURDSSON

Björgvin was born in 1974. He was first elected as a Director at a shareholders' meeting on 18 December 2013. He is not a shareholder of Arion Bank and is an independent Director.

Björgvin completed a PhD from the Management Science and Engineering Department at Stanford University in 2005. He gained a master's in economics and finance from the same university in 2002. Björgvin completed a degree in mechanical and industrial engineering from the University of Iceland in 1998.

He is currently executive vice president of marketing and business development at Landsvirkjun, the National Power Company of Iceland. Between 2010 and

2013 he worked in credit structuring at Deutsche Bank in London. He then worked at LBHI Services Limited from 2008 to 2010 where he was part of a team unwinding the credit derivatives books of Lehman Brothers. Between 2005 and 2008 Björgvin was a specialist in credit trading at Lehman Brothers in London.

MÅNS HÖGLUND

Måns was born in 1951. He is Swedish and lives in Portugal. He was first elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder in Arion Bank and is an independent Director. Måns is chairman of the Board Audit and Risk Committee and is a member of the Board Credit Committee.

He graduated with a BSc in business and economics from the Stockholm School of Economics in 1975.

From 2002 to 2011 Måns worked for Swedish Export Credit Corporation (SEK) as executive director and head of corporate and structured finance. He was also a member of SEK's Executive Committee. In 1999 to 2002 he worked for both Unibank (as head of the Sweden operation) and Nordea (as Head of Private Banking, Sweden). From 1991 to 1999 he worked at Swedbank where his roles included being head of the corporate division. In 1984 he joined Götabanken in London and was transferred to the bank's Stockholm operation in 1989 where he was head of the international finance division until 1991. From 1977 to 1984 he worked for Hambros Bank in London, where he was regional director for Iceland and Denmark for two years. He previously worked as a lecturer and researcher at the Stockholm School of Economics.

THÓRA HALLGRÍMSDÓTTIR

Thóra was born in 1974. She was first elected as an Alternate Director at a shareholders' meeting on 21 March 2013. She was elected as a Director at a shareholders' meeting on 24 March 2011. She is not a shareholder in Arion Bank and is an independent Director. Thóra is a member of the Board Audit and Risk Committee.

Thóra completed a degree in law at the University of Iceland in 2000 and qualified as an attorney to the district court in 2002.

Since 2011 she has worked as a specialist in the faculty of law at Reykjavík University in insurance law, contract law and law of tort. Before that Thóra worked as a lawyer for two Icelandic insurance companies: for Tryggingamidstödin hf. from 2000 to 2005 and Sjóvá-Almennar tryggingar hf. from 2005 to 2011. Thóra is currently a board member of the rehabilitation fund Virk-Starfsendurhaefingarsjódur ses, appointed by the Confederation of Icelandic Employers and she is also on the board of the Association of Icelandic Lawyers and CEO for the Icelandic Law Journal (Tímarit Lögfraedinga). Thóra serves as chairman of the insurance complaints committee and chairman of the seamen and fishermen's arbitration committee, appointed by the government.

ALTERNATE DIRECTORS

Björg Arnardóttir, served as an Alternate on the Board from 13 May to 18 December 2013, Bödvar Jónsson, managing director of Byggingafélag Námsmanna, Gudrún Björnsdóttir, managing director of Félagsstofnun stúdenta, Hrönn Ingólfsdóttir, employed by Isavia, Kirstín Th. Flygenring, economist, Ólafur Árnason, divisional head at the engineering company Efla, and Ólafur Örn Svansson, supreme court attorney.

COMMUNICATIONS BETWEEN THE SHAREHOLDERS AND THE BOARD OF DIRECTORS

The Chairman of the Board of Directors communicates with shareholders on behalf of the Board and the Bank between legally convened shareholders' meetings, which are the main venue at which the Board and the Bank report information to the shareholders. Shareholders have also at the Board's request, arranged quarterly meetings at which the Chief Executive Officer presents the interim financial results.

CHIEF EXECUTIVE OFFICER

The Chief Executive Officer is responsible for the daily operations of the Bank. The Chief Executive Officer shall provide the Board with reports on the Bank's operations and financial position and all important issues which may affect the Bank's operations and finances. With respect to other duties responsibilities and duties of the Chief Executive Officer please refer to Chapter VII of the Financial Undertakings Act and Chapter IX of the Public Limited Companies Act. The duties of the Chief Executive Officer and his responsibilities take into account the legal environment in which the Bank operates at any given time and the rules which the Board of Directors may establish.

The Chief Executive Officer of Arion Bank is Höskuldur H. Ólafsson. Höskuldur is not a shareholder of Arion Bank and no stock option agreements have been entered into with him.

INFORMATION ON VIOLATIONS OF LAWS AND REGULATIONS

Arion Bank has not been denied registration, authorization, membership or permission to conduct certain business, activity or operations. The Bank has not been subject to withdrawal, revocation or dismissal of registration, authorization, membership or permission.

Information on legal cases relating to Arion Bank can be found in the notes to the annual financial statement.

This Corporate Governance Statement was examined and approved by the Board Audit and Risk Committee and the Board of Directors at a meeting on 26 February 2014.

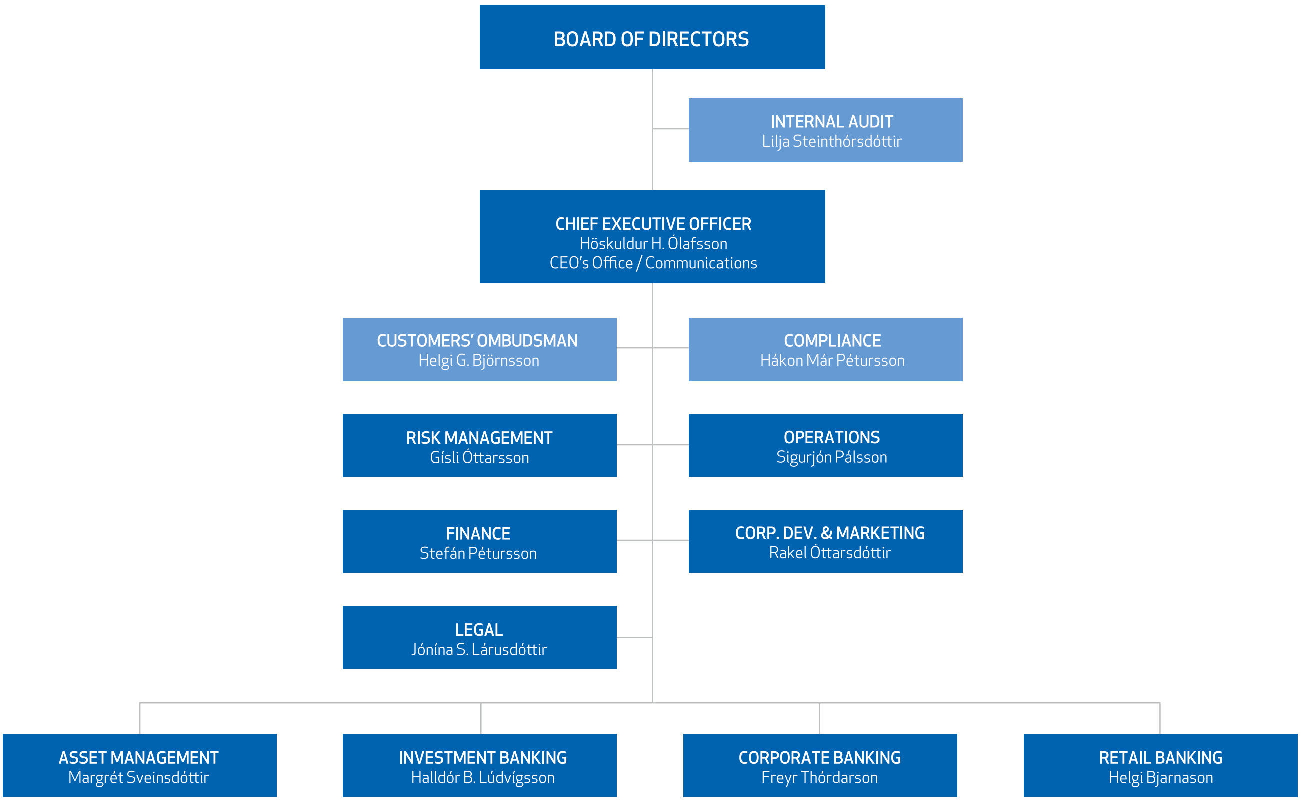
SENIOR MANAGEMENT

HÖSKULDUR H. ÓLAFSSON

Chief Executive Officer

Höskuldur was born in 1959. He was appointed CEO of Arion Bank in June 2010 and joined the Bank from Valitor hf. where he had been CEO since 2006. Prior to that he worked at the Icelandic transportation company Eimskip hf. for 17 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad. Höskuldur is the chairman of the Icelandic Financial Services Association (SFF) and a board member of the European Banking Federation. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987.

ORGANIZATIONAL CHART



SENIOR MANAGEMENT

BUSINESS SEGMENTS

FREYR THÓRDARSON

Managing Director of Corporate Banking

Freyr was born in 1973. He was appointed managing director of Corporate Banking in June 2013. Between 2009 and 2013 Freyr worked at Kaupthing hf. where he managed restructuring and asset recovery projects in the company's Scandinavian portfolio. Freyr has worked in banking and finance since 2001, both in Iceland and abroad, at Straumur Investment Bank, Gnúpur investment company, and Íslandsbanki/Glitnir. From 1999 to 2001, prior to his financial career, Freyr worked at a bottling company called IcelandSpring on plant development and management. He has served on the boards of several companies, both in Iceland and abroad, and he was a board director at Arion Bank from 2012 to 2013 and was a member of the Board Credit Committee. Freyr gained an MBA degree from Reykjavík University in 2010 and completed a BSc in business administration at Reykjavík University in 2003. Before that he studied at Universität Salzburg in Austria and completed a Vordiplom in Communication Science in 1999.

HALLDÓR BJARKAR LÚDVÍGSSON

Managing Director of Investment Banking

Halldór was born in 1967. Halldór was appointed managing director of Investment Banking in September 2011. Between 2010 and 2011 Halldór was managing director of Corporate Finance and Recovery. In 2009 he worked for Kaupthing's Resolution Committee as managing director of the bank's Nordic asset portfolio. From 2005 to 2008 he worked in the corporate banking division of Kaupthing Bank where he supervised lending activities in Scandinavia. Between 1992 and 2005 Halldór held a number of management positions, including the position of CEO at Maritech A/S, an international company which sells technical solutions for the fishing industry. He has served on the boards of a number of companies in Iceland and abroad. Halldór graduated with a degree in mechanical engineering from the University of Iceland in 1991 and a BSc in computer science in 1992 from the same university. He is also a certified stock broker.

HELGI BJARNASON

Managing Director of Retail Banking

Helgi was born in 1969. Helgi was appointed managing director of Retail Banking in October 2011. He joined Arion Bank as managing director of Operations in October 2010. In 2006, Helgi started work at Sjóvá Almennar Insurance and served as managing director of the life insurance company in addition to being vice-president of the non-life insurance company. From 1997 to 2006 Helgi worked as an actuary at Okkar Life Insurance. Helgi has served on various boards of directors, such as the Association of Icelandic Actuaries, the Confederation of Employers, the Icelandic Financial Services Association, and he is currently the chairman of the board of directors of Okkar Life Insurance. Helgi gained a cand. act. degree in actuarial mathematics from the University of Copenhagen in 1997 and graduated with a BSc in mathematics at the University of Iceland in 1992.

SENIOR MANAGEMENT

MARGRÉT SVEINSDÓTTIR

Managing Director of Asset Management

Margrét was born in 1960. She has been managing director of Asset Management at Arion Bank since February 2009. Between 2007 and 2009 she was head of financial institutions client relations at Glitnir. From 1990 to 2007 she was head of securities brokerage and advisory at Íslandsbanki Securities Ltd, later the asset management division of Glitnir. Between 1985 and 1988 she worked in the credit division of the Industrial Bank of Iceland. Margrét has served on a number of boards of directors, including: The Depositors' and Investors' Guarantee Fund on behalf of SFF, Okkar Life Insurance and several funds in Luxembourg. Margrét graduated with an MBA from Babson College in Massachusetts in 1990 and a cand. oecon. degree in business administration from the University of Iceland in 1986. She is also a certified stockbroker.

SUPPORT UNITS

JÓNÍNA S. LÁRUSDÓTTIR

Managing Director of Legal Division

Jónína was born in 1970. She was appointed managing director of the Legal division in November 2010. She was permanent secretary of the Ministry of Economic Affairs and Commerce, from 2007 to 2010. She was appointed director of the general office of the Ministry of Industry and Commerce in 2004 and remained there until 2007. Between 2000 and 2004 she was a specialist in the financial markets department at the Ministry of Commerce. Jónína worked for the A&P law firm from 1996 to 2000. She has served on and chaired numerous committees, including on behalf of the Prime Minister's Office, and has worked as a lecturer in several institutions, such as the faculty of law of the University of Iceland. She was chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004. Jónína gained a master's from the London School of Economics and Political Science in 2010. She graduated from the faculty of law at the University of Iceland in 1996 and qualified as a district court attorney the following year.

RAKEL ÓTTARSDÓTTIR

Managing Director of Corporate Development and Marketing

Rakel was born in 1973. She was appointed managing director of Corporate Development and Marketing in December 2011. Rakel was head of Arion Bank's Project Office from 2010 to 2011. She was an account manager in the IT division of Kaupthing Bank between 2005 and 2010. Rakel previously worked as a software designer and later as head of development at TM Software – Libra, a financial services software company. Rakel graduated with an MBA from Duke University in North Carolina in 2002 and a BSc in computer science from the University of Iceland in 1997.

SENIOR MANAGEMENT

SIGURJÓN PÁLSSON

Chief Operating Officer

Sigurjón was born in 1972. Sigurjón was appointed chief operating officer in October 2011. He was the head of the recovery team at Arion Bank from 2009 to 2011. Sigurjón worked in Kaupthing Bank's corporate finance division from 2005 to 2009. Prior to 2004 Sigurjón held various management positions with the Icelandic contractor Ístak, including the management of infrastructure projects and the construction of industrial buildings. He was also the head of IT while managing these projects. Sigurjón has served on the boards of directors of various companies in Iceland and abroad. Sigurjón graduated with a master's degree in supply chain management from MIT in 2005. He completed a master's degree in 1998 in construction management from KTH in Stockholm, Sweden, and in 1996 he graduated as a civil engineer from the University of Iceland. He is also a certified stockbroker.

STEFÁN PÉTURSSON

Chief Financial Officer

Stefán was born in 1963. He was appointed chief financial officer at Arion Bank in August 2010. Stefán joined Landsvirkjun in 1991, first as head of funding and from 1995 as treasurer. He became chief financial officer of Landsvirkjun in 2002 and sat on the company's negotiation committee with energy intense industry. While on leave from Landsvirkjun in 2008 he served as the CEO of the investment company HydroKraft Invest hf. From 1986 to 1989 Stefán worked as head of administration at the Icelandic Fisheries Laboratories Institute. Stefán has held a number of directorship positions and other positions of responsibility in recent years. He is currently a member of the board of Landfestar hf. and the Depositors' and Investors' Guarantee Fund on behalf of SFF. Stefán graduated with an MBA from Babson College in Massachusetts in 1991 and a cand. oecon. degree from the faculty of business of the University of Iceland in 1986.

▶ SENIOR MANAGEMENT

INTERNAL CONTROL

GÍSLI ÓTTARSSON PHD

Chief Risk Officer

Gísli was born in 1963. Gísli was appointed chief risk officer of Arion Bank in April 2009. From 2006 to 2009 he was head of research and development in Kaupthing Bank's risk management division. From 2001 to 2006 he was a software designer and advisor for the engineering software company MSC. Software in the United States. From 1994 to 2001 Gísli worked for Mechanical Dynamics Inc. in the US as a software architect and development manager for the multibody dynamics and motion analysis software ADAMS. Gísli was awarded a PhD in mechanical engineering in 1994 and gained an MSc in applied mechanics in 1989, both from the University of Michigan. Gísli received a BSc in civil engineering from the University of Iceland in 1986. He is also a certified stockbroker.

HÁKON MÁR PÉTURSSON

Compliance Officer

Hákon was born in 1981. He was appointed compliance officer at Arion Bank in April 2011. From 2009 to 2011 Hákon worked for Kvasir Legal as a specialist in financial services and financial restructuring. Between 2006 and 2009 Hákon worked as a specialist in the securities market division at the Financial Supervisory Authority of Iceland (FME). During this time he was the FME's representative on various expert groups, including the Takeover Directive expert group and the MiFID expert group at the Committee of European Securities Regulators (CESR). He was also a guest lecturer at the University of Iceland and Reykjavík University. He graduated from the faculty of law at the University of Iceland in 2007 and is also a certified stockbroker and holds an international advanced certificate in anti-money laundering.

LILJA STEINTHÓRSDÓTTIR

Chief Audit Executive

Lilja was born in 1949. She became Arion Bank's chief audit executive in October 2008. Lilja was chief audit executive at Kaupthing Bank from 2006 to 2008. Prior to joining the Bank she was the chief auditor at the Central Bank of Iceland for eight years. In 1986 she set up an accounting firm in Akureyri which she managed for 13 years. She served on the audit committee of the Icelandic Banks' Data Centre from 1998 to 2010, first on behalf of the Central Bank of Iceland and then Arion Bank. Lilja gained an MBA from the University of Edinburgh in 1998. She qualified as a chartered accountant in 1984 and graduated with a cand. oecon. degree in business administration from the University of Iceland in 1980.

SENIOR MANAGEMENT

OMBUDSMAN

HELGI G. BJÖRNSSON

Customers' Ombudsman

Helgi was born in 1961. He was appointed customers' ombudsman of Arion Bank in April 2012. He worked in the Customers' Ombudsman department as a specialist from 2010 to 2012. Helgi was the branch manager at Búnadarbanki Íslands and then Kaupthing Bank in Grafarvogur, Reykjavík from 1999 to 2010, and he was deputy branch manager at Búnadarbanki from 1993 to 1999. Between 1989 and 1993 Helgi worked for the Director of Tax Investigations. From 1987 to 1989 Helgi worked at Bifröst University in Iceland, teaching accounting, production management and human resource management. Helgi graduated with a diploma in industrial technology from the Technical College of Iceland (now Reykjavík University) in 1987.

ARION BANK
MORTGAGES

Customers of Arion Bank have a wide range of options when it comes to buying a home. We have launched several popular new products such as non-indexed loans with fixed 5-year interest, mixed loans and lower repayments during paternal leave. Our financial advisers have great expertise in this area and played a key role in introducing these products in 2013.

Arion Bank

STRATEGY AND VISION

Arion Bank is a financially robust bank which offers comprehensive financial services to corporate and retail customers. We place great importance on developing long-term business relationships with customers who require a diverse range of financial services and we provide personal service and customized solutions. The mainstays of the Bank's business are retail banking, corporate banking, asset management and investment banking.

Our objective is to gain a leading position in the long term on the Icelandic banking market in terms of profitability, efficiency and product offering. We are making every effort to contribute to the development of the business sector and society as a whole.

BUILDING RELATIONSHIPS

Our customers have many goals, dreams and challenges. It is our job to help them realize their dreams, achieve their goals and seize new opportunities. We do this by building better relationships.

We build better relationships by getting to know our customers and their circumstances and understanding what advice and services they require to reach their goals. We offer a broad range of services, are solution-oriented and develop goods and services which fulfil the needs of our customers. We endeavour to maintain good long-term business relationships with individual customers, companies and investors and to exceed their expectations.

By providing outstanding services and advice we help our customers make the best decisions for them.

BETTER CUSTOMER SERVICE WITH A PLUS

We have invested in the implementation of lean management, something we refer to as A Plus at the Bank. By using A Plus we are implementing the Bank's strategy and organizing our day-to-day work with the aim of providing even better service and further improving customer satisfaction.

We listen to the voice of the customer and make it our priority. We strive to understand our customers, their needs and their experience of the Bank's services. It is important that the customer has a positive experience when it matters most.

We underline the importance of having effective end to end processes across the Bank where the customer is the main focus. We eliminate waste, instability and inflexibility and use the benefit to improve services and the experience and satisfaction of our customers.

A Plus helps us to continuously improve and to find new ways of enabling our customers to reach their goals.

A Plus helps us to be better today than we were yesterday and to find new ways of enabling our customers to reach their goals.

▶ STRATEGY AND VISION

CORNERSTONES

We refer to our core values as Arion Bank's cornerstones and they provide guidance in our day-to-day work. They are the foundations of the success and long-term prosperity for both the Bank and our customers. The cornerstones are: We make a difference, we say what we mean and we get things done.

We make a difference

We lay the basis for our customers' success by getting to know them, their goals and circumstances and by offering them varied solutions and developing new products. We make a difference in the community by operating a good bank and helping to ensure that Iceland has a financial system which people can rely on. We work together, supporting and relying on one another.

We say what we mean

We say what we mean, show respect and we maintain confidentiality at all times. We work with integrity, are fair and speak our minds. We respect the community in which we live and follow sound business practices. This is how we earn the trust of our customers and the community.

We get things done

What matters most is what we get done, not what we say we are going to do. We do not avoid difficult tasks but instead face them head on and deal with them professionally. We show courage to get things done and shoulder responsibility for the tasks we undertake and the decisions we make. We take the initiative, respond quickly and keep people informed.

A RELATIONSHIP BANK FOR THE FUTURE

In a constantly changing world it is important to understand how the needs and wishes of our customers will also change in the future. Rapid developments in technology in recent years have made it easier for customers to gain access to information and services and their requirements and demands are becoming ever more complex.

Our customers increasingly want to be able to choose where, when and how they obtain financial services. They want a range of products, customized solutions and options which meet their expectations and requirements. It is important to develop and bring out new services to meet our customers' future needs.

Financial advice and professional services when it matters most will play an increasing role throughout our branch network. At the same time we are offering more self-service options to simplify the service process for customers. Online and smart phone services will continue to be a focus for development.

This will allow us to maximize the value of the service we provide in the most cost-effective way.

GREATER FINANCIAL LITERACY

Financial literacy is becoming increasingly important because the multitude of available options and the rapid development of financial services can make finance a complex area. Financial literacy improves people's understanding of their own finances and the choices that are on offer and makes it easier for people to take the right decision.

We strive to increase transparency in the Bank's service and product range and offer our customers diverse and inexpensive ways to obtain information and understand their finances better. We offer a number of courses and organize seminars designed to improve financial literacy. We also participate in and encourage informed debate on financial and economic issues and give our customers sound financial advice.

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THE IMPORTANCE OF INNOVATION

Innovation is important for our society and lays the foundation for future growth and development. Innovation enables us to convert ideas and new knowledge into new technology, new products and even new branches of industry needed by the market.

We make an effort to create a healthy environment for entrepreneurs and start-up companies in Iceland. By making direct investment in start-ups, providing guidance from instructors and facilities where entrepreneurs have the opportunity to meet, we have created a positive and stimulating environment to realize new ideas and introduce investors to new opportunities.

Innovation within companies is no less important for society. Rapid technological advances call for constant innovation and development if companies wish to grow and flourish. We provide support to innovation at companies by providing funding and helping them reach their goals.

CORPORATE SOCIAL RESPONSIBILITY

Arion Bank demonstrates its corporate social responsibility first and foremost by carrying out its role as a financial institution conscientiously and responsibly and by taking an active role in the community in which it works. Financial institutions are one of the pillars of society and our role is to help people and businesses reach their goals. We place great importance on doing things fairly with the interests of our customers, employees, shareholders and the community at heart.

INNOVATION AND STARTUP REYKJAVÍK

Innovation can transform ideas and expertise into new technology, new ways of doing things or new products both at established companies and at the seed investment stage. Innovation is important for the growth and value creation of companies and lays the foundation for the future development of society.

Arion Bank supports innovation at companies by providing funding and advice, thereby helping them reach their goals. We want to create a healthy environment for start-up companies in Iceland and have participated in various projects and events which are either directly or indirectly involved with innovation in Iceland. By doing this we contribute towards creating a positive and stimulating environment for the realization of new ideas and present new opportunities to investors.

Arion Bank's main seed investment programme is Startup Reykjavík which is a joint project between Arion Bank and Klak Innovit. The objective of Startup Reykjavík is to create an environment where entrepreneurs can receive advice and guidance from experienced mentors in order to realize their ideas and thereby create new business opportunities. Ten teams are selected from among the applicants and they are offered seed funding, training and joint working facilities. The teams are also given the opportunity to present their business ideas to Icelandic and international investors.

Startup Reykjavík is the first programme of its kind in Iceland and business accelerators such as this have proven very popular and enjoyed great respect among investors and entrepreneurs around the world. Twenty new companies have already passed through Startup Reykjavík and a further ten will participate in the summer of 2014.

Startup Energy Reykjavík (SER) is a business accelerator based on the same template as Startup Reykjavík but it focuses on projects and companies in the energy sector. SER will take place for the first time in 2014 and seven companies were chosen to take part. SER is a collaborative project between Arion Bank, Landsvirkjun, GEORG, Innovation Center Iceland, Klak Innovit and Iceland Geothermal.

The objective of Startup Reykjavík is to create an environment where entrepreneurs can receive advice and guidance from experienced mentors in order to realize their ideas and thereby create new business opportunities.

Startup
Reykjavík
Arion banki
Innovit
Klak

Startup Energy
Reykjavík

CORPORATE SOCIAL RESPONSIBILITY

Arion Bank has already invested in 20 start-up companies through Startup Reykjavík and 10 more companies will come on board in 2014.

CORPORATE SOCIAL RESPONSIBILITY

FINANCIAL LITERACY

Financial literacy is more important than ever nowadays and as part of Arion Bank's corporate social responsibility the Bank promotes better financial literacy. The rapid development of financial services and the multitude of available options can make finance a complex topic but financial literacy improves people's understanding of their own finances and the options available to them.

Financial literacy covers a range of topics, from personal finances, making budgets and setting targets, to decisions such as buying a house or choosing a pension scheme. Major financial decisions can have a huge impact on people's quality of life but by improving financial literacy people can make informed decisions.

Our customers have easy access to information on their own finances and we offer a PFM solution which gives people a better overview of their household finances. We also host seminars on major financial decisions such as buying property or pensions and we have qualified financial advisors who provide good, honest advice. By doing this we help our customers understand all the different options in financial services and to take the decision which is best for them. It is important to start early and that is why it is vital to educate the younger generation about money. We have held a number of well-attended courses for children and teenagers across Iceland, teaching them the basics about money. We also actively participate in the debate on financial and economic issues in Iceland and promote open discussion by organizing a range of meetings and conferences on various financial topics.

Arion Bank is the main sponsor of the Institute for Financial Literacy whose aim is to improve financial literacy in Iceland.

OUR PEOPLE

The Bank's most important asset is its employees. We strive hard towards creating a work environment in which we can all grow and develop our knowledge.

Arion Bank is a knowledge company made up of people with varied experience and expertise. We show initiative and seek new opportunities to progress in order to help the Bank and ourselves develop. We encourage professional development and offer an ambitious educational programme which gives all our employees the opportunity to improve their knowledge and skills. We try to enable our employees to gain more responsibility and to move into management positions within the Bank or to transfer to other jobs and projects.

An employee survey is carried out every year in order to strengthen the working environment and to foster job satisfaction. It is important that there is a healthy balance between work and private life and employees are also encouraged to look after their health. There is zero tolerance towards bullying, sexual harassment or any other inappropriate behaviour. It is the responsibility of everyone to prevent such conduct at the workplace.

We have a clear equal opportunities policy. The Bank's policy is to ensure equal opportunities and terms for employees of both sexes. We have developed an equality action plan incorporating actions such as equal salaries, equality when hiring and appointing people on committees and job development.

CORPORATE SOCIAL RESPONSIBILITY

ENVIRONMENTAL ISSUES

Treating the environment with respect and concern is important to Arion Bank. Our aim is to use energy sparingly at work, use environmentally friendly printing solutions and to increase the proportion of paperless transactions. We sort the rubbish produced at our places of work and choose environmentally friendly goods and services wherever we can.

A new printing solution was introduced at the end of 2012 which has resulted in a 17% reduction in the use of paper between 2012 and 2013. 30% less paper was used at the headquarters in 2013.

