

ARION BANK HF.
(incorporated with limited liability in Iceland)

ISK 51,124,548,392 Inflation Linked Annuity Covered Bonds due 2048

**unconditionally and irrevocably guaranteed as to payments by
ARION BANK MORTGAGES INSTITUTIONAL INVESTOR FUND**

(established in Iceland as an institutional investment fund pursuant to Act No. 30/2003 on UCITS and Investment Funds, as amended by Act No 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds)

Arion Bank hf. (the **Issuer** or the **Bank**) issued the ISK 51,124,548,392 Inflation Linked Annuity Covered Bonds due 2048, **Covered Bonds**) on or about the relevant Issue Dates (as defined herein).

The payments of all amounts due in respect of the Covered Bonds have been unconditionally and irrevocably guaranteed by Arion Bank Mortgages Institutional Investor Fund (the **Fund**).

On the date of this Prospectus, the Pricing Terms set out in the Prospectus will be the only Pricing Terms applicable in respect of the Covered Bonds. The terms of the Covered Bonds will be set out in full in the Terms and Conditions read together with the Pricing Terms.

This Prospectus has been prepared in connection with the admission to trading of the Covered Bonds on the regulated market of the NASDAQ OMX Iceland hf. only.

This document has been approved by the Financial Supervisory Authority of Iceland (**FME**) in its capacity as competent authority under Article 52 of Act No. 108/2007 on Securities Transactions as a Prospectus thus complying with Directive 2003/71/EC of the European parliament and of the Council of the European Union on the prospectus to be published when securities are offered to the public or admitted to trading (**the Prospectus Directive**) and of Commission Regulation No. 809/2004 of 29 April 2004 implementing the Prospectus Directive. The Directive and the Regulation have been transposed into Icelandic law by Act No. 108/2007 and Regulation No. 243/2006 on the transposition of Commission Regulation No. 809/2004. Application will be made to the NASDAQ OMX Iceland hf. stock exchange for the Covered Bonds to be admitted to trading on the regulated market of the NASDAQ OMX Iceland. References in this Prospectus to the Covered Bonds being listed (and all related references) shall mean that an application has been made for such Covered Bonds to be admitted to trading on the regulated market of the NASDAQ OMX Iceland hf., regulated for the purposes of Directive 2004/39/EC which has been transposed into Icelandic law by Act No. 110/2007 on Stock Exchanges.

By Holding any Covered Bond, the holder of a Covered Bonds shall be deemed to have acknowledged and agreed to the appointment of the Representative as its representative to act for the benefit of the holders for the time being of the Covered Bonds in accordance with the terms of the Representative and Agency Agreement (as defined below) (see Condition 17 of the Covered Bonds).

See Risk Factors for a discussion of certain factors to be considered in connection with an investment in the Covered Bonds.

The Covered Bonds and the Covered Bond Guarantee (as defined herein) have not been and will not be registered under the U.S. Securities Act of 1933, as amended (the **Securities Act**) and are subject to U.S. tax law requirements. The Covered Bonds were not offered, sold or delivered within the United States or to U.S. persons, see *Distribution*.

**Arranger
Arion Bank hf.**

**Dealer for the Covered Bonds when issued
Arion Bank hf.**

The date of this Prospectus is 17 December 2014.

This Prospectus is to be read in conjunction with all documents which are deemed to be incorporated herein by reference, see *Documents Incorporated by Reference* below. This Prospectus shall be read and construed on the basis that such documents are incorporated and form part of this Prospectus.

Neither the Dealer nor the Representative have independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Dealer or the Representative as to the accuracy or completeness of the information contained or incorporated in this Prospectus or any other information provided by the Issuer and the Fund in connection with the Covered Bonds. Neither the Dealer nor the Representative accepts any liability in relation to the information contained or incorporated by reference in this Prospectus or any other information provided by the Issuer or the Fund in connection with the Covered Bonds.

No person is or has been authorised by the Issuer, the Fund, the Dealer or the Representative to give any information or to make any representation not contained in or not consistent with this Prospectus or any other information supplied in connection with the Covered Bonds and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the Fund, the Dealer or the Representative.

Neither this Prospectus nor any other information supplied in connection with the Covered Bonds: (i) is intended to provide the basis of any credit or other evaluation; or (ii) should be considered as a recommendation by the Issuer, the Fund, the Dealer or the Representative that any recipient of this Prospectus or any other information supplied in connection with the Covered Bonds should purchase any Covered Bonds. Each investor contemplating purchasing any Covered Bonds should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer and the Fund. Neither this Prospectus nor any other information supplied in connection with the issue of any Covered Bonds constitutes an offer or invitation by or on behalf of the Issuer, the Fund, the Dealer or the Representative to any person to purchase any Covered Bonds.

Neither the delivery of this Prospectus nor any offering, sale or delivery of any Covered Bonds shall in any circumstances imply that the information contained herein concerning the Issuer and the Fund is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Covered Bonds is correct as of any time subsequent to the date indicated in the document containing the same. The Dealer and the Representative expressly do not undertake to review the financial condition or affairs of the Issuer or the Fund during the term of the Covered Bonds or to advise any investor in the Covered Bonds of any information coming to their attention. Investors should review, *inter alia*, the most recently published documents incorporated by reference into this Prospectus when deciding whether or not to purchase any Covered Bonds.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy any Covered Bonds in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Prospectus and any offer or sale of Covered Bonds may be restricted by law in certain jurisdictions. The Issuer, the Fund, the Dealer and the Representative do not represent that this Prospectus may be lawfully distributed, or that any Covered Bonds may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Fund, the Dealer or the Representative which would permit a public offering of any Covered Bonds outside Iceland or distribution of this Prospectus in any jurisdiction where action for that purpose is required. Accordingly, no Covered Bonds may be offered or sold, directly or indirectly, and neither this Prospectus nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Prospectus or any Covered Bonds may come must inform themselves about, and observe, any such restrictions on the distribution of this Prospectus and the offering and sale of Covered Bonds. In particular, there are restrictions on the distribution of this Prospectus and the offer or sale of Covered Bonds in the United States, the European Economic Area (including the United Kingdom and Iceland) and Japan, see *Distribution*.

This Prospectus may only be used for the purposes for which it has been published.

In making an investment decision, investors must rely on their own examination of the Issuer and the terms of the Covered Bonds, including the merits and risks involved. The Covered Bonds have not been approved or disapproved by the United States Securities and Exchange Commission or any other securities commission or other regulatory authority in the United States, nor have the foregoing authorities approved this Prospectus or confirmed the accuracy or determined the adequacy of the information contained in this Prospectus. Any representation to the contrary is unlawful.

None of the Dealer, the Representative, the Fund or the Issuer makes any representation to any investor in the Covered Bonds regarding the legality of its investment under any applicable laws. Any investor in the Covered Bonds should be able to bear the economic risk of an investment in the Covered Bonds for an indefinite period of time.

The Issuer and the Fund will, in the event of any significant new factor, material mistake or inaccuracy relating to information included in this Prospectus which is capable of affecting the assessment of the Covered Bonds, prepare a supplement to this Prospectus.

All references in this document to “ISK”, “krona” or “krónur” refer to the currency of Iceland.

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SUMMARY OF THE COVERED BONDS

The summary below reflects the requirements of the Commission Regulation (EC) No. 809/2004 of April 29, 2004, as amended, as transposed into Icelandic law by virtue of Regulation No.243 2006 with subsequent amendments, including the contents requirement set out in Annex XXII of the Prospectus Regulation (“Annex XXII”). Pursuant to Annex XXII, summaries are made up of disclosure requirements known as “Elements”. These Elements are numbered in Sections A-E (A.1 - E.7). This summary contains all the Elements required to be included in a summary for this type of securities and issuer. Because some Elements are not required to be addressed, there may be gaps in the numbering sequence of the Elements. Even though an Element might be required to be inserted in the summary because of the type of securities and issuer, it is possible that no relevant information can be given regarding the Element. In this case a short description of the Element is included in the summary with the mention of the words “not applicable”.

Words and expressions defined elsewhere in this Prospectus shall have the same meanings in this summary. A glossary of certain defined terms is contained at the end of this Prospectus.

Covered Bonds

Series of Covered Bonds	Principal Amount	Interest Basis	Payment Basis	Final Maturity Date	Initial Issue Price
2	ISK 51,124,548,392	Inflation Linked Interest	Annuity	10 July 2048	89.14% / 95.1957%

Section A - Introduction and warnings		
Element	Disclosure requirement	Disclosure
A.1	Warning	<p>This summary must be read as an introduction to this Prospectus only. It includes certain important information contained in the Prospectus but does not include all the information that may be important to prospective investors. This summary must be read together with the more detailed information in the remainder of the Prospectus, taken as a whole, including documents incorporated by reference and the matters set forth under “Risk Factors”.</p> <p>Following the implementation of the relevant provisions of the Prospectus Directive in each Contracting Party to the Agreement of the European Economic Area no civil liability will attach to the Issuer and the Fund (together the Responsible Persons) in the territory of any such Contracting Party in respect of this Summary, including any translation hereof, unless it is misleading, inaccurate or inconsistent when read together with the other parts of this Prospectus. Where a claim relating to information contained in this Prospectus is brought before a court in the territory of a Contracting Party to the Agreement of the European Economic Area, the plaintiff may, under the national legislation of the State where the claim is brought, be required to bear the costs of translating the Prospectus</p>

		<p>before the legal proceedings are initiated.</p> <p>Civil liability attaches only to those persons who have tabled the summary including any translation thereof, but only if the summary is misleading, inaccurate or inconsistent when read together with the other parts of the Prospectus or if it does not provide, when read together with the other parts of the Prospectus, any required key information in order to aid prospective investors when considering whether to invest in the Covered Bonds.</p>
A.2	Use of the prospectus for subsequent resale or final placement of securities by financial intermediaries	Not applicable. Arion Bank is not engaging any financial intermediaries for any subsequent resale of securities or final placement of securities after and in connection with the publication of this Prospectus.

Section B – The Company		
Element	Disclosure requirement	Disclosure
B.1	Legal and commercial name of the Issuer	Arion Bank hf.
B.2	Domicile and legal form of the issuer, legislation under which the issuer operates and its country of incorporation	<p>Arion Bank hf. is incorporated in Reykjavik and domiciled in Iceland under Icelandic law and having its registered office at Borgartun 19, 105 Reykjavik, Iceland. It is a public limited company established under Act No 2/1995 regarding Public Limited Companies, under the laws of the Republic of Iceland with ID number 581008-0150 in the Icelandic Register of Enterprises.</p> <p>The Issuer holds a licence from the FME to conduct financing business as a commercial bank under Article 2, Act number 161/2002, on financial undertakings.</p> <p>Arion Bank has been appointed:</p> <ul style="list-style-type: none"> • to service, on behalf of the Fund, the Loans and Related Security in the Portfolio pursuant to the terms of the Servicing and Custody Agreement; • to provide cash management services to the Fund and to monitor compliance by the Fund with the Asset Coverage Test pursuant to the Cash Management Agreement; • to act as GIC Provider to the Fund pursuant to the Guaranteed Investment Contract; • to act as an Account Bank to the Fund pursuant to the Bank Account Agreement; • to act as Seller pursuant to the terms of the Mortgage Sale

		<p>Agreement between Arion Bank hf. (in its capacity as Seller), the Fund and the Representative.</p> <p>For a more detailed description of Arion Bank see <i>Description of the Issuer</i> below.</p>
B.4b	Description of the most significant recent trends affecting the issuer and the industries in which it operates	Not applicable.
B.5	Issuer group and the issuer's position within the group	<p>The Bank was established at the end of 2008 as the vehicle to receive the transfer of certain assets and liabilities of Kaupthing following the Icelandic government assuming control over Kaupthing towards the end of 2008. Kaupthing was the product of a merger in May 2003 of two of Iceland's then leading banks, Kaupthing Bank hf. and Bunadarbanki Islands hf. (Bunadarbanki). Bunadarbanki was established in 1929 by a law passed by the Icelandic parliament, the Althingi. At the beginning of 1998, Bunadarbanki became a limited liability company and was privatised in stages up to the beginning of 2003. Kaupthing hf. was established in Reykjavik in 1982, coinciding with the launch of the free capital market in Iceland. Kaupthing hf. later became an investment bank before its merger with Bunadarbanki in 2003.</p> <p>In July 2009, the Icelandic government and the resolution committee of Kaupthing (the Kaupthing Resolution Committee) reached agreement on the valuation of the assets transferred to the Bank through the issue of a compensation instrument by the Bank to Kaupthing. In addition, the agreement identified certain ring-fenced assets in respect of which Kaupthing's creditors were accorded a share in certain future increases of value through an escrow and contingent rights agreement (the ECVRA) and creditors (through the Kaupthing Resolution Committee) were also granted an option to purchase up to 87 per cent. of the Bank's equity, see "—Related Party Transactions".</p> <p>In March 2009, following a ruling from the FME, the Bank acquired all the deposits and card transactions of over 20,000 customers from SPRON. The operations of the six SPRON branches and its online bank were discontinued following the acquisition. In April 2009, the Bank acquired Mýrasýsla Savings Bank (SPM) in Borgarnes and merged SPM with its branch in Borgarnes, increasing its customer base by a further 2,000 clients.</p> <p>In December 2009, the Kaupthing Resolution Committee acting through Kaupskil ehf. (Kaupskil), a whollyowned subsidiary of Kaupthing, exercised its option to acquire shares in the Bank and, following a capital injection in January 2010, Kaupthing is currently the owner of 87 per cent. of the Bank with the Icelandic government owning the remaining 13 per cent.</p> <p>In March 2010 a new board of directors (the Board) was appointed at the Bank's annual general meeting and, on 1 June 2010, the Board appointed a new chief executive officer (CEO).</p>

		<p>On 30 June 2011, the Bank and Kaupthing executed a settlement agreement under which the compensation instrument and the ECVRA were both discharged.</p> <p>In January 2012, the Bank acquired the mortgage portfolio managed in a special fund (the Fund) owned by the estate of Kaupthing. The Fund had guaranteed the covered bonds issued from 2006 to 2008 by Kaupthing to finance its mortgage loans (the Kaupthing Covered Bonds) under the covered bond programme established by Kaupthing on 30 March 2006 (the Kaupthing Covered Bond Programme). As a part of this acquisition, the Bank was substituted for, and has assumed all liabilities and obligations (past, present and future, other than Kaupthing's liabilities and obligations relating to withholding tax payments) of, Kaupthing in respect of each of the six series of outstanding Kaupthing Covered Bonds. The Kaupthing Covered Bonds are inflation linked with final maturities between 2033 and 2048, and have an aggregate face value of approximately ISK 92.5 billion.</p> <p>The Bank paid an agreed cash consideration to the Kaupthing Resolution Committee in connection with its acquisition of the Fund. The mortgage portfolio which the Bank now holds following the acquisition of all of the units in the Fund was valued at ISK 110 billion when it was acquired.</p>																				
B.9	Profit forecast or estimates	Not applicable.																				
B.10	Qualifications in the audit report on the historical financial information	Not applicable. The consolidated financial statements for the fiscal years 2013, 2012 and 2011 have been audited by Ernst & Young ehf., and Ernst & Young ehf. issued an unqualified auditor's report in each case.																				
B.12	Selected historical key financial information	<p>Arion is a leading universal Icelandic bank, whose business includes mortgage lending in Iceland, with total assets at 31 December 2013 of ISK 938,850 million and net earnings of ISK 12,657 million for the period ended 31 December 2013. For the financial year ended 31 December 2012 the Bank's net earnings was ISK 17,056 million. For the six months ended 30 June 2014 the Bank's net earnings was ISK 17,409 million.</p> <p>Key financial information as per 30 June 2014, 31 December 2013 and 31 December 2012</p> <p>Six month period ended as at 30 June 2014</p> <table border="1"> <thead> <tr> <th><i>(ISK million)</i></th> <th>Operating income</th> <th>Earnings before tax</th> <th>Total assets</th> </tr> </thead> <tbody> <tr> <td>Corporate Banking</td> <td>4,318</td> <td>6,211</td> <td>238,184</td> </tr> <tr> <td>Retail Banking</td> <td>7,653</td> <td>3,817</td> <td>401,183</td> </tr> <tr> <td>Asset Management</td> <td>2,166</td> <td>1,447</td> <td>4,858</td> </tr> <tr> <td>Investment Banking</td> <td>5,602</td> <td>5,219</td> <td>30,783</td> </tr> </tbody> </table>	<i>(ISK million)</i>	Operating income	Earnings before tax	Total assets	Corporate Banking	4,318	6,211	238,184	Retail Banking	7,653	3,817	401,183	Asset Management	2,166	1,447	4,858	Investment Banking	5,602	5,219	30,783
<i>(ISK million)</i>	Operating income	Earnings before tax	Total assets																			
Corporate Banking	4,318	6,211	238,184																			
Retail Banking	7,653	3,817	401,183																			
Asset Management	2,166	1,447	4,858																			
Investment Banking	5,602	5,219	30,783																			

Treasury	1,332	1,883	191,420
Other Divisions and Subsidiaries	3,688	1,084	60,121
Head-Quarters and Elimination	941	(4,935)	22,444
Total	25,700	14,726	948,993

Year ended/as at 31 December 2013

<i>(ISK million)</i>	Operating income	Earnings before tax	Total assets
Corporate Banking	9,315	12,446	248,082
Retail Banking	14,565	3,353	397,721
Asset Management	3,701	2,924	4,840
Investment Banking	4,422	5,564	34,799
Treasury	2,710	2,886	168,334
Other Divisions and Subsidiaries	8,791	3,071	77,150
Head-Quarters and Elimination	844	(11,971)	7,924
Total	44,348	18,273	938,850

Year ended/as at 31 December 2012

<i>(ISK million)</i>	Operating income	Earnings before tax	Total assets
Corporate Banking	11,434	10,559	251,384
Retail Banking	14,274	3,310	318,700
Asset Management	4,170	2,528	4,597

		Investment Banking	4,510	5,006	26,000
		Treasury	4,661	4,634	212,315
		Other Divisions and Subsidiaries	9,586	4,750	80,057
		Head-Quarters and Elimination	867	(10,643)	7,622
		Total	49,502	20,144	900,675
		<p>There has been no material adverse change in the prospects of the issuer since the date of its last published audited financial statements or a description of any material adverse change.</p> <p>There have not been any significant changes in the financial or trading position subsequent to the period covered by the historical financial information.</p>			
B.13	Description of recent events	Not applicable. There are no recent events particular to the issuer which are to a material extent relevant to the evaluation of the issuer's solvency.			
B.14	Dependent upon other entities	Not applicable. The issuer is not dependent upon other entities within the group.			
B.15	Issuer's principal activities	<p>Arion Bank was established on 18 October 2008.</p> <p>The Bank has six main reporting segments:</p> <ol style="list-style-type: none"> 1) 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. 2) 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 26 branches all around Iceland are over 100,000. 3) Asset Management division comprises Institutional Asset Management, Private Banking and Investment Services. Asset Management manages financial assets on behalf of its customers 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.

- 4) 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.
- 5) Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management. Treasury is also responsible for the internal pricing of interest rates and currency and for liaising with other financial institutions.
- 6) Other divisions and Subsidiaries include the Bank's market making business in domestic securities and currencies and the management of assets that the Bank has acquired through debt restructurings and other enforcement procedures. The subsidiaries are Eignabjarg ehf., Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities.

Strategy of Arion Bank

Following the appointment of a new Board and CEO in mid-2010, a new strategic plan for the Bank was adopted in October 2010. The key elements of the strategy are:

- a) positioning the Bank as a universal bank in Iceland, providing a wide range of services and focusing on tailored and personalized solutions for its customers, with special emphasis being placed on the Bank's ability to meet the financial needs of those customers, both retail and corporate, which require comprehensive and diverse financial services;
- b) improving the Bank's competitiveness by focusing on its product offering, quality of service, efficiency and profitability in its operations. In particular, the Bank reduced its branch network from 39 branches at the end of 2008 to 25 branches at the end of 2013 and has also sought to reduce back office costs and streamline its organizational structure; and
- c) in relation to business customers, emphasizing the Bank's focus on developing long-term business relationships through continuous dialogue with customers so as to fully understand their needs and continuous product development which the Bank believes is fundamental to successful business relationships. The Bank aims to innovate and develop products and services which respond to the changing needs of its customers and to put its customers' interests first in all transactions.

		<p>The Bank's core values (or Cornerstones) were introduced in 2012 and are "We make a difference, we say what we mean, and we get things done". The Cornerstones guide the Bank in everything it says and does, particularly in its interaction with its main stakeholders, that is its customers, employees, society and shareholders.</p> <p>From its creation at the end of 2008, the immediate and ongoing areas of focus for the Bank have been the restructuring of its loan portfolio, expansion of its sources of funding and the need to rebuild trust with its customers, Icelandic society as a whole and international financial institutions and investors. In addition, the Bank inherited certain significant risks in terms of loan and funding concentrations and currency mismatches which it has sought to reduce whilst focusing on maintaining high levels of liquidity and capital.</p>
B.16	Major shareholders	<p>Kaupthing's shareholding in the Bank is held through its wholly owned subsidiary Kaupskil, a private limited liability company, ID no. 580609-0150, Borgartún 26, Reykjavík. The Kaupthing Winding-up Committee appoints one member of Kaupskil's board but the other two must be independent. Further, under a special representation agreement between Kaupskil and Kaupthing dated 20 April 2010, Kaupthing has agreed to respect the independence of the board of directors of Kaupskil and Kaupthing's duty to promote sound and solid financial operations of the Bank free of external intervention. The board of directors of Kaupskil is required to report to the FME on the implementation of this policy on a quarterly basis. In order to facilitate supervision, Kaupskil is required to transfer the ownership of all financial and insurance subsidiaries to a single parent company if the FME considers such a transfer necessary.</p> <p>Various restrictions have been placed on Kaupthing by the FME, including with regard to the sale of shares of the Bank before September 2012. Kaupthing is required to notify the FME in advance of a proposed transfer of ownership of shares in the Bank or Kaupskil. Upon receipt of any such notification, the FME will carry out a new eligibility assessment of the prospective owners if the change of ownership affects the board of directors of the Bank. The FME set out the details of its approval and conditions in a press release dated 18 January 2010 (http://www.fme.is/utgefid-efni/frettir-og-tilkynningar/frettir/nr/602).</p>
B.17	Credit ratings	The Covered Bonds are not rated.
B.18	Description of the nature and scope of the guarantee	<p>Arion Bank Mortgages Institutional Investor Fund, ID no. 570106-9610, registered office being Borgartun 19, 105 Reykjavik, Iceland, an institutional investment fund established in Iceland pursuant to Act No. 30/2003 on Undertaking for Collective Investment in Transferable Securities (UCITS), as amended by Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds. The day-to-day operations of the Fund are managed by Stefnir hf. (the Management Company). The business of the Fund is to acquire, <i>inter alia</i>, Loans and their Related Security from the Seller pursuant to the terms of the Mortgage Sale Agreement and to guarantee the Covered Bonds.</p> <p>The Fund has provided a guarantee covering all Guaranteed Amounts when the same shall become Due for Payment, but only following service</p>

		<p>of a Notice to Pay or a Fund Acceleration Notice.</p> <p>Payment of Guaranteed Amounts in respect of the Covered Bonds when Due for Payment is irrevocably guaranteed by the Fund. The obligations of the Fund to make payment in respect of the Guaranteed Amounts when Due for Payment are subject to the condition that a Notice to Pay or a Fund Acceleration Notice has been served on the Fund. The obligations of the Fund under the Covered Bond Guarantee will accelerate against the Fund upon service of a Fund Acceleration Notice. The obligations of the Fund under the Covered Bond Guarantee constitute direct and unsecured obligations of the Fund.</p> <p>For a more detailed description of the Fund, see <i>Description of the Fund</i> below.</p> <p>Loans and their Related Security are sold to the Fund from time to time pursuant to the terms of the Mortgage Sale Agreement entered into on 20 January 2012 between Arion Bank hf. (in its capacity as Seller), the Fund and the Representative. For a more detailed description of the Seller, see <i>Description of the Issuer</i> below.</p> <p>Stefnir hf., ID no. 700996 2479, registered office being Borgartun 19, 105 Reykjavik, Iceland, has been appointed pursuant to the Fund's Articles of Association to manage the day to day operations of the Fund in accordance with the Articles of Association of the Fund and the Transaction Documents.</p> <p>Verdis hf., ID no. 470502 4520, registered office being Armuli 13, 108 Reykjavik, Iceland, has been appointed pursuant to the Fund's Articles of Association to provide certain administration and depository services to the Fund in accordance with a the Servicing and Custody Agreement entered into by, inter alios, it and the Management Company on behalf of the Fund. Verdis merged with Arion Bank 29 June 2012. Arion took over all operations of Verdis including the role of Custody Agent.</p> <p>A reputable institution appointed pursuant to the Asset Monitor Agreement as an independent monitor to perform tests in respect of the Asset Coverage Test when required. The Asset Monitor, as at the date of this Prospectus, is KPMG ehf., ID no. 590975-0449, registered office being Borgartun 27, 105 Reykjavik, Iceland.</p> <p>Deutsche Bank AG, London Branch, acting through its office at Winchester House, 1 Great Winchester Street, London EC2N 2DB, has been appointed pursuant to the Representative and Agency Agreement as issuing and principal paying agent, agent bank and paying agent.</p> <p>Deutsche Trustee Company Limited, acting through its office at Winchester House, 1 Great Winchester Street, London EC2N 2DB, has been appointed to act as the representative of the Covered Bondholders, the Receiptholders and the Couponholders in respect of the Covered Bonds.</p>
B.19	Information about the guarantor as if it were the issuer of the same type of security that is the subject	Arion Bank Mortgages Institutional Investor Fund, formerly Kaupthing Mortgages Institutional Investor Fund (the Fund) was established in Iceland on 10 March 2006 as an institutional investment fund pursuant to Article 4 of Act No 30/2003 on Undertaking for Collective Investment in

	of the guarantee	<p>Transferable Securities and Investment Funds (the Act), as amended on 1 November 2011 by Article 4 of Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds. The Fund changed its name to Arion Bank Mortgages Institutional Investor Fund on 19 October 2011.</p> <p>The Fund's registration number is 570106-9610. The registered office of the Fund is at Borgartun 19, 105 Reykjavik, Iceland. The telephone number of the Fund's registered office is +354 444-6000.</p> <p>The day-to-day operations of the Fund are managed by Stefnir hf. (Stefnir Asset Management Company hf.), formerly Kaupthing Bank Asset Management Company hf. (the Management Company) pursuant to the Fund's Articles of Association. The Asset Management Company's registration number is 700996-2479. The registered office of the Management Company is at Borgartun 19, 105 Reykjavik, Iceland. The telephone number of the Management Company's registered office is +354 444 7400. The Asset Management Company is incorporated under the laws of Iceland and is a wholly-owned subsidiary of the Issuer. The principal activity of the Management Company consists of the management of the day-to-day operations of funds and other enterprises for mutual investment in transferable securities.</p> <p>Verdis hf., formerly Arion Custody Services hf. has been appointed pursuant to the Fund's Articles of Association to provide certain administration and depository services to the Fund in accordance with a custody agreement entered into by it and the Management Company on behalf of the Fund. The Custody Agent's registration number is 470502-4520, The registered office of the Custody Agent is at Ármúli 13, 105 Reykjavik, Iceland. The telephone number of the Custody Agent's registered office is +354 528-2800. Verdis merged with Arion Bank 29 June 2012. Arion took over all operations of Verdis including the role of Custody Agent.</p> <p>The Fund has no subsidiaries or employees. Other than the Asset Management Company and the Custody Agent, the Fund is dependent on the Servicer and the Cash Manager to provide certain management and administrative services to it, on the terms of the Transaction Documents.</p> <p>The principal activities of the Fund are set out in the Fund Deed and include, <i>inter alia</i>, the ability to carry on the business of acquiring the Loans and their Related Security pursuant to the terms of the Mortgage Sale Agreement with a view to profit, to borrow money and to do all such things as are incidental or conducive to the carrying on of that business.</p> <p>The Fund has not traded since the date of its establishment (other than those matters incidental to the Covered Bonds), nor has it engaged since its establishment, and will not engage whilst the Covered Bonds or any Term Advance remains outstanding, in any material activities other than activities incidental to its establishment, activities contemplated under the Transaction Documents to which it is or will be a party and other matters which are incidental or ancillary to the foregoing.</p> <p>There are no potential conflicts of interest between, on the one hand, any duties of the directors of the Management Company to the Fund and, on</p>
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the other hand, their private interests or other duties.

Except as described in this Prospectus, there has been no material adverse change in the prospects of the Fund since the date of the last Financial Statements of the Fund, dated 11 March 2014.

Except as described in this Prospectus, there has not been any significant change in the financial or trading position of the Fund since the date of the last Financial Statements of the Fund, dated 11 March 2014.

The Fund's accounting reference date is 31 December with its most recent statutory accounts being drawn up to 31 December 2013.

The audited consolidated annual financial statements of the Fund for the financial year ended 31 December 2013 (the Fund's 2013 Financial Statements) and the unaudited interim financial statements for the periods ended 30 June 2014 (the Fund's 2014 Interim Financial Statements) are set out in section of the Prospectus entitled "*Fund's Financial Statements*". The Fund's 2013 Financial Statements have been accurately reproduced and, as far as each of the Issuer and the Fund are aware, no facts have been omitted which would render the reproduced information inaccurate or misleading. Ernst & Young ehf. of Borgartún 30, 105 Reykjavik, Iceland audited the Fund's 2013 Financial Statements and provided the auditor's report contained in the Fund's 2013 Financial Statements. Ernst & Young ehf. are members of The Institute of State Authorised Public Accountants in Iceland and have no material interest in the Fund.

Key financial information as per 30 June 2014, 31 December 2013 and 31 December 2012 of the Fund:

Six month period ended as at 30 June 2014

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets
	1,348	1,263	167,079

Year ended/as at 31 December 2013

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets
	2,351	2,176	165,612

Year ended/as at 31 December 2012

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets

		1,841	1,661	173,107
<p>Stefnir hf. is an independent financial institution according to the Financial Undertakings Act No. 161/2002. The company manages UCITS, investment funds and professional investor funds under Act No. 128/2011. In addition to this, the company is licensed to operate asset management services, investment advisory and to manage financial instruments for collective investments, cf. sub-paragraphs 1-3 of paragraph 1 of Article 27 of Act No. 161/2002. Stefnir is Iceland's largest fund manager with assets of approximately ISK 414 billion under active management. Stefnir has 21 employees with average experience on the financial markets of 10 years.</p> <p>Stefnir is a subsidiary of Arion Bank hf. The company is fully owned by Arion Bank and related companies. The company's corporate governance statement serves to encourage open and reliable communications between the board, shareholders and other stakeholders such as unit holders in funds managed by Stefnir, parties that service and participate in the operations of Stefnir, employees and the general public.</p> <p>The company's operations are subject to stringent restrictions by the legislator. The company's operations are governed by acts of law including the Financial Undertakings Act No. 161/2002 and the UCITS, Investment Funds and Institutional Investor Funds Act, No. 128/2011. Stefnir is monitored by the FME under Act No. 87/1998.</p> <p>Compliance, internal audit and some risk management functions are outsourced to Arion Bank with the permission of the FME and the board is regularly informed of issues concerning the above.</p> <p>The company's accounting is the responsibility of Arion Bank's finance division. The FME has authorized the outsourcing of this task. Arion Bank is also the depositary of Stefnir hf. and the financial statements of Stefnir's funds are the responsibility of the Bank. The auditing committee examines the financial statement and obtains the opinion of an external auditor on the six-month financial results and 12-month financial results of Stefnir and the funds managed by Stefnir. Reporting to the board of directors with respect to the accounts is the responsibility of the committee; the board also meets the auditing company Ernst & Young hf.</p> <p>Stefnir has five board members and five alternate members. The majority of the board is independent of Arion Bank, Stefnir's parent company, and the company itself. All board members are elected at a shareholders' meeting of the company. The managing director is hired by the board and has the mandate from the board to manage the day-to-day operations of the company. Board meetings are held regularly, on average once a month and more often if required. An employee of Stefnir is the secretary of the board. Stefnir's legal representative is also present and provides board members with legal advice at board meetings. There were 14 board meetings during the year and there was a quorum present at every meeting. The board's rules of procedure, work schedule and articles of association can be seen on the company's website, www.stefnir.is/english.</p>				

Section C — Securities		
C.1	Types and class of the securities, securities identification	<p>ISK 51,124,548,392 Inflation Linked Annuity Covered Bonds due 2048. All bonds are bonds of the same class.</p> <p>ISIN Code: XS0249806935</p> <p>Common Code: 026345782</p>
C.2	Currency of the securities issue	ISK.
C.5	Restriction on free transfer	<p>The Covered Bonds have been issued in bearer form as described in <i>Form of the Covered Bonds</i>.</p> <p>There are restrictions on the offer, sale and transfer of the Covered Bonds in the United States, the European Economic Area (including the United Kingdom and Iceland) and Japan, see <i>Distribution</i>.</p>
C.8	Description of the rights attached to the bonds	<p>The Covered Bonds constitute direct, unconditional, unsubordinated and unsecured obligations of the Issuer and rank <i>pari passu</i> without any preference with the Covered Bonds and among themselves and (save for any obligations required to be preferred by law) at least equally with all other present and future unsecured and unsubordinated obligations of the Issuer from time to time outstanding.</p> <p>The Covered Bonds have been issued in denominations of ISK 1.</p> <p>The Covered Bonds have been issued in bearer form as described in <i>Form of the Covered Bonds</i>.</p> <p>The Covered Bonds are governed by, and construed in accordance with, Icelandic law.</p> <p>The terms of the Covered Bonds contain a negative pledge provision as further described in Condition 3 of the Terms and Conditions of the Covered Bonds.</p> <p>If a Fund Acceleration Notice is served in respect of any one Series of Covered Bonds, then the obligation of the Fund to pay Guaranteed Amounts in respect of all Series of Covered Bonds then outstanding will be accelerated.</p>
C.9	Nominal interest rate and interest obligations	<p>The Covered Bonds are Inflation Linked Annuity Covered Bonds that bear interest which will be payable on the Interest Payment Dates specified in the Pricing Terms. The Covered Bonds will be redeemed by payment of one or more amounts, adjusted for indexation in accordance with the provisions set out in the Pricing Terms, on the Interest Payment Dates specified in the Pricing Terms.</p> <p>The Covered Bonds will be redeemable at the option of the Issuer upon giving notice to the relevant Covered Bondholders, on any Interest Payment Date and at the Optional Redemption Amount specified in the Pricing Terms.</p> <p>All payments in respect of the Covered Bonds will be made without</p>

		deduction for or on account of withholding taxes imposed by any relevant tax jurisdiction. In the event that any such deduction is made, the Issuer will, save in certain limited circumstances detailed in Condition 7 of the Terms and Conditions of the Covered Bonds, be required to pay additional amounts to cover the amounts so deducted.
C.10	Derivative component in interest payments	Not applicable.
C.11	Bond trading venue	The bonds will be traded on the regulated market of the NASDAQ OMX Iceland hf. only.

Section D — Risks		
D.2	Key information on key risks that are specific to the Issuer	<p>Risk factors relating to the Issuer, including the ability of the Issuer to fulfil its obligations under the Covered Bonds</p> <ul style="list-style-type: none"> a) The Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and, although GDP growth returned in 2011, 2012 and 2013, Iceland's economy remains vulnerable to a range of internal risks and external shocks b) Iceland's banking sector is in the process of being restructured and remains subject to considerable risks. Should any of these risks materialise the Bank could be materially and adversely affected, either directly or by association should the risks primarily materialise in relation to other Icelandic banks c) Existing currency restrictions - Icelandic rules on foreign exchange - On 28 November 2008, the Rules on Foreign Exchange were adopted in accordance with temporary provisions in the Foreign Exchange Act. The Foreign Exchange Rules as codified with certain minor amendments effectively prohibit the outflow of foreign currency from Iceland except in the case of a payment for goods or services. Therefore, all financial transactions leading to currency outflow are prohibited unless explicitly permitted. The Foreign Exchange Act provides for several general exceptions and provides for specific exemptions from the restrictions under this legislation, subject to the Central Bank's approval. Arion Bank has separately obtained a specific exemption from the Foreign Exchange Act set out in the Central Bank's letter dated 10 April 2014 which confirms that, subject to the preceding paragraph of this risk factor, the payment of an Early Redemption Amount or an Optional Redemption Amount under the Covered Bonds will be exempt from the Foreign Exchange Act. Prospective investors must consider the risk of changes to the above currency controls and the impact this may have on an investment in the Covered Bonds. d) The Bank has a number of significant exposures and its loan portfolio contains a high level of impaired loans and would be materially adversely affected should a customer to which it has a large exposure default or if the level of impairment in its loan portfolio were to increase. e) The Bank has a high proportion of inflation-linked mortgage loans and there is a risk that legislation might be imposed which varies the terms of these

		<p>loans in a manner that is adverse to the Bank.</p> <p>f) The Bank is exposed to significant liquidity risk. In particular, the Bank's funding is dominated by deposits and a significant amount of these are on demand. The Bank is also limited in its ability to seek alternative sources of funding.</p> <p>g) The Bank is exposed to significant foreign exchange risk through a currency mismatch between its assets and liabilities and through legal uncertainties relating to certain foreign currency loans.</p> <p>h) The Bank is exposed to a range of other typical market risks, including interest rate risk, equity price risk and inflation risk.</p> <p>i) While the Bank seeks to manage its operational risks, these risks remain an inherent part of its business.</p> <p>j) The Bank's risk management methods may leave it exposed to unidentified, unanticipated or incorrectly quantified risks, which could lead to material losses or material increases in liabilities.</p> <p>k) The Bank is exposed to competition, principally from other large Icelandic banks, and expects that this competition will increase as Iceland's economy recovers.</p> <p>l) The Bank is exposed to the risk of failure of its information technology (IT) systems and breaches of its security systems.</p> <p>m) There are regulatory and legal risks inherent in the Bank's businesses.</p> <p>n) Legal risks</p> <p>The Bank's business operations are governed by law and regulations and are subject to authority supervision. Any changes to the current legislation might affect the Bank's business operations and its operating results. Furthermore, competition and other factors might also affect the Bank's business.</p> <p>o) The Bank is involved as defendant in ongoing litigation which, if determined adversely to the Bank, could result in significant losses. In addition, the Bank is a plaintiff in a case which, if not successful, could have a material adverse effect on the Bank's results of operations.</p> <p>p) The Bank is subject to investigations by the ICA in relation to alleged abuse of a dominant position and any determination that the Bank has violated the law could result in fines or business restrictions.</p> <p>q) Changes in tax laws or in their interpretation could harm the Bank's business.</p> <p>r) Changes to the Capital Requirements Directive could adversely affect the Bank's results.</p> <p>s) Catastrophic events, terrorist attacks and other acts of war could have a negative impact on the Bank's business.</p> <p>t) The Bank may be unable to recruit or retain experienced and qualified</p>
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		<p>personnel and is dependent on key members of management.</p> <ul style="list-style-type: none"> u) The Bank's insurance coverage may not adequately cover all losses. v) The Bank's accounting policies and methods are critical to how it reports its financial condition and results of operations. They require management to make estimates about matters that are uncertain. w) Abnormal pricing as a consequence of capital controls. Due to currency controls domestic parties are prohibited from transferring their funds and investing outside of the Icelandic market. This may have a negative impact on the Bank's business. x) The claims of Covered Bondholders will be subordinated to the claims of certain of the Bank's depositors in the event of a winding-up. y) Credit risks relating to the Bank's collateral. Given that the Bank's loans are granted with mortgages on residential real estate as collateral, the credit risk is driven in part by performance of the real estate and housing market in Iceland. There can be no assurance regarding the future development of the value of this collateral. Should the prices of real property and the housing market substantially decline, this could adversely affect the Bank's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds. z) The Council of the European Union has published revised proposals for a bank recovery and resolution directive which is intended to enable a range of actions to be taken in relation to credit institutions and investment firms considered to be at risk of failing. The full scope of the directive and its impact on the Bank is currently unclear but the implementation of the directive or the taking of any action under it could materially affect the value of any Covered Bonds. aa) Iceland's national implementation of EEA rules may be inadequate in certain circumstances. <p>Risk factors relating to the Fund, including the ability of the Fund to fulfil its obligations in relation to the Covered Bond Guarantee</p> <ul style="list-style-type: none"> a) Finite resources available to the Fund to make payments due under the Covered Bond Guarantee <p>The Fund's ability to meet its obligations under the Covered Bond Guarantee will depend on: (i) the realisable value of Selected Loans and their Related Security in the Portfolio; (ii) the amount of Revenue Receipts generated by the Portfolio and the timing thereof; and (iii) the receipt by it of credit balances and interest on credit balances on the GIC Account. The Fund will not have any other source of funds available to meet its obligations under the Covered Bond Guarantee.</p> b) Maintenance of Portfolio <p>The Asset Coverage Test is met if the Adjusted Aggregate Loan Amount is equal to or exceeds the ISK Equivalent of the aggregate Principal Amount</p>
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		<p>Outstanding under the Covered Bonds from time to time. If the collateral value of the Portfolio has not been maintained in accordance with the terms of the Asset Coverage Test then that may affect the realisable value of the Portfolio or any part thereof (both before and after the occurrence of a Fund Event of Default) and/or the ability of the Fund to make payments under the Covered Bond Guarantee.</p> <p>c) Factors that may affect the realisable value of the Portfolio or any part thereof or the ability of the Fund to make payments under the Covered Bond Guarantee</p> <p>The realisable value of Selected Loans and their Related Security comprised in the Portfolio may be reduced (which may affect the ability of the Fund to make payments under the Covered Bond Guarantee) by:</p> <ul style="list-style-type: none"> a. no representations or warranties being given by the Fund or (unless otherwise agreed with the Seller) the Seller; b. default by Borrowers in payment of amounts due on their Loans; c. the Loans of New Sellers being included in the Portfolio d. changes to the lending criteria of the Seller or any New Seller; e. set off risks in relation to some types of Loans in the Portfolio; f. limited recourse to the Seller; and g. possible regulatory changes by regulatory authorities in Iceland.
D.3	<p>Key information on the key risks that are specific to the securities</p>	<p>Risk factors relating to the Covered Bonds</p> <p>a) The Issuer is liable to make payments when due on the Covered Bonds</p> <p>The Issuer is liable to make payments when due on the Covered Bonds. The obligations of the Issuer under the Covered Bonds are direct, unsecured, unconditional and unsubordinated obligations, ranking pari passu without any preference amongst themselves or the Covered Bonds and equally with its other direct, unsecured, unconditional and unsubordinated obligations (save for any obligations required to be preferred by law).</p> <p>The Fund has no obligation to pay the Guaranteed Amounts payable under the Covered Bond Guarantee until service of a Notice to Pay following service of an Issuer Acceleration Notice or a Fund Acceleration Notice following the occurrence of a Fund Event of Default.</p> <p>The occurrence of an Issuer Event of Default does not constitute a Fund Event of Default. However, failure by the Fund to pay amounts when Due for Payment under the Covered Bond Guarantee will constitute a Fund Event of Default.</p> <p>Following the occurrence of a Fund Event of Default, the Representative may accelerate the obligations of the Fund under the Covered Bond</p>

Guarantee by serving a Fund Acceleration Notice. Service of a Fund Acceleration Notice will also accelerate the obligations of the Issuer under the Covered Bonds (if they have not already become due and payable following service of an Issuer Acceleration Notice).

- b) The Fund only obliged to pay Guaranteed Amounts when the same are Due for Payment

Following service of a Notice to Pay (but prior to service of a Fund Acceleration Notice) the Fund will be obliged under the terms of the Covered Bond Guarantee to pay Guaranteed Amounts as and when the same are Due for Payment. In these circumstances the Fund will not be obliged to pay any other amounts which become payable for any other reason.

Payments by the Fund under the Covered Bond Guarantee will be made subject to any applicable withholding or deduction and the Fund will not be obliged to pay any additional amounts as a consequence. Prior to service on the Fund of a Fund Acceleration Notice, the Fund will not be obliged to make any payments in respect of broken funding indemnities, penalties, premiums, default interest or interest on interest which may accrue on or in respect of the Covered Bonds.

Subject to the applicable grace period in the Terms and Conditions, if (after service of a Notice to Pay) the Fund fails to make a payment when Due for Payment under the Covered Bond Guarantee or any other Fund Event of Default occurs, then the Representative may accelerate the obligations of the Fund under the Covered Bond Guarantee by service of a Fund Acceleration Notice, whereupon the Representative will have a claim under the Covered Bond Guarantee for an amount equal to the Early Redemption Amount of each Covered Bond, together with accrued interest and all other amounts then due under the Covered Bonds.

- c) Limited description of the Portfolio

Covered Bondholders will not receive detailed statistics or information in relation to the Loans in the Portfolio, because it is expected that the constitution of the Portfolio will frequently change due to, for instance:

- i. the Seller selling New Loans and their Related Security to the Fund;
- ii. the Seller repurchasing Loans and their Related Security from the Fund in accordance with the Mortgage Sale Agreement and the Fund Deed; and
- iii. New Sellers acceding to the Transaction Documents and selling and/or repurchasing New Seller Loans and their Related Security to or from the Fund. .

There is no assurance that the characteristics of the New Loans or New Seller Loans assigned to the Fund on any Assignment Date will be the same as those Loans in the Portfolio as at that Assignment Date. However, each Loan will be required to meet the Eligibility Criteria and the Representations and Warranties set out in the Mortgage Sale Agreement, see Summary of the Principal Documents – Mortgage Sale Agreement – Sale by the Seller of the Loans and Related Security (although the Eligibility Criteria and Representations and Warranties may change in certain circumstances, see

		<p>The Representative may agree to modifications to the Transaction Documents without the Covered Bondholders' prior consent below). In addition, the Asset Coverage Test is intended to ensure that the Adjusted Aggregate Loan Amount is an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds for so long as Covered Bonds remain outstanding (although there is no assurance that it will do so) and the Cash Manager will provide monthly reports that will set out certain information in relation to the Asset Coverage Test.</p> <p>d) Acceleration of Covered Bonds</p> <p>All of the Covered Bonds rank pari passu with each other and all Covered Bonds in all respects.</p> <p>Following the occurrence of an Issuer Event of Default and service by the Representative of an Issuer Acceleration Notice, the Covered Bonds of all outstanding Series will accelerate against the Issuer but will be subject to, and have the benefit of, payments made by the Fund under the Covered Bond Guarantee (following service of a Notice to Pay).</p> <p>Following the occurrence of a Fund Event of Default and service by the Representative of a Fund Acceleration Notice, the Covered Bonds of all Series outstanding will accelerate against the Issuer (if not already accelerated following service of an Issuer Acceleration Notice) and the obligations of the Fund under the Covered Bond Guarantee will accelerate.</p> <p>e) Obligations under the Covered Bonds</p> <p>The Covered Bonds do not represent an obligation or be the responsibility of the Dealer, the Representative or any other party to the Transaction Documents, their officers, members, directors, employees, security holders or incorporators, other than the Issuer and the Fund. The Issuer and the Fund will be liable solely in their corporate capacity for their obligations in respect of the Covered Bonds and such obligations will not be the obligations of their respective officers, members, directors, employees, security holders or incorporators.</p> <p>f) The Representative may agree to modifications to the Transaction Documents without the Covered Bondholders' prior consent</p> <p>Pursuant to the terms of the Representative and Agency Agreement, the Representative may, without the consent or sanction of any of the Covered Bondholders, concur with any person in making or sanctioning any modification to, or waive or authorise any breach or proposed breach in respect of, the Transaction Documents and the Terms and Conditions of the Covered Bonds:</p> <ul style="list-style-type: none"> i. provided that the Representative is of the opinion that such modification, waiver or authorisation will not be materially prejudicial to the interests of the holders of any Series of Covered Bonds; or ii. which is, in the sole opinion of the Representative, of a formal, minor or technical nature or is to correct a manifest error or an error which is, in the sole opinion of the Representative, proven, or is to comply with
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mandatory provisions of law.

Notwithstanding the above, the Issuer, the Fund and the Principal Paying Agent may, without the consent or sanction of the Representative or the Covered Bondholders, Receiptholders or Couponholders, concur with any person in making or sanctioning any modification to the provisions of any Pricing Terms which is of a formal, minor or technical nature or is made to correct a proven or manifest error or to comply with any mandatory provisions of law.

g) Certain decisions of Covered Bondholders

Any Extraordinary Resolution to direct the Representative to serve an Issuer Acceleration Notice following an Issuer Event of Default or to direct the Representative to serve a Fund Acceleration Notice following a Fund Event of Default and any direction to the Representative to take any enforcement action must be passed at a single meeting of the holders of Covered Bonds of all Series then outstanding.

h) Absence of secondary market

There is not, at present, an active and liquid secondary market for the Covered Bonds and there can be no assurance that a secondary market for the Covered Bonds will develop. Neither the Covered Bonds nor the Covered Bond Guarantee has been, or will be, registered under the Securities Act or any other applicable securities laws and are subject to certain restrictions on the resale and other transfer thereof as set forth under "*Distribution*". If a secondary market does develop it may not continue for the life of the Covered Bonds or it may not provide Covered Bondholders with liquidity of investment with the result that a Covered Bondholder may not be able to find a buyer to buy its Covered Bonds readily or at prices that will enable the Covered Bondholder to realise a desired yield.

i) Exchange of the Covered Bonds for Covered Bonds issued in compliance with Act on Covered Bonds No. 11/2008

The Terms and Conditions of the Covered Bonds permit the Issuer to exchange, without the consent of the Representative or the Covered Bondholders, any existing Covered Bonds then outstanding for new Covered Bonds issued in compliance with Act on Covered Bonds No. 11/2008. Any such new Covered Bonds will qualify as covered bonds under the legislation, rules, regulations or guidelines and will be in identical form, amounts and denominations and will be subject to the same economic terms and conditions as the existing Covered Bonds then outstanding.

j) Covered Bonds not in physical form

Unless the Global Covered Bonds are exchanged for Definitive Covered Bonds, which exchange will only occur in the limited circumstances set out under Form of the Covered Bonds below, the beneficial ownership of the Covered Bonds will be recorded in book entry form only with Euroclear and Clearstream, Luxembourg. The fact that the Covered Bonds are not represented in physical form could, among other things:

- i. result in payment delays on the Covered Bonds because distributions on the Covered Bonds will be sent by, or on behalf of, the Issuer to

		<p>Euroclear or Clearstream, Luxembourg instead of directly to Covered Bondholders;</p> <ul style="list-style-type: none"> ii. make it difficult for Covered Bondholders to pledge the Covered Bonds as security if Covered Bonds in physical form are required or necessary for such purposes; and iii. hinder the ability of Covered Bondholders to resell the Covered Bonds because some investors may be unwilling to buy Covered Bonds that are not in physical form. <p>k) Ranking of Covered Bonds</p> <p>The Covered Bonds issued rank <i>pari passu</i> with each other in all respects. The Covered Bonds rank <i>pari passu</i> with all Covered Bonds that have been issued from time to time in all respects.</p> <p>l) Covered Bondholder Meetings</p> <p>Provisions regarding meetings of Covered Bondholders permit defined majorities to bind all Covered Bondholders including Covered Bondholders who did not attend and vote at the relevant meeting and Covered Bondholders who voted in a manner contrary to the majority. As a result, Covered Bondholders can be bound by the result of a vote they voted against.</p> <p>m) Change of law</p> <p>The Terms and Conditions of the Covered Bonds are governed by Icelandic law in effect as at the date of this Prospectus. No assurance can be given as to the impact of any possible judicial decision or change to Icelandic law or administrative practice after the date of this Prospectus.</p> <p>n) Reliance on Euroclear and Clearstream, Luxembourg procedures</p> <p>The Covered Bonds are represented by one or more Global Covered Bonds that may be deposited with a common depository for Euroclear S.A./N.V. and Clearstream Banking, société anonyme. While the Covered Bonds are represented by Global Covered Bonds, investors will be able to trade their beneficial interests only through the relevant clearing systems and their respective participants. While the Covered Bonds are represented by Global Covered Bonds, the Issuer will discharge its payment obligation under the Covered Bonds by making payments through the relevant clearing systems. The Issuer has no responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in any Global Covered Bond. Holders of beneficial interests in a Global Covered Bonds will not have a direct right to vote in respect of the Covered Bonds so represented.</p> <p>o) The secondary market generally</p> <p>Although the Covered Bonds will be admitted to trading on the regulated market of the NASDAQ OMX Iceland, an established market may never develop. If a market does develop, it may not be very liquid. Additionally, the market places concerned may be closed, or temporary restrictions may be imposed. Therefore, investors may not be able to sell their Covered Bonds easily or at prices that will provide them with a yield comparable to similar</p>
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		<p>investments that have a developed secondary market. This is particularly the case for Covered Bonds that are especially sensitive to interest rate, currency or market risks, are designed for specific investment objectives or strategies or have been structured to meet the investment requirements of limited categories of investors. These types of Covered Bonds generally would have a more limited secondary market and more price volatility than conventional debt securities. Illiquidity may have a severely adverse effect on the market value of Covered Bonds.</p> <p>p) Lack of liquidity in the secondary market may adversely affect the market value of the Covered Bonds</p> <p>Generally weak global credit market conditions could contribute to a lack of liquidity in the secondary market for instruments similar to the Covered Bond. In addition, the difficult market conditions which have prevailed since mid September 2008 have limited the primary market for a number of financial products including instruments similar to the Covered Bonds. While some measures have been taken by governments, there can be no assurance that the market for securities similar to the Covered Bonds will recover at the same time or to the same degree as such other recovering global credit market sectors.</p> <p>q) Exchange rate risks and exchange controls</p> <p>The Issuer will pay principal and interest on the Covered Bonds in the Specified Currency. Subject to currency restrictions in place at each time, this presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit other than the Specified Currency. Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.</p>
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Section E — Offer		
E.2b	Reasons for the offer	Not applicable: there is no offer of securities to the public.
E.3	Terms and conditions of the offer Price range Offer period Amendments to the term of the offering Offer price	<p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p>

	<p>Delivery and settlement</p> <p>Over-allotment / stabilization and greenshoe option</p> <p>Admission to and commencement of trading.</p> <p>Underwriters</p>	<p>made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p> <p>An application has been made for the Covered Bonds to be admitted to listing and trading on the regulated market of the NASDAQ OMX Iceland hf. only.</p> <p>Not applicable as no offer of the Bonds to the public is being or will be made.</p>
E.4	Material interests	Not applicable.
E.7	Estimated expenses charged to investor	Not applicable: there are no commissions, fees or expenses to be charged to investors by the Company.

RISK FACTORS

Each of the Issuer and the Fund believes that the following factors may affect its ability to fulfil its obligations under the Covered Bonds. Most of these factors are contingencies which may or may not occur and neither the Issuer nor the Fund is in a position to express a view on the likelihood of any such contingency occurring.

In addition, factors which are material for the purpose of assessing the market risks associated with the Covered Bonds are also described below.

Each of the Issuer and the Fund believes that the factors described below represent the principal risks inherent in investing in the Covered Bonds, but the inability of the Issuer or the Fund to pay interest, principal or other amounts on or in connection with any Covered Bonds may occur for other reasons which may not be considered significant risk by the Issuer or the Fund based on information currently available to them or which they may not currently be able to anticipate. Prospective investors should also read the detailed information set out elsewhere in this Prospectus and reach their own views prior to making any investment decision.

This section of the Prospectus is divided into three main sections: Risk Factors relating to the Issuer, Risk Factors relating to the Fund and Risk Factors relating to the Covered Bonds

RISK FACTORS RELATING TO THE ISSUER, INCLUDING THE ABILITY OF THE ISSUER TO FULFIL ITS OBLIGATIONS UNDER THE COVERED BONDS

The Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and, although GDP growth returned in 2011, 2012 and 2013, Iceland's economy remains vulnerable to a range of internal risks and external shocks

Iceland's economy entered into a severe recession in the fourth quarter of 2008, with gross domestic product (GDP) falling by 6.6 per cent. in 2009 and by 4.1 per cent. in 2010, in each case relative to the year before. The recession followed a period of high growth of Iceland's economy that began in 2003 and was characterised by enhanced access to credit at lower interest rates, which resulted in rising real estate prices and a sharp expansion of private consumption. GDP grew at an annual rate of over 7 per cent. in each of 2004 and 2005. The economic growth became increasingly imbalanced, however, as the mounting debt of households, rising real estate prices and expansion of private consumption in turn fuelled inflationary pressures and a widening deficit.

Early in October 2008, Iceland's economy experienced a serious banking crisis when nearly nine-tenths of Iceland's banking system collapsed. The three large commercial banks, Glitnir Bank hf. (**Glitnir**), Landsbanki Íslands hf. (**Landsbanki**) and Kaupthing Bank hf. (**Kaupthing**), were taken into special resolution regimes on the basis of emergency legislation passed by Parliament. This collapse accelerated the prevailing recessionary forces, as did the international contraction in world trade and economic activity in the last months of 2008 and the first half of 2009.

To restore confidence and stabilise the economy, a joint economic programme was developed in November 2008 (the **Joint Economic Programme**) by the Icelandic government, the Icelandic Central Bank (the **Central Bank**) and the International Monetary Fund (the **IMF**) under a two year Stand-By Arrangement that was subsequently extended until 31 August 2011. The Stand-By Arrangement included a loan of approximately U.S.\$2.1 billion and was accompanied by bilateral loan commitments from European neighbours and other loan commitments and standing facilities aggregating approximately U.S.\$3 billion. The Joint Economic Programme was successfully concluded in August 2011.

Although Iceland's economy has shown some signs of recovery since 2011, with GDP growth of 2.9 per cent. in 2011, 1.6 per cent. in 2012 and 3.3 per cent. in 2013, it is too early to predict whether or not

there will be a sustained and stable recovery because of the difficulties in resolving the problems arising out of the financial crisis and sustaining the economic recovery process.

Iceland's economy is also vulnerable to a range of risks affecting the banking system (see "*Iceland's banking sector is in the process of being restructured and remains subject to considerable risks. Should any of these risks materialise the Bank could be materially and adversely affected, either directly or by association should the risks primarily materialise in relation to other Icelandic banks*") as well as risks relating to a range of domestic and external factors discussed below.

The domestic factors that could undermine or reverse Iceland's recent economic recovery include:

- *Removal of capital controls:* As a result of the financial crisis in 2008, the Central Bank introduced capital controls in November 2008 which are now in the process of being gradually relaxed in accordance with the capital controls liberalisation strategy established in March 2011. In March 2013, the Icelandic parliament repealed the original deadline for the removal of capital controls and there is currently no set date for their removal. Removing the restrictions on capital flows imposed by the capital control regime too rapidly would likely result in rapid and severe depreciation of the krona, resulting in increased inflation and strain on borrowers in Iceland as well as disruption to the Icelandic economy and financial system, resulting in depressed consumption, foreign direct investment and employment levels. For example, should current capital controls be lifted without the appropriate safeguards in place, funding of Iceland's commercial banks could be adversely affected by the rapid withdrawal of krona demand deposits by customers, particularly non-resident holders of krona, who are currently prevented from doing so by the capital control regime, but who would be able to withdraw their krona funds at will if these restrictions were lifted. If the capital control regime is terminated too quickly, or in a manner which fails to protect the Icelandic economy from the negative impact of its removal, there will be negative consequences for the government's fiscal position, the stability and recovery of Iceland's financial sector, and the Icelandic economy as a whole.
- *Lack of foreign direct investment:* Even if gradual liberalisation of the capital control regime is successful, there can be no assurance that additional foreign direct investment in Iceland will materialise when capital controls are removed. Should there be insufficient foreign direct investment in Iceland following removal of the capital controls, Iceland's fiscal and balance of payments deficits could worsen.
- *Other factors:* Other factors also pose significant risks to Iceland's economic and fiscal position. For example, as a result of slower than expected economic growth, lower than projected tax revenue, high labour costs and other factors, Iceland missed its budget targets in 2010, 2011, 2012 and 2013. Whilst inflation currently remains within the Central Bank's target rate, because of concerns of an output gap over the next two years the Central Bank's inflation outlook for this period is that the rate of inflation could rise. As a result of these other factors, including the high level of corporate and household debt, the ongoing restructuring of the financial sector including the winding up of the failed banks, and levels of consumption or foreign direct investment, Iceland's economy risks a return to recession, either on its own or in tandem with the economies of its largest trading partner, the European Union.

Iceland's economy remains vulnerable to external factors, including conditions in Europe and other international economic and political developments, many of which are outside the control of the government. In particular, instability or deterioration of the international financial markets and the European sovereign debt crisis could have a material adverse effect on the recovery of Iceland's economy. Although the financial sector in Iceland is subject to capital controls and is mostly funded by domestic deposits, a global recession is likely to affect demand for, and the price of, Iceland's most important exports (being fish products and aluminium) and adversely impact its receipts from tourism (which is also an important element of its economy).

