

**Arion Bank Mortgages
Institutional Investor Fund**
Financial Statements 2014

Contents

Endorsement and Signatures of the Board of Directors and the Managing Director	3
Independent Auditor's Report	4
Income Statement	5
Balance Sheet	6
Statement of Changes in Net Assets	7
Investment Statement	8
Notes	9

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 3,532 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 46,982 million according to the balance sheet.

The Board of Directors and CEO of Stefir hf. hereby confirm the fund's Financial Statements for the year 2014 with their signatures.

Reykjavik, 26 February 2015

Board of Directors:

Árni Þurðarsson

Lára Bjarnadóttir

Þórunn Þorvaldsson

CEO:

Jóhann L. Alfrann

Ólafur Þorvaldsson

Finnur Hauðsson

Independent Auditor's Report

To the unit holder of ABMIF.

We have audited the accompanying financial statements of ABMIF, 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 ABMIF as at 31 December 2014, 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, 26 February 2015



Margrét Pétursdóttir

State Authorized Public Accountant

Ernst & Young ehf.

Borgartúni 30

105 Reykjavík

Income Statement 2014

		2014	2013
Financial income and (expenses)	4-6		
Interests, indexation, dividends and currency exchange rate difference		8.255	11.956
Interest expense		(5.625)	(9.669)
Reversal of impairment on loans	8	1.067	64
Net financial income		3.697	2.351
 Operating expenses			
Administration fee	7	160	173
Other operating expenses		5	2
		165	175
 Profit transferred to units		3.532	2.176

Balance Sheet at 31 December 2014

	Notes	2014	2013
Assets			
Securities with fixed income	8	115.233	118.493
Total investments		<u>115.233</u>	<u>118.493</u>
Foreclosed assets	9	3	104
Cash	10	33.008	47.015
Total other assets		<u>33.011</u>	<u>47.119</u>
Total assets		<u><u>148.244</u></u>	<u><u>165.612</u></u>
Liabilities			
Units	12	46.982	43.450
Loan from financial institutions	13	101.250	122.148
Liabilities with management- and custody company		12	14
Total other liabilities		<u>101.262</u>	<u>122.162</u>
Total liabilities		<u><u>148.244</u></u>	<u><u>165.612</u></u>
Net assets		46.982	43.450
Number of units		23.200	23.200
Exchange rate of units at the end of the period	12	<u>2,03</u>	<u>1,87</u>

Statement of Changes in Net Assets 2014

	2014	2013
Operating activities		
Profit transferred to units	3.532	2.176
Financing activities		
Units sold	0	0
	0	0
Changes in net assets	3.532	2.176
Net assets at the beginning of the year	43.450	41.274
Net assets at the end of the period 12	46.982	43.450

Investment Statement 2014

	Market value	Asset 2014 %	Asset 2013 %	Asset Change %	Investment policy	
					Minimum %	Maximum %
Mortgages	115.233	100	100	0	0	100
Total assets	115.233	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 Stefir 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 the end of December 2014, 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 2015. 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 Stefir 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 2014. At the end of the year 52,8% 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 365 million, which of specific provision amounts to ISK 197 million and collective provision amounts to ISK 168 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:	2014	2013
Mortgages before impairment	115.598	119.928
Provision at the beginning of the year	(1.435)	(1.582)
Write-offs during the period	3	83
Reversal during the period	1.067	64
Mortgages at the end of the period	115.233	118.493
Provision for losses as a ratio of total loans	0,32%	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 31 December 2014

	Return
Last 3 months	2,97%
Last 6 months	5,15%
Last 12 months	7,02%

b. Statement of book value and exchange rate of units.

	Book value	Exchange rate
31 December 2014	46.982	2,03
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	101.250
Repayments on loan agreements at the end of the period are as follows:	
Repayments 2015	2.860
Repayments 2016	2.098
Repayments 2017	2.178
Repayments 2018	2.261
Repayments 2019	2.348
Repayments later	89.505
	<u>101.250</u>

14. Segmentation of investments and proportional division

	Other ISK	%	Total ISK	%
Other financial instruments, mortgages	115.233	100	115.233	100
	<u>115.233</u>	<u>100</u>	<u>115.233</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.