ANNUAL REPORT 2011

Íslandsbanki

Contents

1 Financial highlights

Income statement

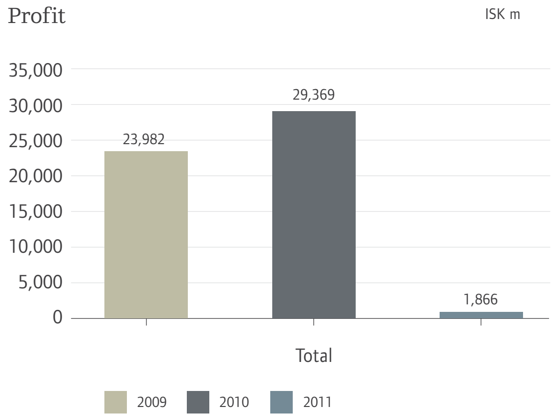
ISK m	2011	2010
Net interest income	31,225	34,874
Net valuation changes	(1,220)	13,993
Net fee and commission income	5,966	7,380
Other net operating income	4,480	(687)
Total operating income	40,451	55,560
Administrative expenses	(19,870)	(17,866)
Impairment of goodwill	(17,873)	-
Contribution to the Depositors' and Investors' Guarantee Fund	(965)	(607)
Share of profit of associates	39	-
Profit before tax	1,782	37,087
Income tax	(75)	(7,214)
Bank tax	(682)	(221)
Profit for the year from continuing operations	1,025	29,652
Profit (loss) from discontinued operations, net of income tax	841	(283)
Profit for the year	**1,866**	**29,369**

Financial position and key figures

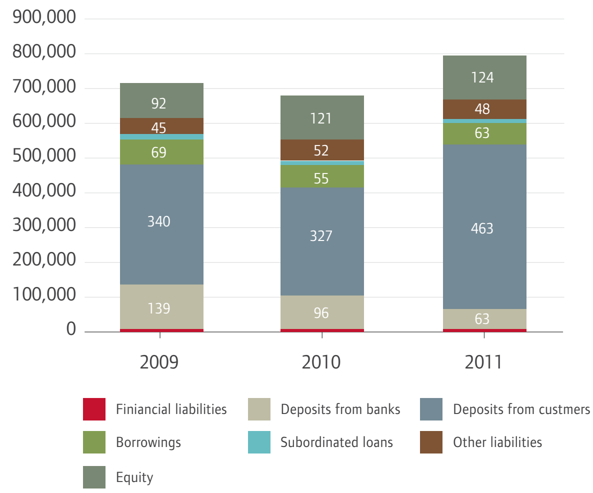
ISK m	2011	2010
Total assets	795,915	683,222
Total loans to customers and credit institutions	608,049	546,031
Total deposits	525,788	423,396
Equity	123,703	121,463

Key ratios		
Return on equity	1.5%	28.5%
Core cost/income ratio	56.0%	43.7%
Net interest margin	4.5%	5.0%
Tier 1 ratio	19.1%	22.6%
Total capital ratio	22.6%	26.6%
Total deposit/loan ratio	86.5%	77.5%
Customer deposit/loan ratio	82.0%	63.5%
Employees (yearly average) - consolidated	1,344	1,080
Employees (yearly average) - parent	1,003	933

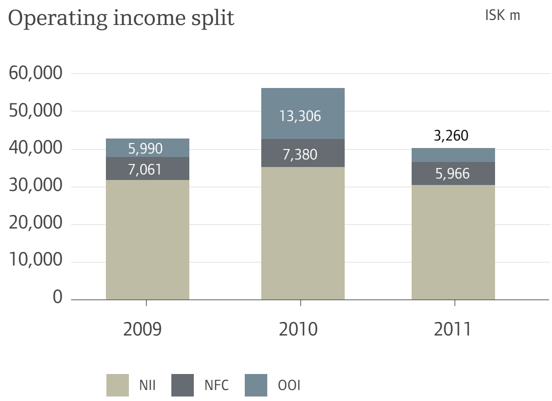
Profit



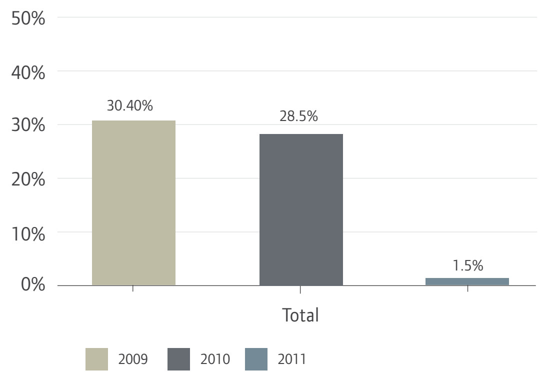
Total liabilities and equity



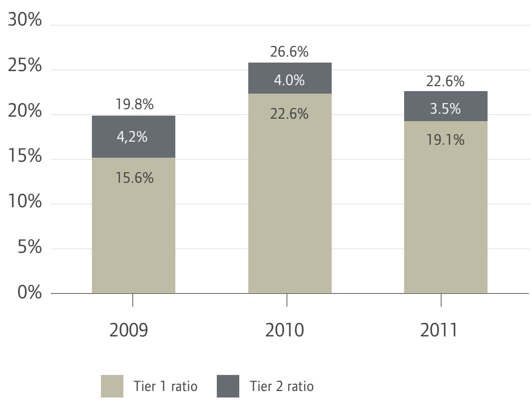
Operating income split



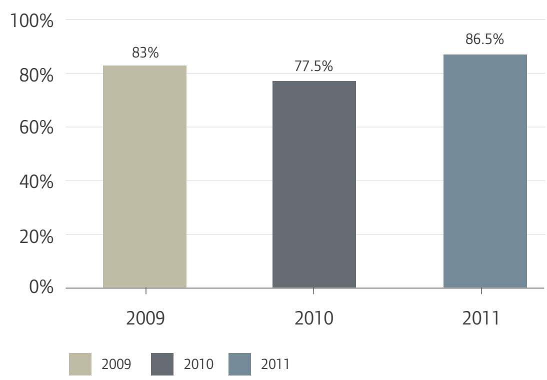
Return on equity



Capital ratios



Total deposit/loan ratio



2 Chairman's statement

Íslandsbanki has undergone sweeping changes since its foundation in the Autumn of 2008. It has been gratifying to see the ambitious work which has taken place in this time. The Bank's Board has been an active participant in this process along with management and staff.

Fridrik Sophusson

Healthy core operations in a challenging environment

2011 saw the Bank's core operations grow stronger and reach more of a balance. Its strong capital position has enabled it to operate securely in the tumultuous external environment we have seen over the past years, a period which will hopefully soon be behind us. Íslandsbanki's acquisition of all the outstanding equity in Byr increases the merged Bank's efficiency and improves its service to customers even further. The merger was, moreover, an important step in consolidating and creating a more efficient financial sector in Iceland. Íslandsbanki made a further major contribution to the resurrection of the Icelandic capital markets when in December it issued a covered bond, thus becoming the first bank to issue listed securities in Iceland since the 2008 collapse.

Essential tasks lie ahead

Although the Icelandic economy and the business environment have improved since the collapse, Icelandic companies and authorities still face tasks they cannot shy away from. It is of supreme importance that the Central Bank and the Icelandic authorities introduce a realistic and transparent plan on how to lift capital controls and execute it as soon as possible. While there is no denying that the controls give support to short term stability, it is also quite clear that in the longer term they do more harm than good. The danger is that Icelandic companies operating internationally will simply give up on their operations in Iceland and move them overseas. What is more, the controls are detrimental to the foreign direct investment so desperately needed in Iceland.

Íslandsbanki has worked hard at restructuring the finances of households and companies alike in the past three years. If we measure cumulative debt relief as a ratio of the Bank's initial loan portfolio it stands at around 17% for the corporate portfolio and 26% for loans to individuals. However, some uncertainties surrounding the validity of certain loans still remain which delay further the necessary and urgent task of rebuilding the economy.

The framework for taxation of Icelandic financial institutions has changed greatly over the past three years. While there is an urgent need for increased tax revenues in wake of the financial collapse of 2008 it is important that Icelandic authorities be careful not to overburden financial institutions with domestic taxes which are not consonant with international tax regimes. The burden of new taxes and levies will ultimately be borne by the banks' customers and will impede the rebuilding process.

Good governance and rebuilding of trust

Demands made of board of directors, not least those working for financial institutions, have increased greatly in the past years. Íslandsbanki´s Board of Directors has in the past year placed emphasis on improving the Bank's governance structure. Among the projects initiated as part of this effort is the detailed mapping of the decision making process within the Bank. The objective is to ensure that systems and processes are in place that minimise risk, support sound business practices, and that the Bank's governance is on a par with international best practice.