Should Iceland's economy be adversely affected by domestic factors or external shocks, whether as a result of any of the above factors or for other reasons, this could adversely affect the ability of the Bank's customers to repay their loans (many of which have already been restructured) which in turn could have a material adverse affect on the Bank's business, financial conditions, results of operations, cash flows and prospects, and its ability to make payments in respect of the Covered Bonds.

Iceland's banking sector is in the process of being restructured and remains subject to considerable risks. Should any of these risks materialise the Bank could be materially and adversely affected, either directly or by association should the risks primarily materialise in relation to other Icelandic banks

Following the collapse of Glitnir, Landsbanki and Kaupthing (the **Old Banks**), the Icelandic Financial Supervisory Authority (the **FME**) transferred certain of their assets and liabilities (including the domestic deposits) into three new banks, Islandsbanki, Landsbankinn and Arion, respectively (the **New Banks**), that were established in October 2008. The Icelandic banking sector is dominated by the New Banks but also includes other commercial banks and savings banks. The New Banks currently have limited access to the international financial markets and have so far engaged in only limited new lending, primarily domestic lending in krona. The vast majority of the New Banks' funding comes from deposits by customers and it may be difficult for these banks to diversify their funding in the near future. Since October 2008, the government has maintained a policy that deposits in banks domiciled in Iceland are guaranteed by the State but this guarantee may be withdrawn at any time, which may adversely affect the availability of deposits and therefore have a negative impact on the business and assets of Icelandic banks. Moreover, as current capital controls are lifted, funding of Icelandic banks could be adversely affected by the withdrawal of deposits by customers who are currently unable to do so due to such capital controls. The government has stated its intention to manage the exchange controls with a view to mitigating the risk of capital flight from such customers. However, there is no guarantee that the central bank will be able to halt capital flight as controls are lifted. In addition, the ability of the central bank to manage the controls may be affected by the need for foreign investment to spur economic growth. If the capital control regime is terminated too quickly, or in a manner which fails to protect the Icelandic financial sector from the negative impact of its removal, Icelandic banks would suffer a material adverse effect.

Further, the growth of foreign currency transactions by Icelandic banks is expected to be limited by continued capital controls, which may continue to be in place for some time as there is no set date for their removal. Even though a large amount of Icelandic banks' assets are denominated in foreign currencies, the banks do not have access to foreign funding or exchange rate hedging to the same degree as before and may continue to experience difficulty in protecting the value of their portfolios.

Uncertainty about the quality of the loan assets held by the New Banks and the continued high levels of problem loans on their balance sheets is a major risk to the business, financial condition, performance and prospects of Icelandic banks. Iceland's New Banks are capitalised with pre-crisis domestic loans extended by the failed banks, many of which are being restructured and many of which may be unrecoverable. During the period from 2003 through 2007, the Old Banks maintained liberal lending policies, and Icelandic households and businesses took on a large amount of debt, of which a large proportion was denominated in, or indexed to the value of, a foreign currency. Prior to October 2008, the Old Banks lent extensively in foreign currency. As a result, a large portion of the assets of the New Banks consist of foreign currency loans to businesses and individuals in Iceland that were made before the financial crisis. As a result of the pre-crisis lending practices of the Old Banks, these borrowers were highly indebted before the crisis, and the subsequent collapse of the krona raised their foreign loan balances sharply. In many cases, these borrowers lack sources of foreign currency income or assets to service their borrowings. The depreciation of the krona and the resulting changes in operating conditions have caused these borrowers financial and operating difficulties. Many borrowers have negotiated deferred payments or have had their loans frozen temporarily, many others are in need of balance sheet restructuring and defaults have escalated. In the current economic climate, it is exceptionally difficult to determine both borrowers' actual capacity to pay and the value of loan collateral. Uncertainty about the quality of the loan book also reflects legal risk regarding loans linked to foreign currencies, especially

with respect to commercial loans indexed to a foreign currency, and various adverse Supreme Court judgments in relation to such loans have resulted in significant impairments being taken by Icelandic banks. As a result, loan recovery is unusually uncertain, in terms of both the amount recoverable and whether loans will be repaid on time.

Levels of problem loans, determination of loan values and the levels of write-offs will depend, in the medium term, on general economic developments and on the operating and financial condition of the particular borrowers, as well as decisions by the Icelandic Supreme Court affecting the value of foreign exchange indexed loans. Worldwide financial and economic developments, and particularly financial and economic developments in the United Kingdom and the other European countries that constitute Iceland's main trading partner countries, will also have an effect. If the assets of one or more of the New Banks turn out to be inadequate to sustain the relevant bank's capital adequacy ratios, capital contributions from the State will likely be necessary to restore their financial condition. Any such rescue could be costly for the State and would represent a major setback for the growth and international acceptance of the new Icelandic banking system.

Iceland's savings banks, which represent a smaller share of the banking system than the commercial banks, have also experienced distress. The total assets of the savings bank system amounted to ISK 56 billion as of 30 June 2013 compared to ISK 627 billion as of 31 December 2007. The biggest factor in this decline was the collapse of Reykjavik Savings Bank (**SPRON**), the largest of the savings banks, which was taken over by the FME in March 2009. **SPRON**'s deposits were subsequently transferred to the Bank, and a bond was issued to the Bank to back up those deposits, secured by the estate of **SPRON** and by a State indemnity. Overall, the savings banks have made substantial write-offs due to falling securities prices and anticipated loan losses.

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 bond from 2009. The bond was paid in full 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 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 2013. 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.

Iceland's new banking system is small and the New Banks have limited opportunities for growth in the near term. Given the existing leverage of Icelandic households and businesses and continuing lack of economic growth, the New Banks are not expected to grow significantly through domestic lending in the near term. It is also unlikely that the New Banks will grow through international operations in the near future. The New Banks have begun to re-establish credit lines with foreign institutions which is beginning to give them access to foreign currency transactions, but on a limited scale. They are unlikely to be able to engage in such transactions to any meaningful degree until capital controls are completely removed, which may not happen for a considerable time as there is no set date for the removal of capital controls. If Iceland's banking system does not increase in size and in the strength of its assets and business, or if some or all of the New Banks should collapse, Iceland's economy could be vulnerable to renewed disruptions, cessation or reversal of growth and a deepening recession. The New Banks could also be adversely affected if other developments in the Icelandic economy or in world affairs result in further slowing of growth in Iceland's economy or trigger a deepening recession.

In addition, the guarantee by the Icelandic Government of deposits in domestic commercial and savings banks that has been in place since October 2008 has never been enacted into Law by the Icelandic Parliament, and the basis of this guarantee is an announcement from the Prime Minister's Office of 6 October 2008 stating that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered. This announcement has since been repeated by subsequent Governments

and the European Free Trade Association Surveillance Authority has not objected to the guarantee under the European Economic Area (EEA) State Aid rules to date. It is assumed that the blanket guarantee will be gradually lifted when the banking market both domestic and foreign has stabilised. However, a sudden lifting of the guarantee, with or without regulatory intervention, could have an impact on deposit holders and the outflow of deposits held by Arion.

The estates of Glitnir, Landsbanki and Kaupthing have not reached any form of composition and these banks have not been formally declared bankrupt. As a result, there have been limited payments of funds from the estates to creditors. A significant share of the bankruptcy estates assets are in Icelandic krona, primarily in the form of shares in the New Banks. At this point, it is unclear what will happen to those shares in the New Banks when they are distributed to creditors of Glitnir, Landsbanki and Kaupthing. Such process, and any significant sales of the shares by creditors, could materially adversely impact the share price and market capitalisation of each of the New Banks.

The occurrence of any the factors described above could seriously undermine Iceland's economy and confidence in the banking system in Iceland and could have a material adverse effect on the Bank's business, financial conditions, results of operations, cash flows and prospects, and its ability to make payments in respect of the Covered Bonds.

Existing currency restrictions – Icelandic rules on foreign exchange

On 28 November 2008, the Icelandic Parliament passed Act no. 134/2008 (the **Amending Act**) on Amendments to the Act on Foreign Exchange no 87/1992, as amended (the **Foreign Exchange Act**) granting the Icelandic Central Bank powers to intervene in the currency-market with the view of stabilising the foreign exchange rate of the Icelandic krona. For this purpose, the Central Bank issued new Rules on Foreign Exchange no 1082 of 28 November 2008 (the **Foreign Exchange Rules**). The Foreign Exchange Rules were codified with the adoption of Act no 127/2011 in 2011 amending the Foreign Exchange Act. The Foreign Exchange Act has since been amended four times, once in March 2012, twice in March 2013 and again in May 2014. The general regime on currency restrictions is set out in Article 13 of the Foreign Exchange Act.

The Foreign Exchange Rules as codified with certain minor amendments effectively prohibit the outflow of foreign currency from Iceland except in the case of a payment for goods or services. Therefore, all financial transactions leading to currency outflow are prohibited unless explicitly permitted. More specifically these rules include provisions prohibiting certain transactions, including lending and borrowing between resident and non-resident parties, as well as currency-derivatives of any kind and the acquisition by domestic parties of financial instruments denominated in foreign currency. Furthermore, these rules make it compulsory for Icelanders and Icelandic companies to "repatriate" all of their foreign currency.

The Foreign Exchange Act provides for several general exceptions. Commercial banks are provided with a general exemption from certain provisions of the Foreign Exchange Act and consequently the capital controls. Accordingly, commercial banks, savings banks and credit institutions operating under a FME licence are exempt from restrictions on borrowing and lending between national and foreign parties, the restriction on assuming liability for payments between national and foreign parties, and the requirement to repatriate all foreign currency.

In addition to the general exemptions, the Foreign Exchange Act provides for specific exemptions from the restrictions under this legislation, subject to the Central Bank's approval. An application of any such exemptions must be made to the Central Bank and this process can take around 8 weeks.

Subject to the preceding paragraph, the payment by the Bank of interest on the relevant Interest Payment Date and of principal on the relevant Maturity Date will, therefore, be exempt from the restrictions of the Foreign Exchange Act under the general exemption. However, it is not clear whether the general

exemption covers prepayments and, therefore, whether it covers the payment of an Early Redemption Amount or an Optional Redemption Amount under the Covered Bonds.

Accordingly, the Bank has separately obtained a specific exemption from the Foreign Exchange Act set out in the Central Bank's letter dated 10 April 2014 which confirms that, subject to the preceding paragraph of this risk factor, the payment of an Early Redemption Amount or an Optional Redemption Amount under the Covered Bonds will be exempt from the Foreign Exchange Act. The amendments made in March 2012 by Act no 17/2012 imposed further restrictions on the outflow of foreign currency. This involved two amendments to the capital controls regime, among others, in response to a perceived increase in circumvention of the currency controls. Before these amendments, an investor could change its interests in the principal amortisation and indexation payments under a Consumer Price Index (**CPI**) indexed annuity bond into foreign currency and transfer such payments out of the economy. This legislation removed the previous exemption provided for such payments and these are now subject to the general capital controls regime, meaning that only interest payments remain within the exemption. Furthermore, the wide exemptions for payments by the winding-up committees of the failed Icelandic banks to creditors were removed and are now subject to the Central Bank's approval.

Two additional amendments were made to the Foreign Exchange Act in March 2013. Firstly on 9 March, Act No 16/2013 was adopted, implementing certain changes to the currency control regime, including the removal of the expiration date from the Foreign Exchange Act. Moreover these amendments imposed limits on the exemptions which the Central Bank can apply and the extent to which these may now be subject to prior consultation with the relevant ministry. These limits primarily relate to financial institutions or legal entities under the control of the FME through winding up proceedings or legal entities with a balance sheet exceeding ISK 400bn and where the transaction may have a substantial effect on the debt position of the economy or regards ownership of a commercial bank. Secondly, on 26 March 2013 further amendments were adopted with Act No. 35/2013, primarily relating to general exemptions and enhanced authorisations for the Central Bank. These amendments enhanced the Central Bank's surveillance of foreign exchange, including in relation to payments of interest, indexation, dividends and contractual maturities. The Central Bank also received authorisation to collect certain information, which may extend to any relevant third party, and to impose fines. In May 2014 the Foreign Exchange Act was amended once more. The term Interests was clarified and a clause regarding the criminal liability of legal entities was inserted into the Act.

On 25 March 2011, the Central Bank of Iceland announced a new strategy for the gradual removal of remaining capital controls in phases, each of which is subject to conditions. The three conditions for lifting of controls include: macroeconomic stability, an adequate level of foreign reserves and a sound financial system.

The above currency controls constitute protective measures under Article 44 of the EEA Agreement (the **EEA Agreement**) and have as such been notified to the European Free Trade Association (the **EFTA**) Standing Committee under the procedures provided for in Protocol 18 of the EEA Agreement as well as Protocol 2 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (the **Surveillance and Court Agreement**). Following a referral by the District Court of Reykjavík, the Court of Justice of the European Free Trade Association States (the **EFTA Court**) issued a reasoned opinion on 14 December 2011, whereby the EFTA Court ruled that it had competence under these currency controls and the Surveillance and Court Agreement to review such currency controls, inter alia, in light of the general principle of proportionality. The Court further declared that at the time in question these currency controls were proportionate. However, this ruling of the EFTA Court does not preclude further scrutiny of the above currency controls by the relevant EEA institutions at any time.

In light of this, prospective investors must consider the risk of further changes to the above currency controls and the impact this may have on an investment in the Covered Bonds.

The Bank has a number of significant exposures and its loan portfolio contains a high level of impaired loans and would be materially adversely affected should a customer to which it has a large exposure default or if the level of impairment in its loan portfolio were to increase

The Bank was established as the successor to Kaupthing following its take over by the FME at the end of 2008. Following the establishment of the Bank, a portfolio of assets and liabilities was transferred to the Bank. These assets and liabilities resulted in significant foreign exchange, interest rate and liquidity mismatches. In addition, the serious recession in Iceland in 2009 and 2010 resulted in a significant increase in problem loans and poor asset quality.

The valuation of assets that were transferred to the Bank from Kaupthing attempted to account for all realised and foreseen losses and this has significantly reduced the credit risk that would otherwise have been present in the Bank's loan portfolio. However, the Bank is still exposed to credit risk in its loan portfolio as a result of these transfers relating to the accuracy of the transfer valuation performance of the loans and the extent to which the Bank is successful in restructuring problem loans. The Bank also has credit concentrations transferred in a few significant customers and certain business sectors.

In accordance with applicable Icelandic regulations, a large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10 per cent. of a bank's capital base net of eligible collateral. The legal maximum for individual large exposures is 25 per cent. of a bank's risk capital and the sum of all large exposures cannot exceed 400 per cent. of a bank's risk capital. The loans which were transferred from Kaupthing to the Bank include loans which have led to high counterparty concentration for the Bank. In particular, as at 30 June 2014, the Bank had five large exposures (as defined by Icelandic regulation) with a gross exposure in excess of 10 per cent. of its capital base. Should any of the customers to which the Bank has a large exposure default, this would have a material adverse effect on the Bank's business, financial conditions, results of operations, cash flows and prospects, and its ability to make payments in respect of the Covered Bonds.

At 30 June 2014, 5.4 per cent. of the Bank's customer loans (the **customer loan portfolio**) were classified as problem loans, furthermore at 31 December 2013, 6.3 per cent. of the Bank's customer loans were classified as problem loans. 1.9 per cent. of this figure relates to loans to individuals which the Bank acquired in relation to the settlement of Drómi Bond (see note 21 to the Financial Statements 2013). As at 30 June 2014, the Bank's provisions on its customer loan portfolio amounted to 4.1 per cent. of the total gross amount of the portfolio and 6.7 per cent. of the aggregate amount of customer loans outstanding had been wholly or partially impaired. At 30 June 2014, the value of collateral that the Bank holds relating to loans individually determined to be impaired amounted to ISK 19.8 billion, or 44.5 per cent., of the aggregate amount of such loans.

As at 30 June 2014, the aggregate amount of the Bank's 10 largest customer loans equalled 15 per cent. of its total gross customer loans at that date. The Bank's loan portfolio is also highly concentrated in Icelandic borrowers.

The Bank has developed a number of solutions to assist customers that are experiencing payment difficulties. The recovery strategy is based on identifying clusters of similar customers, such as small to medium sized enterprises (SMEs) and individuals, and implementing standardised solutions for those customers. In the case of larger companies, the solutions are tailored to the circumstances of each company. Although significant progress has been made in restructuring the debts of the Bank's largest corporate customers, considerable work remains in relation to the restructuring of the debts of SMEs and individuals, especially in the case of customers with foreign currency loans that have been the subject of court cases. The goal of the corporate restructuring process is to create companies with a healthy capital structure, no covenant breaches, satisfactory operating results and motivated management teams and owners, although no assurance can be given as to the extent to which this can be achieved or that the Bank will not be forced to put a significant number of corporate customers into liquidation, thereby experiencing material losses.

Should a customer to which the Bank has a large exposure default or if the outcome of the restructuring process is that a greater number of loans prove to be non-recoverable in whole or in part than originally anticipated, the Bank's business, financial conditions, results of operations, cash flows and prospects, and its ability to make payments in respect of the Covered Bonds, would be materially adversely affected.

The Bank has a high proportion of inflation-linked mortgage loans and there is a risk that legislation might be imposed which varies the terms of these loans in a manner that is adverse to the Bank

A high proportion of the Bank's mortgage loans are inflation-linked. Under these loans, the monthly repayment increases if and to the extent that inflation in Iceland increases. Following the financial crisis in 2008, inflation in Iceland increased significantly. This resulted in higher payments falling due under inflation-linked loans at the same time as borrowers faced lower wages and less purchasing power. In November 2013, the government of Iceland announced an action plan aimed at reducing the payment burden under inflation-linked mortgages. The government intends to finance this action plan through a levy (see "*Changes in tax laws or in their interpretation could harm the Bank's business*" cf. page 39) but should this levy need to be increased or new levies or taxes introduced which affect the Bank then this may have a materially negative impact on the Bank's loan portfolio, financial condition and results of operations. The implementation of this action plan will involve the government effectively paying down such inflation-linked mortgage loans on behalf of borrowers, which is to be funded by an increase in the annual levy imposed on certain financial institutions, including the Bank. (See "*Changes in tax laws or in their interpretation could harm the Bank's business*" cf. page 39).

If the action plan is unsuccessful in reducing the payment burden of borrowers under such inflation-linked mortgage loans, further measures would be taken to reduce this burden.

The Bank is exposed to significant liquidity risk. In particular, the Bank's funding is dominated by deposits and a significant amount of these are on demand. The Bank is also limited in its ability to seek alternative sources of funding

The Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of its loans exceeds the maturity of its deposits, the majority of which are on demand deposits.

The Bank's total deposit base was ISK 474 billion at 30 June 2014. The Bank's other funding at 30 June 2014 was in the form of long-term debt and subordinated debt (ISK 200 billion and ISK 31 billion, respectively, at 30 June 2014) and Shareholders equity (ISK 150 billion at 30 June 2014). As at 30 June 2014, around 64.0 per cent. of the Bank's deposits were on demand, 22.0 per cent. had a maturity of up to three months, 8.4 per cent. had a maturity of between three and 12 months, 4.9 per cent. had a maturity of between one and five years and 0.6 per cent. had a maturity of more than five years.

On 1 December 2013, new liquidity rules issued by the Central Bank of Iceland took effect, overriding rules on liquidity and cash ratios that had 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. These standards specify the Liquidity Coverage Ratio (LCR), which is the balance between highly liquid assets and the expected net cash outflow of the Group in the following 30 day period under stressed conditions.

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorisation 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 Depositors' and Investors' Guarantee Fund, which is a fund set up in Iceland pursuant to the provisions of Act No. 98/1999 and which guarantees a minimum level of protection to depositors in commercial banks and savings banks, and to customers of companies engaging in securities trading pursuant to law. Other

deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions.

According to the LCR classification, 56.0 per cent of the Bank's deposits at 30 June 2014 are categorised as "less stable" while deposits classified as "stable" or "term deposits" represent 7.7 and 36.3 per cent, respectively of all deposits. Deposits from financial entities being wound up represent 17.4 per cent. of total deposits and deposits from pension funds and domestic financial entities represent 11.9 and 8.5 per cent, respectively, of total deposits.

The Bank's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Bank's liquidity reserve. The Bank has made significant progress in converting its on demand deposits to term deposits. At 31 December 2009, over 90 per cent. of the Bank's deposits were on demand compared to 64.0 per cent. at 30 June 2014. However, no assurance can be given that the Bank will continue to be successful in so converting its base deposits or will otherwise be able to increase the maturity profile of its funding.

The Bank's non-deposit funding principally comprises covered bond issues (including covered bonds previously issued by Kaupthing and assured by the Bank in January 2012), a limited number of other loans (including two subordinated loans from the Icelandic state, a loan from the Central Bank and a senior unsecured bond offering denominated in Norwegian krone (NOK)) and equity funding.

For so long as the Bank is unable to match more closely the maturity profiles of its assets and liabilities, the Bank will continue to be exposed to a material risk that it may be unable to repay its funding or will only be able to do so at excessive cost. The Bank is also exposed to the risk that it experiences a material loss of its least stable deposits in the future. In either of these cases, the Bank's business, financial conditions, results of operations, cash flows and prospects and its ability to make payments in respect of the Covered Bonds would be materially adversely affected.

The Bank is exposed to significant foreign exchange risk through a currency mismatch between its assets and liabilities and through legal uncertainties relating to certain foreign currency loans

The Bank is primarily exposed to currency risk through a currency mismatch between its assets and liabilities, given that it has a greater proportion of foreign currency denominated assets on its balance sheet than foreign currency denominated liabilities.

The Bank's strategy for reducing its currency imbalance is first to seek to convert into ISK foreign currency denominated loans to customers who have ISK income and second to hedge its other currency imbalances, principally through agreements with the Central Bank and other counterparties. Notwithstanding the foregoing, for so long as the Bank is unable to match more closely the currencies of its assets and liabilities, the Bank will continue to be exposed to a material risk that it may experience significant losses as a result of changes in currency exchange rates.

Currently, the legitimacy of certain types of loans remains unclear. By a series of judgments since 2010, the Icelandic Supreme Court has held that certain types of foreign currency-linked loans and lease agreements with SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. As a result, these loans were held to be in breach of applicable Icelandic legislation relating to interest and price indexation. Following these judgments, the Bank recalculated approximately 2,000 retail and corporate foreign currency indexed ISK loans as ISK denominated loans.

During 2012, further Supreme Court cases were determined (including cases to which the Bank was party) as a result of which, in November 2012, the Bank decided to recalculate additional foreign currency-linked loans. After consideration of such judgements, the Bank has provisioned a total amount of ISK 22.2 billion of which ISK 18.3 billion have been written-off since 2011. The Bank remains party to court cases relating to such loans, see "*Description of the Bank—Litigation*".

The recalculation of foreign currency-linked loans has adversely affected the Bank's results of operations and financial position in 2011, 2012 and 2013. There remains uncertainty regarding these loans in three respects:

- estimation uncertainty in relation to the types of loan covered by the Supreme Court judgments and with respect to the assumptions used in the method of recalculation of recalculated loans;
- there are differing views as to the rate of interest that should be paid with respect to recalculated loans from the date of their recalculation; and
- there may be future cases or new legislation in respect of other categories of loan not currently considered to be vulnerable by the Bank.

Reflecting this uncertainty, there is no assurance that the Bank will not make further material impairment provisions in respect of its customer loans during 2014 and future years. Any such provisions could materially adversely affect the Bank's results of operations and financial condition, and therefore impact its ability to make payments in respect of the Covered Bonds.

The Bank is exposed to a range of other typical market risks, including interest rate risk, equity price risk and inflation risk

The Bank's exposure to market risk arises from imbalances in the Bank's balance sheet as well as in market making activities and position taking in certain securities traded by it. The Bank's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances in the Bank's balance sheet but to accept limited market risk in its trading book. The market risk in the trading book arises from proprietary trading activities whereas market risk in the banking book arises from mismatches in assets and liabilities principally in relation to currencies, maturities and interest rates. The Bank principally trades Icelandic treasury notes and housing fund bonds and, to a limited extent, listed equity securities. The Bank has implemented a number of position limits and other controls designed to limit its trading book exposure but no assurance can be given that these controls will be effective in all circumstances. The Bank is exposed to the risk that these controls do not prove to be effective in all circumstances and that the Bank could therefore experience material losses on its trading book. In addition, to the extent that these securities are marked to market, the Bank could experience significant fluctuations in its consolidated income statement as a result of movements in the market value of these securities.

In relation to its balance sheet, the Bank's operations are subject to interest rate risk associated with mismatches between its interest bearing assets and its interest bearing liabilities. The principal mismatch is the large maturity gap resulting from the fact that the Bank has significant on demand liabilities. The Bank also faces interest rate risk between its interest bearing assets and interest bearing liabilities due to different floating rate calculations in different currencies. The Bank's own account equity price risk principally arises as a result of the fact that, through the loan restructuring process, it has acquired significant shareholdings in troubled companies. The Bank is exposed to inflation risk when there is a mismatch between its inflation-linked assets and liabilities. As at 30 June 2014, the total amount of the Bank's inflation-linked assets was ISK 295.3 billion and the total amount of its inflation-linked liabilities was ISK 218 billion. The Bank also has significant maturity mismatches in its inflation-linked assets and liabilities. Whilst the Bank has implemented a range of risk management procedures designed to control these risks, no assurance can be given that these controls will be effective in all circumstances. The Bank is exposed to the risk that these controls do not prove to be effective in all circumstances and that the Bank could therefore experience material losses.

Any losses experienced by the Bank as a result of its market risk exposures could materially adversely affect the Bank's business, financial conditions, results of operations, cash flows and prospects and its ability to make payments in respect of the Listed Covered Bonds.

While the Bank seeks to manage its operational risks, these risks remain an inherent part of its business

The operational risks that the Bank faces include the possibility of inadequate or failed internal or external processes or systems failures, human error, regulatory breaches, employee misconduct or external events such as fraud. The Bank's business inherently generates operational risks. The business is dependent on processing numerous complex transactions. The recording and processing of these transactions are potentially exposed to the risk of human and technological errors or a breakdown in internal controls relating to the due authorisation of transactions. Given the volume of transactions processed by the Bank, errors may be repeated or compounded before they are discovered and rectified, and there can be no assurance that risk assessments made in advance will adequately estimate the costs of these errors.

The Bank has implemented controls designed to mitigate operational risks but these controls cannot eliminate such risks and failures in internal control could subject the Bank to regulatory scrutiny. These events could potentially result in financial loss as well as harm to the Bank's reputation.

The Bank's risk management methods may leave it exposed to unidentified, unanticipated or incorrectly quantified risks, which could lead to material losses or material increases in liabilities

The Bank's risk management strategies may fail under certain circumstances, particularly when confronted with risks that have not been identified or anticipated. Risk methodologies and techniques that the Bank adopts to assess credit risk, market risk, liquidity risk and operational risk may be flawed or may not take all risks into account, and it is possible that the methods for assessing these risks are not sound or are based on faulty information, or that they will be misunderstood, not implemented correctly or misapplied by the Bank's personnel. In addition, the Bank's risk management policies are constantly being re-evaluated and there may be a lag in implementation. Furthermore, some of the Bank's qualitative tools and metrics for managing risk are based upon the use of observed historical market behaviour. The Bank may apply statistical and other tools to these observations to arrive at quantifications of risk exposures. These tools and metrics may fail to predict future risk exposures.

The Bank's losses thus could be significantly greater than its risk management measures would indicate. In addition, the Bank's quantified modelling does not take all risks into account. The Bank's more qualitative approach to managing risks takes into account a broader set of risks, but is less precise than quantified modelling and could prove insufficient. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Bank's business, financial condition and results of operations, and its ability to make payments in respect of the Covered Bonds.

The Bank is exposed to competition, principally from other large Icelandic banks, and expects that this competition will increase as Iceland's economy recovers

The Bank currently faces competition from the two other large commercial banks in Iceland, Landsbankinn and Islandsbanki. The Bank also faces competition domestically from the Housing Financing Fund, a provider of financing for residential housing in Iceland (see "*Financial Markets in Iceland – Other relevant institutions*"). As Iceland's economy recovers and demand for new lending and other banking products increases, the Bank expects to face increased competition from both the other large Icelandic banks and smaller specialised institutions as well as, potentially, foreign banks seeking to establish operations in Iceland.

The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation and price. If the Bank is unable to compete effectively in the future in any market in which it has a significant presence, this could adversely affect its business, results of operations and prospects.

The Bank is exposed to the risk of failure of its information technology (IT) systems and breaches of its security systems

The Bank relies on the proper functioning and continuity of its IT systems. Any significant interruption, degradation, failure or lack of capacity of its IT systems or any other systems in its clearing operations or elsewhere could cause it to fail to complete transactions on a timely basis or at all. A sustained failure of the Bank's IT systems centrally or across its branches would have a significant impact on its operations and the confidence of its customers in the reliability and safety of its banking systems.

The secure transmission of confidential information is a critical element of the Bank's operations. The Bank cannot guarantee that its existing security measures will prevent security breaches, including break-ins, viruses and disruptions. Persons that circumvent the security measures could use the Bank's or its clients' confidential information wrongfully, which could expose it to a risk of loss, adverse regulatory consequences or litigation.

There are regulatory and legal risks inherent in the Bank's businesses

The Bank's operations entail considerable regulatory and legal risk, including litigation and liability risk. The Bank and certain of its subsidiaries are subject to government regulation and supervision as financial companies in Iceland, and regulations may be extensive and may change rapidly, as they have done since the global financial crisis. In addition, certain of the Bank's and its subsidiaries' operations are contingent upon licences issued by financial authorities.

Violations of rules and regulations, whether intentional or unintentional, may lead to the withdrawal of some of these licences or to liability claims. Any breach of these or other regulations may adversely affect the Bank's reputation or financial condition, results of operations and prospects. In addition, existing laws and regulations could be amended, the manner in which laws and regulations are enforced or interpreted could change and new laws or regulations could be adopted, which could adversely affect the way the Bank operates its business and its market reputation.

The Bank is also exposed to legal risks in its role as a financial intermediary and consultant to third party businesses. These risks include potential liability for the Bank's role in determining the price of a company and for advice the Bank provides to participants in corporate transactions and in disputes over the terms and conditions of trading arrangements. The Bank also faces the possibility that counterparties in trading transactions will claim that the Bank failed to properly inform them of the associated risks or that they were not authorised or permitted to enter into these transactions with the Bank and that their obligations are therefore not enforceable. The Bank is also exposed to customer claims, including significant claims in relation to loans advanced by its predecessor, Kaupthing. See "*The Bank is involved as defendant in ongoing litigation which, if determined adversely to the Bank, could result in significant losses. In addition, the Bank is a plaintiff in a case which, if not successful, could have a material adverse effect on the Bank's results of operations*".

The Bank may also be subject to claims arising from disputes with employees for, among other things, alleged illegal dismissal, discrimination or harassment. These risks may often be difficult to assess or quantify and their existence and magnitude often remain unknown for substantial periods of time. Liability resulting from any of the foregoing or other claims could have a material adverse effect on the Bank's business, financial condition and results of operations, and its ability to make payments in respect of the Covered Bonds.

Legal risks

The Bank's business operations are governed by law and regulations and are subject to authority supervision. Any changes to the current legislation might affect the Bank's business operations and its operating results. Furthermore, competition and other factors might also affect the Bank's business.

The Bank is involved as defendant in ongoing litigation which, if determined adversely to the Bank, could result in significant losses. In addition, the Bank is a plaintiff in a case which, if not successful, could have a material adverse effect on the Bank's results of operations

The bank is involved as defendant in a number of cases, including:

- cases concerning the legality of foreign currency-linked loans owed to the Bank; and
- competition claims by the Icelandic Competition Authority (ICA), see "*The Bank is subject to investigations by the ICA in relation to alleged abuse of a dominant position and any determination that the Bank has violated the law could result in fines or business restrictions*".

Should any of the cases described above be determined adversely to the Bank, this could have a material adverse effect on its results of operations and financial condition, and therefore impact its ability to make payments in respect of the Covered Bonds. See "*Description of the Bank – Litigation*".

The Bank is subject to investigations by the ICA in relation to alleged abuse of a dominant position and any determination that the Bank has violated the law could result in fines or business restrictions

The ICA has opened the following formal investigations concerning the Bank:

- an investigation into the alleged abuse of an alleged collective dominant position by the three major banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf., MP banki hf. and an insurance company 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 insurance company's complaint concerns the banks' alleged tying of banking services and insurances; and
- an investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Bank, following a complaint by Kortathjónustan, a credit card payment acquirer, in 2009.

The Bank has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Bank, although if the Bank is found to have violated the law it could be subject to fines or future restrictions on its business activities, either of which could materially adversely affect its results of operations, financial condition and reputation.

Changes in tax laws or in their interpretation could harm the Bank's business

The Bank's results of operations could be harmed by changes in tax laws and tax treaties or the interpretation thereof, changes in corporate tax rates and the refusal of tax authorities to issue or extend advanced tax rulings. The unavailability of tax rulings could diminish the range of structured transactions the Bank can enter into with its clients.

In December 2010, the Icelandic Parliament passed a new law (Act No. 155/2010) under which certain types of financial institution, including the Bank, are required to pay an annual levy calculated at 0.041 per cent. of the carrying amount of their liabilities as determined for tax purposes, with effect from the year ending 31 December 2010. In December 2011, a transitional provision was introduced under which financial institutions, including the Bank, must pay an additional 0.0875 per cent. of their tax base as assessed for the years 2012 and 2013. In late 2013, this levy was further increased in order to finance a government plan on household debt relief in relation to inflation-linked mortgage loans (see "*The Bank has a high proportion of inflation-linked mortgage loans and there is a risk that legislation might be imposed which varies the terms of these loans in a manner that is adverse to the Bank*", cf. page 33). The levy for the year 2013 was 0.376 per cent. on the total debt of the Bank excluding tax liabilities in excess of ISK 50 billion at end of the year. Non-financial subsidiaries are exempt from this tax. For the year

2012 this levy was 0.1285 per cent. on the total debt of the Bank excluding tax liabilities. There can be no assurance that this levy may not be increased further in the future, including in the event the 2013 increase in the levy is insufficient to meet the costs of the above government plan on household debt relief or such relief does not result in a sufficient reduction in the payment burden for the borrowers concerned and any such increase could have a material adverse effect on the financial condition of the Bank.

In June 2009, the Icelandic Parliament adopted an amendment to the income tax law as a result of which payments of Icelandic sourced interest by an Icelandic debtor (such as the Bank) to a foreign creditor (including holders of Bonds who are not Icelandic) is taxable in Iceland and can be subject to withholding tax at the rate of 10 per cent. This withholding is applicable unless the foreign creditor can demonstrate and obtain approval from the Icelandic Inland Revenue that an exemption applies, such as the existence of a relevant double taxation treaty (and in such a case the provisions of the double tax treaty will apply). Also exempt are bonds issued by certain financial institutions (including the Bank) and energy companies. Subject to certain other requirements, the exemption applies to bonds that are held through a clearing system (such as the Icelandic Securities Depository, Euroclear and Clearstream, Luxembourg) within a member state of the Organisation for Economic Co-operation and Development (the **OECD**), the EEA, a founding member state of European Free Trade Association or the Faroe Islands.

In December 2011, the Icelandic Parliament passed a new law (Act no. 165/2011) under which certain types of financial institution, including the Bank, were required to pay a special additional 5.45 per cent. tax levied on all remuneration paid to employees, with effect from 1 January 2012. This levy was subsequently raised to 6.7 per cent. but has since been lowered and as of 1 January 2014 the levy is set at 5.5 per cent of such remuneration.

Changes to the Capital Requirements Directive could adversely affect the Bank's results

The new international regulatory framework for banks, Basel III, has been developed and includes requirements regarding regulatory capital, liquidity, leverage ratio and counterparty credit risk measurements. In December 2010, the Basel Committee issued the first version of the Basel III framework and a revised version was issued in June 2012. On 26 June 2013, the European parliament and Council adopted a legislative package (known as **CRD IV**) for the implementation of the Basel III framework in the European Union and to strengthen the regulation of the banking sector. CRD IV replaces the current Capital Requirements Directives (2006/48/EC and 2006/49/EC) with a Directive (2013/36/EU) (the **CRD IV Directive**) and a Regulation ((EU) No. 575/2013) (**CRR**). The global implementation plan of the framework extends throughout 2018. The Ministry of Industries and Innovation has formed a committee to implement CRD IV in Iceland. The timeframe for the implementation has not yet been published.

The introduction of new rules in Iceland reflecting CRD IV could limit the Bank's ability to effectively manage its capital requirements. These and other changes to capital adequacy and liquidity requirements imposed on the Bank may require the Bank to raise additional tier 1, core tier 1 and tier 2 capital by way of further issuances of securities and could result in existing tier 1 and tier 2 securities ceasing to count towards the Bank's regulatory capital, either at the same level as at present or at all. Any failure by the Bank to maintain any increased regulatory capital requirements or to comply with any other requirements introduced by regulators could result in intervention by regulators or the imposition of sanctions, which may have a material adverse effect on the Bank's financial condition and results of operations and may also have other effects on the Bank's financial performance and on the pricing of the Covered Bonds, both with or without the intervention by regulators or the imposition of sanctions. Prospective investors in the Covered Bonds should consult their own advisers as to the consequences of the implementation of CRD IV in Iceland.

Catastrophic events, terrorist attacks and other acts of war could have a negative impact on the Bank's business

Catastrophic events, terrorist attacks, other acts of war or hostility, and responses to those acts may create economic and political uncertainties, which could have a negative impact on economic conditions in Iceland and, more specifically, on the Bank's business, financial condition, results of operations, cash flows and prospects, in ways that cannot be predicted.

The Bank may be unable to recruit or retain experienced and qualified personnel and is dependent on key members of management

The Bank's future success depends, in part, on its ability to attract, retain and motivate qualified and experienced banking and management personnel. Competition for personnel with relevant expertise is significant, due to the relatively small number of available qualified individuals. The geographical location of employment in Iceland may also make employment by the Bank less attractive to a large portion of potential applicants.

The loss of the services of key members of the Bank's senior management or staff with institutional and client knowledge may significantly delay the Bank's achievement of its business objectives and could have a material adverse effect on its business and prospects.

The Bank's insurance coverage may not adequately cover all losses

The Bank maintains customary insurance policies for its operations, including insurance for its liquid assets, money transport and directors' and officers' liability, as well as insurance against computer crimes and for employee dishonesty and mistakes. Due to the nature of the Bank's operations and the nature of the risks that it faces, there can be no assurance that the coverage that the Bank maintains is adequate to cover the losses for which it believes it is insured.

The Bank's accounting policies and methods are critical to how it reports its financial condition and results of operations. They require management to make estimates about matters that are uncertain.

Accounting policies and methods are fundamental to how the Bank records and reports its financial condition and results of operations. Management must exercise judgment in selecting and applying many of these accounting policies and methods so they comply with IFRS.

Management has identified certain accounting policies in the Covered Bonds to its financial statements as being critical because they require management's judgement to ascertain the valuations of assets, liabilities, commitments and contingencies. See note 2 to the Financial Statements.

A variety of factors could affect the ultimate value that is obtained either when earning income, recognising an expense, recovering an asset or reducing a liability. The Bank has established detailed policies and control procedures that are intended to ensure that these critical accounting estimates and judgements are well controlled and applied consistently. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. Because of the uncertainty surrounding the Bank's judgements and the estimates pertaining to these matters, the Bank cannot guarantee that it will not be required to make changes in accounting estimates or restate prior period financial statements in the future.

Abnormal pricing as a consequence of capital controls

The currency controls described in "*Existing currency restrictions – Icelandic rules on foreign exchange*", cf. page 31, mean that domestic parties, primarily investors, are prohibited from transferring their funds and investing outside of the Icelandic market. Consequently they are confined to and must focus their investments on Iceland, which entails various risks, including a risk for abnormal pricing and financial bubbles occurring within several sectors of the Icelandic market. This applies both to

investments in shares of listed and un-listed companies, investment funds, various other financial instruments, and real-estate (primarily commercial) and may have a negative impact on the Bank's business.

The claims of Covered Bondholders will be subordinated to the claims of certain of the Bank's depositors in the event of a winding-up

The claims of holders of senior ranking unsecured debt instruments, such as the Covered Bonds, issued by a financial institution such as the Bank which holds bank deposits are subordinated to Article 101 of the Act on Financial Undertakings to the claims of certain depositors. Should the Bank therefore enter into winding-up proceedings pursuant, the claims of Covered Bondholders would be subordinated to the claims of such depositors and there may not be sufficient assets in the resulting estate to pay the claims of Covered Bondholders after the claims of those depositors have been paid.

Credit risks relating to the Bank's collateral

Given that the Bank's loans are granted with mortgages on residential real estate as collateral, the credit risk is driven in part by performance of the real estate and housing market in Iceland. There can be no assurance regarding the future development of the value of this collateral. Should the prices of real property and the housing market substantially decline, this could adversely affect the Bank's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

There are many circumstances that affect the level of credit loss, including early repayments, withdrawals and final payments of interest and principal amounts, such as changes in the economic climate, both nationally and internationally, changes regarding taxation, interest rate developments, inflation and political changes. Borrowers may default as a result of interest rate increases or as a result in changes in their own personal circumstances (for example, following redundancy or divorce).

Default in respect of a material amount of the Bank's assets could jeopardise the Bank's ability to make payments in full or on a timely basis on the Covered Bonds. If a material amount of assets in the Cover Pool were to default, there is no guarantee that the required level of assets within the Cover Pool could be maintained or that the Issuer would be able to substitute non-defaulting assets for the defaulting assets. Any such failure could adversely affect the Issuer's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

The Council of the European Union has published revised proposals for a bank recovery and resolution directive which is intended to enable a range of actions to be taken in relation to credit institutions and investment firms considered to be at risk of failing. The full scope of the directive and its impact on the Bank is currently unclear but the implementation of the directive or the taking of any action under it could materially affect the value of any Listed Covered Bonds.

On 18 December 2013, the Council of the European Union published a revised draft of a directive providing for the establishment of an EU-wide framework for the recovery and resolution of credit institutions and investment firms (the **RRD**). Iceland, Liechtenstein, Norway and Switzerland are members of the EFTA and Iceland, together with Liechtenstein and Norway (the **EEA EFTA States**) is also a party to the EEA Agreement by which the EEA EFTA States participate in the internal market of the European Union (the **EU**). On 27 November 2013, the EFTA Working Group on Financial Services stated that "it would appear that [the proposal represented by the June 2012 draft of the RRD] may be deemed EEA relevant and thus likely to be incorporated into the EEA Agreement once adopted by the EU side." The draft RRD is designed to provide authorities with a credible set of tools to intervene sufficiently early and quickly in an unsound or failing institution so as to ensure the continuity of the institution's critical financial and economic functions, while minimising the impact of an institution's failure on the economy and financial system.

The draft RRD currently contains four resolution tools and powers which may be used alone or in combination where an institution is considered as failing or likely to fail: (i) sale of business - which enables resolution authorities to direct the sale of the firm or the whole or part of its business on commercial terms; (ii) bridge institution - which enables resolution authorities to transfer all or part of the business of the firm to a "bridge institution" (an entity created for this purpose that is wholly or partially in public control); (iii) asset separation - which enables resolution authorities to transfer impaired or problem assets to a bridge institution or one or more asset management vehicles to allow them to be managed with a view to maximising their value through eventual sale or orderly wind-down; and (iv) bail-in - which gives resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert unsecured debt claims to equity (subject to certain parameters as to which liabilities would be eligible for the bail-in tool).

An institution will be considered as failing or likely to fail when: it is, or is likely in the near future to be, in breach of its requirements for continuing authorisation; when its assets are, or are likely in the near future to be, less than its liabilities; when it is, or is likely in the near future to be, unable to pay its debts as they fall due; or when it requires extraordinary public financial support (except in limited circumstances).

The draft RRD currently contemplates that it will be applied by Member States from 1 January 2015 except for the bail-in tool which is to be applied from 1 January 2016.

The powers currently set out in the draft RRD would impact how credit institutions and investment firms are managed as well as, in certain circumstances, the rights of creditors. However, the proposed directive is not in final form and changes may be made to it in the course of the legislative process. Accordingly, it is not yet possible to assess the full impact of the draft RRD on the Bank and there can be no assurance that, if implemented in Iceland, the fact of its implementation or the taking of any actions currently contemplated in it would not adversely affect the rights of Covered Bondholders, the price or value of their investment in the Covered Bonds and/or the ability of the Bank to satisfy its obligations under the Listed Covered Bonds.

Iceland's national implementation of EEA rules may be inadequate in certain circumstances

Iceland is obligated to implement certain EU instruments with EEA relevance, including legislation relating to financial markets, as a member state of the EEA. Where implementation of such instruments into Icelandic law is inadequate, i.e. Iceland has failed to adapt national law to conform to EEA rules, citizens may be unable to rely on them and the Icelandic courts barred from applying them (unless Icelandic legislation may be interpreted to conform with the relevant EEA rules). As a result Covered Bondholders may not, in all circumstances, enjoy the same legal protection they would expect as holders of securities issued by issuers in EU member states where EU instruments are directly applicable or have been adequately implemented into national legislation.

RISK FACTORS RELATING TO THE FUND, INCLUDING THE ABILITY OF THE FUND TO FULFIL ITS OBLIGATIONS IN RELATION TO THE COVERED BOND GUARANTEE

Finite resources available to the Fund to make payments due under the Covered Bond Guarantee

The Fund's ability to meet its obligations under the Covered Bond Guarantee will depend on: (i) the realisable value of Selected Loans and their Related Security in the Portfolio; (ii) the amount of Revenue Receipts generated by the Portfolio and the timing thereof; and (iii) the receipt by it of credit balances and interest on credit balances on the GIC Account. The Fund will not have any other source of funds available to meet its obligations under the Covered Bond Guarantee.

Covered Bondholders should note that the Asset Coverage Test has been structured to ensure that the Adjusted Aggregate Loan Amount is equal to or greater than the ISK Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds for so long as Covered Bonds remain outstanding,

which should reduce the risk of there being a shortfall (although there is no assurance of this), see *Summary of the Principal Documents – Fund Deed – Asset Coverage Test*.

Maintenance of Portfolio

The Asset Coverage Test is met if the Adjusted Aggregate Loan Amount is equal to or exceeds the ISK Equivalent of the aggregate Principal Amount Outstanding under the Covered Bonds from time to time. Pursuant to the terms of the Fund Deed, the Seller agreed to use all reasonable endeavours to transfer Loans and their Related Security or Substitution Assets to the Fund in order to ensure that the Portfolio is in compliance with the Asset Coverage Test. In consideration thereof, the Seller receives a combination of: (a) a cash payment made by the Fund; and/or (b) being treated as having made an Equity Contribution to the Fund (in an amount up to the difference between the Outstanding Principal Balance of the Loans sold by the Seller to the Fund as at the relevant Assignment Date and the cash payment (if any) made by the Fund for such Loans).

Alternatively, Arion Bank hf. (in its capacity as a Holder) may make a Cash Equity Contribution to the Fund pursuant to the Fund Deed in order to ensure that the Fund is in compliance with the Asset Coverage Test. If a breach of the Asset Coverage Test occurs on any Calculation Date and is not cured by the following Calculation Date, the Representative will serve an Asset Coverage Test Breach Notice on the Fund which (unless and until it is revoked) will result, *inter alia*, in the sale of Selected Loans, see further *Summary of the Principal Documents – Fund Deed – Sale of Selected Loans and their Related Security*. If an Asset Coverage Test Breach Notice has been served and not revoked on or before the second Calculation Date after service of such Asset Coverage Test Breach Notice, then an Issuer Event of Default shall occur and the Representative shall be entitled (and, in certain circumstances may be required) to serve an Issuer Acceleration Notice on the Issuer. Following service of an Issuer Acceleration Notice, the Representative must serve a Notice to Pay on the Fund. There is no specific recourse by the Fund to the Seller in respect of the failure to transfer Loans and their Related Security or Substitution Assets to the Fund nor is there any specific recourse to Arion Bank hf. if it does not make Cash Equity Contributions to the Fund.

If the collateral value of the Portfolio has not been maintained in accordance with the terms of the Asset Coverage Test then that may affect the realisable value of the Portfolio or any part thereof (both before and after the occurrence of a Fund Event of Default) and/or the ability of the Fund to make payments under the Covered Bond Guarantee.

Prior to service of a Notice to Pay or a Fund Acceleration Notice, the Asset Monitor will, subject to receipt of the relevant information from the Cash Manager, test the calculations performed by the Cash Manager in respect of the Asset Coverage Test every three months and more frequently in certain circumstances, see *Summary of the Principal Documents – Asset Monitor Agreement*.

The Representative shall not be responsible for monitoring compliance with, nor the monitoring of, the Asset Coverage Test or any other test, or supervising the performance by any other party of its obligations under any Transaction Document.

Factors that may affect the realisable value of the Portfolio or any part thereof or the ability of the Fund to make payments under the Covered Bond Guarantee

The realisable value of Selected Loans and their Related Security comprised in the Portfolio may be reduced (which may affect the ability of the Fund to make payments under the Covered Bond Guarantee) by:

- no representations or warranties being given by the Fund or (unless otherwise agreed with the Seller) the Seller;
- default by Borrowers in payment of amounts due on their Loans;

- the Loans of New Sellers being included in the Portfolio
- changes to the lending criteria of the Seller or any New Seller;
- set-off risks in relation to some types of Loans in the Portfolio;
- limited recourse to the Seller; and
- possible regulatory changes by regulatory authorities in Iceland.

Each of these factors is considered in more detail below. However, it should be noted that the Asset Coverage Test and the Eligibility Criteria are intended to ensure that there will be an adequate amount of Loans in the Portfolio and moneys standing to the credit of the GIC Account to enable the Fund to repay the Covered Bonds following service on the Fund of a Notice to Pay or a Fund Acceleration Notice and accordingly it is expected (but there is no assurance) that Selected Loans and their Related Security could be realised for sufficient value to enable the Fund to meet its obligations under the Covered Bond Guarantee.

Default by Borrowers in paying amounts due on their Loans

Borrowers may default on their obligations under the Loans in the Portfolio. Defaults may occur for a variety of reasons. The Loans are affected by credit, liquidity and interest rate risks. Various factors influence mortgage delinquency rates, prepayment rates, repossession frequency and the ultimate payment of interest and principal, such as changes in the national or international economic climate, regional economic or housing conditions, changes in tax laws, interest rates, inflation, the availability of financing, yields on alternative investments, political developments and government policies. Other factors in Borrowers' individual, personal or financial circumstances may affect the ability of Borrowers to repay the Loans. Loss of earnings, illness, divorce and other similar factors may lead to an increase in delinquencies by and bankruptcies of Borrowers, and could ultimately have an adverse impact on the ability of Borrowers to repay the Loans. In addition, the ability of a Borrower to sell a property given as security for a Loan at a price sufficient to repay the amounts outstanding under that Loan will depend upon a number of factors, including the availability of buyers for that property, the value of that property and property values in general at the time.

Any Defaulted Loans in the Portfolio will be given a reduced weighting for the purposes of any calculation of the Asset Coverage Test.

The Loans of New Sellers may be included in the Portfolio

New Sellers may in the future sell Loans and their Related Security to the Fund. However, this would only be permitted if the conditions precedent relating to New Sellers acceding to the relevant Transaction Documents (more fully described under *Summary of the Principal Documents – Mortgage Sale Agreement – New Sellers* below) are met. Provided that those conditions are met, the consent of Covered Bondholders to the accession of any New Seller to the relevant Transaction Documents will not need to be obtained.

Any loans originated by a New Seller will have been originated in accordance with the lending criteria of the New Seller which may differ from the Lending Criteria for Loans originated by the Seller. If the lending criteria differ in a way that affects the creditworthiness of the Loans in the Portfolio, that may lead to increased defaults by Borrowers and may affect the realisable value of the Portfolio or any part thereof or the ability of the Fund to make payments under the Covered Bond Guarantee. However, as noted above, Defaulted Loans will be given a reduced weighting for the purposes of the calculation of the Asset Coverage Test.

Changes to the Lending Criteria of the Seller

Each of the Loans originated by the Seller will have been originated in accordance with its Lending Criteria at the time of origination. It is expected that the Seller's Lending Criteria will generally consider type of property, term of loan, age of applicant, the loan-to-value ratio, status of applicants and credit history. In the event of the assignment or assignation of any Loans and their Related Security to the Fund, the Seller will warrant only that such Loans and Related Security were originated in accordance with its Lending Criteria applicable at the time of origination. The Seller retains the right to revise its Lending Criteria from time to time but would do so only to the extent that such a change would be acceptable to a Reasonable, Prudent Mortgage Lender. If the Lending Criteria change in a manner that affects the creditworthiness of the Loans, that may lead to increased defaults by Borrowers and may affect the realisable value of the Portfolio, or part thereof, and the ability of the Fund to make payments under the Covered Bond Guarantee. However, as noted above, Defaulted Loans will be given a reduced weighting for the purposes of the calculation of the Asset Coverage Test.

Set-off risks in relation to some types of Loans may adversely affect the value of the Portfolio or any part thereof

Once notice has been given to the Borrowers of the assignment or assignation (as appropriate) of the Loans and their Related Security to the Fund, independent set-off rights which a Borrower has against the Seller (such as, for example, set-off rights associated with Borrowers holding deposits with the Seller) will crystallise and further rights of independent set-off would cease to accrue from that date and no new rights of independent set-off could be asserted following that notice. Set-off rights arising under 'transaction set-off' (which are set-off claims arising out of a transaction connected with the Loan) will not be affected by that notice and will continue to exist. In relation to potential transaction set-off in respect of the Loans, see the following risk factor.

It should be noted however, that the Asset Coverage Test seeks to take account of the potential set-off risk associated with Borrowers holding deposits with the Seller (although there is no assurance that all such risks will be accounted for).

Sale of Selected Loans and their Related Security following service of an Asset Coverage Test Breach Notice or a Notice to Pay

If an Asset Coverage Test Breach Notice or a Notice to Pay is served on the Fund (and, in the case of an Asset Coverage Test Breach Notice, for as long as such notice has not been revoked), the Fund will be obliged to sell Selected Loans and their Related Security (selected on a random basis) in order to remedy a breach of the Asset Coverage Test or to make payments to the Fund's creditors, including payments under the Covered Bond Guarantee, as appropriate, see *Summary of the Principal Documents – Fund Deed – Sale of Selected Loans and their Related Security following service of an Asset Coverage Test Breach Notice and Summary of the Principal Documents – Fund Deed – Sale of Selected Loans and their Related Security following service of a Notice to Pay*.

No representations or warranties to be given by the Fund or the Seller if Selected Loans and their Related Security are to be sold

Following service of an Asset Coverage Test Breach Notice (which is not revoked) or a Notice to Pay, the Fund will be obliged to sell Selected Loans and their Related Security to third party purchasers, subject to a right of pre-emption in favour of the Seller pursuant to the terms of the Fund Deed, see *Summary of the Principal Documents – Fund Deed – Method of Sale of Selected Loans and their Related Security*. In respect of any sale of Selected Loans and their Related Security to third parties, however, the Fund will not be permitted to give representations and warranties or indemnities in respect of those Selected Loans and their Related Security. There is no assurance that the Seller would give any representations and warranties or indemnities in respect of the Selected Loans and their Related Security. Any Representations and Warranties previously given by the Seller in respect of the Loans in the

Portfolio may not have value for a third party purchaser if the Seller is then insolvent. Accordingly, there is a risk that the realisable value of the Selected Loans and their Related Security could be adversely affected by the lack of representations and warranties or indemnities which in turn could adversely affect the ability of the Fund to meet its obligations under the Covered Bond Guarantee.

Excess Proceeds received by the Representative

Following service of an Issuer Acceleration Notice, the Representative may receive Excess Proceeds. The Excess Proceeds will be paid by the Representative on behalf of the Covered Bondholders of the relevant Series to the Fund for its own account, as soon as practicable, and will be held by the Fund in the GIC Account. The Excess Proceeds will thereafter be used by the Fund in the same manner as all other moneys from time to time standing to the credit of the GIC Account. Any Excess Proceeds received by the Representative will discharge *pro tanto* the obligations of the Issuer in respect of the Covered Bonds, Receipts and Coupons (subject to restitution of the same if such Excess Proceeds shall be required to be repaid by the Representative or the Fund). However, the obligations of the Fund under the Covered Bond Guarantee are (subject only to service of a Notice to Pay or a Fund Acceleration Notice) unconditional and irrevocable and the receipt by the Representative of any Excess Proceeds will not reduce or discharge any such obligations.

Each of the Covered Bondholders of Covered Bonds has irrevocably directed the Representative to pay the Excess Proceeds to the Fund in the manner as described above.

Limited recourse to the Seller

The Fund and the Representative will not undertake any investigations, searches or other actions on any Loan or its Related Security and will rely instead on the Representations and Warranties given in the Mortgage Sale Agreement by the Seller in respect of the Loans sold by it to the Fund.

If any Loan sold by the Seller does not materially comply with any of the Representations and Warranties made by the Seller as at the Assignment Date of that Loan, then the Seller will be required to remedy the breach within 20 Business Days of receipt by it of a notice from the Fund requiring the Seller to remedy the breach.

If the Seller fails to remedy the breach of the relevant Representation and Warranty within such 20 Business Day period, then the Seller will be required to repurchase on or before the next following Calculation Date (or such other date that may be agreed between the Fund and the Seller) the relevant Loan and its Related Security and any other Loan secured or intended to be secured by that Related Security or any part of it at their Outstanding Principal Balance and all Arrears of Interest, Accrued Interest and amounts deducted from amounts outstanding under such Loan or Loans in accordance with the terms of the Mortgage Sale Agreement as of the date of repurchase.

There can be no assurance that the Seller will have the financial resources to repurchase a Loan or Loans and its or their Related Security. However, if the Seller does not repurchase those Loans and their Related Security which are in breach of the Representations and Warranties, then the Outstanding Principal Balance of those Loans will be excluded from the calculation of the Asset Coverage Test. There is no further recourse to the Seller in respect of a breach of a Representation or Warranty.

Reliance of the Fund on third parties

The Fund has entered into agreements with a number of third parties which have agreed to perform services for the Fund. In particular, but without limitation, the Servicer has been appointed to service Loans in the Portfolio, the Cash Manager has been appointed to calculate and monitor compliance with the Asset Coverage Test and to provide cash management services to the Fund and the GIC Provider has been appointed to receive and hold moneys on behalf of the Fund and to provide an agreed rate of interest thereon. In the event that any of those parties fails to perform its obligations under the relevant agreement to which it is a party, the realisable value of the Portfolio or any part thereof or pending such

realisation (if the Portfolio or any part thereof cannot be sold) the ability of the Fund to make payments under the Covered Bond Guarantee may be affected. For instance, if the Servicer has failed to adequately administer the Loans, this may lead to higher incidences of non payment or default by Borrowers.

If a Servicer Event of Default occurs pursuant to the terms of the Servicing and Custody Agreement, then the Fund will be entitled to terminate the appointment of the Servicer and appoint a new servicer in its place. There can be no assurance that a substitute servicer with sufficient experience of administering mortgages of residential properties would be found who would be willing and able to service the Loans in the Portfolio on the terms of the Servicing and Custody Agreement. The ability of a substitute servicer to perform fully the required services would depend on, among other things, the information, software and records available at the time of the appointment. Any delay or inability to appoint a substitute servicer may affect the realisable value of the Portfolio or any part thereof and/or the ability of the Fund to make payments under the Covered Bond Guarantee.

The Servicer has no obligation itself to advance payments that Borrowers fail to make in a timely fashion. The Servicer will not be required to seek the consent or approval of the Covered Bondholders before taking any action under the Servicing and Custody Agreement.

The Representative is not obliged in any circumstances to act as a servicer or to monitor the performance by the Servicer of its obligations.

Change of counterparties

The parties to the Transaction Documents who receive and hold moneys pursuant to the terms of such documents (such as the Account Banks) are required to satisfy certain criteria in order that they can continue to receive and hold moneys.

These criteria comprise requirements imposed by the Financial Supervisory Authority in Iceland and under the applicable Transaction Documents. If the party concerned ceases to satisfy the applicable criteria, then the rights and obligations of that party (including the right or obligation to receive moneys on behalf of the Fund) may be required to be transferred to another entity which does satisfy the applicable criteria. In these circumstances, the terms agreed with the replacement entity may not be as favourable as those agreed with the original party pursuant to the relevant Transaction Document.

In addition, should the applicable criteria cease to be satisfied, then the parties to the relevant Transaction Document may agree to amend or waive certain of the terms of such document, including the applicable criteria, in order to avoid the need for a replacement entity to be appointed. The consent of Covered Bondholders may not be required in relation to such amendments and/or waivers.

RISK FACTORS RELATING TO THE COVERED BONDS

The Issuer is liable to make payments when due on the Covered Bonds

The Issuer is liable to make payments when due on the Covered Bonds. The obligations of the Issuer under the Covered Bonds are direct, unsecured, unconditional and unsubordinated obligations, ranking *pari passu* without any preference amongst themselves or the Covered Bonds and equally with its other direct, unsecured, unconditional and unsubordinated obligations (save for any obligations required to be preferred by law).