A new printing solution was introduced at the end of 2012 which has resulted in a 17% reduction in the use of paper between 2012 and 2013.

We have introduced a transport policy which encourages employees to use environmentally friendly means of transport. By doing this Arion Bank is endeavouring to make our environment a better place and to improve the health of our employees. We want to show a good example and raise people's awareness of environmentally friendly transport.

COMMUNITY PROJECTS

We support numerous organizations, companies and projects in the community. Arion Bank sponsors the Icelandic Handball Federation, the Icelandic Sports Association for the Disabled, Harpa Concert Hall and also provides backing to charities such as the Icelandic Cancer Society and the Icelandic Red Cross. Arion Bank operates 25 branches across Iceland and each branch endeavours to support good causes in its immediate surroundings.

HUMAN RESOURCES

At Arion Bank we strive to create a working environment shaped by professional, ambitious and progressive attitudes, and close teamwork throughout the Bank. The employees are the heart of Arion Bank's business and we do our utmost to take good care of our people.

SEX RATIO AND AGE RATIO OF EMPLOYEES

At the beginning of 2013 there were 1,016 employees occupying 949 full-time equivalent positions at Arion Bank. At the end of 2013 the Bank had 969 employees in 911 full-time equivalent positions, 67% women and 33% men. A total of 60 new people were appointed in 2013, 65% women and 35% men. The employee turnover was 10.8%. Full-time equivalent positions decreased by 38 in 2013.

The sex ratio among the Bank's management is almost equal as shown in the diagram.

The age distribution is spread rather equally. The average age of Arion Bank employees is 42. The retirement age at the Bank is 67.

Many employees have remained very loyal to the Bank and its predecessors. Some employees have been with the Bank for more than 40 years. The average length of employment is 9.7 years.

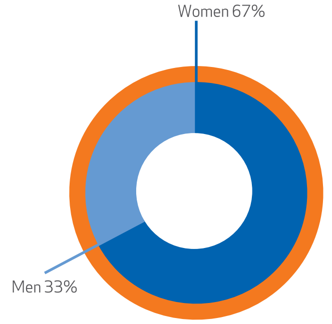
EMPLOYEES' EDUCATIONAL BACKGROUND

The proportion of employees with a university degree is 59% and this figure has increased in recent years.

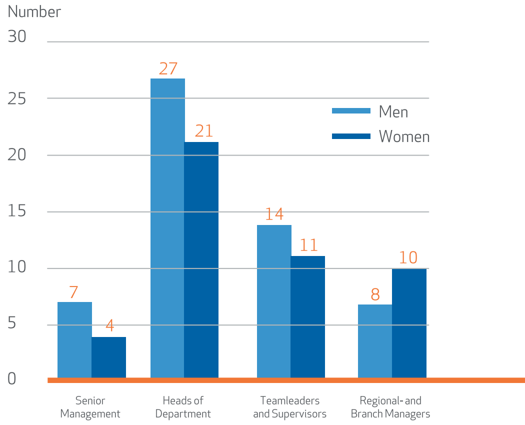
Job development is fostered at the Bank through goal-oriented employee training and a wide range of courses. There is an emphasis on enabling the employees to develop their professional and personal skills. It is also required that employees have a sound knowledge of the laws and regulations which apply to their jobs. In our opinion education is just as much the responsibility of the management as of the employees themselves.

As a part of the effort to improve service to customers, financial institutions in Iceland have organized a course of study for financial advisers. It is a part-time two-year course. Over the last two years 23 Arion Bank employees have graduated as certified financial advisers. The job of a financial adviser includes giving advice on loans to individual customers and transactions with securities.

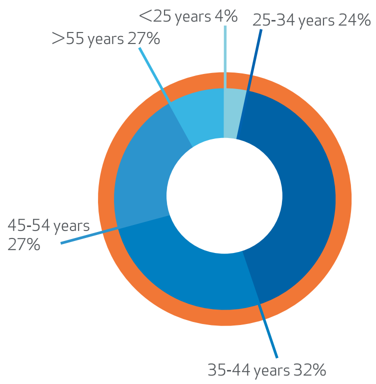
Sex ratio of Arion Bank's epmloyees



Men/women in management



Age distribution of Arion Bank's employees



HUMAN RESOURCES

Since the autumn of 2012 the focus has been on providing courses and staff training in connection with the implementation of the A Plus lean management scheme and this will continue throughout 2014.

The average cost of acquired services for educating and retraining employees in 2013 was ISK 105,000 per employee.

LEAN MANAGEMENT– A PLUS

Lean management continued to be introduced at the Bank in 2013. This project requires new working practices and organization of employees' time. The aim of the scheme is to improve services to customers and thereby implement the Bank's strategy of fostering closer relations with customers. New working practices often place a strain on employees but we believe that it will make our work more efficient and ultimately benefit our customers. The aim is for our employees to spend more time interacting with our customers. An integral part of A Plus is a greater focus on the training of management and employees.

HUMAN RESOURCES POLICY OF ARION BANK

Arion Bank employs an integrated team of hard-working employees. We are proud of our place of work and are constantly striving to improve our results and the services we provide to our customers. Arion Bank is a relationship bank and we do our utmost to develop good relationships with our customers and colleagues. We work professionally and think in terms of providing solutions. We are flexible, progressive and dedicated in everything we do.

We choose the right people

It is important for us to have the right person in the right place. Desirable traits in employees are initiative, independence, the willingness to embrace change, service mindedness and good communication skills. We give new employees a warm welcome and provide them with focused training and instruction.

HUMAN RESOURCES

We generally advertise vacant positions on the intranet, the Bank's website and in other media as appropriate. New people are hired in accordance with a well-defined hiring process. In addition to the qualities outlined above, we take into account an applicant's professional expertise, experience, education and interests. It is also crucial that applicants have the qualities set out in the Bank's cornerstones, and the way in which employees advance in the Bank depends on how they adopt the cornerstones in their work.

We enjoy good relationships with Icelandic educational institutions and we select talented people for summer jobs at the Bank. This gives us an opportunity to get to know promising young people who gain experience at the Bank and in some cases lay the foundations for future employment at the Bank.

We aspire to create a stimulating, positive and success-driven work environment

We strive hard towards creating a work environment in which we can all grow and develop our knowledge. We help each other in our day-to-day work and foster a good working atmosphere. We are aware that our actions, or lack of actions, have an effect on our colleagues and our customers' experience of the Bank's services. Our objective is to exceed the expectations both of our colleagues and our customers.

Arion Bank is a knowledge company made up of people with varied experience and knowledge. We show initiative and seek new opportunities to progress in order to help the Bank and ourselves develop. We encourage professional development and offer an ambitious educational programme which gives all our employees the opportunity to add to their knowledge and skills. We try to enable our employees to gain more responsibility and to move into management positions within the Bank or to transfer them to other jobs and projects.

We endeavour to offer first-class facilities and the Bank's working environment is characterized by open working spaces where knowledge and information can be freely exchanged. An employee survey is carried out every year in order to strengthen the working environment and to foster a sense of job satisfaction. It is important that there is a healthy balance between work and private life and employees are also encouraged to look after their health. There is zero tolerance towards bullying, sexual harassment or any other inappropriate behaviour. It is the responsibility of everyone to prevent such conduct at the workplace.

We strive hard towards creating a work environment in which we can all grow and develop our knowledge.

HUMAN RESOURCES

Employees of Arion Bank have an active social life and the employees' association, Skjöldur, arranges numerous well-attended events and a wide range of sporting and leisure events where everyone can find something to suit their interests. Employees can also rent holiday homes and apartments across the country.

We place great importance on strong leadership and good management

It is important that the Bank employs a highly competent management team with a clear future vision for their divisions. We strive hard towards developing our management's leadership skills. It is important that managers possess outstanding communication skills, set a good example, encourage their colleagues to work independently and authorize them to take action. Employees are encouraged by the management to show initiative in their daily work. It is also the role of management to ensure that employees get the opportunity to develop in the work by being given challenging and varied tasks. It is vital that there is trust between the management and employees and that giving regular and constructive feedback forms an integral part of the job of management.

We have a clear equal opportunities policy

The Bank's policy is to guarantee equal opportunities and terms for employees of both sexes. Any kind of sexual discrimination is contrary to the Bank's equal opportunities policy and equal opportunities legislation. The CEO is responsible for the equal opportunities policy. An equal opportunities committee implements the policy in consultation with the management.

We have developed an equality action plan incorporating actions such as equal salaries, equality when hiring and appointing people on committees and job development. The Bank's equal opportunities policy also states that employees should be enabled to coordinate their professional and family lives and that men as well as women should be encouraged to exercise their right to parental leave.

We act responsibly

We know our role and take responsibility for our tasks and decisions.

We make a difference. We have a broad interpretation of our role and ensure that tasks are not overlooked and left to somebody else. We keep to our word and complete what is entrusted to us.

We get things done. Each and every employee of Arion Bank is an important link in the chain and should act responsibly in their job. We bear joint responsibility for creating a positive team spirit and showing each other respect.

ARION BANK'S EQUAL OPPORTUNITIES POLICY

Arion Bank's policy is to maximize its human resources by ensuring equal opportunities and terms for employees of both sexes and to be an attractive place to work for both women and men. Any kind of sexual discrimination is contrary to the Bank's equal opportunities policy and equal opportunities legislation.

Employees should treat each other with respect and without discrimination at all times.

HUMAN RESOURCES

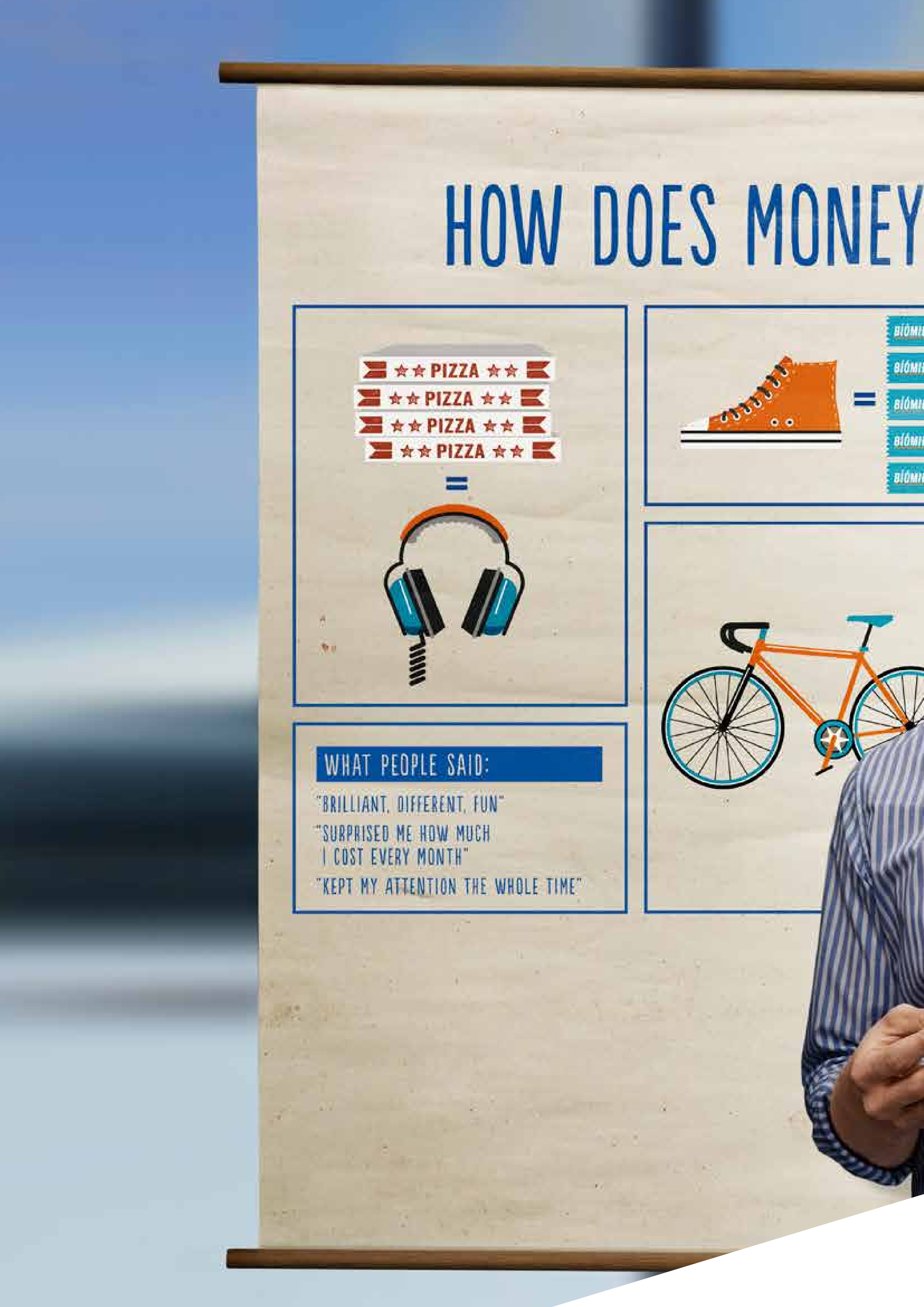
We say what we mean. Open and frank exchanges of views are an essential key to success. This enables us to share information with our colleagues. Constructive criticism allows us to point out what can be done better and we are also receptive to suggestions made by others.

We make sure we praise each other for work that has been done well.

We are honest and maintain confidentiality at all times, always abiding by the rules of procedure and code of conduct.

EMPLOYEE SURVEY

One of the main objectives of the annual employee survey is to make Arion Bank a better place to work and to enhance job satisfaction. The survey gives us an important insight into employees' attitudes to the work place. The most recent employee survey was carried out during the first half of 2013 and the results were very positive. The results are used to help make improvements wherever necessary. The CEO held ten meetings with a sample of 100 employees from across the Bank to listen to their views and discuss what improvements could be made.


HOW DOES MONEY
PIZZA
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WHAT PEOPLE SAID:
"BRILLIANT, DIFFERENT, FUN"
"SURPRISED ME HOW MUCH
I COST EVERY MONTH"
"KEPT MY ATTENTION THE WHOLE TIME"

FINANCIAL LITERACY

Arion Bank is responsible for a diverse financial education programme. Its objective is to improve financial literacy among the public and make it easier for people to keep their personal finances in good shape. It's good to start at an early age and we enlisted the help of musician and economist Jón Jónsson to talk to young people across the country about money. Arion Bank is also one of the main sponsors of the Institute for Financial Literacy.

Arion Bank

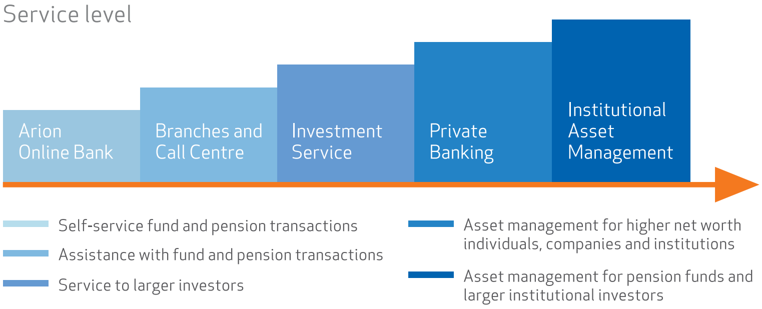
ASSET
MANAGEMENT

Asset Management and Arion Bank's subsidiaries are leading players on the Icelandic asset management market, with assets under management close to ISK 900 billion. Asset Management comprises Institutional Asset Management, Private Banking and Investment Services. It manages financial assets on behalf of its clients in accordance with a predetermined investment strategy. Asset Management is the main fund distributor for Stefnir, selling to individuals, companies, institutions and institutional investors and offering funds of international companies. Stefnir hf. is an independent financial company owned by Arion Bank. It manages a broad range of mutual funds, investment funds and institutional investor funds. More information on Stefnir can be found in the chapter on Arion Bank's subsidiaries. Asset Management had 35 employees in 32 full-time equivalent positions at the end of 2013. The managing director is Margrét Sveinsdóttir.

BROAD RANGE OF SERVICES TO CATER FOR DIFFERENT NEEDS

Asset Management specializes in providing a full spectrum of investment opportunities for clients with varying investment objectives. The focus is on having a broad range of products and services tailored to our clients' needs. Several new products were launched during the year for clients of Private Banking with a positive response. The division's employees have decades of experience and expertise in this field. The main emphasis is on offering personal services, which lays the foundation for strong, long-term and financially rewarding relationships with our clients.

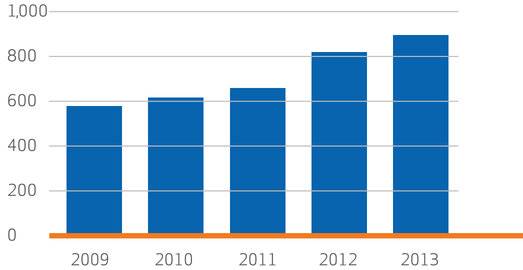
Service level



STEADY GROWTH

Asset Management enjoyed a good year in 2013 and assets under management increased by 9.2% or ISK 76 billion during the year. This growth is a result of positive returns and an inflow of new capital from existing and new pension fund clients, new Private Banking clients and new products. Overall, asset classes yielded strong returns, particularly Icelandic and international equities which outperformed their benchmarks.

Assets under management with subsidiaries
ISK bn.



LÍFEYRISAUKI – THE LARGEST VOLUNTARY PENSION FUND

In 2012 the voluntary pension funds VISTA and Lífeyrisauki merged under the name Lífeyrisauki. Both funds formed part of Arion Bank's product range and the merger has simplified and at the same time enhanced the choice of products. Lífeyrisauki has performed well in recent years as the returns in the table below clearly demonstrate.

NOMINAL RETURN ON LÍFEYRISAUKI

Investment plan	2013	2012	2011	2010	2009	Last 5 years*	Last 10 years*
Lífeyrisauki 1	7.2%	15.2%	3.1%	0.3%	25.8%	9.9%	7.3%
Lífeyrisauki 2	9.3%	15.2%	7.3%	0.9%	16.6%	9.7%	8,8%
Lífeyrisauki 3	7.4%	11.8%	10.7%	4.8%	15.6%	10.0%	8.9%
Lífeyrisauki 4	6.7%	7.8%	13.6%	7.7%	12.3%	9.6%	8.9%
Lífeyrisauki 5	5.6%	6.7%	8.3%	6.4%	14.5%	8.3%	11.0%
International securities	3.4%	12.1%	-1.1%	-3.9%	32.4%	7.8%	
Icelandic bonds	1.9%	5.6%	15.7%	10.8%	14.9%	9.7%	

*Nominal return on annual basis as of 31 December 2013
Right to make corrections is reserved
Past returns are not reliable indication of future returns

At the end of 2013 the fund had assets of ISK 55 billion, an increase of 10% during the year. The fund members are approximately 66,000, making it the largest pension fund in Iceland to receive only voluntary pension savings under Act No. 129/1997.

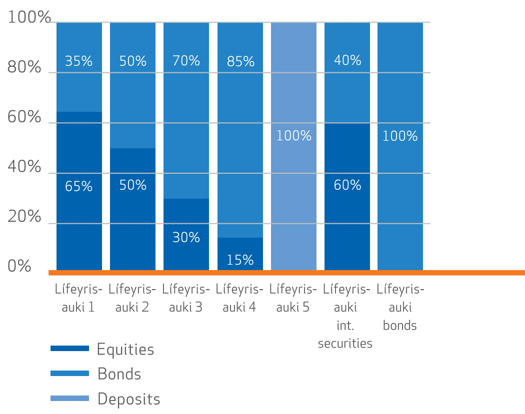
NEW PRODUCT – PENSION PORTAL

In 2013 the Pension Portal was launched which provides fund members with access to information on all acquired pension rights in insurance funds. The Pension Portal is available for all fund members via Arion Online Bank and has proven very popular so far.

WELL ATTENDED INFORMATION MEETINGS ON PENSIONS

Several information meetings were held during the year to discuss pensions at Arion Bank. Among the topics for discussion were pension payouts, pensions in plain language and Frjálsi Pension Fund. The meetings were very well attended which underlines what an important subject this is for many people.

Lífeyrisauki Investment plans



ASSET MANAGEMENT

RETURNS OF FRJÁLSI PENSION FUND

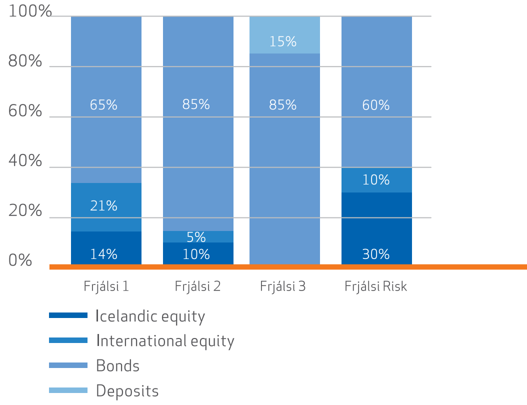
Frjálsi Pension Fund is the oldest independent pension fund in Iceland. The role of the fund is to guarantee pensions for its fund members until the end of their lives and to protect them and their families against loss of earnings in the event of disability or death. Frjálsi Pension Fund, which is managed by Arion Bank, has assets of ISK 132 billion and more than 48,000 fund members. The fund is suited to investors who can choose which pension fund they make their 12% minimum contribution to and also to people who wish to make voluntary savings.

NOMINAL RETURN ON FRJÁLSI PENSION FUND

Investment plan	2013	2012	2011	2010	2009	Last 5 years*	Last 10 years*
Frjálsi 1	7.7%	14.1%	9.5%	8.1%	15.4%	10.9%	9.7%
Frjálsi 2	5.8%	8.8%	12.5%	9.4%	9.4%	9.2%	9.7%
Frjálsi 3	4.2%	5.4%	14.7%	8.8%	10.5%	8.7%	10.5%
Frjálsi Risk	12.6%	9.8%	13.4%	10.3%	16.0%	12.4%	
Insurance fund**	9.2%	10.5%	9.0%	7.8%	9.3%	9.2%	8.8%

*Nominal return on annual basis as of 31 December 2013
** Bonds settled at yield
Right to make corrections is reserved
Past returns are not reliable indication of future returns

Frjálsi Pension Fund
Investment plans



Voted best pension fund of any European nation with under one million inhabitants

In 2013 Frjálsi Pension Fund was named the best pension fund in Europe in countries with fewer than one million inhabitants by the magazine Investment Pension Europe (IPE). Frjálsi was competing with funds from countries such as Luxembourg, Montenegro and Cyprus. Frjálsi had previously been named best pension fund in Iceland by IPE in 2009, 2010 and 2011 and the best pension fund in Europe in the category DB/DC structuring/strategies in 2005.

International awards won by Frjálsi Pension Fund.

CONTINUED BENEFITS FOR OUR CLIENTS

Long-term relationships with our clients are of vital importance in Asset Management. Understanding our clients' needs and being able to provide fitting solutions is paramount. Asset Management will continue to seek ways to create and identify the best possible investment opportunities for our clients. Our mission remains to generate benefits for our clients with satisfactory returns, using our professional approach and targeted risk management, with a focus on our clients' interests.

CORPORATE
BANKING

Corporate Banking provides comprehensive financial services and customized solutions to larger companies in Iceland. Many of Iceland's largest companies have strong business relationships with the division and have been clients of the Bank for many years. Good communications and an in-depth knowledge of the clients' needs are paramount to successful, long-term relationships. Our objective is to further cultivate our links with our current clients and to reach out to future business partners. Corporate Banking had 30 employees in 29 full-time equivalent positions at the end of 2013. The managing director is Freyr Thórdarson.

ACHIEVEMENTS DURING THE YEAR

Demand for credit from corporate clients was moderate in early 2013 but as the year progressed the situation changed when demand took off. Corporate Banking participated in numerous rewarding projects with its clients during the year and many new business relationships were forged. There was substantial growth in loans to new clients, particularly in the form of loan facilities to real estate projects and projects in the fishing industry. During the year Corporate Banking financed projects throughout Iceland and provided funding to support the growth of new and existing clients abroad.

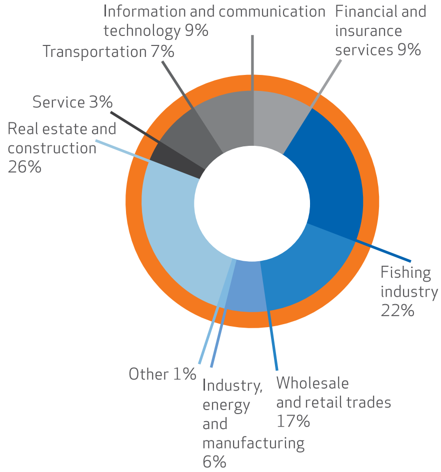
Total loans to customers from Corporate Banking amounted to ISK 248 billion at the end of 2013, or 39% of the Bank's total loan portfolio. Corporate Banking's client base reflects the diversity of the Icelandic business sector and many clients are leaders in their respective fields. The largest sectors in Corporate Banking's loan portfolio are wholesale and retail trades (17%), fisheries (22%), real estate companies (26%) and finance and insurance (9%).

In mid-year a new managing director was appointed at Corporate Banking and the implementation of the Bank's lean management strategy, A Plus, began in the second half of the year. The objective of A Plus is to improve efficiency in all the division's activities with a focus on customer service. Following organizational changes, the division honed its areas of specialization, with expert teams now focusing on the fisheries, real estate and energy, and trade and services.

PROFESSIONAL EXPERTISE AND STRONG CONNECTIONS

One of the chief aims of Corporate Banking is to employ people with expert knowledge of the sectors which make up the majority of the loan portfolio at any given time. The specialists and account managers in Corporate Banking therefore possess comprehensive knowledge and experience of the Icelandic business sector. Many of the employees have worked at the Bank for many years and some have brought in their broad experience gained prior to joining the Bank when working as specialists, managers or directors of other companies.

Loan portfolio by sector
31.12.2013



▶ CORPORATE BANKING

A sound understanding of the clients' business is a prerequisite for providing good service and the key to a successful new business relationship.

The division's real estate team has worked on projects ranging from the financing of major real estate construction projects to the traditional financing of residential property. During the year the fisheries team has financed clients' investments in shipping vessels and factories in Iceland and abroad. The team has also funded projects and gained knowledge in fish farming, which is a growing activity in the fisheries industry. The trade and services team has been involved in the development and refinancing of numerous businesses and there is a growing interest in funding for corporate acquisitions. These teams have the experience and ability to tackle complex and unconventional projects which tend to require specialized solutions. In recent years such projects have included major project financing, financing corporate acquisitions and syndicated loans. In 2013 Corporate Banking refinanced Skipti, the parent company of telecom company Síminn. This was a milestone deal as the Bank financed a company which at the same time was issuing bonds on the NASDAQ OMX Iceland.

The Corporate Services department is responsible for providing electronic corporate solutions and accounts receivable financing. Electronic solutions include foreign exchange and collection systems, issuing electronic documents and invoicing. Corporate Services aims to provide outstanding services in electronic solutions which can be used via the online bank. Every day Corporate Services contacts numerous companies in an effort to find out how it can improve its services and range of products. Factoring is one of the many financing options offered by Corporate Banking. There has been a huge increase in both factoring and trade finance. Corporate Finance enjoys a good relationship with the insurance company Euler Hermes. The newest insurance product is credit opinions which were introduced in the autumn of 2013 in partnership with the Federation of Trade and Services.

THE YEAR AHEAD

Rising demand for loan facilities in the second half of 2013 make us optimistic that 2014 will see the continued growth of investment in the Icelandic business sector. Corporate Banking aims to continue to provide a platform for the growth of its clients' business, domestic and international, in the coming year. The real estate market is expected to continue to grow in terms of financing residential housing and hotel construction. Financing is expected to be required on several large-scale projects in the energy sector in 2014. There is a certain amount of underlying need for financing in the fisheries and Corporate Banking expects increased activity in this sector in the year ahead. Higher capital formation will also enable many companies to expand their business. The availability of credit in Iceland makes the future exciting yet challenging at the same time.

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INVESTMENT BANKING

The main services provided by Investment Banking are securities brokerage and corporate advisory. Arion Research is part of the division and it issues regular economic reports and research for clients. Investment Banking had 33 employees in 32 full-time equivalent positions at the end of 2013. The managing director is Halldór Bjarkar Lúdvígsson.