Comprehensive changes have also been implemented to the regulatory framework of the Icelandic financial sector. Oversight has been strengthened and budget contributions to regulatory bodies have been substantially increased. It is important to monitor closely the developments in the regulation of international financial markets and to make sure that the Icelandic regime is aligned accordingly.

One of the most important tasks facing the financial sector is regaining the trust of the public, corporate sector and international investor community. This is obviously a long term project which will only be achieved over time through arduous work and dedication. All of Íslandsbanki's work is centred on providing excellent service to customers of all classes and thereby building a long term business relationship. For this reason it was particularly pleasing to learn that the Bank's customers are the most satisfied of any financial institution in Iceland.

Íslandsbanki's ownership

Íslandsbanki is 95% owned by ISB Holding ehf., an independent holding company, with the remaining 5% held by the Icelandic Government. The majority of Bank's Directors are independent from its owners and were selected due to their expertise and wide experience of international financial markets and management. Íslandsbanki´s owners have no influence on the Bank's daily operations but have always been supportive and understanding of decisions made with respect to the many tasks needing resolution. As has been publicly declared, the current ownership structure is not to remain a permanent one. The Bank's owners, its Board of Directors and management have retained advisors to examine the possibilities of domestic as well as international investors joining the Bank's shareholder base. This work is well underway. It is nonetheless clear that the continued turmoil in international capital markets will delay Íslandsbanki´s change of ownership.

Human resources

The Board has in past years enjoyed a fruitful co-operation with a vast number of the Bank's employees. We welcome the new addition of Byr employees who joined the Bank through the banks' recent merger. The Bank's employees have faced many challenges in the years following the collapse, especially so for our customer-facing people who have performed remarkably, often in difficult circumstances. Surveys nonetheless show job satisfaction and morale to be high at the Bank. It has been rewarding to see how employees have approached their work in a positive and professional manner.

Íslandsbanki in society

Íslandsbanki wants to make a positive impact on the society it operates in. The Bank sees itself as a valuable contributor to the national creation of value. Íslandsbanki wants to support its customers, be they households or companies. The Bank's corporate social responsibility policy is predicated on the Bank's sustainability in the widest sense of that word. Only by being sustainable can the Bank ultimately give back to society. Íslandsbanki has in the past year supported a number of worthwhile causes around the country.

A strong and dynamic business sector is the key to economic recovery

The rebuilding of a vibrant business sector is vital for growth and prosperity to resume. The Icelandic authorities need to secure stability and help to remove the current suspicion of investments, which are vital for the creation of new jobs. Economic growth rooted mostly in private consumption is not sustainable. Íslandsbanki has been a leading force in the recovery and is committed to continue to be so in the future.

Fridrik Sophusson, Chairman of the Board

2.2 Corporate governance

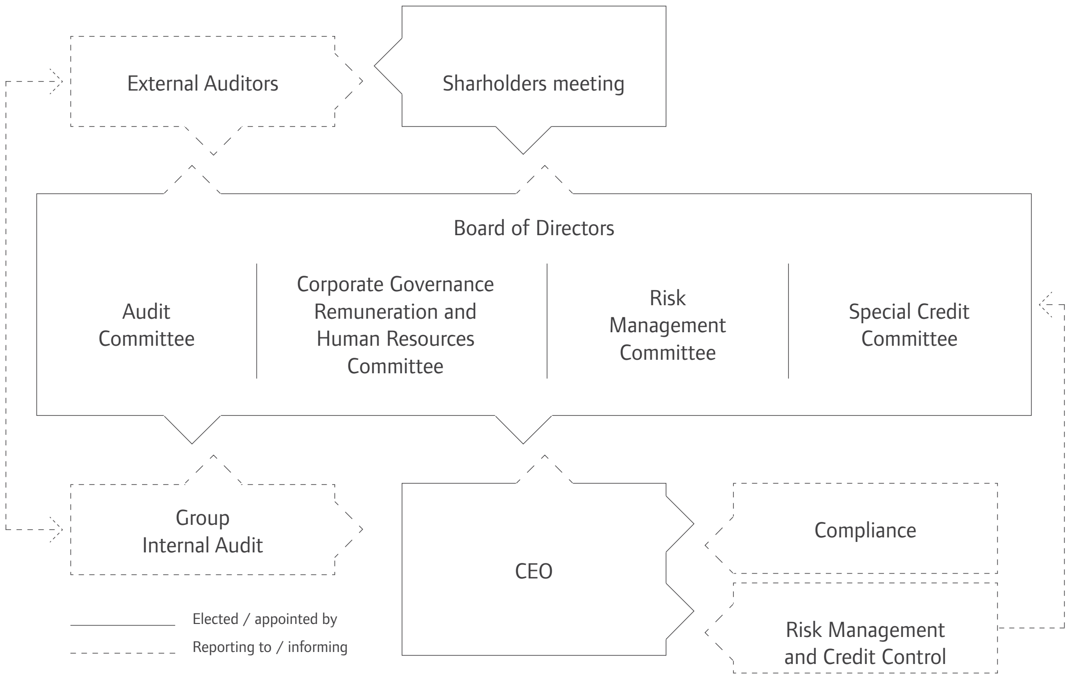
A clear governance framework enhances accountability, supports good management and aids the progress of responsible value creation.

Corporate governance at Íslandsbanki follows generally adopted principles of corporate governance as regulated by external governing bodies, laws and policies. These include the Icelandic Companies Act, the Financial Undertakings Act, the NASDAQ OMX Iceland Rules and the Guidelines on Corporate Governance as issued by the Iceland Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers (the Guidelines).

The management and control of Íslandsbanki is divided between the shareholders, the Board of Directors and the Chief Executive Officer (CEO) in accordance with the external framework described above, as well as the Bank's Articles of Association and other instructions laid down by the Board.

Shareholders' meetings

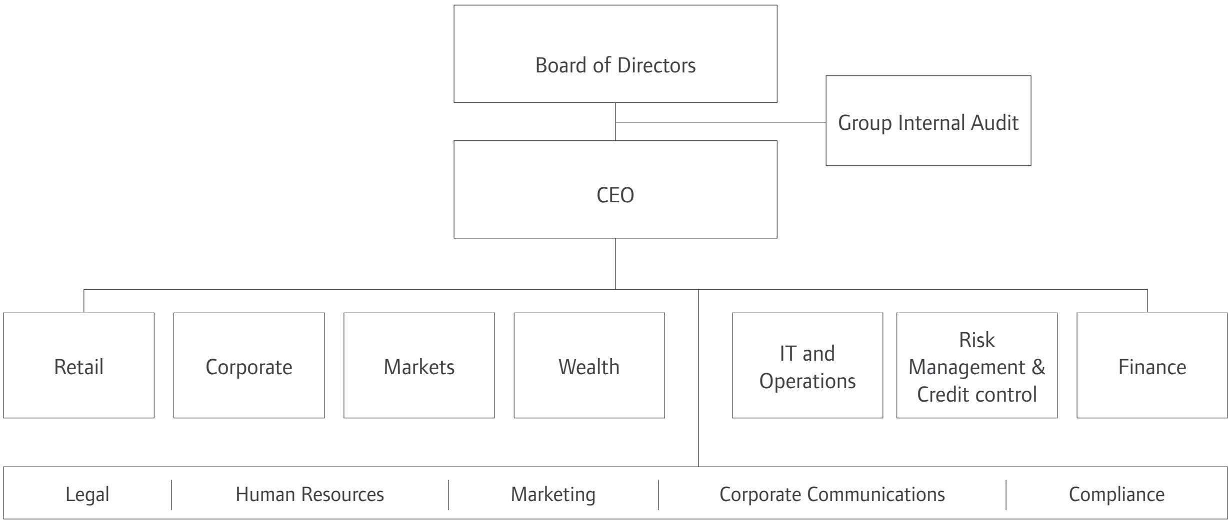
Under statutory law and the Bank's Articles of Association, shareholders have supreme authority in all matters relating to the affairs of the Bank. The Annual General Meeting (AGM) must be held every year before the end of April. At the AGM, shareholders shall make decisions on the Bank's activities and the conduct of its business in the upcoming year. This includes the election of the Board of Directors and an auditing firm, approval of the Bank's annual accounts for the preceding fiscal year, approval of the Bank's remuneration policy as well as any amendments to the Articles of Association, when necessary, and declaration of dividends.



Íslandsbanki corporate governance structure

External framework
Laws, regulation, the Guidelines, NASDAQ OMX Iceland rules.

Internal framework
Articles of Association, rules of procedure, Code of Ethics, instructions, guidelines and corporate values.