The Fund has no obligation to pay the Guaranteed Amounts payable under the Covered Bond Guarantee until service of a Notice to Pay following service of an Issuer Acceleration Notice or a Fund Acceleration Notice following the occurrence of a Fund Event of Default.

The occurrence of an Issuer Event of Default does not constitute a Fund Event of Default. However, failure by the Fund to pay amounts when Due for Payment under the Covered Bond Guarantee will constitute a Fund Event of Default.

Following the occurrence of a Fund Event of Default, the Representative may accelerate the obligations of the Fund under the Covered Bond Guarantee by serving a Fund Acceleration Notice. Service of a Fund Acceleration Notice will also accelerate the obligations of the Issuer under the Covered Bonds (if they have not already become due and payable following service of an Issuer Acceleration Notice).

The Fund only obliged to pay Guaranteed Amounts when the same are Due for Payment

Following service of a Notice to Pay (but prior to service of a Fund Acceleration Notice) the Fund will be obliged under the terms of the Covered Bond Guarantee to pay Guaranteed Amounts as and when the same are Due for Payment. In these circumstances the Fund will not be obliged to pay any other amounts which become payable for any other reason.

Payments by the Fund under the Covered Bond Guarantee will be made subject to any applicable withholding or deduction and the Fund will not be obliged to pay any additional amounts as a consequence. Prior to service on the Fund of a Fund Acceleration Notice, the Fund will not be obliged to make any payments in respect of broken funding indemnities, penalties, premiums, default interest or interest on interest which may accrue on or in respect of the Covered Bonds.

Subject to the applicable grace period in the Terms and Conditions, if (after service of a Notice to Pay) the Fund fails to make a payment when Due for Payment under the Covered Bond Guarantee or any other Fund Event of Default occurs, then the Representative may accelerate the obligations of the Fund under the Covered Bond Guarantee by service of a Fund Acceleration Notice, whereupon the Representative will have a claim under the Covered Bond Guarantee for an amount equal to the Early Redemption Amount of each Covered Bond, together with accrued interest and all other amounts then due under the Covered Bonds.

Limited description of the Portfolio

Covered Bondholders will not receive detailed statistics or information in relation to the Loans in the Portfolio, because it is expected that the constitution of the Portfolio will frequently change due to, for instance:

- the Seller selling New Loans and their Related Security to the Fund;
- the Seller repurchasing Loans and their Related Security from the Fund in accordance with the Mortgage Sale Agreement and the Fund Deed; and
- New Sellers acceding to the Transaction Documents and selling and/or repurchasing New Seller Loans and their Related Security to or from the Fund. .

There is no assurance that the characteristics of the New Loans or New Seller Loans assigned to the Fund on any Assignment Date will be the same as those Loans in the Portfolio as at that Assignment Date. However, each Loan will be required to meet the Eligibility Criteria and the Representations and Warranties set out in the Mortgage Sale Agreement, see *Summary of the Principal Documents – Mortgage Sale Agreement – Sale by the Seller of the Loans and Related Security* (although the Eligibility Criteria and Representations and Warranties may change in certain circumstances, see *The Representative may agree to modifications to the Transaction Documents without the Covered Bondholders' prior consent* below). In addition, the Asset Coverage Test is intended to ensure that the Adjusted Aggregate Loan Amount is an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds for so long as Covered Bonds remain outstanding (although there is no assurance that it will do so) and the Cash Manager will provide monthly reports that will set out certain information in relation to the Asset Coverage Test.

Acceleration of Covered Bonds

All of the Covered Bonds rank *pari passu* with each other and all Covered Bonds in all respects.

Following the occurrence of an Issuer Event of Default and service by the Representative of an Issuer Acceleration Notice, the Covered Bonds of all outstanding Series will accelerate against the Issuer but will be subject to, and have the benefit of, payments made by the Fund under the Covered Bond Guarantee (following service of a Notice to Pay).

Following the occurrence of a Fund Event of Default and service by the Representative of a Fund Acceleration Notice, the Covered Bonds of all Series outstanding will accelerate against the Issuer (if not already accelerated following service of an Issuer Acceleration Notice) and the obligations of the Fund under the Covered Bond Guarantee will accelerate.

Obligations under the Covered Bonds

The Covered Bonds do not represent an obligation or be the responsibility of the Dealer, the Representative or any other party to the Transaction Documents, their officers, members, directors, employees, security holders or incorporators, other than the Issuer and the Fund. The Issuer and the Fund will be liable solely in their corporate capacity for their obligations in respect of the Covered Bonds and such obligations will not be the obligations of their respective officers, members, directors, employees, security holders or incorporators.

The Representative may agree to modifications to the Transaction Documents without the Covered Bondholders' prior consent

Pursuant to the terms of the Representative and Agency Agreement, the Representative may, without the consent or sanction of any of the Covered Bondholders, concur with any person in making or sanctioning any modification to, or waive or authorise any breach or proposed breach in respect of, the Transaction Documents and the Terms and Conditions of the Covered Bonds.

- provided that the Representative is of the opinion that such modification, waiver or authorisation will not be materially prejudicial to the interests of the holders of any Series of Covered Bonds; or
- which is, in the sole opinion of the Representative, of a formal, minor or technical nature or is to correct a manifest error or an error which is, in the sole opinion of the Representative, proven, or is to comply with mandatory provisions of law.

Notwithstanding the above, the Issuer, the Fund and the Principal Paying Agent may, without the consent or sanction of the Representative or the Covered Bondholders, Receiptholders or Couponholders, concur with any person in making or sanctioning any modification to the provisions of any Pricing Terms which is of a formal, minor or technical nature or is made to correct a proven or manifest error or to comply with any mandatory provisions of law.

Certain decisions of Covered Bondholders

Any Extraordinary Resolution to direct the Representative to serve an Issuer Acceleration Notice following an Issuer Event of Default or to direct the Representative to serve a Fund Acceleration Notice following a Fund Event of Default and any direction to the Representative to take any enforcement action must be passed at a single meeting of the holders of Covered Bonds of all Series then outstanding.

Absence of secondary market

There is not, at present, an active and liquid secondary market for the Covered Bonds and there can be no assurance that a secondary market for the Covered Bonds will develop. Neither the Covered Bonds nor the Covered Bond Guarantee has been, or will be, registered under the Securities Act or any other

applicable securities laws and are subject to certain restrictions on the resale and other transfer thereof as set forth under *Distribution*. If a secondary market does develop it may not continue for the life of the Covered Bonds or it may not provide Covered Bondholders with liquidity of investment with the result that a Covered Bondholder may not be able to find a buyer to buy its Covered Bonds readily or at prices that will enable the Covered Bondholder to realise a desired yield.

Exchange of the Covered Bonds for Covered Bonds issued in compliance with Act on Covered Bonds No. 11/2008

The Terms and Conditions of the Covered Bonds permit the Issuer to exchange, without the consent of the Representative or the Covered Bondholders, any existing Covered Bonds then outstanding for new Covered Bonds issued in compliance with Act on Covered Bonds No. 11/2008. Any such new Covered Bonds will qualify as covered bonds under the legislation, rules, regulations or guidelines and will be in identical form, amounts and denominations and will be subject to the same economic terms and conditions as the existing Covered Bonds then outstanding.

Covered Bonds not in physical form

Unless the Global Covered Bonds are exchanged for Definitive Covered Bonds, which exchange will only occur in the limited circumstances set out under *Form of the Covered Bonds* below, the beneficial ownership of the Covered Bonds will be recorded in book-entry form only with Euroclear and Clearstream, Luxembourg. The fact that the Covered Bonds are not represented in physical form could, among other things:

- result in payment delays on the Covered Bonds because distributions on the Covered Bonds will be sent by, or on behalf of, the Issuer to Euroclear or Clearstream, Luxembourg instead of directly to Covered Bondholders;
- make it difficult for Covered Bondholders to pledge the Covered Bonds as security if Covered Bonds in physical form are required or necessary for such purposes; and
- hinder the ability of Covered Bondholders to resell the Covered Bonds because some investors may be unwilling to buy Covered Bonds that are not in physical form.

Ranking of Covered Bonds

The Covered Bonds issued rank *pari passu* with each other in all respects. The Covered Bonds rank *pari passu* with all Covered Bonds that have been issued from time to time in all respects.

Covered Bondholder Meetings

The conditions of the Covered Bonds contain provisions for calling meetings of Covered Bondholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Covered Bondholders including Covered Bondholders who did not attend and vote at the relevant meeting and Covered Bondholders who voted in a manner contrary to the majority. As a result, Covered Bondholders can be bound by the result of a vote they voted against. Certain significant modifications may be made following approval of a quorum of one or more persons holding or representing not less than two-thirds in aggregate nominal amount of the Covered Bonds for the time being outstanding, including modifying the date of maturity of the Covered Bonds or any date for payment of interest thereof, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Covered Bonds or altering the currency of payment of the Covered Bonds.

Change of law

The Terms and Conditions of the Covered Bonds are governed by Icelandic law in effect as at the date of this Prospectus. No assurance can be given as to the impact of any possible judicial decision or change to Icelandic law or administrative practice after the date of this Prospectus.

Reliance on Euroclear and Clearstream, Luxembourg procedures

The Covered Bonds are represented by one or more Global Covered Bonds that may be deposited with a common depository for Euroclear S.A./N.V. (**Euroclear**) and Clearstream Banking, *société anonyme* (**Clearstream**). Except in the circumstances described in each Global Covered Bond, investors will not be entitled to receive Covered Bonds in definitive form. Each of Euroclear and Clearstream, Luxembourg and their respective direct and indirect participants maintain records of the beneficial interests in each Global Covered Bond held through it. While the Covered Bonds are represented by Global Covered Bonds, investors will be able to trade their beneficial interests only through the relevant clearing systems and their respective participants.

While the Covered Bonds are represented by Global Covered Bonds, the Issuer will discharge its payment obligation under the Covered Bonds by making payments through the relevant clearing systems. A holder of a beneficial interest in a Global Covered Bond must rely on the procedures of the relevant clearing system and its participants to receive payments under the Covered Bonds. The Issuer has no responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in any Global Covered Bond.

Holders of beneficial interests in a Global Covered Bonds will not have a direct right to vote in respect of the Covered Bonds so represented. Instead, such holders will be permitted to act only to the extent that they are enabled by the relevant clearing system and its participants to appoint appropriate proxies.

The secondary market generally

Although the Covered Bonds will be admitted to trading on the regulated market of the NASDAQ OMX Iceland, an established market may never develop. If a market does develop, it may not be very liquid. Additionally, the market places concerned may be closed, or temporary restrictions may be imposed. Therefore, investors may not be able to sell their Covered Bonds easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. This is particularly the case for Covered Bonds that are especially sensitive to interest rate, currency or market risks, are designed for specific investment objectives or strategies or have been structured to meet the investment requirements of limited categories of investors. These types of Covered Bonds generally would have a more limited secondary market and more price volatility than conventional debt securities. Illiquidity may have a severely adverse effect on the market value of Covered Bonds.

The Covered Bonds have not been, and will not be, registered under the Securities Act or any other applicable securities laws and they are subject to certain restrictions on the resale and other transfer thereof as set forth under *Distribution*.

Lack of liquidity in the secondary market may adversely affect the market value of the Covered Bonds

Generally weak global credit market conditions could contribute to a lack of liquidity in the secondary market for instruments similar to the Covered Bond. In addition, the difficult market conditions which have prevailed since mid-September 2008 have limited the primary market for a number of financial products including instruments similar to the Covered Bonds. While some measures have been taken by governments, there can be no assurance that the market for securities similar to the Covered Bonds will recover at the same time or to the same degree as such other recovering global credit market sectors.

Exchange rate risks and exchange controls

The Issuer will pay principal and interest on the Covered Bonds in the Specified Currency. Subject to currency restrictions in place at each time, this presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the **Investor's Currency**) other than the Specified Currency. These include the risk that exchange rates may significantly change (including changes due to devaluation of the Specified Currency or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to the Specified Currency would decrease: (1) the Investor's Currency-equivalent yield on the Covered Bonds; (2) the Investor's Currency-equivalent value of the principal payable on the Covered Bonds; and (3) the Investor's Currency-equivalent market value of the Covered Bonds.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.

STATEMENTS

Issuer's statement

CEO of Arion Bank hf. (in its capacity as Issuer), ID-number 581008-0150, registered office being Borgartun 19, 105 Reykjavik, Iceland, hereby declare that, having taken all reasonable care to ensure that such is the case, the information contained in the prospectus is, to the best of their knowledge in accordance with the facts and contains no omissions likely to affect its import.

Reykjavik, Iceland, 17 December 2014

On behalf of the Issuer

Höskuldur H. Ólafsson, ID-number 090259-5479

CEO of the Issuer

The Fund's statement

Flóki Halldórsson, the Managing Director of Stefmir hf., ID-number 700996-2479, registered office being Borgartun 19, 105 Reykjavik, Iceland, on behalf of the Fund, ID-No. 570106-9610, registered office being Borgartun 19, 105 Reykjavik, Iceland, hereby declares that, having taken all reasonable care to ensure that such is the case, the information contained in the prospectus is, to the best of its knowledge in accordance with the facts and contains no omissions likely to affect its import.

Reykjavik, Iceland, 17 December 2014

On behalf of the Fund

Flóki Halldórsson, ID-number 291273-4329

Managing Director of Stefmir hf.

Auditor's statement

Ernst & Young ehf., ID-number 520902-2010, registered office being Borgartún 30, 105 Reykjavik, Iceland, hereby declares that it has audited and expressed an opinion on the financial statements of the Issuer for the financial years ended 31 December 2012 and 2013 and reviewed the interim financial statements for the period ended 30 June 2014.

From the Independent Auditors Report on the Consolidated Financial Statements for the year ended 31 December 2012, issued on 28 February 2013.

"Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the financial position of the Group as at 31 December 2012, of its financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU".

From the Independent Auditors Report on the Consolidated Financial Statements for the year ended 31 December 2013, issued on 26 February 2014:

"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 financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU."

From the Review Report on the Interim Financial Statements for the period ended 30 June 2014, issued on 27 August 2014:

"Scope of review

We conducted our review in accordance with the International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity". A review of interim financial statements consists of

making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

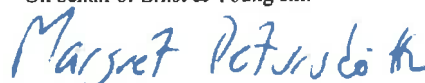
Based on our review, nothing has come to our attention that causes us to believe that the accompanying Interim Consolidated Financial Statements are not prepared, in all material respects, in accordance with IAS 34 "Interim Financial Reporting" as adopted by the EU."

Statement to the content of financial information presented in this Prospectus

On pages 8-10,15, 34-37,95, 100-101, 107-116, 120-122, 124-126,144 the prospectus contains selected financial information for the years ended 31 December 2012 and 2013 as well as information for the period ended 30 June 2014. We have read this information and compared the amounts to the relevant amounts shown in the audited consolidated financial statements for the years 2012 and 2013 and amounts shown in the reviewed 30 June 2014 interim financial statements. We confirm that the financial information amounts in question have been accurately extracted from the abovementioned audited and reviewed financial statements. We confirm that we have checked clerical and arithmetic accuracy of the percentages based on information in the audited and reviewed financial statements.

Reykjavik, Iceland, 17.12.2014

On behalf of Ernst & Young ehf.



Margrét Pétursdóttir, ID-number 010168-3769

Partner

DOCUMENTS INCORPORATED BY REFERENCE

The audited consolidated annual financial statements of the Issuer for each of the financial years ended 31 December 2012 and 31 December 2013 (including the audit reports issued in respect thereof) and the reviewed interim financial statements of the Issuer for the period ended 30 June 2014 and 30 June 2013 shall be deemed to be incorporated in, and to form part of, this Prospectus.

Consolidated Financial Statements for the year 2012:

<http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/2012/Arion%20Bank%20Consolidated%20Financial%20Statements%2031.12.2012.pdf>

Annual Report 2012:

<http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/Annual-Reports/Annual%20Report%202012.pdf>

Interim Consolidated Financial Statements 1 January – 30 June 2013:

<http://arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/2013/Arion%20Bank's%20Interim%20Consolidated%20Financial%20Statements%2030.06.2013.pdf>

Consolidated Financial Statements for the year 2013:

<http://arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/2013/Arion%20Bank%20Consolidated%20Financial%20Statements%2031.12.2013.pdf>

Annual Report 2013:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/2013/AnnualReport_LOW_samsett.pdf

Interim Consolidated Financial Statements 1 January – 30 June 2014:

<http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Financial-information/Financial-Statements/2014/Arion%20Bank%20Consolidated%20Interim%20Financial%20Statements%2030%20June%202014.pdf>

Copies of documents incorporated by reference in this Prospectus can be obtained from the registered office of the Issuer and are available at <http://www.arionbanki.is/english/about-us/investor-relations/debt-investors/>.

Asset Monitor Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Asset_Monitor_Agreement.pdf

Bank Account Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Bank_Account_Agreement.pdf

Cash Management Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Cash_Management_Agreement.pdf

Deed of Waiver Substitution Amendment and Restatement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Deed_of_Waiver_Substitution_Amendment_and_Restatement.pdf

Fund Deed:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Fund_Deed.pdf

Guaranteed Investment Contract:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Guaranteed_Investment_Contract.pdf

Intercompany Loan Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Intercompany_Loan_Agreement.pdf

Master Definitions Reformatted:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Master_Definitions_Reformatted.pdf

Mortgage Sale Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Mortgage_Sale_Agreement.pdf

Representative and Agency Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Representative_and_Agency_Agreement.pdf

Servicing and Custody Agreement:

http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Servicing_and_Custody_Agreement.pdf

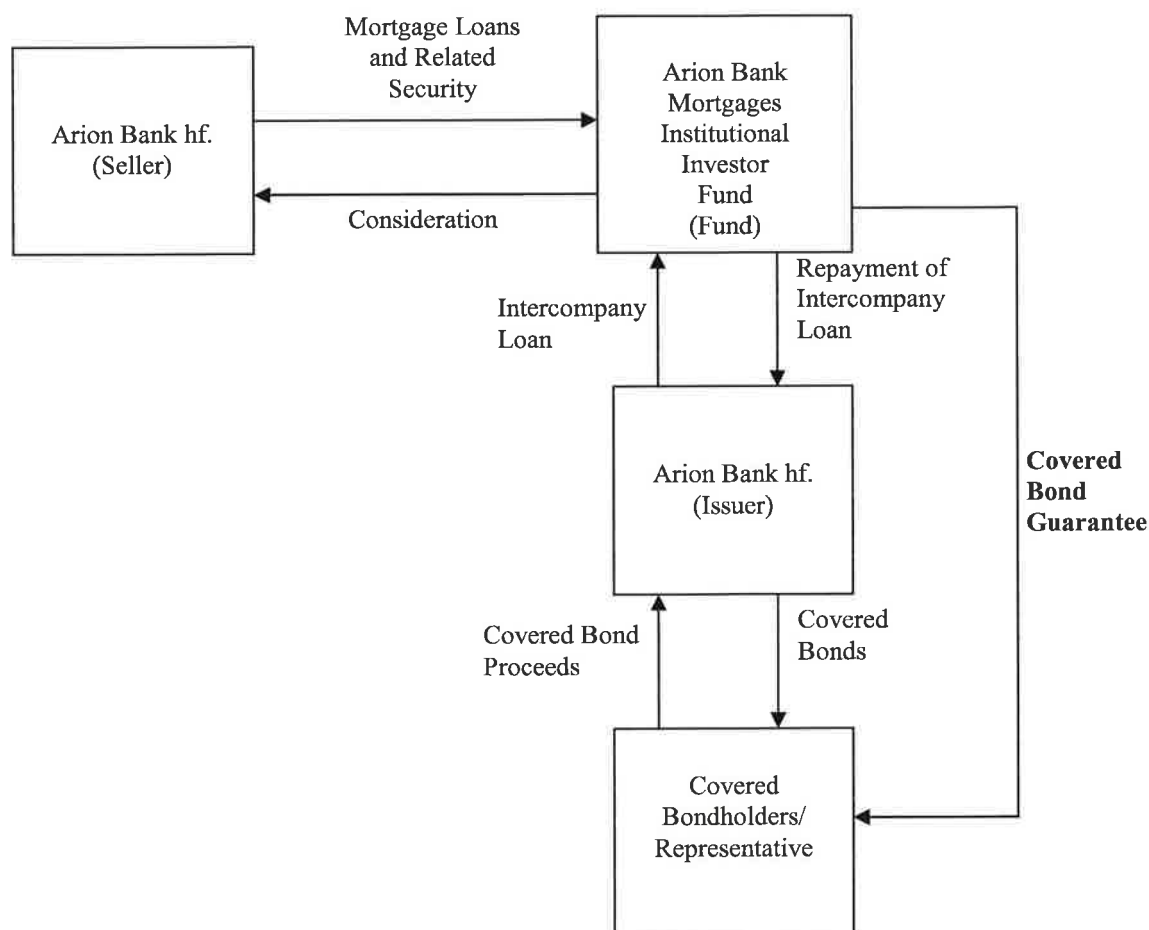
Articles of Association of the Fund:

<http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Legislative-Covered-Bonds/Articles-of-Association/Tab044-%20Articles%20of%20Association%20of%20the%20Fund.pdf>

STRUCTURE OVERVIEW

The information in this section is a summary of the structure and does not purport to be complete. The information is taken from, and is qualified in its entirety by, the remainder of this Prospectus. Words and expressions defined elsewhere in this Prospectus shall have the same meanings in this summary. A glossary of certain defined terms used in this document is contained at the end of this Prospectus.

Structure Diagram



Structure Overview

- *Covered Bonds*: The Issuer has issued the Covered Bonds to Covered Bondholders on the respective Issue Dates thereof. The Covered Bonds are direct, unsecured and unconditional obligations of the Issuer.
- *Intercompany Loan Agreement*: Under the terms of the Intercompany Loan Agreement the Issuer has made Term Advances to the Fund in an amount equal to the gross proceeds of each Series of Covered Bonds. Payments by the Issuer of amounts due under the Covered Bonds are not conditional upon receipt by the Issuer of payments from the Fund pursuant to the Intercompany Loan Agreement. Amounts owed by the Fund under the Intercompany Loan Agreement are subordinated to amounts owed by the Fund under the Covered Bond Guarantee.
- *Covered Bond Guarantee*: Under the terms of the Covered Bond Guarantee, the Fund has provided a guarantee as to payments of interest, principal and indexation amounts due under the

Covered Bonds. The Fund has agreed to pay an amount equal to the Guaranteed Amounts when the same shall become Due for Payment but which would otherwise be unpaid by the Issuer. The obligations of the Funds under the Covered Bond Guarantee constitute direct, unsecured and (following service of a Notice to Pay or a Fund Acceleration Notice) unconditional obligations of the Fund. The Representative will be required to serve a Notice to Pay on the Fund following the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice.

A Fund Acceleration Notice may be served by the Representative on the Fund following the occurrence of a Fund Event of Default.

If a Fund Acceleration Notice is served, the Covered Bonds will (if an Issuer Acceleration Notice has not been served) become immediately due and payable as against the Issuer and the Fund's obligations under the Covered Bond Guarantee will be accelerated. Payments made by the Fund under the Covered Bond Guarantee will be made subject to, and in accordance with, the Guarantee Priority of Payments or the Post-Enforcement Priority of Payments, as applicable. The recourse of the Covered Bondholders to the Fund under the Covered Bond Guarantee will be limited to the assets of the Fund from time to time.

- *The proceeds of Term Advances:* The Fund has and will use the proceeds of the Term Advances received under the Intercompany Loan Agreement from time to time:
 - (a) to purchase each New Portfolio, consisting of Loans and their Related Security, from the Seller in accordance with the terms of the Mortgage Sale Agreement;
 - (b) subject to an Asset Coverage Test Breach Notice not having been served, to make a Unit Distributions to Holders;
 - (c) to invest in Substitution Assets in an amount not exceeding the prescribed limit; and/or
 - (d) if an existing Series, or part of an existing Series, of Covered Bonds is being refinanced, to repay the Term Advance(s) corresponding to the Covered Bonds being refinanced; and/or
 - (e) to make a deposit in the GIC Account.
- *Consideration:* Under the terms of the Mortgage Sale Agreement, the consideration payable to the Seller for the sale of Loans and their Related Security to the Fund on any Assignment Date has been and will be a combination of:
 - (a) a cash payment made by the Fund to the Seller; and/or
 - (b) the Seller being treated as having made an Equity Contribution to the Fund (in an amount up to the difference between the aggregate Outstanding Principal Balance of the Loans sold by the Seller as at the relevant Assignment Date and the cash payment (if any) made by the Fund).
- *Cashflows:* Prior to service on the Fund of an Asset Coverage Test Breach Notice, a Notice to Pay or a Fund Acceleration Notice, the Fund will apply Available Receipts to pay amounts due on the Term Advances to the Issuer. However, these payments will only be made after payment of certain items ranking higher in the Pre Acceleration Priority of Payments. For further details of the Pre Acceleration Priority of Payments, see *Cashflows* below.

Following service on the Fund of an Asset Coverage Test Breach Notice (which has not been revoked) but prior to service of a Notice to Pay or a Fund Acceleration Notice, the Fund will

continue to apply Available Receipts as described above, except that, whilst any Covered Bonds remain outstanding in respect of Available Receipts, no further amounts will be paid towards any Unit Distribution to the Holders and no payments will be made other than into the GIC Account (see *Cashflows* below).

Following service of a Notice to Pay on the Fund (but prior to service of a Fund Acceleration Notice) the Fund will use all moneys (other than Third Party Amounts) to pay Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment subject to paying certain higher ranking obligations of the Fund in the Guarantee Priority of Payments.

Following service of a Fund Acceleration Notice on the Fund, the Covered Bonds will become immediately due and payable (if not already due and payable following service of an Issuer Acceleration Notice) and the Representative will then have a claim against the Fund under the Covered Bond Guarantee for an amount equal to the Early Redemption Amount in respect of each Covered Bond together with accrued interest and any other amounts due under the Covered Bonds.

- *Asset Coverage:* The assets of the Fund are subject to an asset coverage test in respect of the Covered Bonds. Accordingly, for so long as Covered Bonds remain outstanding, the Fund must ensure that, on each Calculation Date, the Adjusted Aggregate Loan Amount will be in an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds from time to time. The Asset Coverage Test will be tested by the Cash Manager on each Calculation Date. A breach of the Asset Coverage Test on a Calculation Date which is not remedied on the immediately succeeding Calculation Date will require the Representative to serve an Asset Coverage Test Breach Notice on the Fund. The Asset Coverage Test Breach Notice will be revoked if, on any Calculation Date falling on or prior to the second Calculation Date following service of an Asset Coverage Test Breach Notice, the Asset Coverage Test is satisfied and neither a Notice to Pay nor a Fund Acceleration Notice has been served.

If an Asset Coverage Test Breach Notice has been delivered and has not been revoked:

- (a) the application of Available Receipts will be restricted;
- (b) the Fund will be required to sell Selected Loans; and
- (c) the Issuer will not be permitted to make to the Fund, and the Fund will not be permitted to borrow from the Issuer, any new Term Advances under the Intercompany Loan Agreement.

If an Asset Coverage Test Breach Notice has been served and not revoked on or before the second Calculation Date after service of such Asset Coverage Test Breach Notice, then an Issuer Event of Default shall occur and the Representative shall be entitled (and, in certain circumstances may be required) to serve an Issuer Acceleration Notice on the Issuer. Following service of an Issuer Acceleration Notice, the Representative must serve a Notice to Pay on the Fund.

- *Servicing:* In its capacity as Servicer, Arion Bank hf. has entered into the Servicing and Custody Agreement with the Fund pursuant to which it has agreed to provide certain administrative services in respect of the Loans and their Related Security sold by the Seller to the Fund. In addition, the Custody Agent has entered into the Servicing and Custody Agreement with the Fund pursuant to which it has agreed to provide certain services specified in Article 20 of the Act to the Fund.
- *Further Information:* For a more detailed description of the transactions summarised above relating to the Covered Bonds see, amongst other relevant sections of this Prospectus, *Summary of the Covered Bonds, Terms and Conditions of the Covered Bonds, Summary of the Principal Documents, Credit Structure, Cashflows* and *Loan Portfolio* below.

FORM OF THE COVERED BONDS

The Covered Bonds were initially issued either in the form of a temporary global covered bond without receipts and interest coupons attached (a **Temporary Global Covered Bond**) or, if so specified in the Pricing Terms, a permanent global covered bond without receipts and interest coupons attached (a **Permanent Global Covered Bond** and, together with the Temporary Global Covered Bond, the **Global Covered Bonds** and each a Global Covered Bond) which, in either case, was delivered on or prior to the relevant original issue date thereof to a common depository (the **Common Depository**) for Euroclear Bank S.A./N.V. as operator of the Euroclear System (**Euroclear**) and Clearstream Banking, société anonyme (**Clearstream, Luxembourg**). Whilst any Covered Bonds were represented by a Temporary Global Covered Bond, payments of principal, interest (if any) and any other amount payable in respect of the Covered Bonds due prior to the Exchange Date (as defined below) were made against presentation of the Temporary Global Covered Bond only to the extent that certification (in a form to be provided) to the effect that the beneficial owners of interests in such Covered Bonds were not U.S. persons or persons who had purchased for resale to any U.S. person, as required by U.S. Treasury regulations, had been received by Euroclear and/or Clearstream, Luxembourg and Euroclear and/or Clearstream, Luxembourg, as applicable, had given a like certification (based on the certifications it has received) to the Principal Paying Agent.

On and after the date (the **Exchange Date**) which was 40 days after each Temporary Global Covered Bond was issued, interests in such Temporary Global Covered Bond were exchangeable (free of charge) upon a request as described therein either for: (a) interests in a Permanent Global Covered Bond of the same Series; or (b) for Definitive Covered Bonds of the same Series with, where applicable, receipts, interest coupons and talons attached (as indicated in the Pricing Terms and subject, in the case of Definitive Covered Bonds, to such notice period as is specified in the Pricing Terms), in each case against certification of non-U.S. beneficial ownership as described above unless such certification has already been given. The holder of a Temporary Global Covered Bond was not entitled to collect any payment of interest, principal or other amount due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Global Covered Bond for an interest in a Permanent Global Covered Bond or for Definitive Covered Bonds was improperly withheld or refused.

Payments of principal, interest (if any) or any other amounts on a Permanent Global Covered Bond are made through Euroclear and/or Clearstream, Luxembourg against presentation or surrender (as the case may be) of the Permanent Global Covered Bond without any requirement for certification.

The Pricing Terms specifies that a Permanent Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for Definitive Covered Bonds with, where applicable, receipts, interest coupons and talons attached upon the occurrence of an Exchange Event. For these purposes, **Exchange Event** means that: (i) the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, whether statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and no successor clearing system is available; or (ii) the Issuer has or will become subject to adverse tax consequences which would not be suffered were the Global Covered Bond (and any interests therein) exchanged for Definitive Covered Bonds. The Issuer will promptly give notice to Covered Bondholders of each Series of Global Covered Bonds in accordance with Condition 13 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Global Covered Bond) or the Representative may give notice to the Principal Paying Agent requesting exchange and, in the event of the occurrence of an Exchange Event as described in (ii) above, the Issuer may also give notice to the Principal Paying Agent requesting exchange. Any such exchange shall occur not later than 45 days after the date of receipt of the first relevant notice by the Principal Paying Agent.

The following legend appears on all Covered Bonds and on all receipts and interest coupons relating to such Covered Bonds:

“ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS, INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287(a) OF THE INTERNAL REVENUE CODE.”

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on Covered Bonds, receipts or interest coupons and will not be entitled to capital gains treatment of any gain on any sale or other disposition in respect of such Covered Bonds, receipts or interest coupons.

Covered Bonds which are represented by a Global Covered Bond will only be transferable in accordance with the rules and procedures for the time being of Euroclear or Clearstream, Luxembourg, as the case may be.

Any reference herein to Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, be deemed to include a reference to any successor operator and/or successor clearing system and/or additional or alternative clearing system specified in the Pricing Terms or as may otherwise be approved by the Issuer, the Principal Paying Agent and the Representative.

No Covered Bondholder, Receiptholder or Couponholder shall be entitled to proceed directly against the Issuer or the Fund unless the Representative, having become so bound to proceed, fails so to do within a reasonable period and the failure shall be continuing.

The Covered Bonds may not be a suitable investment for all investors

Each potential investor in the Covered Bonds must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

- (a) have sufficient knowledge and experience to make a meaningful evaluation of the Covered Bonds, the merits and risks of investing in the Covered Bonds and the information contained or incorporated by reference in this Prospectus or any applicable supplement;
- (b) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Covered Bonds and the impact the Covered Bonds will have on its overall investment portfolio;
- (c) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Covered Bonds, including Covered Bonds with principal or interest payable in one or more currencies, or where the currency for principal or interest payments is different from the potential investor’s currency;
- (d) understand thoroughly the terms of the Covered Bonds and be familiar with the behaviour of any relevant indices and financial markets; and
- (e) be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for legislative, economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

The Covered Bonds are complex financial instruments. Sophisticated institutional investors generally do not purchase complex financial instruments as stand-alone investments. They purchase complex financial instruments as a way to reduce risk or enhance yield with an understood, measured, appropriate addition of risk to their overall portfolios. A potential investor should not invest in the Covered Bonds

unless it has the expertise (either alone or with a financial adviser) to evaluate how the Covered Bonds will perform under changing conditions, the resulting effects on the value of the Covered Bonds and the impact this investment will have on the potential investor's overall investment portfolio.

Judicial considerations may restrict certain investments

The investment activities of certain investors are subject to rules and regulations and/or review or regulation by certain authorities. Each potential investor should consult its legal advisers or responsible supervisory authority in order to determine whether and to what extent the investor has the opportunity to invest in Covered Bonds.

Legal investment considerations may restrict certain investments

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent: (1) the Covered Bonds are legal investments for it; (2) the Covered Bonds can be used as collateral for various types of borrowing; and (3) other restrictions apply to its purchase or pledge of any Covered Bonds. Financial institutions should consult their legal advisers or the appropriate regulators to determine the appropriate treatment of the Covered Bonds under any applicable risk-based capital or similar rules.

TERMS AND CONDITIONS OF THE COVERED BONDS

The following are the Terms and Conditions of the Covered Bonds which have been incorporated (in relevant part) by reference into each Covered Bonds in the form of a Global Covered Bond (as defined below) or Definitive Covered Bond (as defined below), in the latter case only if permitted by the relevant stock exchange or other relevant authority (if any) and agreed by the Issuer and the Dealer at the time of issue but, if not so permitted and agreed, such Definitive Covered Bond will have endorsed thereon or attached thereto such Terms and Conditions. The Pricing Terms in relation to the Covered Bonds specify other terms and conditions which, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of the Covered Bonds. The Pricing Terms (or the relevant provisions thereof) are endorsed on, or attached to, each Covered Bonds in the form of a Global Covered Bond or a Definitive Covered Bond. Reference should be made to "Form of the Covered Bonds" for a description of the content of Pricing Terms which will specify which of such terms are to apply in relation to the Covered Bonds. The terms of the Covered Bonds will be set out in full in the Terms and Conditions read together with the Pricing Terms.

This Covered Bonds is one of a Series (as defined below) of Covered Bonds issued by Arion Bank hf. (the Issuer) pursuant to the Representative and Agency Agreement (as defined below). The Covered Bonds have been issued in denominations of ISK 1.

Save as provided for in Conditions 10 and 15, references herein to the **Covered Bonds** shall be references to the Covered Bonds of this Series and shall mean:

- (a) in relation to any Covered Bonds represented by a global Covered Bond (a **Global Covered Bond**), units of each Specified Denomination in the Specified Currency;
- (b) any Global Covered Bond; and
- (c) any definitive Covered Bonds (**Definitive Covered Bonds**) issued in exchange for a Global Covered Bond.

The Covered Bonds, the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an Amended and Restated Representative and Agency Agreement (such representative and agency agreement as amended and/or supplemented and/or restated from time to time, the **Representative and Agency Agreement**) dated 20 January, 2012 and made between the Issuer, Arion Bank Mortgages Institutional Investor Fund as guarantor (the **Fund**), Deutsche Trustee Company Limited as the representative of the Covered Bondholders (as defined below) (the **Representative**, which expression shall include any successor as Representative), Deutsche Bank AG, London Branch, as issuing and principal paying agent and agent bank (in such capacity, the **Principal Paying Agent**, which expression shall include any successor principal paying agent and, together with Arion Bank hf., the **Paying Agents**, which expression shall include any additional or successor paying agents).

Interest-bearing Definitive Covered Bonds have interest coupons (**Coupons**) and, if indicated in the Pricing Terms, talons for further Coupons (**Talons**) attached on issue. Any reference herein to Coupons or coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons or talons. Definitive Covered Bonds repayable in instalments have receipts (**Receipts**) for the payment of the instalments of principal (other than the final instalment) attached on issue, Global Covered Bonds do not have Receipts, Coupons or Talons attached on issue.

The pricing terms for the Covered Bonds (or the relevant provisions thereof) are set out in Part A of the Pricing Supplements attached to or endorsed on this Covered Bonds which supplement these Terms and Conditions (the **Terms and Conditions**) and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the Terms and Conditions, replace or modify the Terms and Conditions for the purposes of this Covered Bond. References to the **Pricing Terms** are to

Part A of the Pricing Supplements (or the relevant provisions thereof) attached to or endorsed on this Covered Bond.

The Fund has, in the Representative and Agency Agreement, irrevocably and unconditionally guaranteed the due and punctual payment of Guaranteed Amounts in respect of the Covered Bonds as and when the same shall become Due for Payment, but only after service of a Notice to Pay on the Fund following, service of an Issuer Acceleration Notice on the Issuer (after the occurrence of an Issuer Event of Default) or service of a Fund Acceleration Notice on the Fund (after the occurrence of a Fund Event of Default).

The Representative acts for the benefit of the holders for the time being of the Covered Bonds (the **Covered Bondholders**, which expression shall, in relation to any Covered Bonds represented by a Global Covered Bond, be construed as provided below), the holders of the Receipts (the Receiptholders) and the holders of the Coupons (the **Couponholders**, which expression shall, unless the context otherwise requires, include the holders of the Talons), and for the holders of each other Series of Covered Bonds in accordance with the provisions of the Representative and Agency Agreement.

As used herein, **Series** means Covered Bonds which are (i) expressed to be consolidated and form a single series and (ii) identical in all respects (including as to listing and admission to trading) except for their respective Issue Dates, initial Principal Amounts Outstanding, first Interest Payment Dates, Interest Commencement Dates and/or Issue Prices.

Copies of the Master Definitions and Construction Agreement (as defined below), the Representative and Agency Agreement and each of the other Transaction Documents are available for inspection during normal business hours at the office for the time being of the Representative being at 20 January, 2012 at Winchester House, 1 Great Winchester Street, London EC2N 2DB and at the specified office of each of the Paying Agents. Copies of the Pricing Terms are available for viewing at the office of the Issuer at Borgartun 19, 105 Reykjavik, Iceland and copies may be obtained from the Principal Paying Agent at Winchester House, 1 Great Winchester Street, London EC2N 2DB. The Covered Bondholders, the Receiptholders and the Couponholders are deemed to have notice of, are bound by, and are entitled to the benefit of, all the provisions of, and definitions contained in, the Master Definitions and Construction Agreement, the Representative and Agency Agreement, each of the other Transaction Documents and the Pricing Terms which are applicable to them. The statements in these Terms and Conditions include summaries of, and are subject to, the detailed provisions of the Representative and Agency Agreement.

Except where the context otherwise requires, capitalised terms used and not otherwise defined in these Terms and Conditions (including the preceding paragraphs) shall bear the meanings given to them in the Pricing Terms and/or the amended and restated master definitions and construction agreement made between the parties to the Transaction Documents on or about 20 January, 2012 (as amended and/or supplemented and/or restated from time to time, the **Master Definitions and Construction Agreement**), provided that, in the event of inconsistency between the Master Definitions and Construction Agreement and the Pricing Terms, the Pricing Terms will prevail.

1. **Form, Denomination and Title**

The Covered Bonds are in bearer form and, in the case of Definitive Covered Bonds, serially numbered, in the Specified Currency and the Specified Denomination(s). Covered Bonds of one Specified Denomination may not be exchanged for Covered Bonds of another Specified Denomination.

This Covered Bond is an Inflation Linked Annuity Covered Bond.

Definitive Covered Bonds are issued with Coupons and Receipts attached.

Definitive Covered Bonds are issued with Receipts, unless they are not Inflation Linked Annuity Covered Bonds or Instalment Covered Bonds in which case references to Receipts and Receiptholders in these Terms and Conditions are not applicable.

Subject as set out below, title to the Covered Bonds, Receipts and Coupons will pass by delivery. The Issuer, the Fund, the Paying Agents and the Representative will (except as otherwise required by law) deem and treat the bearer of any Covered Bond, Receipt or Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any Global Covered Bond, without prejudice to the provisions set out in the next succeeding paragraph.

For so long as any of the Covered Bonds is represented by a Global Covered Bond held on behalf of or, as the case may be, registered in the name of a common depository for, Euroclear Bank S.A./N.V. (**Euroclear**) and/or Clearstream Banking, société anonyme (**Clearstream, Luxembourg**), each person (other than Euroclear or Clearstream, Luxembourg) who is for the time being shown in the records of Euroclear or Clearstream, Luxembourg as the holder of a particular nominal amount of such Covered Bonds (in which regard any certificate or other document issued by Euroclear or Clearstream, Luxembourg as to the nominal amount of such Covered Bonds standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error or proven error) shall be treated by the Issuer, the Fund, the Paying Agents and the Representative as the holder of such nominal amount of such Covered Bonds in accordance with and subject to the terms of the relevant Global Covered Bond and the expressions **Covered Bondholder** and **holder of Covered Bonds** and related expressions shall be construed accordingly. In determining whether a particular person is entitled to a particular nominal amount of Covered Bonds as aforesaid, the Representative may rely on such evidence and/or information and/or certification as it shall, in its absolute discretion, think fit and, if it does so rely, such evidence and/or information and/or certification shall, in the absence of manifest error or proven error, be conclusive and binding on all concerned.

Covered Bonds which are represented by a Global Covered Bond will be transferable only in accordance with the rules and procedures for the time being of Euroclear and Clearstream, Luxembourg, as the case may be.

References to Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, except in relation to Covered Bonds in New Global Note form, be deemed to include a reference to any additional or alternative clearing system specified in the Pricing Terms or as may otherwise be approved by the Issuer, the Fund, the Principal Paying Agent and the Representative.

2. **Status of the Covered Bonds and the Covered Bond Guarantee**

2.1 *Status of the Covered Bonds*

The Covered Bonds and any relative Receipts and Coupons constitute direct, unconditional, unsubordinated and (subject to provisions of Condition 3) unsecured obligations of the Issuer and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations (other than subordinated obligations, if any) of the Issuer, from time to time outstanding.

2.2 *Status of the Covered Bond Guarantee*

The payment of Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment has been unconditionally and irrevocably guaranteed by the Fund pursuant to the Representative and Agency Agreement (the **Covered Bond Guarantee**). However, the Fund shall have no obligation under the Covered Bond Guarantee to pay any Guaranteed Amounts when the same shall become Due for Payment under the Covered Bonds until service of a Notice to Pay by the Representative on the Fund (which the Representative will be required to serve following the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice by the Representative on the Issuer) or, if earlier, the occurrence of a Fund Event of Default and service of a Fund Acceleration Notice by the Representative on the Fund. The obligations of the Fund under the Covered Bond Guarantee are, subject as aforesaid, direct, unconditional, unsubordinated and unsecured obligations of

the Fund (save for certain obligations required to be preferred by law) equally with all other unsecured obligations (other than subordinated obligations, if any) of the Fund, from time to time outstanding.

Any payment made by the Fund under the Covered Bond Guarantee shall (unless such obligation shall have been discharged as a result of the payment of Excess Proceeds to the Representative pursuant to Condition 9) discharge pro tanto the obligations of the Issuer in respect of such payment under the Covered Bonds, Receipts and Coupons, except where such payment by the Fund has been declared void, voidable or otherwise recoverable in whole or in part and recovered from the Representative or the Covered Bondholders.

3. Negative Pledge

So long as any of the Covered Bonds, Receipts or Coupons remains outstanding the Issuer undertakes that it will not and that it will procure that none of its Subsidiaries will create or have outstanding any mortgage, charge, pledge, lien or other security interest (each a **Security Interest**) (other than a Permitted Security Interest) upon the whole or any part of its undertaking, assets or revenues (including any uncalled capital), present or future, in order to secure any Relevant Indebtedness (as defined below) or to secure any guarantee of or indemnity in respect of any Relevant Indebtedness unless: (a) all amounts payable by it under the Covered Bonds, Receipts and Coupons are equally and rateably secured therewith by such Security Interest; or (b) such other Security Interest or other arrangement (whether or not it includes the giving of a Security Interest) is provided as shall be approved by an Extraordinary Resolution (as defined in the Representative and Agency Agreement) of the Covered Bondholders.

For the purposes of these Terms and Conditions:

Excluded Indebtedness means any Relevant Indebtedness in respect of which the person or persons to whom any such Relevant Indebtedness is or may be owed by the relevant borrower has or have no recourse whatsoever to the Issuer or any Subsidiary (whether or not also the relevant borrower) for the repayment thereof other than:

- (a) recourse to such borrower for amounts limited to the cash flow or net cash flow (other than historic cash flow or historic net cash flow) from a Specified Asset; and/or
- (b) recourse to such borrower for the purpose only of enabling amounts to be claimed in respect of such Relevant Indebtedness in an enforcement of any encumbrance given by such borrower over a Specified Asset or the income, cash flow or other proceeds deriving therefrom (or given by a shareholder or the like in the borrower over its shares or the like in the capital of the borrower) to secure such Relevant Indebtedness, provided that: (i) the extent of such recourse to such borrower is limited solely to the amount of any recoveries made on any such enforcement; and (ii) such person or persons is/are not entitled, by virtue of any right or claim arising out of or in connection with such Relevant Indebtedness, to commence proceedings for the winding up or dissolution of the borrower or to appoint or procure the appointment of any receiver, trustee or similar person or officer in; respect of the borrower or any of its assets (save for the assets the subject of such encumbrance); and/or
- (c) recourse to such borrower generally, or directly or indirectly to the Issuer or any Subsidiary, under any form of assurance, undertaking or support, which recourse is limited to a claim for damages (other than liquidated damages and damages required to be calculated in a specified way) for breach of an obligation (not being a payment obligation or an obligation to procure payment by another or an indemnity in respect thereof or any obligation to comply or to procure compliance by another with any financial ratios or other tests of financial condition) by the person against which such recourse is available;

Government Entities means any body, agency, ministry, department, authority, statutory corporation or other entity of or pertaining to a member state of the European Economic Area or the government thereof or any political subdivision, municipality or local government thereof (whether autonomous or not);

Permitted Security Interest means any security interest created by the Issuer or its Subsidiaries over the whole or any part of their present or future assets or revenues where such assets or revenues are comprised of the following (or are otherwise qualifying collateral for issues of covered bonds pursuant to any relevant contractual arrangements and/or specific provisions of the laws of Iceland relating to covered bonds): (a) mortgage receivables; or (b) receivables against Government Entities; or (c) asset-backed securities backed by any of the assets under paragraph (a) or (b); or (d) any other assets permitted by any applicable governing law to collateralise the covered bonds issued by the Issuer or any of its Subsidiaries, in each case provided that the creation of such security interest is pursuant to the relevant contractual arrangements or, as the case may be, specific provisions of the relevant laws relating to such covered bonds applicable at the time of creation of such security interest. In addition, Permitted Security Interest means a prior Security Interest granted over an asset existing before such asset is acquired by the Issuer or one of its Subsidiaries, provided that that Security Interest was not created in contemplation of the acquisition of such asset by the Issuer or its Subsidiary;

Relevant Indebtedness means any present or future indebtedness (which term shall be construed so as to include any obligation (whether incurred as principal or as surety) for the payment or repayment of money, whether present or future, actual or contingent) in the form of, or represented or evidenced by, bonds, debentures, notes or other securities which are, or are intended to be, with the agreement of the issuer thereof, quoted, listed, dealt in or traded on any stock exchange or over the-counter or other securities market other than such indebtedness which by its terms will mature within a period of one year from its date of issue and other than Excluded Indebtedness;

Specified Asset means an asset of the Issuer or any Subsidiary over which security is given in connection with any limited recourse securitisation or other asset-backed financing; and

Subsidiary means any entity whose affairs are required by law or in accordance with generally accepted accounting principles applicable to Iceland to be consolidated in the consolidated accounts of the Issuer.

4. **Interest**

4.1 *Interest on Inflation Linked Annuity Covered Bonds*

Each Inflation Linked Annuity Covered Bond bears interest from (and including) the Interest Commencement Date at the rate per annum equal to the Rate of Interest payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Final Maturity Date.

If interest is required to be calculated for a period other than an Interest Period (as defined in Condition 4.4) such interest shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction (as defined in Condition 4.4), and rounding the resultant figure to the nearest sub-unit (as defined in Condition 4.4) of the Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

4.2 *Interest following a Notice to Pay*

If a Notice to Pay is served on the Fund, the Fund shall, in accordance with the terms of the Covered Bond Guarantee, pay Guaranteed Amounts corresponding to the amounts of interest described under Condition 4.1 above, under the Covered Bond Guarantee, in respect of the Covered Bonds on the Due for Payment Dates.

4.3 *Accrual of interest*

Each Covered Bond (or in the case of the redemption of part only of a Covered Bond, that part only of such Covered Bond) will cease to bear interest (if any) from the date for its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue in accordance with Sections 5 and 6 of the Act on Interest and Price Indexation no. 38/2001 (*lög um vexti og verðtryggingu*).

4.4 *Business Day, Business Day Convention, Day Count Fractions and other adjustments*

- (a) In these Terms and Conditions, **Business Day** means:
- (i) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London, Reykjavik and any Additional Business Centre specified in the Pricing Terms; and
 - (ii) in relation to any sum payable in the Specified Currency, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the Specified Currency.
- (b) If a **Business Day Convention** is specified as the **Following Business Day Convention** and (x) if there is no numerically corresponding day in the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then such Interest Payment Date shall be postponed to the next day which is a Business Day.
- (c) **Day Count Fraction** means, in respect of the calculation of an amount of interest for any Interest Period, if **30/360**, **360/360** or **Bond Basis** is specified in the Pricing Terms, the number of days in the Interest Period divided by 360, calculated on a formula basis as follows:

$$\text{Day Count Fraction} = \frac{[360 \times (Y2 - Y1)] + [30 \times (M2 - M1)] + (D2 - D1)}{360}$$

where:

“**Y1**” is the year, expressed as a number, in which the first day of the Interest Period falls;

“**Y2**” is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

“**M1**” is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

“**M2**” is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

“**D1**” is the first calendar day, expressed as a number, of the Interest Period, unless such number is 31, in which case D1 will be 30; and

“**D2**” is the calendar day, expressed as a number, immediately following the last day included in the Interest Period, unless such number would be 31 and D, is greater than 29, in which case D2 will be 30;

- (d) **Interest Period** means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.
- (e) **Principal Amount Outstanding** means, in respect of a Covered Bond, on any day the principal amount of that Covered Bond on the Issue Date less principal amounts (if any) received by the holder of such Covered Bond in respect thereof on or prior to that day.
- (f) **sub-unit** means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, euro 0.01.

5. **Payments**

5.1 *Payments in respect of Inflation Linked Annuity Covered Bonds*

In respect of each Inflation Linked Annuity Covered Bond, the Issuer shall, on each relevant Interest Payment Date, make a combined payment of principal due under Condition 4.1, interest due under Condition 4.1 and any indexation amount (together, the Annuity Amount) as calculated by the Calculation Agent in accordance with the formula specified in the Pricing Terms.

5.2 *Method of payment*

Subject as provided below, payments in the Specified Currency will be made by credit or transfer to an account in the Specified Currency maintained by the payee with, or, at the option of the payee, by a cheque in the Specified Currency drawn on, a bank in the principal financial centre of the country of the Specified Currency.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment but without prejudice to the provisions of Condition 7.

5.3 *Presentation of Definitive Covered Bonds, Receipts and Coupons*

Payments of principal in respect of Definitive Covered Bonds will (subject as provided below) be made in the manner provided in Condition 5.2 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Definitive Covered Bonds, and payments of interest in respect of Definitive Covered Bonds will (subject as provided below) be made as aforesaid only against presentation and surrender (or in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia, its territories, its possessions and other areas subject to its jurisdiction)).

Payments of instalments of principal (if any), other than the final instalment, will (subject as provided below) be made in the manner provided in Condition 5.2 above only against presentation and surrender (or, in the case of part of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in Condition 5.2 above only against presentation or surrender (or, in the case of part of any sum due, endorsement) of the relevant Covered Bond in accordance with the preceding paragraph. Each Receipt must be presented for payment of the relevant instalment together with the Definitive Covered Bond to which it appertains. Receipts presented without the Definitive Covered Bond to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any Definitive Covered Bond becomes due

and payable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect of them.

Inflation Linked Annuity Covered Bonds in definitive form should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the total amount due) will be deducted from the amount due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 8) in respect of such principal (whether or not such Coupon would otherwise have become void under Condition 8) or, if later, four years from the date on which such Coupon would otherwise have become due but in no event thereafter.

Upon any Inflation Linked Annuity Covered Bond in definitive form becoming due and repayable by the Issuer (in the absence of a Notice to Pay or a Fund Acceleration Notice) or by the Fund under the Covered Bond Guarantee (if a Notice to Pay or a Fund Acceleration Notice has been served) prior to its Final Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

If the due date for redemption of any Definitive Covered Bond is not an Interest Payment Date, interest (if any) accrued in respect of such Covered Bond from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against presentation and surrender of the relevant Definitive Covered Bond.

5.4 *Payments in respect of Global Covered Bonds*

Payments of principal, interest (if any) and other amounts (if any) in respect of Covered Bonds represented by any Global Covered Bond will (subject as provided below) be made in the manner specified above in relation to Definitive Covered Bonds and otherwise in the manner specified in the relevant Global Covered Bond against presentation or surrender, as the case may be, of such Global Covered Bond at the specified office of any Paying Agent outside the United States. A record of each payment made against presentation or surrender of any Global Covered Bond, distinguishing between any payment of principal and any payment of interest, will be made on such Global Covered Bond by the Paying Agent to which it was presented and such record shall be prima facie evidence that the payment in question has been made.

No payments of principal, interest or other amounts due in respect of a Global Covered Bond will be made by mail to an address in the United States or by transfer to an account maintained in the United States.

5.5 *General provisions applicable to payments*

The holder of a Global Covered Bond shall be the only person entitled to receive payments in respect of Covered Bonds represented by such Global Covered Bond and the obligations of the Issuer or, as the case may be, the Fund will be discharged by payment to, or to the order of, the holder of such Global Covered Bond in respect of each amount so paid. Each of the persons shown in the records of Euroclear or Clearstream, Luxembourg as the beneficial holder of a particular nominal amount of Covered Bonds represented by such Global Covered Bond must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for his share of each payment so made by the Issuer or, as the case may be, the Fund to, or to the order of, the holder of such Global Covered Bond.

5.6 *Payment Day*

If the date for payment of any amount in respect of any Covered Bond, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment of the relevant amount due until the next following Payment Day and shall not be entitled to any interest or other sum in respect of any such delay. For these purposes, Payment Day means any day which (subject to Condition 8) is:

- (a) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:
 - (i) the relevant place of presentation;
 - (ii) London; and
 - (iii) each Additional Financial Centre specified in the Pricing Terms; and
- (b) in relation to any sum payable in the Specified Currency, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the Specified Currency.

5.7 *Interpretation of principal*

Any reference in these Terms and Conditions to principal in respect of the Covered Bonds shall be deemed to include, as applicable:

- (a) the Final Redemption Amount of the Covered Bonds;
- (b) the Early Redemption Amount of the Covered Bonds;
- (c) the Optional Redemption Amount(s) (if any) of the Covered Bonds;
- (d) any premium and any other amounts (other than interest) which may be payable under or in respect of the Covered Bonds; and
- (e) any Excess Proceeds attributable to principal which may be payable by the Representative to the Fund in respect of the Covered Bonds.

6. **Redemption and Purchase**

6.1 *Redemption of Inflation Linked Annuity Covered Bonds*

Unless previously redeemed or purchased and cancelled, each Inflation Linked Annuity Covered Bond will, subject to Condition 5.1, be redeemed in one or more amounts, calculated in accordance with the formula specified in the Pricing Terms, in the Specified Currency on the relevant Interest Payment Dates.

6.2 *Redemption at the option of the Issuer (Issuer Call)*

If Issuer Call is specified in the Pricing Terms, the Issuer may, having given:

- (a) not less than 15 nor more than 30 days' notice to the Covered Bondholders in accordance with Condition 13; and
- (b) not less than 15 days before the giving of the notice referred to in (a) above, notice to the Representative and to the Principal Paying Agent;

(which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Covered Bonds then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the Pricing Terms together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount not less than the Minimum Redemption Amount and not more than the Maximum Redemption Amount, in each case as may be specified in the Pricing Terms. In the case of a partial redemption of Covered Bonds, the Covered Bonds to be redeemed (**Redeemed Covered Bonds**) will be selected individually by lot, in the case of Redeemed Covered Bonds represented by Definitive Covered Bonds, and in accordance with the rules of Euroclear and/or Clearstream, Luxembourg, (to be reflected in the records of Euroclear and Clearstream, Luxembourg as either a pool factor or a reduction in nominal amount, at their discretion) in the case of Redeemed Covered Bonds represented by a Global Covered Bond, not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the **Selection Date**). In the case of Redeemed Covered Bonds represented by Definitive Covered Bonds, a list of the serial numbers of such Redeemed Covered Bonds will be published in accordance with Condition 13 not less than 15 days prior to the date fixed for redemption. No exchange of the relevant Global Covered Bond will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this Condition 6.2 and notice to that effect shall be given by the Issuer to the Covered Bondholders in accordance with Condition 13 at least five days prior to the Selection Date.

6.3 *Redemption due to illegality or invalidity*

The Covered Bonds of all Series may be redeemed at the option of the Issuer in whole, but not in part, at any time, on giving not less than 30 nor more than 60 days' notice to the Representative and the Principal Paying Agent and, in accordance with Condition 13, all Covered Bondholders (which notice shall be irrevocable), if the Issuer satisfies the Representative immediately before the giving of such notice that it has, or will, before the next Interest Payment Date of any Covered Bond of any Series, become unlawful for the Issuer to make, fund or allow to remain outstanding any Term Advance made by it to the Fund under the Intercompany Loan Agreement, as a result of any change in, or amendment to, the applicable laws or regulations or any change in the application or official interpretation of such laws or regulations, which change or amendment has become or will become effective before the next such Interest Payment Date.

Covered Bonds redeemed pursuant to this Condition 6.3 will be redeemed at their Early Redemption Amount referred to in Condition 6.5 together (if appropriate) with interest accrued (and, if this is an Inflation Linked Annuity Covered Bond, adjusted for indexation in accordance with the provisions set out in the Pricing Terms) to (but excluding) the date of redemption.

6.4 *Certification*

Prior to the publication of any notice of redemption pursuant to Condition 6.3, the Issuer shall deliver to the Representative a certificate signed by two Directors of the Issuer stating that the Issuer is entitled or required to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred and the Representative shall be entitled to accept the certificate as sufficient evidence of the satisfaction of the conditions precedent set out above, in which event it shall be conclusive and binding on all Covered Bondholders, Receiptholders and Couponholders.

6.5 *Early Redemption Amounts*

For the purpose of Conditions 6.3 and Condition 9, each Covered Bond will be redeemed at its Early Redemption Amount calculated, in the case of a Covered Bond, at the amount specified in, or determined in the manner specified in, the Pricing Terms or, if no such amount or manner is so specified in the Pricing Terms, at its Principal Amount Outstanding (and adjusted for indexation in accordance with the provisions set out in the Pricing Terms) or on such other calculation basis as may be specified in the Pricing Terms.

6.6 *Purchases*

The Issuer, any of its Subsidiaries or the Fund may at any time purchase Covered Bonds (provided that, in the case of Definitive Covered Bonds, all unmatured Receipts, Coupons and Talons appertaining thereto are purchased therewith) at any price in the open market or otherwise. Subject to the proviso below, such Covered Bonds may be held, reissued, resold or, at the option of the Issuer, surrendered to any Paying Agent for cancellation, provided that any Covered Bonds purchased by the Fund must be immediately surrendered to any Paying Agent for cancellation.