CORPORATE FINANCE

Corporate Finance provides M&A advisory services and is a leading arranger of stock market listings on NASDAQ OMX Iceland. Corporate Finance's clients include some of the largest companies and major investors in Iceland, and building on the department's strong reputation is paramount to success.

The main projects completed by Corporate Finance in 2013 were the listing of VÍS hf. and the sale of Klakki ehf.'s stake in VÍS. During the year Corporate Finance also prepared the prospectus for N1 ehf. and arranged the listing of the company's shares on the main market of NASDAQ OMX Iceland. The department also prepared the prospectus for the bond offering by Skipti ehf. and the subsequent listing of the bonds on the main market of NASDAQ OMX Iceland. Corporate Finance furthermore arranged the sale of Fram Foods Ísland hf. which was owned by Arion Bank's subsidiary Eignabjarg ehf. During the first half of the year it advised the sellers on the sale of a 30% stake in Sena ehf. At the end of the year SF IV slhf., which is managed by Arion Bank's subsidiary Stefnir hf., acquired Skeljungur hf. and Magn P/F in the Faroe Islands, with Corporate Finance advising the buyers in these deals. The department has also been involved in merger talks between the Bank's subsidiary Landfestar ehf. and Eik Fasteignafélag hf. In addition it arranged the listing on NASDAQ OMX Iceland of covered bonds issued by institutional investor funds managed by Stefnir.

Some of the advisory assignments currently being worked on by Corporate Finance have been announced and they include the refinancing and possible stock market listing of the real estate company Reitir, the listing of HB Grandi hf. on the main market of NASDAQ OMX Iceland and the sale of up to a 32% stake in the period leading up to listing.

INVESTMENT BANKING

CAPTAL MARKETS

Capital Markets brokers financial instruments for the Bank's international and Icelandic clients. More listings on NASDAQ OMX Iceland have added depth to the stock market and prepared the ground for further IPOs in 2014. While the equities market has been revitalized, the government-backed bond market has reached a certain level of saturation. It has therefore been most welcome for investors to have more investment options like asset-backed bonds and corporate bonds. Trading on the foreign exchange market has been on the increase and the range of products is expanding. The Central Bank of Iceland held a number of currency auctions in 2013 as part of the process of lifting the capital controls, and Capital Markets is a leading advisor on the Central Bank auctions.

The main aim of Capital Markets has been to provide its growing client base with good services and access to expert knowledge. The focus in the medium term will continue to be on product development, offering clients more opportunities to invest and diversify risk.

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RESEARCH

Arion Research publishes macro research on the Icelandic economy and its developments, as well as research on individual sectors and companies. Arion Research publishes regular forecasts and updates on key economic issues. Arion Research also holds regular conferences at which new research and reports produced by the unit are presented, such as economic forecasts, analyses of the real estate market, analyses of the finances of various municipalities and other sectors.

Arion Research provides a key role at the Bank in enhancing the services provided by other divisions of the Bank with detailed, high quality research. As more IPOs on NASDAQ OMX Iceland take place, the focus is on providing clients of Investment Banking with research on listed companies and other companies planning to go public in the near future. Arion Research is independent of the other divisions of the Bank.

OUTLOOK

The outlook for Investment Banking is shaped by Iceland's economic environment. The capital controls influence investor behaviour and restrict investment opportunities outside Iceland. The controls therefore impede companies' growth potential and investors' risk distribution. While potential investments abroad are held back by the capital controls, there is always a risk that an asset bubble may form in Iceland. It is therefore important that, over the next few years, investors are able to put their capital into investments which will create the most value for themselves and the economy as a whole.

Developments on the asset markets in recent quarters give cause for greater optimism in Iceland. The price of residential housing rose sharply in 2013 and activity on the real estate market also increased. The stock market rallied strongly last year and is expected to perform well this year as well. The turnover in equities on NASDAQ OMX Iceland increased by 190% to ISK 240 billion. The higher turnover goes hand in hand with the increase in the number of companies on the stock exchange, with three companies holding IPOs in 2013, two of which were arranged by Arion Bank's Investment Banking. It is positive to see the financial restructuring of healthy companies concluding with a stock market listing and we expect more companies to take this route over the next few years. Further corporate bond issues are expected this year. However, it appears that there will be few government bond issues as the government's borrowing requirements have decreased.

Increased activity on the securities and financial markets stimulate demand for Investment Banking's services, both corporate finance as well as securities and foreign exchange brokerage and the outlook for 2014 is bright. By producing high quality research and issuing professional advice, Arion Research, Investment Banking and Arion Bank as a whole are making a united effort to encourage the healthy growth of the securities markets in Iceland and to stimulate profitable investments.

RETAIL BANKING

Retail Banking provides retail customers and small and medium-sized enterprises with high quality financial services at the Bank's branch network throughout Iceland. The Bank operates 25 branches and service points in Iceland as well as a call centre. Our mission is to meet the needs of our customers by providing a diverse product offering and professional financial advice. Retail Banking had 400 employees in 367 full-time equivalent positions at the end of 2013. The managing director is Helgi Bjarnason.

Our employees strive to develop and consolidate relationships with Arion Bank's customers by offering them high quality services. The division's core activities take place in the branches and the call centre where customers can get advice on deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. The Bank has deliberately moved the decision-making on key services such as loans to the branches and therefore closer to customers and this has been viewed positively.

KEY TASKS

A key aim last year was to increase efficiency and to do this we adopted lean management. The methods and practices used in implementing this strategy are called A Plus. The majority of the Bank's branches have already implemented A Plus and it is expected to have been introduced across the Retail Bank by the second half of 2014. A Plus has enabled to us to attain significant improvements in efficiency in Retail Banking and the employees have been able to devote more time to providing advice and valuable services to our customers. We believe this to be the best way of meeting the needs of our customers.

Arion Bank has continued along the route set out several years ago with regard to training employees. An increasing number of employees have now qualified as financial advisers. This qualification standardizes the requirements made of financial advisers and ensures that they possess the requisite skills and expertise to do their job. It complements the Bank's strategy of cultivating links with the Bank's customers in order to develop long-term business relationships.

An increasing number of employees have now qualified as financial advisers. This qualification standardizes the requirements made of financial advisers and ensures that they possess the requisite skills and expertise to do their job.

RETAIL BANKING

COMPREHENSIVE FINANCIAL SERVICES

In August 2012 Arion Bank launched a new app which enables our customers to keep track of their finances with one click of the button and without having to log in. The app underwent further development in 2013 and now it can be used to pay bills with one click of the button and also to make money transfers using fast payments. This has enabled Arion Bank to maintain the competitive lead it gained with the first generation of the app. The app has proven popular among our customers, with around one third of customers having downloaded it, making it an excellent addition to the broad spectrum of services already available.

2013 was the first full year of operations of a new unit at Retail Banking which specializes in financing vehicles and various other types of equipment for personal and commercial use. Customers have welcomed this new service and we have registered a healthy growth in loans in this area, which we believe has great future potential.

ARION BANK'S BRANCH NETWORK

NATIONWIDE

REYKJAVÍK AREA

NORTH- AND EAST COAST
Akureyri
Ólafsfjördur
Saudárkrókur
Varmahlíd
Blönduós
Egilsstadir

WEST COAST
Borgarnes
Búðardalur
Stykkishólmur
Grundarfjördur
Hólmavík

SOUTH COAST
Selfoss
Hveragerdi
Hella
Kirkjubaejarklaustur
Vík

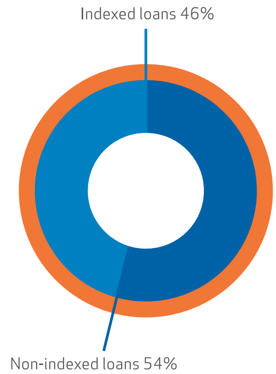
▶ RETAIL BANKING

GREATER REYKJAVÍK AREA

SUSTAINED GROWTH IN MORTGAGES

Since 2011 Arion Bank has been a leading player on the Icelandic mortgage market, after the Bank became the first lender to offer realistic non-indexed financing of residential housing. Last year we detected substantial growth in demand for mortgages, both from customers buying their first home and also from people wanting to refinance older loans under the improved terms available from Arion Bank. At the end of the year the Icelandic government abolished stamp duty on loan documents. This creates opportunities for the Bank and at the same time it is good news for Icelandic households who now have even more reason to refinance less favourable loans and therefore possibly increase their disposable income.

New mortgages in 2013
ratio of indexed and non-indexed loans



GROWING LOAN PORTFOLIO

At the beginning of 2013 Arion Bank and the holding company of the Central Bank of Iceland, ESÍ, reached an agreement on the Drómi bond from 2009, according to which Arion Bank acquired all retail loans which had previously been owned by Drómi, Frjálsi and Hilda. The portfolio which was transferred to Arion Bank amounts to ISK 50 billion and represents a considerable increase in the Bank's retail loans. The agreement is an important milestone for the Bank as loans to individuals now constitute almost half of total loans to customers.

▶ RETAIL BANKING

OUTLOOK

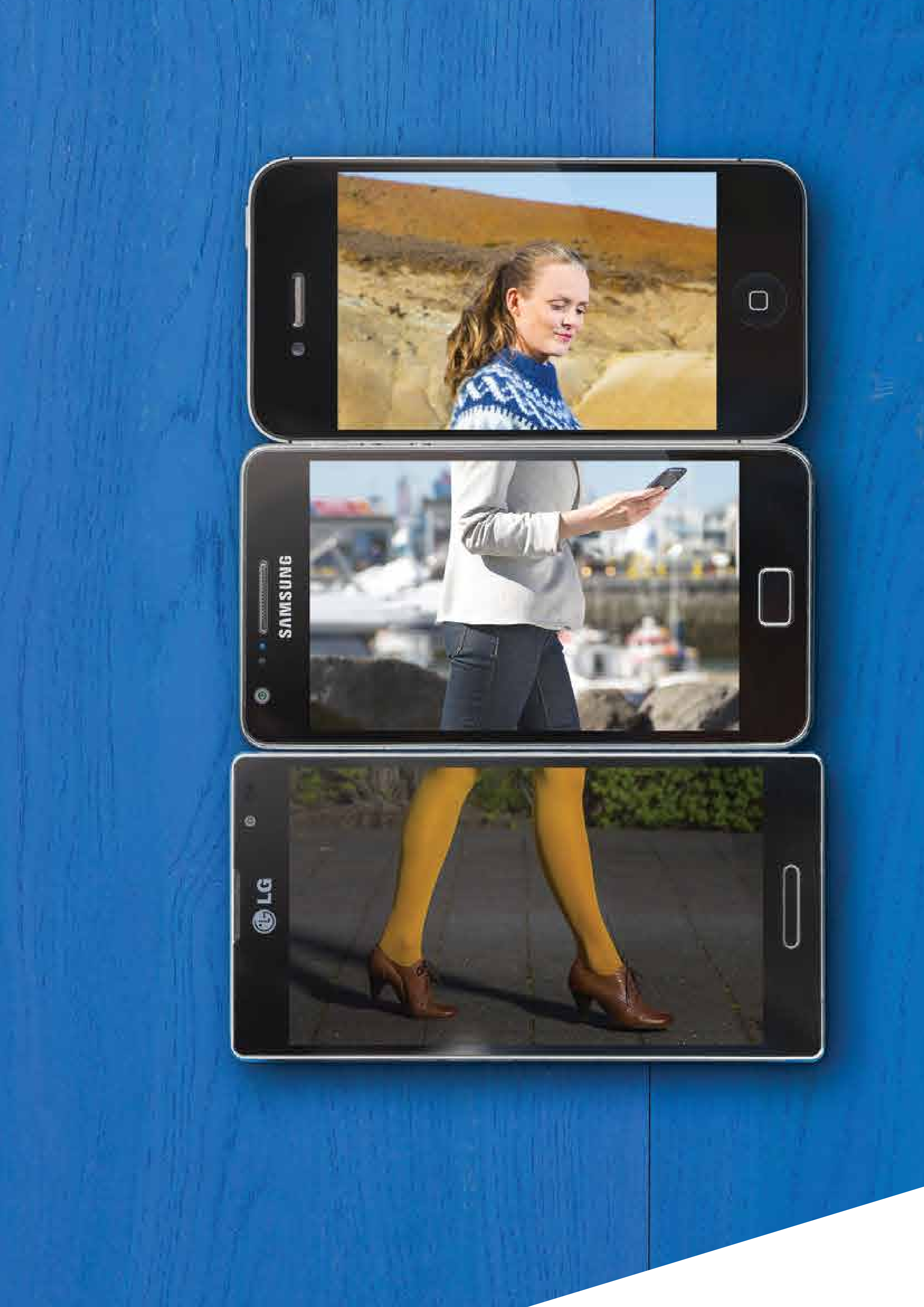
The transfer of the loan portfolio from Drómi, Frjálsi and Hilda brings with it several challenges but also opportunities for Arion Bank to consolidate its business relationship with an expanding group of customers. During the first half of 2014 these challenges will be tackled with great vigour and the aim is to have completed this work by mid-year. The turnover on the property market has been increasing and property prices may rise during the year. This will have a positive effect on Retail Banking and present further growth opportunities.

At the end of November 2013 the government announced its debt relief programme for indexed mortgages. This programme is scheduled for implementation in mid-2014 and these measures are likely to have a considerable impact on the activities of Retail Banking during the year as lenders are expected to be involved in the implementation of the debt relief programme.

In the first half of 2014 the back office function operated in the branches and the call centre will be brought together under one roof at Borgartún in Reykjavik. This merger will allow us to improve our procedures and increase the quality and reliability of this service. The vehicle and equipment financing business has performed well and there is a strong platform for further growth in this market. We also intend to add to our experience and expertise in the six regions into which the branch network is divided and to continue to decentralize the decision-making process.

This year our Reykjavík branches at Hlemmur and Austurstræti will merge in a state-of-the-art branch at Borgartún 18, which will set the mould for the development of other branches and the way in which the Bank wishes to conduct its business in the future.

The future is both challenging and exciting and Retail Banking is well placed to tackle whatever lies ahead.


SAMSUNG
LG

THE ARION APP

Arion Bank is a pioneer in terms of new technology which makes banking easier and faster for our customers. The Arion app is undergoing constant development and even more options were added in 2013. Using the Arion app customers can pay bills and transfer money to known and regular recipients. All at the click of a button.

Arion Bank

SUBSIDIARIES

Arion Bank has three subsidiaries which play a vital role in the long-term operation and strategy of the Bank. They operate in the fields of asset management, life insurance and payment services and complement the services that Arion Bank offers its customers. These subsidiaries are Stefnir Asset Management Company, OKKAR Life Insurance and Valitor.

STEFNIR ASSET MANAGEMENT COMPANY

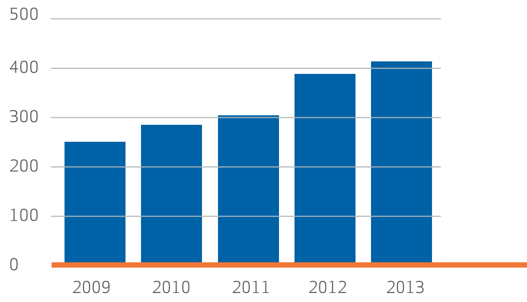
Stefnir Asset Management Company hf. is Iceland's largest fund management company with assets of approximately ISK 413 billion under active management. The company is wholly owned by Arion Bank and it is based at the Bank's headquarters. The assets managed by the company are owned by a diverse group of investors, from private individuals to Iceland's largest institutional investors. The fund members' assets are in mutual funds, investment funds or institutional investor funds, and Stefnir has also signed asset management agreements with a number of partnerships limited by shares. Stefnir had 21 employees at the end of 2013.

In 2013 assets under management increased from approximately ISK 388 billion to more than ISK 413 billion, an increase of over 6.5%. At the same time the company has diversified its income base by achieving a broader spread of asset classes in its asset portfolio. New funds were launched and certain asset classes, such as Icelandic equities, grew considerably.

The company's employees and board of directors placed great importance on consolidating the company's infrastructure. The board of directors of Stefnir is committed to good corporate governance and endeavours to promote responsible behaviour and corporate culture within Stefnir for the benefit of all the company's stakeholders. The Center for Corporate Governance at the University of Iceland confirmed in January 2012 that Stefnir was a model company in terms of good corporate governance and Stefnir is the first company in Iceland to be acknowledged in this way. In July 2013 the company was given this accolade again. The company now publishes a corporate governance statement on its website once a year, describing its activities and its focuses in the near term. Transparency is paramount and this is reflected by the keen focus on investor relations on the company's website. This disclosure of information is far more extensive than legally required. In March 2013 Stefnir became a member of the Icelandic Financial Services Association (SFF). By becoming a member of the SFF the company will help protect the interests of the Icelandic financial sector and will also become a member of the Confederation of Icelandic Employers (SA).

Returns on the main markets were either good or acceptable during the year. The investment environment continues to be shaped by the restrictions imposed by the capital controls on foreign investment. The assets of Icelandic pension funds continued to grow and it has been a priority to develop fund products suited to pension funds, insurance companies and other institutional investors. However, many private clients have been drawing on their own savings and therefore there has been little growth in sales of fund products to these clients.

Assets under management
ISK bn.



SUBSIDIARIES

Returns on equities funds, both Icelandic and international, have been good. There was a substantial inflow of new capital to equities funds and this, combined with returns, led to the 50% growth of equities funds managed by Stefnir in 2013. The Icelandic equities funds Stefnir Icelandic Growth Fund and Stefnir ÍS-5 more than doubled in size during the year. International equities funds managed by Stefnir are rated by the international ratings agencies Morningstar and Lipper. The funds have been assigned good ratings by these companies. At the beginning of the year all four Stefnir funds had 3 or 4 star ratings from Morningstar and one fund had the highest rating from Lipper. As a result of the strong returns generated by the funds, Icelandic investors contributed new capital to the funds during the year. The capital controls have meant that Icelandic investors have first needed to redeem this capital from other international funds or from foreign assets. The proportion of international funds managed by Stefnir in the foreign assets of pension funds therefore continues to grow.

Stefnir continued to develop its Icelandic private equity business

In January 2013 Stefnir announced that it was setting up a new private equity fund, SÍA II. The fund is approximately ISK 7.5 billion, more than twice the size of its predecessor. It is a successor to SÍA I which was set up in 2010 and is now fully invested. Towards the end of 2013, the fund finalized a deal to acquire all the share capital in Skeljungur and the Faroese oil company P/F Magn.

Investors also showed interest in funding high quality real estate. Stefnir's fixed income team set up several institutional investor funds which issued asset-backed bonds to finance commercial property. The institutional investor fund lends real estate companies money with a mortgage in the financed property and other collateral to secure the lender. At the same time the funds issue bonds which are sold to institutional investors. The institutional investor funds are then given a certain time frame to list the bonds on the Icelandic stock market, NASDAQ OMX Iceland. During the first half of 2013 bonds issued by the institutional investor funds REG1 and REG2 were admitted to trading on NASDAQ OMX Iceland. In August 2013 it was announced that bonds issued by the institutional investor fund KLS had been admitted for trading. Preparations for the listing of bonds issued by institutional investor fund BRIC ELN are currently under way.

Balanced funds grew by almost 7% during the year. The funds generated most satisfactory returns, with Stefnir Balanced Fund, for example, yielding 21%. Stefnir Balanced Fund is the oldest balanced fund in Iceland and dates back to 1996. The fund has therefore represented an excellent investment option for general investors who wish to invest their savings in different types of assets yet who do not have the expertise to move their assets around between different investments and markets. The fund has more than 3,200 unit holders and it is therefore the Stefnir fund with the most owners. At the beginning of 2014 the investment funds Stefnir Verdbréfaval 1 and Stefnir Verdbréfaval 2 were merged into Stefnir Balanced Fund. Following the merger the fund has a capacity of more than ISK 5 billion and has over 4,000 unit holders.

Despite the capital controls, the small but growing equities market and the limited issue of corporate bonds, Stefnir has nevertheless managed to adapt to a changed environment in recent years and has emerged as a leader in the development of new products to meet the demands of a diverse group of Icelandic investors.

SUBSIDIARIES

OKKAR LIFE INSURANCE

OKKAR Life Insurance is the oldest life insurance company in Iceland. The company's main roles are to provide modern insurance services and to offer our customers financial security in the event of illness, disability or death, while at the same time generate a profit and protect the interests of the company's owners. OKKAR had 14 employees at the end of 2013.

OKKAR is an independent life insurance company and its operations are divided into four divisions: Insurance, Finance, Sales & Marketing and Information Technology. From the very beginning OKKAR has been a pioneer in the development of life insurance in Iceland. Health insurance, children's insurance, disability insurance and a range of group insurance policies are areas where OKKAR has been at the forefront on the Icelandic market.

Highlights of 2013

The company enjoyed a positive 2013. Net premiums increased by 17% between years, and by the end of the year the company had become the largest life insurance company in Iceland in terms of net premiums. Earnings from insurance activities were also strong and exceeded expectations; return on equity was 19% and the combined ratio was 87%. Investment income grew between years by 15% and the solvency ratio at the end of 2013 was 2.17.

Sales increased strongly between years. Sales of a new pension product, "OKKAR Séreign" which was launched in mid-year 2012 with Arion Bank Asset Management, have exceeded all expectations Sales of the company's other products have also been strong and there was a substantial increase in the number of insurance policies. OKKAR enjoyed a fruitful partnership during the year with Tekjuvernd and Arion Bank on the sale and distribution of the company's products.

The operating environment has changed in recent years and become rather unconventional. Competition from British and German life insurance companies is on the rise and the public increasingly takes out insurance and saves money in foreign currencies. At the same time Icelandic life insurance companies are not allowed the opportunity to offer products in a foreign currency.

Meeting the needs of our customers and enhancing the product line remain the focus of OKKAR's business, while factors such as cost control are also critical. An advertising campaign was launched during the year to raise awareness of the brand name. A new and innovative health insurance policy was launched where it is possible to reinstate an insurance policy after benefits have been paid. The EU directive banning discrimination in the purchase of goods and services served as a guideline when changing premiums during the year. Premiums in life insurance and health insurance are no longer determined by the sex of the insured party. The provisions of this directive will be introduced into Icelandic legislation in 2014.

Tasks ahead

A number of important tasks await the company in 2014. We have high hopes for a new insurance system which is scheduled to be introduced this year. Arion Bank and OKKAR are now expanding the range of services to customers and will soon launch a new life insurance policy for customers who have a mortgage with the Bank. We are continuing to develop and introduce innovations to our product line and are working on the introduction of the Solvency II directive.

Outlook

The outlook for 2014 is positive. The company expects a moderate increase in sales this year, both in terms of the number of policies sold and paid premiums. The company also aims to reduce the number of cancelled policies. Despite the uncertainty in the economic environment, particularly in respect to the government's measures on pension savings, we are positive about the long-term outlook, and the continued successful partnership with Tekjuvernd and Arion Bank is paramount in this respect.

SUBSIDIARIES

VALITOR

Valitor is a leading service company in the field of payment solutions. Valitor operates internationally and places great importance on initiative, innovation and trust in its business. The company's mission is to provide its customers with state-of-the-art solutions to open up new opportunities.

Valitor has long been a leader in the Icelandic payment solutions market in terms of service, product development and efficiency. Acquiring international transactions has also become a key area of the company's business. At the end of 2013 Valitor had 155 employees.

VALITOR

Highlights of 2013

During the year Valitor introduced a new card issuing system for retail banks in Iceland. The system represents a milestone in services to issuers and cardholders, offering customized solutions and enabling customers to market new products more quickly than before and with greater emphasis on product differentiation. It represents one of the most extensive software development projects undertaken in Iceland and software engineers at Valitor designed the system from scratch.

The NFC pilot project for contactless payments entered its final stages. Competition issues also remained high on the agenda. In 2013 the Competition Authority fined Valitor ISK 500 million for violating the Competition Act., maintaining that Valitor had breached its agreement with the Authority that came into effect at the beginning of 2008. The decision also concerned an assessment of whether Valitor had abused its market dominant position. Valitor takes firm exception to the decision of the Competition Authority.

Valitor celebrated its 30th year in business during the year, marking the occasion with a number of events. The company moved into new open office headquarters in Hafnarfjördur which will facilitate staff collaboration and help the company better implement its future strategy. The construction and design of the new building also emphazises Valitor's concern for the environment.

The company continued to expand internationally and opened an office in the United Kingdom.

Future tasks and opportunities

In 2014 the company intends to consolidate its position on the European market. It will continue to work on issuing prepaid cards and on increasing the number of partners in its key markets in the United Kingdom and Scandinavia. The company will continue to strengthen its position in e-commerce acquiring services. The London office will also launch a campaign on the UK acquiring services market.

Valitor plays a leading role in Europe with prepaid cards and this presents exciting opportunities. The key areas identified for the future are in developing software for payment solutions and issuing prepaid cards in Iceland and abroad.

Valitor intends to play a key role in the debate on future competition issues in collaboration with stakeholders and regulators. It is important that the future environment be shaped using professional and sensible criteria with Icelandic interests at the forefront.

HOLDING COMPANIES

Arion Bank operates three holding companies, whose main purpose is to manage the assets the Bank has taken over in the debt restructuring process. The goal of these companies is the professional management, utilization and eventual disposal of these assets in due course – all at arm's length from the Bank.

EIGNABJARG

Eignabjarg ehf. is responsible for administrating and disposing of shareholdings in companies which Arion Bank has taken possession of and which Eignabjarg acquires following financial restructuring.

Eignabjarg aims to safeguard the independence of all the companies it acquires and seeks to ensure that they are sold in an open, transparent and fair sales process.

Most companies which have formed part of Eignabjarg's asset portfolio have now been sold in an open sales process.

In 2013 the sale of the subsidiaries of Fram Foods ehf. was completed. Eignabjarg still retains ownership of the holding company Fram Foods ehf. which no longer has any activities.

Eignabjarg owns a 42.7% interest in the real estate company Reitir fasteignafélag hf. The company is currently undergoing financial restructuring and the aim is to list Reitir on the main market of NASDAQ OMX Iceland in 2014.

LANDEY

Landey is a property development company. Projects undertaken by the company are usually complex and extensive and do not generate high levels of income. The company's objective is to maintain and increase the value of its properties through professional development, design and construction until a satisfactory price can be obtained.

HOLDING COMPANIES

LANDFESTAR

Landfestar ehf. is a real estate company which specializes in leasing out and managing commercial property. The aim is to develop a robust company in the real estate market. The company leases out more than 100,000 square metres of high quality property. The majority is office space in the Reykjavík area. The main clients include government institutions and some of Iceland's largest companies.

The main focus in 2013 was to consolidate the occupancy ratio. Despite the volatile economic climate faced by its tenants the company managed to slightly increase the number of properties it leased out. The occupancy ratio is about 96%. The company worked hard to consolidate the long-term relationships with its tenants.

On 20 December 2013 Arion Bank hf. signed a purchase agreement with Eik fasteignafélag hf. on the sale of all the Bank's share capital in Landfestar. The agreement was subject to the approval of the Competition Authority. The deal will make the merged company the second largest real estate company in Iceland, with 271,000 leasable square metres and an asset portfolio valued at ISK 60 billion. It is planned to list Eik on the main market of NASDAQ OMX Iceland after the appropriate authorities have examined the acquisition.

LANDFESTAR
FASTEIGNAFÉLAG

Startup
Reykjavík
Arion banki
Innovit
Klak

Zalibuna

STARTUP REYKJAVÍK

Arion Bank organized Startup Reykjavík for the second successive year in collaboration with Klak Innovit. It is an important innovation programme for the Icelandic business sector. Ten teams of entrepreneurs with diverse and exciting ideas were chosen to participate. They received firm backing, facilities and mentoring, as well as capital from Arion Bank. The Bank has now invested in 20 companies via Startup Reykjavík.

Arion Bank

RISK
MANAGEMENT

The Bank faces various risks arising from its day-to-day operations. Managing risk is therefore a core activity within the Bank. 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.