Íslandsbanki's organisational chart

Shareholders' meetings may be attended by shareholders, or their proxies, and advisors. Each share carries one vote at shareholders' meetings. Decisions at shareholders' meetings are made by a majority vote, except as otherwise provided in the Bank's Articles of Association or statutory law.

The AGM is held in Reykjavík. For the minutes of the AGM see www.islandsbanki.is

Articles of Association

Íslandsbanki's Articles of Association (the Articles) regulate the Bank's internal affairs and management. The Articles contain provisions on the name of the Bank, its share capital, shareholders' meetings, elections to the Board of Directors and the responsibilities and duties of the Board and CEO.

Board of Directors

The Board of Directors comprises seven members and an equal number of alternates, elected at the AGM for a term of one year. No specific retirement age is set for Íslandsbanki's board members nor is there a limit on how long a board member may serve on the Board.

Board members of entities regulated by the Financial Supervisory Authority - Iceland (FME) must undergo an independent assessment of their eligibility. The process was implemented by the FME in order to advance monitoring of compliance with rules on the eligibility of Board Members and – no less importantly – to make them aware of the required level of knowledge and the responsibility that goes with their post. For this purpose the FME has appointed an advisory committee which summons each Board Member to a hearing on matters relating to their knowledge and viewpoints regarding the business activities of the Bank as well as their responsibilities as Members of the Bank's Board[1]. All of Íslandsbanki's Board Members have completed this assessment. Information on current Board Members can be found in chapter 2.3.

Íslandsbanki's Board of Directors constitutes the supreme authority of the Bank between shareholders' meetings, except as otherwise provided in the Bank's Articles. The Board is charged with the organisation and monitoring of Íslandsbanki´s operations, affairs, disbursement of funds and general financial position in accordance with the external and internal frameworks. The work of the Board includes but is not limited to:

- Approving the main aspects of the Bank's organisational structure.
- Appointing one or more Bank managers (CEOs)

[1] More detailed information available on the FME's website http://www.fme.is/lisalib/getfile.aspx?itemid=7127

- Appointing the Chief Audit Executive
- Deciding which employees are authorised to commit Íslandsbanki, and establish rules governing such empowerment
- Approval of risk policies on material risks, in consultation with the CEO
- Approving final write-offs of the Bank's assets and loans
- Laying out and monitoring the Bank's risk management framework, and deciding on the Bank's risk appetite
- Ultimate responsibility for internal control
- Addressing any other business provided for, at any time, in the Financial Undertakings Act or the Companies Act
- Submitting proposals to the AGM on the disposal of earnings

In 2011 the Board of Directors held 19 meetings. In addition to the duties laid out above, the Board, furthermore reviewed or signed off on issues in 2012 such as the Bank's five-year business plan, the Bank's Internal Capital Adequacy Assessment Process (ICAAP) report and remuneration issues.

Chairman of the Board

The Chairman of the Board is elected at a shareholders' meeting. The Board elects the Vice-Chairman from amongst its members. The Chairman organises and leads the Board's work and convenes board meetings. This includes maintaining regular contact with the CEO, ensuring that the Board receives sufficient information and documentation and making sure that the Board completes the mandatory self-assessment of its work on an annual basis.

In addition to the regularly planned board meetings, a board meeting must also be held if requested by a member of the Board or the CEO. Any resolution submitted to a board meeting requires the majority of votes to pass. Such resolutions are binding for the Bank.

Chief Executive Officer

The Chief Executive Officer (CEO) is appointed by the Bank's Board of Directors and is responsible for the daily operations of the Bank pursuant to the policy and resolutions of the Board of Directors. It is also the task of the CEO to ensure that the Bank's operations are at all times consistent with the Bank's Articles and applicable laws.

Sub-committees of the Board of Directors

In accordance with the Rules of Procedures issued by the Board of Directors, the Board has appointed separate working committees, whose members are all Directors of the Board. These are the: Audit Committee, Corporate Governance, Remuneration and Human Resources Committee, Risk Management Committee and the Special Credit Committee. Each committee reports on its work and communicates to the Board.

The Board Audit Committee

The Audit Committee assists the Board of Directors in monitoring the Bank's accounting process and reviewing significant accounting and financial reporting issues, the effectiveness of the Bank´s internal control and risk management systems as well as compliance. Other responsibilities include:

- Evaluation of management reporting on financial matters
- Proposing to the Board of Directors on the selection of external auditors, assessing their independence and other tasks auditors may undertake
- Monitoring auditing of the annual financial statements and consolidated financial statements
- Reviewing audit plans, activities, staffing and organisation of Group Internal Audit
- Reviewing audit reports and significant audit findings and recommendations
- Reviewing the effectiveness of the system to monitor compliance with law and regulations and any findings related to non-compliance
- Assessing if the financial statements are in accordance with information known to Committee members and reflect appropriate accounting standards
- Other matters delegated by the Board of Directors to the Committee.

The Board Audit Committee comprises three Directors.

The Board Corporate Governance, Remuneration and Human Resources Committee

The Corporate Governance, Remuneration and Human Resources Committee is responsible for assisting the Board in setting corporate objectives and providing oversight of the relationships between the Bank's management and the Board, the shareholders and other stakeholders, with the aim of ensuring accountability. The Committee also assists the Board in assessing the effectiveness of the Directors. Other responsibilities include:

- Preparing clear lines of responsibility and accountability
- Preparing guidelines to ensure proper oversight by senior management
- Assisting the Board in strategic objectives and corporate values
- Providing general guidance and policy on the salary and other remuneration and benefits and terms and conditions of employment of employees, the appointment or dismissal of the CEO and any employee share-based remuneration schemes
- Advising the Board on the most effective deployment of the Bank's human resources.

The Board's Corporate Governance, Remuneration and Human Resources committee comprises four Directors.

The Board Risk Management Committee

The Risk Management committee is responsible for reviewing the risk management methods used by Management in the conduct of the Bank's operations, and proposing to the Board a description of material risks facing the Bank. The Committee makes proposals to the Board of Directors on inter alia:

- Risk appetite
- Internal Capital Adequacy Assessment Process (ICAAP)
- Financial targets relevant for risk management
- Authorisation limits by risk grade for credit decisions
- Limits on holdings in own shares
- Limits on large exposures
- Limits on currency, liquidity and interest rate risks
- The use of risk measurements in the pricing of credit
- Guidelines on limits on maximum credit exposure to a single borrower by risk class, and the pricing of credit

The Board's Risk Management Committee comprises three Directors.

The Board Special Credit Committee

The Special Credit Committee handles and makes proposals to the Board on credit cases that entail customer credit limits or write-offs that exceed the authorisation limits of the Bank's internal Risk Committee. Other responsibilities include:

- Reviewing the Bank's credit policy
- Providing oversight of the Bank's debt restructuring framework and implementation

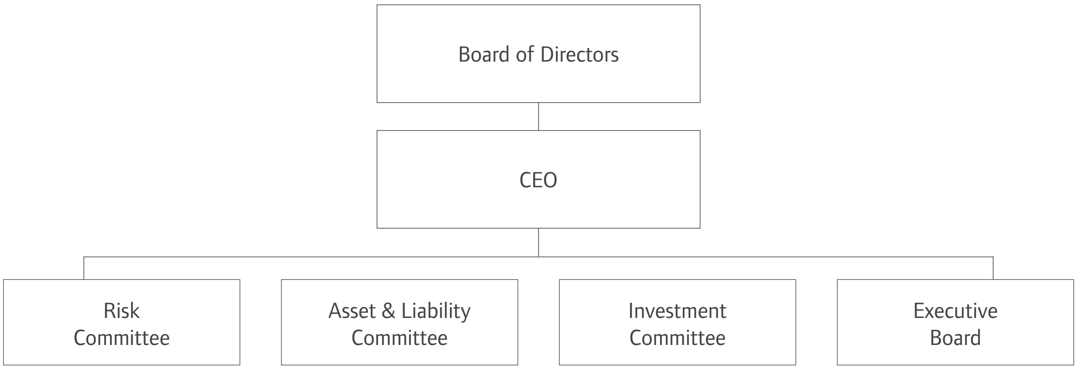
The Board Special Credit Committee comprises four Directors.

Risk Management Committee structure

The implementation of the risk management framework, limit setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee, Investment Committee and the Executive Board. The Board of Directors has granted authority to these committees to issue specific guidelines and targets regarding acceptable risk limits and to decide on individual positions. The members of these committees are appointed by the CEO and their mandate letters and work procedures are approved by the Board.