6.7 *Cancellation*

All Covered Bonds which are redeemed will forthwith be cancelled (together with all unmatured Receipts, Coupons and Talons attached thereto or surrendered therewith at the time of redemption). All Covered Bonds so cancelled and any Covered Bonds purchased and surrendered for cancellation pursuant to Condition 6.6 and cancelled (together with all unmatured Receipts, Coupons and Talons cancelled therewith) shall be forwarded to the Principal Paying Agent and cannot be reissued or resold.

6.8 *Legislative Exchange*

Following the coming into force in Iceland of (i) any legislation similar to covered bond legislation in force in any European Union, country, or (ii) any rules, regulations or guidelines published by any governmental authority that provides for bonds issued by Icelandic issuers to qualify for the same benefits available to covered bonds issued under covered bond legislation in force in any European Union country, the Issuer may, at its option and without the consent of the Representative, the Covered Bondholders, the Receiptholders or the Couponholders, exchange all (but not some only) of the Covered Bonds of all Series then outstanding (the **Existing Covered Bonds**) for new Covered Bonds which qualify as covered bonds under such new legislation, rules, regulations or guidelines (the **New Covered Bonds**) in identical form, amount and denomination as the Existing Covered Bonds and on the same economic terms and conditions as the Existing Covered Bonds, (the **Legislative Exchange**), if not more than 60 nor less than 30 days' notice to the Covered Bondholders (in accordance with Condition 13), the Representative and the Principal Paying Agent is given by the Issuer and provided that:

- (a) on the date on which such notice expires the Issuer delivers to the Representative a certificate signed by two Directors of the Issuer and a certificate signed by two Directors of the Management Company on behalf of the Fund confirming that, in the case of the Issuer, no Issuer Event of Default (as defined in Condition 9.1) or Potential Issuer Event of Default (as defined in Condition 14) and, in the case of the Fund, no Fund Event of Default (as defined in Condition 9.2) or Potential Fund Event of Default (as defined in Condition 14), shall have occurred and be continuing (disregarding for the purposes of this certificate any such event which occurs or which has occurred due to the implementation of such legislation, rules, regulations or guidelines); and
- (b) if the Existing Covered Bonds are listed, quoted and/or traded on or by a competent and/ or relevant listing authority, stock exchange and/or quotation system on or before

the date on which such notice expires the Issuer delivers to the Representative a certificate signed by two Directors of the Issuer confirming that all applicable rules of such competent and/or relevant listing authority, stock exchange and/or quotation system have been or will be complied with (or compliance with such rules has been waived by the relevant listing authority, stock exchange and/or quotation system).

- (c) The Existing Covered Bonds will be cancelled concurrently with the issue of the New Covered Bonds and with effect on and from the date of issue thereof all references herein to Covered Bonds shall be deemed to be references to the New Covered Bonds and the Representative may, pursuant to the provisions described in Condition 14, agree with the Issuer and the Fund such modifications to the Transaction Documents as may be necessary for the issue of the New Covered Bonds under the new legislation, rules, regulations or guidelines.

7. Taxation

All payments of principal and interest in respect of the Covered Bonds, Receipts and Coupons by the Issuer will be made without withholding or deduction for or on account of any present or future taxes or duties, assessments or government charges of whatever nature imposed or levied by or on behalf of the Tax Jurisdiction unless such withholding or deduction is required by law. The Issuer will not be required to pay any additional amounts with respect to amounts withheld pursuant to such withholding or deduction:

- (a) presented for payment in Iceland;
- (b) the holder of which is liable for such taxes or duties in respect of such Covered Bond, Receipt or Coupon by reason of his having some connection with a Tax Jurisdiction other than the mere holding of such Covered Bond, Receipt or Coupon; or
- (c) presented for payment more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on such thirtieth day assuming that day to have been a Payment Day (as defined in Condition 5.6); or
- (d) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (e) presented for payment by or on behalf of a holder who would have been able to avoid such withholding or deduction by presenting the relevant Covered Bond, Receipt or Coupon to another Paying Agent in a Member State of the European Union; or
- (f) where such withholding or deduction is required to be made based on provisions of the Act on Withholding of Public Levies at Source No 45/1987, as amended, the Act on Withholding of Tax on Financial Income No 91/1996, as amended, and Article 3 of the Income Tax Act no. 90/2003 (ITA).

If any payments made by the Fund under the Covered Bond Guarantee are or become subject to any withholding or deduction on account of any taxes or duties of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction, the Fund will not be obliged to pay any additional amount as a consequence.

As used in this Terms and Conditions:

Relevant Date means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Paying Agent, on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Covered Bondholders in accordance with Condition 13; and

Tax Jurisdiction means Iceland or any political subdivision or any authority thereof or therein having power to tax.

8. **Prescription**

The Covered Bonds, Receipts and Coupons will become void in accordance with Act 150/2007 unless presented for payment within 10 years (in the case of principal) and four years (in the case of interest or any other amount) after the Relevant Date (as defined below).

There shall not be included in any Coupon sheet issued on exchange of a Talon, any Coupon the claim for payment in respect of which would be void pursuant to this Condition.

9. **Events of Default, Acceleration and Enforcement**

9.1 *Issuer Events of Default*

The Representative at its discretion may, and if so requested in writing by the holders of at least one-fifth of the aggregate Principal Amount Outstanding of the Covered Bonds (which for this purpose or the purpose of any Extraordinary Resolution referred to in this Condition 9.1 means the Covered Bonds of this Series together with the Covered Bonds of any other Series then outstanding) then outstanding as if they were a single Series or if so directed by an Extraordinary Resolution of all the Covered Bondholders shall (subject in each case to being indemnified and/or secured to its satisfaction), give notice (an **Issuer Acceleration Notice**) in writing to the Issuer that as against the Issuer (but not, for the avoidance of doubt, against the Fund under the Covered Bond Guarantee) each Covered Bond of each Series then outstanding is, and each such Covered Bond shall thereupon immediately become, due and repayable at its Early Redemption Amount together with accrued interest (and adjusted for indexation in accordance with the provisions specified in the Pricing Terms) as provided in the Representative and Agency Agreement if any of the following events (each an **Issuer Event of Default**) shall occur and be continuing:

- (a) if default is made in the payment of any principal, premium (if any), interest or any other amount due in respect of the Covered Bonds or any of them and the default continues for a period of five days in the case of principal or premium (if any) and five days in the case of interest or any other amount; or
- (b) if the Issuer fails to perform or observe any of its other obligations under these Terms and Conditions, the Conditions of any other Series of Covered Bonds or any other Transaction Document (but excluding any obligation of the Issuer to comply with the Asset Coverage Test) and (except in any case where, in the opinion of the Representative, the failure is incapable of remedy when no such continuation or notice as is hereinafter mentioned will be required) the failure continues for the period of 30 days next following the service by the Representative on the Issuer of notice requiring the same to be remedied; or
- (c) if any borrowed money of the Issuer or any of its, Principal Subsidiaries is not paid when due or becomes (whether by declaration or automatically in accordance with the relevant agreement or instrument constituting the same) due and payable by reason of

any default (however described) prior to the date when it would otherwise have become due or any creditor of the Issuer or any of its Principal Subsidiaries becomes entitled to declare any such borrowed money due and payable by reason of any default (however described) or any facility or commitment available to the Issuer or any of its Principal Subsidiaries relating to borrowed money is withdrawn, suspended or cancelled by reason of any default (however described) of the company concerned, provided that, for the purposes of this subparagraph (c), the borrowed money must, when aggregated with all other borrowed money to which any part of this Condition 9.1(c) applies, exceed U.S.\$25,000,000 (or its equivalent in any other currency); or

- (d) if any order is made by any competent court or resolution passed for the winding up or dissolution of the Issuer or any of its Principal Subsidiaries, save for the purposes of reorganisation on terms approved by an Extraordinary Resolution of the Covered Bondholders; or
- (e) if the Issuer or any of its Principal Subsidiaries ceases or threatens to cease to carry on the whole or a substantial part of its business, save for the purposes of reorganisation on terms approved by an Extraordinary Resolution of the Covered Bondholders, or the Issuer or any of its Principal Subsidiaries stops or threatens to stop payment of, or is unable to, or admits inability to, pay, its debts (or any class of its debts) as they fall due, or is deemed unable to pay its debts pursuant to or for the purposes of any applicable law, or is adjudicated or found bankrupt or insolvent; or
- (f) if (A) proceedings are initiated against the, Issuer or any of its Principal Subsidiaries under any applicable liquidation, insolvency, composition, reorganisation or other similar laws, or an application is made for the appointment of an administrative or other receiver, manager, administrator or other similar official, or an administrative or other receiver, manager, administrator or other similar official is appointed, in relation to the Issuer or any of its Principal Subsidiaries or, as the case may be, in relation to the whole or a part of the undertaking or assets of any of them, or an encumbrancer takes possession of the whole or a part of the undertaking or assets of any of them, or a distress, execution, attachment, sequestration or other process is levied, enforced upon, sued out or put in force against the whole or a part of the undertaking or assets of any of them and (B) in any case (other than the appointment of an administrator) the same is not discharged within 14 days; or
- (g) if the Issuer or any of its Principal Subsidiaries initiates or consents to judicial proceedings relating to itself under any applicable liquidation, insolvency, composition, reorganisation or other similar laws or makes a conveyance or assignment for the benefit of, or enters into any composition or other arrangement with, its creditors generally (or any class of its creditors) or any meeting is convened to consider a proposal for an arrangement or composition with its creditors generally (or any class of its creditors); or
- (h) if an Asset Coverage Test Breach Notice has been served and not revoked (in accordance with the terms of the Transaction Documents) on or before the second Calculation Date after service of such Asset Coverage Test Breach Notice,

provided that any condition, event or act described in subparagraphs (b), (c), (e), (f) and (g) above shall only constitute an Issuer Event of Default if the Representative shall have certified in writing to the Issuer and the Fund that such condition, event or act is, in its opinion, materially prejudicial to the interests of the Covered Bondholders of any Series.

For the purposes of these Terms and Conditions:

Principal Subsidiary at any time shall mean a Subsidiary of the Issuer:

- (i) whose gross revenues (consolidated in the case of a Subsidiary which itself has Subsidiaries) or whose total assets (consolidated in the case of a Subsidiary which itself has Subsidiaries) represent not less than five per cent, of the consolidated gross revenues, or, as the case may be, consolidated total assets, of the Issuer and its Subsidiaries taken as a whole, all as calculated respectively by reference to the then latest audited accounts (consolidated or, as the case may be, unconsolidated) of the Subsidiary and the then latest audited consolidated accounts of the Issuer and its Subsidiaries; or
- (ii) to which is transferred the whole or substantially the whole of the undertaking and assets of a Subsidiary of the Issuer which immediately before the transfer is a Principal Subsidiary, all as more particularly defined in the Representative and Agency Agreement.

A report by the auditors of the Issuer (whether or not addressed to the Representative) that in their opinion a Subsidiary of the Issuer is or is not or was or was not at any particular time or throughout any specified period a Principal Subsidiary shall, in the absence of manifest error, be conclusive and binding on all parties.

Upon the Covered Bonds becoming immediately due and payable against the Issuer pursuant to this Condition 9.1, the Representative shall forthwith serve a notice to pay (the **Notice to Pay**) on the Fund pursuant to the Covered Bond Guarantee. If a Notice to Pay has been served, the Fund shall be required to make payments of Guaranteed Amounts when the same shall become Due for Payment in accordance with the terms of the Covered Bond Guarantee.

Following service of an Issuer Acceleration Notice, the Representative may or shall take such proceedings against the Issuer in accordance with the first paragraph of Condition 9.3.

The Representative and Agency Agreement provides that all moneys received by the Representative from the Issuer or any administrator, administrative or other receiver, manager or other similar official appointed in relation to the Issuer following service of an Issuer Acceleration Notice (the **Excess Proceeds**), shall be paid by the Representative on behalf of the Covered Bondholders of the relevant Series to the Fund for its own account, as soon as practicable, and shall be held by the Fund in the GIC Account and shall be used by the Fund in the same manner as all other moneys from time to time standing to the credit of the GIC Account pursuant to the Fund Deed. Any Excess Proceeds received by the Representative shall discharge pro tanto the obligations of the Issuer in respect of the payment of the amount of such Excess Proceeds under the Covered Bonds, Receipts and Coupons. However, the obligations of the Fund under the Covered Bond Guarantee are (following service of a Notice to Pay) unconditional and irrevocable and the receipt by the Representative of any Excess Proceeds shall not reduce or discharge any of such obligations. By holding any Covered Bond, each Covered Bondholder shall be deemed to have irrevocably directed the Representative to pay the Excess Proceeds to the Fund in the manner as described above.

9.2 *Fund Events of Default*

The Representative at its discretion may, and if so requested in writing by the holders of at least one-fifth of the aggregate Principal Amount Outstanding of the Covered Bonds (which for this purpose and the purpose of any Extraordinary Resolution referred to in this Condition 9.2 means the Covered Bonds of this Series together with the Covered Bonds of any other Series then outstanding) then outstanding as if they were a single Series or if so directed by an Extraordinary Resolution of all the Covered Bondholders shall (subject in each case to being indemnified and/or secured to its satisfaction), give notice (a **Fund Acceleration Notice**) in writing to the Issuer and the Fund, that: (i) each Covered Bond of each Series then outstanding

is, and each Covered Bond of each Series then outstanding shall as against the Issuer (if not already due and repayable against the Issuer following service of an Issuer Acceleration Notice), thereupon immediately become, due and repayable at its Early Redemption Amount together with accrued interest (and such accrued interest to be adjusted for indexation in accordance with the provisions set out in the Pricing Terms); and (ii) all amounts payable by the Fund under the Covered Bond Guarantee shall thereupon immediately become due and payable at the Guaranteed Amount corresponding to the Early Redemption Amount for each Covered Bond of each Series then outstanding together with accrued interest (and adjusted for indexation in accordance with the provisions set out in the Pricing Terms), in each case as provided in the Representative and Agency Agreement if any of the following events (each a **Fund Event of Default**) shall occur and be continuing:

- (a) if default is made in the payment of any Guaranteed Amounts which are Due for Payment on the relevant Guaranteed Amounts Due Date in respect of the Covered Bonds of any Series then outstanding and the default continues for a period of five days except in the case of the payments of a Guaranteed Amount which is Due for Payment under Condition 9.1 when the Fund shall be required to make payments of Guaranteed Amounts which are Due for Payment on the dates specified therein; or
- (b) if the Fund fails to perform or observe any of its other obligations under the Covered Bond Guarantee, the Representative and Agency Agreement or any other Transaction Document (other than the obligation to satisfy the Asset Coverage Test in accordance with Clause 10 of the Fund Deed) to which the Fund is a party and (except in any case where, in the opinion of the Representative, is incapable of remedy when no such continuation and notice as is hereinafter mentioned will be required) the failure continues for the period of 30 days next following the service by the Representative on the Fund of notice requiring the same to be remedied; or
- (c) if an order is made by any competent court or resolution passed for the winding up or dissolution of the Fund; or
- (d) if the Fund ceases or threatens to cease to carry on the whole or a substantial part of its business or the Fund stops or threatens to stop payment of, or is unable to, or admits inability, to pay its debts (or any class of its debts) as they fall due, is deemed unable to pay its debts pursuant to or for the purposes of any applicable law, or is adjudicated or found bankrupt or insolvent; or
- (e) if: (A) proceedings are initiated against the Fund under any applicable liquidation, insolvency, composition, reorganisation or other similar laws, or an application is made for the appointment of an administrative or other receiver, manager, administrator or other similar official, or an administrative or other receiver, manager, administrator or other similar official is appointed, in relation to the Fund or, as the case may be, in relation to the whole or a part of the undertaking or assets of any of them, or an encumbrancer takes possession of the whole or a part of the undertaking or assets of any of them, or a distress, execution, attachment, sequestration or other process is levied, enforced upon, sued out or put in force against the whole or a part of the undertaking or assets of any of them; and (B) in any case (other than the appointment of an administrator) the same is not discharged within 14 days; or
- (f) if the Fund initiates or consents to judicial proceedings relating to itself under any applicable liquidation, insolvency, composition, reorganisation or other similar laws or makes a conveyance or assignment for the benefit of, or enters into any composition or other arrangement with, its creditors generally (or any class of its creditors) or any meeting is convened to consider a proposal for an arrangement or composition with its creditors generally (or any class of its creditors),

provided that any condition, event or act described in subparagraphs (b) or (d) to (f) (inclusive) above shall only constitute a Fund Event of Default if the Representative shall have certified in writing to the Issuer and the Fund that such condition, event or act is, in its opinion, materially prejudicial to the interests of the Covered Bondholders of any Series then outstanding.

Following service of a Fund Acceleration Notice, the Representative may or shall take such proceedings or steps in accordance with the first and second paragraphs, respectively, of Condition 9.3.

Upon service of a Fund Acceleration Notice, the Covered Bondholders shall have a claim against the Fund, under the Covered Bond Guarantee, for an amount equal to the Early Redemption Amount in respect of each Covered Bond together with accrued interest and any other amount due under such Covered Bonds as provided in the Representative and Agency Agreement.

9.3 *Enforcement*

The Representative may at any time, at its discretion and without further notice, take such proceedings against the Issuer and/or the Fund, as the case may be, and/or any other person as it may think fit to enforce the provisions of the Representative and Agency Agreement, the Covered Bonds, the Receipts, the Coupons or any other Transaction Document, but it shall not be bound to take any such enforcement proceedings in relation to the Representative and Agency Agreement, the Covered Bonds, the Receipts, the Coupons or any other Transaction Document unless: (i) it shall have been so directed by an Extraordinary Resolution of all the Covered Bondholders of all Series then outstanding (with the Covered Bonds of all Series taken together as a single Series as aforesaid) or so requested in writing by the holders of not less than one-fifth of the aggregate Principal Amount Outstanding of the Covered Bonds of all Series then outstanding; and (ii) it shall have been indemnified and/or secured to its satisfaction.

In exercising any of its powers, authorities and discretions the Representative shall only have regard to the interests of the Covered Bondholders of all Series then outstanding.

No Covered Bondholder, Receiptholder or Couponholder shall be entitled to proceed directly against the Issuer or the Fund or to take any action with respect to the Representative and Agency Agreement, any other Transaction Document, the Covered Bonds, the Receipts or the Coupons unless the Representative, having become bound so to proceed, fails so to do within a reasonable period and such failure shall be continuing.

10. **Replacement of Covered Bonds, Receipts, Coupons and Talons**

Should any Covered Bond, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Principal Paying Agent upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Covered Bonds, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

11. **Paying Agents**

The names of the initial Paying Agents and their initial specified offices are set out below.

The Issuer is entitled, with the prior written approval of the Representative, to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/or approve any change in the specified office through which any Paying Agent acts, provided that:

- (a) there will at all times be a Principal Paying Agent;

- (b) there will at times be a Paying Agent having short term, unsecured, unsubordinated and unguaranteed debt obligation rating of at least P-1 by Moody's (which may be the Principal Paying Agent) in a jurisdiction within Europe, other than Iceland;
- (c) so long as the Covered Bonds are listed on any stock exchange or admitted to listing or trading by any other relevant authority, there will at all times be a Paying Agent with a specified office in such place as may be required by the rules and regulations of the relevant stock exchange or other relevant authority; and
- (d) there will at all times be a Paying Agent in a Member State of the European Union that will not be obliged to withhold or deduct tax pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in the United States in the circumstances described in Condition 5.5. Notice of any such variation, termination, appointment or change will be given by the Issuer to the Covered Bondholders as soon as reasonably practicable in accordance with Condition 13.

In acting under the Representative and Agency Agreement, the Paying Agents act solely as agents of the Issuer and the Fund and, in certain circumstances specified therein, of the Representative and do not assume any obligation to, or relationship of agency with, any Covered Bondholders, Receiptholders or Couponholders. The Representative and Agency Agreement contains provisions permitting any entity into which any Paying Agent is merged or converted or with which it is consolidated or to which it transfers all or substantially all of its assets to become the successor paying agent.

12. **Exchange of Talons**

On and after the Interest Payment Date on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Principal Paying Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Covered Bond to which it appertains) a further Talon, subject to the provisions of Condition 8.

13. **Notices**

All notices regarding the Covered Bonds will be valid if published: (a) in a leading English language daily newspaper of general circulation in London; and (b) if and for so long as the Covered Bonds are admitted to trading on, and listed on the Regulated market of NASDAQ OMX Iceland hf., in a daily newspaper of general circulation in Iceland. It is expected that any such publication in a newspaper will be made in the Financial Times in London and any daily newspaper in Iceland. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any stock exchange or any other relevant authority on which the Covered Bonds are for the time being listed or by which they have been admitted to trading. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers. If publication as provided above is not practicable, notice will be given in such other manner, and will be deemed to have been given on such date, as the Representative shall approve.

Until such time as any Definitive Covered Bonds are issued, so long as any Global Covered Bonds representing the Covered Bonds are held in their entirety on behalf of Euroclear and/or Clearstream, Luxembourg, there shall be substituted for such publication in such newspapers the delivery of the relevant notice to Euroclear and/or Clearstream, Luxembourg for

communication by them to the holders of the Covered Bonds and, in addition, for so long as any Covered Bonds are listed on a stock exchange or admitted to listing or trading by any other relevant authority and the rules of the stock exchange, or other relevant authority so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules. Any such notice shall be deemed to have been given to the holders of the Covered Bonds on the seventh day after the day on which the said notice was given to Euroclear and/or Clearstream, Luxembourg.

Notices to be given by any Covered Bondholder shall be in writing and given by lodging the same, together (in the case of any Covered Bond in definitive form) with the relevant Covered Bonds or Covered Bonds, with the Principal Paying Agent. Whilst any of the Covered Bonds are represented by a Global Covered Bond, such notice may be given by any holder of a Covered Bond to the Principal Paying Agent through Euroclear and/or Clearstream, Luxembourg, as the case may be, in such manner as the Principal Paying Agent and Euroclear and/or Clearstream Luxembourg, as the case may be, may approve for this purpose.

14. Meetings of Covered Bondholders, Modification and Waiver

Covered Bondholders, Receiptholders and Couponholders should note that the Issuer, the Fund and the Principal Paying Agent may without their consent or the consent of the Representative agree to modify any provision of the Pricing Terms which is of a formal, minor or technical nature or is made to correct a proven or manifest error or to comply with any mandatory provisions of law.

The Representative and Agency Agreement contains provisions for convening meetings of the Covered Bondholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification to the Covered Bonds, the Receipts, the Coupons or any of the provisions of the Representative and Agency Agreement. Such a meeting may be convened by the Issuer, the Fund or the Representative and shall be convened by the Issuer at the request in writing of Covered Bondholders holding not less than five per cent, of the Principal Amount Outstanding of the Covered Bonds for the time being outstanding. The quorum at any such meeting for passing an Extraordinary Resolution is one or more persons holding or representing not less than 50 per cent, of the aggregate Principal Amount Outstanding of the Covered Bonds for the time being outstanding, or at any adjourned meeting one or more persons being or representing Covered Bondholders whatever the Principal Amount Outstanding of the Covered Bonds so held or represented, except that at any meeting the business of which includes the modification of any Reserved Matter (as defined in the Representative and Agency Agreement), the quorum shall be one or more persons holding or representing not less than two-thirds of the aggregate Principal Amount Outstanding of the Covered Bonds for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third of the aggregate Principal Amount Outstanding of the Covered Bonds for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Covered Bondholders shall, subject as provided below, be binding on all the Covered Bondholders, whether or not they are present at the meeting, and on all Receiptholders and Couponholders. Pursuant to the Representative and Agency Agreement, the Representative may convene a single meeting of the holders of Covered Bonds of more than one Series if in the opinion of the Representative there is no conflict between the holders of such Covered Bonds, in which event the provisions of this paragraph shall apply thereto *mutatis mutandis*.

Notwithstanding the provisions of the immediately preceding paragraph, any Extraordinary Resolution to direct the Representative to accelerate the Covered Bonds pursuant to Condition 9 or to direct the Representative to take any enforcement action pursuant to Condition 9 (each a **Covered Bond Resolution**) shall only be capable of being passed at a single meeting of the holders of the Covered Bonds of all Series then outstanding. Any such meeting to consider a

Covered Bond Resolution may be convened by the Issuer, the Fund or the Representative or by Covered Bondholders, in the case of a direction to accelerate the Covered Bonds pursuant to Conditions 9.1 and 9.2 or to take enforcement action pursuant to Condition 9.3, holding at least one-fifth of the Principal Amount Outstanding of the Covered Bonds of all Series then outstanding. The quorum at any such meeting for passing a Covered Bond Resolution is one or more persons holding or representing at least 50 per cent, of the aggregate Principal Amount Outstanding of the Covered Bonds of all Series for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing Covered Bonds whatever the Principal Amount Outstanding of the Covered Bonds of all Series then outstanding. A Covered Bond Resolution passed at any meeting of the Covered Bondholders of all Series shall be binding on all Covered Bondholders of all Series, whether or not they are present at the meeting, and on all related Receiptholders and Couponholders.

The Representative, the Fund and the Issuer may also agree, without the consent of the Covered Bondholders, Receiptholders or Couponholders (and for this purpose the Representative may disregard whether any such modification relates to a Reserved Matter), to:

- (a) any modification of the terms and conditions applying to Covered Bonds of one or more Series (including these Terms and Conditions), the related Receipts and/or Coupons or any Transaction Document provided that, in the sole opinion of the Representative, such modification is not materially prejudicial to the interests of the Covered Bondholders of any Series then outstanding; or
- (b) any modification of the terms and conditions applying to Covered Bonds of any one or more Series (including these Terms and Conditions), the related Receipts and/or Coupons or any Transaction Document which is, in the sole opinion of the Representative, of a formal, minor or technical nature or is to correct a manifest error or an error which is, in the sole opinion of the Representative, proven, or is to comply with mandatory provisions of law.

Notwithstanding the above, the Issuer, the Fund and the Principal Paying Agent may agree, without the consent of the Representative, the Covered Bondholders, Receiptholders or Couponholders, to any modification of any of the provisions of the Pricing Terms which is of a formal, minor or technical nature or is made to correct a proven or manifest error or to comply with any mandatory provisions of law.

The Representative may also agree, without the consent of the Covered Bondholders of any Series then outstanding, the related Receiptholders and/or Couponholders, to the waiver or authorisation of any breach or proposed breach of any of the provisions of the Covered Bonds of any Series, or determine, without any such consent as aforesaid, that any Issuer Event of Default or Fund Event of Default or Potential Issuer Event of Default or Potential Fund Event of Default shall not be treated as such, provided that, in any such case, it is not, in the sole opinion of the Representative, materially prejudicial to the interests of the Covered Bondholders of any Series then outstanding.

In connection with the exercise by it of any of its powers, authorities and discretions (including, without limitation, any modification, waiver, authorisation or determination), the Representative shall have regard to the general interests of the Covered Bondholders as a class (but shall not have regard to any interests arising from circumstances particular to individual Covered Bondholders, Receiptholders or Couponholders whatever their number) and, in particular but without limitation, shall not have regard to the consequences of any such exercise for individual Covered Bondholders, the related Receiptholders, Couponholders (whatever their number) resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any particular territory or any political sub-division thereof and the Representative shall not be entitled to require, nor shall

any Covered Bondholder, Receiptholder or Couponholder be entitled to claim, from the Issuer, the Fund, the Representative or any other person any indemnification or payment in respect of any tax consequences of any such exercise upon individual Covered Bondholders, Receiptholders and/or Couponholders.

For the purposes of these Terms and Conditions:

Potential Fund Event of Default means any condition, event or act which, with the lapse of time and/ or the issue, making or giving of any notice, certification, declaration, demand, determination and/or request and/or the taking of any similar action and/or the fulfilment of any similar condition, would constitute a Fund Event of Default; and

Potential Issuer Event of Default means any condition, event or act which, with the lapse of time and/or the issue, making or giving of any notice, certification, declaration, demand, determination and/or request and/or the taking of any similar action and/or the fulfilment of any similar condition, would constitute an Issuer Event of Default.

15. **Indemnification of the Representative and Representative Contracting with the Issuer and/or the Fund**

If, in connection with the exercise of its powers, authorities or discretions the Representative is of the opinion that the interests of the holders of the Covered Bonds of any one or more Series then outstanding would be materially prejudiced thereby, the Representative shall not exercise such power, authority or discretion without the approval of such Covered Bondholders by Extraordinary Resolution or by a direction in writing of such Covered Bondholders of at least one-fifth of the Principal Amount Outstanding of Covered Bonds then outstanding.

The Representative and Agency Agreement contain provisions for the indemnification of the Representative and for its relief from responsibility, including provisions relieving it from taking any action unless indemnified and/or secured to its satisfaction.

The Representative and Agency Agreement also contain provisions pursuant to which the Representative is entitled, *inter alia*: (i) to enter into business transactions with the Issuer, any of its Subsidiaries and affiliates and/or the Fund and to act as representative or trustee for the holders of any other securities issued or guaranteed by, or relating to, the Issuer, any of its Subsidiaries and affiliates and/or the Fund; (ii) to exercise and enforce its rights, comply with its obligations and perform its duties under or in relation to any such transactions or, as the case may be, any such trusteeship without regard to the interests of, or consequences for, the Covered Bondholders, Receiptholders or Couponholders; and (iii) to retain and not be liable to account for any profit made or any other amount or benefit received thereby or in connection therewith.

The Representative will not be responsible for any loss, expense or liability, which may be suffered as a result of any Loans or Related Security, or any deeds or documents of title thereto, being uninsured or inadequately insured or being held by clearing organisations or their operators or by intermediaries such as banks, brokers or other similar persons on behalf of the Representative. The Representative will not be responsible for: (i) supervising the performance by the Issuer, the Fund or any other party to the Transaction Documents of their respective obligations under the Transaction Documents and the Representative will be entitled to assume, until it has written notice to the contrary, that all such persons are properly performing their duties; (ii) considering the basis on which approvals or consents are granted by the Issuer, the Fund or any other party to the Transaction Documents under the Transaction Documents; (iii) monitoring the Portfolio, including, without limitation, whether the Portfolio is in compliance with the Asset Coverage Test; or (iv) monitoring whether Loans and Related

Security satisfy the Eligibility Criteria. The Representative will have no responsibility in relation to the legality, validity, sufficiency and enforceability of the Transaction Documents.

The Representative will not be liable for any expense, loss or damage suffered by or occasioned by reason of any action taken or omitted to be taken by the Representative pursuant to the Representative and Agency Agreement, these Terms and Conditions or any other Transaction Document or in connection therewith unless directly caused by the fraud, gross negligence or wilful default of the Representative and, in no circumstances shall the Representative be liable for any special, general or consequential damages even if the Representative has been advised of the possibility of such damages.

16. Appointment of the Representative

By holding this Covered Bond, the holder of this Covered Bonds shall be deemed to have acknowledged and agreed to the appointment of the Representative as its representative to act for the benefit of the holders for the time being of the Covered Bonds in accordance with the terms of the Representative and Agency Agreement.

17. Governing Law and Jurisdiction

The Representative and Agency Agreement, the Covered Bonds, the Receipts, the Coupons and the other Transaction Documents are governed by, and shall be construed in accordance with, Icelandic law.

The Issuer irrevocably agrees that any dispute arising out of the Representative and Agency Agreement, the Covered Bonds, the Coupons, the Receipts and/or any other Transaction Document shall be subject to the exclusive jurisdiction of the District Court of Reykjavik (*Héraðsdómur Reykjavíkur*).

Legal action taken under this Condition 17 may be proceeded with in accordance with the Act on Civil Procedure No. 91/1991 (*Lög um meðferð einkamála*), Chapter 17.

THE PRICING TERMS

Set out below are the Pricing Terms applicable to the Covered Bonds to be admitted to trading on the regulated market of the NASDAQ OMX Iceland hf. only. For the avoidance of doubt, on the date of this Prospectus, the Pricing Terms will be the only Pricing Terms applicable in respect of the Covered Bonds. The terms of the Covered Bonds will be set out in full in the Terms and Conditions read together with the Pricing Terms. No further Pricing Terms will be prepared in respect of the listing of the Covered Bonds. The Pricing Terms have been prepared on the basis of the information set out in the Pricing Supplements prepared in respect of the Covered Bonds at the time of issuance thereof.

PART A – GENERAL INFORMATION

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|-----|-----|---|--|
| 1. | (a) | Issuer: | Arion Bank hf. |
| | (b) | Guarantor: | Arion Bank Mortgages Institutional Investor Fund |
| 2. | | Series Number: | 2 |
| 3. | | Specified Currency or Currencies: | ISK. The Covered Bonds have been issued in denominations of ISK 1. |
| 4. | | Aggregate Nominal Amount: | 51,124,548,392 |
| 5. | | Issue Price: | 89.14 per cent. of the Aggregate Nominal Amount of the Covered Bonds issued on 30 March, 2006

95.1957 per cent. of the Aggregate Nominal Amount of the Covered Bonds issued on 1 August, 2006 |
| 6. | | Specified Denominations: | ISK |
| 7. | (a) | Issue Date: | 30 March, 2006 and 1 August, 2006 |
| | (b) | Interest Commencement Date: | 10 April, 2006 |
| 8. | | Final Maturity Date: | 10 July, 2048 |
| 9. | | Interest Basis: | Inflation Linked Interest |
| 10. | | Redemption/Payment Basis: | Annuity |
| 11. | | Change of Interest Basis or Redemption/Payment Basis: | Not Applicable |
| 12. | | Call Option: | Issuer Call |
| 13. | (a) | Status of the Covered Bonds: | Senior |
| | (b) | Status of the Covered Bond Guarantee: | Senior |
| | (c) | Board approval for issuance of Covered Bonds and Covered Bond Guarantee obtained: | 26 October, 2011 (with respect to the Issuer) and 10 March, 2006 and 21 February, 2008 (with respect to the Guarantor) |

14. Method of distribution: Non-syndicated

PROVISIONS RELATING TO INFLATION LINKED ANNUITY COVERED BONDS

15. Inflation Linked Annuity Covered Bonds Applicable

- (a) Rate(s) of Interest: 3.75 per cent. per annum payable quarterly in arrear
- (b) Interest Payment Date(s): The 10th day of January, April, July and October in each year up to and including the Final Maturity Date, with the first Interest Payment Date being 10 July, 2006.
- (c) Day Count Fraction: 30/360
- (d) Business Day Convention: Following
- (e) Formula for calculation of principal in amount due as specified in Condition 6.1: An amount calculated by the Calculation Agent in accordance with the following formula:

$$A = \frac{r(1+r)^{k-1}}{(1+r)^n - 1} \times d$$

where:

A = The amount of each instalment of the relevant Covered Bonds;

$r = c/4$;

c = The Rate of Interest applicable to the relevant Covered Bonds;

d = The Specified Denomination of the relevant Covered Bonds;

n = 109; and

k = The number of payments that have already taken place + 1 (*k = 1 for the first payment, k = 2 for the second payment, etc*)

- (f) Calculation of Annuity Amount: The formula to calculate the Annuity Amount is as follows:

$$P = \frac{r}{1 - (1+r)^{-n}} \times IR \times d$$

where:

P = The combined payment of principal, interest and indexation amount of the relevant Covered Bonds;

$$r = c/4;$$

c = The Rate of Interest applicable to the relevant Covered Bonds;

d = The Specified Denomination of the relevant Covered Bonds;

n = 169; and

IR = The Index Ratio as determined in accordance with subparagraph (h) below

- | | | |
|-----|-------------------------|---|
| (g) | Calculation Agent: | Issuer |
| (h) | Initial Annuity Amount: | 343,480,165 in respect of the Covered Bonds issued on 30 March, 2006
261,253,506 in respect of the Covered Bonds issued on 1 August, 2006 |
| (i) | Index Ratio: | The value of the Index Ratio (IR) on the relevant Interest Payment Date shall be the value of the Reference Index (RI) applicable to the relevant Interest Payment Date divided by the value of the Base Index (BI) as calculated by the Calculation Agent |

$$\text{being IR} = \frac{\text{RI}}{\text{BI}}$$

where:

Reference Index or RI means:

- (i) for the first day of the relevant calendar month, the value of the Consumer Price Index (the **CPI**) for the relevant month as calculated by Statistics Iceland pursuant to the Consumer Price Index Act of 1995 (*lög um visitölu neysluverðs nr. 12/1995*) and published monthly in the Legal Gazette (*Lögbirtingarblaðið*);
- (ii) for each day in the relevant calendar month other than the first day:
 - (a) if the CPI for the calendar month immediately succeeding the month in which the relevant Interest Payment Date falls (the **Succeeding Month CPI**) has been published as at the relevant Interest Payment Date:

$$RI = CPI_t \times \left(\frac{CPI_{t+1}}{CPI_t} \right)^{\frac{d}{30}}$$

- (b) if the Succeeding Month CPI has not been published as at the relevant Interest

Payment Date:

$$RI = CPI_t \times (1 + i)^{\frac{d}{360}}$$

Where:

RI = Reference Index;

CPI_t = CPI value for the first day of the relevant calendar month;

CPI_{t+1} = Succeeding Month CPI;

d = number of days since the first day of the month; and

i = annualised inflation forecast of the Central Bank of Iceland

and

Base Index means 252.3.

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

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

PROVISIONS RELATING TO REDEMPTION

16.	Issuer Call:	Applicable
(a)	Optional Redemption Date(s):	Each Interest Payment Date
(b)	Optional Redemption Amount of each Covered Bonds and method, if any, of calculation of such amount(s):	Condition 6.5 applies
(c)	If redeemable in part:	
(i)	Minimum Amount:	Redemption Not Applicable
(ii)	Maximum Amount:	Redemption Not Applicable

- (d) Notice period (if other than as set out in the Terms and Conditions): As set out in the Terms and Conditions
17. Final Redemption Amount of each Covered Bond: Not Applicable
18. Early Redemption Amount of each Covered Bond payable on redemption on event of default, etc. and/or the method of calculating the same (if required or if different from that set out in Condition 6.4): As set out in Condition 6.4

GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS

19. Form of Covered Bonds: Temporary Global Covered Bond exchangeable for a Permanent Global Covered Bond which is exchangeable for Definitive Covered Bonds only after an Exchange Event
20. Additional Financial Centre(s) or other special provisions relating to Payment Days: Not Applicable
21. Talons for future Coupons or Receipts to be attached to Definitive Covered Bonds (and dates on which such Talons mature): Yes

DISTRIBUTION

22. (a) If syndicated, names of Managers: Not Applicable/
 (b) Date of Subscription Agreement: 30 March, 2006 in respect of the Covered Bonds issued on such Issue Date
 1 August, 2006 in respect of the Covered Bonds issued on such Issue Date
23. If non-syndicated, name of relevant Dealer: Arion Bank hf.
24. Whether TEFRA D or TEFRA C rules applicable or TEFRA rules not applicable: TEFRA D

PART B – OTHER INFORMATION

1. LISTING

- (a) Listing: NASDAQ OMX Iceland hf.
- (b) Admission to trading: Application has been made for the Covered Bonds to be admitted to trading on Nasdaq OMX Iceland hf.
- (c) Estimate of total expenses related to admission to trading: ISK 1,617,500

2. RATINGS

Ratings: Not Applicable

3. NOTIFICATION

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

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

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

5. REASONS FOR THE OFFER, ESTIMATED NET PROCEEDS AND TOTAL EXPENSES

- (a) Reasons for the offer: As set out in *Use of Proceeds*.
- (b) Estimated net proceeds: ISK 47,805,806,144
- (c) Estimated total expenses: ISK 1,617,500

6. PERFORMANCE OF INDEX/FORMULA/CPI, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING

Historic performance of the CPI and its influence on the value of the Covered Bonds

The general cash-flow of the Covered Bonds is determined in real terms on the Issue Date. The nominal value of each future payment depends on the development of the CPI as demonstrated by the formula in paragraph 15 of Part A of this Pricing Terms.

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

The development of the CPI since 2004 is set out in the table below:

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
January	230,1	239,2	249,7	266,9	282,3	334,8	356,8	363,4	387,1	403,3	415,9
February	229,4	239,7	249,5	268,0	286,2	336,5	360,9	367,7	391,0	409,9	418,7
March	230,7	241,5	252,3	267,1	290,4	334,5	362,9	371,2	395,1	410,7	419,7
April	232,0	242,0	255,2	268,7	300,3	336,0	363,8	374,1	398,2	411,5	421,0
May	233,9	240,7	258,9	271,0	304,4	339,8	365,3	377,6	398,1	411,3	421,3
June	235,7	242,4	261,9	272,4	307,1	344,5	364,1	379,5	400,1	413,5	422,8
July	234,6	242,7	263,1	273,0	310,0	345,1	361,7	379,9	397,2	412,4	422,1
August	234,6	243,2	264,0	273,1	312,8	346,9	362,6	380,9	396,6	413,8	423,1
September	235,6	246,9	265,6	276,7	315,5	349,6	362,6	383,3	399,6	415,2	422,6
October	237,4	248,4	266,2	278,1	322,3	353,6	365,3	384,6	400,7	415,2	-
November	237,9	248,0	266,1	279,9	327,9	356,2	365,5	384,6	402,0	416,7	-
December	239,0	248,9	266,2	281,8	332,9	357,9	366,7	386,0	402,2	418,9	-

Source: Iceland Statistics

The Central Bank's main objective is price stability, defined as a 12-month rise in the CPI of 2.5 per cent. The aim is to keep the rate of inflation on average as close to the target as

possible. If it deviates by more than 1.5 per cent. in either direction, the Central Bank is obliged to present the Icelandic Government with a report, which will be made public, explaining the reasons for the deviation from the target and the Central Bank's responses to the deviation.

The development of 12 month inflation (in percentage terms) since 2004 is set out in the table below:

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
January	2,4	4,0	4,4	6,9	5,8	18,6	6,6	1,8	6,5	4,2	3,1
February	2,3	4,5	4,1	7,4	6,8	17,6	7,3	1,9	6,3	4,8	2,1
March	1,8	4,7	4,5	5,9	8,7	15,2	8,5	2,3	6,4	3,9	2,2
April	2,2	4,3	5,5	5,3	11,8	11,9	8,3	2,8	6,4	3,3	2,3
May	3,2	2,9	7,6	4,7	12,3	11,6	7,5	3,4	5,4	3,3	2,4
June	3,9	2,8	8,0	4,0	12,7	12,2	5,7	4,2	5,4	3,3	2,2
July	3,6	3,5	8,4	3,8	13,6	11,3	4,8	5,0	4,6	3,8	2,4
August	3,7	3,7	8,6	3,4	14,5	10,9	4,5	5,0	4,1	4,3	2,2
September	3,4	4,8	7,6	4,2	14,0	10,8	3,7	5,7	4,3	3,9	1,8
October	3,7	4,6	7,2	4,5	15,9	9,7	3,3	5,3	4,2	3,6	-
November	3,8	4,2	7,3	5,2	17,1	8,6	2,6	5,2	4,5	3,7	-
December	3,9	4,1	7,0	5,9	18,1	7,5	2,5	5,3	4,2	4,2	-

Source: Iceland Statistics

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

Information about the CPI can be obtained from www.hagstofa.is or www.statice.is.

7. OPERATIONAL INFORMATION

- (a) ISIN Code: XS0249806935
- (b) Common Code: 026345782
- (c) Any clearing system(s) other than Euroclear Bank S.A./N.V. or Clearstream Banking, société anonyme and the relevant identification number(s): Not Applicable
- (d) Delivery: Delivery against payment
- (e) Names and addresses of additional Paying Agent(s) (if any): Not Applicable

USE OF PROCEEDS

The gross proceeds from each issue of Covered Bonds has been used by the Issuer to make available Term Advances to the Fund pursuant to the terms of the Intercompany Loan Agreement, which in turn have been used by the Fund either:

- (a) to acquire Loans and their Related Security;
- (b) subject to an Asset Coverage Test Breach Notice not having been served (and not revoked), to make a Unit Distribution to a Holder;
- (c) to invest in Substitution Assets in an amount not exceeding the prescribed limit; and/or
- (d) if an existing Series, or part of an existing Series, of Covered Bonds was being refinanced, to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced; and/or
- (e) to deposit all or part of the proceeds into the GIC Account.

DESCRIPTION OF THE ISSUER

OVERVIEW

Arion Bank hf. is the entity to which certain assets and liabilities of Kaupthing Bank hf. (**Kaupthing**) were transferred following the assumption of control of Kaupthing by the Icelandic government towards the end of 2008. The Bank was established on 18 October 2008 and is incorporated in Reykjavik and domiciled in Iceland. It is a public limited company established under Act No 2/1995 regarding Public Limited Companies, under the laws of the Republic of Iceland with ID number 581008-0150 in the Icelandic Register of Enterprises. Arion Bank holds a licence from the Financial Supervisory Authority of Iceland to conduct financing business as a commercial bank under Article 2, Act number 161/2002, on financial undertakings. The Bank was initially named New Kaupthing banki hf. and, on 21 November 2009, its name was changed to Arion banki hf.

The Bank faced a number of challenges following its establishment. In particular, the assets and liabilities acquired by the Bank resulted in significant foreign exchange, interest rate and liquidity mismatches. In addition, an asset shortfall of ISK 38.3 billion resulted in a priority claim on Kaupthing, see "*—Related Party Transactions*". Further, a serious recession in Iceland in 2009 and 2010 resulted in significant nonperforming loans and poor asset quality.

To address these risks, the Bank has focused on restructuring its loan portfolio and expanding its sources of funding as well as reducing other mismatches and maintaining high levels of liquidity and capital. In addition, a strategic plan was adopted in October 2010 which seeks to position the Bank as a universal bank providing a range of quality services and focuses on improving the Bank's competitiveness.

Since 2011, the Bank has made significant progress in loan restructuring and has completed the majority of this work, although it expects that some personal and corporate borrowers will continue to require assistance for some time. In 2014, the Bank continued its progress in the sale of companies acquired as a result of collateral enforcement procedures and has now sold most of these companies.

As a result of debt restructurings and other enforcement procedures, the Bank has in recent years acquired a significant amount of assets (largely in the form of shareholdings in companies). Since 2012, the Bank has made steady progress in the sale of companies acquired as a result of these collateral enforcement procedures (see "*- Asset Holding Companies*").

In the six month period ended 30 June 2014, the Bank's net interest income was ISK 12.0 billion (compared to ISK 12.7 billion in the six month period ended 30 June 2013), its operating income was ISK 25.7 billion (compared to ISK 20.7 billion in the six month period ended 30 June 2013) and its net earnings were ISK 17.4 billion (compared to ISK 5.9 billion in the six month period ended 30 June 2013). As at 30 June 2014, the Bank's total assets were ISK 949.0 billion.

In the year ended 31 December 2013, the Bank's net interest income was ISK 23.8 billion (compared to ISK 27.1 billion in 2012), its operating income was ISK 44.3 billion (compared to ISK 49.5 billion in 2012) and its net earnings were ISK 12.7 billion (compared to ISK 17.1 billion in 2012). As at 31 December 2013, the Bank's total assets were ISK 938.8 billion.

The Bank's registered address is Borgartún 19, 105 Reykjavík and its telephone number is +354 444 7000.

HISTORY

The Bank was established at the end of 2008 as the vehicle to receive the transfer of certain assets and liabilities of Kaupthing following the Icelandic government assuming control over Kaupthing towards the end of 2008. Kaupthing was the product of a merger in May 2003 of two of Iceland's then leading banks, Kaupthing Bank hf. and Bunadarbanki Islands hf. (**Bunadarbanki**). Bunadarbanki was established in 1929 by a law passed by the Icelandic parliament, the Althingi. At the beginning of 1998,

Bunadarbanki became a limited liability company and was privatised in stages up to the beginning of 2003. Kaupthing hf. was established in Reykjavik in 1982, coinciding with the launch of the free capital market in Iceland. Kaupthing hf. later became an investment bank before its merger with Bunadarbanki in 2003.

In July 2009, the Icelandic government and the resolution committee of Kaupthing (the **Kaupthing Resolution Committee**) reached agreement on the valuation of the assets transferred to the Bank through the issue of a compensation instrument by the Bank to Kaupthing. In addition, the agreement identified certain ring-fenced assets in respect of which Kaupthing's creditors were accorded a share in certain future increases of value through an escrow and contingent rights agreement (the **ECVRA**) and creditors (through the Kaupthing Resolution Committee) were also granted an option to purchase up to 87 per cent. of the Bank's equity, see "*—Related Party Transactions*".

In March 2009, following a ruling from the FME, the Bank acquired all the deposits and card transactions of over 20,000 customers from SPRON. The operations of the six SPRON branches and its online bank were discontinued following the acquisition. In April 2009, the Bank acquired Mýrasýsla Savings Bank (**SPM**) in Borgarnes and merged SPM with its branch in Borgarnes, increasing its customer base by a further 2,000 clients.

In December 2009, the Kaupthing Resolution Committee acting through Kaupskil ehf. (**Kaupskil**), a whollyowned subsidiary of Kaupthing, exercised its option to acquire shares in the Bank and, following a capital injection in January 2010, Kaupthing is currently the owner of 87 per cent. of the Bank with the Icelandic government owning the remaining 13 per cent.

In March 2010 a new board of directors (the **Board**) was appointed at the Bank's annual general meeting and, on 1 June 2010, the Board appointed a new chief executive officer (**CEO**).

On 30 June 2011, the Bank and Kaupthing executed a settlement agreement under which the compensation instrument and the ECVRA were both discharged.

In January 2012, the Bank acquired the mortgage portfolio managed in a special fund (the **Fund**) owned by the estate of Kaupthing. The Fund had guaranteed the covered bonds issued from 2006 to 2008 by Kaupthing to finance its mortgage loans (the **Kaupthing Covered Bonds**) under the covered bond programme established by Kaupthing on 30 March 2006 (the **Kaupthing Covered Bond Programme**). As a part of this acquisition, the Bank was substituted for, and has assumed all liabilities and obligations (past, present and future, other than Kaupthing's liabilities and obligations relating to withholding tax payments) of, Kaupthing in respect of each of the six series of outstanding Kaupthing Covered Bonds. The Kaupthing Covered Bonds are inflation linked with final maturities between 2033 and 2048, and have an aggregate face value of approximately ISK 92.5 billion.

The Bank paid an agreed cash consideration to the Kaupthing Resolution Committee in connection with its acquisition of the Fund. The mortgage portfolio which the Bank now holds following the acquisition of all of the units in the Fund was valued at ISK 110 billion when it was acquired.

CURRENT WINDING UP PROCEEDINGS FOR KAUPTHING

In October 2008, Kaupthing was taken into a special resolution regime (see "*Risk Factors - The Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and remains vulnerable to external shocks and a range of internal risks*"), and the Kaupthing Resolution Committee was appointed by the FME.

Under this regime, Kaupthing entered into moratorium on 24 November 2008, which ended following a ruling of the Reykjavik District Court, on 22 November 2010, after which it entered into a winding-up process.

Prior to its dissolution, the Kaupthing Resolution Committee represented Kaupthing in all matters and safeguarded its interest. The Kaupthing Resolution Committee had a legal obligation to maximise the value of Kaupthing's assets and preserve the interests of its creditors as a whole. In addition, the Kaupthing Resolution Committee was responsible for managing Kaupthing's daily operations.

In May 2009, the Reykjavik District court approved a request from the Kaupthing Resolution Committee and appointed a Winding-up Committee (the **Winding-up Committee**) for Kaupthing, to administer the processing of claims against Kaupthing. Prior to the dissolution of the Kaupthing Resolution Committee, the Winding-up Committee worked alongside the Kaupthing Resolution Committee and administered the formal process of filing and handling all claims against Kaupthing.

Under winding-up proceedings, agreements and obligations of the financial undertaking continue to exist and Kaupthing is protected against petitions for insolvent liquidation. Its assets cannot become subject to an attachment, execution or forced sale. No law suit can be filed against Kaupthing in Iceland while it is in winding-up proceedings, unless in accordance with a provision of law (primarily concerning disputes as to the processing of claims against Kaupthing) or through criminal proceedings.

The Kaupthing Resolution Committee was dissolved on 1 January 2012 and the Winding-up Committee has assumed all responsibility for managing the Kaupthing estate since that date.

Since the claims against Kaupthing exceed its assets, the Winding-up Committee is currently seeking a composition with Kaupthing's creditors and working to prepare a draft proposal to that effect. In the event that such efforts prove unsuccessful and a proposal is not approved by the creditors or there is no basis for seeking a composition, the Winding-up Committee is likely to request the District Court which appointed it to place Kaupthing in bankruptcy proceedings. If Kaupthing is declared bankrupt, the general rules on bankruptcy proceedings would apply, which may result in the forced sale of assets and other similar processes. However, all actions taken during the winding-up proceedings concerning claims against Kaupthing including the notice to creditors and the processing of claims submitted shall remain valid.

More information about Kaupthing, its current status and potential closing of the winding-up proceedings can be found on <http://www.kaupthing.com>.

SHAREHOLDER OF THE BANK

Kaupthing's shareholding in the Bank is held through its wholly owned subsidiary Kaupskil, a private limited liability company, ID no. 580609-0150, Borgartún 26, Reykjavik. Kaupthing Bank, through its subsidiary Kaupskil ehf., now holds an 87 per cent. stake in the Bank and the Ministry of Finance holds the remaining 13 per cent. The Kaupthing Winding-up Committee appoints one member of Kaupskil's board but the other two must be independent. Further, under a special representation agreement between Kaupskil and Kaupthing dated 20 April 2010, Kaupthing has agreed to respect the independence of the board of directors of Kaupskil and Kaupthing's duty to promote sound and solid financial operations of the Bank free of external intervention. The board of directors of Kaupskil is required to report to the FME on the implementation of this policy on a quarterly basis. In order to facilitate supervision, Kaupskil is required to transfer the ownership of all financial and insurance subsidiaries to a single parent company if the FME considers such a transfer necessary.

Various restrictions have been placed on Kaupthing by the FME, including with regard to the sale of shares of the Bank before September 2012. Kaupthing is required to notify the FME in advance of a proposed transfer of ownership of shares in the Bank or Kaupskil. Upon receipt of any such notification, the FME will carry out a new eligibility assessment of the prospective owners if the change of ownership affects the board of directors of the Bank. The FME set out the details of its approval and conditions in a press release dated 18 January 2010 (<http://www.fme.is/utgefid-efni/frettir-og-tilkynningar/frettir/nr/602>).

STRATEGY

Following the appointment of a new Board and CEO in mid-2010, a new strategic plan for the Bank was adopted in October 2010. The key elements of the strategy are:

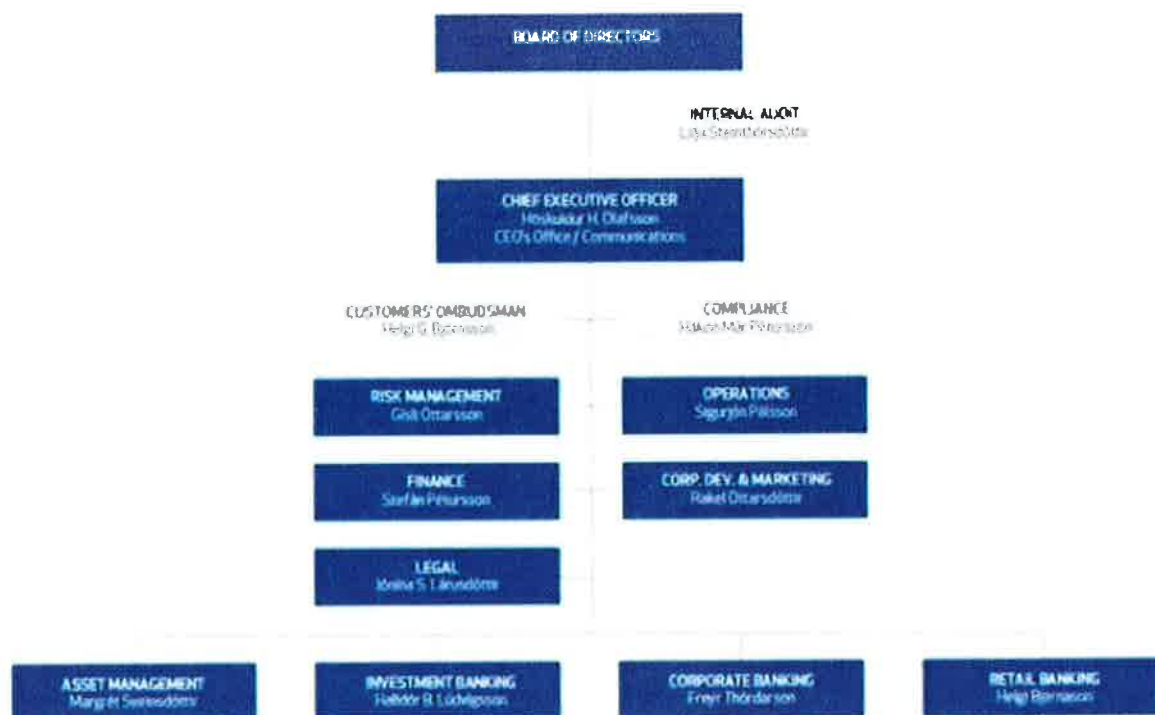
- positioning the Bank as a universal bank in Iceland, providing a wide range of services and focusing on tailored and personalised solutions for its customers, with special emphasis being placed on the Bank's ability to meet the financial needs of those customers, both retail and corporate, which require comprehensive and diverse financial services;
- improving the Bank's competitiveness by focusing on its product offering, quality of service, efficiency and profitability in its operations. In particular, the Bank reduced its branch network from 39 branches at the end of 2008 to 25 branches at the end of 2013 and has also sought to reduce back office costs and streamline its organisational structure; and
- in relation to business customers, emphasising the Bank's focus on developing long-term business relationships through continuous dialogue with customers so as to fully understand their needs and continuous product development which the Bank believes is fundamental to successful business relationships. The Bank aims to innovate and develop products and services which respond to the changing needs of its customers and to put its customers' interests first in all transactions.

The Bank's core values (or Cornerstones) were introduced in 2012 and are "We make a difference, we say what we mean, and we get things done". The Cornerstones guide the Bank in everything it says and does, particularly in its interaction with its main stakeholders, that is its customers, employees, society and shareholders.

From its creation at the end of 2008, the immediate and ongoing areas of focus for the Bank have been the restructuring of its loan portfolio, expansion of its sources of funding and the need to rebuild trust with its customers, Icelandic society as a whole and international financial institutions and investors. In addition, the Bank inherited certain significant risks in terms of loan and funding concentrations and currency mismatches, which it has sought to reduce whilst focusing on maintaining high levels of liquidity and capital.

BUSINESS

The chart below illustrates the Bank's principal operating and support functions as at 30 June 2014.



The Bank has six main reporting 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, 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 26 branches all around Iceland are over 100,000.

Asset Management division comprises Institutional Asset Management, Private Banking and Investment Services. Asset Management manages financial assets on behalf of its customers 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. Treasury is also responsible for the internal pricing of interest rates and currency and for liaising with other financial institutions.

Other divisions and Subsidiaries include the Bank's market making business in domestic securities and currencies and the management of assets that the Bank has acquired through debt restructurings and other enforcement procedures. The subsidiaries are Eignabjarg ehf., Eignarhaldsfélagið Landey ehf., Landfestar ehf. (sold 30 June 2014), Okkar líftryggingar hf., Valitor holding hf. and other smaller entities.

The tables below show operating income and earnings before tax for each segment for the six month period ended 30 June 2014 and each of the years ended 31 December 2013 and 31 December 2012 and the total assets of each reporting segment at, 30 June 2014, 31 December 2013 and 31 December 2012.

Six month period ended as at 30 June 2014								
	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Head- Quarters and Elimination	Total
<i>(ISK million)</i>								
Operating income	4,318	7,653	2,166	5,602	1,332	3,688	941	25,700
Earnings before tax	6,211	3,817	1,447	5,219	1,883	1,084	(4,935)	14,726
Total assets	238,184	401,183	4,858	30,783	191,420	60,121	22,444	948,993

Year ended/as at 31 December 2013								
	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Head- Quarters and Elimination	Total
<i>(ISK million)</i>								
Operating income	9,315	14,565	3,701	4,422	2,710	8,791	844	44,348
Earnings before tax	12,446	3,353	2,924	5,564	2,886	3,071	(11,971)	18,273
Total assets	248,082	397,721	4,840	34,799	168,334	77,150	7,924	938,850

Year ended/as at 31 December 2012								
	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Head- Quarters and Elimination	Total
<i>(ISK million)</i>								
Operating income	11,434	14,274	4,170	4,510	4,661	9,586	867	49,502

Year ended/as at 31 December 2012

	Corporate Banking	Retail Banking	Asset Management and Stefmir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Head- Quarters and Elimination	Total
Earnings								
before tax..	10,559	3,310	2,528	5,006	4,634	4,750	(10,643)	20,144
Total assets	251,384	318,700	4,597	26,000	212,315	80,057	7,622	900,675

Corporate Banking Division

The Bank's Corporate Banking division provides a range of financial services and products to its corporate clients. The prime focus of the division is to maintain long-term relationships with its clients and to deliver tailored solutions and personalised services. The division had 28 full time equivalent employees (FTEs) at 30 June 2014.