The Board of Directors is ultimately responsible for the Bank's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Bank's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets the risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The CEO is responsible for sustaining an effective risk management framework, policies and controls as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into five units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Economic Capital, which is responsible for the Bank's ICAAP; Portfolio Risk, which monitors liquidity risk and risks in the Bank's assets and liabilities at the portfolio level; and Operational Risk which monitors risks associated with the daily operation of the Bank.

BOARD OF DIRECTORS

- Board Credit Committee
- Board Audit and Risk Committee
- Board Remuneration Committee

EXECUTIVE MANAGEMENT

- Arion Credit Committee
- Asset & Liability Committee
- Underwriting & Investment Committee
- Security Committee

BUSINESS LEVEL

- Credit Committees
- Valuation Committees

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital adequacy assessment process (ICAAP). The Asset and Liability Committee (ALCO), chaired by the CEO or his deputy, is responsible for managing the asset-liability mismatch, liquidity risk, market risk and interest rate risk, and capital management. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits. There are also five valuation committees whose role is to establish criteria for estimating collateral and also to inspect valuations of securities owned by the Bank.

Credit Analysis helps the Bank's credit committees to assess individual credit cases and to ensure that credit decisions are within a committee's credit granting authority. Credit Analysis prepares a comment on all credit applications submitted to the BCC, the ACC and the CCC in which all the risks and weaknesses of the cases are discussed. Credit Analysis follows up on the comment by participating in meetings of the credit committees as a non-voting advisor. Credit Analysis is authorized to escalate controversial credit decisions from one committee to a committee with higher authority.

The most significant risks the Bank is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk, legal risk and operational risk. The Bank's Pillar 3 Risk Disclosures 2013 report discusses risk factors and risk management in detail.

INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP)

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 with its risk profile. The Financial Supervisory Authority (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.

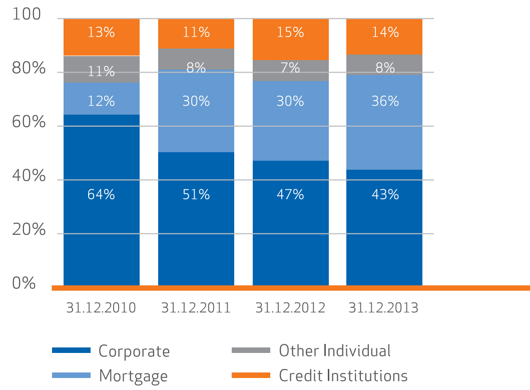
CREDIT RISK

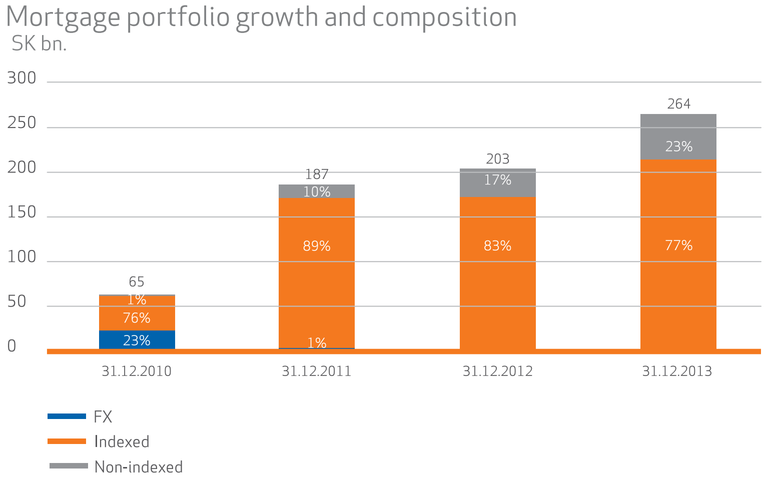
Credit risk is defined as the current or prospective risk to earnings and capital arising from the failure of an obligor to discharge an obligation at the stipulated time or otherwise to perform as agreed. Loans to customers and credit institutions are by far the largest source of credit risk.

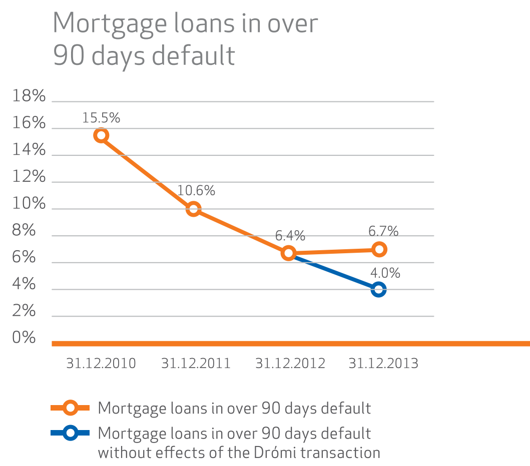
Strong and improving mortgage portfolio

Mortgages are a core product for Arion Bank. The mortgage portfolio represents 36% of the total loan portfolio at year end, up from 12% from the end of 2010. Key to the growth of the mortgage portfolio was the acquisition of a mortgage portfolio from Kaupthing in 2011 and the settlement of the Drómi bond in

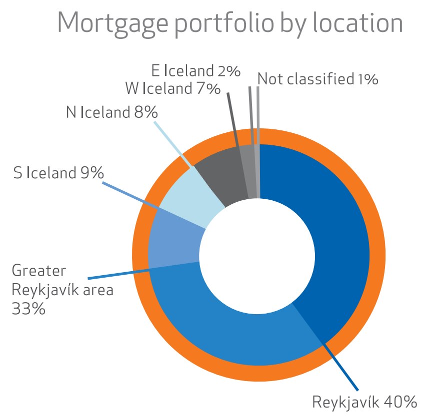
Loan book composition

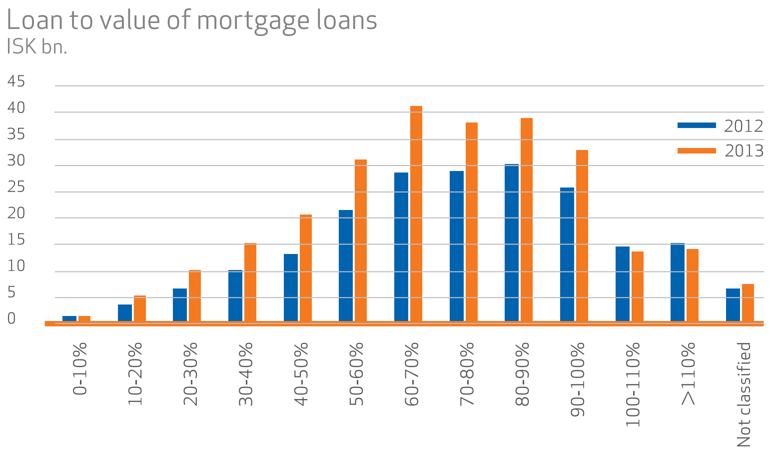






2013, coupled with strong organic growth via new mortgage lending. The Bank has been at the forefront of the mortgage market, e.g., offering non-indexed mortgages in ISK. At the end of 2013 non-indexed mortgage loans represented 23% of the mortgage portfolio; the remainder being CPI index-linked loans. Prior to the Drómi transaction, the quality of the mortgage portfolio had been steadily improving, with lowered average loan-to-value and a dramatic reduction in default rates. Higher default rates among the loans in the transaction raised the average mortgage default rates at the end of 2013.



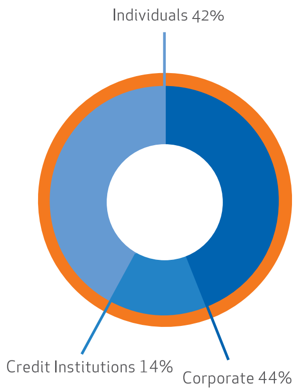


At the end of 2013, 61% of the mortgages, by value, had loan-to-value below 80% compared to 55% at the end of 2012, with mortgage property primarily located in the greater Reykjavík area or 73% of the portfolio, by value.

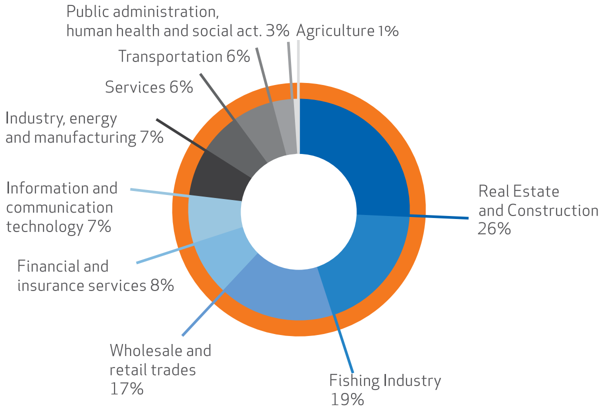
Well diversified loan portfolio

Loans to customers are well diversified. Loans to individuals represent 49% of the total loans to customers, of which 80% are due to mortgages. The corporate

Loan book concentration



Industry sector concentration of corporate loans

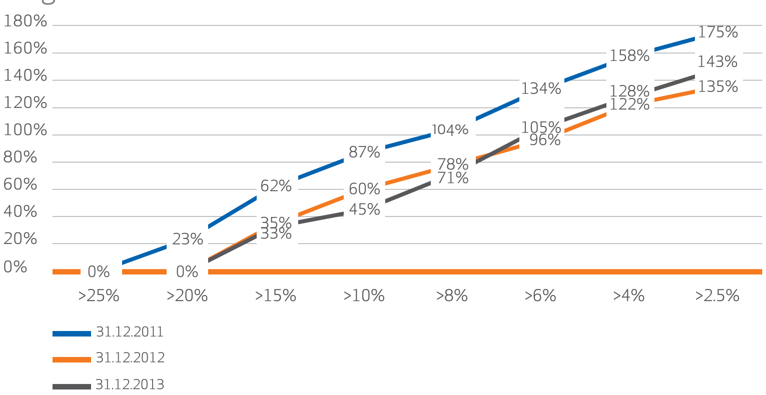


portfolio is mainly in three sectors: Real Estate and Construction, Fishing, and Wholesale and Retail Trade, which represent 26%, 19% and 17% of the corporate portfolio respectively. Although sector diversification is good, some single name concentration remains.

Single name concentration is decreasing

At the end of 2013 the Bank had three exposures to related parties that exceeded 10% of the capital base (so called large exposure), compared with four large exposures at the end of 2012. As seen in the following diagram, the sum of large exposures fell from 87% of the capital base in 2011, to 60% in 2012, to 45% in 2013. The sum of related exposures exceeding 2.5% of the capital base has been steady at 143% at the end of 2013, compared with 135% at the end of 2012. The largest exposure to a group of related parties at the end of 2013 was ISK 29 billion before accounting for credit risk mitigation of eligible collateral.

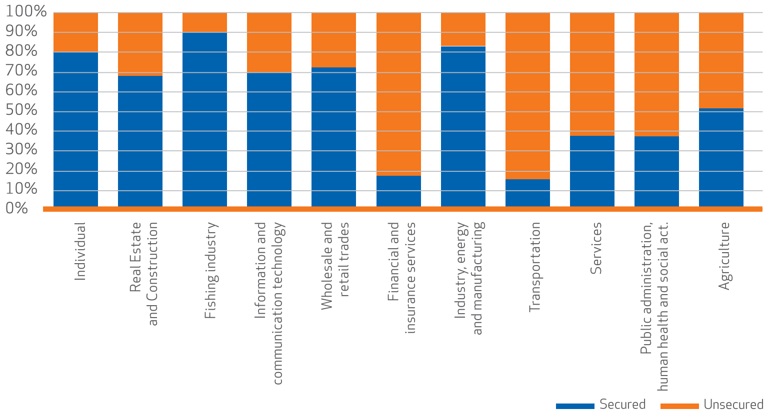
Single name concentration



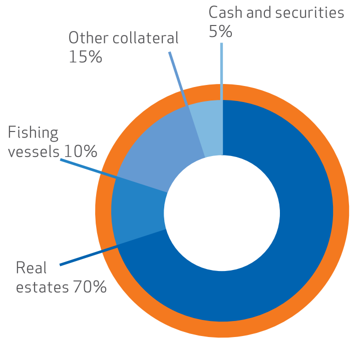
Collateral coverage of loans to customers

The collateral obtained by the Bank is typically mortgages over residential properties, charges over commercial real estates, fishing vessels and other fixed and current assets, cash and securities. The Bank places emphasis on collateral maintenance, valuation and central storage of collateral information. At the end of 2013 loans to customers (gross value ISK 665 billion) are secured by collateral, conservatively valued at ISK 514 billion, for a collateral coverage ratio of 77%, but as shown in the following diagram this ratio varies between different sectors. Collateral held at year end is primarily real estate, making up 70% of total collateral. Loans to credit institutions are largely unsecured, i.e. bank accounts and money market loans.

Collateral coverage of loans to customers 2013 down to sectors



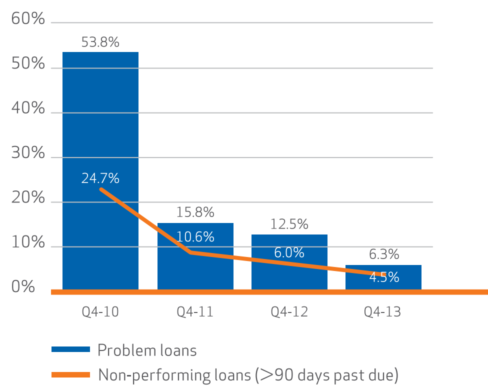
Collateral by type



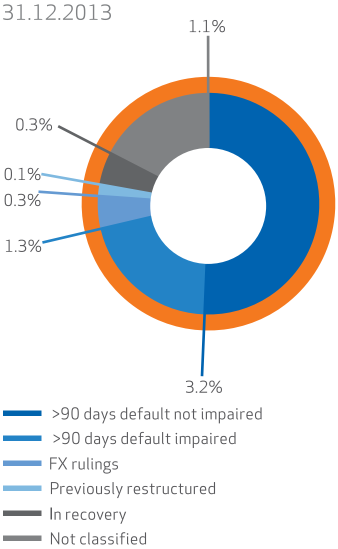
Loan book quality is steadily improving

The Bank defines *Problem loans* as loans that are more than 90 days past due and loans that are not past due but individually impaired. The ratio of problem loans has steadily decreased since its peak in 2010 mostly due to the progress made in problem-loan restructuring and the resolution of the legal uncertainty surrounding FX loans. At the end of 2013, problem loans had fallen to 4.5% of loans to customers, but rose to 6.3% with the Drómi transaction. Approximately a third of problem loans are 90 days past due but are not impaired due to sufficient collateral. Out of 6.3% of problem loans, 4.2% are secured by tangible collateral.

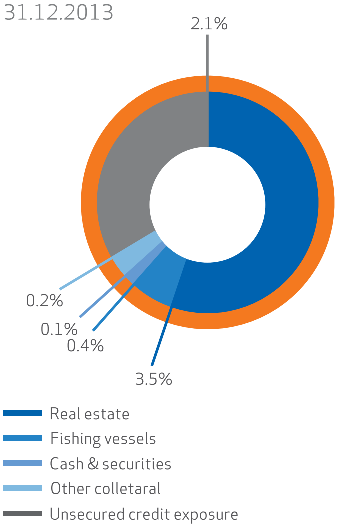
Problem loans



Problem loans 2013
by status
31.12.2013



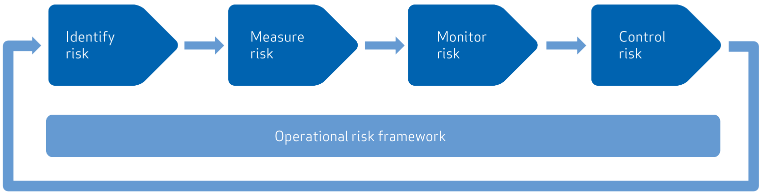
Collateral coverage of
problem loans
31.12.2013



OPERATIONAL RISK

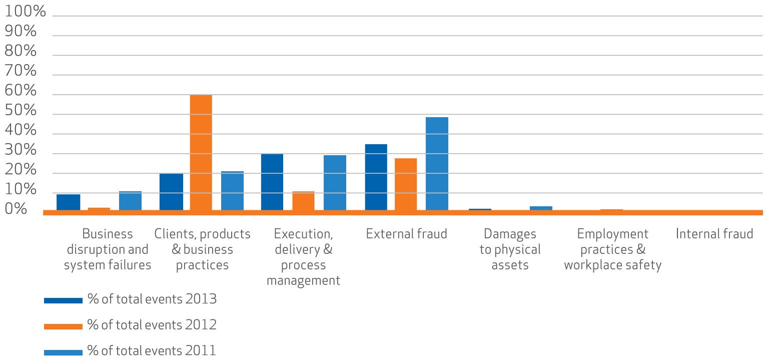
Operational risk is the risk of direct or indirect loss, or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Bank's image and operational earnings. The Bank defines IT risk, legal risk and reputational risk as subcategories of operational risk.

Each business unit within the Bank is primarily responsible for taking and managing its own operational risk. The Bank's Operational Risk department is responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk at the Bank.



The primary tools used by the Bank to measure operational risk are loss data collection and Risk and Control Self-Assessment (RCSA). Loss data is collected and categorized according to the Basel II event categories. Key loss data is reported to the senior management on a monthly basis and is used to enhance the Bank's operating procedures. The Bank is developing a method of using loss data to assess the adequacy of the capital requirement for operational risk. The total amount of loss events in 2013 was ISK 604 million and the number of events was 456. The RCSA is carried out in all business units of the Bank. The results of the RCSA are used among other things to make operational improvements within the Bank and to create scenarios to assess the adequacy of the operational risk capital.

Distribution of loss events by number



Distribution of loss events by amount

The management of IT and data security is the responsibility of the Bank's Security Officer who is part of the Operational Risk department. With the number of channels to interact with customers greater than ever before and rapid technological developments, the potential for risk relating to data and IT security has increased. In order to respond to these changes the Bank has strengthened its efforts in managing data and IT security.

The Bank uses the Basel II Basic Indicator Approach to calculate the capital requirement for operational risk. The capital requirement for operational risk in 2013 was ISK 6,088 million.

MARKET RISK

Market risk is the risk that price changes and interest rate changes will affect the value and cash flow from the Bank's financial instruments. The main types of market risk are interest rate risk, equity price risk and currency risk.

Interest rate risk is primarily related to the fact that in part of the balance sheet there is a mismatch between interest-bearing assets and liabilities and a gap in interest-fixing periods. Generally the value of the Bank's fixed-interest assets is higher than the value of liabilities with the same interest-fixing period as the Bank is partly funded with deposits. An increase in market interest rates would therefore have a negative effect on the Bank's earnings. The Bank has reduced this risk by issuing covered bonds, although the Bank's takeover of loans from Drómi, Frjálsi and Hilda has increased risk.

The main equity price risk is related to the Bank's holdings in unlisted equity, which the Bank acquired during the process of restructuring companies following the 2008 economic crisis. Risk Management closely monitors risk and ensures that positions are kept within limits.

Foreign exchange risk is the risk that movements in the exchange rate of the Icelandic króna could have a negative impact on the Bank's earnings. The Group's currency imbalance at the end of 2013 was ISK 31.6 billion and the increase is mainly due to an increase in the currency position of subsidiaries. Arion Bank's currency imbalance has been positive and stable since the early part of 2012. The Bank uses derivatives to hedge against foreign exchange risk.

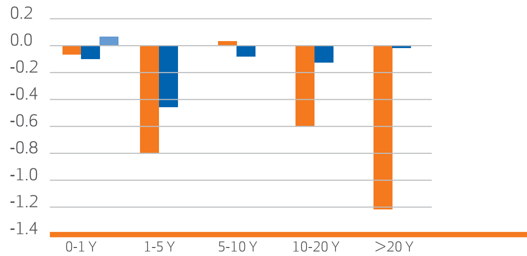
The net position of the Bank's inflation-indexed assets and liabilities is ISK 67.9 billion. The indexation imbalance increased in 2012, primarily as a result of loans to companies. The increase in 2013 is largely due to the Bank's takeover of loans in connection with the settlement of the Drómi debt. It is the Bank's policy to reduce this imbalance.

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Bank, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due or can secure them only at excessive cost. Liquidity and liquidity risk are discussed in more detail in the next chapter.

Sensitivity of interest bearing assets and liabilities to a parallel shift of all yield curves upwards by 1%*

ISK bn.

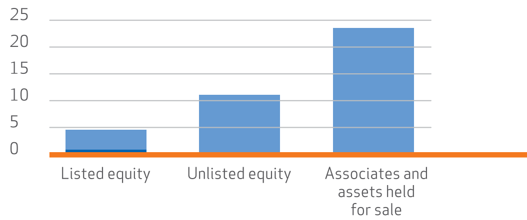


*Negative numbers represent net loss due to valuation change in assets and liabilities

ISK, indexed
ISK, non-indexed
FX

Equity positions

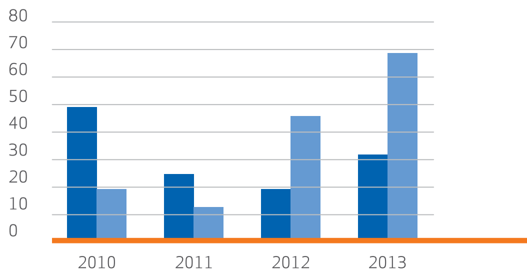
ISK bn.



Banking book
Trading book

Indexation and currency imbalance

ISK bn.



Currency imbalance
Indexation imbalance

FUNDING
AND LIQUIDITY

Arion Bank has taken crucial steps towards diversifying its funding base and in early 2013 completed its first ever international bond offering. The international ratings agency Standard and Poor's (S&P) assigned Arion Bank BB+ ratings with a stable outlook. The Bank has continued to issue covered bonds in Iceland. It has maintained its strong liquidity ratio and meets all the requirements made in this respect by the Financial Supervisory Authority (FME) and the Central Bank of Iceland.

FUNDING

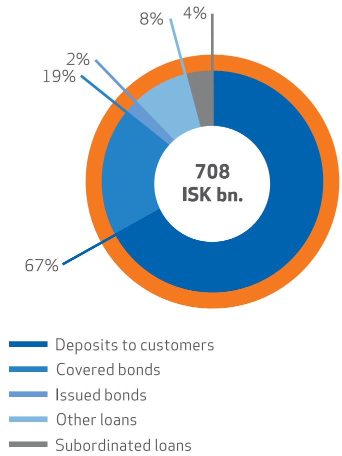
In 2013 Arion Bank continued its efforts to diversify its funding. An important milestone was reached in February 2013 when the Bank completed a bond offering in Norwegian kroner arranged by Pareto Öhman. This is the first time the Bank has raised funding on the international markets and it is also the first international bond offering by an Icelandic financial institution since 2007. Unsecured bonds with a value of approximately NOK 500 million (ISK 11.2 billion) were placed with more than 60 international investors. The issue was oversubscribed and the bonds were admitted to trading on the Oslo Stock Exchange on 2 July 2013. The bonds are floating rate notes with NIBOR plus 5.00% interest, maturing in 2016.

The Bank has over the past three years had numerous investors meetings in the United States, the United Kingdom, Germany and Scandinavia. The Bank will continue to present its business to investors and international financial institutions in 2014. This bond issue is clearly not just significant for Arion Bank as the International Monetary Fund and the Central Bank of Iceland have both pointed out that one of the main prerequisites for lifting the capital controls in Iceland is that financial institutions can access the international credit markets.

At the beginning of 2014 the international ratings agency Standard and Poor's (S&P) assigned Arion Bank BB+ ratings with a stable outlook. The ratings assigned by S&P reflect Arion Bank's solid position on the Icelandic market. The Bank has increased its market share in the household segment in recent years and its loans to customers are now divided equally between corporates and individuals. However, the Bank is small in international comparison. The Bank considers its rating from S&P to be good in view of the credit rating assigned to the Icelandic sovereign which is BBB- from S&P. A credit rating from an international ratings agency will improve the Bank's access to international credit markets, which is highly significant.

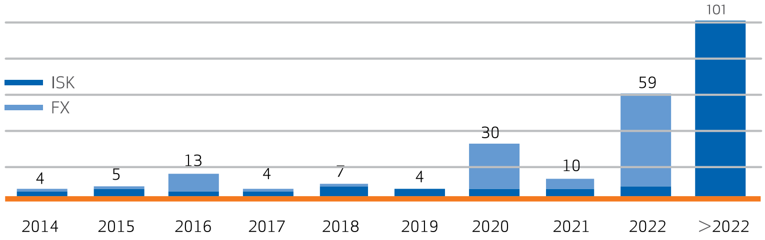
Arion Bank continued to issue covered bonds during the year. In July a new series of covered bonds was issued. This series is indexed and matures in 2019. The Bank issued covered bonds worth a total of ISK 6.3 billion in 2013. The Bank plans to issue ISK 10 billion in covered bonds every year over the next few years to finance the mortgage loans it provides to its customers.

Combination of total funding



FUNDING AND LIQUIDITY

Maturity of long-term funding
ISK bn.



The covered bonds are used to fund mortgages which Arion Bank provides to its customers. The Bank has played a leading role on the Icelandic mortgage market with its favourable lending rates. Since being introduced in September 2011 Arion Bank's non-indexed mortgages have proven highly popular.

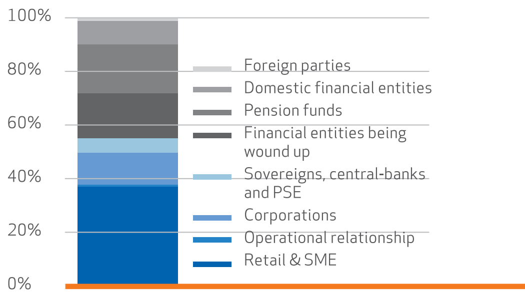
The Bank intends to bring added diversity to its funding by continuing to issue covered bonds and issuing bonds on the international markets.

LIQUIDITY AND LIQUIDITY RISK

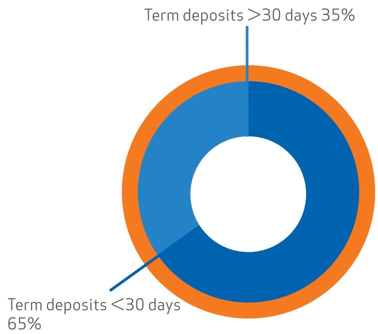
Arion Bank partly funds itself through deposits from individuals, corporations and pension funds. On 1 December 2013 new Central Bank rules on liquidity ratio came into effect. They are based on the same criteria as the liquidity requirements made since 2005 under the Basel III standard. The rules state that from 1 January 2014 liquidity coverage ratios of Icelandic financial institutions should be a minimum of 70% and 100% in foreign currency. The liquidity coverage ratio shall be increased by 10 percentage points a year until it reaches 100% in 2017.

The above requirements on the liquidity coverage ratio reflect the fact that a large proportion of a bank's liabilities are typically to a large extent short-term or demand deposits, while the contractual maturity of the assets is long-term. The Icelandic banks are faced with particular uncertainties linked to the possible outflow of capital triggered by the lifting of the capital controls. One of Arion Bank's key objectives is to maintain strong liquidity. At the end of 2013 the Bank's liquidity coverage ratio was 123% and the ratio for foreign currencies was 274%. Risk Management analyzes liquidity and the behaviour of its deposit base and reports its findings to ALCO.

Deposits from customers by LCR categories
total deposits



Short-term funding
total deposits



The Banker

Bank of the Year 2013

ICELAND

BANK OF THE YEAR

At the end of 2013 The Banker Magazine, which is published by The Financial Times, named Arion Bank as bank of the year in Iceland for 2013. In supporting its decision the magazine cited the Bank's success in diversifying its funding and reducing the ratio of problem loans, its leading role on the mortgage market and strong track record in product development.

Arion Bank

FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 12.7 billion in 2013, compared with ISK 17.1 billion in 2012. Return on equity was 9.2% compared with 13.8% in 2012. Total assets amounted to ISK 938.9 billion, compared with ISK 900.7 billion at the end of 2012. New loans increased by 60% between years to almost ISK 120 billion. The Bank's capital ratio at the end of 2013 was 23.6% compared with 24.3% at the end of 2012.

NET EARNINGS

Net earnings amounted to ISK 12,657 million in 2013 compared with ISK 17,056 million in 2012. Decrease in net earnings is mainly due to lower net interest income, decrease in other income and increased taxes.