Risk Committee

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks at a consolidated level. The Risk Committee governs the Bank's Credit Risk Policy and other credit rules and procedures.
The Risk Committee can delegate authorisation power to subcommittees and decides on credit authorisation limits to individuals.
The Risk Committee and each of its subcommittees



Risk committee structure

have the authority to decide on credit proposals, credit risk and counterparty credit risk within defined limits. Decisions on exposures that exceed committee limits shall be referred to a more senior committee. In turn, credit decisions exceeding the limits of the Risk Committee need to be referred to the Board for confirmation. The Risk Committee is also responsible for approving products and services according to a formal product approval process within the Bank.

Asset and liability committee

The Asset and Liability Committee (ALCO) supervises other financial risks, including market risk, liquidity risk and interest rate risk in the banking book (non-trading portfolio). ALCO decides on and sets limits for these risks and governs the Bank's Market Risk Policy and Liquidity Risk Policy. ALCO also oversees the Bank's capital allocation framework and transfer pricing mechanism.

Investment committee

The Investment Committee makes decisions pertaining to the purchase or sale of equity stakes in companies as well as other types of investments such as investment funds and real estate.

Executive board

The Executive Board is responsible for the operational risk framework on consolidated level. The operational risk framework covers how operational risk is identified, assessed, measured, monitored, controlled and mitigated at the Bank. In addition, the Executive Board supervises reputational risk, business risk and strategic risk. The Executive Board governs the Bank's Operational Risk Policy.

Risk Report

Íslandsbanki publishes a comprehensive Risk Report together with the Annual Report. The Risk Report provides additional information about the Bank's risk management framework, capital structure and adequacy, material risk exposures and risk assessment processes. The Risk Report is available on the Bank's website.

Group Audit

Internal Audit

Group Internal Audit provides Íslandsbanki with independent, objective assurance and consulting services designed to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of risk management, controls and governance processes. Furthermore, Group Internal Audit leads internal investigations on alleged fraud. The scope of Group Internal Audit's work is to determine whether the organisation's network of risk management, control, and governance processes, as designed and represented by management, is adequate and functioning and robust enough to ensure:

- Risks are appropriately identified and managed
- Legislative or regulatory issues are recognised and addressed appropriately
- Employees' actions are in compliance with

policies, standards, procedures, and applicable laws and regulations
- Programmes and plans are completed and objectives are met
- Quality and continuous improvement are fostered in the Bank's control process
- Significant financial, managerial, and operating information is accurate, reliable, and timely
- Resources, including outsourced activities, are acquired economically, used efficiently and adequately protected

The Chief Audit Executive is appointed by and reports directly to the Board, and directs Internal Audit with a mandate from the Board. The Chief Audit Executive is responsible for Internal Audit within the Íslandsbanki group, i.e. both within the Bank and its subsidiaries, including tasks which have been outsourced. Group Internal Audit is not responsible for internal control or for its implementation.

External Audit

As stipulated by the Articles and the Act on Financial Undertakings, the Bank's external auditing firm shall be elected at the Annual General Meeting for a term of five years. At the AGM in March 2010, Deloitte hf. (Deloitte) was elected to serve as Íslandsbanki's independent external auditing firm. Deloitte is a state authorised public accountancy firm and a separate legal entity forming a part of the network of member firms of Deloitte Touche Tohmatsu.

Compliance

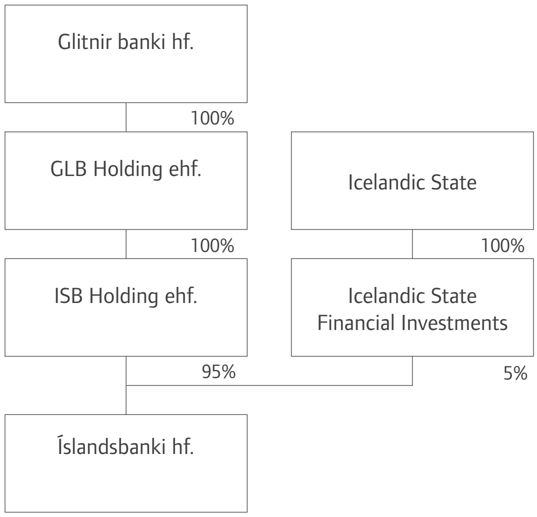
Íslandsbanki's Compliance Officer is appointed by the CEO and has an independent position in the Bank's organisational chart. The appointment must be confirmed by the Board of Directors and the division has a mandate letter from the Board. Íslandsbanki is obligated to operate a compliance unit according to its operating license as a financial undertaking which offers trading and other services relating to financial instruments and as an issuer of listed securities. The Compliance division's task is to monitor that Íslandsbanki maintains adequate policies and procedures to ensure that the Board and employees of the Bank comply with its obligations according to law, regulations and internal policies and operate in accordance with proper and sound business practices and customs on the financial market. The Compliance Officer files reports on an annual basis to the CEO and to the Board of Íslandsbanki.

Compliance risk can be defined as the risk of legal or regulatory sanctions, financial loss, or damage to the Bank's reputation in the event of failure to comply with applicable law, regulations, and codes of conduct and standards of good practice. Compliance, in co-operation with Group Internal Audit, performs a special fit and proper test by virtue of information gathering via questionnaires and exams on Executive Board Members and key employees. Amongst other things, Compliance monitors:

- That the Bank complies with law, regulations and internal policies concerning investor protection
- Trading of qualifying holdings by owners, management and employees
- Separation of operating divisions' systems (Chinese walls)
- Lists of insiders of Íslandsbanki
- Transactions by primary insiders involving the Bank's financial instruments
- Handling and use of insider information regarding Íslandsbanki
- Complaints from clients concerning alleged infringements and maintenance of personal records
- Anti-money laundering procedures and compliance
- The policy of Íslandsbanki on conflict of interests
- Employee participation in management and business operations.
- The handling of notices from employees regarding suspicion of market abuse
- The dissemination of information on the division's work and findings to the Bank's Board and employees

Ownership structure

Íslandsbanki is in the majority ownership of Glitnir banki hf. which, on behalf of creditors, holds 95% of the Bank's shares through its subsidiaries. The remaining 5% is held by the Icelandic Government and is managed by Icelandic State Financial Investments.



Íslandsbanki's ownership structure

2.3 Board of Directors

Fridrik Sophusson

Fridrik Sophusson (b. 1943)
Chairman of the Board

An Icelandic national, Fridrik Sophusson has nearly forty years of wide-ranging experience in fiscal policy making, management and public service in Iceland. Elected to Parliament in 1978, he served as a Member of Parliament for a period of twenty years, being Minister of Industry and Energy from 1987 - 1988 and Minister of Finance from 1991 - 1998. Most recently, he was CEO of Landsvirkjun ltd., the Icelandic National Power Company from 1999 - 2009. He has further served as a board director for a number of Icelandic and international companies.

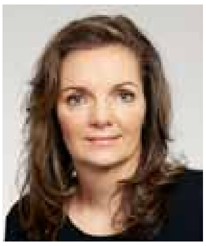
Mr Sophusson holds a cand. jur. degree in law from the University of Iceland.

Árni Tómasson

Árni Tómasson (b. 1955)
Board Director

An Icelandic national, Árni Tómasson started his accounting career in 1979 and has worked in bank and financial institution auditing since 1985. He was partner and later chairman of Deloitte Iceland until 2001. He was CEO of Búnaðarbankinn (later merged with Kaupthing) from 2001 – 2003, and has extensive experience in consultancy as well as teaching at Icelandic universities. In 2008, he was appointed chairman of Glitnir's Resolution Committee and served in that capacity until October 2011. He continues to represent ISB Holding on Íslandsbanki's Board of Directors.

Mr Tómasson has a cand. oecon. degree in business administration from the University of Iceland and is a State Authorised Public Accountant.



Kolbrún Jónsdóttir

Kolbrún Jónsdóttir (b.1962)
Board Director

An Icelandic national, Kolbrún Jónsdóttir was appointed to the Board of Directors in 2010 as a representative of the Icelandic State Financial Investments. She was Managing Director of Finance for VÍS Insurance from 2008– 2010. She worked at Íslandsbanki from 1996–2008, both as Branch Manager in the Reykjavík area and as the Head of Back Office. Prior to that, she was Managing Director of Finance for the home improvement and construction retailer Húsasmidjan.

Ms Jónsdóttir has completed an executive education programme from Kenan-Flagler Business School at the University of North Carolina at Chapel Hill and holds a cand. oecon. degree in business administration from the University of Iceland.

Neil Graeme Brown

Neil Graeme Brown (b. 1959)
Board Director

A British national, Neil Graeme Brown has an extensive experience in finance and restructuring of international companies. With 20 years of experience in international private equity, he is an expert in US and European M&A markets and has listed companies on the London, AIM and Nasdaq markets. He has held a number of positions, including head of buyouts and financial services at Apax Partners, and partner at Coopers & Lybrand (now PwC). He has a broad board experience and serves as a board member for a number of international companies.