The Corporate Banking division provides services to corporate clients, from medium-sized businesses to large corporations. Corporate Banking comprises a team of account managers specialising in industries, such as services, manufacturing and real estate, and/or lending, such as project finance and structured finance. The account managers are each responsible for specific clients, thus ensuring personal services and a clear overview of each client's financial requirements. Each account manager also relies on the assistance of staff in a range of support functions, including trade finance and guarantees, legal and documentation, portfolio management and corporate services.

Although a significant proportion of the Corporate Banking division's business is the provision of credit, the Bank offers a wide range of products and financial solutions to meet the needs of each customer. Examples of these services include cash management solutions, a range of deposit products, automatic billing and collection services, online payment slips, internet banking and factoring.

The Corporate Banking loan portfolio principally comprises large corporate customers many of which had become over-leveraged following the 2008 financial crisis and the sharp depreciation of the Icelandic krona. The loans of a majority of the Corporate Banking customers in this position have either been restructured, refinanced or are still undergoing a restructuring process.

In 2011, the Bank started to offer factoring, or asset-based lending, which is used by SMEs, both importers and exporters. In particular, the Bank uses factoring in connection with trade finance, where inventory financing is linked with the financing of receivables which suits the needs of exporters, such as fishing companies.

At the beginning of 2012, the Bank entered into a partnership with European insurer, Euler Hermes, which enables its corporate clients to insure themselves against counterparty default. This type of credit insurance is increasingly important to companies engaged in the export and import business.

The Corporate Banking division is organised into six units; corporate lending, specialised lending, factoring, legal and documentation, portfolio management and corporate services. A seventh unit, recovery, existed until the end of 2013. The recovery unit was responsible for the Bank's debt recovery and was particularly involved in restructuring companies which were experiencing payment difficulties. As at 31 December 2013, 1,026 clients had entered the restructuring process and the process had been completed in 1,012 of these cases. During the restructuring process, the Bank acquired assets previously owned by the restructured companies. These assets have been transferred into separate holding companies under the control of the Bank. The restructuring process is now overseen by the Bank's legal department.

Retail Banking Division

The Retail Banking division provides a range of banking services to individual as well as SMEs. Retail Banking serves its customers through its branch network and other points of contact such as online banking, a call centre and automatic telling machines (ATMs). As at 30 June 2014, the Bank had 26 branches throughout Iceland and over 100,000 retail customers. The branches provide a comprehensive range of financial services, including advice on deposits and loans, payment cards, pension savings, insurance, securities and funds, with a focus on tailored solutions and personalised services to meet customer needs. Retail Banking had 375 FTEs at 30 June 2014.

Following its establishment in late 2008, the Bank has sought to streamline its retail banking operations by merging a number of its branches. This strategy has resulted in a reduction of the branch network and has created larger and stronger branches which the Bank believes are better able to meet the needs of its customers.

Retail Banking seeks to build long-lasting and profitable relationships with its customers. To maximise operational efficiency the branch network is divided into six clusters, and each cluster has its own business manager. Smaller branches capitalise on the strength of larger units within each cluster. As a result, more executive authority and responsibility is transferred to the branches and therefore closer to the customers. Three of the business managers work in the greater Reykjavik area and three in other large urban areas.

Retail Banking is in the process of establishing financial consultants within its branches with a view to improving the level of service to its customers. The financial consultants are expected to be knowledgeable in a wide range of fields including banking services, pensions and insurance and other financial instruments.

In the period up to 2012, the Bank's key focus was to work with its customers to restructure their debts. However, during 2012 the Bank noted clear signs that demand for traditional financial services was increasing and accordingly switched its focus to providing such services. In August 2012, the Bank launched a new application which enables its customers to keep track of their finances with a single click and without having to log in. Use of the application has steadily increased and, during 2013, 32 per cent. of online access to Arion Online Bank was through this application.

In October 2011, the Bank was the first bank in Iceland to offer non-inflation indexed mortgages with interest fixed for five years. The Bank also offers mixed mortgages which are partly indexed and partly noninflation indexed, which allows customers to find the type of loan that best suits their risk appetite and ability to repay. The Bank's latest product is designed to temporarily lower the borrower's debt repayments during parental leave.

In the autumn of 2012, Retail Banking launched a new unit which specialises in financing vehicles and various other types of equipment for personal and commercial use. In late 2012, the savings bank, Sparisjodur Olafsfjardar, merged with the Bank. This increased the number of the Bank's branches by one and allows the Bank to improve the services it offers in northern Iceland and to consolidate its position in that region.

Asset Management Division

The Asset Management division is responsible for managing assets on behalf of the Bank's clients, including institutional investors, corporations, high net worth clients and retail investors. It offers a wide range of services and a broad product mix. In addition to mutual funds, alternative investment vehicles and pension plan schemes, the division offers customised asset allocation strategies and managed accounts designed to meet the diverse needs of investors. The division also offers funds from other leading global fund management companies.

Private Banking, a unit within the Asset Management division, seeks to provide first-class financial services tailored to the needs of individual clients with over ISK 10 million in assets under management. Each private banking client has his own account manager who provides personal service and financial advice suited to the client's needs.

Institutional Asset Management, another unit within the Asset Management division, services pension fund clients, trade unions, insurance companies, government institutions and other institutional investors. The services offered to these clients include portfolio management and advice on devising investment strategies.

The Bank's subsidiary, Stefmir Asset Management Company (**Stefmir**), is also part of the Asset management division. Stefmir is Iceland's largest fund management company with assets of around ISK 413.6 billion under active management. Stefmir caters for both retail and professional clients with the aim of managing its clients' assets as best serves their interests. The company was founded in 1996 and its employees possess on average over 10 years' experience in the financial market. Stefmir has 16 specialists in four teams managing a diverse collection of mutual, investment and institutional investment funds. The company also manages assets of several limited partnerships that have been established around private equity investments in well known Icelandic companies. Stefmir is wholly-owned by the Bank and had 22 FTEs at 30 June 2014.

As at 30 June 2014, the Bank had consolidated assets under management of ISK 915 billion. Asset Management had 32 FTEs at 30 June 2014.

During 2012, the Bank's subsidiary, Verdis, was merged into the Bank. Verdis provided custody and fund administration services which are now provided under the Arion brand.

The Asset Management division aims to continue satisfying its clients' needs by offering first-class services and a broad product range with competitive returns on investments as well as safeguarding its clients' interests.

Investment Banking Division

The Investment Banking division is divided into three units, Corporate Finance, Capital Markets and Research. The Investment Banking division had 34 FTEs at 30 June 2014.

Corporate Finance

Corporate Finance provides advisory services to corporate clients and investors in relation to merger and acquisition (**M&A**) and capital markets transactions, together with advice on funding and capital controls. The Bank's principal investments are also managed within Corporate Finance.

The collapse of the Icelandic stock market in 2008 and the over-leveraging of a significant proportion of Icelandic companies had a significantly negative impact on M&A activities in Iceland. During 2009 and 2010, Corporate Finance was involved in a limited number of share listings and delistings as well as the sale of shares in companies which had been acquired by the Bank in settlement of debts owed. Corporate Finance has also provided valuation reports, managed bond offerings and advised clients on investment opportunities.

In 2011, Corporate Finance managed the listing of Hagar hf. (**Hagar**), which the Bank had acquired through a debt enforcement process, in Iceland's first public equity offering since 2008.

During 2012, Corporate Finance managed the sale of the Group's shares in Hagar, B.M. Valla ehf., Penninn a Islandi ehf., Boyfood Oy in Finland and Fram Foods AB in Sweden. Corporate Finance also advised the Bakkavor Group on its financial restructuring and arranged the listing of asset-backed bonds issued by institutional investor funds run by Stefmir on NASDAQ OMX Iceland hf.

In 2013, Corporate Finance managed the listing of each of VÍS hf., N1 ehf. and Skipti ehf., the sale of a stake in Sena ehf., the sale of Klakki ehf.'s stake in VÍS hf., the sale of Fram Foods Ísland hf. (which was owned by Arion Bank's subsidiary Eignabjarg ehf.) and the acquisition of both Skeljungur hf. and Magn P/F by SF IV slhf. (which is managed by Arion Bank's subsidiary Stefnir). Corporate Finance has also been involved in the merger between the Bank's subsidiary Landfestar ehf. and Eik Fasteignafélag hf. (Eik). In addition, Corporate Finance arranged the listing on NASDAQ OMX Iceland hf. of covered bonds issued by institutional investor funds managed by Stefnir.

In the first half of 2014 the Bank sold majority of its shareholding in HB Grandi hf and the company's listed the shares on the Main List of NASDAQ OMX Iceland hf.

Corporate Finance is currently working on the refinancing and possible stock market listing of Reitir Properties hf., a real estate company and is involved in two major investment projects in Iceland in recent months, namely projects for United Silicon and Silicor Materials. The United Silicon project is in the execution phase while Silicor is still in the development phase.

Capital Markets Unit

The Capital Markets unit provides securities brokerage and FX sales for institutional investors and corporate clients. It is divided into FX and Fixed Income Sales and Equity Sales.

FX and Fixed Income Sales offers domestic and foreign brokerage of currency, fixed income and derivatives for institutional investors, corporate clients and smaller domestic financial institutions. Equity Sales is responsible for the brokerage of domestic and foreign equities for institutional investors and corporate clients. Trading on the FX market is significantly restricted in Iceland by the capital controls established in 2008. In the fixed income market, the principal instruments traded are government bonds.

On the equities side, the Bank focuses on the United States and Nordic equity markets. The Bank also remains active in the domestic equity market although the market is currently limited. However, a number of companies were listed on NASDAQ OMX Iceland hf. in 2012 and 2013.

In the fixed income market, while the government bond market has reached saturation levels, additional investment options, such as asset-backed bonds and corporate bonds, have been introduced.

Trading on the foreign exchange market remains minimal, although the Central Bank held a number of currency auctions in 2012 and 2013 as part of the process of lifting capital controls. The main aim of Capital Markets is to provide its growing client base with a comprehensive range of capital markets services and access to expert knowledge. The focus in the medium term is expected to shift towards product development as investors seek more opportunities to invest and distribute risk.

Research

Arion Research publishes macro research on the Icelandic economy and its developments, as well as research on individual companies and sectors. It publishes regular forecasts and updates on key economic issues. Arion Research holds regular conferences at which new research and reports produced by the unit are presented, such as economic forecasts, analysis of the real estate market, analysis of the finances of various municipalities as well as other different sectors. As more domestic initial public offerings take place, Arion Research is also focusing on providing clients of Investment Banking and Asset Management with research on listed companies and companies planning to go public in the near future. Arion Research is independent of the other divisions of the Bank.

Other Divisions and Subsidiaries

Other divisions

The Bank has five support divisions:

- **Corporate Development & Marketing:** This division assists the Bank in implementing organisational changes, entering new markets, introducing new products, acquiring or divesting assets or divisions and establishing strategic partnerships. The division also develops the Bank's marketing strategy and is responsible for brand management, coordinating marketing initiatives, marketing and tactical plans for products and services and market research, such as statistical analysis, focus groups, interviews and surveys. Finally, the division is responsible for developing the Bank's internet banking solutions, websites, online communication and electronic distribution channels. This division had 29 FTEs at 30 June 2014.
- **Finance:** The Finance division includes funding and treasury (which together form the Treasury reporting segment) as well as accounting and planning and analysis. The accounting unit is responsible for the Bank's financial reporting, both internally and to external stakeholders, including the FME and the Central Bank. The Planning and analysis unit is responsible for short-term and long-term budgeting and for benchmarking the Bank with comparable financial institutions, both local and international. The funding unit is responsible for the Bank's long-term funding in both the domestic and international markets and the treasury unit is responsible for the Bank's liquidity, currency and interest rate management, the internal pricing of interest rates and currency, liaison with other financial institutions, proprietary trading and market making in domestic securities and currencies. The Finance division had 53 FTEs at 30 June 2014.
- **Risk Management:** For a description of the activities of the Risk Management division, see "*Risk Management*". The Risk Management division had 28 FTEs at 30 June 2014.
- **Legal:** The Legal division handles collection, appropriated assets and legal representation on behalf of the Bank as well as a range of other legal services for the Bank's other divisions. As at 31 December 2013, the legal division was working on 3,600 collection cases, compared with 4,050 at 31 December 2012. The legal division had 46 FTEs at 30 June 2014.
- **Operations:** The Operations division comprises information technology (IT), human resources, back office and property management units. The Operations division had 237 FTEs at 30 June 2014.

Subsidiaries

The Bank is the parent company of a number of wholly-owned and majority-owned subsidiaries, of which the most significant are:

Okkar liftryggingar hf. (Okkar Life Insurance)

Okkar Life Insurance was founded in 1966 and acquired by Kaupthing in 2005. Okkar Life Insurance provides a range of insurance policies against illness, disability and death. Okkar Life Insurance has sales and distribution partnerships with the Bank and KB ráðgjöf, which also sells pension products on behalf of the Bank. Okkar is wholly-owned by the Bank and had 15 FTEs at 30 June 2014.

Valitor Holding hf. (Valitor)

Valitor is a leading payment services company in Iceland. It is a group member of Visa Europe and a licensee of MasterCard and provides card acquiring services to merchants and card issuing services to

Icelandic and international banks, savings banks and cardholders. Valitor is 60.8 per cent. owned by the Bank and had 148 FTEs at 30 June 2014.

Asset Holding Companies

The Bank operates three holding companies, whose main purpose is to manage the assets the Bank has acquired through collateral enforcement. The goal is to preserve or increase the value of these assets before they are sold. The three principal asset holding companies are:

Eignabjarg ehf. (Eignabjarg)

Eignabjarg is a wholly-owned subsidiary of the Bank and is responsible for managing and selling shareholdings in companies which the Bank has acquired through debt restructurings or other enforcement procedures. Its function is to maximise the value of the shareholdings held, to develop a strategy for each asset and to implement good business practices and good corporate governance in the transferred companies. Eignabjarg aims to limit its holding period to as short a time as possible, without compromising its goal of maximising recovery through the divestment of assets.

During 2012 and 2013, Eignabjarg completed a significant number of disposals from its asset portfolio:

- Hagar was listed on the main market of NASDAQ OMX Iceland hf. in December 2011. In February 2012, Eignabjarg sold a 13.3 per cent. share in Hagar in a private placement. By the end of 2012, Eignabjarg had sold its entire stake in Hagar.
- All share capital in Sigurplast ehf. was sold in April 2012 to the company Hilmar D. Ólafsson ehf.
- B.M. Vallá ehf., which specialises in the production of cement, prefabricated housing units, walls and pumice, was sold to BMV Holding ehf. in October 2011. The sale was completed in June 2012, following approval from the Icelandic Competition Authority.
- The entire share capital of Penninn á Íslandi ehf., which owns and operates a range of stores in Iceland, was offered for sale at the beginning of 2012. In June 2012, the company was sold to a consortium of investors led by Ingimar Jónsson, Ólafur Stefán Sveinsson and Stefán D. Franklín.
- In March 2012, the Bank offered Fram Foods ehf. for sale. In April 2012, the Bank decided to sell each business unit separately as no satisfactory offer had been received. In July 2012, the subsidiary, Boyfood Oy in Finland, was sold to the Finnish company, Felix Abba Oy. In November 2012, the subsidiary, Fram Foods AB in Sweden, was sold to the Swedish company, Domstein Sverige AB. The sale of the subsidiary, Fram Foods ehf. in Iceland, is currently being prepared.

Other significant sales recently completed by Arion Bank

- In April 2014 the Bank sold 18,8% share in HB Grandi hf. in connection with the listing of the company in NASDAQ OMX Iceland. Prior to the sale the Bank held 31% share in HB Grandi. The financial impact of the sale is reflected in the Interim Consolidated Statement of Comprehensive Income. The shareholding in HB Grandi hf. as at 30 June is classified as listed shares designated at fair value among Financial instruments.
- Further to an agreement signed in December 2013 the Bank sold all its shares in the subsidiary Landfestar ehf. to Eik fasteignafélag hf. at the end of June 2014. In return the Bank received a 44% share in Eik fasteignafélag hf.

Eignarhaldsfélagið Landey ehf. (Landey)

Landey is a property development company which manages properties that currently do not generate any revenue but which may do so in the future. Such assets include unfinished housing developments, building lots and the rights attached to them. The company's objective is to maintain and increase the value of its properties through professional development, design and construction in collaboration with the planning authorities until a satisfactory price can be obtained.

LOAN PORTFOLIO

The table below sets out details of the Bank's loans to customers as at 30 June 2014, 31 December 2013 and 2012 classified by type of loan.

	As at 30 June 2014		
	Individuals	Corporates	Total
	<i>(ISK million)</i>		
Overdrafts	18,044	23,444	41,488
Credit cards	9,084	716	9,800
Mortgage loans.....	259,118	9,199	268,317
Subordinated loans.....	-	453	453
Other loans.....	40,477	303,871	344,348
Provision on loans.....	(12,685)	(14,636)	(27,321)
Loans to customers.....	314,038	323,047	637,085

	As at 31 December 2013		
	Individuals	Corporates	Total
	<i>(ISK million)</i>		
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

	As at 31 December 2012		
	Individuals	Corporates	Total
	<i>(ISK million)</i>		
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 table below sets out details of the book value of the Bank's loans to customers as at 30 June 2014, 31 December 2013 and 2012 classified by customer sector.

	<u>30.06.2014</u>	<u>2013</u>	<u>2012</u>
Individuals.....	49.3%	48.8%	42.8%
Real estate activities and construction	14.4%	13.1%	12.1%
Fishing industry	10.6%	9.6%	12.0%
Information and communication technology	3.7%	3.8%	5.1%
Wholesale and retail trade	7.9%	8.7%	9.8%
Financial and insurance activities	4.5%	4.3%	4.4%
Industry, energy and manufacturing.....	3.7%	3.5%	4.0%
Transportation	0.9%	3.0%	3.8%
Services	3.2%	3.1%	3.3%
Public administration, human health and social activities	1.0%	1.4%	1.8%
Agriculture and forestry	0.8%	0.7%	0.9%
Total	100.0%	100%	100.0%

As at 30 June 2014, the aggregate amount of the Bank's 10 largest customer loans equalled 15 per cent. of its total gross customer loans at that date.

In addition to its customer loans, the Bank has a portfolio of loans to credit institutions. The table below sets out details of the Bank's loans to credit institutions as at 30 June 2014, 31 December 2013 and 2012 classified by type of loan.

	<u>2014</u>	<u>2013</u>	<u>2012</u>
		<i>(ISK million)</i>	
Bank accounts	84,751	70,671	84,164
Money market loans.....	54,741	26,197	13,763
Other loans	346	5,439	3,888
Provision on loans	-	-	(804)
Loans to credit institutions.....	139,838	102,307	101,011

The table below shows the credit quality of the Bank's financial assets, including its net loans, as at 30 June 2014, 31 December 2013 and 2012.

	<u>As at 30 June 2014</u>			<u>Total</u>
	<u>Neither past due nor impaired</u>	<u>Past due but not impaired⁽¹⁾</u>	<u>Individuall y impaired⁽¹⁾</u>	
				<i>(ISK million)</i>
Cash and balances with Central Bank.....	17,361	-	-	17,361
Loans to credit institutions	139,838	-	-	139,838
Loans to customers.....				
Loans to corporates	300,525	11,575	10,947	323,047
Loans to individuals	272,704	31,143	10,191	314,038
Financial instruments	69,147	-	-	69,147
Other assets with credit risk	5,527	-	-	5,527
Total	805,102	42,718	21,138	868,958

As at 31 December 2013				
	Neither past due nor impaired	Past due but not impaired	Individually impaired ⁽¹⁾	Total
	<i>(ISK million)</i>			
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
Total	783,148	44,396	18,013	845,557

As at 31 December 2012				
	Neither past due nor impaired	Past due but not impaired	Individually impaired ⁽¹⁾	Total
	<i>(ISK million)</i>			
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
Total	731,682	40,696	49,997	822,375

(1) 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.

The table below shows the ageing of the Bank's past due but not impaired loans by class as at 30 June 2014, 31 December 2013 and 2012.

As at 30 June 2014	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
	<i>(ISK million)</i>				
Loans to corporates	7,884	936	387	2,368	11,575
Loans to individuals	13,988	4,297	2,143	10,715	31,143
Past due but not impaired loans	21,872	5,233	2,530	13,083	42,718

As at 31 December 2013	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
	<i>(ISK million)</i>				
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

<u>As at 31 December 2012</u>	<u>Up to 30 days</u>	<u>31 to 60 days</u>	<u>61 to 90 days</u>	<u>More than 90 days</u>	<u>Total</u>
	<i>(ISK million)</i>				
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

The table below sets out details of the Bank's impaired loans to customers as at 30 June 2014, 31 December 2013 and 2012 classified by customer sector.

	<u>As at 30 June 2014</u>					
	<u>Loans impaired due to borrower credit quality</u>		<u>Loans impaired due to FX-loan court rulings</u>		<u>Total impaired amount</u>	<u>Total loan carrying amount</u>
	<u>Impaired amount</u>	<u>Loan carrying amount</u>	<u>Impaired amount</u>	<u>Loan carrying amount</u>		
	<i>(ISK million)</i>					
Individuals.....	10,424	20,413	105	307	10,529	20,720
Real estate activities and construction.....	1,893	3,796	-	-	1,893	3,796
Fishing industry.....	428	1,760	460	1,583	888	3,343
Information and communication technology.....	179	180	-	-	179	180
Wholesale and retail trade.....	1,264	1,713	-	-	1,264	1,713
Financial and insurance activities.....	7,555	12,573	-	-	7,555	12,573
Industry, energy and manufacturing.....	432	561	-	-	432	561
Transportation.....	20	24	-	-	20	24
Services.....	444	853	21	21	465	874
Public sector.....	8	35	-	-	8	35
Agriculture and forestry.....	98	650	-	-	98	650
Total.....	22,745	42,558	586	1,911	23,331	44,469

As at 31 December 2013						
	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impaired amount	Total loan carrying amount
	Impaired amount	Loan carrying amount	Impaired amount	Loan carrying amount		
<i>(ISK million)</i>						
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 sector.....	8	35	-	-	8	35
Agriculture and forestry.....	352	790	-	-	352	790
Total.....	24,224	40,403	902	2,736	25,126	43,139

As at 31 December 2012						
	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impaired amount	Total loan carrying amount
	Impaired amount	Loan carrying amount	Impaired amount	Loan carrying amount		
<i>(ISK million)</i>						
Individuals.....	13,143	19,397	5,032	18,626	18,175	38,023
Real estate activities and construction.....	4,684	10,091	1,586	4,139	6,270	14,230
Fishing industry.....	2,361	4,343	2,648	6,913	5,009	11,256
Information and communication technology.....	7,561	11,192	187	307	7,748	11,499
Wholesale and retail trade.....	5,295	8,399	2,639	5,638	7,934	14,037
Financial and insurance activities.....	6,405	8,363	1,142	1,492	7,547	9,855
Industry, energy and manufacturing.....	604	1,152	483	999	1,087	2,151
Transportation.....	35	40	36	120	71	160
Services.....	744	1,168	505	1,328	1,249	2,496
Public sector.....	30	38	262	406	292	444
Agriculture and forestry.....	636	895	422	1,391	1,058	2,286
Total.....	41,498	65,078	14,942	41,359	56,440	106,437

As at 30 June 2014, 24 per cent. of the book value of all problem loans was attributable to five customers. Of these five customers, one had performing senior loans and only restructured subordinated debt that was classified as problem loan. An additional 10 per cent. of problem loans as at 30 June 2014 was attributable to a further 39 customers.

FUNDING AND LIQUIDITY

Funding

The Bank is predominantly funded with domestic deposits. Its total deposit base at 30 June 2014 was ISK 503,506 billion, or 63.4 per cent. of its total liabilities. The Bank's other funding at 30 June 2014 comprised bonds, other debt and equity.

The Bank's funding profile changed significantly in 2012. In January 2012, the Bank acquired a mortgage portfolio from Kaupthing and was substituted as issuer under six series of Kaupthing Covered Bonds. In February 2012, the Bank issued its first series of covered bonds. The bonds, which mature in 2034, are denominated in Icelandic krona and the total issue amounted to ISK 2.5 billion. The Bank issued a total of ISK 5 billion in covered bonds in 2012. In May 2012 the Bank became the first Icelandic bank to issue covered bonds that were not inflation-linked and further issuances of such covered bonds took place in January 2013.

In February 2013, the Bank completed a senior unsecured bond offering denominated in Norwegian krone. 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. The bonds, with a value of NOK 500 million (ISK 11.2 billion), were placed with more than 60 investors in Norway, Sweden, Finland, the United Kingdom, continental Europe and Asia.

As at 30 June 2014, the aggregate amount of the Bank's 10 largest deposits equalled 28 per cent. of the aggregate amount of the Bank's total deposits at that date. At the beginning of 2010, the Bank received a senior unsecured loan from the Central Bank amounting to ISK 61.3 billion and an ISK 29.5 billion subordinated loan from the Icelandic State that qualifies as Tier II capital. In June 2011, the Bank received a foreign currency subordinated loan from the Icelandic State in an amount equivalent to ISK 6.1 billion that qualifies as Tier II capital, see "*—Related Party Transactions*".

The Bank is focused on maintaining a large and stable deposit base originated from its clients. Deposits are expected to continue to form the core of the Bank's funding in the future. However, there are external factors that might affect the Bank's deposit base in the short to medium term, such as the lifting of capital controls and the increased availability of other investment opportunities for investors who currently hold deposits with the Bank. The Bank intends to continue diversifying its funding profile by issuing bonds in the domestic and international bond market when conditions permit.

Liquidity

On 1 December 2013 new liquidity rules issued by the Central Bank of Iceland took effect, overriding the rules on liquidity and cash ratios that have previously been reported by the Group. The new rules are based on the liquidity standards introduced in the Basel III Accord which are to be implemented in 2015 on a global level. The standard defines the 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 under these new liquidity measures. The assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank and not issued by the Group or its related entities.

The Central Bank has set a guideline for the minimum LCR which requires that, as at 1 January 2014, the LCR is 100 per cent. in foreign currency and 70 per cent. in total (ISK and foreign currency). The

latter benchmark increases by 10 per cent. every year until a 100 per cent. requirement is implemented in 2017.

The LCR as at 30 June 2014 and 31 December 2013 (which is the end of the first complete year in which the LCR rules have been in effect) is shown below:

	As at	
	30 June	31 December
	2014	2013
Liquidity coverage ratio		
FX	226%	274%
Total	184%	123%

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorisation 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 Bank 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.

The table below shows the breakdown of the Bank's deposit base according to the LCR categorisation, with the associated expected stressed outflow weights as at 30 June 2014 and 31 December 2013. Some similar categories are grouped together.

As at 30 June 2014					
Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits*
<i>(ISK million)</i>					
Retail	78,211	10%	33,371	5%	55,422
SME	35,396	10%	3,722	5%	6,615
Operational relationship	1,124	25%	-	5%	3
Corporations	44,550	40%	826	20%	15,010
Sovereigns, central-banks and PSE	21,989	40%	-	-	5,149
Financial entities being wound up	23,665	100%	-	-	62,893
Pension funds	38,522	100%	-	-	20,847
Domestic financial entities	28,536	100%	-	-	13,615
Foreign financial entities	5,070	100%	-	-	511
Other foreign parties	1,670	100%	639	25%	363
Total	278,733		38,558		180,428

As at 31 December 2013					
Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits*
<i>(ISK million)</i>					
Retail	79,688	10%	33,791	5%	50,732
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
Pension funds	46,463	100%	-	-	20,430

As at 31 December 2013

	Deposits maturing within 30 days				Term deposits*
	Less stable	Weight (%)	Stable	Weight (%)	
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

RISK MANAGEMENT

Overview

The Bank seeks to manage its risks through a process of on-going risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and price the risk encountered is critical to the Bank's continuing profitability and its ability to ensure that the Bank's exposure to risk remains within acceptable levels.

The Board 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 defines the overall risk appetite of the Bank which is translated into exposure limits and targets that are monitored by the Bank's Risk Management division, which reports its findings regularly to the Bank's CEO and the Board. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board at least annually. The Board is also responsible for the Bank's internal capital adequacy assessment process (**ICAAP**). The Board has determined that management of risks encountered within subsidiaries should principally be carried out within each subsidiary.

The 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 Bank's employees.

The Bank operates the following committees to manage risk:

- Board Audit and Risk Committee (the **BARC**). This committee is responsible for supervising the Bank's risk management framework, risk appetite and ICAAP. The BARC regularly reviews reports on the Bank's risk exposures.
- Asset and Liability Committee (the **ALCO**). This committee is chaired by the CEO and is responsible for managing any asset-liability mismatches, liquidity risk, market risk, interest rate risk and capital management.
- Credit Committees. 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.

In addition the Bank operates five Collateral Valuation Committees, which set guidelines on collateral assessment and valuation, and a Debt Cancellation Committee which deals with applications to reach composition with debtors.

The Bank's internal audit division conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal audits examine both the adequacy and completeness of the Bank's control environment and processes as well as the Bank's

compliance with its procedures, internal rules and external regulations. Internal audit results are discussed with the Bank's management and reported 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 Bank is exposed to four major areas of risk: credit risk, market risk, liquidity risk and operational risk.

Credit Risk

Credit risk is managed and controlled by setting limits on the amount of risk the Bank is willing to accept for individual counterparties and groups of connected clients, and by monitoring exposures in relation to such limits.

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

The Bank seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to groups of connected clients. Note 38 to the Financial Statements shows the Bank's maximum exposure to credit risk by type of instrument and industry classification of customer. As at 30 June 2014 and 31 December 2013, the Bank's total on and off balance sheet credit risk exposure totalled ISK 983,049 million and ISK 941,435 million respectively, of which the major industry exposures at 31 December 2013 were (i) individuals (35 per cent. of the total exposure), (ii) financial and insurance activities (19 per cent. of the total exposure) and (iii) real estate and construction (10 per cent. of the total exposure).

Credit Approval Process

As discussed above, the Bank has a tiered structure of credit approval committees.

The BCC, which acts on the behalf of the Board of Directors, is the committee with the highest lending authority. The BCC delegates lending authorities to the ACC which in turn delegates lending authorities and sets credit granting rules and guidelines for the business units. The Risk Management department is represented at credit committee meetings in an advisory role with a view to ensuring that all credit decisions are taken in line with the Bank's credit policy. Risk Management has the power to escalate a controversial credit committee decision to a higher authority.

For each credit application, the Bank gathers information and evaluates certain elements that serve as a basis for the decision, for example the borrower's profile, a financial analysis of the borrower, any proposed collateral, the borrower's credit rating and related parties and their total exposure.

Credit Analysis is Risk Management's primary interface with the Bank's credit committees. Credit Analysis prepares an opinion for all credit applications that go before the BCC, the ACC and the CCC. The Chief Risk Officer or his designated representative from Credit Analysis participates in all meetings of the CCC, the ACC and the BCC as a non-voting advisor. Credit Analysis also monitors the activities of the RBC. Credit Analysis ensures that credit decisions are within a committee's credit granting

authority and is authorised to escalate controversial credit decisions from one committee to a committee with a higher authority.

Credit Analysis is also responsible for the approval of the corporate credit rating performed by account managers by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings.

The Bank generally requires collateral, but a central element in its assessment of a proposed borrower's creditworthiness is the borrower's ability to service debt. The main types of collateral obtained by the Bank are:

- For retail loans to individuals, mortgages over residential properties;
- For corporate loans, charges over real estate, properties, fishing vessels and other fixed and current assets, inventory and trade receivables, cash and securities; and
- For derivative exposures, cash or treasury bills.

In addition to collateral, other important credit risk mitigating techniques are pledges, guarantees and master netting agreements.

To ensure consistent collateral value assessment, the Bank has five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The committees are divided by area of expertise as follows:

- Agriculture;
- Fishing vessels and fishing quotas;
- Real estate;
- Securities; and
- Inventory and trade receivables.

The value of any collateral given is monitored by Risk Management and additional collateral may be requested in accordance with the underlying agreement. The value of any collateral given is taken into account when determining the adequacy of the allowance for impairment losses made in relation to each loan.

At 30 June 2014, the total value of the collateral that the Bank holds relating to loans individually impaired or more than 90 days past due but not impaired, was ISK 28,730 million, corresponding to a collateral coverage ratio of 84 per cent. Of this collateral, real estate collateral represents 80 per cent; fishing vessels represent 8 per cent. and the remaining 12 per cent. is made up of other types of collateral.

Credit Monitoring

The Bank has credit concentrations to a few significant customers and to certain business sectors, such as the real estate activities and construction sector, the fishing industry and wholesale and retail trade.

The Bank uses an internal rating system to rate its loans to companies and individuals. The rating model for larger companies bases its rating both on qualitative factors (such as sector stability and outlook) and quantitative factors (such as their equity and liquidity ratios). The rating model for SMEs and individuals are purely quantitative models.

To monitor the performance of its loan portfolio, the Bank relies on an Early Warning System (EWS), which is a forward-looking classification system for loans and borrowers. The monthly EWS classification is a prelude to the credit review by the Credit Control department. The need for impairment and/or financial restructuring is identified and evaluated during the review. The loan portfolio is grouped into four categories according to the borrower's financial strength and behaviour: Green, Yellow, Orange and Red.

In this system, borrowers in the Green category are financially the strongest, whereas a possible loss has been identified in the case of borrowers in the Red category. The EWS attempts to anticipate a deterioration in a customer's credit quality.

The classification is based on borrowers' contractual arrangements with the Bank, i.e. the timeliness of payments and compliance with other loan terms, financial ratio and the borrowers' credit ratings. The table below shows certain underlying criteria for the EWS.

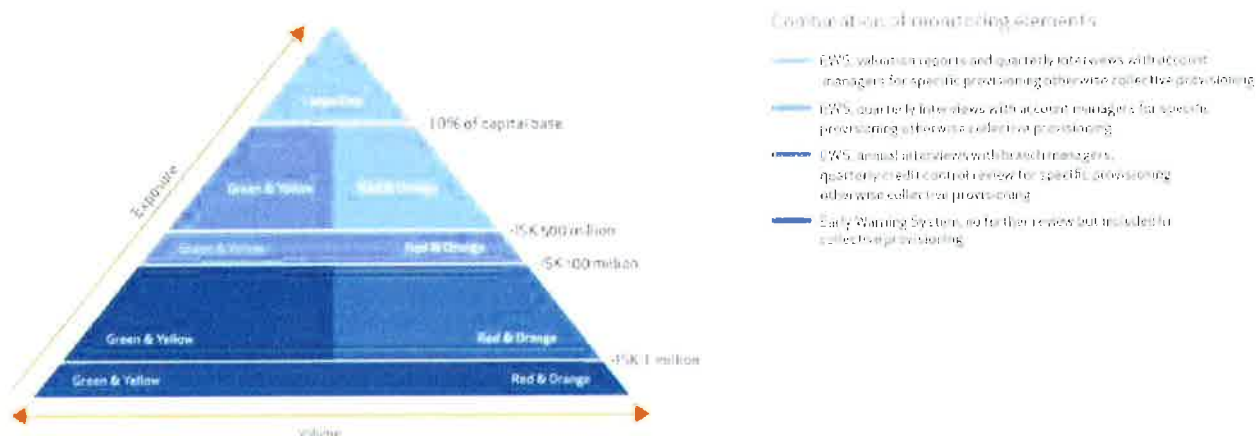
Category	Provision	Default	(Debt/EBITDA)/LT V	Equity ratio	Credit rating	Covenant breach
Green	No	<30	<4.0–5.0 / <75-80%	>15-25%	≥B-	None
Yellow	No	30-90	4.0–6.0 / <75-90%	10-25%	CCC+	Minor
Orange	No	>90	>5.0–6.0 / 90-100%	<10-20%	<CCC+	Serious
Red	Yes	>90	>5.0–6.0 / >100%	<10-20%	<CCC+	Serious

The classification is made on a customer basis; all conditions must be met for all loans of each borrower for that borrower to be classified as Green.

The classification is intentionally strict since its main purpose is to draw attention to plausible evidence of impairment e.g. payment difficulties of borrowers with resulting credit loss by the Bank. The Gatekeeper, a group within Risk Management, has the authority to reassess the classification if an account manager has solid arguments for the change.

Risk Management's Credit Control department monitors individual credits based on selected samples. The samples are determined by the size of the exposure and its risk. The risk measurements are based on the EWS. The level-of-detail in credit monitoring depends on credit size and loan volume. Credit monitoring consists of a quarterly review by Credit Control which usually involves communication with the borrower's account manager. A semi-annual valuation report is prepared for borrowers with a credit above 10 per cent. of the capital base and for borrowers in the orange and red category with credit above ISK 500 million.

The following chart describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.



The monitoring utilises semi-annual reports, quarterly interviews with account managers, an annual interview with branch managers and other communications, in addition to a Credit Control review. The legend for the figure describes the combination of monitoring elements which is applied for the different areas in the pyramid.

Loan Provisioning

The Group analyses whether loans are impaired at both a borrower-specific level and a collective level. Analysing whether loans are impaired at a borrower-specific level involves an assessment of a combination of factors, including the borrowers' exposure, the number of 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 at this level, the following factors are considered:

- the Group's aggregate exposure to the borrower;
- 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 are only subject to collective provisions.

In assessing collective impairment two deciding quantitative components are addressed in order to perform the calculation: (i) the probability of default and (ii) the loss given default. The Group uses internally developed models to calculate the probability of default, and these models are regularly benchmarked against actual outcomes to ensure their accuracy. When calculating loss given default, the Group uses standard values.

Provision on loans are recognised within loans to credit institutions, as reflected in the statement of financial position. Impairment losses are recognised within net impairment, as reflected in the statement of comprehensive income. When an event occurs after an impairment is accounted for that results in a decrease in the level of impairment, this is classified as a reversal of impairment and such reversal is reflected within the net impairment figure contained in the statement of comprehensive income.

As a result of debt restructurings and enforcement procedures, the Bank has in some cases acquired financial instruments at a deep discount. This discount reflects the incurred credit losses. The Group includes these incurred credit losses in the estimated cash flows when calculating the effective interest rate of the relevant financial instrument. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial instrument to reflect the actual and revised estimated cash flows. The Group recalculates the carrying amount by calculating the present value of estimated future cash flows at the financial instrument's original effective interest rate. This adjustment is recognised in the statement of comprehensive income as an increase in net impairment when such

recalculation results in an increase in the carrying amount and as a decrease in net impairment when recalculation results in a decrease in the carrying amount.

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.

Counterparty Credit Risk

The Bank offers financial derivatives instruments to professional investors, including interest rate swaps, FX forwards and swaps, and options and forwards on Icelandic listed equities, treasury notes and housing financing bonds. The fair value of these derivative instruments varies in response to changes in interest rates, foreign currency rates and security prices. Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values (being those under which the Bank is owed money). The Bank applies limits to its total exposure and on the positive fair value net of collateral to control the Bank's risk in relation to these instruments. These limits are generally client specific and may refer specifically to different categories of derivative contract. Generally, collateral is required to cover potential losses on a derivative contract. Should the net-negative position of a contract fall below a certain level, the Bank seeks additional collateral. If extra collateral is not supplied within the specified deadline, the contract is closed. The Bank also seeks to reduce its exposure to credit losses by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. These agreements reduce the Bank's credit risk since, in the case of default, all amounts owing between the Bank and the counterparty are terminated and settled on a net basis.

Large Exposures

In accordance with applicable Icelandic regulations, a large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10 per cent. of the Bank's capital base net of eligible collateral. The legal maximum for individual large exposures is 25 per cent. of the Bank's capital base and the sum of all large exposures cannot exceed 400 per cent. of the Bank's capital base. The Bank had no large exposures in excess of the legal limit of 25 per cent. at 30 June 2014. The sum of all large exposures at 30 June 2014 was 63 per cent. of the Bank's capital base before collateral mitigation or 62 per cent. net of eligible collateral, which is well below the 400 per cent. legal maximum.

The table below shows all gross exposures exceeding 10 per cent. of the Bank's capital base as at 30 June 2014 and 31 December 2013, together with the net amount of each of those exposures after taking account of collateral.

	As at			
	30 June		31 December	
	2014		2013	
	Gross	Net	Gross	Net
Drómi ⁽¹⁾	-	-	-	-
1	16%	15%	17%	17%
2	15%	15%	16%	16%
3	11%	11%	<1%	<1%
4	11%	11%	-	-
5	10%	10%	12%	12%
6	<5%	<5%	10%	<10%
7	<2%	<2%	10%	<10%
Sum of exposure gross	63%	62%	65%	45%
>10%				

Note:

- (1) This exposure comprises a bond claim on Drómi hf. The Icelandic Ministry of Finance has confirmed that the Bank will be held harmless in respect of this claim. The FME has agreed that the Bank can use this confirmation as a credit enhancement in relation to the claim. See note 21 of the Financial Statements for information regarding the settlement of the Drómi hf. bond.

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. The risk arises from imbalances in the Bank'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 Bank's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances in the Bank's balance sheet (referred to as its **banking book**) but to accept limited market risk in its trading book. The market risk in the trading book arises from proprietary trading activities whereas market risk in the banking book arises from mismatches in assets and liabilities principally in relation to currencies, maturities and interest rates.

Market risk allowance is determined by the Board and the CEO determines the limit framework for each trading desk and sets individual limits. The ALCO is responsible for managing the Bank's overall market risk. The Risk Management department is responsible for measuring and monitoring market risk exposure and reporting exposure, usage and limit breaches.

Interest Rate Risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The Bank's operations are subject to interest rate risk associated with mismatches between interest bearing assets and interest bearing liabilities. The mismatch is characterised by a large maturity 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 Bank. Note 39 to the Bank's Interim Financial Statements as at 30 June 2014 provides further information on the Bank's maturity asset and liability gap. The Bank also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate calculations in different currencies, of which the largest is euro.

The Bank'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.

Inflation Risk

The Bank is exposed to inflation risk when there is a mismatch between its inflation-linked assets and liabilities. As at 30 June 2014, the total amount of the Bank's inflation-linked assets was ISK 295.3 billion and the total amount of its inflation-linked liabilities was ISK 218.0 billion. See note 39 to the Interim Financial Statements. The Bank also has significant maturity mismatches in its inflation-linked assets and liabilities. Whilst the Bank has implemented a range of risk management procedures designed to control these risks, no assurance can be given that these controls will be effective in all circumstances. The Bank is exposed to the risk that these controls do not prove to be effective in all circumstances and that the Bank could therefore experience material losses.

Currency Risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Bank are predominantly ISK denominated deposits whereas a substantial part of the

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

There have been a number of court cases in which the legality of different types of foreign currency loan has been considered by the Icelandic courts in recent years. See "*Litigation*". Although these cases have clarified the law relating to these loans, there remains uncertainty regarding certain foreign currency linked loans. Nevertheless, the Bank considers that its portfolio of foreign currency linked loans is fully provisioned for the most likely outcome.

The table below indicates the currencies to which the Bank had significant exposure at 30 June 2014. The analysis calculates the effect of a 10 per cent. movement of the currency rate against the ISK (with +10% in the table denoting a depreciation of the ISK) on the Bank's income statement as a result of the change in 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.

The table assumes that all other variables remain constant.

	As at 30 June 2014	
	-10%.	+10%
	<i>(ISK million)</i>	
EUR	(561)	561
USD	(298)	298
CHF	(57)	57
GBP	(472)	472
JPY	(59)	59
Other	(179)	179

Equity Price Risk

Equity price risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Bank's assets i.e. restructuring of troubled companies which the Bank has taken over. For information on assets seized and held for sale and equity exposures, see Notes 26 and 21 respectively to the Interim Financial Statements 30 June 2014.

Derivatives

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

Prepayment Risk

Prepayment risk is the risk that the Bank 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 Bank was not materially exposed to prepayment risk at 30 June 2014.

Liquidity Risk

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

The Bank's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Bank's liquidity reserve. The Bank has made significant process in converting its on demand deposits to term deposits. As at 31 December 2009, over 90 per cent. of the Bank's deposits were on demand compared to 59.7 per cent. at 31 December 2012, 53 per cent. as at 31 December 2013 and 64 per cent as at 30 June 2014.

Operational Risk

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

Operational risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner. Each business unit within the Bank is primarily responsible for taking and managing their own operational risk. The operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk.

The Bank uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk. The Bank's capital base for operational risk is measured as 15 per cent. of the average over three years of the sum of net interest income and net non-interest income, as required by applicable legislation.

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analysed to understand the cause of the event and any control failure and amendments to controls are made where applicable to reduce the risk of the event recurring. Losses are categorised according to the Basel II event categories for operational risk. In the first half of 2014, the categories "external fraud" and "execution, delivery & process management" accounted for 37 per cent. and 33 per cent., respectively, of total reported loss events. Measured by amount, external fraud accounted for 36 per cent. and clients, products & business practices accounted for 37 per cent. of the total losses in the first half of 2014.

CAPITAL ADEQUACY

The Bank's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress.

Capital requirements according to Pillar 1 are based on the sum of risk weighted assets (**RWA**) for credit risk, market risk and operational risk, computed using formulas from the EU's Capital Requirements Directives (the **CRD**), which have now been replaced by CRD IV.

The CRD offers different approaches for calculating RWA for these risk types.

The Bank uses the following approaches for its capital requirement calculations:

- The standardised approach is used to calculate the capital requirements for credit risk;

- The standardised method is used to calculate the capital requirements for market risk; and
- The basic indicator approach is used for operational risk.

The Ministry of Industries and Innovation has formed a committee to implement the CRD IV in Iceland although the timeframe for such implementation has not yet been published (see "*Risk Factors – Changes to the Capital Requirements Directive could adversely affect the Bank's results*").

Banking operations are categorised as either trading book or banking book and the calculation of RWA is conducted differently for the assets in different books. Banking book RWA are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account eligible collateral or guarantees. Banking book off balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned risk weights appropriate to the category of the counterparty, taking into account eligible collateral or guarantees. Trading book RWA are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

The Bank carries out an ongoing process, the ICAAP, with the aim of ensuring 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 Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance to its risk profile. The FME supervises the Bank, reviews the Bank's ICAAP and sets capital requirements for the Group as a whole.

To measure the Pillar 2 capital requirement the Bank uses an internal economic capital model. Pillar 2 is based on Pillar 1 calculations, using internal models for credit risk calculations, and takes into consideration risks that are not covered under Pillar 1, including concentration risk, residual risk, country risk, settlement risk, liquidity risk, interest rate risk in the banking book, reputational risk, legal and compliance risk, business risk and political risk.

Although the Bank uses credit rating models for credit risk monitoring, these models are not used for capital adequacy calculations. The Bank intends to recalibrate those models for use in its ICAAP. The Bank has implemented methods and tools for operational risk management based on the minimum requirements for the standardised approach. The Bank expects to continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macro-economic changes, downturns in the Bank's core business or other major events.

The Group is subject to capital requirements which are specified by the FME following a supervisory review and evaluation process (SREP). The Group's capital base exceeded the FME's SREP requirements in each of 2013, 2012 and 2011.

The Bank's capital base at 30 June 2014 amounted to ISK 179,413 million. The Bank's capital adequacy ratio, calculated in accordance with Icelandic requirements, was 25.6 per cent., exceeding the minimum legal requirement of eight per cent.

The table shows the Bank's RWA calculations as at 30 June 2014, 31 December 2013 and 31 December 2012.

	<u>30 June</u>	<u>31 December</u>	
	<u>2014</u>	<u>2013</u>	<u>2012</u>
Capital Base	<i>(ISK million, except percentages)</i>		
Share capital and share premium	75,861	75,861	75,861
Other reserves	1,635	1,637	1,639
Retained earnings	72,043	62,591	49,572
Non-controlling interest	5,004	4,858	3,806
Total equity	154,543	144,947	130,878
Intangible assets	(5,375)	(5,383)	(4,941)
Tax assets	(734)	(818)	(463)
Other statutory deductions	(110)	(119)	-
Total tier 1 capital	148,324	138,627	125,474
Subordinated Liabilities	31,189	31,918	34,220
Other statutory deductions	(100)	(106)	-
Total capital base	179,413	170,439	159,694
Risk weighted assets			
Credit risk	604,993	608,029	557,964
Market risk FX	16,317	31,703	20,063
Market risk other	4,362	4,993	7,407
Operational risk	76,097	76,097	72,329
Total risk weighted assets	701,769	720,822	657,763
Tier 1 ratio	21.1%	19.2%	19.1%
Capital adequacy ratio	25.6%	23.6%	24.3%

COMPLIANCE

According to Icelandic law, financial institutions are required to establish a compliance function and must ensure that it is effective and independent of other aspects of the institution's operations. The compliance function is required to:

- monitor and regularly assess the adequacy and effectiveness of policies and procedures designed to detect any risk of failure by an institution and to put in place procedures to minimise that risk;
- monitor and assess the actions taken to address any deficiencies in the institution's compliance with its obligations; and
- provide the employees of the institution responsible for carrying out the execution of securities transactions with the necessary training, advice and assistance to enable them to discharge the institution's obligations under applicable Icelandic law.

The Bank's compliance officer coordinates the Bank's compliance activities. The Bank's compliance department had five FTEs at 30 June 2014.

The compliance officer works independently and reports directly to the CEO in accordance with both FME and internal audit requirements. The compliance officer has monthly meetings with the CEO at which the compliance officer presents a report on activities during the past month and refers certain matters to the CEO. The compliance officer also meets the chief risk officer and the internal auditor on a monthly basis.

The compliance officer is also responsible for the Bank's anti-money laundering (AML) and terrorist financing procedures. The compliance officer organises and is responsible for:

- know your customer (KYC) due diligence;

- constant monitoring of the Bank's clients; and
- coordinating the Bank's compliance with applicable AML and terrorist financing laws, regulations and guidelines.

INVESTMENTS

The Bank has a small portfolio of debt and equity investments. These instruments are classified either as trading assets (being assets which are held by the Bank with a view to generating profit from short-term changes in price) or as assets held at fair value through profit and loss. The Bank's shares and equity instruments include those shareholdings that the Bank has acquired in recent years through debt restructurings and other enforcement procedures. Since 2012, the Bank has made steady progress in the sale of companies acquired as a result of these collateral enforcement procedures (see "*Asset Holding Companies*").

The table below shows the classification of the Bank's investment portfolio as at 30 June 2014 and 31 December 2013.

	As at 30 June 2014		
	Trading	Designated at fair value	Total
	<i>(ISK million)</i>		
Listed bonds and debt instruments	3,451	61,043	64,494
Unlisted bonds and debt instruments	45	1,688	1,733
Total bonds and debt instruments	3,496	62,731	66,227
Listed shares and equity instruments	2,217	8,002	10,219
Unlisted shares and equity instruments	1,360	10,550	11,910
Bond funds with variable income	642	1,229	1,871
Total shares and equity instruments	4,219	19,781	24,000

	As at 31 December 2013		
	Trading	Designated at fair value	Total
	<i>(ISK million)</i>		
Listed bonds and debt instruments	4,708	55,625	60,333
Unlisted bonds and debt instruments	49	1,789	1,838
Total bonds and debt instruments	4,757	57,414	62,171
Listed shares and equity instruments	1,420	2,858	4,278
Unlisted shares and equity instruments	1,387	9,553	10,940
Bond funds with variable income	906	1,325	2,231
Total shares and equity instruments	3,713	13,736	17,449

COMPETITION

The Bank currently faces competition from the two other large commercial banks in Iceland, Landsbankinn and Islandsbanki, although this competition is currently limited as all three banks are focused on restructuring their loan portfolios and improving their asset and liability matching. The Bank also faces competition domestically from the Housing Financing Fund (see "*Financial Markets in Iceland – Other relevant institutions*").

As Iceland's economy recovers and demand for new lending and other banking products increases, the Bank expects to face increased competition from both the other large Icelandic banks and smaller specialised institutions as well as, potentially, foreign banks seeking to establish operations in Iceland. The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation and price.

The Bank also believes that it has a leading investment banking franchise in Iceland although there is currently little activity in this area in Iceland.

INFORMATION TECHNOLOGY

The Bank's IT division is responsible for developing, operating and advising on the Bank's information systems and solutions, including the Internet Bank, websites, its internally developed and third party software, its hardware such as data centres, telephone systems, ATMs and personal computers. The IT division had 118 FTEs at 31 December 2013. The Bank's focus in the IT area in the next few years will be on upgrading its systems and thereby improving its operational efficiency.

The Bank engages in a wide range of activities involving finance and financial services. The reliability of information and communications systems is a key factor in the Bank's activities as a financial enterprise.

Control of information security is an essential tool to achieve this objective. The Bank's Information Security Policy forms the basis of the measures used by the Bank to ensure the security of data, data systems and communication systems. Through the implementation of this policy, the Bank aims to prevent the inappropriate use of information, to safeguard the secure and uninterrupted transfer of electronic data and communications, and to integrate a risk management process into the work processes and daily tasks of all employees.

Legal security and the secrecy of information on customers are required to be observed at all times when IT is used. The Bank operates two data centres in an active mode to ensure continuous system uptime and to minimise downtime in disaster scenarios.

LITIGATION

Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland, the chances of litigation against the Bank have increased. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of any possible loss has been reasonably estimated, the Bank takes appropriate steps to mitigate any adverse effects which the claims may have on its financial standing.

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 Kortþjónustan 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.

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 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 has referred the decision to the courts of law for annulment.

In 2012 Kortapjónustan hf. filed a suit against Valitor claiming damages for the alleged loss suffered by Kortapjónustan 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 Kortapjónustan hf. filed another suit, now against the Bank and Valitor, as well as Landsbanki, Íslandsbanki and Borgun, claiming damages for the alleged loss suffered by Kortapjónustan 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. With a judgment of the District Court of Reykjavík on 20 December 2013 the Group was acquitted. The judgment has been appealed to the Supreme Court of Iceland. If 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.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages which they believe they suffered because of the conduct of the Bank's employees in connection with the bankruptcy of BM Vallá and its subsidiary, Fasteignafélagið Ártún ehf. In the two cases the plaintiffs claim total damages in the amount of over four billion ISK plus further specified interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá and Fasteignafélagið Ártún, damage by not granting the companies financial restructuring and thereby forcing the companies into bankruptcy. The Bank believes it is more likely that it will be acquitted of the plaintiff's claims in both cases and has therefore made no provision.

Legal proceedings regarding CPI loans

In 2013 the Supreme Court of Iceland requested an Advisory Opinion from the EFTA Court in two separate cases regarding the interpretation of certain provisions of EC directives, in cases where the disagreement is whether the CPI-indexation of a consumer loan and its presentation is in accordance with certain provisions of Icelandic law on contracts and consumer loans. An Advisory Opinion in one of those cases was published 28 August 2014. The EFTA Court concluded that the EC Directive does not prohibit contractual terms providing for CPI-indexation of consumer loans. The EFTA Court stated that it was for the Icelandic courts to take a position on whether price indexation falls within the scope of the Directive and to assess whether indexation of consumer loan agreements can be considered unfair contractual terms. The second case was presented to the EFTA Court 11 June 2014. The EFTA Court concluded that it is not compatible with Directive 87/102/EEC to calculate the total cost of the credit and the annual percentage rate of charge on the basis of 0% inflation if the known rate of inflation at the time of the credit agreement is not 0%. It is however for the national court to assess the legal consequences of

and the remedies for such incorrect information. It is difficult to predict the likely outcome in these cases.

Act no 35/2014 on “adjustment” of CPI-indexed mortgage loans

In May 2014 the Icelandic Parliament passed a bill on adjustment of CPI-indexed mortgage loans, Act no 35/2014. The Act entails that all individuals who had indexed mortgage loans in 2008-2009 can apply to have their loans reduced by the amount corresponding to the difference between real inflation compensation and adjusted inflation compensation. The adjusted figure can be a maximum of ISK 4 million for each household and if borrowers have already had some of their mortgage written down, that amount will be subtracted from the figure being adjusted. When the amount has been adjusted, the current loans of the borrower in question will be reduced by that amount and moved into a special "adjusted loan". The Treasury will pay the adjusted part of the loan over the next four years, provided that funding is obtained from the Parliament each year. The applications period is to 1st of September 2014 and the extent of the adjustment will be clearer after that date. In Article 2 of the Act it is expected that the Treasury will reach an agreement with the Bank on the execution and settlement of the adjustment and that the aim should be not to create any profit or loss to the Bank. Negotiation between the concerned parties has not been concluded.

Uncertainty regarding the book value of foreign currency lending

In recent years there has been considerable uncertainty over the legitimacy of certain types of loans. By a series of judgments since 2010, the Icelandic Supreme Court has held that certain types of foreign currencylinked loans and lease agreements with SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. As a result, these loans were held to be in breach of applicable Icelandic legislation relating to interest and price indexation. Following these judgments, the Bank has recalculated approximately 2,000 retail and corporate foreign currency indexed ISK loans as ISK denominated loans.

This uncertainty continued in 2013 and, accordingly, the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. After consideration of such judgments, the Group has provisioned a total amount of ISK 22.2 billion of which ISK 18.3 billion have been written-off since 2011.

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

RELATED PARTY TRANSACTIONS

The Bank has a related party relationship with Kaupskil ehf. Being the ultimate controlling party with and 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 period commencing on 1 January 2013 and ending on 30 June 2014. Transactions with related parties have been conducted on an arm's length basis. There have been no guarantees provided or received for related party receivables or payables during the aforementioned period.

See note 37 to the Interim Financial Statements for the first nine months of the year 2014 and note 39 to the Financial Statements 2013 for further information in relation to the Bank's related party transactions.

MANAGEMENT AND EMPLOYEES

MANAGEMENT

Shareholders' meetings

The Bank's shareholders in general meetings are the supreme authority in the affairs of the Bank, within the limits established by the articles of association and statutory law. The Bank's annual general meeting is required to be held before the end of April each year.

Board of Directors

The Board is the supreme authority between shareholders' meetings, as further stipulated by law, regulations, and the Articles of Association.

The Board appoints the CEO. The Board also manages the Bank's affairs and ensures that its organisation and activities are at all-time maintained in good order. The Board and the CEO undertake the administration of the Bank.

The Board is responsible for ensuring that the Bank's book-keeping and the handling of its funds is sufficiently supervised. The Board represents the Bank and may grant directors, the CEO or others authority to sign for the Bank.

The Board bears the principal responsibility for the Bank's daily operations and is required to regularly discuss the manner in which it discharges its duties, its substantive areas of focus and the main goals of its work.

The Board also bears the principal responsibility for the development and long-term success of the Bank. To that effect, individual directors must exercise their duties with due diligence and care, and with good faith in the best interests of the Bank and its shareholders. The Board confirms and bears the principal responsibility for the Bank's strategy.

The Board and the CEO are required to inform the FME without delay of any issues they become aware of that could affect the ongoing operation of the Bank.

The Board, which must be of a size and composition that makes it possible for the Board to discharge its duties efficiently and with integrity, currently comprises seven members. All the members are nominated by Kaupskil except one, Thóra Hallgrímsdóttir who was nominated by the ISFI.

The Bank's Board comprises the following members:

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 the Bank and is an independent Director. Monica is also Chairman of the Board Credit Committee.

Monica graduated in economics from the Stockholm School of Economics in 1976. 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.

She currently sits on the board of numerous companies and non-profit organisations and is the chairman of several of them.

Guðrún Johnsen, Vice-Chairman

Guðrún 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 the Bank. Guðrún is Chairman of the Board Remuneration Committee and is a member of the Board Audit and Risk Committee.

Guðrún completed her BA in economics at the University of Iceland in 1999. In 2002 she graduated with an MA in applied economics at the University of Michigan, Ann Arbor in the United States and with an MA in statistics from the same university the following year. Guðrún worked as a securities broker at the Icelandic Investment Bank (FBA) between 1999 and 2001, and as a teaching and research assistant at the University of Michigan, Ann Arbor from 2002 to 2003. Between 2004 and 2006 she worked as a specialist in the Financial Systems and Monetary Department of the International Monetary Fund (IMF) in Washington, DC.

Guðrún has been an assistant professor at Reykjavík University School of Business since 2006. She has served on the board of a fund management company of MP Bank and is the current chairman of the research company THOR. In 2009 and 2010 Guðrún 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 sector in 2008.

Guðrún is currently a lecturer in finance in the faculty of business administration at the University of Iceland.

Guðrún Johnsen undertakes work for Kaupthing on a contractual basis. This is permissible by Icelandic Law and guidelines. The Bank and Kaupthing, as owner of Kaupskil, may have different interests with respect to the financial reorganisations of customers who have obligations with both parties. According to the Rules of Procedure for the Board, a director is not permitted to attend Board meetings or participate in the discussion or the decision-making process if any conflicts of interest arise concerning that particular director. There are no other conflicts of interest between the duties of the members of the Board listed above to the Bank and their private interests or other duties. The address of each Board member is Borgartún 19, 105 Reykjavík.

Kirstín Th. Flygenring, Director

Kirstín was born in 1955. She was first elected to the Board as an Alternate at a shareholders' meeting on 22 March 2012. She was elected to the Board as a Director at the Bank's annual general meeting on 20 March 2014. She is not a shareholder of the Bank. Kirstín is a member of the Board Remuneration Committee.