Net earnings from core operations amounted to ISK 11,534 million. Core operation are defined as the Group's operations minus income and expenses related to legal entities held for sale acquired in connection with debt settlement agreements, and other irregular items. Earnings from core operations have been quite stable for the last four years.

OPERATING INCOME

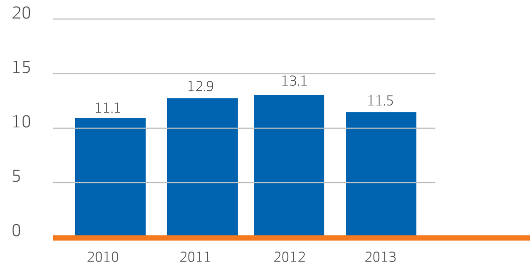
Operating income decreased by ISK 5,154 million between years to ISK 44,348 million in 2013. This decrease is primarily a result of the lower interest-rate differential and the decrease in other operating income compared with 2012.

Net interest income amounted to ISK 23,800 million in 2013, compared with ISK 27,142 million in 2012. This represents a decrease of ISK 3,342 million between years and is primarily a result of higher interest expenses on funding, both on term loans and new borrowing in Iceland and abroad and lower inflation. The net interest margin as a percentage of the average interest-bearing assets was 2.9%, compared with 3.4% in 2012. The net interest margin has developed more or less in line with inflation and the composition of interest-bearing assets and liabilities also has some effect. In the future the Bank expects the net interest margin on interest-bearing assets to be around 3% under normal circumstances.

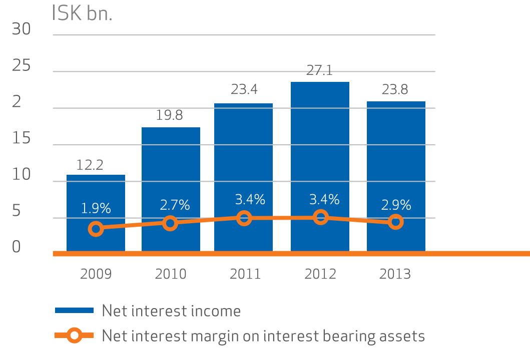
Net commission income increased slightly to ISK 11,223 million in 2013, compared with ISK 10,748 million in 2012. Commission income in Asset Management and Investment Banking has increased significantly, while income from card transactions and loans fell slightly between years.

Net financial income amounted to ISK 3,441 million in 2013, compared with ISK 583 million in 2012. This income is primarily generated by the group's equities holdings, while bond holdings also create some income. Positive conditions on the Icelandic securities market are the main reasons for the significant change between years.

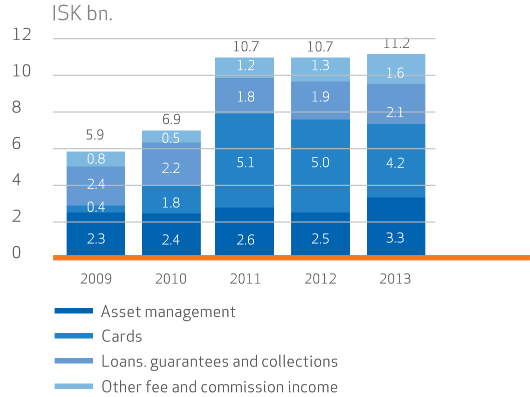
Net earnings from core operations
ISK bn.



Net interest income
ISK bn.



Net commission income
ISK bn.



▶ FINANCIAL RESULTS

Net exchange rate loss amounted to ISK 1,766 million in 2013, compared with a net gain of ISK 1,434 million in 2012. The Bank's net foreign exchange balance was ISK 31.6 billion at the end of the year which meant that volatility in the exchange rate had a significant impact on operating income. The foreign exchange balance of the parent company is within the 15% limit stipulated by the Central Bank of Iceland. It is the Bank's policy to have strong liquidity in foreign currency. However, the exchange rate in recent periods meant this policy generated an exchange rate loss during the year.

Other operating income amounted to ISK 7,650 million in 2013, compared with ISK 9,595 million in 2012. The main types of income included in other operating income are lease income, valuation changes and profit from the sale of investment properties owned by Landfestar and Landey, valuation changes on associated company owned by Eignabjarg and income from insurance premiums at OKKAR Life Insurance, all of which are subsidiaries of the Bank. Valuation changes and profit from sale of investment properties and associate companies are lower in 2013 than in 2012 which is the main reason for the decrease between years in other operating income.

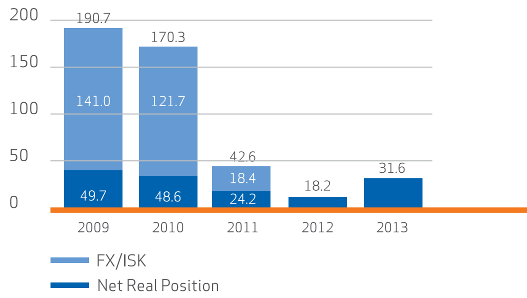
OPERATING EXPENSES

Operating expenses totalled ISK 25,395 million in 2013, an increase of ISK 727 million or 2.9% from 2012. Operating expenses include a fine of ISK 500 million imposed on Valitor by the Competition Authority and confirmed by the Competition Authority Appeals Committee. Operating expenses include the writing down of real estate and software used by the Bank, a total of ISK 600 million. This is partly offset by a decrease in operating expenses owing to the reversal of a provision relating to litigation against Stefnir which was expensed in 2012. The cost-to-income ratio increased to 57.3%, compared with 49.8% in 2012. The cost-to-assets ratio was 2.8% in 2013, the same figure as in 2012. The cost-to-income ratio is affected by the decrease in operating income which partly results from lower net interest income and the aforementioned expenses relating to housing and software.

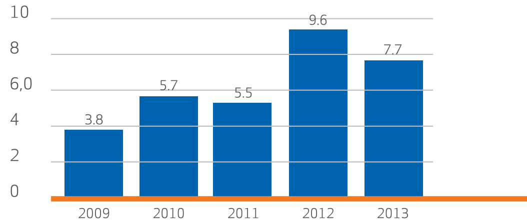
Salaries and related expenses amounted to ISK 13,537 million, compared with ISK 12,459 million in 2012. In 2013 there were on average 1,159 full-time equivalent positions at Arion Bank, compared with 1,166 in 2012. The average salary has increased by approximately 8.2%, which is 2.5% above the 5.7% increase in the salary index between periods. This above average increase is partly due to a 1.3% increase in the financial sector tax which is calculated on the salaries of employees of financial institutions and the bonus scheme which was set up during the year. The scheme is in compliance with FME regulations and a bonus can be a maximum of 25% of an employee's total salary. 40% of a bonus may not be paid out for three years. Approximately 100 employees belong to the scheme and the estimated total cost, salaries and related expenses, was ISK 494 million and this was expensed during the year.

Other operating expenses amounted to ISK 11,858 million in 2013, compared with ISK 12,209 million in 2012. This represents a decrease of ISK 351 million and is largely explained by cost control and improving efficiency at the Bank. In other respects other operating expenses were as expected.

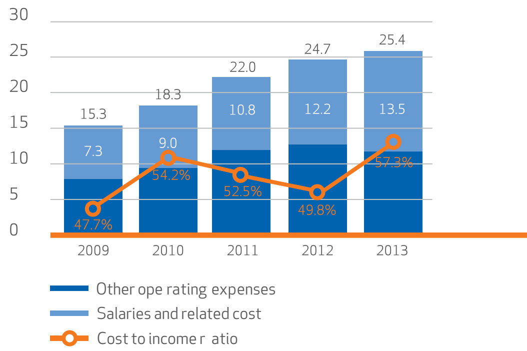
FX Imbalance
ISK bn.



Other income
ISK bn.



Operating expenses
ISK bn.



FINANCIAL RESULTS

NET VALUATION CHANGE

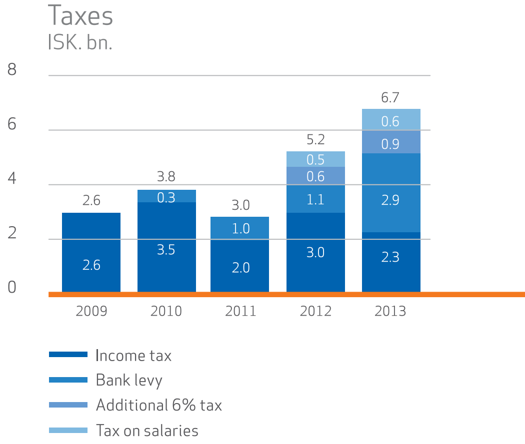
Net valuation change was negative of ISK 680 million during 2013 compared with ISK 4,690 million negative valuation change in 2012. Net valuation change in 2013 is broadly divided into three categories. Firstly, valuation increases on loans of ISK 9,099 million, mainly relating to loans to large companies. Secondly, loan impairment of ISK 8,940 million during the year. This impairment is largely related to loans which had been deemed illegal currency-linked loans and other loans to individuals and smaller companies. Thirdly, an ISK 839 million impairment relating to intangible assets linked to the Bank's holding in the subsidiary Valitor.

TAXES

Income tax amounted to ISK 3,143 million, compared with ISK 3,633 million in 2012. Income tax, as presented in the annual financial statement, comprises 20% income tax on earnings and a separate 6% additional tax on financial institutions which is levied on the earnings of financial institutions above ISK 1 billion. The effective income tax rate was slightly lower in 2013 or 17.2%, compared with 18.0% in 2012.

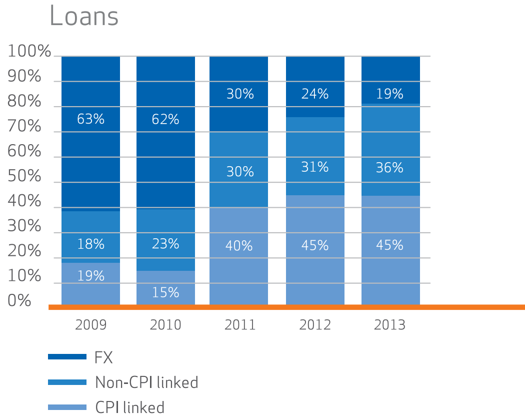
Bank levy amounted to ISK 2,872 million, compared with ISK 1,062 million in 2012. The increase between years is attributable to the increase in the bank levy from 0.1285% to 0.376%. This tax rate was approved by the Icelandic parliament at the end of 2013 and part of the tax will be used to fund the government's debt relief programme.

The tax environment for Icelandic financial institutions has been very unstable in recent years and the tax burden has increased sharply, as seen in the accompanying diagram. New taxes which have only been imposed on financial institutions are playing an increasing role in the operations of these companies and comparisons with other business sectors are as a result impossible. In addition to the above taxes the group paid ISK 502 million in fees to the Financial Supervisory Authority and the Debtors' Ombudsman.



DISCONTINUED OPERATIONS

Net income from discontinued operations amounted to ISK 399 million, compared with ISK 1,607 million in 2012. In 2013 the sales of assets had an insignificant effect, and the profit on other discontinued operations and foreclosure assets owned by the Bank was insignificant, unlike 2012 when the Bank generated profit from the sale of a shareholding in Hagar and the sale of the Bank's share in N1.



▶ FINANCIAL RESULTS

BALANCE SHEET

Arion Bank had total assets of ISK 938,850 million at the end of 2013, compared with ISK 900,675 million at the end of 2012. This increase is similar to the rate of inflation during the year. The changes in individual asset classes during the year are mainly related to the settlement of the Drómi bond, whereby the Bank received loans to individuals in place of the bond which the Bank received in 2009 when SPRON deposits were transferred to Arion Bank. The Bank's liquidity has also improved in 2013 on account of increased deposits at the Central Bank of Iceland and more bond holdings, taking into account the settlement of the Drómi bond.

LOANS TO CUSTOMERS

Loans to customers amounted to ISK 635,774 million at the end of 2013, compared with ISK 566,610 million at the end of 2012. Loans to individuals increased by approximately ISK 50 billion at the end of the year when the Drómi bond was settled. New loans in 2013 increased by 60%, but loans paid off increased by virtually the same amount during the period. As a result the total increase in the Bank's loan portfolio is almost entirely due to the new loans relating to the settlement of the Drómi bond.

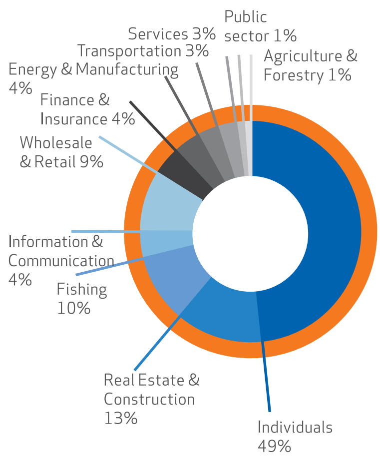
SECURITIES

Securities holdings amounted to ISK 86,541 million at the end of 2013, compared with ISK 137,800 million at the end of 2012. Several changes occurred to securities holdings during the year, particularly in connection with the ISK 70 billion settlement of the Drómi bond. The Bank has, however, increased its liquid assets in the form of listed bonds, both Icelandic and international. The proportion of derivatives and securities bought as hedges has also increased between years.

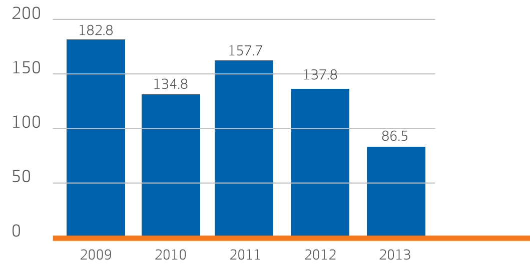
LIABILITIES

Total liabilities amounted to ISK 793,903 million at the end of 2013, compared with ISK 769,797 million at the end of 2012. The increase is primarily attributable to bond issues in Iceland and abroad during the period, while deposits have also increased.

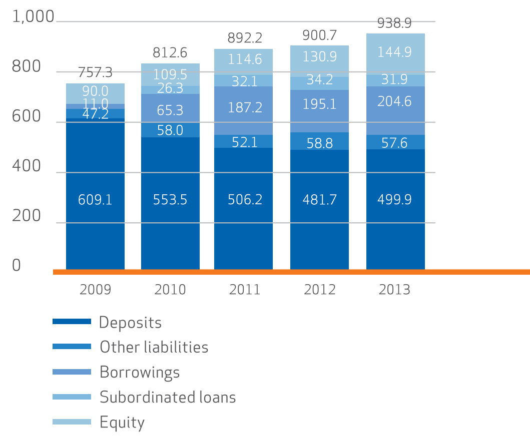
Sectors



Securities
ISK. bn.



Liabilities and equity
ISK bn.

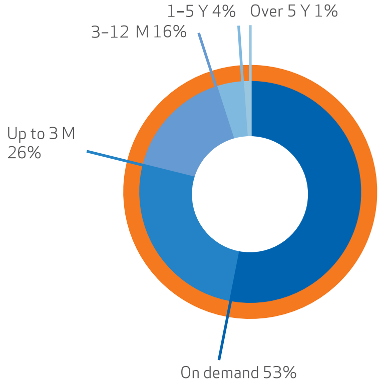


FINANCIAL RESULTS

DEPOSITS

Total deposits amounted to ISK 499,866 million at the end of the year, compared with ISK 481,673 million at the end of 2012. Ever since Arion Bank was founded in 2008, deposits have been at the core of the Bank's funding strategy. Deposits have tended to fluctuate depending on the availability of other investment options. With the capital controls in place and in an uncertain economic environment investors have turned to products in which they had previously only invested to a limited extent. Deposits in the Icelandic system have been at an historical high in recent years. Systematic efforts have been made to increase the proportion of term deposits at the Bank in order to ensure more secure funding. At the end of 2013 47% of total deposits were term deposits, compared with 42% at the end of 2012 and 23% at the end of 2011.

Breakdown by maturity of total deposits



BORROWINGS

Borrowings amounted to ISK 204,568 million at the end of 2013, compared with ISK 195,085 million at the end of 2012. This increase is chiefly explained by the Bank's issue of ISK 6.3 billion in CPI linked and fixed rate covered bonds, which are listed on NASDAQ OMX Iceland, and NOK 500 million (approx. ISK 11 billion) in bonds which were sold to international investors and have been listed on the Oslo Stock Exchange. However, the appreciation of the Icelandic króna and repayments of long-term liabilities have reduced borrowings. At the beginning of the year the Bank was assigned a rating by the international ratings agency Standard & Poor's, the first Icelandic bank to obtain a rating for more than five years. The Bank was rated BB+ and this will increase Arion Bank's opportunities on the credit markets both in Iceland and abroad.

SUBORDINATED LIABILITIES

Subordinated liabilities amounted to ISK 31,918 million at the end of 2013, compared with ISK 34,220 million at the end of 2012. The change is solely related to changes in the exchange rate of foreign currencies to which the loans are linked.

EQUITY

Total equity amounted to ISK 144,947 million at the end of 2013, compared with ISK 130,878 million at the end of 2012. The change relates entirely to the financial results for 2013. The capital ratio calculated in accordance with the rules of the Icelandic financial supervisory authority was 23.6% at the end of the year. The statutory minimum is 8%. The capital ratio at the end of 2012 was 24.3% and the decrease between years is due to the settlement of the Drómi bond which was guaranteed by the ministry of finance and economic affairs. This instrument was replaced by loans to individuals which have a higher risk-weighting.

FINANCIAL RESULTS

Income statement	2013	2012	2011	2010	2009
Net interest income	23,800	27,142	23,388	19,785	12,188
Net commission income	11,223	10,748	10,685	6,866	5,862
Net financial income	1,675	2,017	2,347	1,361	10,353
Other income	7,650	9,595	5,505	5,733	3,758
Total operating income	**44,348**	**49,502**	**41,925**	**33,745**	**32,161**
Total operating expenses	-25,395	-24,668	-22,016	-18,292	-15,346
Net valuation change	-680	-4,690	-8,649	1,878	-296
Net earnings before taxes	**18,273**	**20,144**	**11,260**	**17,331**	**16,519**
Income tax	-3,143	-3,633	-1,912	-3,481	-2,568
Bank levy	-2,872	-1,062	-1,046	-290	0
Net gain (loss) from disc. Operations	399	1,607	2,792	-1,003	-1,080
Net earnings	**12,657**	**17,056**	**11,094**	**12,557**	**12,871**

Balance sheet					
Cash and balances with Central Bank	37,999	29,746	29,200	30,628	41,906
Loans to credit institutions	102,307	101,011	69,103	67,846	38,470
Loans to customers	635,774	566,610	561,550	451,219	357,734
Financial instruments	86,541	137,800	157,659	134,767	182,802
Compensation instrument	0	0	0	24,188	34,371
Investment properties	28,523	28,919	27,100	27,642	22,947
Other assets	47,706	36,589	47,509	76,325	79,114
Total assets	**938,850**	**900,675**	**892,121**	**812,615**	**757,344**
Total deposits	499,866	481,673	506,155	553,527	609,112
Other liabilities	57,551	58,819	52,100	58,017	47,156
Borrowings	204,568	195,085	187,203	65,278	11,042
Subordinated liabilities	31,918	34,220	32,105	26,257	0
Equity	144,947	130,878	114,558	109,536	90,034
Total liabilities and equity	**938,850**	**900,675**	**892,121**	**812,615**	**757,344**

Key ratios and figures					
Return on equity	9.2%	13.8%	10.5%	13.4%	16.7%
Core return on equity	10.5%	11.4%	11.5%	11.4%	8.4%
Net interest margin	2.9%	3.4%	3.4%	2.7%	1.9%
Cost-to-total income	57.3%	49.8%	52.5%	54.2%	47.7%
CAD ratio	23.6%	24,3%	21,2%	19,0%	13,7%
Tier 1 ratio	19.2%	19.1%	16.4%	15.2%	13.7%
Total equity/Total assets	15.4%	14.5%	12.8%	13.5%	11.9%
90 days default/Loans to customers	4.5%	6.1%	10.6%	24,7%	22.8%
RWA/Total assets	76.8%	73.0%	74.5%	84.7%	83.9%
Loans to deposits ratio	135.0%	126.3%	114.6%	98.5%	72.2%
Full-time equivalent at the end of the year	1,145	1,190	1,158	1,241	1,124

CONSOLIDATED FINANCIAL STATEMENTS **2013**

ENDORSEMENT AND STATEMENT
BY THE BOARD OF DIRECTORS ANDTHE CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2013 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Operations during the year

Net earnings amounted to ISK 12,657 million for the year ended 31 December 2013. The Group's equity amounted to ISK 144,947 million at year end. The capital adequacy ratio of the Group, calculated according to the Financial Undertakings Act, was 23.6% and comfortably meets the requirements set by law and the Financial Supervisory Authority ("FME"). The liquidity position was strong at year end and well above the regulatory minimum. The Board of Directors proposes that 60% of Net earnings will be paid out as a dividend in 2014 for the financial year 2013.

The Group performed well during the year and operations were characterized by greater stability. The appreciation of the Icelandic króna had the effect of reducing interest income and the value of the loan portfolio. Another item which changed significantly from 2012 is that impairment on loans decreased, reflecting the success which has been achieved in restructuring the loan portfolio in recent years. However, there was a threefold increase in the bank levy compared with the previous year and the increase was ninefold when compared with the levy as it was initially presented for the year.

At the end of 2013 an agreement was reached between Arion Bank and ESÍ ehf., a subsidiary of the Central Bank of Iceland, on the settlement of the Drómi bond from 2009. The bond was paid with assets including three loan portfolios originating from two small failed banks, SPRON savings bank and Frjálsi Investment Bank. The transfer of these loan portfolios enables thousands of former customers of these banks to combine their business at Arion Bank as the deposits of those same customers had previously been transferred to the Bank. The effect of the agreement on the balance sheet and income statement can be seen in the transfer of assets from securities holdings over to loans to customers. The loans received by the Bank are only to individuals which increases the ratio of loans to individuals in the Bank's loan portfolio to 48.8% at the end of the year. This fits in well with the Bank's strategy of increasing the proportion of loans to individuals. At the same time it raises slightly the ratio of problem loans, as the quality of these loan portfolios is slightly less than that of similar loans already owned by the Bank. The agreement and its effects are discussed in more detail in Note 21.

The Bank has made concerted efforts to diversify its funding base in the short term and long term. To this end the Bank has issued bond series which have been sold and listed in Iceland and abroad. The Bank has also increased the term of its deposits. An important milestone in the Bank's funding was reached in January 2014 when Standard & Poor's assigned Arion Bank a credit rating of BB+ with a stable outlook which is just one notch below the rating of the Republic of Iceland.

Very good progress has been made in recent years in selling the companies that the Bank had to take over in debt restructuring, and during the year the sale of assets linked to the Fram Foods group was completed. However, the Bank acquired a 38% share in the telecommunications company Skipti hf. in the process of financially restructuring the company which increased the Group's assets in associate companies.

The Bank has strived to promote its intrinsic values called the Bank's cornerstones. The cornerstones are "We make a difference", "We say what we mean" and "We get things done". A great deal of effort has gone into the introduction of a lean management called A plus which is designed to ensure efficiency and strengthen customer relationships throughout the Bank with the ultimate goal of improving the level of service to customers.

In November the Banker magazine named Arion Bank as the Bank of the Year 2013 in Iceland. The magazine gave Arion Bank the award in recognition of the greater diversity in the Bank's funding, its reduced default ratio, the strong focus on product development, its efficient online bank and the Arion Bank app. Arion Bank is very proud of this international recognition of the effort and hard work that has been undertaken by the Bank's employees over recent years and the award only encourages the Bank to do even better.

The Group had 1,145 full-time equivalent positions at the end of the year, compared with 1,190 at the end of 2012. 911 of these positions were at the parent company Arion Bank hf., compared with 949 at the end of 2012.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Outlook

Arion Bank is a leading financial institution on the Icelandic market and enjoys a strong position in all its business segments. In recent years the Bank has reduced the risk in its loan portfolio by increasing the share of retail mortgage loans. The loan portfolio now comprises loans to individuals and companies in equal measure. The Bank has also greatly improved the quality of its funding. The Bank is financially robust in international comparisons and has a very good liquidity position.

The core of the Bank's business is traditional banking activities now that debt recovery work has largely been completed. The Bank sees great opportunity in strengthening the business relationship with the new customers from SPRON and Frjálsi Investment Bank and is confident that the issues which have been on hold for many of them can be quickly resolved. The focus in the near future will be to further improve operations and to take advantage of the foundations already in place to take the business forward. The Bank aims to continue reducing operating expenses, mainly through automation and further optimization in both back office functions as well as the branch network. The Bank will also concentrate on selling the remaining shareholdings acquired by the Bank as a result of the financial restructuring of some of its corporate clients. Arion Bank's financial position and risk distribution enables the Bank to support the expected growth in activities of individual and corporate clients over the coming years. The Bank's solid position, its rating from S&P and plans for new funding will enable it to support its customers in their operations and investment activities domestically as well as in their current operation and expansion internationally.

Risk Management

The Group faces various risks arising from its day-to-day operations as a financial institution. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure, policy and main risk factors are addressed in the notes, starting at Note 40.

Group ownership

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, investment banking and asset management. The Group includes subsidiaries in the real estate sector, card services and insurance.

Kaupskil ehf., a company owned by Kaupthing 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.

Corporate governance

The Board of Directors of Arion Bank is committed to good corporate governance and endeavours to promote responsible behaviour and corporate culture within Arion Bank for the benefit of all the Bank's stakeholders.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2013 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance and cash flows of the Group for the year 2013 and its financial position as at 31 December 2013.

Further, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2013 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 26 February 2014

Board of Directors

Monica Caneman
Stjórnarformaður

Agnar Kofoed-Hansen | Björgvin Skúli Sigurðsson | Måns Höglund

Benedikt Olgeirsson | Guðrún Johnsen | Þóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion Bank and its subsidiaries ("the Group"), which comprise the Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position as at 31 December 2013, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flow for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Consolidated Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Consolidated Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Consolidated Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the financial position of the Group as at 31 December 2013, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with the International Financial Reporting Standards as adopted by the EU.

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

Pursuant to the requirement of Paragraph 2 Article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Reykjavík, 26 February 2014

Ernst & Young ehf.