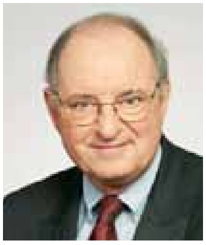
Mr Brown holds an MA degree in business from Emmanuel College Cambridge and is an associate of the Institute of Chartered Accountants (ACA).

Marianne Økland

Marianne Økland (b. 1962)
Board Director

A Norwegian national, Marianne Økland is the Managing Director of Avista Partners, a London based consulting firm specialising in advisory and capital raising. She has spent most of her career in banking, dealing with debt financing in various positions at JP Morgan and UBS. In particular, she worked for their respective Capital Markets divisions focusing on Nordic Debt Origination and Structuring. She is also an experienced consultant from her time with Marsoft Limited, a Boston, Oslo and London based consulting firm specialising in shipping investments.

Ms Økland holds an MSc degree in finance and economics from the Norwegian School of Economics and Business Administration, where she also worked as a researcher and taught mathematics.



John E. Mack

John E. Mack (b. 1947)
Vice-chairman of the Board

A US national, John E. Mack has extensive experience in international banking, M&A, and the development of best-practice in corporate governance. He was Corporate Executive Officer and CFO of Shinsei Bank in Tokyo from 2002–2005 where he managed the bank's Global IPO. Prior to that, he spent 27 years working for Bank of America (BoA) and its affiliates, most recently as a funding executive for the parent company. He has specific experience in corporate work-outs and problem loans through his former role as Director of Strategic Solutions, Inc., a majority-owned subsidiary of BoA.

Mr Mack holds an MBA degree from the University of Virginia, Darden School of Business and an undergraduate degree in economics from Davidson College.

Dr. Daniel Levin

Dr. Daniel Levin (b. 1963)
Board Director

A US and Swiss national, Daniel Levin has broad experience of governance, finance and capital markets. He is a member of the Board of the Liechtenstein Foundation for State Governance and has advised governments and development agencies globally in the development of financial and capital markets. His work further involves consulting on the implementation of ethical and corporate governance standards for financial institutions. He has been actively involved in numerous financial legislation and parliamentary initiatives and has represented corporate and sovereign issuers and borrowers in the US capital markets. He regularly lectures at universities and conferences on his areas of expertise.

Dr. Levin holds a lic.iur. (J.D.) and a Dr.iur. (J.S.D./Ph.D.) degree from the faculty of Law of the University of Zürich, Switzerland, and an LLM degree from Columbia University School of Law.

3 CEO's review

2011 was another important year for Íslandsbanki where we prioritised the financial restructuring of customers. Moreover, we realigned the Bank's business divisions, positioning them to meet increased competition while providing the best service.

Birna Einarsdóttir

Íslandsbanki has, by involving its employees and customers, set itself clear and ambitious goals for the future. The Bank's annual Strategy Summits have played a key part in this respect serving as a venue for lively discussions and for the exchanging of ideas, thus helping us to continue the task of rebuilding the Bank.

Financial Restructuring

We turned a corner in the financial restructuring effort this year. At Íslandsbanki, around 20,000 individuals and corporates have received some form of debt forgiveness totalling ISK 340 billion. These numbers represent ordinary people who in the past three years have found themselves in extraordinary circumstances. We have conducted this work to exacting standards of professionalism so as to safeguard the valued business relationship we enjoy with our customers.

The Bank completed several large corporate restructuring projects, including that of the leading oil and retailer N1, which represents one of the Bank's single biggest cases.

At the beginning of last year I declared that 2011 would be the year of restructuring and 2012 would mark the turnaround. While uncertainties still linger, I remain optimistic and contend that 2012 will be the year where all the hard work of the past three years will start to pay off.

The year of integration and consolidation

The merger of Íslandsbanki and Byr contributed greatly to the sector's increased efficiency. Integration has gone well, the two banks' harmonious corporate cultures being a key component. Merging two of the country's biggest banks was indeed a challenge and we are grateful for our customers' patience and positive attitude. With this merger, we have achieved our desired market position, to operate the country's most efficient branch network with 21 branches.

Financial markets starting to pick up

Íslandsbanki became the first bank since the 2008 collapse to list securities on the Nasdaq OMX Iceland and in so doing contributed greatly to the restoration of the Icelandic capital market. Íslandsbanki is also actively preparing to diversify its international funding efforts and maintains good relations with its foreign relationship banks. While we remain committed to support our customers in need of foreign financing it is clear that the turbulence in international credit markets will delay this process.

The restoration of capital markets will only be expedited through the operation of dynamic investment banks. We need to diversify investment opportunities to the benefit of investors and companies alike. Íslandsbanki promises to continue its good efforts to that end.

Well positioned for growth and increased competition

Noteworthy changes were implemented to business segments in 2011. In February, Íslandsbanki's Wealth Management resumed the name VÍB, putting itself at a clearer arm's length distance from the Bank's other divisions. With a more independent voice in the public arena, VÍB has carved out a unique position for itself in offering customers an ambitious educational programme.

In July, the Bank's asset-based financing unit was rebranded to Ergo. The exercise has been a success resulting in increased business by appealing to a broader group of customers. Ergo is currently the market leader in financing commercial equipment for companies as well as vehicles for individuals.

During the year, Íslandsbanki acquired all the shares in Kreditkort hf., the issuer of American Express and Master Card in Iceland. The objective of the acquisition was to support the Bank's credit card strategy and increase efficiency.

Íslandsbanki has long supported research within the geothermal and seafood sectors and is a founding member of both the Icelandic Seafood and Geothermal Clusters. The Bank's US subsidiary, Glacier Securities, specialising in M&A advisory to companies in these sectors, was granted a broker/dealer license from the US regulator FINRA last spring.

Number 1 in Service

Íslandsbanki's vision is to be #1 in service. Through arduous work we recently reached a major milestone when Íslandsbanki ranked first in customer satisfaction measured by the Icelandic Customer Satisfaction Index. Moreover, surveys indicate that Íslandsbanki is the market leader in servicing corporates giving the Bank good ground to build on. Íslandsbanki has always prided itself of providing excellent service and one of Byr's core competences was also personal service. The merged Bank should therefore be well prepared to realise its vision.

Strong foundations

The financial crisis taught us the need for banks to have effective and appropriate internal control measures built on top of a strong infrastructure. Íslandsbanki has significantly strengthened the Bank's infrastructure, preparing it to handle external shocks. To that end a comprehensive IT Policy was approved at Board level, an electronic Quality Assurance Manual was issued and operational risk was further mitigated through the financial restructuring of the Bank's loan portfolio.

In a bid to increase transparency and trust in the Bank's operations, Íslandsbanki, ahead of the other Icelandic banks, issued a specific Risk Report detailing its risk profile and material operational risk factors. The objective is not only to fulfil information disclosure requirements, but also to facilitate understanding of the Bank's operations and capital position.

Ready for the next round

The rebuilding of Íslandsbanki has progressed well. The many projects mentioned above have significantly strengthened the Bank's operations and its ability to meet increased competition. The Bank's balance sheet is sound, a fact which has allowed us to operate effectively in the ever-changing circumstances in which we find ourselves.

Íslandsbanki´s operational platform has been purposely strengthened during the past three years giving us a solid ground to support the much needed rebuilding effort that lies ahead. As soon as the economy picks up, financial institutions need to be ready and able to support and facilitate the necessary progress of the business sector. Íslandsbanki is well prepared for this responsibility and it will rise up to meet the high expectations that the sector holds of it.

Birna Einarsdóttir, CEO of Íslandsbanki

4 Economic review 2011

Now, three years onwards from the collapse of Iceland's main banks, growth has replaced contraction in the Icelandic economy. Unemployment is decreasing and the economic standing of households and corporates is gradually improving.

The turn-around started in mid-year 2010 and has gained further momentum in the following quarters. The rather high level of growth is mainly driven by investment, consumption and exports. Increased purchasing power, lowering unemployment, historically low real interest rates and the financial restructuring of households and companies has facilitated private consumption and investment. Furthermore, the low real exchange rate of the Icelandic Krona (ISK) accompanied with high commodity prices has strengthened the position of the export sector. The solid results of export companies have a spill-over effect onto other sectors of the economy, especially those servicing them.