Kirstín graduated with a cand. oecon. degree in business administration from the University of Iceland in 1980. In 1983 she completed an MA in economics from Northwestern University in Illinois. She completed practical media studies at the University of Iceland in 1993-1994.

Kirstín was marketing manager at the Icelandic Freezing Plants Corporation (now Icelandic Group hf.) from 1986 to 1989. Between 1995 and 1998 she was an economist and deputy managing director at the Fisheries Association of Iceland. From 1989 to 2000 she was editor of the economics glossary at the Icelandic Language Institute at the University of Iceland. From 2002 to 2007 she was an economist in the Department of Economics at the Central Bank of Iceland. She was a part-time lecturer and adjunct at the University of Iceland between 2007 and 2012 and was a specialist at the Institute for Research in Finance and Economics at Reykjavík University from 2007 to 2009. From 2011 to 2013 she was a member of a three-person committee on the Icelandic parliament's investigative committee on the Housing Financing Fund.

Benedikt Olgeirsson, Director

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 the Bank and is an independent Director.

Benedikt completed a degree in civil engineering from the University of Iceland in 1986. He then received an MSc in construction engineering and project management at the University of Washington in Seattle. He has also completed courses at Wharton Business School and Harvard Business School. Between 1988 and 1992 Benedikt worked as a project manager in civil engineering. He was a manager at Eimskip between 1993 and 2004, most recently as head of Eimskip's operations in Hamburg. He was managing director of Parlogis from 2004 to 2005, and managing director of Atorka between 2005 and 2009.

Benedikt has been Deputy CEO of Landspítali University Hospital since 2010.

Brynjólfur Bjarnason

Brynjólfur was born in 1946. He was elected as a Director at the Bank's shareholders' meeting on 20 November 2014.

Brynjólfur was managing director of the Enterprise Investment Fund from 2012 to 2014. Between 2007 and 2010 he was the chief executive officer of Skipti. Brynjólfur was chief executive officer of Síminn from 2002 to 2007 and chief executive officer of Grandi hf. from 1984 to 2002. Between 1976 and 1983 he was managing director of the publisher AB bókaútgáfa. He was also head of the economics department of VSÍ from 1973 to 1976. Brynjólfur has broad experience as a director and has served on numerous boards and been chairman of several. Brynjólfur has served on the board of Genís since 2011 and the board of the Reykjavík Dramatic Society Playwright Fund since 2009.

Brynjólfur graduated with an MBA from the University of Minnesota in 1973 and a cand. oecon. degree in business studies from the University of Iceland in 1971.

Måns Höglund, Director

Måns was born in 1951. He is Swedish and lives in Portugal. He was first elected as a Director at a shareholders' meeting on 24 March 2011. He is not a shareholder of the 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.

Måns graduated from Stockholm School of Economics in 1975 where he became a lecturer and researcher after completing his studies. He served in various posts at Hambros Bank in London between 1977 and 1984 and was regional director for Denmark and Iceland for two years. In 1984 he started working for 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 1991 to 1999 he worked for Swedbank, where his roles included director and head of the bank's large corporate business. In 1999 to 2002 he worked for both Unibank (as head of Sweden operation) and Nordea (as Head of Private Banking, Sweden).

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.

Thóra Hallgrímsdóttir, Director

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

Thóra gained a degree in law from the University of Iceland in 2000. She qualified as a district court attorney in 2002. Thóra worked in the insurance business for ten years, from 2000 for Tryggingamidstöðin hf. and from 2005 for Sjóvá-Almennar tryggingar hf. as a legal advisor in claims. She was director of claims for Sjóvá-Almennar tryggingar hf. from 2006 to 2007 and in 2007-2011 was general counsel for Sjóvá-Almennar tryggingar hf. Thóra served on behalf of Sjóvá-Almennar tryggingar hf. on the board of International Motor Insurance in Iceland sf. and was an alternate member of the board of the Icelandic Financial Services Association.

Since 2011 Thóra has worked as a specialist for the School of Law in Reykjavik University, specializing in insurance law, contract law and tort law. Thóra is a member of the Board of VIRK, the Icelandic Rehabilitation Fund, nominated by SA-Confederation of Icelandic Employers, and is an alternate member of the Insurance Complaints Committee, nominated by the Icelandic Financial Services Association. She is also chairman of the insurance arbitration committee and the chairman of the seamen's and fishermen's arbitration committee, as appointed by the relevant minister. Thóra is also chief editor of the journal "Tímarit lögfræðinga" issued by the Association of Icelandic Lawyers.

Board of Directors Alternates

In the event that a Director resigns or is unable to attend a meeting of the Board, an alternate director attends such meeting. The Board's alternate directors are as follows:

Sigurbjörg Ásta Jónsdóttir

Sigurbjörg Ásta Jónsdóttir was born in 1970. She was first elected as an Alternate Director at the Bank's Annual General Meeting on 20 March 2014. She is not a shareholder of the Bank.

Sigurbjörg graduated with a Cand. Jur. degree from the University of Iceland in 1996 and LL.M. degree from St. John's College, Cambridge University, in 1998.

From 1996 to 1997 Sigurbjörg worked as a Lawyer at Lögmenn Austurstræti and in 1998 she received professional education at UNICEF in Madrid, Spain. From 1999 to 2013 Sigurbjörg worked at NATO's Headquarters in Tirana, Albania, and in Brussels, Belgium, first as a Lawyer and later as a specialist. From 2013 to 2014 Sigurbjörg worked as a Lawyer at the Icelandic Coast Guard.

Ólafur Örn Svansson

Ólafur Örn Svansson was born in 1972. Ólafur graduated in 2000 from the University in Iceland with a Cand. Jur. degree. He was first elected as an Alternate Director at the Bank's Annual General Meeting on 21 March 2013. Ólafur Örn is not a shareholder of the Bank.

Ólafur became a District Court Attorney in 2001 and an Attorney to the Supreme Court in 2008. Ólafur has been a Lecturer in University of Iceland, University of Reykjavik and the University of Bifröst. Ólafur is a member of the Icelandic Bar Association.

Ólafur worked at LMK Law Offices 2000-2004 and became Partner at Forum Lawyers in 2005.

Björg Arnardóttir

Björg was born in 1980. She was first elected as an Alternate Director at the Bank's Annual Meeting on 22 March 2012. She is not a shareholder of the Bank.

Björg graduated from Reykjavik University in 2004 where she completed a BSc degree in Business Administration. Björg worked at BYR savings bank between 2004 and 2005 and from 2005 to 2008 at Creditinfo hf., where she worked as a specialist in risk assessment. From 2008 to 2009 she worked at Sparisjóðabanki Ísland, where she worked in risk management and credit risk. From March to October 2009 Björg worked for the resolution committee of Sparisjóðabanki Íslands.

Björg Arnardóttir is an employee of Kaupthing. The Bank and Kaupthing, as owner of Kaupskil, may have different interests with respect to the financial reorganisations of customers who have obligations with both parties. Accordingly, the Bank has implemented a procedure whereby Björg Arnardóttir is not permitted to act as an alternate director where such a conflict arises. There are no other conflicts of interest between the duties of the Board's alternate directors listed above to the Bank and their private interests or other duties. The address of each of the Board's alternate directors is Borgartún 19, 105 Reykjavík.

Board's sub-committee members (other than Directors)

Gudjón Gústafsson, Business Administrator & CPA, Vice President of International Treasury at Actavis. Gudjón is a member of the Board Audit and Risk Committee.

Senior Management

The Bank's senior management team comprises the following members:

Höskuldur H. Ólafsson, CEO

Höskuldur graduated with a degree in business administration from the University of Iceland in 1987. He joined the Bank in June 2010 from Valitor - VISA Iceland, where he was CEO from 2006. Prior to that he worked at the Icelandic transportation company, Eimskip, for almost 20 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 organisations in Iceland and abroad. Höskuldur is the chairman of the Icelandic Financial Services Association (SFF) and is also a board member of the Icelandic Chamber of Commerce.

Freyr Thórdarson, Managing Director of Corporate Banking

Freyr was born in 1973 and lives in Iceland. Freyr completed a Bachelor's degree in business administration at Reykjavík University in 2003 and earned an MBA degree from the Reykjavík University School of Business in 2010. Before that, he studied at Universität Salzburg in Austria and completed a Vor-diplom in Communication Science in 1999. Freyr has worked in banking and finance since 2001, both in Iceland and abroad, at Straumur Investment Bank, Gnúpur investment company, and Íslandsbanki/Glitrir. In 1999 to 2001, prior to his financial career, Freyr worked at a bottling company called IcelandSpring on plant development and management. Since 2009, Freyr has managed restructuring and asset recovery projects in Kaupthing hf.'s Scandinavian portfolio as a Senior Director. He currently sits on the board of Norvestia Oyj, which is listed on the NASDAQ OMX Helsinki, and also sits on the boards of two unlisted industrial companies in Scandinavia on behalf of Kaupthing. Freyr was previously a Board member of Arion's Board of Directors from 22 March 2012 until 13 May. He was hired as the Managing Director of Corporate Banking on 13 May 2013.

Halldór Bjarkar Lúdvígsson, Managing Director of Investment Banking

Halldór graduated with a degree in mechanical engineering from the University of Iceland in 1991 and a B.Sc. in computer studies in 1992 from the same university. 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. In 2005, Halldór joined the Corporate Banking division of Kaupthing where he supervised lending activities in Scandinavia. Halldór worked for the Kaupthing Resolution Committee in 2008 in his capacity as managing director of the Bank's Nordic asset portfolio and in December 2009 he was appointed managing director of Corporate Finance at the Bank. Halldór has served on the boards of a number of companies, particularly start-up companies.

Helgi Bjarnason, Managing Director of Retail Banking

Helgi graduated from the faculty of mathematics of the University of Iceland in 1992 and completed a degree in actuarial mathematics from the University of Copenhagen in 1997. From 1997 to 2006, Helgi worked as an actuary at Okkar Life Insurance. 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 company. In October 2010, Helgi joined the Bank as managing director of Operations. Helgi has served on various boards of directors, such as the Association of Icelandic Actuaries, the Confederation of Employers and the Icelandic Financial Services Association. He is currently on the board of Okkar Life Insurance. He was appointed managing director of Retail Banking in October 2011.

Gísli S. Óttarsson, Chief Risk Officer and Managing Director

Gísli received a Ph.D. in mechanical engineering from the University of Michigan in 1994. Gísli worked as a software designer and adviser for various engineering software companies in the United States before he joined Kaupthing's risk management division as head of research and development in January 2006. In April 2009, Gísli became the chief risk officer of the Bank.

Jónína S. Lárusdóttir, Managing Director of Legal Division

Jónína graduated from the faculty of law at the University of Iceland in 1996 and qualified as a district court attorney the following year. In 2000, Jónína completed a master's degree from the London School of Economics and Political Science, including European competition law. In 1996, Jónína started working for the A&P law firm, but moved to the Ministry of Commerce in 2000 where she was a specialist in the financial markets department. She was appointed director of the general office of the Ministry of Industry and Commerce in 2004. In 2007, she became permanent secretary of the Ministry of Commerce, now the Ministry of Economic Affairs, where she worked until late 2010 when she took over the post of managing director of the Bank's Legal Division. Jónína has served on and chaired numerous committees and has worked as a lecturer in several institutions, including the faculty of law of the University of Iceland. She was chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004.

Margrét Sveinsdóttir, Managing Director of Asset Management

Margrét graduated with an MBA from Babson College in Massachusetts in 1990. She has a degree in business administration from the University of Iceland and is a certified stockbroker. Margrét has been managing director of Asset Management at the Bank since February 2009. She has more than 20 years' experience in the financial sector, having worked in credit analysis, customer relationship management and asset management. She started her career in the corporate banking division of the Industrial Bank of Iceland in 1985. Margrét then moved on to Íslandsbanki Securities Ltd, later the asset management division of Glitnir, where she was head of securities brokerage and advisory. In 2007, she became head of financial institutions client relations at Glitnir. 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. She has also contributed to several books and magazines on asset management services, investments and financial planning.

Rakel Óttarsdóttir, Managing Director of Corporate Development & Marketing

Rakel joined the IT division of Kaupthing Bank in 2005 where she was an account manager. In 2010 she became head of project management in the Corporate Development & Marketing division of the Bank. In December 2011 she was appointed managing director of Corporate Development & Marketing. Before joining the Bank, Rakel was head of development at TM Software. Rakel is a computer science graduate from the University of Iceland and has an MBA from Duke University in the United States.

Stefán Pétursson, Chief Financial Officer and Managing Director

Stefán graduated with an MBA from Babson College in Massachusetts in 1991 and a degree from the faculty of business of the University of Iceland in 1986. Stefán was appointed CFO at the Bank in August 2010. In 1986 to 1989, Stefán worked as head of administration at the Icelandic Fisheries Laboratories Institute. After completing his studies in the United States, Stefán joined Landsvirkjun. He began as head of funding but later took over as treasurer and finally CFO, a position he held from 2002. Stefán was on leave from Landsvirkjun in 2008 while serving as the CEO of the investment company HydroKraft Invest hf. 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.

Sigurjón Pálsson, Managing Director of Operations

Sigurjón joined the Investment Banking division of Kaupthing in 2005 and later became a departmental head in Corporate Recovery at the Bank. Sigurjón was appointed managing director of Operations in October 2011. Sigurjón previously held a management position at the contracting firm Ístak hf., where he was in charge of IT and other key projects. Sigurjón is educated as an engineer and has a master's degree from KTH in Stockholm and MIT.

Hákon Már Pétursson, Compliance Officer

Hákon studied law at the University of Iceland and University of Copenhagen, and is also a certified stockbroker. From 2006 to 2009 he worked as a specialist in the Securities Market division at the FME. During this time he was, among other things, the FME's representative in the Takeover Directive expert group and the Markets in Financial Instruments Directive (MiFID) expert group at the Committee of European Securities Regulators. He was also a guest lecturer at the University of Iceland and University of Reykjavík. From 2009 to 2011 he worked for KVASIR Legal on various matters relating to banking and financial restructuring. Hákon joined the Bank's Compliance Division in 2011.

Lilja Steinhórsdóttir, Chief Audit Executive

Lilja gained an MBA degree from the University of Edinburgh in 1998. She qualified as a chartered accountant in 1984 and graduated with a degree in business administration in 1980. Before she joined the Bank in late 2006 as chief audit executive, she was the chief auditor at the Central Bank for eight years. She established an accounting firm in Akureyri in 1986 and headed it for 13 years when it was sold to Deloitte. She is a member of the Institute of State Authorised Public Accountants and has served on the audit committee on behalf of the organisation. She also served on the audit committee of Icelandic Banks' Data Centre from 1998 to 2010, first on behalf of the Central Bank and then the Bank.

Helgi G. Björnsson, Customers' Ombudsman

In 1993, Helgi was appointed deputy branch manager at Búnadarbanki (a predecessor of the Bank) in Akureyri and became branch manager at Höfði, Reykjavík, in 1999. He was then branch manager in Grafarvogur, Reykjavík, until spring 2010 when he joined the Customers' Ombudsman department as a specialist. Helgi was appointed Customers' Ombudsman of the Bank in April 2012. Between 1989 and 1993 Helgi worked for the Director of Tax Investigations and also advised on accounting for companies in north eastern Iceland. 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.

There are no conflicts of interest between the duties of the members of senior management listed above to the Bank and their private interests or other duties. The address of each member of senior management is Borgartún 19, 105 Reykjavík.

Corporate Governance

The Bank's Corporate Governance framework is based on law, the Bank's Articles of Association and the Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland hf. and the Confederation of Icelandic Employers in accordance with the Bank's Corporate Governance Statement. The Bank is directed and controlled by this framework. By establishing rules on corporate governance, the Bank sets forth criteria of conduct in key areas, which complement statutory rules. The Bank believes that a strong governance culture enhances trust, reduces risk and increases economic benefit for the Bank and its shareholders in the long term. The Bank continually seeks to update its corporate governance framework in response to new events, changes in statutory law and developments in domestic and international standards.

Management

The CEO is appointed by the Board. He is in charge of the day-to-day operations of the Bank and represents it in all matters concerning normal operations. The CEO is assisted by an executive management committee, in which all nine managing directors hold a seat.

Customers' Ombudsman

The Customers' Ombudsman is appointed by the Board in accordance with a government recommendation made at the end of 2008.

The role of the Ombudsman is to ensure fairness and objectivity when dealing with recovery cases, prevent discrimination between customers and to ensure that the process for handling cases is transparent and documented. In the case of companies, the Ombudsman must also ensure that competition perspectives are taken into account, viable companies are entered into the restructuring process and rules on financial restructuring are adhered to.

In order to achieve these objectives, the Ombudsman takes part in the formation of procedures and solutions for customers as appropriate. In addition, the Ombudsman reviews specific cases upon request from customers, the Bank's employees or at his own initiative. Such a review can take place both while cases are being processed and after they are closed. The Ombudsman has access to information and data on specific issues. The Ombudsman submits information about the outcome of cases to clients, employees and the Board as appropriate.

Internal Audit

The Internal Auditor is appointed by the Board 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 work. Internal Audit is required to provide independent and objective assurance and consulting services 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 the Bank.

The internal audit is governed by the audit charter, an FME directive on the internal audit function in financial institutions and international standards on internal auditing. All internal audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by Internal Audit every quarter. Internal Audit had 11 employees at 31 December 2012.

Employees

During the first six months of 2014, the average number of FTEs at the Group was 1,133 (compared to 1,159 during 213). At 30 June 2014, the number of FTEs at the Group was 1,118.

The Bank had 900 average number of full time equivalent employees during the first six months of 2014 and 887 full time equivalent employees at 30 June 2014 .

FINANCIAL MARKETS IN ICELAND

General

Towards the end of 2008, Iceland suffered a currency and banking crisis. The government of Iceland was forced to step in and take control of the three major Icelandic banks Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf., all of which had been very active in the international financial markets, to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly functioning of the payment system. Following this, certain assets and liabilities were transferred from the banks into three new entities, including the Bank, which have operated as commercial banks from that time.

The establishment of the new banks

After the government took control of Kaupthing, Glitnir and Landsbanki in October 2008, certain assets and liabilities were transferred from the banks into new entities, which have now become the Bank, Íslandsbanki hf. and Landsbankinn hf. Following an agreement between the Icelandic government and the Kaupthing Resolution Committee in July 2009, the Kaupthing Resolution Committee announced that it intended to exercise its option to purchase 87 per cent. of the Bank's equity, and a subsequent capital injection took place on 8 January 2010. Kaupthing Bank, through its subsidiary Kaupskil ehf., now holds an 87 per cent. stake in the Bank and the Ministry of Finance holds the remaining 13 per cent. A similar agreement was reached between the government and Íslandsbanki hf., and the Glitnir's Resolution Committee, through ISB Holding, now holds 95 per cent. of the shares in Íslandsbanki and the Ministry of Finance holds the remaining 5 per cent. Landsbankinn hf. remains fully state-owned.

The Icelandic financial sector before 2008

Prior to the collapse of the banking system in Iceland, the financial sector and the legislative environment in Iceland had undergone much transition. For example, in connection with the EEA Agreement, Icelandic legislation and regulations regarding commercial banks and other financial undertakings and the financial market had been adopted to implement various regulations and directives of the European Union.

Before 2000 the Icelandic banking system mostly consisted of three investment banks, four commercial banks and 26 savings banks. By 2008, however, the financial market mainly consisted of three major international banks (Kaupthing Bank hf., Glitnir Bank hf. and Landsbanki Íslands hf.), while the number of savings banks had been reduced to 21. The total assets of the Icelandic banking system amounted to around ISK 9,739 billion at the end of December 2007.¹

Other relevant institutions

A Housing Financing Fund (<http://www.ils.is>) was established at the beginning of 1999. The fund is based on legislation approved by the Icelandic Parliament in June 1998, which was aimed at rationalising the existing state financing system for housing. The Housing Financing Fund used to be by far the largest provider of financing for residential housing in Iceland but with the competition from the three major banks over the years leading up to 2008 its market share shrunk significantly. After the collapse of the banking system, the importance of the Housing Financing Fund grew at first. The three major banks have been strengthening their position in the market for the financing of residential housing again over the past two years, partly due to Icelandic banks starting to offer non-inflation linked mortgage loans from 2011 onwards.

¹ <http://sedlabanki.is/lisalib/getfile.aspx?itemid=848>

Several domestic securities houses are currently operating in Iceland. However, the operations of these securities houses have been greatly limited since the banking collapse, but before 2008, many of them operated mutual funds of various kinds.

In addition, there are several insurance companies licensed to operate in Iceland. Insurance companies have been active in the financial market through their investment activities especially before 2008.

Furthermore, pension funds receive payments from employers and employees and are an important source of long term finance in the country. Membership in a pension fund is obligatory for wage earners and self-employed people, in accordance with Act No. 129/1997, on Mandatory Pension Insurance and on the Activities of Pension Funds. The pension funds are independent non-government entities. They invest mainly in domestic bond issues, equity capital and foreign securities.

The Financial Supervisory Authority, the Central Bank of Iceland and the Iceland Stock Exchange

At the beginning of 1999, the Bank Inspectorate of the Central Bank of Iceland and the Insurance Supervisory Authority were merged into a new independent entity, the Financial Supervisory Authority (the FME) (www.fme.is). The field of supervision covered by the new entity is the whole range of financial institutions as well as insurance companies and pension funds. The activities of FME are primarily governed by Act No. 87/1998, on the Official Supervision of Financial Operations, and Act No. 98/1999, on the Payment of Cost Due to the Official Supervision of Financial Activities.

The Central Bank (www.sedlabanki.is) is responsible for implementing monetary policy consistent with the goal of maintaining price stability. The activities of the Central Bank are primarily governed by Act No. 36/2001, on The Central Bank of Iceland. The Central Bank imposes a reserve requirement on all commercial banks and savings banks. The purpose of this requirement is to ensure these credit institutions are able to meet fluctuations in their liquidity positions. Foreign exchange transactions have been subject to capital controls since the banking system collapsed in 2008. The Central Bank oversees surveillance of the Rules on foreign exchange. See "*Risk Factors - Existing currency restrictions – Icelandic rules on foreign exchange*" cf. page 31.

The Iceland Stock Exchange (NASDAQ OMX Iceland hf.) (<http://www.nasdaqomxnordic.com/nordic/Nordic.aspx>) operates under Act No. 110/2007, on Stock Exchanges. In the autumn of 2000, the Iceland Stock Exchange joined NOREX, a joint project of the Nordic stock exchanges. One of the main benefits from the NOREX Alliance is the SAXESS trading system, which is used by all NOREX participants. In September 2006, the Iceland Stock Exchange joined the OMX Nordic Exchange.

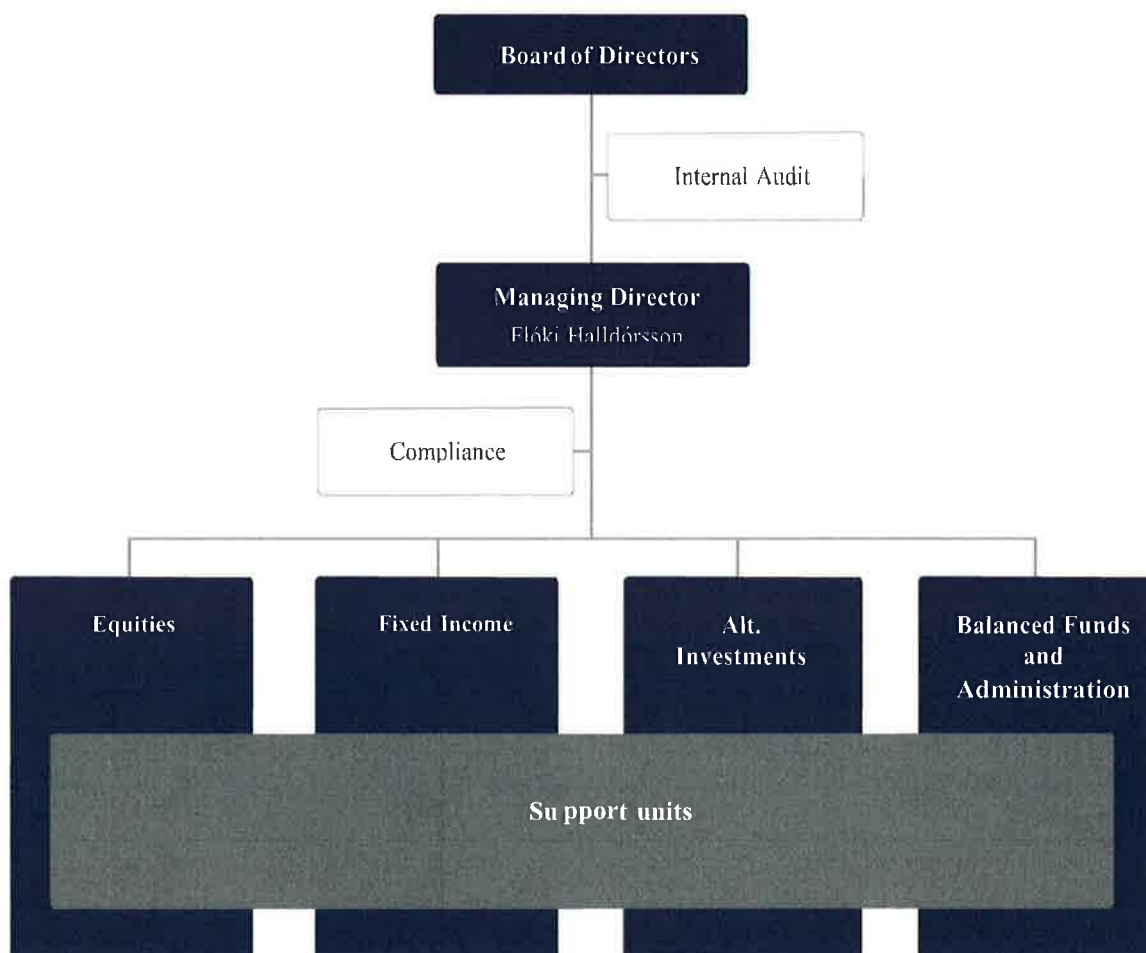
DESCRIPTION OF THE FUND

Arion Bank Mortgages Institutional Investor Fund, formerly Kaupthing Mortgages Institutional Investor Fund (the **Fund**) was established in Iceland on 10 March 2006 as an institutional investment fund pursuant to Article 4 of Act No 30/2003 on Undertaking for Collective Investment in Transferable Securities and Investment Funds (the Act), as amended on 1 November 2011 by Article 4 of Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds. The Fund changed its name to Arion Bank Mortgages Institutional Investor Fund on 19 October 2011. On 20 January 2012, Kaupthing subsequently transferred all of the unit shares which it held in the fund to Arion with the consent of the Covered Bondholders.

As Kaupthing was the original issuer of the Covered Bonds and the original owner of the unit shares held by the Fund, the quality of the assets of the Fund deteriorated from 24 November 2008 which was the date on which insolvency proceedings were brought against Kaupthing.

The Fund's registration number is 570106-9610. The registered office of the Fund is at Borgartun 19, 105 Reykjavik, Iceland. The telephone number of the Fund's registered office is +354 444-6000.

Organisation Chart of Stefair:



At the annual meeting of Stefmir hf. on the 19th of March 2014 the following people were elected on to the main board of directors and alternate board of directors.

Board of Directors

The Board is the supreme authority between shareholders' meetings, as further stipulated by law, regulations, and the Articles of Association. Stefmir's Board comprises the following members:

Hrund Rudolfsdottir, Chairman, CEO of Veritas.

Jokull H. Ulfsson, Head of A plus at Arion Bank.

Kristjan Johannsson, Vice Chairman, Chairman of Icepharma.

Svava Bjarnadottir, Partner and counsellor at Stategia.

Þórður Sverrisson, self-employed.

Board of Directors Alternates

In the event that a Director resigns or is unable to attend a meeting of the Board, an alternate director attends such meeting. The Board's alternate directors are as follows:

Asgerdur Hronn Sveinsdottir, Branch Manager at Arion Bank hf.

Gunnar Ingi Johannsson, Attorney at Logmenn Hofdabakka.

Kristbjorg Edda Johannsdottir, Executive Director of Marketing at Siminn hf.

Thorhallur Orn Gudlaugsson, Lecturer in the Faculty of business Administration at the University of Iceland.

Hordur Kvaran, Specialist in the Finance Division at Arion Bank hf.

The majority of the board is independent of Arion Bank, Stefmir's parent company. The managing director of Stefmir hf. is Floki Halldorsson.

Audit Committee

The board of directors of Stefmir has appointed an audit committee which operates in accordance with Article 108 a of the Annual Accounts Act no. 3/2006 which states that units in which there is a public interest at stake should have an audit committee with at least three members.

The members of the committee are:

Svava Bjarnadottir, chairman, Partner and counsellor at Stategia.

Gudlaug Sigurdardottir, Engineer at Össur.

Sigríður Guðmundsdóttir, Internal auditor at Marel.

The majority of the committee members are independent of Arion Bank, Stefmir's parent company.

The day-to-day operations of the Fund are managed by Stefmir hf. (Stefmir Asset Management Company hf.), formerly Kaupthing Bank Asset Management Company hf. (the **Management Company**) pursuant to the Fund's Articles of Association. The Funds' Manager is Jón Finnbogason at Stefmir hf. The Asset Management Company's registration number is 700996-2479. The registered office of the Management Company is at Borgartun 19, 105 Reykjavík, Iceland. The telephone number of the Management Company's registered office is +354 444 7400. The Asset Management Company is incorporated under the laws of Iceland and is a wholly-owned subsidiary of the Issuer. The principal activity of the Management Company consists of the management of the day-to-day operations of funds and other enterprises for mutual investment in transferable securities.

Verdis hf., formerly Arion Custody Services hf. has been appointed pursuant to the Fund's Articles of Association to provide certain administration and depository services to the Fund in accordance with a custody agreement entered into by it and the Management Company on behalf of the Fund. The Custody Agent's registration number is 470502-4520, The registered office of the Custody Agent is at Ármúli 13, 105 Reykjavik, Iceland. The telephone number of the Custody Agent's registered office is +354 528-2800. Verdis merged with Arion Bank 29 June 2012. Arion took over all operations of Verdis including the role of Custody Agent.

The Fund has no subsidiaries or employees. Other than the Asset Management Company and the Custody Agent, the Fund is dependent on the Servicer and the Cash Manager to provide certain management and administrative services to it, on the terms of the Transaction Documents.

The principal activities of the Fund are set out in the Fund Deed and include, *inter alia*, the ability to carry on the business of acquiring the Loans and their Related Security pursuant to the terms of the Mortgage Sale Agreement with a view to profit, to borrow money and to do all such things as are incidental or conducive to the carrying on of that business.

The Fund has not traded since the date of its establishment (other than those matters incidental to the Covered Bonds), nor has it engaged since its establishment, and will not engage whilst the Covered Bonds or any Term Advance remains outstanding, in any material activities other than activities incidental to its establishment, activities contemplated under the Transaction Documents to which it is or will be a party and other matters which are incidental or ancillary to the foregoing.

There are no potential conflicts of interest between, on the one hand, any duties of the directors of the Management Company to the Fund and, on the other hand, their private interests or other duties.

Except as described in this Prospectus, there has been no material adverse change in the prospects of the Fund since the date of the last Financial Statements of the Fund, dated 11 March 2014.

Except as described in this Prospectus, there has not been any significant change in the financial or trading position of the Fund since the date of the last Financial Statements of the Fund, dated 11 March 2014.

The Fund's accounting reference date is 31 December with its most recent statutory accounts being drawn up to 31 December 2013.

The audited consolidated annual financial statements of the Fund for the financial year ended 31 December 2013 (the **Fund's 2013 Financial Statements**) and the unaudited interim financial statements for the periods ended 30 June 2014 (the **Fund's 2014 Interim Financial Statements**) are set out in section of the Prospectus entitled "*Fund's Financial Statements*". The Fund's 2013 Financial Statements have been accurately reproduced and, as far as each of the Issuer and the Fund are aware, no facts have been omitted which would render the reproduced information inaccurate or misleading. Ernst & Young ehf. of Borgartún 30, 105 Reykjavik, Iceland audited the Fund's 2013 Financial Statements and provided the auditor's report contained in the Fund's 2013 Financial Statements. Ernst & Young ehf. are members of The Institute of State Authorised Public Accountants in Iceland and have no material interest in the Fund.

Key financial information as per 30 June 2014, 31 December 2013 and 31 December 2012 of the Fund:

Six month period ended as at 30 June 2014

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets
	1,348	1,263	167,079

Year ended/as at 31 December 2013

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets
	2,351	2,176	165,612

Year ended/as at 31 December 2012

<i>(ISK million)</i>	Net financial income	Profit transferred to units	Total assets
	1,841	1,661	173,107

Corporate Governance Statement of Stefir hf. 2014

The corporate governance statement by Stefir hf. is in compliance with the requirements set forth in recognized guidelines at the time these financial statements are approved by the board of the company and the provisions Article 19 of Act No. 161/2002. Guidelines on Corporate Governance, 4th edition, issued by the Icelandic Chamber of Commerce, the Confederation of Icelandic Employers and NASDAQ OMX Iceland hf. and OECD Principles of Corporate Governance were taken into special consideration when the Stefir hf.'s corporate governance statement was written. Both the Guidelines on Corporate Governance and the Principles of Corporate Governance can be viewed on Stefir's website.

In 2012 Stefir was recognized as the first Icelandic company to be "A model company in good corporate governance." This honour was granted by the Center for Corporate Governance at the University of Iceland and is based on a survey conducted by the auditing company KPMG ehf. In 2013 Stefir was granted the same recognition and therefore remains a model company in good corporate governance in Iceland.

The board of directors of Stefir believes that good corporate governance is a key factor behind Stefir's success as a leading fund management company in Iceland. Corporate governance provides companies with a framework in which objectives are defined, which tools should be used to achieve these objectives and how the success of these objectives is measured. Good corporate governance is designed to provide the right incentives to the board of directors and management to exploit the opportunities which serve the interests of the company, the shareholders and general public. Good corporate governance also enables the board to perform its monitoring duties effectively.

Stefir hf. is an independent financial institution according to the Financial Undertakings Act No. 161/2002. The company manages UCITS, investment funds and professional investor funds under Act No. 128/2011. In addition to this, the company is licensed to operate asset management services, investment advisory and to manage financial instruments for collective investments, cf. sub-paragraphs 1-3 of paragraph 1 of Article 27 of Act No. 161/2002. Stefir is Iceland's largest fund manager with assets of approximately ISK 414 billion under active management. Stefir has 21 employees with average experience on the financial markets of 10 years.

Stefir is a subsidiary of Arion Bank hf. The company is fully owned by Arion Bank and related companies. The company's corporate governance statement serves to encourage open and reliable communications between the board, shareholders and other stakeholders such as unit holders in funds managed by Stefir, parties that service and participate in the operations of Stefir, employees and the general public.

The company's operations are subject to stringent restrictions by the legislator. The company's operations are governed by acts of law including the Financial Undertakings Act No. 161/2002 and the UCITS, Investment Funds and Institutional Investor Funds Act, No. 128/2011. Stefir is monitored by the FME under Act No. 87/1998.

Risk management and active internal control are mainstays of the responsible operation of a fund management company. The board of directors of Stefmir has devised a risk strategy for the company: "Stefmir's board of directors is aware that risk management and active internal control are some of the mainstays of a responsible fund management company. By formulating a clear risk policy the board continues to encourage the existing strong risk management culture within Stefmir and simultaneously informs its policy to its stakeholders. All risk within Stefmir's operations is identified and assessed regularly and a process to monitor and report this risk is in place. Stefmir operates a strong control environment which utilizes policies, processes and systems to appropriate internal controls and risk mitigation. Stefmir has in place a continuity plan to ensure the ability to operate despite a severe business disruption. Through corporate governance the board of directors ensures that the policies, processes and systems are implemented at all decision levels."

Compliance, internal audit and some risk management functions are outsourced to Arion Bank with the permission of the FME and the board is regularly informed of issues concerning the above.

The company's accounting is the responsibility of Arion Bank's finance division. The FME has authorized the outsourcing of this task. Arion Bank is also the depositary of Stefmir hf. and the financial statements of Stefmir's funds are the responsibility of the Bank. The auditing committee examines the financial statement and obtains the opinion of an external auditor on the six-month financial results and 12-month financial results of Stefmir and the funds managed by Stefmir. Reporting to the board of directors with respect to the accounts is the responsibility of the committee; the board also meets the auditing company Ernst & Young hf.

Stefmir has five board members and five alternate members. The majority of the board is independent of Arion Bank, Stefmir's parent company, and the company itself. All board members are elected at a shareholders' meeting of the company. The managing director is hired by the board and has the mandate from the board to manage the day-to-day operations of the company. Board meetings are held regularly, on average once a month and more often if required. An employee of Stefmir is the secretary of the board. Stefmir's legal representative is also present and provides board members with legal advice at board meetings. There were 14 board meetings during the year and there was a quorum present at every meeting. The board's rules of procedure, work schedule and articles of association can be seen on the company's website, www.stefmir.is/english.

The board of directors of Stefmir comprises the independent board members Hrund Rudolfsdóttir, Chairman, CEO of Veritas, Snjólfur Ólafsson, Vice Chairman, professor in the faculty of business administration at the University of Iceland, Kristján Jóhannsson, chairman of Icepharma hf. and Svava Bjarnadóttir, partner and consultant at Strategía. The dependent board member is Jökull H. Úlfsson, head of A Plus at Arion Bank hf. The majority of board members have served on the board since 2009. Kristján Jóhannsson was elected to the board in June 2011 and Jökull H. Úlfsson in March 2013. Further information on the board members of Stefmir can be seen on the company's website.

The alternate board members are Ásgerdur Hrönn Sveinsdóttir, area and branch manager at Arion Bank hf, Gunnar Ingi Jóhannsson, attorney at Lögmenn Höfðabakka, Kristbjörg Edda Jóhannsdóttir, head of marketing at Síminn, Thórhallur Örn Gudlaugsson, lecturer in the faculty of business administration at the University of Iceland, and Hörður Kvaran, specialist in Arion Bank's finance division.

The audit committee is elected by the board. The chairman of the committee is Svava Bjarnadóttir. The other committee members are Gudlaug Sigurdardóttir and Sigríður Guðmundsdóttir. The audit committee met five times in 2013 and achieved a quorum on each occasion. The committee members are independent of the company and their broad expertise in business administration, auditing and management was put to good use in the course of the committee's business. The committee submits its annual report to the board of directors in the first quarter of every year. Stefmir's remuneration committee was founded during the year. Its members are Hrund Rudolfsdóttir and Svava Bjarnadóttir. The main roles of the committee are to establish a remuneration policy for the company and to make proposals on salaries and other remuneration to the managing director, other management and board of Stefmir. The company's remuneration policy can be read on its website.

The board members of Stefmir jointly devised the following mission statement for the board:

The board's key role is to establish a corporate strategy and ensure that it is implemented. The core of the strategy is for the company to be a leading fund management company and to ensure that the interests of clients, owners, employees and the community at large are prime considerations. The focus is on running a solid and

profitable business and minimizing risk. The board places a strong emphasis on good corporate governance and ensuring that the board and company operate at all times in compliance with the law, rules and good business practices.

The role of the board is defined in more detail in the rules of procedures and the company's articles of association.

The board assesses its work annually and proposes ways to make improvements. The managing director is not present during the assessment and the chairman leaves the meeting when the board members assessed her work. The assessment is then compiled, the board's proposals for improvements are sent out the relevant parties and a time frame is set for completion.

The company's managing director since 1 July 2009 has been Flóki Halldórsson (born 1973), an economics graduate from the University of Iceland. Flóki has extensive experience of the financial markets and management. The managing director is responsible for ensuring that the day-to-day operations of the company are conducted according to the strategy and instructions given by the board of directors; cf. Paragraph 2, Article 68 of the Public Limited Companies Act. He is responsible for reporting to internal and external supervisory bodies. The managing director is authorized to grant other employees of the company the power to handle limited authorizations of their duties.

The managing director is responsible for analysing, measuring, monitoring and supervising risks associated with the operations of the company. The managing director shall maintain an organizational chart that clearly specifies areas of responsibility, employees' authorizations and channels of communications. The managing director shall formalize objectives for internal control in consultation with the board and ensure that the follow-up is efficient. The managing director hires and dismisses the employees of the company, other than those discussed in Article 16 of Act No. 161/2002 and discharges them.

New rules of procedure for the board were approved in January 2014. The rules were established with reference to Article 54 (2) of the Financial Undertakings Act and Article 70 (5) of the Public Limited Companies Act. The rules of procedure are largely based on guidelines No. 1/2010 of the Financial Supervisory Authority (FME) and the company's articles of association. The work undertaken in relation to the company's recognition as a model company in good corporate governance has been important in this respect. The rules of procedure can be viewed on Stefmir's website.

Stefmir has been at the forefront in offering its clients competitive and responsible investment options in virtually all asset classes. It is vital that the company is able to pass on information accurately and simply to investors. The company's website performs an important role in this respect by displaying detailed information on all the Stefmir funds available to the public.

No judgements for punishable acts according to the Criminal Code, the competition law, the act on financial undertakings or laws on public limited companies, private limited companies, book-keeping, annual accounts, bankruptcy or taxation, nor under special legislation applicable to parties subject to public supervision of financial activities, have been passed on Stefmir hf. Information on court cases relating to Stefmir can be found in the notes to the company's annual financial statement.

SUMMARY OF THE PRINCIPAL DOCUMENTS

Due to the Fund's status as an institutional investment fund established pursuant to Article 4 of Act No. 30/2003 on Undertaking for Collective Investment in Transferable Securities and Investment Funds, as amended pursuant to Article 4 of Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds, the Management Company has executed each relevant Transaction Document on behalf of the Fund in accordance with the Articles of Association of the Fund. All documents are available at <http://www.arionbanki.is/english/about-us/investor-relations/debt-investors/> and at Arion Bank hf., Borgartún 19, 105 Reykjavík.

The summaries below comprise summaries of key points for potential investors to note under the Transaction Documents.

Representative and Agency Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Representative_and_Agency_Agreement.pdf

The Representative and Agency Agreement, made between the Issuer, the Fund, the Representative and the Paying Agents on 20 January 2012, is the principal agreement governing the Covered Bonds. The Representative and Agency Agreement contains provisions relating to, *inter alia*:

- the terms and conditions of the Covered Bonds (as more fully set out under *Terms and Conditions of the Covered Bonds* above);
- the forms of the Global Covered Bonds, Definitive Covered Bonds, Receipts and Coupons;
- the covenants of the Issuer and the Fund;
- the terms of the Covered Bond Guarantee (as described below);
- the enforcement procedures relating to the Covered Bonds and the Covered Bond Guarantee;
- the appointment, powers and responsibilities of the Representative and the circumstances in which the Representative may resign, or retire or be removed;
- the indemnification of the Representative and its relief from liability in certain circumstances; and
- the ability of the Representative, in certain circumstances, to remove the Management Company and appoint a replacement Management Company.

Covered Bond Guarantee

Under the terms of the Covered Bond Guarantee, if the Issuer defaults in the payment on the due date of any moneys due and payable under or pursuant to the Representative and Agency Agreement or the Covered Bonds or any Receipts or Coupons or if any other Issuer Event of Default occurs (other than by reason of non payment), and, in either case, if the Representative has served an Issuer Acceleration Notice, the Fund has agreed (subject as described below) to pay or procure to be paid (following service of a Notice to Pay) unconditionally and irrevocably to or to the order of the Representative (for the benefit of the Covered Bondholders) an amount equal to that portion of the Guaranteed Amounts which shall become Due for Payment but would otherwise be unpaid, as of any Due for Payment Date, by the Issuer. Payment by the Fund of the Guaranteed Amounts pursuant to the Covered Bond Guarantee will be made on the later of: (a) the day which is two Business Days following service of a Notice to Pay on the Fund; and (b) the day on which the Guaranteed Amounts are otherwise Due for Payment (the **Guaranteed Amounts Due Date**). The Representative will be required to serve a Notice to Pay following the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice.

Under the Covered Bond Guarantee, the Guaranteed Amounts will become due and payable on any earlier date on which, following the occurrence of a Fund Event of Default, a Fund Acceleration Notice is served in accordance with Condition 9.2. Following service of a Fund Acceleration Notice, the Covered Bonds will (if an Issuer Acceleration Notice has not already been served) become immediately due and payable as against the Issuer and the obligations of the Fund under the Covered Bond Guarantee will be accelerated.

All payments of Guaranteed Amounts by or on behalf of the Fund will be made without withholding or deduction for, or on account of, any present or future taxes or duties of whatever nature, unless the withholding or deduction of such taxes or duties are imposed or levied by or on behalf of any Tax Jurisdiction. If any such withholding or deduction is required, the Fund will pay the Guaranteed Amounts net of such withholding or deduction and shall account to the appropriate tax authority for the amount required to be withheld or deducted. The Fund will not be obliged to pay any amount to the Representative or any holder of Covered Bonds in respect of the amount of such withholding or deduction.

Under the terms of the Covered Bond Guarantee, the Fund has agreed that its obligations under the Covered Bond Guarantee shall be as principal debtor and not merely as surety and shall be absolute and unconditional (subject to Notice to Pay being given), irrespective of, and unaffected by, any invalidity, irregularity or unenforceability of, or defect in, any provisions of the Representative and Agency Agreement or the Covered Bonds or Receipts or Coupons or the absence of any action to enforce the same or the waiver, modification or consent by the Representative or any of the Covered Bondholders, Receiptholders or Couponholders in respect of any provisions of the same or the obtaining of any judgment or decree against the Issuer or any action to enforce the same or any other circumstances which might otherwise constitute a legal or equitable discharge or defence of a guarantor.

Subject to the grace period specified in Condition 9.2(a) of the Terms and Conditions, failure by the Fund to pay the Guaranteed Amounts which are Due for Payment on the relevant Guaranteed Amounts Due Date will result in a Fund Event of Default.

The Representative and Agency Agreement provides that any Excess Proceeds shall be paid by the Representative on behalf of the Covered Bondholders of the relevant Series to the Fund for its own account, as soon as practicable, and shall be held by the Fund in the GIC Account, to be used in the same manner as all other moneys from time to time standing to the credit of the GIC Account. Any Excess Proceeds received by the Representative shall discharge *pro tanto* the obligations of the Issuer in respect of the Covered Bonds, Receipts and Coupons. However, the obligations of the Fund under the Covered Bond Guarantee are (following service of a Notice to Pay) unconditional and irrevocable and the receipt by the Representative of any Excess Proceeds shall not reduce or discharge any of such obligations.

By holding any Covered Bond(s), each Covered Bondholder shall be deemed to have irrevocably directed the Representative to pay the Excess Proceeds to the Fund in the manner as described above.

The Representative and Agency Agreement is governed by Icelandic law.

Intercompany Loan Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Intercompany_Loan_Agreement.pdf

On each Issue Date, the Issuer lent to the Fund the gross proceeds from the issue by it of the Covered Bonds by way of Term Advances that correspond to the Covered Bonds issued by the Issuer on the relevant Issue Date pursuant to the Intercompany Loan Agreement. Each Term Advance was used by the Fund:

- (a) as consideration (in whole or in part) for the acquisition of Loans and their Related Security from the Seller pursuant to the terms of the Mortgage Sale Agreement, as described under – *Mortgage Sale Agreement – Sale by the Seller of the Loans and Related Security*;
- (b) subject to an Asset Coverage Test Breach Notice not having been served (and not revoked) on the relevant Issue Date, to make Unit Distributions to Holders by way of a distribution of each

Holder's holding of Units in the Fund in an amount equal to the ISK Equivalent of the Term Advance or any part thereof;

- (c) to invest in Substitution Assets in an amount not exceeding the prescribed limit;
- (d) if an existing Series, or part of an existing Series, of Covered Bonds was refinanced by such issue of Covered Bonds, to repay the Term Advance(s) corresponding to the Covered Bonds being so refinanced; and/or
- (e) to make a deposit in the GIC Account.

Payments in respect of each Term Advance will be the same as on the corresponding Covered Bonds.

Certain Term Advances (the "**Original Term Advances**") have already been made pursuant to an original intercompany loan agreement dated 29 March 2006 between Kaupthing, the Fund and the Representative prior to the substitution of the Bank as the Seller under the Intercompany Loan Agreement with respect to the Original Issuances. The parties to the Intercompany Loan Agreement have agreed that the terms of such agreement summarised in this section will apply to the Original Term Advances as if they had been made in accordance with the terms of the Intercompany Loan Agreement and references in this section to "**Term Advances**" mean both the Original Term Advances as well as any subsequent Term Advances issued pursuant to the Intercompany Loan Agreement. The Original Term Advances were made in respect of the issue of and correspond to the Covered Bonds.

The Issuer will not be relying on repayment of any Term Advance in order to meet its repayment obligations under the Covered Bonds. The Fund will pay amounts due in respect of Term Advances(s) in accordance with the relevant Priorities of Payments. Prior to service of an Asset Coverage Test Breach Notice (which has not been revoked) or a Notice to Pay on the Fund, amounts due in respect of each Term Advance will be paid by the Fund to, or as directed by, the Issuer on each Interest Payment Date, subject to paying all higher ranking amounts in the Pre Acceleration Priority of Payments. The Issuer may (but is not required to) use the proceeds of the Term Advances to pay amounts due on the Covered Bonds; any failure by the Fund to pay any amounts due on the Term Advances, however, will not affect the liability of the Issuer to pay the relevant amount due on the Covered Bonds. For so long as an Asset Coverage Test Breach Notice is outstanding and has not been revoked, the Fund may not borrow any new Term Advances from the Issuer under the Intercompany Loan Agreement.

The amounts owed by the Fund to the Issuer under the Term Advances will be reduced by: (i) any amounts paid by the Fund under the terms of the Covered Bond Guarantee; and (ii) the Principal Amount Outstanding of any Covered Bonds (the proceeds of which were originally applied to make such Term Advances) purchased by the Fund and cancelled in accordance with Condition 6.7.

The Intercompany Loan Agreement is governed by Icelandic law.

Mortgage Sale Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Mortgage_Sale_Agreement.pdf

The Seller

Loans and their Related Security are sold to the Fund from time to time pursuant to the terms of the Mortgage Sale Agreement entered into on 20 January 2012 between Arion Bank hf. (in its capacity as Seller), the Fund and the Representative. The Initial Portfolio was sold to the Fund on the First Assignment Date pursuant to an original mortgage sale agreement dated 29 March 2006 between Kaupthing, the Fund and the Representative, prior to the substitution of the Bank as the Seller under the Mortgage Sale Agreement, and the Initial Portfolio remains subject to the terms of the Mortgage Sale Agreement.

Sale by the Seller of the Loans and Related Security

The Portfolio will consist of, and the Initial Portfolio consisted of, the Loans and their Related Security sold from time to time by the Seller to the Fund in accordance with the terms of the Mortgage Sale Agreement. The types of Loans forming the Portfolio will vary over time provided that the Eligibility Criteria (as described below) in respect of such Loans are met on the relevant Assignment Date. Accordingly, the Portfolio may, at any time, include Loans with different characteristics from Loans that were included in the Portfolio or being offered to Borrowers on previous Assignment Dates.

Prior to the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice or a Fund Event of Default and service of a Fund Acceleration Notice, the Fund will acquire the Loans and their Related Security from the Seller in certain circumstances, including the three circumstances described below;

- (a) *First*, in relation to the issue of the Covered Bonds, the Issuer made Term Advances to the Fund, the proceeds of which were applied in whole or in part by the Fund to acquire Loans and their Related Security from the Seller.
- (b) *Second*, the Fund, in certain circumstances, uses the Available Receipts to acquire New Loans and their Related Security from the Seller and/or Substitution Assets (in respect of any Substitution Assets up to the prescribed limit) on each Fund Payment Date.
- (c) *Third*, the Fund and the Seller are required to ensure that the Portfolio is maintained at all times in compliance with the Asset Coverage Test (as determined by the Cash Manager on each Calculation Date). If on any Calculation Date there is a breach of the Asset Coverage Test, the Seller will use all reasonable endeavours to offer to sell sufficient New Loans and their Related Security to the Fund on or before the next Calculation Date to ensure compliance with the Asset Coverage Test as at the next Calculation Date.

If an Issuer Event of Default has occurred but no liquidator or administrator has been appointed to the Seller, Loans and their Related Security may only be acquired from the Seller if the Seller has provided a solvency certificate to the Fund and the Representative.

In exchange for the sale of the Loans and their Related Security to the Fund, the Seller will receive an amount equal to the Outstanding Principal Balance of those Loans sold by it as at the Assignment Date, which will be satisfied by a combination of:

- (a) a cash payment to be made by the Fund from the ISK Equivalent of the proceeds of the relevant Term Advance and/or from Available Receipts; and/or
- (b) the Seller being treated as having made an Equity Contribution in Kind in an amount up to the difference between the aggregate Outstanding Principal Balance of the Loans sold by the Seller as at the relevant Assignment Date and the cash payment (if any) made by the Fund in accordance with (a) above.

If Selected Loans and their Related Security are sold by or on behalf of the Fund as described below under *Fund Deed – Sale of Selected Loans and their Related Security following service of an Asset Coverage Test Breach Notice and Sale of Selected Loans and their Related Security following service of a Notice to Pay*, the obligations of the Seller insofar as they relate to those Selected Loans and their Related Security will cease to apply.

The Seller will also be required to repurchase Loans and their Related Security sold to the Fund in the circumstances described below under – *Repurchase of Loans*.

Eligibility Criteria

The sale of Loans and their Related Security to the Fund is subject to various conditions (the **Eligibility Criteria**) being satisfied on the relevant Assignment Date. These are as follows:

- (c) there shall have been neither an Issuer Event of Default and service of an Issuer Acceleration Notice nor a Fund Event of Default and service of a Fund Acceleration Notice as at the relevant Assignment Date;
- (d) no Loan that is proposed to be sold to the Fund on the relevant Assignment Date has a loan-to-value ratio of more than 80 per cent.;
- (e) no Loan that is proposed to be sold to the Fund on the relevant Assignment Date has, on such Assignment Date, an Outstanding Principal Balance of more than ISK 100,000,000;
- (f) no Loan that is proposed to be sold to the Fund on the relevant Assignment Date relates to a Property which is not a residential Property and each Property is the primary residence of each Borrower and is owner-occupied;
- (g) no Loan that is proposed to be sold to the Fund on the relevant Assignment Date is on such Assignment Date in default for 90 days or more; and
- (h) the Seller has, since the making of each Loan, kept or procured the keeping of full and proper accounts, books and records showing clearly all transactions, payments, receipts, proceedings and notices relating to such Loan.

On the relevant Assignment Date, the Representations and Warranties (described below in – *Representations and Warranties*) will be given by the Seller in respect of the Loans and their Related Security sold by the Seller to the Fund.

Transfer of Title to the Loans to the Fund

The assignment, assignation or transfer (as appropriate) of the Loans and their Related Security as contemplated by the Mortgage Sale Agreement shall be perfected by the Seller on the relevant Assignment Date. Such perfection shall be effected by annotation by the Seller of the Mortgage Document. Notice of such assignment, assignation or transfer (as appropriate) will be given to the Borrower following the occurrence of certain circumstances.

Representations and warranties

Neither the Fund nor the Representative has made or has caused to be made on its behalf any enquiries, searches or investigations in respect of the Loans and their Related Security to be sold to the Fund. Instead, each is relying entirely on the Representations and Warranties by the Seller contained in the Mortgage Sale Agreement. The parties to the Mortgage Sale Agreement may, with the prior written consent of the Representative, amend or waive the Representations and Warranties in the Mortgage Sale Agreement. The material Representations and Warranties are as follows and are given on the relevant Assignment Date in respect of the Loans and Related Security to be sold to the Fund only on that date:

- each Loan was originated by either Kaupthing or the Seller and was originated and is denominated in ISK;
- no Loan has an Outstanding Principal Balance of more than ISK 100,000,000;
- each Loan was originated not earlier than 20 August 2004;
- each Loan matures for repayment not later than 1 January 2060;
- prior to the making of each advance under a Loan, the Lending Criteria and all preconditions to the making of that Loan were satisfied in all material respects subject only to exceptions as would be acceptable to a Reasonable, Prudent Mortgage Lender;
- prior to the making of each advance under a Loan, the requirements of the relevant Standard Documentation were met, so far as applicable to that Loan;

- other than with respect to Monthly Payments, no Borrower is, in material breach of any obligation owed in respect of the relevant Loan or under the Related Security and currently no steps have been taken by the Seller to enforce any Related Security;
- the total amount of Arrears of Interest or arrears of principal, together with any fees, commissions and premiums payable at the same time as such interest payment or principal repayment, on any Loan is not on the relevant Assignment Date in respect of such Loan three or more times the Monthly Payment payable in respect of such Loan in respect of the month in which that Assignment Date falls;
- all of the Borrowers are individuals and were aged 18 years or older at the date of entering into the relevant Loan and its Related Security;
- each Borrower has made at least one Monthly Payment;
- interest on each Loan is charged in accordance with the Standard Documentation;
- interest on each Loan is payable monthly in arrears;
- each Loan complies fully with the Consumer Credit Act No.121 from 1994;
- the whole of the Outstanding Principal Balance on each Loan and any Arrears of Interest and all Accrued Interest is secured by a Mortgage;
- each Mortgage constitutes a valid and subsisting first charge by way of legal mortgage or first ranking standard security over the relevant Property and may also constitute a valid and subsisting second charge by way of legal mortgage over a Property in the Portfolio over which a first charge is also taken;
- each Loan and its Related Security is valid and binding and enforceable in accordance with its terms;
- all of the Properties are residential properties situated in Iceland;
- except in the case of certain Loans which have a low loan-to-value ratio (being about 50 per cent.) and the valuation of the relevant Property can be easily determined by using publicly available sources, not more than six months (or such longer period as would be acceptable to a Reasonable, Prudent Mortgage Lender) prior to the grant of each Mortgage, the Seller received a Valuation Report on the relevant Property (or such other form of report concerning the valuation of the relevant Property as would be acceptable to a Reasonable, Prudent Mortgage Lender), the contents of which were such as would be acceptable to a Reasonable, Prudent Mortgage Lender;
- the benefit of all Valuation Reports, any other valuation report referred to above (if any) can be validly assigned to the Fund without obtaining the consent of the relevant valuer;
- insurance cover for each Property is or will at all times be available under a policy arranged by the Borrower in accordance with the relevant Mortgage Conditions;
- the Seller has, since the making of each Loan, kept or procured the keeping of full and proper accounts, books and records showing clearly all transactions, payments, receipts, proceedings and notices relating to such Loan;
- neither the Seller nor any of its agents has received written notice of any litigation or dispute (subsisting, threatened or pending) in respect of any Borrower, Property or Mortgage which might have a material adverse effect on a Loan or its Related Security;
- there are no authorisations, approvals, licences or consents required as appropriate for the Seller to enter into or to perform the obligations under the Mortgage Sale Agreement or to make the Mortgage Sale Agreement legal, valid, binding, enforceable and admissible in evidence; and

- the Seller has good title to, and is the absolute unencumbered legal owner of, all interests, rights and benefits agreed to be sold by the Seller to the Fund pursuant to the Mortgage Sale Agreement free and clear of all mortgages, securities, charges, liens, encumbrances, claims and equities.

Repurchase of Loans

If the Seller receives a Loan Repurchase Notice from the Fund identifying a Loan or its Related Security in the Portfolio which did not, as at the relevant Assignment Date, materially comply with the Representations and Warranties set out in the Mortgage Sale Agreement, then the Seller will be required to repurchase: (a) any such Loan and its Related Security; and (b) any other Loan secured or intended to be secured by that Related Security or any part of it. The repurchase price payable upon the repurchase of any such Loan is an amount (not less than zero) equal to the Outstanding Principal Balance thereof and all Arrears of Interest and Accrued Interest relating thereto plus any amounts deducted from the amounts outstanding under such Loan in accordance with the Mortgage Sale Agreement as at the relevant repurchase date. The repurchase proceeds received by the Fund will be applied (other than Accrued Interest and Arrears of Interest) in accordance with the Pre Acceleration Priority of Payments, see 'Cashflows' below.

General ability to repurchase

Prior to the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice or a Fund Event of Default and service of a Fund Acceleration Notice, the Seller may from time to time offer to repurchase a Loan and its Related Security from the Fund for a purchase price of not less than the aggregate Outstanding Principal Balance of the relevant Loan and all Arrears of Interest and Accrued Interest relating thereto. The Fund may accept such offer at its discretion. If an Issuer Event of Default has occurred but no liquidator or administrator has been appointed to the Seller, the Seller's right to repurchase Loans and their Related Security will be conditional upon the delivery by the Seller of a solvency certificate to the Fund and the Representative.