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR 2013

	Notes	2013	2012
Interest income		56,867	59,094
Interest expense		(33,067)	(31,952)
Net interest income	6	23,800	27,142
Fee and commission income		16,443	16,166
Fee and commission expense		(5,220)	(5,418)
Net fee and commission income	7	11,223	10,748
Net financial income	8	1,675	2,017
Other operating income	9	7,650	9,595
Operating income		44,348	49,502
Salaries and related expense	10	(13,537)	(12,459)
Other operating expense	11	(11,858)	(12,209)
Net impairment	12	(680)	(4,690)
Earnings before tax		18,273	20,144
Income tax expense	13	(3,143)	(3,633)
Bank levy	14	(2,872)	(1,062)
Net earnings from continuing operations		12,258	15,449
Net gain from discontinued operations, net of tax	15	399	1,607
Net earnings		12,657	17,056
Attributable to			
Shareholders of Arion Bank		13,019	16,622
Non-controlling interest		(362)	434
Net earnings		12,657	17,056
Other comprehensive income			
Exchange difference on translating foreign subsidiaries		(2)	2
Total comprehensive income for the year		12,655	17,058
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	6.31	7.51

The notes on pages 117 to 176 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2013

Assets	Notes	2013	2012
Cash and balances with Central Bank	17	37,999	29,746
Loans to credit institutions	18	102,307	101,011
Loans to customers	19	635,774	566,610
Financial instruments	20-22	86,541	137,800
Investment property	22	28,523	28,919
Investments in associates	24	17,929	7,050
Intangible assets	25	5,383	4,941
Tax assets	26	818	463
Other assets	27	23,576	24,135
Total Assets		938,850	900,675
Liabilities			
Due to credit institutions and Central Bank	21	28,000	32,990
Deposits	21	471,866	448,683
Financial liabilities at fair value	21	8,960	13,465
Tax liabilities	26	4,924	3,237
Other liabilities	28	43,667	42,117
Borrowings	21,29	204,568	195,085
Subordinated liabilities	21,30	31,918	34,220
Total Liabilities		793,903	769,797
Equity			
Share capital and share premium	32	75,861	75,861
Other reserves	32	1,637	1,639
Retained earnings		62,591	49,572
Total Shareholders' Equity		140,089	127,072
Non-controlling interest		4,858	3,806
Total Equity		144,947	130,878
Total Liabilities and Equity		938,850	900,675

The notes on pages 117 to 176 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR 2013

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
2013						
Equity 1 January 2013	75,861	1,639	49,572	127,072	3,806	130,878
Total comprehensive income for the year		(2)	13,019	13,017	(362)	12,655
Increase in non-controlling interests during the year					1,533	1,533
Decrease of non-controlling interest due to dividend payment from subsidiary					(119)	(119)
Equity 31 December 2013	75,861	1,637	62,591	140,089	4,858	144,947
2012						
Equity 1 January 2012	75,861	1,637	32,950	110,448	4,110	114,558
Total comprehensive income for the year		2	16,622	16,624	434	17,058
Decrease due to purchase of non-controlling interest					(738)	(738)
Equity 31 December 2012	75,861	1,639	49,572	127,072	3,806	130,878

The notes on pages 117 to 176 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions

CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR 2013

	2013	2012
Operating activities		
Net earnings	12,657	17,056
Non-cash items included in net earnings and other adjustments	(20,930)	(25,672)
Changes in operating assets and liabilities	(3,728)	8,063
Interest received	46,141	49,012
Interest paid*	(26,683)	(23,865)
Dividend received	46	25
Income tax and bank levy paid	(2,149)	(3,556)
Net cash from operating activities	5,354	21,063
Investing activities		
Investment in associated companies	(40)	(1,658)
Proceeds from sale of associated companies	-	396
Purchase of property and equipment and intangible assets	(3,022)	(1,674)
Proceeds from sale of property and equipment	185	30
Net cash used in investing activities	(2,877)	(2,906)
Financing activities		
Decrease in non-controlling interest	(119)	(738)
Net cash used in financing activities	(119)	(738)
Net increase in cash and cash equivalents	2,358	17,419
Cash and cash equivalents at beginning of the year	105,173	82,815
Effect of exchange rate changes on cash and cash equivalents	(7,848)	4,939
Cash and cash equivalents at the end of the year	99,683	105,173
Non-cash investing and financing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	9,017	2,051
Settlement of loans through foreclosure on collateral from customers with view to resale	(9,017)	(2,051)

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

The notes on pages 117 to 176 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF CASH FLOW FOR THE YEAR 2013

	2013	2012
Non-cash items included in net earnings and other adjustments		
Net interest income	(23,799)	(27,142)
Net impairment	680	4,690
Income tax expense	3,143	3,633
Bank levy	2,872	1,062
Net foreign exchange loss (gain)	1,766	(1,434)
Net gain on financial instruments	(3,395)	(561)
Depreciation and amortisation	1,788	1,436
Share of profit of associates and fair value change	(1,986)	(2,405)
Investment property, fair value change	(1,219)	(1,584)
Net gain on disposal of investment in associates	-	(396)
Net gain on disposal of property and equipment	(9)	(8)
Net gain on disposal of investment property	(372)	(1,356)
Net gain from discontinued operations, net of tax	(399)	(1,607)
Non-cash items included in net earnings and other adjustments	(20,930)	(25,672)

	2013	2012
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(250)	(177)
Loans to credit institutions	(15,225)	(9,729)
Loans to customers	(31,027)	3,008
Financial instruments	(14,373)	30,000
Investment property	2,132	(44)
Other assets	3,363	12,775
Due to credit institutions and Central Bank	(4,569)	16,901
Deposits	44,551	(45,537)
Borrowings	11,633	422
Other liabilities	37	444
Changes in operating assets and liabilities	(3,728)	8,063

	2013	2012
Cash and cash equivalents comprises		
Cash in hand and demand deposits	37,999	29,746
Due from credit institutions	70,671	84,164
Mandatory reserve with Central Bank	(8,987)	(8,737)
Cash and cash equivalents at the end of the year	99,683	105,173

The notes on pages 117 to 176 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENT
CONTENTS

▶ NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Financial Statements for the year ended 31 December 2013 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards, as endorsed by the European Union.

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 26 February 2014.

Basis of measurement

The Financial Statements are prepared on the historical cost basis except for the following:

– Financial assets and financial liabilities held for trading are measured at fair value;
– Investment properties are measured at fair value; and
– 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.

Functional and presentation currency

The Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated. At the end of the year the exchange rate of the ISK against the USD was 115.09 and 158.49 for the EUR (2012: USD 128.09 and EUR 168.89).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within:

- impairment losses and reversal of impairment losses on loans;
- the foreign currency loan portfolio caused by legal dispute and court judgements ;
- investment property; and
- assets classified as held for sale.

3. The Group

Shares in main subsidiaries in which Arion Bank held a direct interest at the end of the year

			Equity interest	
	Country	Currency	2013	2012
AFL - sparisjóður, Aðalgata 34, Siglufjörður	Iceland	ISK	99.3%	99.3%
Arion Bank Mortgages Institutional Investor Fund, Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%
BG12 slhf., Borgartún 19, Reykjavík	Iceland	ISK	62.0%	-
EAB 1 ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%
Eignabjarg ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Hátún 2b, Reykjavík	Iceland	ISK	100.0%	100.0%
Landfestar ehf., Álfheimar 74, Reykjavík	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%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður	Iceland	ISK	60.8%	60.8%

In addition the Bank holds subsidiaries classified as Non-current assets and disposal groups held for sale, see Note 27.

Changes within the Group

Arion Bank hf. established BG12 slhf. in partnership with others to manage the shareholding of Bakkavör Group Ltd.

Amounts are in ISK millions

OPERATING SEGMENT REPORTING

Segment information is presented in respect of the Group's operating segments based on the Group´s management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

Inter segment pricing is determined on an arm's length basis. Business segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital and funding cost.

Operating segments

The Group comprises six main operating segments:

Corporate Banking provides services to the Bank’s larger corporate clients. Its role is to provide comprehensive financial services and tailored services to meet the needs of each company.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund and AFL Sparisjóður, provide a comprehensive range of services. That includes among other advice on deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six 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 manages financial assets on behalf of its clients according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

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., Eignarhaldsfélagið Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

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

4. The Group's business segments

2013	Corporate Banking	Retail Banking	Asset Manage-ment and Stefnir	Investment Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	8,630	12,058	560	120	3,813	(1,473)	92	23,800
Other income	685	2,507	3,141	4,302	(1,103)	10,264	752	20,548
Operating income	9,315	14,565	3,701	4,422	2,710	8,791	844	44,348
Operating expense	(658)	(5,518)	(774)	(596)	(244)	(5,409)	(12,196)	(25,395)
Net impairment	3,789	(5,694)	(3)	1,738	420	(311)	(619)	(680)
Earnings before tax	12,446	3,353	2,924	5,564	2,886	3,071	(11,971)	18,273
Net seg. rev. from ext. customers	16,780	24,805	1,462	4,087	(13,995)	11,616	(407)	44,348
Net seg. rev. from other segments	(7,465)	(10,240)	2,239	335	16,705	(2,825)	1,251	-
Operating income	9,315	14,565	3,701	4,422	2,710	8,791	844	44,348
Depreciation and amortisation	-	166	-	-	-	281	1,341	1,788
Total assets	248,082	397,721	4,840	34,799	168,334	77,150	7,924	938,850
Total liabilities	208,389	356,086	1,781	29,231	148,696	42,746	6,974	793,903
Allocated equity	39,693	41,635	3,059	5,568	19,638	34,404	950	144,947

2012	Corporate Banking	Retail Banking	Asset Manage-ment and Stefnir	Investment Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	10,300	11,437	1,814	(6)	4,857	(1,218)	(42)	27,142
Other income	1,134	2,837	2,356	4,516	(196)	10,804	909	22,360
Operating income	11,434	14,274	4,170	4,510	4,661	9,586	867	49,502
Operating expense	(605)	(5,448)	(1,651)	(599)	(191)	(4,755)	(11,419)	(24,668)
Net impairment	(270)	(5,516)	9	1,095	164	(81)	(91)	(4,690)
Earnings before tax	10,559	3,310	2,528	5,006	4,634	4,750	(10,643)	20,144
Net seg. rev. from ext. customers	20,600	23,553	489	4,243	(11,477)	11,292	802	49,502
Net seg. rev. from other segments	(9,166)	(9,279)	3,681	267	16,138	(1,706)	65	-
Operating income	11,434	14,274	4,170	4,510	4,661	9,586	867	49,502
Depreciation and amortisation	-	170	-	-	-	198	1,068	1,436
Total assets	251,384	318,700	4,597	26,000	212,315	80,057	7,622	900,675
Total liabilities	211,444	291,701	1,497	22,784	185,326	50,338	6,707	769,797
Allocated equity	39,940	26,999	3,100	3,216	26,989	29,719	915	130,878

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.

Amounts are in ISK millions

QUARTERLY STATEMENTS

5. Operations by quarters

2013	Q4	Q3	Q2	Q1	Total
Net interest income	5,487	5,646	6,379	6,288	23,800
Net fee and commission income	2,939	2,986	2,849	2,449	11,223
Net financial income (expense)	721	658	1,123	(827)	1,675
Other operating income	3,615	1,610	1,249	1,176	7,650
Operating income	12,762	10,900	11,600	9,086	44,348
Salaries and related expense	(4,098)	(2,760)	(3,357)	(3,322)	(13,537)
Other operating expense	(3,114)	(2,516)	(2,951)	(3,277)	(11,858)
Net impairment	(561)	(253)	456	(322)	(680)
Earnings before tax	4,989	5,371	5,748	2,165	18,273
Tax expense	(2,864)	(1,214)	(1,260)	(677)	(6,015)
Net earnings from continuing operations	2,125	4,157	4,488	1,488	12,258
Net gain (loss) from discontinued operations, net of tax	402	62	14	(79)	399
Net earnings	2,527	4,219	4,502	1,409	12,657

2012					
Net interest income	7,008	6,254	7,666	6,214	27,142
Net fee and commission income	2,695	2,715	3,002	2,336	10,748
Net financial income (expense)	967	869	(1,248)	1,429	2,017
Other operating income	4,952	1,637	2,054	952	9,595
Operating income	15,622	11,475	11,474	10,931	49,502
Salaries and related expense	(3,646)	(2,644)	(3,124)	(3,045)	(12,459)
Other expense	(4,148)	(2,586)	(2,718)	(2,757)	(12,209)
Net impairment	(5,169)	(2,053)	2,608	(76)	(4,690)
Earnings before tax	2,659	4,192	8,240	5,053	20,144
Tax expense	(549)	(723)	(2,094)	(1,329)	(4,695)
Net earnings from continuing operations	2,110	3,469	6,146	3,724	15,449
Net gain (loss) from discontinued operations, net of tax	409	(181)	652	727	1,607
Net earnings	2,519	3,288	6,798	4,451	17,056

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

Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2013	2012
Cash and balances with Central Bank	628	650
Loans	48,932	49,112
Securities	6,630	8,790
Other	677	542
Interest income	56,867	59,094
Deposits	(19,108)	(17,769)
Borrowings	(12,568)	(12,572)
Subordinated liabilities	(1,334)	(1,520)
Other	(57)	(91)
Interest expense	(33,067)	(31,952)
Net interest income	23,800	27,142
Net interest income from assets and liabilities at fair value	6,630	8,790
Interest income from assets not at fair value	50,237	50,304
Interest expense from liabilities not at fair value	(33,067)	(31,952)
Net interest income	23,800	27,142

7. Net fee and commission income

	2013	2012
Fee and commission income		
Asset management	3,388	2,715
Cards	7,895	8,951
Collection and payment services	1,157	871
Investment banking	1,266	722
Interbank clearing	707	706
Lending and guarantees	986	1,098
Other fee and commission income	1,044	1,103
Fee and commission income	16,443	16,166
Fee and commission expense		
Asset management	(138)	(192)
Cards	(3,648)	(3,956)
Collection and payment services	(56)	(17)
Investment banking	(175)	(40)
Interbank clearing	(704)	(723)
Other fee and commission expense	(499)	(490)
Fee and commission expense	(5,220)	(5,418)
Net fee and commission income	11,223	10,748

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.

Amounts are in ISK millions

8. Net financial income

	2013	2012
Dividend income	46	25
Net gain (loss) on financial assets and financial liabilities classified as held for trading	475	(298)
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	2,920	856
Net foreign exchange gain (loss)	(1,766)	1,434
Net financial income	1,675	2,017

Net gain (loss) on financial assets and financial liabilities held for trading

	2013	2012
Net gain (loss) on equity instruments and related derivatives	690	456
Net gain (loss) on interest rate instruments and related derivatives	(61)	(502)
Net gain (loss) on other derivatives	(154)	(252)
Net gain (loss) on financial assets and financial liabilities held for trading	475	(298)

Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss

	2013	2012
Net gain (loss) on equity instruments designated at fair value	2,232	776
Net gain (loss) on interest rate instruments designated at fair value	688	80
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	2,920	856

9. Other operating income

	2013	2012
Share of profit of associates	1,986	2,405
Rental income from investment property	2,303	2,184
Fair value changes on investment property	1,219	1,584
Realised gain on investment property	372	1,356
Earned premiums, net of reinsurance	1,073	918
Net gain on disposals of assets other than held for sale	9	396
Other income	688	752
Other operating income	7,650	9,595

Earned premiums, net of reinsurance

	2013	2012
Premium written	1,235	1,075
Outward reinsurance premiums	(118)	(99)
Change in the gross provision for unearned premiums	(44)	(58)
Earned premiums, net of reinsurance	1,073	918

10. Personnel and salaries

The Group's total number of employees

	2013	2012
Average number of full time equivalent positions during year	1,159	1,166
Full time equivalent positions at the end of the year	1,145	1,190

The Bank's total number of employees

	2013	2012
Average number of full time equivalent positions during the year	923	927
Full time equivalent positions at the end of the year	911	949

Amounts are in ISK millions

10. Personnel and salaries, continued

Salaries and related expense	2013	2012
Salaries	10,289	9,562
Defined contribution pension plans	1,436	1,288
Salary related expense	1,812	1,609
Salaries and related expense	13,537	12,459

Salaries and related expense for the Bank		
Salaries	8,117	7,127
Defined contribution pension plans	1,133	960
Salary related expense	1,406	1,592
Salaries and related expense	10,656	9,679

In 2013 the Group made a provision of ISK 494 million (2012: ISK 78 million) for performance plan payments, including salary related expense. Forty per cent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. In 2013 the Bank made a provision of ISK 452 million (2012: nil).

	2013			2012		
Compensation of key management personnel	Fixed remuneration[1]	Additional remuneration[2]	Total	Fixed remuneration[1]	Additional remuneration[2]	Total
Monica Caneman, Chairman of the Board	16.8	1.8	18.6	16.8	1.8	18.6
Guðrún Johnsen, Vice-Chairman of the Board	6.3	3.6	9.9	6.3	3.6	9.9
Agnar Kofoed-Hansen, Director	4.2	3.6	7.8	4.2	3.2	7.4
Freyr Þórðarson, Director (1.1.-13.5.2013)	1.6	0.9	2.5	3.5	1.5	5.0
Jón G. Briem, Director	4.2	2.3	6.5	4.2	4.1	8.3
Måns Höglund, Director	8.4	3.6	12.0	8.4	3.6	12.0
Þóra Hallgrímsdóttir, Director	3.5	1.1	4.6	-	-	-
Björg Arnardóttir, alternate director	3.0	1.0	4.0	0.7	-	0.7
Other alternate directors of the Board	5.2	2.5	7.7	3.9	0.5	4.4
Total remuneration	53.2	20.4	73.6	48.0	18.3	66.3

	2013	2012
Höskuldur H. Ólafsson, CEO	50.7	44.5
Nine managing directors of the Bank's divisions being members of the Bank's Executive Committee	219.9	227.6

Board Members receive remuneration for their involvement in board committees. In addition to 13 Board meetings (2012: 14), during the year 14 Board Credit Committee meetings (2012: 20), 6 Board Audit and Risk Committee meetings (2012: 10) and 5 Board Remuneration Committee meetings (2012: 6) were held. Five committee meetings with alternate directors of the Board were held in 2013.

The 2013 Annual General Meeting of the Bank held on 21 March 2013 approved the monthly salaries for 2013 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 700,000, ISK 525,000 and ISK 350,000 (2012: ISK 700,000; 525,000; 350,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 175,000 (2012: ISK 175,000) per meeting, up to a maximum of ISK 350,000 (2012: ISK 350,000) per month. For Board Members resident abroad, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 150,000 (2012: ISK 150,000) per month for each committee they serve on.

1. Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.
2. Additional remuneration represents Board Member compensation for their participation in Board Committees.

Amounts are in ISK millions

11. Other operating expense

	2013	2012
Administration expense	8,398	9,142
Depositors' and investors' guarantee fund	791	899
Depreciation of property and equipment	1,228	899
Amortisation of intangible assets	560	537
Direct operating expense derived from rental-earning investment properties	547	499
Claims incurred, net of reinsurance	323	233
Other expense	11	-
Other operating expense	11,858	12,209

Claims incurred, net of reinsurance

	2013	2012
Claims paid	368	324
Change in the provision for claims	40	(38)
Claims paid, net of reinsurers' share	(118)	(63)
Change in the provision for claims, reinsurers' share	33	10
Claims incurred, net of reinsurance	323	233

Auditor's fee

2013	EY	KPMG	Total
Audit and review of the Financial Statements	141	7	148
Other audit related services	27	-	27
Auditor's fee	168	7	175

2012			
Audit and review of the Financial Statements	137	16	153
Other audit related services	33	9	42
Other service	-	2	2
Auditor's fee	170	27	197

12. Net impairment

	2013	2012
Reversal of impairment of loans to corporates	7,769	12,098
Reversal of impairment of loans to individuals	1,330	726
Impairment of loans to corporates	(3,093)	(12,074)
Impairment of loans to credit institutions	-	(70)
Impairment of loans to individuals	(4,900)	(5,956)
Collective (impairment) reversal	(947)	586
Impairment of intangible assets	(839)	-
Net impairment	(680)	(4,690)

Amounts are in ISK millions

13. Income tax expense

	2013	2012
Current tax expense	3,627	3,160
Deferred tax expense	(484)	473
Income tax expense	3,143	3,633

Reconciliation of effective tax rate	2013		2012	
Earnings before tax		18,273		20,144
Income tax using the Icelandic corporation tax rate	20.0%	3,655	20.0%	4,030
Additional 6% tax on financial institutions	4.7%	865	3.1%	621
Non-deductible expenses	1.7%	305	0.1%	25
Tax exempt revenue	(6.5%)	(1,183)	(6.5%)	(1,318)
Recognition of previously unrecognised tax losses	(3.5%)	(641)	(2.9%)	(578)
Other changes	0.8%	142	4.2%	853
Effective tax rate	17.2%	3,143	18.0%	3,633

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1.0 billion.

14. Bank levy

Bank levy is calculated according to law. The levy for the year 2013 is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions, at end of the year. Non-financial subsidiaries are exempt from this tax. The total rate for this tax was 0.1285% for the year 2012 on debt excluding tax liabilities. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

15. Net gain from discontinued operations, net of tax

	2013	2012
Net gain (loss) from legal entities	10	836
Net gain (loss) from associated companies	250	1,376
Net gain (loss) from real estate	60	(577)
Net gain (loss) from other assets	79	(28)
Net gain from discontinued operations, net of tax	399	1,607

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 year.

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2013	2012	2013	2012
Net earnings attributable to the shareholders of Arion Bank	12,620	15,015	13,019	16,622
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	6.31	7.51	6.51	8.31

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2012: none).

Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank

	2013	2012
Cash on hand	4,099	3,495
Cash with Central Bank	24,912	17,514
Mandatory reserve deposit with Central Bank	8,987	8,737
Cash and balances with Central Bank	37,999	29,746

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

18. Loans to credit institutions

Loans to credit institutions

	2013	2012
Bank accounts	70,671	84,164
Money market loans	26,197	13,763
Other loans	5,439	3,888
Provision on loans	-	(804)
Loans to credit institutions	102,307	101,011

Changes in the provision for losses on loans to credit institutions

	2013	2012
Balance at the beginning of the year	804	774
Provision for losses (reversal)	-	70
Write-offs	(804)	(40)
Provision for losses on loans to credit institutions at the end of the year	-	804

19. Loans to customers

	Individuals	Corporates	Total
2013			
Overdrafts	18,205	19,669	37,874
Credit cards	11,296	878	12,174
Mortgage loans	258,065	8,103	266,168
Subordinated loans	-	531	531
Other loans	36,133	312,120	348,253
Provision on loans	(13,208)	(16,018)	(29,226)
Loans to customers	310,491	325,283	635,774
2012			
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	43,560	340,208	383,768
Provision on loans	(19,222)	(40,559)	(59,781)
Loans to customers	242,773	323,837	566,610

The total book value of pledged loans that were pledged against amounts borrowed was ISK 173 billion at the end of the year (31.12.2012: ISK 167 billion). Pledged loans comprised mortgage loans to individuals, loans to municipals and loans to state related entities.

Further analysis of loans is provided in Risk Management Disclosures.

Amounts are in ISK millions

19. Loans to customers, continued

Changes in the provision for losses on loans to customers

	Specific	FX rulings	Collective	Total
2013				
Balance at the beginning of the year	41,498	14,942	3,341	59,781
Provision for losses during the year	6,041	1,952	947	8,940
Write-offs during the year	(24,228)	(12,008)	(188)	(36,424)
Transferred to liabilities	-	(3,984)	-	(3,984)
Payment of loans previously written off	914	-	-	914
Balance at the end of the year	24,224	902	4,100	29,226
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

The Bank made good progress in restructuring large loans to corporates which resulted in a write-off. Consequently the provision for losses on those loans decreased in the Statement of Financial Position. The Bank settled a great part of the recalculated foreign currency loans that had been provisioned for in prior years following court rulings that such loans were illegal. This resulted in a decrease in the provision for FX rulings between years.

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans and the valuation of foreign currency-linked loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

For the foreign loan portfolio the Group estimates the impact of Court judgements that have dealt with the legality of foreign currency-linked loans on the cash flows recoverable from the portfolios. The Group remains exposed to uncertainty regarding the foreign loan portfolio arising from firstly, the Group‘s interpretation of judgments made, and secondly, the outcome of future legal decisions and new or amended government legislation. Management judgment is required in the determination of the loans that require recalculation, and the estimated loss is based on assumptions that may be revised by future court decisions. In addition, the outcome of future legal decisions and new or amended government legislation may require recalculation of other categories of foreign loan portfolio that the Group has not previously considered vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

20. Financial instruments

	2013	2012
Bonds and debt instruments	62,171	117,730
Shares and equity instruments with variable income	17,449	16,844
Derivatives	1,070	788
Securities used for hedging	5,851	2,438
Financial instruments	86,541	137,800

Amounts are in ISK millions

21. Financial assets and financial liabilities

2013	Amortised cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers	635,774	-	-	635,774
Loans	776,080	-	-	776,080
Bonds and debt instruments				
Listed	-	4,708	55,625	60,333
Unlisted	-	49	1,789	1,838
Bonds and debt instruments	-	4,757	57,414	62,171
Shares and equity instruments with variable income				
Listed	-	1,420	2,858	4,278
Unlisted	-	1,387	9,553	10,940
Bond funds with variable income	-	906	1,325	2,231
Shares and equity instruments with variable income	-	3,713	13,736	17,449
Derivatives				
OTC derivatives	-	1,070	-	1,070
Derivatives	-	1,070	-	1,070
Securities used for hedging				
Bonds and debt instruments	-	490	-	490
Shares and equity instruments with variable income	-	5,361	-	5,361
Securities used for hedging	-	5,851	-	5,851
Other financial assets	5,746	-	-	5,746
Financial assets	781,826	15,391	71,150	868,367
Liabilities at amortised cost				
Due to credit institutions and Central Bank	28,000	-	-	28,000
Deposits	471,866	-	-	471,866
Borrowings	204,568	-	-	204,568
Subordinated liabilities	31,918	-	-	31,918
Liabilities at amortised cost	736,352	-	-	736,352
Financial liabilities at fair value				
Short position in bonds	-	8,199	-	8,199
Derivatives	-	761	-	761
Financial liabilities at fair value	-	8,960	-	8,960
Other financial liabilities	36,747	-	-	36,747
Financial liabilities	773,099	8,960	-	782,059

Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

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

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 and was closed by contract at year end 2013.

Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value specified by issuer

	2013	2012
Financial and insurance activities	1,363	70,142
Public administration, human health and social activities	55,007	40,679
Corporates	1,044	1,262
Bonds and debt instruments designated at fair value	57,414	112,083

The total amount of pledged bonds at the end of the year was ISK 18.4 billion (31.12.2012: ISK 35.7 billion). 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.

Settlement of Drómi Bond

At the end of 2013 the Bank reached an agreement with Eignasafn Seðlabanka Íslands ehf. (ESÍ) on the settlement of a bond issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. The bond was secured with all Drómi's assets and also with a hold harmless statement from the Ministry of Finance and Economic Affairs. The bond was due in June 2014 with a possible extension to 2015. The agreement stated that the Bank would acquire loans to individuals held by Drómi hf., Frjálsi hf. (subsidiary of Drómi hf.) and Hilda hf. (entity held by ESÍ). The Hilda loans transferred were previously owned by SPRON but pledged against liabilities with the Central Bank.

The bond, with a book value of approximately ISK 70 billion, will be fully settled through this agreement and the settlement of the potential value of business relationships attributable to the deposits transferred from SPRON in 2009. In respect of these transactions and the former customers of SPRON and Frjálsi fjárfestingarbankinn that became the customers of Arion Bank when their loans are transferred, business relationships worth ISK 1 billion were capitalized. The financial effect of this settlement was as follows:

	2013
Loans to customers	49,977
Financial instruments, bonds	(69,020)
Intangible assets	1,000
Other assets	1,675
Total effect on assets	(16,368)
Deposits	(15,374)
Tax liabilities	(234)
Other liabilities	178
Total effect on liabilities	(15,430)
Interest income on Drómi Bond	444
Net impairment on loans	(1,616)
Tax expense	234
Total effect on Net earnings	(938)

The remaining balance of 1.7 billion will be settled in March 2014 as well as any possible correction of the transfer valuation.

Amounts are in ISK millions

22. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities 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.

For assets and liabilities that are recognised at fair value on a recurring basis, the Group determines whether 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 year.

Assets and liabilities recorded at fair value by level of the fair value hierarchy

	Level 1	Level 2	Level 3	Total
2013				
Assets at fair value				
Bonds and debt instruments	21,411	39,531	1,229	62,171
Shares and equity instruments with variable income	3,570	13,441	438	17,449
Derivatives	-	1,070	-	1,070
Securities used for hedging	4,495	1,355	-	5,850
Investment property	-	-	28,523	28,523
Assets at fair value	29,476	55,397	30,190	115,063
Liabilities at fair value				
Short position in bonds	8,199	-	-	8,199
Derivatives	-	761	-	761
Liabilities at fair value	8,199	761	-	8,960
2012				
Assets at fair value				
Bonds and debt instruments	4,397	111,914	1,420	117,731
Shares and equity instruments with variable income	1,799	14,530	515	16,844
Derivatives	-	788	-	788
Securities used for hedging	1,733	706	-	2,438
Investment property	-	-	28,919	28,919
Assets at fair value	7,929	127,937	30,854	166,720
Liabilities at fair value				
Short position in bonds	12,490	-	-	12,490
Derivatives	-	975	-	975
Liabilities at fair value	12,490	975	-	13,465

There have been no transfers between Level 1 and Level 2 in 2013 (2012: none).

Amounts are in ISK millions

22. Fair value hierarchy, continued

The fair value of assets and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for a asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

Level 1: Fair value established from quoted market prices
The best evidence of the fair value of a asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of a asset in Note 21 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information
For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

Level 3: Fair value established using valuation techniques with significant unobservable market information
In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

When determining the fair value of rental earning investment property net present value of future cash flow is calculated. When determining the cash flow, general accepted valuation techniques are applied, such as international valuation standard, IVS no. 1 Market Value Basis of Valuation. Vast majority of the rental earning investment properties are valued based on aforementioned valuation technique but when preconditions are not available the Group uses management valuation.