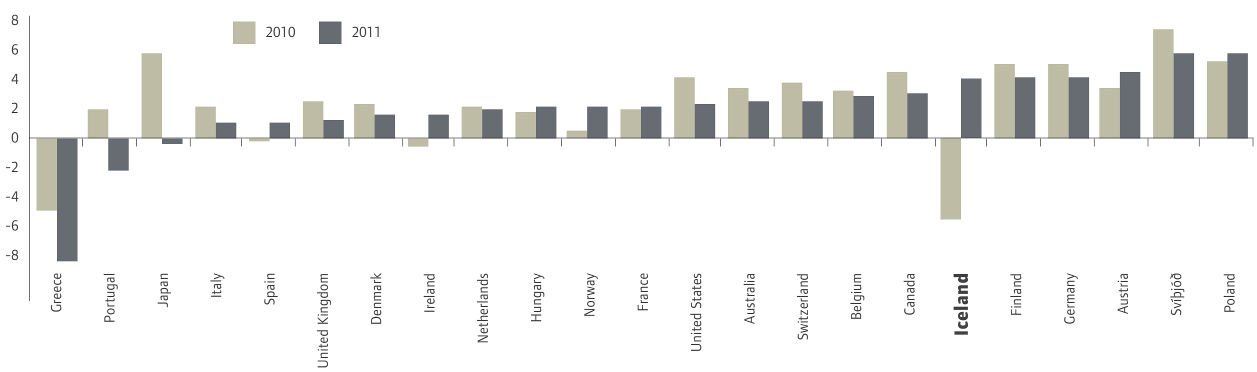
A fragile recovery

The recovery however, is fragile. It is taking place in the context of capital controls and in the face of substantial systemic challenges that are yet to be remedied. The level of indebtedness of households and companies is still high making them more susceptible to shocks which acts to diminish the strength of the recovery. Unemployment is still at levels historically high for Iceland. The sovereign debt crisis taking root in Europe and other countries outside the continent impacts Iceland's foreign currency revenues, foreign direct investment as well as the country's holdings of foreign assets and access to international capital markets.

Growth driven by domestic demand

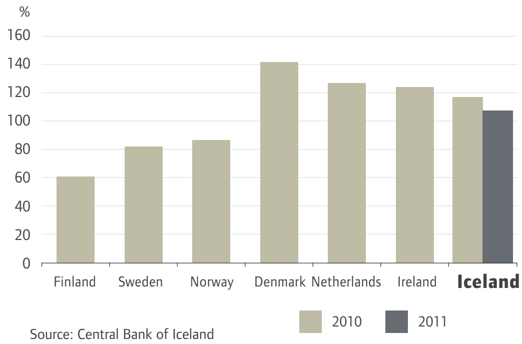
A turn-around has been reached in investment following substantial contraction in the past years. Nonetheless, the level of investment in the economy is still very low both by historical as well as international comparison. Investments in the energy sector are starting to come through as well as several smaller projects in the export sector. The largest part of the growth seen in the past quarters has however been fuelled by private consumption. What makes this situation different from other similar periods in Iceland's history is that this consumption is being financed by savings and a modest increase in purchasing power, and not by increased borrowings.

GDP growth



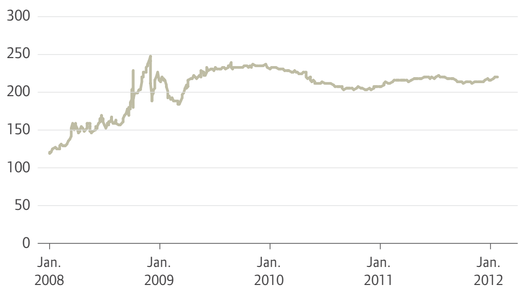
Source: OECD

Debt as a % of GDP



Source: Central Bank of Iceland

ISK Trade weighted index (TWI)



Source: Central Bank of Iceland

Inflation

Source: Statistics Iceland

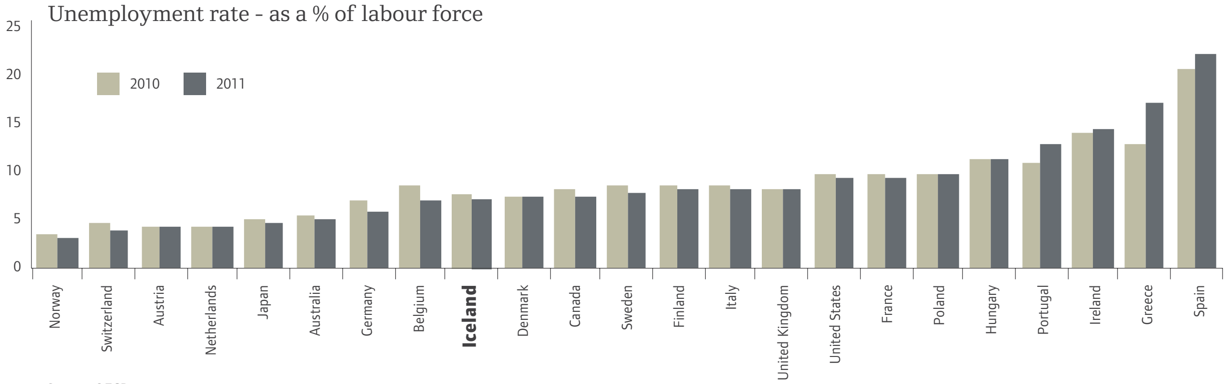
IMF programme completed

Many important milestones have been passed on Iceland's path to economic resurrection in 2011. In August the country completed the sixth and final review of the Stand-by Arrangement (SBA) with the IMF, making Iceland the first country to complete an IMF sponsored programme following the financial crisis in 2008. The programme was successful and its objectives were met in all its main aspects; the financial and banking system has been resurrected, the exchange rate has stabilised and public finances have been consolidated with austerity measures in place. Since August, improvements in these areas have continued to occur e.g. through increased fiscal austerity in the 2012 State Budget and increased consolidation in the financial sector, which should lead to its stronger standing.

Sound fundamentals

Despite still being faced with the consequences of a recent currency and banking crisis, Iceland is still amongst the most prosperous countries in the world, offering a very high standard of living for its citizens. GDP per capita is high amongst developed economies and unemployment is low by international comparison. The economy has through recent shocks shown remarkable endurance and adaptability. Iceland's workforce is well educated and the country has ample natural resources. The vigour seen in the country's recovery in the past year is based on these strong foundations.

Unemployment rate - as a % of labour force



Source: OECD

5 Review of operations

The following presentation of the performance and financials of Íslandsbanki hf. ("the Bank") is based on the Bank's consolidated financial statements 2011

The year 2011

Three years on from its foundation in the midst of the economic turmoil surrounding the financial collapse in Iceland, growth has replaced contraction in the Icelandic economy, powered by exports and increase in private consumption. Unemployment is falling and the economic standing of households and corporates is gradually improving. Inflation and interest rates remained relatively stable throughout the year and exports, in particular, are benefitting from the low real exchange rate of the ISK accompanied by high commodity prices worldwide.

Households and companies have continued to de-leverage and the Bank did therefore not experience an uplift in new lending activities. Debt restructuring has been one of the key projects of the year and good progress was made, whereby corporate loan facilities saw a total write-off of ISK 159 billion with ISK 53 billion being written off from household debt. The Bank will continue to monitor its loan portfolio closely in the context of developments within the Icelandic economy as well as in markets abroad and works closely with customers who are experiencing payment difficulties.

The Bank is largely funded by deposits, whilst a large part of the interest income is currently fixed. This has resulted in a significantly lower funding cost which positively affected the net interest margin. The Bank will focus on extending the maturities of its funding base and has, to this end, launched a ISK 100 billion covered bond programme, out of which the Bank plans to issue around ISK 10 billion annually. The programme was inaugurated in December 2011 with an ISK 4 billion issue, followed by two issuances amounting to ISK 3.3 billion in March 2012.

The Bank reduced its vulnerability to foreign exchange rate changes by engaging in a foreign exchange swap contract at year end 2010. Foreign exchange loans to borrowers with ISK income have also been treated as ISK loans by impairment of foreign exchange differences. The net foreign exchange gap has thus been kept at a manageable level.

The year 2011 saw the first syndicated credit facility of an Icelandic state-owned entity involving foreign banks since 2008 when the Bank was part of a syndicate for Landsvirkjun, together with three overseas banks and two Icelandic banks. This is a positive indicator of a growing confidence by international markets in the Icelandic economy.

Taxation increased considerably during the year with a corporation income tax rate increase of two percentage points and the introduction of a new bank tax, as well as a temporary two year tax to fund tax credits to mortgage borrowers. Taxation will further increase in 2012 with the introduction of a new payroll tax and additional income tax on taxable profits over ISK 1 billion.