Defaulted Loans

Defaulted Loans will be attributed a reduced weighting in the calculation of the Asset Coverage Test as at the relevant Calculation Date. Prior to the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice or a Fund Event of Default and service of a Fund Acceleration Notice, the Seller may, at its option, offer to repurchase a Defaulted Loan for an amount equal to its Outstanding Principal Balance and all Arrears of Interest and Accrued Interest relating thereto as at the date of repurchase. The Fund may accept such offer at its discretion. If an Issuer Event of Default has occurred but no liquidator or administrator has been appointed to the Seller, the Seller's right to repurchase Defaulted Loans and their Related Security will be conditional upon the delivery by the Seller of a solvency certificate to the Fund and the Representative.

Right of Pre-emption

Under the terms of the Mortgage Sale Agreement, the Seller has a right of pre-emption in respect of any sale, in whole or in part, of Selected Loans and their Related Security.

The Fund will serve on the Seller a Selected Loan Offer Notice offering to sell those Selected Loans and their Related Security for an offer price at least equal to: (a) where the Selected Loan Offer Notice is given following the service of an Asset Coverage Test Breach Notice but prior to the service of a Notice to Pay, the then Outstanding Principal Balance of the Selected Loans and all Arrears of Interest and Accrued Interest relating thereto; and (b) where the Selected Loan Offer Notice is given following the service of a Notice to Pay, the greater of the then Outstanding Principal Balance of the Selected Loans and all Arrears of Interest and Accrued Interest relating thereto and the Required Redemption Amount, in each case subject to the offer being accepted by the Seller within 10 Business Days. If an Issuer Event of Default has occurred but no liquidator or administrator has been appointed to the Seller, the Seller's right to accept the offer (and therefore its right of pre-emption) will be conditional upon the delivery by the Seller of a solvency certificate to the Fund and the Representative. If the Seller rejects the Fund's offer or fails to accept it in accordance with the foregoing, the Fund will offer to sell the Selected Loans and their Related Security to other Purchasers (as described under – *Fund Deed – Sale of Selected Loans in the Portfolio following the service of a Notice to Pay below*).

If the Seller validly accepts the Fund's offer to sell the Selected Loans and their Related Security, the Fund will, within three Business Days of such acceptance, serve a Selected Loan Repurchase Notice on the Seller. The Seller will sign and return a duplicate copy of the Selected Loan Repurchase Notice and will repurchase from the Fund the relevant Selected Loans and their Related Security (and any other Loan secured or intended to be secured by that Related Security or any part of it) referred to in the relevant Selected Loan Repurchase Notice. Completion of the purchase of the Selected Loans and their Related Security by the Seller will take place on the Fund Payment Date next occurring after receipt of the Selected Loan Repurchase Notice or such date as the Fund may direct in the Selected Loan Repurchase Notice (provided that, where a Notice to Pay has been served, such date is not later than the earlier to occur of the date which is: (a) 10 Business Days after receipt by the Fund of the returned Selected Loan Repurchase Notice; and (b) the Final Maturity Date of the Earliest Maturing Covered Bonds).

New Sellers

In the future, it is expected that New Sellers may sell loans and their related security to the Fund. Any such New Seller will be required to enter into a New Mortgage Sale Agreement, which will be in substantially the same form and contain substantially the same provisions as the Mortgage Sale Agreement entered into on 20 January 2012 between the Seller, the Fund and the Representative. The sale of New Seller Loans and their Related Security by New Sellers to the Fund will be subject to certain conditions, including the following:

- each New Seller accedes to the terms of the Fund Deed (with such subsequent amendments as may be agreed by the parties thereto) so that it has, in relation to those New Seller Loans and their Related Security to be sold by the relevant New Seller, substantially the same rights and obligations as the Seller had in relation to those Loans and their Related Security comprised in each New Portfolio under the Fund Deed;
- each New Seller enters into a New Mortgage Sale Agreement with the Fund and the Representative, in each case so that it has, in relation to those New Seller Loans and their Related Security to be sold by the relevant New Seller, substantially the same rights and obligations as the Seller had in relation to those Loans and their Related Security comprised in each New Portfolio under the Mortgage Sale Agreement entered into on 20 January 2012 between the Seller, the Fund and the Representative;
- each New Seller accedes to such Transaction Documents and enters into such other documents as may be required by the Representative, the Fund and/or the Cash Manager (in each case acting reasonably) to give effect to the addition of a New Seller to the transaction;
- any New Seller Loans and their Related Security sold by a New Seller to the Fund comply with the Eligibility Criteria set out in the New Mortgage Sale Agreement;
- either the Servicer services the New Seller Loans and their Related Security sold by a New Seller on the terms set out in the Servicing Agreement (with such subsequent amendments as may be agreed by the parties thereto) or the New Seller (or its nominee) enters into a servicing agreement with the Fund and the Representative which sets out the servicing obligations of the New Seller (or its nominee) in relation to the New Seller Loans and their Related Security and which is on terms substantially similar to the terms set out in the Servicing Agreement (provided that the fees payable to the Servicer or the New Seller (or its nominee) acting as servicer of such New Seller Loans and their Related Security would be determined on or around the date of the accession of the New Seller); and
- the Representative is satisfied that any modifications to the Transaction Documents in order to accommodate the accession of a New Seller will not be materially prejudicial to the interests of any of the Covered Bondholders.

If the above conditions are met, the consent of Covered Bondholders will not be required in relation to the accession of a New Seller.

The Mortgage Sale Agreement is governed by Icelandic law.

Servicing and Custody Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Servicing_and_Custody_Agreement.pdf

Pursuant to the terms of the Servicing and Custody Agreement entered into on 20 January 2012 between the Seller, the Fund, the Servicer, the Custody Agent and the Representative, the Servicer has agreed to service, on behalf of the Fund, the Loans and their Related Security comprised in the Portfolio and the Custody Agent has agreed to provide the services specified in Article 20 of Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds. For the avoidance of doubt, the Servicer shall not provide any services which the Management Company or the Custody Agent is obliged to provide to the Fund as a matter of Icelandic law and/or pursuant to the terms of the Articles of Association of the Fund.

The Servicer is required to administer the Loans and their Related Security in accordance with the Servicing and Custody Agreement:

- (a) as if the Loans and their Related Security sold by the Seller to the Fund had not been sold to the Fund but remained with the Seller; and
- (b) in accordance with the Seller's administration, arrears and enforcement policies and procedures forming part of the Seller's Policy from time to time as they apply to those Loans.

The Servicer's actions in servicing the Loans in accordance with its procedures will be binding on the Fund, the Seller and the Covered Bondholders.

The Servicer will have the power to exercise the rights, powers and discretions and to perform the duties of the Fund and the Seller (according to their respective estates and interests) in relation to the Loans and their Related Security that it is servicing pursuant to the terms of the Servicing and Custody Agreement, and to do anything which it reasonably considers necessary, convenient or incidental to the administration of the Loans and their Related Security.

Right of delegation by the Servicer

The Servicer may from time to time sub-contract or delegate the performance of its duties under the Servicing and Custody Agreement, provided that it will nevertheless remain responsible for the performance of those duties to the Fund and the Representative and, in particular, will remain liable at all times for servicing the Loans and their Related Security and for the acts or omissions of any delegate or subcontractor. Any such sub-contracting or delegation may be varied or terminated at any time by the Servicer.

Undertakings of the Servicer

Pursuant to the terms of the Servicing and Custody Agreement, the Servicer has undertaken in relation to those Loans and their Related Security that it is servicing, *inter alia*, to:

- keep records and books of account on behalf of the Fund in relation to the Loans and their Related Security;
- keep the Customer Files in its possession in safe custody and maintain records necessary to enforce each Mortgage and to provide the Fund, the Representative and the Custody Agent with access to the Customer Files and other records relating to the administration of the Loans and their Related Security in its possession;
- keep and maintain records in respect of the Portfolio for the purposes of identifying amounts paid by each Borrower, any amount due from a Borrower and the Outstanding Principal Balance of each Loan and such other records as would be kept by a Reasonable, Prudent Mortgage Lender;
- provide to the Fund and the Representative a report on a monthly basis containing information about the Loans and their Related Security comprised in the Portfolio;

- provide to each beneficial owner of the Covered Bonds a monthly report in the same form as that provided above to the Fund and the Representative;
- assist the Cash Manager in the preparation of a Monthly Asset Coverage Report in accordance with the Cash Management Agreement;
- take all reasonable steps to recover all sums due to the Fund, including instituting proceedings and enforcing any relevant Loan or its Related Security using the discretion of a Reasonable, Prudent Mortgage Lender in applying the enforcement procedures forming part of the Seller's policy; and
- enforce any Loan which is in default in accordance with the Seller's enforcement procedures or, to the extent that such enforcement procedures are not applicable having regard to the nature of the default in question, with the procedures that would be undertaken by a Reasonable, Prudent Mortgage Lender on behalf of the Fund.

Remuneration

The Fund pays to the Servicer an administration fee (inclusive of applicable taxes) for its services. Such administration fee is calculated in relation to each Calculation Period is payable to the Servicer in arrear on each Fund Payment Date.

Removal or resignation of the Servicer

The Fund and the Representative may, upon written notice to the Servicer, terminate the Servicer's appointment under the Servicing and Custody Agreement if any of the following events (each a **Servicer Termination Event** and, each of the first three events set out below, a **Servicer Event of Default**) occurs and while such event continues:

- the Servicer defaults in the payment on the due date of any amount due and payable by it under the Servicing and Custody Agreement and does not remedy that default for a period of three Reykjavik Business Days after the earlier of the Servicer becoming aware of the default or receipt by the Servicer of written notice from the Representative or the Fund requiring the default to be remedied;
- the Servicer defaults in the performance or observation of any of its other covenants and obligations under the Servicing and Custody Agreement, which default in the reasonable opinion of the Representative is materially prejudicial to the interests of the Covered Bondholders, and does not remedy that default within five Reykjavik Business Days after the earlier of the Servicer becoming aware of the default or receipt by the Servicer of written notice from the Fund and the Representative requiring the default to be remedied, provided however that where the relevant default occurs as a result of a default by any person to whom the Servicer has sub-contracted or delegated part of its obligations under the Servicing and Custody Agreement, such default shall not constitute a Servicer Termination Event if, within such period of five Reykjavik Business Days of receipt of such notice from the Fund and the Representative, the Servicer terminates the relevant sub-contracting or delegation arrangements and takes such steps as the Fund and the Representative may specify to remedy such default or to indemnify the Fund against the consequences of such default;
- an Insolvency Event occurs in relation to the Servicer;
- neither the Servicer nor a directly or indirectly wholly-owned subsidiary of the Servicer is servicing the Portfolio pursuant to the Servicing and Custody Agreement; or
- an Insolvency Event occurs in relation to any person to whom the Servicer has sub-contracted or delegated part of its obligations and the Servicer has not subsequently terminated such subcontracting or delegation within five Reykjavik Business Days.

Subject to the fulfilment of a number of conditions, the Servicer may voluntarily resign by giving not less than 6 months' written notice to the Representative and the Fund provided that a substitute servicer with capability of administering residential mortgages in Iceland has been appointed and enters into a servicing and custody

agreement with the Fund, the Representative and the Custody Agent substantially on the same terms as the Servicing and Custody Agreement.

If the appointment of the Servicer is terminated, the Servicer must deliver the Customer Files relating to the Loans comprised in the Portfolio in its possession to, or at the direction of, the Fund. The Servicing Agreement will terminate at such time as the Fund has no further interest in any of the Loans or their Related Security serviced under the Servicing and Custody Agreement that have been comprised in the Portfolio.

The Representative shall not be obliged to act as servicer in any circumstances.

Custody Agent Services

The Custody Agent is required to provide certain services to the Fund as detailed in Article 20 of Act No. 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds. In providing such services the Custody Agent may, subject to certain requirements being satisfied, use a Central Securities Depository and/or subcontract or delegate the performance of its duties under the Servicing and Custody Agreement, provided that it will nevertheless remain responsible for the performance of those duties to the Fund and the Representative.

The Fund pays, on each Fund Payment Date, to the Custody Agent a fee as agreed upon in writing from time to time by the Custody Agent and the Fund, such fee previously being agreed by the Representative.

The Fund and the Representative may, upon written notice to the Custody Agent, terminate the Custody Agent's appointment under the Servicing and Custody Agreement if any of the events set out above as Servicer Termination Events occur in respect of the Custody Agent. Subject to the fulfilment of a number of conditions the Custody Agent may voluntarily resign by giving not less than six months' written notice to the Representative and the Fund provided that a substitute custody agent with capability of performing the services required to be performed by the Custody Agent has been appointed and enters into a servicing and custody agreement with the Fund, the Representative and the Servicer substantially on the same terms of the Servicing and Custody Agreement.

The Servicing and Custody Agreement is governed by Icelandic law.

Asset Monitor Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Asset_Monitor_Agreement.pdf

Under the terms of the Asset Monitor Agreement entered into on 20 January 2012 between the Asset Monitor, the Fund, the Cash Manager, the Issuer and the Representative, the Asset Monitor agreed, subject to due receipt of the information to be provided by the Cash Manager to the Asset Monitor, to conduct tests in respect of the arithmetical accuracy of the calculations performed by the Cash Manager, prior to service of a Notice to Pay or a Fund Acceleration Notice, on the Calculation Date immediately prior to each anniversary of 29 March 2006 with a view to confirmation of compliance by the Fund with the Asset Coverage Test on that Calculation Date. Following the service of an Asset Coverage Test Breach Notice (which has not been revoked), the Asset Monitor will, subject to receipt of the relevant information from the Cash Manager, be required to conduct such tests following each Calculation Date.

Following a determination by the Asset Monitor of any errors in the arithmetical accuracy of the calculations performed by the Cash Manager such that the Asset Coverage Test has been failed on the applicable Calculation Date (where the Cash Manager had recorded it as being satisfied) or the Adjusted Aggregate Loan Amount is mis-stated by an amount exceeding one per cent. of the Adjusted Aggregate Loan Amount (as at the date of the relevant Asset Coverage Test), the Asset Monitor is required to conduct such tests following each Calculation Date for a period of six months thereafter.

The Asset Monitor is entitled, except in certain limited circumstances, to assume that all information provided to it by the Cash Manager for the purpose of conducting such tests is true and correct and not misleading, and is

not required to conduct a test or otherwise take steps to verify the accuracy of any such information. The Asset Monitor Report is delivered to the Cash Manager, the Fund, the Issuer and the Representative.

Under the terms of the Asset Monitor Agreement, the Fund pays to the Asset Monitor for its services an annual fee (the **Asset Monitor Fee**) in an amount of ISK 3,300,000 excluding VAT for the year 2014, and such Asset Monitor Fee includes the test to be carried out under Clause 2.1 of the Asset Monitor Agreement. The annual Asset Monitor Fee shall be in an amount of ISK 2,200,000 excluding VAT for each year thereafter and will be reviewed annually and adjusted if applicable by reference to the then current Wages Index, provided that the base Wages Index for reference shall be as it is on 20 January 2014. In addition the Asset Monitor will be entitled to receive an additional fee in the amount of ISK 1,000,000 excluding VAT for each additional test it is required to perform pursuant to Clauses 2.2 and 2.3 of the Asset Monitor Agreement.

The Fund may, at any time, but subject to the prior written consent of the Representative, terminate the appointment of the Asset Monitor by giving at least 90 days' prior written notice to the Asset Monitor, provided that such termination may not be effected unless and until a replacement asset monitor has been found by the Fund (such replacement to be approved by the Representative (such approval to be given if the replacement is an accountancy firm of national standing)) which agrees to perform the duties of the Asset Monitor set out in the Asset Monitor Agreement (or substantially similar duties).

The Asset Monitor may, at any time, resign by giving at least 90 days' prior written notice to the Fund and the Representative, and may resign by giving immediate notice in the event of a professional conflict of interest caused by the action of any recipient of its reports.

Upon giving notice of resignation, the Fund shall immediately use its reasonable endeavours to appoint a replacement (such replacement to be approved by the Representative) which agrees to perform the duties of the Asset Monitor set out in the Asset Monitor Agreement. If a replacement is not appointed by the date which is 90 days prior to the date when tests are to be carried out in accordance with the terms of the Asset Monitor Agreement, then the Fund shall use all reasonable endeavours to appoint an accountancy firm of national standing to carry out the relevant tests on a one-off basis, provided that such appointment is approved by the Representative.

The Representative shall not be obliged to act as Asset Monitor in any circumstances. The Asset Monitor Agreement is governed by Icelandic law.

Fund Deed

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Fund_Deed.pdf

Equity Contributions

From time to time the Seller (in its capacity as a Holder) will make Equity Contributions to the Fund. Equity Contributions may be made in cash or in kind (e.g. through a contribution of Loans to the Fund). The Equity Contributions of the Seller shall be calculated in ISK on each Calculation Date as the difference between (a) the Outstanding Principal Balance of Loans in the Portfolio as at the last day of the preceding Calculation Period plus Revenue Receipts standing to the credit of the Revenue Ledger on the GIC Account plus the principal amount of Substitution Assets and Authorised Investments as at the last day of the preceding Calculation Period and (b) the ISK Equivalent of the aggregate Principal Amount Outstanding under the Covered Bonds as at the last day of the preceding Calculation Period. The Fund Deed does not impose any limit on the amount of Equity Contributions the Seller (in its capacity as a Holder) may make to the Fund from time to time. Cash Equity Contributions will normally be credited to the Revenue Ledger or the GIC Account and be applied as Available Receipts. However, the Seller shall be entitled to require that the Fund Transfer Cash Transfer Equity Contributions to the Reserve Ledger of the GIC Account so that they may be applied as Available Receipts.

Equity Contributions or Unit Distributions shall only be paid to Holders after the Fund has paid or, as applicable, provided for all higher ranking amounts in the relevant Priority of Payments.

Asset Coverage Test

Under the terms of the Fund Deed, the Fund must ensure that on each Calculation Date, the Adjusted Aggregate Loan Amount is in an amount at least equal to the ISK Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date.

If on any Calculation Date the Adjusted Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of all Covered Bonds as calculated on the relevant Calculation Date, then the Fund (or the Cash Manager on its behalf) will notify the Seller and the Representative thereof and the Seller will use all reasonable endeavours to sell sufficient further Loans and their Related Security to the Fund in accordance with the Mortgage Sale Agreement (see *Summary of the Principal Documents – Mortgage Sale Agreement – Sale by Seller of Loans and their Related Security*) or provide Equity Contributions to ensure that the Asset Coverage Test is met on the next following Calculation Date. If the Adjusted Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of all Covered Bonds on the next following Calculation Date, the Asset Coverage Test will be breached and the Representative will serve an Asset Coverage Test Breach Notice on the Fund. The Representative shall revoke an Asset Coverage Test Breach Notice if, on any Calculation Date falling on or prior to the second Calculation Date following the service of an Asset Coverage Test Breach Notice the Asset Coverage Test is subsequently satisfied and neither a Notice to Pay nor a Fund Acceleration Notice has been served.

Following service of an Asset Coverage Test Breach Notice (which has not been revoked):

- (a) the Fund will be required to sell Selected Loans (as described further under Fund Deed – Sale of Selected Loans and their Related Security following service of an Asset Coverage Test Breach Notice);
- (b) prior to the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice or, if earlier, the occurrence of a Fund Event of Default and service of a Fund Acceleration Notice, the Pre Acceleration Priority of Payments will be modified as more particularly described in *Allocation and distribution of Available Receipts following service of an Asset Coverage Test Breach Notice*, cf. page 159 below; and
- (c) the Issuer will not be permitted to make to the Fund, and the Fund will not be permitted to borrow from the Issuer, any new Term Advances under the Intercompany Loan Agreement.

If an Asset Coverage Test Breach Notice has been served and not revoked on or before the second Calculation Date after service of such Asset Coverage Test Breach Notice, then an Issuer Event of Default shall occur and the Representative shall be entitled (and, in certain circumstances may be required) to serve an Issuer Acceleration Notice.

Following service of an Issuer Acceleration Notice, the Representative will be required to serve a Notice to Pay on the Fund.

For the purposes hereof:

Adjusted Aggregate Loan Amount means the amount calculated on each Calculation Date as follows:

$$\propto A + B + C + D - W$$

where,

A = the sum of the **Adjusted Outstanding Principal Balance** of each Loan in the Portfolio as at the relevant Calculation Date, which shall be the lower of:

- (i) the actual Outstanding Principal Balance of the relevant Loan in the Portfolio (but, for this purpose, not including any principal payment relating to any such Loan which is scheduled for repayment at any time after the date on which there are no outstanding Covered Bonds), as adjusted for changes in the Icelandic consumer price index, as calculated on the relevant Calculation Date; and

- (ii) the Collateral Valuation relating to that Loan multiplied by M (where for all Loans that are not in default, $M = 0.80$, for all Loans that have been in default for less than 30 days and have an Outstanding Principal Balance to Collateral Valuation ratio of less than or equal to 80 per cent., $M = 0.60$, for all Loans that have been in default for more than 30 days but less than 90 days and have an Outstanding Principal Balance to Collateral Valuation ratio of less than or equal to 80 per cent., $M = 0.35$) and for all other Loans, $M = 0$,

minus

the aggregate sum of the following deemed reductions to the aggregate Adjusted Outstanding Principal Balance of the Loans in the Portfolio if any of the following occurred during the previous Calculation Period:

- (1) a Loan or its Related Security was, in the immediately preceding Calculation Period, in breach of the Representations and Warranties contained in the Mortgage Sale Agreement or subject to any other obligation of the Seller to repurchase the relevant Loan and its Related Security, and in each case the Seller has not repurchased the Loan or Loans of the relevant Borrower and its or their Related Security to the extent required by the terms of the Mortgage Sale Agreement. In this event, the aggregate Adjusted Outstanding Principal Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to the Adjusted Outstanding Principal Balance of the relevant Loan or Loans (as calculated on the relevant Calculation Date) of the relevant Borrower; and/or
- (2) the Seller, in the preceding Calculation Period, was in breach of any other material warranty under the Mortgage Sale Agreement and/or the Servicer was, in the preceding Calculation Period, in breach of a material term of the Servicing Agreement. In this event, the aggregate Adjusted Outstanding Principal Balance of the Loans in the Portfolio (as calculated on the relevant Calculation Date) will be deemed to be reduced by an amount equal to the expected financial loss incurred by the Fund in the immediately preceding Calculation Period (such financial loss to be calculated by the Cash Manager without double counting and to be reduced by any amount paid (in cash or in kind) to the Fund by the Seller to indemnify the Fund for such financial loss);

B = the aggregate amount of any Revenue Receipts on the Loans in the Portfolio up to the end of the immediately preceding Calculation Period (as recorded in the Revenue Ledger) which have not been applied as at the relevant Calculation Date to acquire further Loans and their Related Security or otherwise applied in accordance with the Fund Deed and/or the other Transaction Documents (including, for the avoidance of doubt, any amount then standing to the credit of the GIC Account and any Authorised Investments (but without double counting));

C = the aggregate amount of any Cash Equity Contributions made by the Holders (as recorded in the Unit Account Ledger of each Holder) or proceeds of Term Advances which have not been applied as at the relevant Calculation Date to acquire further Loans and their Related Security or otherwise applied in accordance with the Fund Deed and/or the other Transaction Documents;

D = the aggregate principal amount of any Substitution Assets as at the relevant Calculation Date;

W = 100 per cent. of an amount equal to the aggregate cash deposits held in the name of any Borrower with the Issuer. Such amount shall be calculated by reference to the aggregate cash deposits held in the name of any Borrower with the Issuer on the 15th calendar day in the month preceding the relevant Calculation Date; and

CC = the Asset Percentage.

Asset Percentage means the over collateralisation asset percentage figure as determined from time to time in accordance with the terms of the Fund Deed. On each Calculation Date, the Fund (or the Cash Manager on its behalf) will calculate the over collateralisation asset percentage.

The Asset Percentage will be adjusted to ensure that sufficient credit enhancement will be maintained, provided that the Asset Percentage may not, at any time, exceed 95 per cent.

Any breach of the Asset Coverage Test will not constitute an Issuer Event of Default. However, in such circumstances, prior to the service of a Notice to Pay on the Fund, Available Receipts will be deposited in the GIC Account in accordance with the Pre Acceleration Priority of Payments.

Sale of Selected Loans and their Related Security following service of an Asset Coverage Test Breach Notice

After service of an Asset Coverage Test Breach Notice (which has not been revoked) but prior to service of a Notice to Pay, the Fund will be obliged to sell Selected Loans and their Related Security in the Portfolio in accordance with the Fund Deed (as described below), subject to the rights of pre-emption in favour of the Seller to buy the Selected Loans and their Related Security pursuant to the Mortgage Sale Agreement and subject to any Cash Equity Contributions made by the Holders. The proceeds from any such sale will be credited to the GIC Account and applied as set out in Allocation and distribution of Available Receipts following service of an Asset Coverage Test Breach Notice below.

Sale of Selected Loans and their Related Security following service of a Notice to Pay

After service of a Notice to Pay on the Fund, but prior to service of a Fund Acceleration Notice, the Fund will be obliged to sell Selected Loans and their Related Security in the Portfolio in accordance with the Fund Deed (as described below), subject to the rights of pre-emption in favour of the Seller to buy the Selected Loans and their Related Security pursuant to the Mortgage Sale Agreement. The proceeds from any such sale will be credited to the GIC Account and applied as set out in the Guarantee Priority of Payments.

Method of Sale of Selected Loans

If the Fund is required to sell Selected Loans and their Related Security to Purchasers following either the service of an Asset Coverage Test Breach Notice (if not revoked) or a Notice to Pay, the Fund will be required to ensure that before offering Selected Loans for sale:

- (a) the Selected Loans have been selected from the Portfolio on a random basis as described in the Fund Deed; and
- (b) the Selected Loans have an aggregate Outstanding Principal Balance in an amount (the **Required Outstanding Principal Balance Amount**) which is as close as possible to the amount calculated as follows:
 - (iii) following the service of an Asset Coverage Test Breach Notice (but prior to service of a Notice to Pay), such amount that would ensure that, if the Selected Loans were sold at their Outstanding Principal Balance plus the Arrears of Interest and Accrued Interest thereon, the Asset Coverage Test would be satisfied on the next Calculation Date taking into account the payment obligations of the Fund on the Payment Date following that Calculation Date (assuming for this purpose that the Asset Coverage Test Breach Notice is not revoked on the next Calculation Date); or
 - (iv) following service of a Notice to Pay:

$$N \times \frac{\text{Outstanding Principal Balance of all Loans in the Portfolio}}{\text{the ISK Equivalent of the Required Redemption Amount in respect of each Series of Covered Bonds then outstanding}}$$

where N is an amount equal to the ISK Equivalent of the Required Redemption Amount of the Earliest Maturing Covered Bonds less amounts standing to the credit of the GIC Account and the principal amount of any Substitution Assets or Authorised Investments (excluding all amounts to be applied on the next following Fund Payment Date to repay higher ranking amounts in the Guarantee Priority of Payments and those amounts that are required to repay any Series of Covered Bonds which mature prior to or on the same date as the relevant Series of Covered Bonds).

For the purposes hereof:

Required Redemption Amount means, in respect of a Series of Covered Bonds, the amount calculated as follows:

the Principal Amount Outstanding of the relevant Series of Covered Bonds \times $1 + \text{Negative Carry Factor} \times (\text{days to maturity of the relevant Series of Covered Bonds}/365)$

The Fund will offer the Selected Loans and their Related Security for sale to Purchasers for the best price reasonably available but in any event:

- (v) following the service of an Asset Coverage Test Breach Notice (but prior to service of a Notice to Pay), for an amount not less than the Outstanding Principal Balance of the Selected Loans plus the Arrears of Interest and Accrued Interest thereon; and
- (vi) following service of a Notice to Pay, for an amount not less than the Required Redemption Amount.

Following service of the Notice to Pay, if the Selected Loans have not been sold (in whole or in part) in an amount equal to the Required Redemption Amount within six months following the date of the service of the Notice to Pay but not later than the date which is six months prior to the Final Maturity Date of the Earliest Maturing Covered Bonds, then the Fund will offer the Selected Loans for sale for the best price reasonably available notwithstanding that such amount may be less than the Required Redemption Amount.

Following service of a Notice to Pay, in addition to offering Selected Loans for sale to Purchasers in respect of the above-mentioned six month period, the Fund (subject to the rights of pre-emption enjoyed by the Seller pursuant to the Mortgage Sale Agreement) is permitted to offer for sale a portfolio of Selected Loans, in accordance with the provisions summarised above, in respect of other Series of Covered Bonds.

The Fund is also permitted to offer for sale to Purchasers a Partial Portfolio. Where a Notice to Pay has been served, except in circumstances where the portfolio of Selected Loans is being sold within six months of the Final Maturity Date of the Earliest Maturing Covered Bonds, the sale price of the Partial Portfolio (as a proportion of the Required Redemption Amount) shall be at least equal to the proportion that the Partial Portfolio bears to the relevant portfolio of Selected Loans.

The Management Company on behalf of the Fund will appoint a portfolio manager of recognised standing on a basis intended to incentivise the portfolio manager to achieve the best price for the sale of the Selected Loans (if such terms are commercially available in the market) and to advise it in relation to the sale of the Selected Loans to Purchasers (except where the Seller is buying the Selected Loans in accordance with its right of pre-emption in the Mortgage Sale Agreement). The terms of the agreement giving effect to the appointment in accordance with such tender shall be approved by the Representative.

In respect of any sale of Selected Loans and their Related Security following service on the Fund of an Asset Coverage Test Breach Notice (if not revoked) or a Notice to Pay, the Fund will instruct the portfolio manager to use all reasonable endeavours to procure that Selected Loans are sold as quickly as reasonably practicable (in accordance with the recommendations of the portfolio manager) taking into account the market conditions at that time and, where relevant, the scheduled repayment dates of the Covered Bonds and the terms of the Fund Deed.

The terms of any sale and purchase agreement with respect to the sale of Selected Loans (which shall give effect to the recommendations of the portfolio manager) will be subject to the prior written approval of the Representative.

Following service of a Notice to Pay, if Purchasers accept the offer or offers from the Fund so that some or all of the Selected Loans and their Related Security shall be sold prior to the Final Maturity Date of the Earliest Maturing Covered Bonds, then the Fund will, subject to the foregoing paragraph, enter into a sale and purchase agreement with the relevant Purchasers which will require *inter alia* a cash payment from the relevant

Purchasers. Any such sale will not include any representations and warranties from the Fund or the Seller (or the applicable New Seller) in respect of the Loans and their Related Security unless expressly agreed by the Representative or otherwise agreed with the Fund and the Seller (or the applicable New Seller).

Limit on Investing in Substitution Assets and Authorised Investments

Prior to service of an Asset Coverage Test Breach Notice (if not revoked) or a Notice to Pay on the Fund, the Fund will be permitted to invest Available Receipts and the proceeds of Term Advances in Substitution Assets, provided that the aggregate amount so invested in such Substitution Assets does not exceed 10 per cent. of the total assets of the Fund at any one time and provided that such investments are made in accordance with the terms of the Cash Management Agreement. Placing such amounts in any Fund Account will not constitute an investment in Substitution Assets for these purposes.

Following service of an Asset Coverage Test Breach Notice (if not revoked) or a Notice to Pay on the Fund, all Substitution Assets must be sold by the Fund (or the Cash Manager on its behalf) as quickly as reasonably practicable and the proceeds credited to the GIC Account and the Fund will be permitted to invest all available moneys in Authorised Investments, provided that such investments are made in accordance with the terms of the Cash Management Agreement.

There is no limit on the amounts that the Fund shall be entitled to invest in Authorised Investments.

Other Provisions

The allocation and distribution of Revenue Receipts and all other amounts received by the Fund is described under *Cashflows* below.

The Fund Deed is governed by Icelandic law.

Cash Management Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Cash_Management_Agreement.pdf

The Cash Manager provides certain cash management services to the Fund pursuant to the terms of the Cash Management Agreement entered into on 20 January 2012 between the Fund, Arion Bank hf. in its capacity as the Cash Manager and the Representative.

The Cash Manager's services include but are not limited to:

- (a) maintaining the Ledgers on behalf of the Fund;
- (b) distributing the Revenue Receipts in accordance with the Priorities of Payment described under *Cashflows* below;
- (c) determining whether the Asset Coverage Test is satisfied on each Calculation Date in accordance with the Fund Deed, as more fully described under *Credit Structure – Asset Coverage Test* below; and
- (d) preparation of Investor Reports for the Covered Bondholders and the Representative.

In certain circumstances the Fund and the Representative will each have the right to terminate the appointment of the Cash Manager and to appoint a substitute (the identity of which will be subject to the Representative's written approval). Any substitute cash manager will have substantially the same rights and obligations as the Cash Manager (although the fee payable to the substitute cash manager may be higher).

The Cash Management Agreement is governed by Icelandic law.

Bank Account Agreement

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Bank_Account_Agreement.pdf

Pursuant to the terms of the Bank Account Agreement entered into on 20 January 2012 between the Fund, the Account Bank, the Cash Manager and the Representative, the Fund maintains with the Account Bank the GIC Account described below, which is operated in accordance with the Cash Management Agreement and the Fund Deed.

All amounts received from Borrowers in respect of Loans in the Portfolio are paid into the GIC Account and credited to the Revenue Ledger. On each Fund Payment Date, as applicable, amounts required to meet the claims of the Fund's various creditors and amounts to be distributed to the Holders under the Fund Deed will be transferred from the Revenue Ledger, the Reserve Ledger or the Unit Account Ledger, as applicable, to the Payment Ledger on the GIC Account and applied by the Cash Manager in accordance with the Priorities of Payments described below under *Cashflows*.

The Bank Account Agreement is governed by Icelandic law.

Guaranteed Investment Contract

Weblink: http://www.arionbanki.is/library/Skrar/English/About-the-Bank/Investor-Relations/Debt-Investors/Structured-Covered-Bonds/Transaction-documents/Guaranteed_Investment_Contract.pdf

The Fund has entered into a Guaranteed Investment Contract (or **GIC**) with the GIC Provider, the Cash Manager and the Representative on 20 January 2012, pursuant to which the GIC Provider has agreed to pay interest on the moneys standing to the credit thereof at specified rates determined in accordance with the GIC.

The Guaranteed Investment Contract is governed by Icelandic law.

CREDIT STRUCTURE

The Covered Bonds are direct, unsecured, unconditional obligations of the Issuer ranking *pari passu* without any preference amongst themselves and the Covered Bonds. The Fund has no obligation to pay the Guaranteed Amounts under the Covered Bond Guarantee until service of a Notice to Pay on the Fund following service by the Representative of an Issuer Acceleration Notice or, if earlier, following the occurrence of a Fund Event of Default and service by the Representative of a Fund Acceleration Notice. The Issuer will not be relying on payments by the Fund in respect of the Term Advances or receipt of Revenue Receipts from the Portfolio in order to pay interest or repay principal under the Covered Bonds.

There are a number of features which enhance the likelihood of timely and, as applicable, ultimate payments to Covered Bondholders, as follows:

- the Covered Bond Guarantee provide credit support to the Issuer;
- the Asset Coverage Test is intended to test the asset coverage of the Fund's assets in respect of the Covered Bonds outstanding at all times; and
- under the terms of the Guaranteed Investment Contract, the GIC Provider has agreed to pay a variable rate of interest on all amounts held by the Fund in the GIC Account at a rate of 0.5 per cent. for one-month ISK deposits or such greater amount as the Fund and the GIC Provider may agree from time to time.

Certain of these factors are considered more fully in the remainder of this section.

Covered Bond Guarantee

The Covered Bond Guarantee provided by the Fund under the Representative and Agency Agreement guarantees payment of Guaranteed Amounts when the same become Due for Payment in respect of all Covered Bonds. The Covered Bond Guarantee will not guarantee any amount becoming payable for any other reason, including any accelerated payment pursuant to Condition 9 (*Events of Default, Acceleration and Enforcement*) following the service of a Notice to Pay. In this circumstance (and until a Fund Event of Default occurs and a Fund Acceleration Notice is served), the Fund's obligations will only be to pay the Guaranteed Amounts as they fall Due for Payment. However, should any payments made by the Fund under the Covered Bond Guarantee be subject to any withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction, the Fund will not be obliged to pay any additional amount as a consequence.

See further *Summary of the Principal Documents – Covered Bond Guarantee* as regards the terms of the Covered Bond Guarantee. See further *Cashflows – Guarantee Priority of Payments* as regards the payment of amounts payable by the Fund to Covered Bondholders following service of a Notice to Pay.

Asset Coverage Test

The Asset Coverage Test is intended to ensure that the Fund can meet its obligations under the Covered Bond Guarantee. Under the Fund Deed, the Fund must ensure that on each Calculation Date the Adjusted Aggregate Loan Amount will be in an amount equal to or in excess of the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date. If the Adjusted Aggregate Loan Amount is not equal to, or greater than, the aggregate Principal Amount Outstanding of the Covered Bonds on the next following Calculation Date, the Asset Coverage Test will be breached and the Representative will serve an Asset Coverage Test Breach Notice on the Fund. The Asset Coverage Test is a formula which adjusts the Outstanding Principal Balance of each Loan in the Portfolio and has further adjustments to take account of set-off on a Borrower's current or deposit accounts held with the Seller and failure by the Seller, in accordance with the Mortgage Sale Agreement, to repurchase Defaulted Loans or Loans that do not materially comply with the Representations and Warranties on the relevant Assignment Date. See further *Summary of the Principal Documents – Fund Deed – Asset Coverage Test*, above.

An Asset Coverage Test Breach Notice will be revoked if, on any Calculation Date falling on or prior to the second Calculation Date following the service of the Asset Coverage Test Breach Notice, the Asset Coverage Test is satisfied and neither a Notice to Pay nor a Fund Acceleration Notice has been served.

If an Asset Coverage Test Breach Notice has been served and not revoked on or before the second Calculation Date after service of such Asset Coverage Test Breach Notice, then an Issuer Event of Default shall occur and the Representative shall be entitled (and, in certain circumstances may be required) to serve an Issuer Acceleration Notice. Following service of an Issuer Acceleration Notice, the Representative must serve a Notice to Pay on the Fund.

Reserve Fund

The Fund is required to credit Available Receipts to the Reserve Fund up to an amount equal to the Reserve Fund Required Amount. The Fund will not be required to maintain the Reserve Fund following the occurrence of an Issuer Event of Default and service of an Issuer Acceleration Notice.

The Reserve Fund Required Amount will be funded from the proceeds from any Term Advances and from Available Receipts after the Fund has paid all of its obligations in respect of items ranking higher than the Reserve Ledger in the Pre Acceleration Priority of Payments on each Fund Payment Date.

A Reserve Ledger will be maintained by the Cash Manager to record the balance from time to time of the Reserve Fund. Following the occurrence of an Issuer Event of Default, service of an Issuer Acceleration Notice and service of a Notice to Pay on the Fund, amounts standing to the credit of the Reserve Fund will be added to certain other income of the Fund in calculating Available Receipts.

The Seller may also direct the Fund to credit any Cash Equity Contributions it makes to the Fund to the Reserve Ledger. The balance on the Reserve Ledger in excess of the Reserve Fund Required Amount will form part of Available Receipts and be applied accordingly.

CASHFLOWS

As described above under *Credit Structure*, cf. page 156, until a Notice to Pay is served on the Fund, the Covered Bonds are obligations of the Issuer only. The Issuer is liable to make payments when due on the Covered Bonds, whether or not it has received any corresponding payment from the Fund.

This section summarises the Priorities of Payments of the Fund, as to the allocation and distribution of amounts standing to the credit of the Fund Accounts and their order of priority:

- (a) prior to service on the Fund of an Asset Coverage Test Breach Notice, a Notice to Pay or a Fund Acceleration Notice;
- (b) following service of an Asset Coverage Test Breach Notice (and for so long as it has not been revoked);
- (c) following service of a Notice to Pay; and
- (d) following service of a Fund Acceleration Notice.

Allocation and distribution of Available Receipts prior to service of an Asset Coverage Test Breach Notice (which has not been revoked), a Notice to Pay or a Fund Acceleration Notice

Prior to service of an Asset Coverage Test Breach Notice (which has not been revoked), a Notice to Pay or a Fund Acceleration Notice on the Fund, Available Receipts will be allocated and distributed as described below.

On the Calculation Date immediately preceding each Fund Payment Date, the Fund, or the Cash Manager on its behalf, shall calculate the amount of Available Receipts available for distribution on the immediately following Fund Payment Date and the Reserve Fund Required Amount (if applicable).

Pre Acceleration Priority of Payments

On each Fund Payment Date, the Fund or the Cash Manager on its behalf will transfer Available Receipts from the Revenue Ledger and the Reserve Ledger, as applicable, to the Payment Ledger on the GIC Account, in an amount equal to the lower of: (a) the amount required to make the payments described below; and (b) the amount of Available Receipts standing to the credit of the GIC Account.

Prior to service on the Fund of an Asset Coverage Test Breach Notice (which has not been revoked), a Notice to Pay or a Fund Acceleration Notice, Available Receipts will be applied by or on behalf of the Fund on each Fund Payment Date in making the following payments and provisions (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, in or towards payment of any amounts due and payable by the Fund to the Representative, each Agent, the Management Company, the Custody Agent and to other third parties and incurred without breach by the Fund of the Transaction Documents to which it is a party (and for which payment has not been provided for elsewhere in this Pre Acceleration Priority of Payments) and to provide for any such amounts expected to become due and payable by the Fund in the immediately succeeding Fund Payment Period and to discharge any liability of the Fund for taxes and/or other official levies;
- (b) *second*, in or towards payment *pro rata* and *pari passu* according to the respective amounts thereof of:
 - (i) any remuneration then due and payable to the Servicer and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicer under the provisions of the Servicing Agreement in the immediately succeeding Fund Payment Period, together with applicable amounts in respect of taxes thereon as provided therein;

- (ii) amounts due and payable to the Asset Monitor pursuant to the terms of the Asset Monitor Agreement together with applicable amounts in respect of taxes thereon as provided therein;
 - (iii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager under the provisions of the Cash Management Agreement in the immediately succeeding Fund Payment Period, together with applicable amounts in respect of taxes thereon as provided therein; and
 - (iv) amounts (if any) due and payable to the Account Banks (including any costs, charges, liabilities and expenses) pursuant to the terms of the Bank Account Agreement, together with applicable amounts in respect of taxes thereon as provided therein;
- (c) *third*, in or towards payment of any amounts due or to become due and payable on such Fund Payment Date (whether in respect of principal, interest or any other amount due) under the Intercompany Loan Agreement, *pro rata* and *pari passu* in respect of each relevant Term Advance;
 - (d) *fourth*, if a Servicer Event of Default has occurred, all remaining Available Receipts to be credited to the GIC Account (with a corresponding credit to the Revenue Ledger) until such Servicer Event of Default is either remedied or waived by the Representative or a new servicer is appointed to service the Portfolio (or the relevant part thereof);
 - (e) *fifth*, in or towards a credit to the Reserve Ledger on the GIC Account of an amount required to ensure that the Reserve Fund is funded to the Reserve Fund Required Amount as calculated on the immediately preceding Calculation Date; and
 - (f) *sixth*, towards payment *pro rata* and *pari passu* to the Holders (as specified in the Fund Deed).

Allocation and distribution of Available Receipts following service of an Asset Coverage Test Breach Notice

At any time after service on the Fund of an Asset Coverage Test Breach Notice (which has not been revoked), but prior to service of a Notice to Pay or service of a Fund Acceleration Notice, all Available Receipts will continue to be applied in accordance with the Pre Acceleration Priority of Payments save that, whilst any Covered Bonds remain outstanding, no moneys will be applied under paragraph (f) of the Pre Acceleration Priority of Payments.

Allocation and distribution of Available Receipts following service of a Notice to Pay

At any time after service of a Notice to Pay on the Fund, but prior to service of a Fund Acceleration Notice, all Available Receipts will be applied as described below under *Guarantee Priority of Payments*.

On each Fund Payment Date, the Fund or the Cash Manager on its behalf will transfer Available Receipts from the Revenue Ledger, the Reserve Ledger or the Unit Account Ledger, as the case may be, to the Payment Ledger on the GIC Account, in an amount equal to the lower of: (a) the amount required to make the payments set out in the Guarantee Priority of Payments; and (b) the amount of all Available Receipts standing to the credit of such ledgers on the GIC Account.

The Fund will create and maintain ledgers for the Covered Bonds and record amounts allocated to of the Covered Bonds in accordance with paragraphs (d) and (e) of the *Guarantee Priority of Payments* below, and such amounts, once allocated, will only be available to pay amounts due under the Covered Bond Guarantee.

Guarantee Priority of Payments

On each Fund Payment Date on and from the date of service of a Notice to Pay on the Fund (but prior to the occurrence of a Fund Event of Default and service of a Fund Acceleration Notice), the Fund or the Cash

Manager on its behalf will apply moneys standing to the credit of the Payment Ledger on the GIC Account to make the following payments and provisions in the following order of priority (the **Guarantee Priority of Payments**) (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, to in or towards payment *pro rata* and *pari passu* according to the respective amounts thereof of all amounts due and payable or to become due and payable to the Representative in the immediately succeeding Fund Payment Period under the provisions of the Representative and Agency Agreement together with interest and applicable amounts in respect of taxes thereon as provided therein;
- (b) *second*, in or towards payment *pro rata* and *pari passu* according to the respective amounts thereof of:
 - (i) any remuneration then due and payable to the Agents under or pursuant to the Representative and Agency Agreement together with applicable amounts in respect of taxes thereon as provided therein; and
 - (ii) any amounts then due and payable by the Fund to third parties (including, for the avoidance of doubt, amounts due and payable to the Management Company and the Custody Agent) and incurred without breach by the Fund of the Transaction Documents to which it is a party (and for which payment has not been provided for elsewhere in this Guarantee Priority of Payments) and to provide for any such amounts expected to become due and payable by the Fund in the immediately succeeding Fund Payment Period and to pay or discharge any liability of the Fund for taxes and/or other official levies;
- (c) *third*, in or towards payment *pro rata* and *pari passu* according to the respective amounts thereof of:
 - (i) any remuneration then due and payable to the Servicer and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicer in the immediately succeeding Fund Payment Period under the provisions of the Servicing Agreement together with applicable amounts in respect of taxes thereon as provided therein;
 - (ii) amounts due and payable to the Asset Monitor pursuant to the terms of the Asset Monitor Agreement, together with applicable amounts in respect of taxes thereon as provided therein;
 - (iii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager in the immediately succeeding Fund Payment Period under the provisions of the Cash Management Agreement, together with applicable amounts in respect of taxes thereon as provided therein; and
 - (iv) amounts (if any) due and payable to the Account Banks (including any costs, charges, liabilities and expenses) pursuant to the terms of the Bank Account Agreement, together with applicable amounts in respect of taxes thereon as provided therein;
- (d) *fourth*, in or towards payment on the Fund Payment Date or to provide for payment on such date in the future of such proportion of the relevant payments falling due in the future as the Cash Manager may reasonably determine, of Scheduled Interest that is Due for Payment (or that will become Due for Payment) under the Covered Bond Guarantee in respect of each Series of Covered Bonds to the Representative or (if so directed by the Representative) the Principal Paying Agent on behalf of the Covered Bondholders *pro rata* and *pari passu* in respect of each Series of Covered Bonds;

- (e) *fifth*, in or towards payment on the Fund Payment Date or to provide for payment prior to the next Fund Payment Date, of Scheduled Principal that is Due for Payment (or that will become Due for Payment in the immediately succeeding Fund Payment Period) under the Covered Bond Guarantee in respect of each Series of Covered Bonds to the Representative or (if so directed by the Representative) the Principal Paying Agent on behalf of the Covered Bondholders *pro rata* and *pari passu* in respect of each Series of Covered Bonds;
- (f) *sixth*, to deposit the remaining moneys in the GIC Account for application on the next following Fund Payment Date in accordance with the priority of payments described in paragraphs (a) to (e) (inclusive) above, until the Covered Bonds have been fully repaid or repayment in full of the Covered Bonds has been provided for (such that the Required Redemption Amount has been accumulated in respect of each outstanding Series of Covered Bonds);
- (g) *seventh*, in or towards payment of any amounts due or to become due and payable in the immediately succeeding Fund Payment Period (whether in respect of principal, interest or any other amount) under the Intercompany Loan Agreement, *pro rata* and *pari passu* in respect of each relevant Term Advance; and
- (h) *eighth*, thereafter any remaining moneys will be applied in accordance with the Fund Deed.

Application of moneys received by the Representative following service of a Fund Acceleration Notice

Under the terms of the Fund Deed, all moneys received or recovered by the Representative will be applied in the following order of priority (the **Post-Enforcement Priority of Payments**) (in each case only if and to the extent that payments or provisions of a higher priority have been made in full):

- (a) *first*, in or towards satisfaction *pro rata* and *pari passu* according to the respective amounts thereof all amounts due and payable or to become due and payable to the Representative under the provisions of the Representative and Agency Agreement together with interest and applicable amounts in respect of taxes thereon as provided therein;
- (b) *second*, in or towards satisfaction of any remuneration then due and payable to the Agents under or pursuant to the Representative and Agency Agreement, the Management Company and the Custody Agent together with applicable taxes thereon as provided therein;
- (c) *third*, in or towards satisfaction *pro rata* and *pari passu* according to the respective amounts thereof of:
 - (i) any remuneration then due and payable to the Servicer and any costs, charges, liabilities and expenses then due or to become due and payable to the Servicer under the provisions of the Servicing Agreement, together with applicable amounts in respect of taxes thereon as provided therein;
 - (ii) any remuneration then due and payable to the Cash Manager and any costs, charges, liabilities and expenses then due or to become due and payable to the Cash Manager under the provisions of the Cash Management Agreement, together with applicable amounts in respect of taxes thereon as provided therein; and
 - (iii) amounts due to the Account Banks (including any costs, charges, liabilities and expenses) pursuant to the terms of the Bank Account Agreement, together with applicable amounts in respect of taxes thereon as provided therein;
- (d) *fourth*, in or towards satisfaction of the amounts due and payable under the Covered Bond Guarantee, to the Representative or (if so directed by the Representative) the Principal Paying Agent on behalf of the Covered Bondholders *pro rata* and *pari passu* in respect of interest and principal due and payable on each Series of Covered Bonds, provided that if the amount available for distribution under this paragraph (d) would be insufficient to pay the ISK

Equivalent of the amounts due and payable under the Covered Bond Guarantee in respect of each Series of Covered Bonds, the shortfall shall be divided amongst all such Series of Covered Bonds on a *pro rata* basis;

- (e) *fifth*, in or towards payment of all amounts outstanding under the Intercompany Loan Agreement *pro rata* and *pari passu* in respect of each relevant Term Advance; and
- (f) *sixth*, in or towards payment to the Holders (as specified in the Fund Deed).

DESCRIPTION OF INVESTMENT FUNDS IN ICELAND

The primary legislation in Iceland applicable to funds for collective investments is Act No 128/2011 on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment funds (the **Act**) which inter alia implemented Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as adopted to the Agreement on the European Economic Area (**EEA**).

The Act essentially deals with different types of funds for collective investments namely:

UCITS

The Act contains detailed provisions on UCITS, being funds covered by the provisions of Directive 85/611/EEC. The scope of Directive 85/611/EEC is limited to undertakings whose sole object is the collective investment in transferable securities and/or other liquid financial assets (as referred to in Article 19(1) of Directive 85/611/EEC) of capital raised from the public and which operate on the principle of risk-spreading and the units of which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of the assets of the relevant undertakings.

Other funds for collective investments in Iceland

Many funds for collective investments are not covered by the terms set out in Directive 85/611/EEC. Contracting Parties to the Agreement of the European Economic Area are, therefore, at liberty to establish rules for funds which fall outside the scope of Directive 85/611/EEC.

Such funds need to obtain a special operating licence in all countries in which they are marketed. One of the objectives of the Icelandic authorities in enacting the Act was to increase the competitive edge of Icelandic funds for collective investments. The legislation was intended to create a more favourable environment for operating funds for collective investments in Iceland than was previously the case. One of the methods used to achieve this objective was to authorise additional types of funds, to broaden their investment authorisations and make funds easier and cheaper to operate. Thus the intention was to increase the diversity of Icelandic funds for mutual investments.

Restrictions on investments by funds is depend on who is authorised to invest in them. According to the Act, management companies of UCITS are authorised to operate investment funds on the one hand and institutional investment funds on the other hand. In addition to funds for collective investments, the management funds of UCITS have the scope to apply for increased authorisation to carry out asset management, investment advice, custody and management of financial instruments in collective investment.

Investment Funds

The investment authorisation of investment funds is broader than for UCITS. This is largely due to the fact that investment funds can invest to a greater extent in unlisted financial instruments and do not require as much risk distribution.

Investment funds are authorised to invest in unlisted financial instruments. It is therefore possible to operate mixed funds of listed and unlisted financial instruments and also funds which invest chiefly in unlisted financial instruments. Funds which invest chiefly in unlisted financial instruments are often called venture capital funds.

In addition to broader authorisation to invest in unlisted financial instruments, investment funds are authorised to invest up to 35 per cent. of their assets in financial instruments issued by the same obligor, provided that investments exceeding 20 per cent. are only in one issuer.

Institutional Investment Funds

The Act stipulates the exclusive right of UCITS and investment funds to accept funds from members of the public for collective investments in financial instruments and other assets on the basis of spreading risk in accordance with a previously stated investment strategy.

Holding companies, companies in mixed operations and companies which do not operate on the basis of spreading risk are therefore not covered by the Act. These companies would not be considered funds for collective investments. Funds for collective investments other than UCITS and investment funds are therefore primarily funds which accept funds from sources other than the public. Operating companies are authorised to operate such funds pursuant to Article 4 of the Act (cf. Article 27 of the financial undertakings act).

The reason why this exclusive right does not apply to institutional investment funds is because institutional investors are considered to have the necessary expertise and experience to assess the risk inherent in different investments and therefore do not require comparable consumer protection as compared to members of the public. Institutional investment funds can involve considerable risks and therefore members of the public are not permitted to invest in them.

Institutional investment funds do not receive accreditation nor an operating licence from the Financial Supervisory Authority in Iceland and, therefore, are not subject to supervision by the Financial Supervisory Authority in Iceland. However, management companies which operate such funds are required to notify the Financial Supervisory Authority in Iceland when such funds are established, since management companies and all their activities are subject to supervision by the Financial Supervisory Authority.

BOOK ENTRY CLEARANCE SYSTEMS

The information set out below is subject to any change in or reinterpretation of the rules, regulations and procedures of Euroclear or Clearstream, Luxembourg or the ISD (together, the Clearing Systems) currently in effect. Investors wishing to use the facilities of any of the Clearing Systems are advised to confirm the continued applicability of the rules, regulations and procedures of the relevant Clearing System. None of the Issuer nor any other party to the Agency Agreement will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Covered Bonds held through the facilities of any Clearing System or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

In light of the existing withholding tax regime in Iceland, potential investors in Covered Bonds who wish to hold their Covered Bonds through Euroclear and Clearstream, Luxembourg are advised to contact those clearing systems to determine the nature of the tax certifications required by each clearing system as a condition to making payments on the Covered Bonds.

Book-Entry Systems

Euroclear and Clearstream, Luxembourg

Euroclear and Clearstream, Luxembourg each holds securities for its customers and facilitates the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depository and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are world-wide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

TAXATION

General

Prospective purchasers of the Covered Bonds are advised to consult their tax advisers as to the consequences, under the tax laws of the countries of their respective citizenship, residence or domicile, of a purchase of Covered Bonds, including, but not limited to, the consequences of receipt of payments under the Covered Bonds and their disposal or redemption.

Iceland

The comments below are of a general nature based on the understanding of the Issuer of current law and practice in Iceland. They should not be construed as providing specific advice as to Icelandic taxation and are subject to changes as to the applicable rules in the future. They relate only to the position of persons who are the absolute beneficial owners of the Covered Bonds. They may not apply to certain classes of persons, such as dealers. Prospective holders of the Covered Bonds who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers.

In light of the existing withholding tax regime in Iceland, potential investors in Covered Bonds who wish to hold their Covered Bonds through Euroclear and Clearstream, Luxembourg are advised to contact those clearing systems to determine the nature of the tax certifications required by each clearing system as a condition to making payments on the Covered Bonds.

(a) *Non Icelandic Tax Residents*

There are taxes payable under the laws of Iceland or any authority of, or in, Iceland in respect of the amounts payable on the Covered Bonds paid to a holder who is not a tax resident of Iceland. Article 3(8) of the ITA specifically states that any interest received from Iceland (outbound payments), such as e.g. the interests payable according to the bonds, received by any person or entity residing outside of Iceland is taxable income in Iceland unless a double taxation treaty states otherwise. According to Article 70(b) of the ITA, numerical 8, the tax shall be: (a) 10% for individuals, of all income exceeding the annual amount of the ISK 100,000.00; and (b) 10% for legal entities.

The Issuer or the relevant custodian will be making the relevant withholding at source in accordance with the provisions of Regulation No 1082/2009, on the taxation and withholding of interest to parties subject to limited tax liability (as based on Article 3(8) of the ITA and Article 41 of the Act No 45/1987 on Withholding of Public Levies at Source). The Issuer confirms that appropriate applications for the exemption/lowered tax rate, have been or will be filed in connection with the issue of Covered Bonds, upon receipt of necessary documentation from the relevant bondholders, in order to implement and make full practical; use of the provisions of Regulation No 1082/2009.

There are no estate or inheritance taxes, succession duties, gift taxes or capital gains taxes imposed on the holder of the Covered Bonds by Iceland or any authority of, or in, Iceland in respect of the Covered Bonds if, at the time of the death of the holder or the transfer of the Covered Bonds, such holder or transferor and transferee are not tax residents of Iceland.

In instances other than those specifically stated herein as being applicable, the provisions of Condition 7 will apply and the Issuer may be required to pay additional amounts as provided in Condition 7.

(b) *Icelandic Tax Residents*

Beneficial owners of the Covered Bonds that are resident in Iceland for tax purposes are subject to income tax in Iceland on their interest income in accordance with Icelandic tax law. The rate depends on their tax status.

Subject to certain exemptions (which apply, *inter alia*, to most banks and pension funds), the Issuer or, as the case may be, the Fund is required to withhold a 20% tax on the interests paid to the holders of Covered Bonds who are Icelandic residents. Such withholding is considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder.

DISTRIBUTION

United States

The Covered Bonds and the Covered Bond Guarantee have not been and will not be registered under the Securities Act and Covered Bonds may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act.

The Covered Bonds are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986, as amended, and regulations thereunder.

The Dealer has represented and agreed that it will not offer, sell or deliver any Covered Bonds (a) as part of its distribution at any time or (b) otherwise until 40 days after the distribution, as determined and certified by the Dealer of all Covered Bonds, within the United States or to, or for the account or benefit of, U.S. persons. The Dealer has sent to each dealer to which it sold any Covered Bonds during the distribution compliance period (if any) a confirmation or other notice setting forth the restrictions on offers and sales of the Covered Bonds within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

Until 40 days after the commencement of the offering of the Covered Bonds, an offer or sale of such Covered Bonds within the United States by the dealer (who is not participating in the offering) may have violated the registration requirements of the Securities Act if such offer or sale was made otherwise than in accordance with an available exemption from registration under the Securities Act.

European Economic Area

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), the Dealer has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Member State (the **Relevant Implementation Date**) it has not made and will not make an offer of Covered Bonds to the public in that Relevant Member State, except that it may, with effect from and including the Relevant Implementation Date, make an offer of Covered Bonds to the public in that Relevant Member State:

- (a) in (or in Germany, where the offer starts within) the period beginning on the date of publication of a prospectus in relation to those Covered Bonds which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive and ending on the date which is 12 months after the date of such publication;
- (b) at any time to legal entities which are authorised or regulated to operate in the financial markets or, if not so authorised or regulated, whose corporate purpose is solely to invest in securities;
- (c) at any time to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000 and (3) an annual turnover of more than €50,000,000, as shown in its last annual or consolidated accounts; or
- (d) at any time in any other circumstances which do not require the publication by the Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression "offer of Covered Bonds to the public" in relation to any Covered Bonds in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Covered Bonds to be offered so as to enable an investor to decide to purchase or subscribe the Covered Bonds, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

United Kingdom

The Dealer has represented and agreed that:

- (a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Covered Bonds in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer or the Fund; and
- (b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to any Covered Bonds in, from or otherwise involving the United Kingdom.

Iceland

The Dealer has agreed that it will not offer the Covered Bonds to the public or any other entity in Iceland, except in compliance with the Icelandic Act on Securities Transactions (No. 108/2007) implementing the Prospectus Directive as incorporated into the EEA Agreement and any applicable laws or regulations of Iceland.

Japan

The Covered Bonds have not been and will not be registered under the Securities and Exchange Law of Japan (the Securities and Exchange Law) and the Dealer has agreed that it will not offer or sell any Covered Bonds, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organised under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

General

The Dealer has agreed that it will (to the best of its knowledge and belief) comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers the Covered Bonds or possesses or distributes this Prospectus and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of the Covered Bonds under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and none of the Issuer, the Fund, the Representative or the Dealer shall have any responsibility therefor.