The Group applies management valuation for determining fair value of investment properties under construction at the end of the year. Management valuation is based on recent transactions and offers for similar assets.

22. Fair value hierarchy, continued

The level of the fair value hierarchy of assets is determined at the end of each reporting year.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	2013	2012	2013	2012	2013	2012
Balance at the beginning of the year	28,919	27,100	1,935	2,021	30,854	29,121
Fair value adjustments	1,219	1,584	231	191	1,450	1,775
Additions	1,804	3,729	-	105	1,804	3,834
Disposal	(3,419)	(3,494)	(407)	(391)	(3,826)	(3,885)
Transfers into Level 3	-	-	-	9	-	9
Transfers out of Level 3	-	-	(92)	-	(92)	-
Balance at the end of the year	28,523	28,919	1,667	1,935	30,190	30,854

Within line items in the Consolidated Statement of Comprehensive Income where gain (loss) related to fair value measurements in Level 3 is recognised

	2013	2012
Net interest income	82	151
Net financial income	149	40
Other operating income	1,219	1,584
Gain (loss) recognised in the Consolidated Statement of Comprehensive Income	1,450	1,775

Significant unobservable inputs to valuation in Level 3

	Valuation technique	Significant unobservable inputs	Range	Sensitivity of the input to fair value
Rental earning investment properties	DCF method	Weighted average cost of capital	4.4-6.3%	+ / - 0.5% change in WACC would result in increase / decrease in FV by ISK 2,072 / ISK1,735 million.
Investment properties under construction	Management Valuation	Years in NPV calculations	1/2-4 yrs	+ / - 1 year change would result in increase / decrease in FV by ISK 439 / ISK 493 million.

Significant accounting estimates and judgements

As the fair value measurement of Level 3 assets is based on valuation techniques with significant unobservable inputs there is uncertainty about the actual fair value of the assets.

Amounts are in ISK millions

22. Fair value hierarchy, continued

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

2013	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	37,999	37,999	-
Loans to credit institutions	102,307	102,307	-
Loans to customers	635,774	626,825	(8,949)
Other financial assets	5,746	5,746	-
Financial assets not carried at fair value	781,826	772,877	(8,949)
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	28,000	28,000	-
Deposits	471,866	472,063	(197)
Borrowings	204,568	196,981	7,587
Subordinated loans	31,918	31,918	-
Other financial liabilities	36,747	36,747	-
Financial liabilities not carried at fair value	773,099	765,709	7,390
Net unrealised gain (loss) not recognised in the Consolidated Statement of Comprehensive Income			(1,559)

2012	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	29,746	29,746	-
Loans to credit institutions	101,011	101,011	-
Loans to customers	566,610	555,468	(11,142)
Other financial assets	5,030	5,030	-
Financial assets not carried at fair value	702,397	691,255	(11,142)
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	32,990	32,990	-
Deposits	448,683	449,047	(364)
Borrowings	195,085	195,562	(478)
Subordinated loans	34,220	34,220	-
Other financial liabilities	35,141	35,141	-
Financial liabilities not carried at fair value	746,119	746,960	(842)
Net unrealised gain (loss) not recognised in the Consolidated Statement of Comprehensive Income			(11,984)

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

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22. Fair value hierarchy, continued

Derivatives

	Fair value	
	Assets	Liabilities
2013		
Forward exchange rate agreements, unlisted	68	20
Interest rate and exchange rate agreements, unlisted	518	42
Bond swap agreements, unlisted	4	54
Share swap agreements, unlisted	33	632
Options - purchased agreements, unlisted	447	13
Derivatives	1,070	761
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

Amounts are in ISK millions

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet				
2013	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognised on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr- angements	Total assets re- cognised on balance sheet
Reverse repurchase agreements	10,381	-	10,381	(8,199)	-	2,182	-	10,381
Derivatives	389	-	389	(22)	-	367	681	1,070
Other assets netted by deposits	17,049	(15,374)	1,675	-	-	1,675	-	1,675
Total assets	27,819	(15,374)	12,445	(8,221)	-	4,224	681	13,126
2012								
Reverse repurchase agreements	13,095	-	13,095	(12,350)	-	745	-	13,095
Derivatives	170	-	170	(8)	-	162	618	788
Total assets	13,265	-	13,265	(12,358)	-	907	618	13,883

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
2013	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognised on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr- angements	Total liabilities recognised on balance sheet
Repurchase agreements	8,199	-	8,199	(8,199)	-	-	-	8,199
Derivatives	39	-	39	(22)	-	17	722	761
Deposits netted against other assets	15,374	(15,374)	-	-	-	-	-	-
Total liabilities	23,612	(15,374)	8,238	(8,221)	-	17	722	8,960
2012								
Repurchase agreements	12,350	-	12,350	(12,350)	-	-	-	12,350
Derivatives	806	-	806	(8)	-	798	169	975
Total liabilities	13,156	-	13,156	(12,358)	-	798	169	13,325

Accounting policies for offsetting are provided in Note 53.

Amounts are in ISK millions

24. Investments in associates

	2013	2012
The Group´s interest in its principal associates		
Auðkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	45.8%	30.1%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	39.3%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúðir, Iceland	30.0%	30.0%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	31.8%	36.3%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	21.7%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmiðjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	23.6%
Skipti hf., Ármúla 25, 108 Reykjavík, Iceland	38.3%	-
SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland	-	39.1%

Investments in associates		
Carrying amount at the beginning of the year	7,050	2,987
Additions	8,903	1,658
Dividend	(10)	-
Share of profit (loss) of associates and reversal of impairment	1,986	2,405
Investment in associates	17,929	7,050

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 38.3% share in Skipti hf.

*Summarised financial information in respect of the Group´s associates**	2013	2012
Total assets	457,202	560,268
Total liabilities	(316,762)	(446,287)
Net assets	140,441	113,981
Total revenue of associates	263,365	396,201
Net earnings of associates	9,595	(11,200)

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

*These information were not audited or reviewed by the Bank's auditor.

25. Intangible assets

Intangible assets comprise three categories: Infrastructure, Customer Relationship and Related Agreements and Software. Infrastructure and Customer Relationship and Related Agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group’s operations.

Infrastructure, which is capitalized as an intangible asset, is connected to two business segments at the Bank, namely Asset Management within the Bank and within the Bank's subsidiary Stefnir hf. and Credit card operation at the Bank’s subsidiary Valitor Holding hf. In both cases the business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as is described below.

Customer Relationship and Related Agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries bought in 2008-2009. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are those of the subsidiaries Okkar líftryggingar, Ekort and Tekjuvernd. Every year existing agreements are examined and compared with agreements which were valid at the time of acquisition. Impairment is made if agreements are closed and recognized impairment in 2013 was ISK 0.5 million (2012: nil).

Amounts are in ISK millions

25. Intangible assets, continued

At the end of 2013 an agreement was reached to settle the bond issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. Included in this agreement was the settlement of any potential value of business relationships attributable to the deposits transferred from SPRON in 2009 and the loans transferred to Arion Bank as a payment for the bond. The Bank valued the business relationships at ISK 1 billion and will amortize this asset over a period of 5-7 years.

Software is acquired computer software licenses and is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3 - 5 years.

2013	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	3,914	144	883	4,941
Additions	-	1,000	841	1,841
Impairment	(839)	-	-	(839)
Amortisation	-	-	(560)	(560)
Intangible assets	3,075	1,144	1,164	5,383
2012				
Balance at the beginning of the year	3,886	144	735	4,765
Additions	28	-	685	713
Amortisation	-	-	(537)	(537)
Intangible assets	3,914	144	883	4,941

Impairment testing

The methodology for impairment testing on the Infrastructure which is part of intangible assets is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment was recognized for Credit card operation in 2013 ISK 839 million (2012: nil).

	2013		2012	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	13.1%	2.5%	12.4%	2.5%
Credit card operation	15.1%	4-10%	13.9%	4.3%

26. Tax assets and tax liabilities

	2013		2012	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,698	17	1,899
Deferred tax	818	1,226	446	1,338
Tax assets and tax liabilities	818	4,924	463	3,237

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

Foreign currency denominated assets and liabilities	25	(212)	-	(694)
Investment property and property and equipment	144	(1,770)	-	(215)
Financial assets	580	-	11	(1,343)
Other assets and liabilities	514	(90)	550	(47)
Deferred tax related to foreign exchange gain	79	-	168	(81)
Tax loss carry forward	322	-	759	-
	1,664	(2,072)	1,488	(2,380)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(846)	846	(1,042)	1,042
Deferred tax assets and tax liabilities	818	(1,226)	446	(1,338)

Amounts are in ISK millions

26. Tax assets and tax liabilities, continued

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 728 million (31.12.2012: ISK 1,371 million) that is not recognised in the Financial Statements, due to uncertainty about the utilisation possibilities of the loss.

Changes in deferred tax assets and tax liabilities

2013	At 1 Jan.	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(248)	61	(187)
Investment property and property and equipment	(1,275)	(351)	(1,626)
Financial assets	565	15	580
Other assets and liabilities	11	413	424
Deferred foreign exchange differences	(696)	775	79
Tax loss carry forward	751	(429)	322
Change in deferred tax assets and tax liabilities	(892)	484	(408)

2012	At 1 Jan.	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(222)	(26)	(248)
Investment property and property and equipment	(529)	(746)	(1,275)
Financial assets	611	(46)	565
Other assets and liabilities	(42)	53	11
Deferred foreign exchange differences	(897)	201	(696)
Tax loss carry forward	660	91	751
Change in deferred tax assets and tax liabilities	(419)	(473)	(892)

27. Other assets

	2013	2012
Non-current assets and disposal groups held for sale	10,046	11,923
Property and equipment	6,943	6,311
Accounts receivable	4,610	4,084
Prepaid expenses	690	687
Accrued income	619	456
Unsettled securities trading	255	125
Sundry assets	413	549
Other assets	23,576	24,135

Amounts are in ISK millions

27. Other assets, continued

Non-current assets and disposal groups held for sale	2013	2012
Legal entities	300	1,733
Associates	5,457	6,384
Real estates	4,150	3,275
Other assets	139	531
Non-current assets and disposal groups held for sale	10,046	11,923

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. (31% share).

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

	2013	2012
Liabilities associated with the legal entities held for sale	567	1,769

Significant accounting estimates and judgements

Associates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. For the most part, fair value at the date of classification of these legal entities was calculated using valuation models based on discounted future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), could have impact on the fair value of these disposal groups.

Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. Fair value at the date of classification is based on independent property valuers or management valuation. As the fair value measurement of real estates is based on valuation techniques there is uncertainty about the actual fair value of the assets.

Property and equipment	Real estate	Equip-ment	Total 2013	Total 2012
Gross carrying amount at the beginning of the year	5,104	4,013	9,117	8,197
Additions	1,104	1,077	2,181	961
Disposals	(189)	(39)	(228)	(41)
Transfers to investment property	(166)	-	(166)	-
Gross carrying amount at the end of the year	5,853	5,051	10,904	9,117
Accumulated depreciation at the beginning of the year	(654)	(2,152)	(2,806)	(1,926)
Depreciation	(389)	(839)	(1,228)	(899)
Disposals	24	28	52	19
Transfers to investment property	21	-	21	-
Accumulated depreciation at the end of the year	(998)	(2,963)	(3,961)	(2,806)
Property and equipment	4,855	2,088	6,943	6,311

The official real estate value (Registers Iceland) amounts to ISK 5,025 million at the end of the year (2012: ISK 4,954 million) and the insurance value amounts to ISK 9,466 million (2012: ISK 9,633 million).

Amounts are in ISK millions

28. Other liabilities

	2013	2012
Accounts payable	19,264	19,318
Provision for settled FX loans	4,524	4,625
Unsettled securities trading	144	842
Depositors' and investors' guarantee fund	2,886	2,919
Insurance claim	2,266	2,138
Withholding tax	1,552	1,926
Non-current liabilities and disposal groups held for sale	567	1,769
Bank levy	2,835	357
Sundry liabilities	9,629	8,223
Other liabilities	**43,667**	**42,117**

29. Borrowings

	Issued	Maturity	Maturity type	Currency	Terms of interest	2013	2012
Covered bond	2013	2019	At maturity	ISK	Fixed, CPI linked, 2.50%	4,453	-
Covered bond	2012	2015	At maturity	ISK	Fixed, 6.50%	4,378	2,540
Covered bond	2012	2034	Amortizing	ISK	Fixed, CPI linked, 3.60%	2,603	2,592
Covered bond	2008	2045	Amortizing	ISK	Fixed, CPI linked, 4.00%	21,361	20,922
Covered bond	2008	2031	Amortizing	ISK	Fixed, CPI linked, 4.00%	4,934	4,948
Covered bond	2006	2048	Amortizing	ISK	Fixed, CPI linked, 3.75%	77,894	76,169
Covered bond	2005	2033	Amortizing	ISK	Fixed, CPI linked, 3.75%	17,873	17,819
Covered bonds						**133,497**	**124,991**
Senior unsecured bond	2013	2016	At maturity	NOK	Floating, NIBOR + 5.00%	9,356	-
Senior unsecured bond	2010	2018	Amortizing	ISK	Floating, REIBOR + 1.00%	2,662	3,192
Senior unsecured bond	2009	2018	Amortizing	EUR	Floating, EURIBOR + 1.00%	2,202	2,815
Secured bond, Landfestar	2010	2044	Amortizing	ISK	Fixed, CPI linked, 4.70%	2,932	2,902
Bonds issued						**17,152**	**8,909**
Central Bank, secured	2010	2022	At maturity	Various	Floating, LIBOR + 3.00%	52,998	60,056
Other						922	1,129
Other loans						**53,920**	**61,185**
Borrowings						**204,568**	**195,085**

Book value of listed bonds was ISK 23,770 million (31.12.2012: ISK 8,034 million) at the end of the year. Market value of those bonds was ISK 24,472 million (31.12.2012: ISK 8,512 million).

The Group did not repurchase any own debts in 2013 (2012: nil).

30. Subordinated liabilities

	Issued	Maturity	Maturity type	Currency	Terms of interest	2013	2012
Tier II capital	2010	2020	At maturity	Various	Floating, LIBOR + 4.00%*	31,918	34,220
Subordinated liabilities						**31,918**	**34,220**

* In 2015 and thereafter 3 month EURIBOR/LIBOR +500 basis points.

Amounts are in ISK millions

31. Pledged assets

Pledged assets against liabilities	2013	2012
Assets which have been pledged as collateral against borrowings	258,762	248,864
Assets which have been pledged as collateral against loans from credit institutions and short positions	18,440	35,701
Pledged assets against liabilities	277,202	284,565

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 259 billion at the end of the year (31.12.2012: ISK 249 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 189 billion at the end of the year (31.12.2012: ISK 188 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.

32. Equity

Share capital and share premium

According to the Bank'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)	2013	Number (million)	2012
Issued share capital	2,000	75,861	2,000	75,861
	2,000	75,861	2,000	75,861

Share premium represents excess of payment above nominal value that Shareholders have paid for shares issued by Arion banki hf.

Other reserves	2013	2012
Statutory reserve	1,637	1,637
Foreign currency translation reserve	-	2
Other reserves	1,637	1,639

OFF BALANCE SHEET INFORMATION

33. Obligations

Guarantees, unused overdraft and loan commitments the Group has granted its customers

	2013	2012
Guarantees	9,922	9,185
Unused overdrafts	37,371	34,545
Loan commitments	48,585	36,001

Depositors' and Investors' Guarantee fund

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.

34. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 22 years. The majority of the contracts include renewal options for various periods of time.

	2013	2012
Less than one year	272	339
Over 1 year and up to 5 years	960	1,173
Over 5 years	800	1,115
Future minimum lease payments under non-cancellable leases	2,032	2,627

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 17 years, with majority being non-cancellable agreements.

	2013	2012
Less than one year	2,353	2,084
Over 1 year and up to 5 years	5,086	5,898
Over 5 years	1,480	1,968
Future minimum lease payments under non-cancellable leases	8,919	9,950

35. Assets under management and under custody

Assets under management	895,457	819,684
Assets under custody	1,490,888	1,378,454

36. Legal matters

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 and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into practices of all card issuers in Iceland, including the Bank, and by two card payment acquirers, including Valitor. The investigation was initiated by a complaint by Kortaþjónustan hf., a card payment acquirer, in 2009. The case concerns alleged concerted practices through associations of undertakings connected to decisions on multilateral interchange fees and alleged anti-competitive practices towards competitors in the field of acquiring.

Amounts are in ISK millions

36. Legal matters, continued

The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made 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 ICA received a complaint from Tryggingamiðstöðin hf. in 2010. The complaint concerns the banks' alleged tying of banking services and insurances.

The extent of the investigations and outcome of the cases before the ICA is still uncertain as well as any effect on the Group. However, if the Bank or Valitor will be deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor for abusing its dominant position on the payment card market and violating conditions set in an earlier decision of the Authority. Valitor appealed the decision to the Competition Appeals Committee. In October 2013 the Committee confirmed the decision of the Competition Authority. Valitor may decide to file a motion and appeal this administrative decision to the courts.

In 2012 Kortaþjónustan hf. filed a suit against Valitor claiming damages for the alleged loss suffered by Kortaþjónustan hf. due to alleged breaches of competition law based on a settlement made by Valitor with the ICA, published in ICA decision No 4/2008. The case is still being contested before the District Court of Reykjavík. In July 2013 Kortaþjónustan hf. filed another suit, now against the Bank and Valitor, claiming damages for the alleged loss suffered by Kortaþjónustan hf. in relation to the alleged breaches of competition law based on the complaint to the ICA in 2009, stated above. The case is being contested before the District Court of Reykjavík.

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 (in foreign currency), 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 defended against the borrowers' summons and with a judgment on 20 December 2013 the Group was acquitted. The case has not yet been appealed to the Supreme Court of Iceland but if the borrowers appeal and the Supreme Court sides with the borrowers, it could have a negative effect on the Bank's loan portfolio with variable interest rates in foreign currency (i.e. foreign currency-linked loans in ISK) and also in ISK.

ii) Other legal matters

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. Recently, the Supreme Court requested Advisory Opinions from the EFTA Court in two separate cases on the interpretation of certain provisions of an EC directive, in cases where the disagreement is whether the CPI-indexation of a loan is in accordance with certain provisions of Icelandic law on contracts. 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 unlikely, and has therefore made no provision due to this.

iii) Legal matters concluded

Legal proceedings regarding Stefnir hf.

In October 2011 the winding-up committee of Landsbanki Íslands brought legal action against Stefnir hf. 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 was ISK 450 million plus interest. As a result of this judgment by Reykjavík District Court, Stefnir, on behalf of the two funds, was ordered to repay the amounts. The company made provision in respect of this case in 2012. The case was appealed to the Supreme Court of Iceland where Stefnir was acquitted on 16 January 2014 and the provision has been revised in the accounts for 2013.

36. Legal matters, continued

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‘s announcement on the Icelandic Stock Exchange from 21 March 2012, whereby Hagar announced that it had decided to take legal action against the Bank regarding Hagar’s foreign currency linked loans, which it had reimbursed in full to the Bank in October 2009. Hagar’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 ISK 515 million, which the Bank subsequently paid to Hagar. After the Supreme Court of Iceland had passed its judgment of 15 February 2012 (in case no. 600/2011), Hagar expressed its view to the Bank that, in light of the above judgment, Hagar believed it had a further claim against the Bank regarding said foreign currency linked loans. The Bank rejected Hagar’s claim and defended the case in court. With a judgement of the District Court pronounced on 28 May 2013 the Bank was acquitted of Hagar’s claim. Hagar appealed the judgement to the Supreme Court and with a judgement on 12 December 2013 the Supreme Court confirmed the judgement of the District Court and the Bank was acquitted. The effect of this judgement has been calculated in the Groups provision for foreign currency loans.

37. The uncertainty regarding the book value of foreign currency loans

In recent years there has been considerable uncertainty over the legality of foreign currency loans to individuals and companies and the recalculation of those loans which are clearly currency-linked loans in Icelandic krona. Firstly, there has been uncertainty over which loans are considered legal foreign currency loans and which loans are considered currency-linked loans in Icelandic krona, and secondly over how loans in the latter category should be recalculated. The Bank has been required to recalculate numerous loans which are considered currency-linked loans in Icelandic krona on the basis of the Interest and Indexation Act No. 38/2001 and after examining the judgments passed by the Supreme Court which were considered to set a precedent for the Bank’s loans.

The uncertainty of legality of FX loans has continued 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 provisioned ISK 1.5 billion in 2013 in addition to ISK 19.6 billion impaired in 2011 and 2012.

Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in three respects:

Firstly, the estimation uncertainty associated with the Group’s interpretation of the impact of several judgments of the Supreme Court of Iceland regarding the method of recalculation of illegal currency-linked loans. This uncertainty is somewhat mitigated by the use of FME prescribed methodology. In the event the Group’s interpretation of the judgments were to change, the total loss could be greater or less than the current provision in the accounts of ISK 5.4 billion.

Secondly, there have been claims that currency-linked loans to consumers should, from the date they have been recalculated and until the loans are repaid, bear their contractual interest rates, and not the non-indexed interest rate for the Icelandic Krona posted by the Central Bank of Iceland, as stipulated in Act No. 151/2010. This will probably be determined by future court rulings, for which it is currently not possible to predict the outcome.

Thirdly, the legal uncertainty over the outcome of future legal decisions and new or amended government legislation that may require the recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome. Some uncertainty still exists over the impact of the above matters on the carrying value of the Group's portfolio of foreign currency linked loans at the end of the year.

Nevertheless, the Group considers its portfolio of foreign currency linked loans fully provisioned for the most likely outcome.

38. Events after Balance Sheet date

In January 2014 the shareholders of Eik fasteignafélag hf. approved an agreement signed by Arion Bank hf. and Eik fasteignafélag hf. in December 2013 on the purchase of all of issued shares of Landfestar hf. After the acquisition Arion Bank hf. will be the largest shareholder of Eik fasteignafélag hf. The agreement was signed subject to due diligence and approval by the Icelandic Competition Authority.

RELATED PARTY

39. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

The Board of Directors of Arion Bank, key Management personnel of the Bank and the Group‘s associates are defined as related parties, as well as close family members of individuals referred to above and legal entities controlled by them.

No unusual transactions took place with related parties during the year. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

2013 *Balances with related parties*	Assets	Liabilities	Net balance
Shareholders with control over the Group	554	(63,949)	(63,395)
Shareholders with influence over the Group	19	(2,003)	(1,984)
Board of Directors and key Management personnel	228	(68)	160
Associates and other related parties	36,546	(19,015)	17,531
Balances with related parties	37,347	(85,035)	(47,688)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(1,206)	76	-
Shareholders with influence over the Group	33	-	2	(11)
Board of Directors and key Management personnel	7	(3)	27	-
Associates and other related parties	4,237	(704)	1,233	(196)
Transactions with related parties	4,277	(1,912)	1,337	(207)

2012 *Balances with related parties*	Assets	Liabilities	Net balance
Shareholders with control over the Group	704	(61,095)	(60,391)
Shareholders with influence over the Group	-	(1,960)	(1,960)
Board of Directors and key Management personnel	129	(128)	1
Associates and other related parties	53,737	(16,379)	37,358
Balances with related parties	54,570	(79,562)	(24,992)

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

Amounts are in ISK millions

RISK MANAGEMENT DISCLOSURES

The Group faces various risks arising from its day to day operations. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, policies and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital adequacy assessment process (ICAAP). The Asset and Liability Committee (ALCO), chaired by the CEO or his deputy, is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes, policies and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BARC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into five units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Economic Capital, which is responsible for the Bank's ICAAP; Portfolio Risk, which monitors liquidity risk and risks in the Bank's assets and liabilities at the portfolio level; and Operational Risk which monitors risks associated with the daily operation of the Bank.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk and legal risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The Group is to some extent exposed to risks through the loan portfolio that are related to assumptions about asset valuation and asset performance. Provisions have in some cases been made to meet possible losses. Concentration in the Group's loan portfolio is relatively high; the total sum of large exposures net of eligible collateral at the end of the year 2013 was 45% of the capital base, down from 60% in the previous year.

The Group is exposed to currency risk. The Bank has met the legal limits on currency imbalance since 2012. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, approximately half of which is on demand.

The Group faces legal risk related to previous court judgments on foreign currency loans, see Note 37.

Further information on risk management and capital adequacy is provided in the annual Consolidated Financial Statements for 2013 and in the Pillar 3 Risk Disclosures for 2013. The Pillar 3 Risk Disclosures 2013 will be published in March 2014 and be available on the Bank's website, www.arionbanki.is. The disclosures have not been subject to external audit.

40. 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. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

Managing and analysing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

40. Credit risk, continued

Maximum exposure to credit risk and credit concentration by industry sectors

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2013

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	37,999	-	-	-	-	-	37,999
Loans to credit institutions	-	-	-	-	-	102,307	-	-	-	-	-	102,307
Loans to customers	310,491	83,002	60,906	24,025	55,061	27,535	22,661	18,966	19,793	8,682	4,652	635,774
Financial instruments	3	26	1	7	42	2,960	1,336	6	514	58,836	-	63,731
Other assets with credit risk	295	312	78	15	835	3,636	23	1	506	45	-	5,746
Total on balance sheet maximum exposure to credit risk	310,789	83,340	60,985	24,047	55,938	174,437	24,020	18,973	20,813	67,563	4,652	845,557

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	387	1,781	534	769	1,328	1,183	2,539	500	833	60	8	9,922
Unused overdrafts	22,282	1,433	395	591	4,095	1,951	1,653	298	2,005	2,298	371	37,371
Loan commitments	205	6,651	2,895	2,617	12,517	5,536	16,529	837	778	20	-	48,585
Total off balance sheet maximum exposure to credit risk	22,874	9,865	3,824	3,977	17,940	8,670	20,721	1,635	3,616	2,378	379	95,878
Maximum exposure to credit risk	333,663	93,205	64,809	28,024	73,878	183,107	44,741	20,608	24,429	69,941	5,031	941,435

40. Credit risk, continued

2012

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	29,746	-	-	-	-	-	29,746
Loans to credit institutions	-	-	-	-	-	101,011	-	-	-	-	-	101,011
Loans to customers	242,775	68,834	67,752	28,754	55,621	24,693	22,794	21,692	18,745	9,952	4,998	566,610
Financial instruments	-	25	-	28	-	74,630	1,210	7	1,233	42,845	-	119,978
Other assets with credit risk	316	1,569	15	83	80	2,388	47	1	501	19	11	5,030
Total on balance sheet maximum exposure to credit risk	243,091	70,428	67,767	28,865	55,701	232,468	24,051	21,700	20,479	52,816	5,009	822,375

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	388	919	348	592	1,879	1,510	2,294	466	677	95	17	9,185
Unused overdrafts	21,499	1,143	295	463	3,548	1,666	1,555	305	1,606	2,209	256	34,545
Loan commitments	118	2,214	5,298	215	10,300	5,634	11,375	837	-	-	10	36,001
Total off balance sheet maximum exposure to credit risk	22,005	4,276	5,941	1,270	15,727	8,810	15,224	1,608	2,283	2,304	283	79,731
Maximum exposure to credit risk	265,096	74,704	73,708	30,135	71,428	241,278	39,275	23,308	22,762	55,120	5,292	902,106

Amounts are in ISK millions

40. Credit risk, continued

Loans to customers specified by sectors	2013	2012
Individuals	48.8%	42.8%
Real estate activities and construction	13.1%	12.1%
Fishing industry	9.6%	12.0%
Information and communication technology	3.8%	5.1%
Wholesale and retail trade	8.7%	9.8%
Financial and insurance activities	4.3%	4.4%
Industry, energy and manufacturing	3.5%	4.0%
Transportation	3.0%	3.8%
Services	3.1%	3.3%
Public administration, human health and social activities	1.4%	1.8%
Agriculture and forestry	0.7%	0.9%
	100.0%	100.0%

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, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

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

2013	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	659	269,700	49	362	270,770
Real estate activities and construction	3,887	55,427	12	1,053	60,379
Fishing industry	89	3,039	52,878	2,361	58,367
Information and communication technology	26	1,842	-	20,452	22,320
Wholesale and retail trade	6,664	10,095	5	28,447	45,211
Financial and insurance activities	12,416	441	-	9,116	21,973
Industry, energy and manufacturing	180	8,645	46	10,719	19,590
Transportation	69	563	51	2,310	2,993
Services	285	3,314	98	2,994	6,691
Public administration, human health and social activities	22	3,190	-	170	3,382
Agriculture and forestry	5	2,331	-	136	2,472
Financial instruments	2,867	-	-	-	2,867
Collateral held against different types of financial assets	27,169	358,587	53,139	78,120	517,015

Amounts are in ISK millions

40. Credit risk, continued

2012	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	560	208,967	39	84	209,650
Real estate activities and construction	677	46,229	5	267	47,178
Fishing industry	642	2,311	50,528	6,020	59,502
Information and communication technology	78	625	-	17,981	18,684
Wholesale and retail trade	1,900	13,793	-	17,489	33,181
Financial and insurance activities	11,141	526	-	884	12,551
Industry, energy and manufacturing	222	7,014	50	1,058	8,344
Transportation	65	493	76	688	1,322
Services	249	2,911	57	1,215	4,432
Public administration, human health and social activities	28	3,263	-	91	3,382
Agriculture and forestry	10	1,858	-	9	1,876
Financial instruments	1,219			68,628	69,847
Collateral held against different types of financial assets	16,792	287,991	50,754	114,414	469,950

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

In the tables above, collateral is allocated based on the claim value of loans. In the 2012 financial statement, collateral was allocated based on book value. The 2012 figures have been restated to reflect this change in methodology.