On 12 July 2011, the Bank signed a share purchase agreement with Byr Sparisjóður and the Ministry of Finance to acquire 100% of the share capital of the commercial bank Byr hf. The total consideration transferred was ISK 6,600 million. After a final approval by the Parliament, the Financial Supervisory Authority, the Competition Authority and the EFTA Surveillance Authority, the Bank successfully merged with Byr on 1 December 2011.

The Bank continued analysing and improving its operations and processes during the year with a view of enhancing objectivity, transparency and disciplined processes. Good progress was made and the Bank expects, as a result, to achieve greater efficiencies of operations in all areas.

Performance

The Bank's pre-tax profit amounted to ISK 1,782m in 2011, compared to ISK 37,087m in 2010. The difference is largely explained by the impairment at year end of goodwill arising on the acquisition of Byr totalling ISK 17,873m. Profit after tax was ISK 1,866m in 2011, compared to ISK 29,369m in 2010. Earnings per share were ISK 0.19 in 2011 compared to ISK 2.94 in 2010.

Earnings from regular operations where one-off items such as the goodwill impairment, costs associated with the Byr merger, net valuation changes arising on the loan portfolio and fair value gain from equity shares are excluded resulted in a pre-tax profit of ISK 13,905m and a return on equity of 11%.

Net interest income

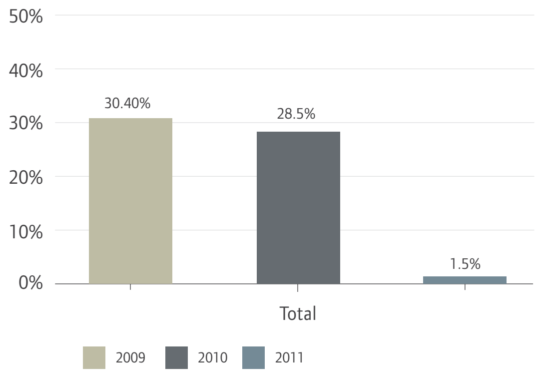
Net interest income amounted to ISK 31,225m in 2011, compared to ISK 34,874m in 2010. The net interest margin, as the ratio of net interest income to the average carrying amount of total assets, was 4.5% in 2011, compared to 5% in 2010.

The difference between the years is largely explained by gradually decreasing interest rates; the Central Bank risk free rate has decreased from 8.4% at the beginning of 2010 reaching 3.75% at year end 2011. This has positively affected the funding, in particular with regards to foreign exchange loans to customers with income in ISK where the foreign exchange gain is impaired in full.

Net valuation changes

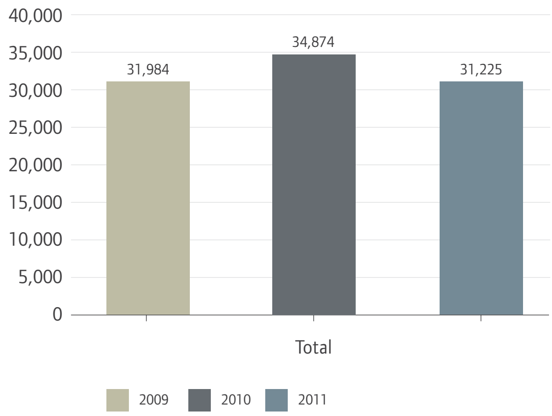
Net valuation changes represent net valuation changes on loans and receivables and provision for latent impairment. The former is the net

Return on equity



Net interest income

ISK m



change in the carrying value of the loan portfolio and is made up of impairment and an increase due to revised estimated future cash flows. The latter is an impairment which is incurred but which has not yet been identified. Net valuation changes show a loss of ISK 1,220m in 2011, compared with a gain of ISK 13,993m in 2010.

Net fee and commission income

Net fee and commission income amounted to ISK 5,966m in 2011, compared to ISK 7,380m for the previous year, which is a decrease of 19%. The difference is largely explained by the Bank's subsidiary Borgun hf. leaving the Bank at the end of March 2011 when the Bank sold part of its shareholding in the entity. Borgun hf. became a subsidiary again on 1 December 2011 through increased shareholding attributable to the acquisition of Byr.

The fee income derives mostly from payment processing and asset management. Advisory and trading fees were somewhat lower than expected due to a slower than expected recovery of the financial markets and restructuring of companies taking longer than anticipated.

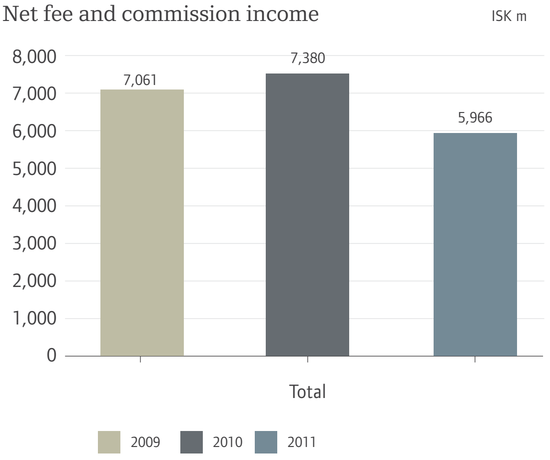
Other income

Net financial income amounted to ISK 2,649m in 2011 compared to a loss of ISK 910m in 2010. The difference is due to a fair value gain of 3,050m following a reclassification of equity shares from non-current assets held for sale to shares and equity instruments. The reclassification came as a result of a sale of a part of the total equity shares held.

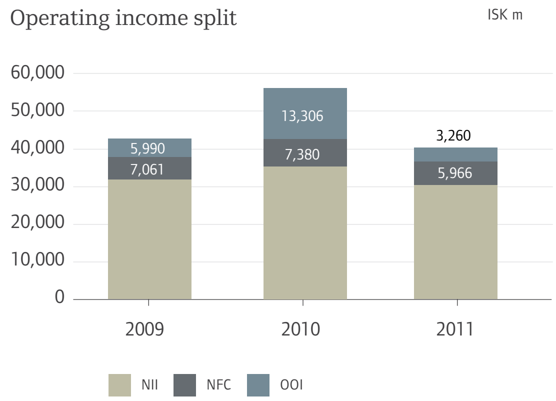
Foreign exchange gain in 2011 amounted to ISK 937m, compared with a loss of ISK 963m in 2010. Other net operating income, mainly rental income and service fees, was ISK 894m in 2011 compared to ISK 1,186 in 2010.

The Bank saw a profit of ISK 841m from discontinued operations, net of income tax, compared to a loss of ISK 283m in 2010.

Net fee and commission income



Operating income split



Other operating expenses

Administrative expenses excluding impairment of goodwill amounted to ISK 20,835m in 2011 compared to ISK 18,473m in 2010. A third of the increase is attributable to the acquisition of Byr which incurred additional costs, in particular in relation to the planning and integration of the merger. Contributions to the Depositors' and Investors' Guarantee Fund also increased by ISK 358m between the years due to a change in the legislation as well as an increased deposit base. Depreciation and amortisation increased from ISK 623m in 2010 to ISK 709m in 2011, following increased investment to improve the Bank's infrastructure.

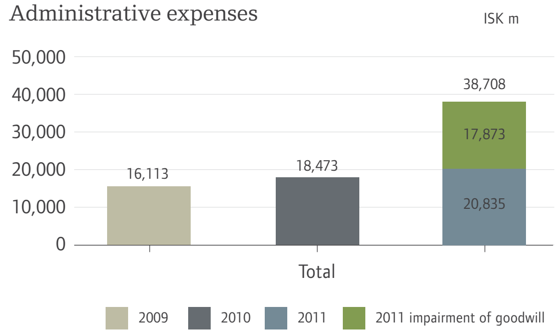
The goodwill which arose from the acquisition of Byr consisted largely of the synergies and economies of scale expected from combining the operations of Byr and the Bank. The Bank, however, impaired the entire goodwill from the acquisition at year end 2011 which resulted in a one-off charge to the comprehensive income statement of ISK 17,873.

Salaries and related expenses amounted to ISK 10,531m in 2011, compared to ISK 9,207m in 2010. The increase is partly explained by a collective salary increase during the year, but also by redundancy costs due to necessary reduction in the number of employees following the Byr merger.

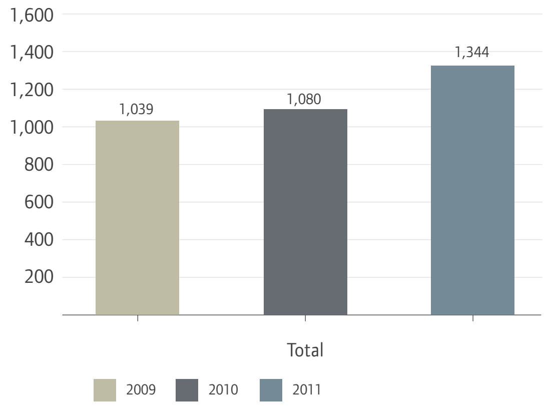
The average number of full time employees at the Bank was 1,344 in 2011, compared to 1,080 in the previous year. The increase is largely attributable to subsidiaries acquired in 2011. The average number of full time employees at the parent company was 1,003 in 2011, compared to 933 in the previous year, an increase explained by the Byr merger.