None of the Issuer, the Fund, the Representative or the Dealer represents that the Covered Bonds may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating any such sale.

The Dealer is required to comply with any additional restrictions as the Issuer and the Dealer have agreed and as set out in the Pricing Terms.

GENERAL INFORMATION

Authorisation

The issue of Covered Bonds was duly authorised by board resolution dated 26 October 2011. The giving of the Covered Bond Guarantee has been duly authorised by board resolutions of the Management Company on behalf of the Fund dated 10 March 2006 and 21 February 2008.

Listing of Covered Bonds

This Prospectus has been prepared in connection with the admission to trading of the Covered Bonds on the regulated market of the NASDAQ OMX Iceland.

Application has been made to the The Financial Supervisory Authority of Iceland to approve this document as a prospectus for the purposes of Article 5.4 of the Prospectus Directive and application will be made to the NASDAQ OMX Iceland for the Covered Bonds to be admitted to trading on the regulated market of the NASDAQ OMX Iceland. The regulated market of the NASDAQ OMX Iceland is a regulated market for the purposes of the Investment Services Directive.

An application will be made for the Covered Bonds to be admitted to trading on the regulated market of NASDAQ OMX Iceland, which is a regulated market within the meaning of Directive 2004/39/EC on Markets in Financial Instruments (“MiFID”) which has been implemented in Icelandic law through the Securities Transaction Act No. 108/2007. NASDAQ OMX Iceland hf. is authorised pursuant to the Act on Stock Exchanges No. 110/2007 to operate a regulated market under the supervision of the Icelandic Financial Supervisory Authority and required under the Act to have rules of its own governing the trading on NASDAQ OMX Iceland.

Documents Available

For the period of 12 months following the date of this Prospectus, copies of the following documents will, when published, be available from the registered office of the Issuer, from the specified office of the Principal Paying Agent for the time being in London and, in the case of this Prospectus, each Transaction Document, or any document incorporated by reference only, at <http://www.arionbanki.is/english/about-us/investor-relations/debt-investors/>:

- (a) the articles of association (with an English translation thereof) of each of the Issuer and the Fund;
- (b) the audited financial statements of the Issuer (with an English translation thereof) in respect of the financial years ended 31 December 2013 and 31 December 2012, in each case together with the audit reports prepared in connection therewith;
- (c) the unaudited interim financial statements of the Issuer (with an English translation thereof) for the period ended 30 June 2014, together with any review reports prepared in connection therewith;
- (d) the forms of the Global Covered Bonds, the Definitive Covered Bonds, the Receipts, the Coupons and the Talons;
- (e) a copy of this Prospectus;
- (f) any future prospectuses, information memoranda and supplements to this Prospectus and any other documents incorporated herein or therein by reference;
- (g) in the case of the Covered Bonds admitted to trading on the regulated market of the NASDAQ OMX Iceland hf. subscribed pursuant to a subscription agreement, the subscription agreement (or equivalent document); and
- (h) each Transaction Document.

Clearing Systems

The Covered Bonds have been accepted for clearance through Euroclear and Clearstream, Luxembourg (which are entities in charge of keeping the records). The appropriate Common Code and ISIN for each Series of Covered Bonds allocated by Euroclear and Clearstream, Luxembourg are specified in the Pricing Terms. The address of Euroclear is 1 Boulevard du Roi Albert II, B-1210 Brussels and the address for Clearstream, Luxembourg is 42 Avenue JF Kennedy, L-1855, Luxembourg. If the Covered Bonds are to clear through an additional or alternative clearing system the appropriate information will be specified in the Pricing Terms.

Conditions for determining price

The price and amount of the Covered Bonds were determined by the Issuer and the Dealer at the time of issue in accordance with prevailing market conditions.

Significant or Material Change

Except as described in this Prospectus, there has been no significant change in the financial or trading position, and there has been no material adverse change in the prospects, of the Issuer, the Fund or the Group since 31 December, 2013.

Except as described in this Prospectus, there has been no significant change in the financial or trading position, and there has been no material adverse change in the prospects of the Fund since 10 March 2006 (being the date of its establishment).

Litigation

Except as described in this Prospectus, none of the Issuer, any of its subsidiaries or the Fund is or has been involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer or the Fund is aware) in the 12 months preceding the date of this document which may have or have in such period had a significant effect on the financial position or profitability of the Issuer, the Group or the Fund, taken as a whole.

Auditors

The auditors of the Issuer and the Fund are Ernst & Young ehf., members of The Institute of State Authorised Public Accountants in Iceland, who have audited the Issuer's and the Fund's accounts, without qualification, in accordance with International Standards on Auditing for each of the two financial years ended on 31 December, 2013. The auditors of the Issuer and the Fund have no material interest in either the Issuer or the Fund.

Reports

The Representative and Agency Agreement provides that the Representative may rely on reports or other information from professional advisers or other experts in accordance with the provisions of the Representative and Agency Agreement, whether or not any such report or other information, or engagement letter or other document entered into by the Representative and the relevant person in connection therewith, contains any monetary or other limit on the liability of the relevant person.

GLOSSARY

The Glossary of this Prospectus sets out definitions relevant in respect of the Covered Bonds only. Defined terms used in the Terms and Conditions of the Covered Bonds and not set out in this Glossary are set out in their entirety in the Prospectus.

Account Banks	Arion Bank hf. and any other financial institution which accedes to the Bank Account Agreement as an Account Bank
Additional Business Centre	The meaning (if any) given in the Pricing Terms
Additional Finance Centre	The meaning given in the Pricing Terms
Adjusted Aggregate Loan Amount	The meaning given on page 153
Adjusted Outstanding Principal Balance	The meaning given on page 153
Agents	The Paying Agents and any Calculation Agent
ALCO	The Bank's Asset and Liability Committee
Amending Act	The Icelandic Parliament Act no. 134/2008, passed on 28 November 2008, on Amendments to the Act on Foreign Exchange no. 87/1992
AML	Anti-money laundering
Annuity Amount	The meaning given in Condition 5.1
Annuity Covered Bonds	Covered Bonds which will be redeemed in Annuity Amounts (subject to adjustment for indexation in accordance with the provisions specified in the Pricing Terms) on one or more Interest Payment Dates as specified in the Pricing Terms
Arion Group	The Bank and its wholly owned and majority owned subsidiaries
Arrears of Interest	In relation to a Loan as at any date, the aggregate of all interest and expenses which are due and payable and unpaid on that date
Asset Coverage Test	The test as to whether the Adjusted Aggregate Loan Amount is at least equal to the ISK Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds as calculated on the relevant Calculation Date
Asset Coverage Test Breach Notice	The notice required to be served by the Representative if the Adjusted Aggregate Loan Amount is less than the ISK Equivalent of the aggregate Principal Amount Outstanding of the Covered Bonds on two consecutive Calculation Dates
Asset Monitor	A reputable institution appointed pursuant to the Agreement
Asset Monitor Agreement	The asset monitor agreement entered into on 20 January 2012 between the Asset Monitor, the Fund, the Case Manager, the Issuer and the Representative (as amended and/or supplemented and/or restated from time to time)
Asset Monitor Report	The results of the tests conducted by the Asset Monitor in accordance with the Asset Monitor Agreement to be delivered

	to the Cash Manager, the Fund, the Issuer and the Representative
Asset Percentage	Such percentage figure as determined from time to time in accordance with the terms of the Fund Deed
Assignment Date	Each date on which a New Portfolio is assigned to the Fund in accordance with the terms of the Mortgage Sale Agreement
ATM	Automatic-telling machines
Authorised Investments	ISK deposits, certificate of deposit and short term debt obligations (including commercial paper) provided that in all cases such investments have a maturity date falling no later than the next following Fund Payment Date
Authority	The EFTA Surveillance Authority
Available Receipts	On a relevant Calculation Date, an amount equal to the aggregate of (without double counting): <ul style="list-style-type: none"> (a) the amount of Revenue Receipts received during the immediately preceding Calculation Period and credited to the Revenue Ledger on the GIC Account; (b) any other amount standing to the credit of the Revenue Ledger including: (i) the proceeds of any Term Advance (where such proceeds have not been applied to acquire New Portfolios, refinance an existing Term Advance or invest in Substitution Assets); (ii) any Cash Equity Contributions received from a Holder (other than those Cash Equity Contributions credited to the Reserve Ledger on the GIC Account); and (iii) the proceeds from any sale of Loans (including, but not limited to, Selected Loans) pursuant to the terms of the Fund Deed or the Mortgage Sale Agreement to the extent that such proceeds represent principal (c) other net income of the Fund including all amounts of interest received on the Fund Accounts, the Substitution Assets and any Authorised Investments in the preceding Calculation Period and the proceeds from any sale of Loans (including, but not limited to, Selected Loans) pursuant to the terms of the Fund Deed or the Mortgage Sale Agreement to the extent that such proceeds comprise Accrued Interest and Arrears of Interest or other interest amounts; (d) amounts standing to the credit of the Reserve Fund in excess of the Reserve Fund Required Amount; (e) any other revenue receipts not referred to in paragraphs (a) to (d) (inclusive) above received during the previous Calculation Period and standing to the credit of the Revenue Ledger on the GIC Account; and

- (f) following service of a Notice to Pay or an Asset Coverage Test Breach Notice (if not revoked), amounts standing to the credit of the Reserve Fund

Bank Account Agreement	The bank account agreement entered into on 20 January 2012 between the Fund, the Account Banks, the Cash Manager and the Representative (as amended and/or supplemented and/or restated from time to time)
Bankruptcy Act	The act on bankruptcy etc. No. 21/1991
BARC	The Bank's Board Audit and Risk Committee
Board	The Bank's board of directors
Borrower	In relation to a Loan, each individual specified as such in the relevant Mortgage Terms together with each individual (if any) who assumes from time to time an obligation to repay such Loan or any part of it
Bunadarbanki	Bunadarbanki Islands hf.
Business Day	The meaning given in Condition 4.4(a)
Business Day Convention	The business day convention specified in the Pricing Terms and determined in accordance with Condition 4.4(b)
Calculation Agent	In relation to the Inflation Linked Annuity Covered Bonds, the person initially appointed as calculation agent in relation to such Covered Bonds by the Issuer and the Fund pursuant to the Representative and Agency Agreement or, if applicable, any successor calculation agent in relation to such Covered Bonds
Calculation Date	The third Business Day prior to each Fund Payment Date
Calculation Period	The period from (and including) one Calculation Date to (but excluding) the next following Calculation Date, except that the first Calculation Period shall commence on (and include) the first Issue Date and end on (but exclude) the next following Calculation Date
Cash Equity Contribution	An equity contribution to the Fund made in cash by way of a loan or otherwise funded by the Seller as a Holder
Cash Management Agreement	The cash management agreement entered into on 20 January 2012 between the Fund, the Cash Manager and the Representative (as amended and/or supplemented and/or restated from time to time)
Cash Manager	Arion Bank hf., in its capacity as cash manager or any successor cash manager appointed from time to time
CEO	Chief Executive Officer
Clearing Systems	Euroclear and/or Clearstream, Luxembourg
Clearstream, Luxembourg	Clearstream Banking, société anonyme or its successors

Common Depository	Deutsche Bank AG, London Branch, in its capacity as the common depository for Euroclear and Clearstream, Luxembourg
Couponholders	The holders of the Coupons (which expression shall, unless the context otherwise requires, include the holders of the Talons)
Coupons	Interest coupons in respect of Definitive Covered Bonds
Covered Bonds	The Listed Covered Bonds, the ISK 51,124,548,392 Inflation Linked Annuity Covered Bonds due 2048 (the Series 2 Covered Bonds) and the ISK 4,500,000,000 Inflation Linked Annuity Covered Bonds due 2045 (the Series 4 Covered Bonds)
Covered Bond Guarantee	An unconditional and irrevocable guarantee by the Fund in the Representative and Agency Agreement for the payment (following service of a Notice to Pay) of Guaranteed Amounts in respect of the Covered Bonds when the same shall become Due for Payment
Covered Bond Resolution	Any Extraordinary Resolution to direct the Representative to accelerate the Covered Bonds pursuant to Condition 9 or to direct the Representative to take any enforcement action pursuant to Condition 9
Covered Bondholders	The holders for the time being of the Covered Bonds
CRD	The Capital Requirements Directive 2006/49/EC
Custody Agent	Verdis hf. or such custody agent appointed by the Fund pursuant to its Articles of Association Verdis merged with Arion Bank 29 June 2012. Arion took over all operations of Verdis including the role of Custody Agent.
Customer Files	The file or files relating to each Loan and its Related Security containing, inter alia: <ul style="list-style-type: none"> (a) all material correspondence relating to that Loan; and (b) the completed mortgage documentation applicable to the Loan including the Mortgage Document and, if applicable, the Valuation Report, <p>whether original documentation, in electronic form or otherwise</p>
Day Count Fraction	The applicable meaning given in Condition 4.4(c)
Dealer	Arion Bank hf.
Defaulted Loan	Any Loan in the Portfolio which is three months or more in arrears
Definitive Covered Bond	A Covered Bond in definitive form issued or, as the case may require, to be issued by the Issuer in accordance with the provisions of the Subscription Agreement or any other agreement between the Issuer and the Dealer and the Representative and Agency Agreement in exchange for either

a Temporary Global Covered Bond or part thereof or a Permanent Global Covered Bond (all as indicated in the Pricing Terms), such Covered Bond in definitive form being in the form or substantially in the form set out in Part 3 of Schedule 4 to the Representative and Agency Agreement with such modifications (if any) as may be agreed between the Issuer, the Principal Paying Agent, the Representative and the Dealer or Lead Manager (in the case of syndicated issues) and having the Terms and Conditions endorsed thereon or, if permitted by the relevant stock exchange, incorporating the Terms and Conditions by reference as indicated in the the Pricing Terms and having the relevant information supplementing, replacing or modifying the Terms and Conditions appearing in the the Pricing Terms endorsed thereon or attached thereto and having Coupons and, where appropriate, Receipts and/or Talons attached thereto on issue

Directors

The directors for the time being of the Issuer or the Management Company, as the case may be

Due for Payment

The requirement by the Fund to pay any Guaranteed Amount:

- (a) following service of a Notice to Pay but prior to service of a Fund Acceleration Notice on the date on which the Scheduled Payment Date in respect of such Guaranteed Amount is reached or such other Interest Payment Date(s) specified in the Pricing Terms (the **Due for Payment Date**).

For the avoidance of doubt, Due for Payment does not refer to any earlier date upon which payment of any Guaranteed Amounts may become due under the guaranteed obligations, by reason of prepayment, acceleration of maturity, mandatory or optional redemption or otherwise; or

- (b) following service of a Fund Acceleration Notice, on the date on which the Fund Acceleration Notice is served on the Issuer and the Fund

Due for Payment Date

The meaning given in paragraph (a) of the definition of Due for Payment

Earliest Maturing Covered Bonds

At any time, the Series of the Covered Bonds (other than any Series which is fully collateralised by amounts standing to the credit of the GIC Account) that has or have the earliest Final Maturity Date as specified in the applicable Pricing Supplements (ignoring any acceleration of amounts due under the Covered Bonds prior to service of a Fund Acceleration Notice)

Early Redemption Amount

The amount calculated in accordance with Condition 6.5

ECVRA

The meaning given on page 96

Eignabjarg

Eignabjarg hf.

Eligibility Criteria

The meaning given on page 144

Equity Contribution	In relation to each Holder, the aggregate of the capital contributed by that Holder to the Fund from time to time by way of Cash Equity Contributions and Equity Contributions in Kind as determined on each Calculation Date in accordance with the formula set out in the Fund Deed
Equity Contribution	A Cash Equity Contribution and/or and Equity Contribution in Kind
Equity Contributions in Kind	A contribution of Loans and their Related Security to the Fund in an amount equal to: (a) the Outstanding Principal Balance of those Loans as at the relevant Assignment Date; minus (b) any cash payment paid by the Fund for the Loans and their Related Security on that Assignment Date
EU	European Union
EURIBOR	Euro-zone inter-bank offered rate
Euroclear	Euroclear Bank S.A./N.V. or its successor
Excess Proceeds	In accordance with Condition 9.1, moneys received (following service of an Issuer Acceleration Notice) by the Representative from the Issuer or any administrator, administrative or other receiver, manager or other similar officer appointed in relation to the Issuer
Exchange Date	On or after the date which is 40 days after a Temporary Covered Bond is issued
Exchange Event	The meaning given on page 63
Excluded Indebtedness	The meaning given in Condition 3
Excluded Scheduled Interest Amounts	The meaning given in the definition of Scheduled Interest
Excluded Scheduled Principal Amounts	The meaning given in the definition of Scheduled Principal
Existing Covered Bonds	In accordance with Condition 6.8, the Covered Bonds of all Series then outstanding
Extraordinary Resolution	A resolution of the Covered Bondholders passed as such under the terms of the Representative and Agency Agreement
FBA	Icelandic Investment Bank
Final Maturity Date	The Interest Payment Date on which the Covered Bonds will be redeemed at the Final Redemption Amount in accordance with the Terms and Conditions
Final Redemption Amount	The meaning given in the Pricing Terms
First Assignment Date	The date on which the Initial Portfolio was assigned to the Fund pursuant to the Mortgage Sale Agreement
FME	The meaning given on the cover page
Following Business Day Convention	The meaning given in Condition 4.4(b)(ii)
Foreign Exchange Act	The Act on Foreign Exchange no. 87/1992, as amended

Foreign Exchange Rules	Rules on Foreign Exchange no. 1082 of 28 November 2008
FSMA	Financial Services and Markets Act 2000, as amended
Fund	Arion Bank Mortgages Institutional Investor Fund
Fund Acceleration Notice	The meaning given in Condition 9.2
Fund Accounts	The GIC Account and any additional or replacement accounts opened in the name of the Fund
Fund Deed	The deed entered into on 20 January 2012 between the Fund, the Seller and the Representative (as amended and/or supplemented and/or restated from time to time)
Fund Event of Default	The meaning given in Condition 9.2
Fund Payment Date	The 15th day of each month or if not a Business Day the next following Business Day
FX	Foreign exchange
GIC Account	The account in the name of the Fund held with Arion Bank hf. and maintained subject to the terms of the Guaranteed Investment Contract and the Bank Account Agreement or such additional or replacement account as may for the time being be in place with the prior consent of the Representative and designated as such
GIC Provider	Arion Bank hf., in its capacity as GIC provider or any successor GIC provider appointed from time to time
Global Covered Bond	A Temporary Global Covered Bond and/or a Permanent Global Covered Bond, as the context may require
Government Entities	The meaning given in Condition 3
Group	The Issuer and its Subsidiaries
Guaranteed Amounts	Prior to service of a Fund Acceleration Notice, with respect to any Due for Payment Date, the sum of Scheduled Interest and Scheduled Principal, in each case, payable on that Due for Payment Date, or after service of a Fund Acceleration Notice, an amount equal to the relevant Early Redemption Amount as specified in the Terms and Conditions plus all accrued and unpaid interest and all other amounts due and payable in respect of the Covered Bonds, including all Excluded Scheduled Interest Amounts, all Excluded Scheduled Principal Amounts (whenever the same arose) and all amounts payable by the Fund under the Representative and Agency Agreement
Guaranteed Amounts Due Date	The later of: (a) the date which is two Business Days following service of a Notice to Pay on the Fund; and (b) the date on which the Guaranteed Amounts are otherwise Due for Payment
Guaranteed Investment Contract or GIC	The guaranteed investment contract entered into on 20 January 2012 between the Fund, the GIC Provider, the

	Representative and the Cash Manager (as amended and/or supplemented and/or restated from time to time)
Guarantee Priority of Payments	The meaning given on page 163
Holder	A holder of unit shares issued by the Fund
holder of Covered Bonds	Any person who holds the Covered Bonds, even if the amount held is only nominal
ICAAP	The Bank's internal capital adequacy process
ICPH	The Bank's internal control and procedure handbook
Inflation Linked Annuity Covered Bonds	Covered Bonds that pay an Annuity Amount on such dates as agreed between the Issuer and the Dealer
Initial Portfolio	The Portfolio of Loans and their Related Security assigned to the Fund on the First Assignment Date pursuant to the terms of the Mortgage Sale Agreement, as replaced by the Mortgage Sale Agreement
Insolvency Event	<p>In respect of the Seller, the Servicer, the Custody Agent or the Cash Manager:</p> <ul style="list-style-type: none"> (a) an order is made by any competent court or an effective resolution passed for the liquidation or winding up or dissolution of the relevant entity except for the purposes of a reconstruction, amalgamation or merger or following the transfer of all or substantially all of the assets of the relevant entity, the terms of which have been approved by an Extraordinary Resolution of the Covered Bondholders; or (b) the relevant entity ceases or threatens to cease to carry on the whole or a substantial part of its business, save for the purposes of reorganisation on terms approved by an Extraordinary Resolution of the Covered Bondholders or for the purposes of a reconstruction, amalgamation or merger between the Issuer and the relevant entity or following the transfer of all or substantially all of the assets of the Issuer to the relevant entity or of the relevant entity to the Issuer, or the relevant entity stops or threatens to stop payment of, or is unable to, or admits inability to, pay, its debts (or any class of its debts) as they fall due, or is deemed unable to pay its debts pursuant to or for the purposes of any applicable law, or is adjudicated or found bankrupt or insolvent; or (c) an encumbrancer takes possession or a receiver, administrator, administrative receiver or other similar officer is appointed to the whole or any material part of the undertaking, property or assets of the relevant entity, or a distress, diligence or execution or other process is levied, enforced upon, sued out or put in force against the whole or any material part of the chattels or property of the relevant entity and, in the

case of the foregoing events, is not discharged within 30 days

Intercompany Loan Agreement	The term loan agreement entered into on 20 January 2012 between the Issuer, the Fund, the Cash Manager and the Representative (as amended and/or supplemented and/or restated from time to time)
Interest Commencement Date	In the case of the Covered Bonds, the date specified in the Pricing Terms from (and including) which the Covered Bonds will accrue interest
Interest Payment Dates	The Interest Payment Dates specified in the Pricing Terms
Interest Period	In accordance with Condition 4.4(e), the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date
Investment Services Directive	Directive 93/22/EC
Investor's Currency	The currency or currency unit that an investor's financial activities are denominated in, other than the Specified Currency
Investor Report	The monthly report made available to the Covered Bondholders and the Representative detailing, <i>inter alia</i> , compliance with the Asset Coverage Test
ISK or krónur	The lawful currency of Iceland
Issue Date	Each date on which the Issuer has issued Covered Bonds, as specified in the Pricing Terms
Issue Price	The price, generally expressed as a percentage of the nominal amount of the Covered Bonds, at which the Covered Bonds have been issued
Issuer	Arion Bank hf.
Issuer Acceleration Notice	The meaning given in Condition 9.1
Issuer Call	If specified as applicable in the Pricing Terms, the provision by which the Issuer may redeem a Series of Covered Bonds in accordance with Condition 7.3
Issuer Event of Default	The meaning given in Condition 9.1
IT	Information technology
Kaupskil	Kaupskil ehf.
Kaupthing	Kaupthing Bank hf.
Landey	Landey ehf.
Landfestar	Landfestar ehf.
Ledger	Each of the Revenue Ledger, the Reserve Ledger, the Unit Account Ledger and the Payment Ledger

Legislative Exchange	The meaning given in Condition 6.8
Lending Criteria	The lending criteria of the Seller from time to time, or such other criteria as would be acceptable to a Reasonable, Prudent Mortgage Lender
LIBOR	London inter-bank offered rate
Covered Bond	The meaning given on page 1
Loan	Each mortgage loan referenced by its mortgage loan identifier number and comprising the aggregate of all principal sums, interest, costs, charges, expenses and other moneys due or owing with respect to that mortgage loan under the relevant Mortgage Terms by a borrower on the security of a Mortgage from time to time outstanding or, as the context may require, the borrower's obligations in respect of the same
Loan Repurchase Notice	A notice in substantially the form set out in the Mortgage Sale Agreement served by the Fund on the Seller in relation to the repurchase of Loans in the Portfolio by the Seller in accordance with the terms of the Mortgage Sale Agreement
LTV	Loan-to-value
M&A	Mergers and acquisitions
Management Company	Stefnir hf. or such other management company appointed pursuant to the Fund's Articles of Association
Master Definitions and Construction Agreement	The master definitions and construction agreement entered into on 20 January 2012 between the parties to the Transaction Documents (as amended and/or supplemented and/or restated time to time)
from	
Maximum Redemption Amount	The amount specified as such in the Pricing Terms
Member State	A state which is a member of the European Economic Area
MiFID	Markets in Financial Instruments Directive
Minimum Redemption Amount	The amount specified as such in the Pricing Terms
Monthly Asset Coverage Report	The report substantially in the form set out in Schedule 3 to the Cash Management Agreement
Monthly Payment	The amount which the relevant Mortgage Terms require a Borrower to pay on each Monthly Payment Day in respect of that Borrower's Loan
Monthly Payment Day	The date on which the Monthly Payment is due to be paid by a Borrower on a Loan or, if any such day is not a Business Day, the next following Business Day
Mortgage	The legal charge, mortgage, standard security or charge securing a Loan
Mortgage Conditions	The terms and conditions applicable to the Loans as contained in the Seller's Standard Documentation

Mortgage Document	The document evidencing the Mortgage
Mortgage Pool	The mortgages owned from time to time by the Fund
Mortgage Sale Agreement	The mortgage sale agreement entered into on 20 January 2012 between the Seller, the Fund and the Representative (as amended and/or supplemented and/or restated from time to time) and, where the context so requires, including any New Mortgage Sale Agreement entered into from time to time between any New Seller, the Fund and the Representative
Mortgage Terms	All of the terms and conditions applicable to a Loan, including, without limitation, the applicable Mortgage Conditions
NASDAQ OMX Iceland	NASDAQ OMX Iceland hf. The Icelandic Stock Exchange
New Covered Bonds	The meaning given in Condition 6.8
New Loan	Loans which the Seller may assign or transfer to the Fund pursuant to the Mortgage Sale Agreement
New Mortgage Sale Agreement	Any new mortgage sale agreement entered into between any New Seller, the Fund and the Representative (as amended and/or supplemented and/or restated from time to time), which shall be substantially in the same form and contain substantially the same provisions as the Mortgage Sale Agreement
New Portfolio	Each portfolio of Loans and their Related Security (other than any Loans and their Related Security which have been redeemed in full prior to the relevant Assignment Date or which do not otherwise comply with the terms of the Mortgage Sale Agreement as at the relevant Assignment Date), particulars of which are set out in the relevant New Portfolio Notice or in a document stored upon electronic media (including, but not limited to, a CD-Rom).
New Portfolio Notice	A notice in the form set out in the Mortgage Sale Agreement served in accordance with the terms of the Mortgage Sale Agreement
New Seller	Any entity that accedes to the relevant Transaction Documents and sells New Seller Loans and their Related Security to the Fund in the future pursuant to a New Mortgage Sale Agreement
New Seller Loans	Loans originated by a New Seller
Notice to Pay	The meaning given in Condition 9.1
Optional Redemption Amount	The meaning (if any) given in the Pricing Terms
Optional Redemption Date	The meaning (if any) given in the Pricing Terms
Outstanding Principal Balance	In relation to a Loan at any date, the aggregate of any amounts advanced to a Borrower and any interest or expenses owed by a Borrower less any prepayment, repayment or payment of the foregoing made on or prior to the determination date

Partial Portfolio	Part of any portfolio of Selected Loans
Paying Agents	The Principal Paying Agent and any other paying agent appointed pursuant to the terms of the Representative and Agency Agreement
Payment Day	The meaning given in Condition 5.6
Payment Ledger	The ledger on the GIC Account of such name maintained by the Cash Manager pursuant to the Cash Management Agreement to record the credits and debits of Available Receipts and for application in accordance with the relevant Priority of Payments
Permanent Global Covered Bond	The meaning given in the section entitled ' <i>Form of the Covered Bonds</i> '
Permitted Security Interest	The meaning given in Condition 3
Portfolio	Each New Portfolio acquired by the Fund but excluding Loans which have been redeemed in full or repurchased by the Seller or a New Seller or otherwise sold by the Fund
Post-Enforcement Priority of Payments	The meaning given on page 164
Potential Fund Event of Default	The meaning given in Condition 14
Potential Issuer Event of Default	The meaning given in Condition 14
Pricing Supplements	The pricing supplements prepared with respect to the Covered Bonds at the time of issuance thereof
Pricing Terms	The pricing information applicable to the Covered Bonds and summarising the provisions of the Pricing Supplement applicable to the Covered Bonds
Principal Amount Outstanding	In accordance with Condition 4.4(f), in respect of a Covered Bond on any day, the principal amount of that Covered Bond on the relevant Issue Date thereof less principal amounts received by the relevant Covered Bondholder in respect thereof on or prior to that day
Principal Paying Agent	Deutsche Bank AG, London Branch, and any successor principal paying agent
Principal Subsidiary	The meaning given in Condition 9.1
Priorities of Payments	The orders of priority for the allocation and distribution of amounts standing to the credit of the Fund Accounts in different circumstances
Property	A residential property in Iceland which is subject to a Mortgage
Prospectus Directive	Directive 2003/71/EC, as amended
Prospectus	The Prospectus
Purchaser	Any third party or the Seller to whom the Fund offers to sell Selected Loans

Rate of Interest	In respect of the Covered Bonds, the rate of interest payable from time to time in respect of such Covered Bonds determined in accordance with the Terms and Conditions and the Pricing Terms
Reasonable, Prudent Mortgage Lender	A lender acting within the policy applied by the Seller and/or the Servicer, as applicable, from time to time to the originating, underwriting and servicing of mortgage loans beneficially owned by the Seller outside the Mortgage Pool
Receiptholders	The holders of the Receipts
Receipts	Receipts for the payment of instalments of principal and indexation amounts (other than the final instalment) attached on issue to Definitive Covered Bonds repayable in instalments
Redeemed Covered Bonds	The meaning given in Condition 6.2
Regulation S	Regulation S under the Securities Act
Related Security	In relation to a Loan, the security for the repayment of that Loan including the relevant Mortgage and all other matters applicable thereto acquired as part of the Portfolio
Relevant Date	The meaning given in Condition 8
Relevant Implementation Date	The meaning given on page 171
Relevant Member State	The meaning given on page 171
Relevant Indebtedness	The meaning given in Condition 3
Representative	Deutsche Trustee Company Limited, in its capacity as representative of the Covered Bondholders together with any successor appointed from time to time under the Representative and Agency Agreement
Representative and Agency Agreement	The representative and agency agreement dated 20 January 2012 and made between the Issuer, the Fund, the Representative, the Principal Paying Agent and the other Paying Agents (as amended and/or supplemented and/or restated from time to time)
Representations and Warranties	The representations and warranties set out in the Mortgage Sale Agreement
Required Amount	An amount equal to the ISK Equivalent of the interest due on the Listed Covered Bonds for X months together with an amount equal to one-quarter of the anticipated aggregate annual amount payable in respect of the items specified in paragraphs (a) to (b) of the Pre Acceleration Priority of Payments plus ISK 10,000,000 or such higher amount as Arion Bank hf. shall direct the Fund from time to time
	where,
	X = the number of months between the Interest Payment Dates in relation to the Covered Bonds

Required Outstanding Principal Balance Amount	The meaning given on page 155
Required Redemption Amount	The meaning given on page 155
Reserve Fund	The reserve fund that the Fund will be required to establish on the GIC Account which will be credited with Available Receipts up to an amount equal to the Reserve Fund Required Amount and any Cash Equity Contributions made to the Fund by the Seller which the Seller directs the Fund to credit thereto
Reserve Ledger	The ledger on the GIC Account of such name maintained by the Cash Manager pursuant to the Cash Management Agreement, to record the crediting of Revenue Receipts and (if so directed by the Seller) Cash Equity Contributions to the Reserve Fund and the debiting of such Reserve Fund in accordance with the terms of the Fund Deed
Reserved Matter	<p>In relation to the Covered Bonds:</p> <ul style="list-style-type: none"> (a) reduction or cancellation of the amount payable or, where applicable, modification of the method of calculating the amount payable or modification of the date of payment or, where applicable, modification of the method of calculating the date of payment in respect of any principal or interest in respect of the Covered Bonds other than in accordance with the terms thereof; (b) alteration of the currency in which payments under the Covered Bonds, Receipts and Coupons are to be made; (c) alteration of the quorum or majority required to pass an Extraordinary Resolution; (d) any amendment to the Covered Bond Guarantee (except in a manner determined by the Representative not to be materially prejudicial to the interests of the Covered Bondholders of any Series or an amendment which is in the sole opinion of the Representative of a formal, minor or technical nature or to correct a manifest error or an error which is, in the sole opinion of the Representative, proven or is to comply with mandatory provisions of law); (e) the sanctioning of any such scheme or proposal for the exchange or sale of the Covered Bonds or the conversion of the Covered Bonds into, or the cancellation of the Covered Bonds in consideration of, shares, stock, covered bonds, bonds, debentures, debenture stock and/or other obligations and/or securities of the Issuer or any other company formed or to be formed, or for or into or in consideration of cash, or partly for or into or in consideration of such shares, stock, bonds, covered bonds, debentures, debenture stock and/or other obligations and/or

securities as aforesaid and partly for or into or in consideration of cash; and

- (f) alteration of the proviso to paragraph 7 or paragraph 8 of Schedule 6 to the Representative and Agency Agreement

Responsible Persons

The Issuer and the Fund

Revenue Ledger

The ledger on the GIC Account of such name maintained by the Cash Manager pursuant to the Cash Management Agreement, to record credits and debits of Revenue Receipts in accordance with the terms of the Fund Deed

Revenue Receipts

Any payment received in respect of any Loan (otherwise than in respect of a Loan that has been repurchased by the Seller), whether as all or part of a Monthly Payment in respect of such Loan, on redemption (including partial redemption) of such Loan, on enforcement of such Loan (including the proceeds of sale of the relevant Property) or on the disposal of such Loan or otherwise

Rules

The Foreign Exchange Rules

RWA

Risk weighted assets

Scheduled Interest

In relation to the Covered Bonds, an amount equal to the amount in respect of interest which is or would have been due and payable under such Covered Bonds on each Interest Payment Date as specified in Condition 4, together with, in the case of Inflation Linked Annuity Covered Bonds, any indexation amount payable in respect of such interest in accordance with the provisions of the Pricing Terms (but excluding any additional amounts relating to premiums, default interest or interest upon interest (**Excluded Scheduled Interest Amounts**) payable by the Issuer following service of an Issuer Acceleration Notice, but including such amounts (whenever the same arose) following service of a Fund Acceleration Notice), as if such Covered Bonds had not become due and repayable prior to their Final Maturity Date or, where applicable, after the Final Maturity Date, such other amount of interest as may be specified in the Pricing Terms

Scheduled Payment Date

In relation to payments under the Covered Bond Guarantee in respect of the Covered Bonds, each Interest Payment Date or the Final Maturity Date as if such Covered Bonds had not become due and repayable prior to their Final Maturity Date

Scheduled Principal

In relation to a Series of Covered Bonds, an amount equal to the amount in respect of principal or other amount which is or would have been due and repayable under such Covered Bonds on each Interest Payment Date or the Final Maturity Date (as the case may be) as specified in Condition 6.1 and Condition 6.5 (but excluding any additional amounts relating to prepayments, early redemption, broken funding indemnities, penalties, premiums or default interest (**Excluded Scheduled Principal Amounts**) payable by the Issuer following service of an Issuer Acceleration Notice, but including such amounts

(whenever the same arose) following service of a Fund Acceleration Notice), as if such Covered Bonds had not become due and repayable prior to their Final Maturity Date

SEB	Skandinaviska Enskilda Banken AB (publ)
Securities Act	U.S. Securities Act of 1933, as amended
Security Interest	The meaning given in Condition 3
Selected Loan Offer Notice	A notice from the Fund served on the Seller offering to sell Selected Loans and their Related Security for an offer price equal to the greater of the then Outstanding Principal Balance of the Selected Loans and the Required Redemption Amount
Selected Loan Repurchase Notice	A notice from the Seller served on the Fund accepting an offer set out in a Selected Loan Offer Notice
Selected Loans	Loans and their Related Security to be sold by the Fund pursuant to the terms of the Fund Deed or the Mortgage Sale Agreement having in aggregate the Required Outstanding Principal Balance Amount
Selection Date	The meaning given in Condition 6.2
Seller	Arion Bank hf.
Seller's Policy	means the originating, underwriting, administration, arrears and enforcement policy applied by the Seller from time to time to Loans and their Related Security for their repayment which are owned by the Seller
Series	Covered Bonds which are (a) expressed to be consolidated and form a single series and (b) identical in all respects (including as to listing and admission to trading) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices
Servicer	Arion Bank hf. in its capacity as servicer under the Servicing Agreement (and any successor servicer)
Servicer Event of Default	The meaning given on page 149
Servicer Termination Event	The meaning given on page 149
Servicing and Custody Agreement	The servicing and custody agreement entered into on 20 January 2012 between the Fund, the Servicer and the Representative (as may be amended and/or supplemented and/or restated from time to time)
SMEs	Small and medium sized enterprises
Specified Asset	The meaning given in Condition 3
Specified Currency	ISK as agreed by the Issuer, the Dealer, the Principal Paying Agent and the Representative and specified in the Pricing Terms

Specified Denomination	In respect of of the Covered Bonds, the denomination or denominations of such Covered Bonds specified in the Pricing Terms
Standard Documentation	The standard documentation, annexed as an exhibit of the Mortgage Sale Agreement or any update or replacement therefor as the Seller may from time to time introduce acting in accordance with the standards of a Reasonable, Prudent Mortgage Lender
Stefnir	Stefnir hf.
Subsidiary	The meaning given in Condition 3
Substitution Assets	Each of: <ul style="list-style-type: none"> (a) ISK deposits, certificates of deposit, long term debt obligations and short term debt obligations (including commercial paper) provided that in all cases such investments have a remaining period to maturity of less than one month; (b) ISK deposits, certificates of deposit, long term debt obligations and short term debt obligations (including commercial paper) provided that in all cases such investments have a remaining period to maturity of one to three months; and (c) ISK deposits, certificates of deposit, long term debt obligations and short term debt obligations (including commercial paper) provided that in all cases such investments have a remaining period to maturity of longer than six months
sub-unit	The meaning given in Condition 4.4(g)
Surveillance and Court Agreement	The meaning given in <i>'Risk Factors relating to the Fund, including the ability of the Fund to fulfil its obligations in relation to the Covered Bond Guarantee - Existing currency restrictions – Icelandic rules on foreign exchange'</i>
Talons	Talons for further Coupons in respect of interest-bearing Definitive Covered Bonds
TARGET System	The meaning given in Condition 4.4(a)(ii)
Tax Jurisdiction	The meaning given in Condition 7
Temporary Global Covered Bond	A temporary global covered bond without receipts and interest coupons attached initially representing each tranche of Covered Bonds, unless otherwise specified in the Pricing Terms
Term Advance	Each term advance made by the Issuer to the Fund from the proceeds of Covered Bonds pursuant to the Intercompany Loan Agreement
Terms and Conditions or Conditions	The terms and conditions of the Covered Bonds (as set out in Schedule 1 to the Representative and Agency Agreement)

Third Party Amounts	Amounts under a direct debit which are repaid to the bank making the payment if such a bank is unable to recoup that amount itself from the customer's account or payments by Borrowers of any fee due to the Seller which amounts shall be payable on receipt by the Fund to the Seller from moneys on deposit in the GIC Account.
Transaction Documents	The following documents (and each a Transaction Document): <ul style="list-style-type: none"> (a) Mortgage Sale Agreement; (b) Servicing Agreement; (c) Asset Monitor Agreement; (d) Intercompany Loan Agreement; (e) Fund Deed; (f) Cash Management Agreement; (g) Guaranteed Investment Contract; (h) Bank Account Agreement; (i) Representative and Agency Agreement; (j) the Pricing Terms(as applicable in the case of each issue of Covered Bonds subscribed for pursuant to a subscription agreement); (l) each Subscription Agreement (as applicable in the case of each issue of Covered Bonds subscribed for pursuant to a subscription agreement); and (m) Master Definitions and Construction Agreement
Treaty	The Treaty establishing the European Community, as amended
Unit Account Ledger	The ledger maintained by the Cash Manager on behalf of the Fund in respect of each Holder to record the balance of each Holder's Equity Contributions from time to time
Unit Distribution	Any return on a Holder's Equity Contribution in accordance with the terms of the Fund Deed
Valitor	Valitor Holding hf.
Valuation Report	The valuation report or reports for mortgage purposes, in the form of the pro-forma report contained in the Standard Documentation, obtained by the Seller from a Valuer in respect of each Property or a valuation report in respect of a valuation of a Property made using a methodology which would be acceptable to a Reasonable, Prudent Mortgage Lender
Valuer	An entity registered as a real estate broker in accordance with Icelandic laws and regulations and having the relevant insurance policy in place.

Wages Index

The wages index published monthly at www.staticice.is and based on the data collected through the Statistics Iceland Icelandic survey on wages, earnings and labour costs (**ISWEL**), or such other index as may replace it from time to time, prepared and published by Statistics Iceland (or by any government department or successor body upon which duties in connection with such index are devolved) pursuant to the Act on the Wage Index No. 89/1989

Winding-Up Committee

Kaupthing Winding-Up Committee

30/360, 360/360 or Bond Basis

The meaning given in Condition 4.4(c)(vi)

€, Euro or euro

The currency introduced at the start of the third stage of European economic monetary union pursuant to the Treaty

THE ISSUER

Arion Bank hf.
Borgartun 19
105 Reykjavik
Iceland

THE FUND

Arion Bank Mortgages Institutional Investor Fund
Borgartun 19
105 Reykjavik
Iceland

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London EC2N 2DB
United Kingdom

PAYING AGENT

Arion Bank hf.
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105 Reykjavik
Iceland

REPRESENTATIVE

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FUND'S FINANCIAL STATEMENTS
PART 1
FUND'S 2013 FINANCIAL STATEMENTS

**Arion Bank Mortgages
Institutional Investor Fund**

Financial Statements 2013

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Endorsement and Signatures of the Board of Directors and the Managing Director

The Financial Statements of ABMIF are included in part B of the Financial Statements of Stefir hf. which contains the Financial Statements of UCITS, investment funds and institutional investors' funds under management. They have been prepared in accordance with law on Financial Statements and rules on the Financial Statements of management companies of UCITS set by the Icelandic Financial Supervisory Authority.

The fund reported profit of ISK 2,176 million according to the income statement and the profit is recognized as an increase in units in the fund's accounts. The net asset of the fund at the end of the period totalled ISK 43,450 million according to the balance sheet.

The Board of Directors and CEO of Stefir hf. hereby confirm the fund's Financial Statements for 2013 with their signatures.

Reykjavik, 11 March 2014

Board of Directors:

Skemur Rindal
Sigríður Ólafsson *Lára Bjarnell*
Jóhann L. Mjörv
Kjetill Rannsókn

CEO:

Elli Hauðsson

Independent Auditor's Report

To the unit holder of ABMIIF.

We have audited the accompanying financial statements of ABMIIF, which comprise the endorsement and statement by the board of directors and the managing director, income statements, balance sheet, changes in net assets, statement of investments and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Icelandic Annual Financial Statements Act, and for such internal control as management determines is necessary to enable the preparation of 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 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the 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 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 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 financial statements give a true and fair view of the financial position of ABMIIF as at 31 December 2013, and of its financial performance and changes in net assets for the year then ended in accordance with the Icelandic Financial Statements Act and Rules on the Financial Statements of management companies of UCITS.

Reykjavik, 11 March 2014



Margrét Pétursdóttir
State Authorized Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Income Statement 2013

	Notes	2013	2012
Financial income and (expenses)	4-6		
Interests, indexation, dividends and currency exchange rate difference		11.956	11.103
Interest expense		(9.669)	(10.639)
Reversal of impairment on loans	8	64	1.377
Net financial income		2.351	1.841
 Operating expenses			
Administration fee	7	173	169
Other operating expenses		2	11
		175	180
 Profit transferred to units		2.176	1.661

Balance Sheet at 31 december 2013

	Notes	2013	2012
Assets			
Securities with fixed income	8	118.493	119.945
Total investments		<u>118.493</u>	<u>119.945</u>
Foreclosed assets	9	104	501
Cash	10	47.015	52.661
Total other assets		<u>47.119</u>	<u>53.162</u>
Total assets		<u><u>165.612</u></u>	<u><u>173.107</u></u>
Liabilities			
Units	12	43.450	41.274
Loan from financial institutions	13	122.148	131.804
Liabilities with management- og custody company		14	29
Total other liabilities		<u>122.162</u>	<u>131.833</u>
Total liabilities		<u><u>165.612</u></u>	<u><u>173.107</u></u>
Net assets		43.450	41.274
Number of units		23.200	23.200
Exchange rate of units at the end of the year	12	<u>1,87</u>	<u>1,78</u>

Statement of Changes in Net Assets 2013

	Notes	2013	2012
Operating activities			
Profit transferred to units		2.176	1.661
Financing activities			
Units sold		0	23.000
		0	23.000
Changes in net assets		2.176	24.661
Net assets at the beginning of the year		41.274	16.613
Net assets at the end of the year	12	43.450	41.274

Investment Statement 2013

	Market value	Asset 2013 %	Asset 2012 %	Asset Change %	Investment policy Minimum %	Maximum %
Mortgages	118.493	100	100	0	0	100
Total assets	118.493	100	100	0		

Notes to the Financial Statements

Accounting methods

1. Basis of preparation

The purpose of the ABMIIF Fund is to invest in residential real estate loans from Arion Bank and its subsidiaries, in accordance with the terms of the issuance of Covered Bonds. And to guarantee the payment of all amounts due under any Covered Bonds issued by the Issuer under the Programme, subject to the term of the Covered Bond Guarantee.

2. Basis of preparation

The Financial Statements of Arion Bank Mortgages Institutional Investor Fund have been prepared in accordance with the Financial Statements Act and rules on the financial statements of management companies of UCITS set by the Icelandic Financial Supervisory Authority. They are prepared on the historical cost basis and according to the same accounting methods as last year. The Financial Statements have been prepared in Icelandic krónur (ISK) rounded to the nearest million. The fund is a part of Stefnir hf. which is a subsidiary of Arion Bank hf. The Financial Statements form part of the consolidated financial statements of Arion Bank hf.

3. Assessment and decisions

When preparing the financial statements, the management is required by the Annual Accounts Act to assess and make decisions on important components of the financial statements which are subjective by their nature. The assessment is based on experience and other relevant factors which are otherwise unavailable. Any changes according to this assessment are recognized during the period in which they occur.

4. Foreign currencies

Assets and liabilities in foreign currencies are translated into ISK at the exchange rate at year end, according to Reuter. Operating income and operating expenses in foreign currencies are translated at the exchange rate on the date of transaction. Foreign exchange difference related to translation of foreign assets is recognised in the income statement.

5. Indexed assets and liabilities

Indexed assets and liabilities are calculated on basis of indexes valid in January 2014. Accrued indexation on principal of assets and liabilities is recognised in the income statement.

6. Interest income and expenses

Interest income and expense are recognised in the income statement as they are incurred.

7. Administration fee

The fund pays Stefnir hf. administration fee which includes the following operating costs for the fund: salaries of employees of the management company, marketing costs and administration; included in the administration fee is a custody fee to Arion banki hf. Administration fees are 0.1% of the fund's total assets.

The fund also pays fees for official supervisory.

8. Securities with fixed income

- a. Mortgages are recognised with accrued interest and indexation at the end of the year. At the year end 54.2% of the fund's mortgages were calculated according to the index for mortgage payment adjustment.
- b. Because of circumstances following the fall of the Icelandic commercial banks in the fall 2008, banks and other financial institutions have taken actions to meet customer's debt conditions. Arion bank hf. offered late in the year 2009 ways for customers to adjust the principal of their debt to 110% of property market value. Customers were able to apply for this special resort until the 30th of June 2011. Provisions are done by a general provision and a special provision. Total provision for losses amounts to ISK 1,435 million, which of specific provision amounts to ISK 424 million and collective provision amounts to ISK 1,011 million. The provision account has been deducted from Securities with fixed income in the Balance sheet.

Notes, contd.:

8. Securities with fixed income, cont.

c. Mortgages are specified as:	2013	2012
Mortgages before impairment	119.928	121.527
Provision at the beginning of the year	(1.582)	(3.138)
Write-offs during the year	83	179
Reversal during the year	64	1.377
Mortgages at year end	118.493	119.945
Provision for losses as a ratio of total loans	1,20%	1,30%

9. Foreclosed assets

The fund has foreclosed real estate (residential property) following auctions of the relevant property to secure the fund's loans. These properties are valued by employees of Arion Bank. The valuation takes into account the condition and location of the property. The valuation is then reduced by 20% as a precautionary provision.

10. Cash

Cash consists of cash and deposits with credit institutions including accrued interests.

11. Taxation

The fund does not pay income tax; instead profit or loss from operations are taxed with the unit holders. Individuals pay capital gains tax on profits on their securities when redeemed. Profit and loss on unit shares owned by companies are treated as taxable income and expenses, regardless of redemption.

The fund is exempt from capital gains tax in Iceland but not in those countries where capital gains tax is imposed on income of foreign residents and when no double taxation agreement stating that such income should be taxed in Iceland exists between Iceland and the relevant country.

12. Units

a. Real return of the mutual fund ABMIIF as of 31 December 2013

	Return
Last 3 months	0,87%
Last 6 months	1,38%
Last 12 months	1,56%

b. Statement of book value and exchange rate of units.

	Book value	Exchange rate
31 December 2013	43.450	1,87
31 December 2012	41.274	1,78
31 December 2011	16.613	1,72

Notes, contd.:

13. Loan agreement

The fund and Arion banki hf. made Subordinated Intercompany Loan Agreements to finance the acquisition of the mortgages. The loan agreements are calculated taking into account accrued interest and the consumer price index. Interest on the loan agreements ranges from 3.75% - 4.00% p.a.

The fund's interest-bearing liabilities are:

Indexed loan agreements	122.148
-------------------------------	---------

Repayments on loan agreements at the end of the year are as follows:

Repayments 2014	2.265
Repayments 2015	2.352
Repayments 2016	2.443
Repayments 2017	2.537
Repayments 2018	2.636
Repayments later	109.915
	<u>122.148</u>

14. Segmentation of investments and proportional division

	Other ISK	%	Total ISK	%
Other financial instruments, mortgages	118.493	100	118.493	100
	<u>118.493</u>	<u>100</u>	<u>118.493</u>	<u>100</u>

In the case of any discrepancy between the English and the Icelandic texts, the Icelandic versions shall prevail and questions of interpretation will be addressed solely in the Icelandic language.

PART 2
FUND'S 2014 INTERIM FINANCIAL STATEMENTS

**Arion Bank Mortgages
Institutional Investor Fund**

Interim Financial Statements 30 June 2014

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Endorsement and Signatures of the Board of Directors and the Managing Director

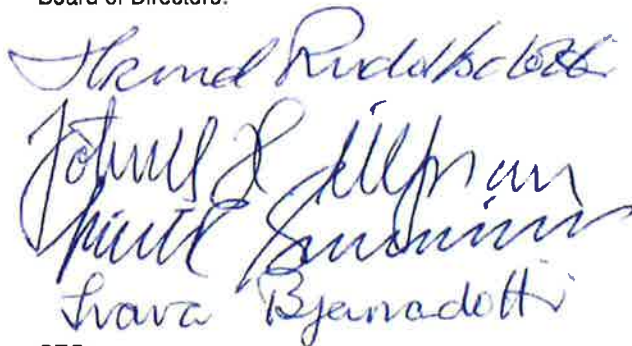
The Interim Financial Statements of ABMIF are included in part B of the Interim Financial Statements of Stefir hf. which contains the Interim Financial Statements of UCITS, investment funds and institutional investors' funds under management. They have been prepared in accordance with law on Financial Statements and rules on the Financial Statements of management companies of UCITS set by the Icelandic Financial Supervisory Authority.

The fund reported profit of ISK 1,263 million according to the income statement and the profit is recognized as an increase in units in the fund's accounts. The net asset of the fund at the end of the period totalled ISK 44,713 million according to the balance sheet.

The Board of Directors and CEO of Stefir hf. hereby confirm the fund's Interim Financial Statements for the period 1 January - 30 June 2014 with their signatures.

Reykjavik, 28 August 2014

Board of Directors:

Handwritten signatures of the Board of Directors: Haraldur Rúnaldsson, Johann S. Jónsson, Páll Gunnarsson, and Svara Bjarnadóttir.

CEO:

Handwritten signature of the CEO: Eldur Hauðarsson.

Report on review of interim financial statements

To the unit holder of ABMIF.

We have reviewed the accompanying interim financial statements of ABMIF for the 6 months ended 30 June 2014, which comprise the endorsement and statement by the board of directors and the managing director, income statements, balance sheet, changes in net assets, statement of investments and explanatory notes. Management is responsible for the preparation and presentation of these interim financial statements in accordance with Icelandic Financial Statements Act. Our responsibility is to express a conclusion on these interim financial statements based on our review.

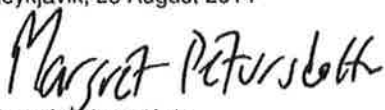
Scope of review

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

Conclusion

Based on our review nothing has come to our attention that causes us to believe that the accompanying Interim Financial Statements are not prepared, in all material respects, in accordance with Icelandic Financial Statements Act and Rules on the Financial Statements of management companies of UCITS.

Reykjavik, 28 August 2014



Margrét Pétursdóttir

State Authorized Public Accountant

Ernst & Young ehf.

Income Statement 1 January - 30 June 2014

	Notes	1.1. -30.06. 2014	1.1. -30.06. 2013
Financial Income and (expenses)	4-6		
Interests, indexation, dividends and currency exchange rate difference		4.946	6.603
Interest expense		(3.640)	(5.542)
Reversal of impairment on loans	8	42	60
Net financial income		1.348	1.121
 Operating expenses			
Administration fee	7	83	87
Other operating expenses		2	6
		85	93
 Profit transferred to units		1.263	1.028

Balance Sheet at 30 June 2014

	Notes	1.1. - 30.06. 2014	1.1. - 31.12 2013
Assets			
Securities with fixed income	8	117.354	118.493
Total investments		<u>117.354</u>	<u>118.493</u>
Foreclosed assets	9	52	104
Cash	10	49.673	47.015
Total other assets		<u>49.725</u>	<u>47.119</u>
Total assets		<u><u>167.079</u></u>	<u><u>165.612</u></u>
Liabilities			
Units	12	44.713	43.450
Loan from financial institutions	13	122.353	122.148
Liabilities with management- and custody company		13	14
Total other liabilities		<u>122.366</u>	<u>122.162</u>
Total liabilities		<u><u>167.079</u></u>	<u><u>165.612</u></u>
Net assets		44.713	43.450
Number of units		23.200	23.200
Exchange rate of units at the end of the period	12	1,93	1,87

Statement of Changes in Net Assets

1 January - 30 June 2014

	Notes	1.1. -30.06. 2014	1.1. -30.06. 2013
Operating activities			
Profit transferred to units		1.263	1.028
Financing activities			
Units sold		0	0
		0	0
Changes in net assets		1.263	1.028
Net assets at the beginning of the year		43.450	41.274
Net assets at the end of the period	12	44.713	42.302

Investment Statement 30 June 2014

	Market value	Asset 30.06.2014 %	Asset 31.12.2013 %	Asset Change %	Investment policy Minimum %	Maximum %
Mortgages	117.354	100	100	0	0	100
Total assets	117.354	100	100	0		

Notes to the Financial Statements

Accounting methods

1. Basis of preparation

The purpose of the ABMIIF Fund is to invest in residential real estate loans from Arion Bank and its subsidiaries, in accordance with the terms of the issuance of Covered Bonds. And to guarantee the payment of all amounts due under any Covered Bonds issued by the Issuer under the Programme, subject to the term of the Covered Bond Guarantee.

2. Basis of preparation

The Interim Financial Statements of Arion Bank Mortgages Institutional Investor Fund have been prepared in accordance with the Financial Statements Act and rules on the Financial Statements of management companies of UCITS set by the Icelandic Financial Supervisory Authority. They are prepared on the historical cost basis and according to the same accounting methods as last year. The Interim Financial Statements have been prepared in Icelandic krónur (ISK) rounded to the nearest million. The fund is a part of Stefnir hf. which is a subsidiary of Arion Bank hf. The Interim Financial Statements form part of the consolidated Interim Financial Statements of Arion Bank hf.

3. Assessment and decisions

When preparing the financial statements, the management is required by the Annual Accounts Act to assess and make decisions on important components of the financial statements which are subjective by their nature. The assessment is based on experience and other relevant factors which are otherwise unavailable. Any changes according to this assessment are recognized during the period in which they occur.

4. Foreign currencies

Assets and liabilities in foreign currencies are translated into ISK at the exchange rate at the end of June, according to Reuter. Operating income and operating expenses in foreign currencies are translated at the exchange rate on the date of transaction. Foreign exchange difference related to translation of foreign assets is recognised in the income statement.

5. Indexed assets and liabilities

Indexed assets and liabilities are calculated on basis of indexes valid in July 2014. Accrued indexation on principal of assets and liabilities is recognised in the income statement.

6. Interest income and expenses

Interest income and expense are recognised in the income statement as they are incurred.

7. Administration fee

The fund pays Stefnir hf. administration fee which includes the following operating costs for the fund: salaries of employees of the management company, marketing costs and administration; included in the administration fee is a custody fee to Arion banki hf. Administration fees are 0.1% of the fund's total assets.

The fund also pays fees for official supervisory.

8. Securities with fixed income

- a. Mortgages are recognised with accrued interest and indexation at the end of the June 2014. At the of June 53,7% of the fund's mortgages were calculated according to the index for mortgage payment adjustment.
- b. Because of circumstances following the fall of the Icelandic commercial banks in the fall 2008, banks and other financial institutions have taken actions to meet customer's debt conditions. Arion bank hf. offered late in the year 2009 ways for customers to adjust the principal of their debt to 110% of property market value. Customers were able to apply for this special resort until the 30th of June 2011. Provisions are done by a general provision and a special provision. Total provision for losses amounts to ISK 1,390 million, which of specific provision amounts to ISK 374 million and collective provision amounts to ISK 1,016 million. The provision account has been deducted from Securities with fixed income in the Balance sheet.

Notes, contd.:

8. Securities with fixed income, cont.

c. Mortgages are specified as:	30.06.2014	31.12.2013
Mortgages before impairment	118.744	119.928
Provision at the beginning of the year	(1.435)	(1.582)
Write-offs during the period	3	83
Reversal during the period	42	64
Mortgages at the end of the period	117.354	118.493
Provision for losses as a ratio of total loans	1,17%	1,20%

9. Foreclosed assets

The fund has foreclosed real estate (residential property) following auctions of the relevant property to secure the fund's loans. These properties are valued by employees of Arion Bank. The valuation takes into account the condition and location of the property. The valuation is then reduced by 20% as a precautionary provision.

10. Cash

Cash consists of cash and deposits with credit institutions including accrued interests.

11. Taxation

The fund does not pay income tax; instead profit or loss from operations are taxed with the unit holders. Individuals pay capital gains tax on profits on their securities when redeemed. Profit and loss on unit shares owned by companies are treated as taxable income and expenses, regardless of redemption.

The fund is exempt from capital gains tax in Iceland but not in those countries where capital gains tax is imposed on income of foreign residents and when no double taxation agreement stating that such income should be taxed in Iceland exists between Iceland and the relevant country.

12. Units

a. Real return of the mutual fund ABMIIF as of 30 June 2014

	Return
Last 3 months	0,66%
Last 6 months	1,78%
Last 12 months	3,19%

b. Statement of book value and exchange rate of units.

	Book value	Exchange rate
30 June 2014	44.713	1,93
31 December 2013	43.450	1,87
31 December 2012	41.274	1,78

Notes, contd.:

13. Loan agreement

The fund and Arion banki hf. made Subordinated Intercompany Loan Agreements to finance the acquisition of the mortgages. The loan agreements are calculated taking into account accrued interest and the consumer price index. Interest on the loan agreements ranges from 3.75% - 4.00% p.a.

The fund's interest-bearing liabilities are:

Indexed loan agreements	122.353
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Repayments on loan agreements at the end of the period are as follows:

Repayments 2014	2.181
Repayments 2015	2.378
Repayments 2016	2.470
Repayments 2017	2.565
Repayments 2018	2.665
Repayments later	110.094
	<u>122.353</u>

14. Segmentation of investments and proportional division

	Other ISK	%	Total ISK	%
Other financial instruments, mortgages	117.354	100	117.354	100
	<u>117.354</u>	<u>100</u>	<u>117.354</u>	<u>100</u>

In the case of any discrepancy between the English and the Icelandic texts, the Icelandic versions shall prevail and questions of interpretation will be addressed solely in the Icelandic language.