Credit quality by class of financial assets

2013	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired*	Total
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers				
Loans to corporates	304,880	9,789	10,614	325,283
Loans to individuals	268,485	34,607	7,399	310,491
Financial instruments	63,731	-	-	63,731
Other assets with credit risk	5,746	-	-	5,746
Credit quality of loans	783,148	44,396	18,013	845,557

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 to credit institutions	101,011	-	-	101,011
Loans to customers				
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Financial instruments	119,978	-	-	119,978
Other assets with credit risk	5,030	-	-	5,030
Credit quality of loans	731,682	40,696	49,997	822,375

* 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.

Amounts are in ISK millions

40. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive.

The table below shows loans to customers which are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

	Risk classification						
2013	1	2	3	4	5	Not rated	Total
Individuals	12,201	68,291	120,751	53,841	9,978	3,422	268,484
Real estate activities and construction	1,889	4,924	37,703	6,848	708	27,612	79,684
Fishing industry	26,962	6,070	7,193	10,865	3,162	3,707	57,959
Information and communication technology	19,242	2,802	1,065	294	2	1,011	24,416
Wholesale and retail trade	12,130	9,550	18,057	3,384	1,644	6,395	51,160
Financial and insurance activities	102	9,178	1,429	211	-	12,721	23,641
Industry, energy and manufacturing	4,610	12,193	2,979	580	550	758	21,670
Transportation	197	17,404	573	458	87	244	18,963
Services	117	10,198	3,288	914	110	442	15,069
Public sector	85	3,335	917	178	38	4,052	8,605
Agriculture and forestry	162	480	1,636	769	11	656	3,714
Neither past due nor impaired loans	77,697	144,425	195,591	78,342	16,290	61,020	573,365
2012							
Individuals	10,411	56,716	85,813	37,534	8,110	6,949	205,533
Real estate activities and construction	27	1,341	25,099	17,636	9,635	3,185	56,923
Fishing industry	2,580	18,566	8,080	9,306	3,210	14,474	56,217
Information and communication technology	139	2,920	514	276	20,146	1,414	25,409
Wholesale and retail trade	12,535	7,001	15,840	2,710	1,706	7,248	47,040
Financial and insurance activities	546	223	1,342	225	6,508	7,430	16,274
Industry, energy and manufacturing	1,316	3,069	2,370	821	3,201	10,713	21,490
Transportation	144	20,062	214	535	1	482	21,439
Services	758	2,000	9,741	471	82	1,113	14,166
Public sector	264	3,006	620	103	112	4,471	8,577
Agriculture and forestry	2	311	1,357	345	48	788	2,851
Neither past due nor impaired loans	28,724	115,215	150,992	69,962	52,759	58,266	475,918

Exposures that are 'Not Rated' are primarily due to newly formed entities and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and some holding companies.

Past due but not impaired loans by class of loans

2013	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,100	923	111	2,655	9,789
Loans to individuals	11,224	3,751	543	19,089	34,607
Past due but not impaired loans	17,325	4,673	655	21,744	44,396
2012					
Loans to corporates	6,285	951	322	10,293	17,851
Loans to individuals	8,719	3,558	287	10,281	22,845
Past due but not impaired loans	15,004	4,509	609	20,574	40,696

Amounts are in ISK millions

40. Credit risk, continued

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

Collateral repossessed

During the year, the Group took possession of real estates with the carrying value of ISK 1,692 million and other assets with the value of ISK 5 million, all which the Group is in the process of selling, see Note 27.

Impaired loans to customers specified by sector

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
2013	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
Individuals	11,538	18,496	173	614	11,711	19,110
Real estate activities and construction	1,726	3,755	37	113	1,763	3,868
Fishing industry	617	1,899	612	1,870	1,229	3,769
Information and communication technology	164	190	-	-	164	190
Wholesale and retail trade	4,020	5,941	14	44	4,034	5,985
Financial and insurance activities	4,513	6,080	-	-	4,513	6,080
Industry, energy and manufacturing	446	996	17	33	463	1,029
Transportation	65	356	6	9	71	365
Services	775	1,865	43	53	818	1,918
Public administration, human health and social activities	8	35	-	-	8	35
Agriculture and forestry	352	790	-	-	352	790
	24,224	40,403	902	2,736	25,126	43,139
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 administration, human health and social activities	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

This note separates impairments that are due to the uncertainty related to foreign currency loans from impairments that are due to borrower credit quality. At year end 2012, a provision of ISK 14,942 million had been made for losses due to court rulings for illegal FX loans, in addition to the ISK 4,625 million transferred to liabilities. The provision is reduced to ISK 902 million at year end 2013 which reflects that the process of recalculating illegal FX loans is nearing completion. Recalculation in 2013 resulted in an additional ISK 1,952 million impairment and ISK 15,992 write-off or repayments. Provisions due to borrower credit quality have been similarly reduced, year on year – largely due to progress in corporate-loan restructuring during the period.

Amounts are in ISK millions

40. Credit risk, continued

The Group made good progress in restructuring large loans to corporates resulting in a write-off. Consequently the impairment related to borrowers credit quality decreased in the Statement of Financial position. The Group settled great part of the recalculated foreign currency loans that had been provisioned for in prior years following court rulings about their illegality. That resulted in a decrease in the impairment amount for FX rulings between years.

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 625/2013.

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) before taking account of eligible collateral. The Group has three large exposures at the end of the period (31.12.2012: four exposures) net of eligible collateral.

	2013		2012	
no.	Gross	Net	Gross	Net
Drómi*	-	-	43%	-
1	17%	17%	18%	17%
2	16%	16%	18%	18%
3	12%	12%	14%	14%
4	10%	<10%	11%	11%
5	10%	<10%	<10%	<10%
Sum of large exposure gross and net > 10%	65%	45%	104%	60%

*See note 21 for information regarding the settlement of the Drómi bond.

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period.

The sum of exposures exceeding 10% of capital base is 65% of the Group's capital base before collateral mitigation or 45% net of eligible collateral, which is well below the 400% legal maximum.

41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

The Group keeps firm track of the market risk and separates its exposure to market risk into trading book and non-trading book i.e. banking book. The market risk in the trading book arises from proprietary trading activities. Market risk in the non-trading book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. The market risk in the trading book and in the non-trading book is managed separately by Treasury.

Market risk allowance is set by the Board in the Bank's risk appetite and the CEO decides on the limit framework for each trading desk and sets individual limits. The Asset and Liability Committee is responsible for managing the Bank's overall market risk. Risk management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

Amounts are in ISK millions

41. Market risk, continued

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a large gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are generally fixed for a long period, resulting in a yield curve risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies, of which the largest one is EUR.

The Group's strategy for managing its interest rate risk is to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

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 liabilities, 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.

2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(44)	(823)	32	(557)	(1,129)
ISK, Non Indexed linked	(103)	(480)	(28)	(29)	(17)
EUR	63	(1)	-	-	-
Other	(36)	-	-	-	-
2012					
ISK, CPI Indexed linked	(35)	(603)	(282)	(1,980)	811
ISK, Non Indexed linked	(102)	(433)	57	-	(10)
EUR	71	(3)	-	-	-
Other	(35)	(6)	(50)	-	-

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.

2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(11)	2	(0)	(34)	(92)
ISK, Non Indexed linked	(1)	(8)	(61)	(92)	-
EUR	1	-	-	-	-
Other	1	-	-	-	-
2012					
ISK, CPI Indexed linked	-	(19)	(80)	(5)	(270)
ISK, Non Indexed linked	(50)	(17)	(8)	(36)	-
EUR	(5)	-	-	-	-
Other	(2)	-	-	-	-

41. Market risk, continued

Group's assets and liabilities at carrying amount by residual maturity

2013 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	37,999	28,666	-	9,333	-	-	-
Loans to credit institutions	102,307	47,197	55,110	-	-	-	-
Loans to customers	635,774	2,151	56,696	85,340	221,979	269,608	-
Financial instruments	86,541	6,889	1,240	13,349	38,569	3,684	22,810
Derivatives - assets leg	23,567	447	8,008	4,094	11,018	-	-
Derivatives - liabilities leg	(22,497)	-	(7,918)	(3,893)	(10,686)	-	-
Investment property	28,523	-	-	-	-	-	28,523
Investments in associates	17,929	-	-	-	-	-	17,929
Intangible assets	5,383	-	-	-	-	-	5,383
Tax assets	818	-	-	-	-	818	-
Other assets	23,576	53	4,014	693	973	13	17,830
Assets 31.12.2013	938,850	84,956	117,060	108,715	261,521	274,123	92,475
Liabilities							
Due to credit institutions and Central Bank	28,000	17,692	3,622	6,636	50	-	-
Deposits	471,866	246,160	126,784	74,426	21,693	2,803	-
Financial liabilities at fair value	8,960	-	8,757	161	42	-	-
Assets leg	(18,830)	-	(16,322)	(911)	(1,597)	-	-
Liabilities leg	19,592	-	16,881	1,072	1,639	-	-
Short position bonds and derivatives	2,837	-	2,837	-	-	-	-
Short position bonds used for hedging	5,362	-	5,362	-	-	-	-
Tax liabilities	4,924	-	924	2,774	1,226	-	-
Other liabilities	43,667	371	28,344	5,098	2,671	263	6,919
Borrowings	204,568	-	1,868	2,319	27,779	172,602	-
Subordinated liabilities	31,918	-	-	-	-	31,918	-
Liabilities 31.12.2013	793,903	264,223	170,299	91,414	53,461	207,586	6,919
Off-balance sheet items:							
Guarantees	9,922	2,216	2,698	2,650	1,106	1,252	-
Unused overdraft	37,371	949	8,909	16,108	11,345	60	-
Loan commitments	48,585	3,301	25,011	14,198	6,075	-	-
Off-balance sheet items	95,878	6,466	36,618	32,956	18,526	1,312	-
Net interest sensitivity gap	49,069	(185,733)	(89,857)	(15,655)	189,534	65,225	85,556

Amounts are in ISK millions

41. Market risk, continued

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	29,746	21,121	-	8,625	-	-	-
Loans to credit institutions	101,011	84,033	16,721	-	257	-	-
Loans to customers	566,610	3,000	47,511	92,258	208,232	215,609	-
Financial instruments	137,800	8,494	693	48	69,159	41,584	17,822
Derivatives - assets leg	18,737	-	16,739	444	1,554	-	-
Derivatives - liabilities leg	(17,949)	-	(16,046)	(421)	(1,482)	-	-
Investment property	28,919	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	7,050
Intangible assets	4,941	-	-	-	-	-	4,941
Tax assets	463	-	-	17	446	-	-
Other assets	24,135	64	2,500	2,047	401	18	19,105
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	26,653	-	6,122	4,631	10,126	5,773	-
Short position bonds and derivatives	5,162	-	5,162	-	-	-	-
Short position bonds used for hedging	7,327	-	7,327	-	-	-	-
Tax liabilities	3,237	-	474	1,425	1,338	-	-
Other liabilities	42,117	492	25,952	5,180	3,207	308	6,978
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

Amounts are in ISK millions

41. Market risk, continued

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 291.6 billion (31.12.2012: ISK 262.0 billion) and the total amount of indexed liabilities amount to ISK 223.7 billion (31.12.2012: 216.8 billion).

The following table shows the transaction maturity profile of indexed assets and liabilities. In previous statements, the profile was based on residual maturity. The 2012 figures have therefore been updated to cash flow basis for accurate comparison. Financial instruments held for proprietary trading or for liquidity purposes are assumed to be on demand.

2013 Assets, CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	13,894	78,509	192,001	284,404
Financial instruments	2,305	-	-	2,305
Off-balance sheet position	2,478	2,394	-	4,872
Assets, CPI indexed linked	18,677	80,903	192,001	291,581
Liabilities, CPI indexed linked				
Deposits	67,044	21,585	2,707	91,336
Borrowings	2,830	12,625	116,914	132,369
Liabilities, CPI indexed linked	69,874	34,210	119,621	223,705
Net on-balance sheet position	(53,675)	44,299	72,380	63,004
Net off-balance sheet position	2,478	2,394	-	4,872
CPI Balance 31.12.2013	(51,197)	46,693	72,380	67,876
CPI Balance 31.12.2012	(40,402)	40,989	44,553	45,140

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

Breakdown of assets and liabilities by currency at the end of the year

2013

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	30,745	4,971	731	693	376	254	229	37,999
Loans to credit institutions	25,156	17,490	10,064	5,856	15,071	4,475	24,195	102,307
Loans to customers	514,206	50,739	27,080	12,296	7,241	6,382	17,830	635,774
Financial instruments	65,025	13,754	4,860	7	73	2	2,820	86,541
Investment property	28,523	-	-	-	-	-	-	28,523
Investments in associates	12,253	-	-	-	5,676	-	-	17,929
Intangible assets	5,383	-	-	-	-	-	-	5,383
Tax assets	818	-	-	-	-	-	-	818
Other assets	22,903	486	104	-	46	-	37	23,576
Assets 31.12.2013	705,012	87,440	42,839	18,852	28,483	11,113	45,111	938,850

Amounts are in ISK millions

41. Market risk, continued

Liabilities	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	23,189	1,832	622	839	4	1,514	-	28,000
Deposits	390,397	27,457	13,751	222	10,940	926	28,173	471,866
Financial liabilities at fair value	8,921	32	2	-	-	-	5	8,960
Tax liabilities	4,924	-	-	-	-	-	-	4,924
Other liabilities	38,508	1,120	2,114	75	59	410	1,381	43,667
Borrowings	140,012	2,202	18,669	20,043	6,728	7,557	9,357	204,568
Subordinated liabilities	-	25,818	2,303	-	3,797	-	-	31,918
Equity	144,947	-	-	-	-	-	-	144,947
Liabilities 31.12.2013	750,898	58,461	37,461	21,179	21,528	10,407	38,916	938,850
Net on-balance sheet position	(45,886)	28,979	5,378	(2,327)	6,955	706	6,195	
Net off-balance sheet position	14,256	(17,076)	924	3,569	1,069	792	(3,534)	
Net position 31.12.2013	(31,630)	11,903	6,302	1,242	8,024	1,498	2,661	

2012

Assets								
Cash and balances with Central Bank	24,874	3,353	729	155	403	4	228	29,746
Loans to credit institutions	26,176	21,098	17,521	2,538	15,462	1,794	16,422	101,011
Loans to customers	427,037	50,966	20,396	21,121	6,670	14,835	25,585	566,610
Financial instruments	132,298	3,278	1,675	7	244	4	294	137,800
Investment property	28,919	-	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	-	7,050
Intangible assets	4,941	-	-	-	-	-	-	4,941
Tax assets	463	-	-	-	-	-	-	463
Other assets	22,254	1,592	245	-	4	-	40	24,135
Assets 31.12.2012	674,012	80,287	40,566	23,821	22,783	16,637	42,569	900,675

Liabilities								
Due to credit inst. and Central Bank ..	31,060	1,486	201	-	24	218	1	32,990
Deposits	362,384	28,663	13,893	1,831	10,185	1,374	30,353	448,683
Financial liabilities at fair value	12,665	791	-	-	-	-	9	13,465
Tax liabilities	3,237	-	-	-	-	-	-	3,237
Other liabilities	34,084	2,786	1,866	298	808	1,430	845	42,117
Borrowings	132,214	2,815	20,785	21,698	7,346	10,227	-	195,085
Subordinated liabilities	-	27,511	2,563	-	4,146	-	-	34,220
Equity	130,878	-	-	-	-	-	-	130,878
Liabilities 31.12.2012	706,522	64,052	39,308	23,827	22,509	13,249	31,208	900,675
Net on-balance sheet position	(32,510)	16,235	1,258	(6)	274	3,388	11,361	
Net off-balance sheet position	14,347	(8,624)	3,667	(1,239)	3,321	(3,672)	(7,800)	
Net position 31.12.2012	(18,163)	7,611	4,925	(1,245)	3,595	(284)	3,561	

Amounts are in ISK millions

41. Market risk, continued

Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at 31 December 2013. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the income statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

	2013		2012	
Currency	-10%	+10%	-10%	+10%
EUR	(1,190)	1,190	(761)	761
USD	(630)	630	(493)	493
CHF	(124)	124	125	(125)
GBP	(802)	802	(360)	360
JPY	(150)	150	28	(28)
Other	(266)	266	(356)	356

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Group's assets i.e. restructuring of troubled companies which the Group has taken over. For information on assets seized and held for sale and equity exposures, see notes 27 and 21 respectively.

Sensitivity analysis on equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the income statement. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase.

	2013		2012	
Equity	-10%	+10%	-10%	+10%
Trading book - Listed	(120)	120	(37)	37
Banking book - Listed	(307)	307	(245)	245
Banking book - Unlisted	(1,094)	1,094	(972)	972

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are FX swaps and forwards, interest rate swaps, cross-currency swaps, as well as options and forwards on equities, Treasury notes and bonds with Government guarantee. Limits on exposures and collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. The Group's exposure to derivative instruments has increased in the year 2013 but is not considered a material risk.

Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at the end of the year 2013.

Amounts are in ISK millions

42. Liquidity risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and financial institutions. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, approximately half of which is on demand.

Liquidity risk is one of the Group's most important risk factors and great deal of emphasis is placed on managing it. The Asset and Liability Committee is responsible for managing liquidity risk within the risk appetite the Board sets. The Bank's Treasury manage liquidity positions on a day-to day basis. Risk management measures, monitors and reports the Bank's liquidity risk.

The Icelandic economy has been subject to capital controls since late 2008. The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. The lifting of the capital controls remain uncertain.

Liquidity coverage ratio

On 1 December 2013 new liquidity rules issued by the Central Bank of Iceland took effect, overriding rules on liquidity and cash ratios that have previously been reported by the Group. The new rules are based on liquidity standards introduced in the Basel III Accord which are to be implemented in 2015 on a global level. The standard defines the Liquidity Coverage Ratio (LCR), which is the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

The criteria for liquid assets used to meet unexpected outflow is stricter for the new liquidity measure. The assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set a guideline for minimum Liquidity Coverage Ratio. As at 1 January 2014, the LCR requirement is 100% in foreign currency and 70% in total (ISK and foreign currency). The latter benchmark increases by 10% every year until a 100% requirement is implemented in 2017.

The Liquidity Coverage Ratio as at year end 2013 is shown below. No comparison is made to 2012 figures as the new LCR rules took effect shortly prior to year end 2013.

Liquidity coverage ratio	2013
FX	274%
Total	123%

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

Amounts are in ISK millions

42. Liquidity risk, continued

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days				Term
	Less Stable	Weight (%)	Stable	Weight (%)	deposits*
Retail	75,385	10%	33,971	5%	30,224
SME	32,496	10%	3,723	5%	6,675
Operational relationship	847	25%	-	5%	530
Corporations	49,841	40%	742	20%	12,977
Sovereigns, central-banks and PSE	19,104	40%	-	-	7,206
Financial entities being wound up	17,616	100%	-	-	59,675
Deposit pension funds	4,346	100%	-	-	20,639
Pension funds	46,420	100%	-	-	20,299
Domestic financial entities	26,652	100%	-	-	13,636
Foreign financial entities	2,135	100%	-	-	495
Other foreign parties	3,830	100%	626	25%	250
Total	278,672		39,062		172,606

*No outflow assumed from term deposits.

43. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk.

Amounts are in ISK millions

44. Capital management

The capital base at 31 December 2013 amounts to ISK 170,439 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 23.6%, 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 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).

Group's RWA calculations

Capital Base	2013	2012
Share capital and share premium	75,861	75,861
Other reserves	1,637	1,639
Retained earnings	62,591	49,572
Non-controlling interests	4,858	3,806
Total Equity	144,947	130,878
Intangible assets	(5,383)	(4,941)
Tax assets	(818)	(463)
Other statutory deductions	(119)	-
Total Tier 1 capital	138,627	125,474
Subordinated liabilities	31,918	34,220
Other statutory deductions	(106)	-
Total Capital base	170,439	159,694
Risk weighted assets		
Credit risk	608,029	557,964
Market risk FX	31,703	20,063
Market risk other	4,993	7,407
Operational risk	76,097	72,329
Total risk weighted assets	720,822	657,763
Tier 1 ratio	19.2%	19.1%
Capital adequacy ratio	23.6%	24.3%

Amounts are in ISK millions

SIGNIFICANT ACCOUNTING POLICIES

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

45. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment, management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures. The Financial Statements are prepared on a going concern basis.

46. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control the Group takes into consideration potential voting rights that are currently exercisable.

The Group measures goodwill at the acquisition date as:
- the fair value of the consideration transferred; plus
- the recognised amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:
- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Loss of control

On the loss of control, the Group derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in subsidiary is classified as held for sale the investment is accounted for, as non-current asset and disposal groups held for sale from the date of classification.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Financial Statements except when the Group controls the entity.

47. Associates

Associates are those entities over which the Group has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The Financial Statements include the Group's share of the total recognised income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current assets and disposal groups held for sale. In instances where control of a subsidiary is lost and the Group retains an associate investment, a portion of the recognised gain or loss on sale is attributable to the investment retained in the former subsidiary at its fair value at the date when control is lost. This gain or loss is recognised as either Other operating income (expense) or Net gain (loss) from discontinued operations in the Statement of Comprehensive Income.

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognised in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

48. Foreign currency

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

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

49. Interest

Interest income and expense are recognised in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- Interest on financial assets and liabilities held for trading; and
- Interest on financial assets designated at fair value through profit or loss.

50. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance, Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognised when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

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

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

52. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognised in the consolidated financial statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

53. Financial assets and financial liabilities

Recognition

The Group initially recognises loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognised on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognised on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

Classification

The Group classifies its financial assets in one of the following categories:

- loans;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost or fair value through profit or loss.

Derecognition

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

Disclosures on offsetting are provided in Note 23.

Amortised cost measurement

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

53. Financial assets and financial liabilities, continued

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

Identification and measurement of impairment

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

- The Group's aggregate exposure to the customer;
- The amount and timing of expected receipts and recoveries;
- The likely distribution available on liquidation or bankruptcy;
- The complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- The realisable value of collateral (or other credit mitigates) and likelihood of successful repossession; and
- The likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment. All loans under ISK 1 million get general provisions only.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Bank uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses standard values.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument´s original effective interest rate. The adjustment is recognised as increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

53. Financial assets and financial liabilities, continued

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of collateral have been received.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

54. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortised cost in the Statement of Financial position.

55. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

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

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a finance lease and a receivable equal to the net investment in the lease is recognised and presented within loans.

When the Group purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognised in the Group's Financial Statements.

56. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer’s margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognised in profit or loss. All changes in fair value are recognised as part of net financial income in profit or loss.

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

57. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognised at fair value. Fair value changes are recognised in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Financial instruments and derivatives with negative fair values are recognised as Financial liabilities at fair value.

58. Intangible assets

Goodwill
Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

Software

Software acquired by the Group is measured at cost less accumulated amortisation and any accumulated impairment losses.

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

Amortisation of software is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is five years.

59. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

60. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognised in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

61. Deposits

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

62. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

63. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 44. The subordinated liabilities have no maturity date and the Group may only retire them with the permission of the Icelandic Financial Supervisory Authority.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognised in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

64. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalised only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Buildings	33-50 years
Equipment	3-7 years

The depreciation methods, useful lives and residual values are reassessed annually.

Non-current assets and disposal groups held for sale

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Other assets and other liabilities

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

65. Equity

Dividends

Dividends on shares are recognised in equity in the period in which they are approved by Arion Bank´s shareholders.

Statutory reserve

According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Financial Statements of foreign operations.

66. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

67. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group’s liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognised in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

68. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

69. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

70. New standards and amendments to standards

New standards and amendments to standards effective in 2013

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS effective as of 1 January 2013:

IFRS 7 Disclosures — Offsetting Financial Assets and Financial Liabilities — Amendments to IFRS 7. These amendments require an entity to disclose information about rights to set-off and related arrangements (e.g., collateral agreements). The disclosures provide users with information that is useful in evaluating the effect of netting arrangements on an entity's financial position. The disclosures are required for all recognised financial instruments that are set off in accordance with IAS 32 Financial Instruments: Presentation. The disclosures also apply to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are set off in accordance with IAS 32. These amendments do not impact the Group's financial position or performance.

IFRS 13 Fair Value Measurement. IFRS 13 establishes a single source of guidance under IFRS for all fair value measurements. IFRS 13 does not change when an entity is required to use fair value, but rather provides guidance on how to measure fair value under IFRS when fair value is required or permitted. There are also additional disclosure requirements. Adoption of the standard does not have a material impact on the financial position or performance of the Group.

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2013, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments: Classification and Measurement. In November 2009, the IASB issued IFRS 9 Financial instruments, which includes new classification and measurement criteria for financial assets. The publication of IFRS 9 represents the completion of the first part of a multi-stage project to replace IAS 39 Financial instruments: recognition and measurement. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Group is currently assessing the impact of the new standard on its Financial Statements. An effective date for the application of IFRS 9 has not yet been decided.

IFRS 10 Consolidated Financial Statements. IFRS 10 replaces the portion of IAS 27 Consolidated and Separate Financial Statements that addresses the accounting for consolidated financial statements. It also includes the issues raised in SIC-12 Consolidation — Special Purpose Entities. IFRS 10 establishes a single control model that applies to all entities including special purpose entities. The changes introduced by IFRS 10 will require management to exercise significant judgement to determine which entities are controlled, and therefore, are required to be consolidated by a parent, compared with the requirements that were in IAS 27. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014.

IFRS 12 Disclosure of Interests in Other Entities. IFRS 12 includes all of the disclosures that were previously in IAS 27 related to consolidated financial statements, as well as all of the disclosures that were previously included in IAS 31 and IAS 28. These disclosures relate to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. A number of new disclosures are also required. The standard will not have any impact on the financial position or performance of the Group. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014.

IAS 32 Offsetting Financial Assets and Financial Liabilities — Amendments to IAS 32. These amendments clarify the meaning of "currently has a legally enforceable right to set-off". It will be necessary to assess the impact to the Group by reviewing settlement procedures and legal documentation to ensure that offsetting is still possible in cases where it has been achieved in the past. In certain cases, offsetting may no longer be achieved. In other cases, contracts may have to be renegotiated. The requirement that the right of set-off be available for all counterparties to the netting agreement may prove to be a challenge for contracts where only one party has the right to offset in the event of default. Adoption of the standard is not expected to have a material impact on the financial position or performance of the Group. These amendments became effective for annual periods beginning on or after 1 January 2014.

IFRIC 21 defines a levy as an outflow from an entity imposed by a government in accordance with legislation. It confirms that an entity recognises a liability for a levy when the triggering event specified in the legislation occurs. IFRIC 21 is not expected to have a material impact on the financial position or performance of the Group. IFRIC 21 became effective for annual periods beginning on or after 1 January 2014.

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