The core cost/income ratio, defined as the administrative expenses (excluding impairment of goodwill) divided by net interest income and net fee and commission income, was 56% in 2011 compared to 44% in 2010.

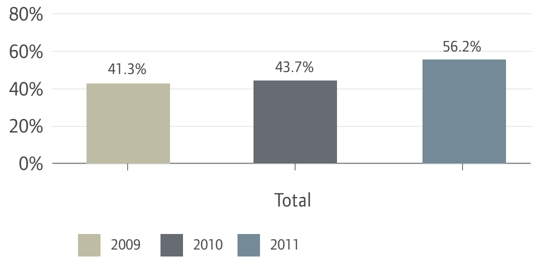
Administrative expenses



Average number of employees



Core cost/ income ratio



Taxes
Taxation in 2011 increased considerably from the previous year with the corporation income tax rate increasing from 18% to 20%. The year 2011 also saw an implementation of a two year temporary taxation of 0.0875% of the previous year's total liabilities, effective for tax periods after 1 January 2011, implemented to fund government tax credits to mortgage borrowers. This temporary taxation is shown in a separate line, bank tax, on the face of the statement of comprehensive income together with the bank tax introduced in 2010 which is calculated as 0.041% of the previous year's total liabilities.

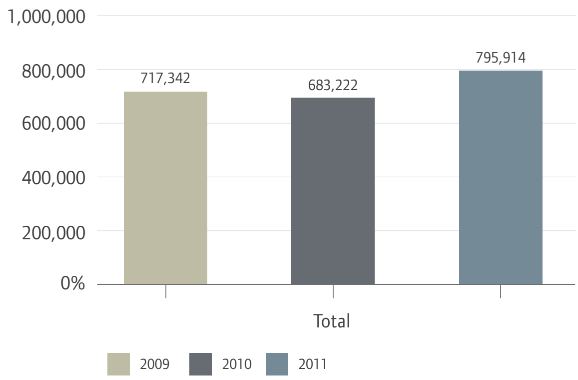
The income tax for the year 2011 was ISK 75m, compared to ISK 7,214m for the previous year, a difference mainly explained by the difference in profit before tax. The effective income tax rate for 2011 was thus 4.2% compared to 19.5% in 2010.

Balance sheet
The Bank's total assets amounted to ISK 795,915m at year end 2011, compared to ISK 683,222m at year end 2010. The increase is mainly explained by the inclusion of Byr assets following the merger on 1 December 2011.

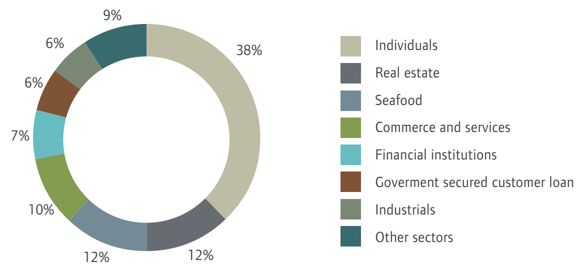
Loans
Loans to customers and credit institutions amounted to ISK 608,049m at year-end 2011, compared to 546,031m at the beginning of the year, which is an increase of 11.4%.

A large part of the loan portfolio was acquired at a deep discount where the fair value purchase price was considerably lower than the balance according to the terms of the loan and the difference is explained by severe financial difficulties of the debtor. This manifests itself in a higher credit spread when estimating the fair value

Total assets



Loans by business sector



of the loans and not because of changes in business environment since the terms of the loan were agreed i.e. market interest and liquidity.

Events, such as a new legislation and court rulings, outside the scope of both the Bank and its customers, have affected the loan portfolio and made it difficult to measure its performance. The Bank performs regular impairment tests on its loan portfolio to ensure that its carrying value accurately reflects the expected recovery.

The Bank believes that the entire loan portfolio can be restructured into a performing portfolio without a reduction in the overall carrying amount below the initial acquisition value, even though there may be fluctuations in individual loan valuations reflecting the level of uncertainty in the loan book. Great progress was made during 2011 in financial restructuring as many customers accepted standardised options made available to borrowers, e.g. principal adjustment, and many large and often complex corporate restructures were completed. Restructuring of the largest corporate clients' loan portfolio is expected to complete by the end of 2012 and by the end of 2013 for the remaining loan portfolios.

While good progress was made in 2011 the Bank, as well as other Icelandic banks, has suffered several setbacks during the last two years in terms of unfavourable Supreme Court rulings on loan contracts and legislation changes. Most important of these rulings was a ruling on the illegality of a principal in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates. Legislative changes were made as a result of these rulings stipulating that the lowest offered Central Bank rates for non-indexed loans should be applied to the contracts affected by the rulings. Based on the above, the Bank initiated a recalculation of all affected foreign currency-linked loan contracts with the aim of converting them to ISK.

A Supreme Court ruling on 15 February 2012 disputed the proposed recalculation methods set out in the legislative changes, as it violated the borrower's constitutional right to an adequate compensation for previously paid up principal. The interpretation of this ruling and how it affects the Bank is uncertain. The Bank therefore made an assessment based on given assumptions and subsequently recognised a provision at year end 2011 for possible outflows. The estimated impact of the court rulings is therefore reflected in the financial statements. Affected loan contracts may therefore need to go through a second recalculation in 2012.

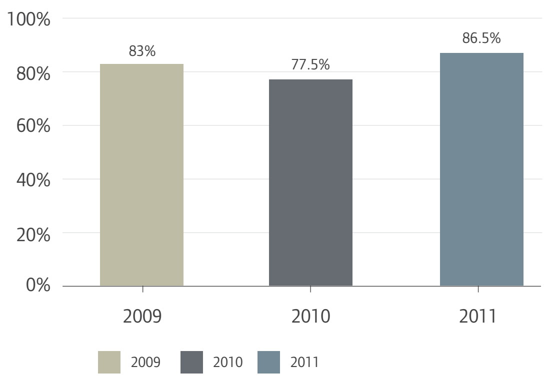
Liabilities

Total liabilities amounted to ISK 672,212m at year end 2011, compared to ISK 561,759m at the beginning of the year. The increase of 19.7% is predominately attributed to the assimilation of deposits totalling ISK 117,614m through the Byr merger.

Equity

At year-end 2011 the Bank's total equity amounted to ISK 123,703m, compared to ISK 121,463m at year-end 2010, which is an increase of 2%. Thereof, ISK 909m is attributable to minority interests. At year-end, the nominal value of the authorised share capital of the Bank was ISK 10,000m.

Total deposit/loan ratio



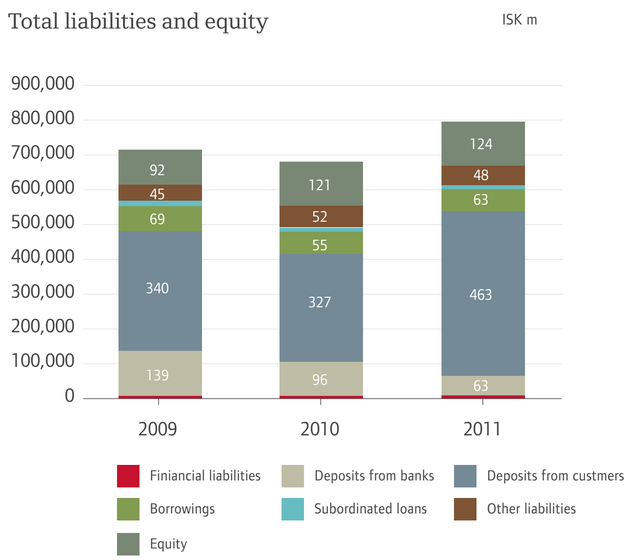
The FME requires the Bank to maintain a minimum Core Tier 1 ratio of 12% of risk weighted assets and a total capital ratio, allowing for a subordinated Tier 2 debt, of 16%. Since its incorporation, the Bank has focused on maintaining strong capital and liquidity ratios. At year-end 2011 the Bank's Tier 1 ratio was 19.1%, compared to 22.6% at year-end 2010. The Bank's total capital ratio was 22.6% at year-end 2011, compared to 26.6% at year-end 2010.

Funding and liquidity

The Bank has been largely funded with deposits since its incorporation in 2008. The ratio of total deposits against total loans was 86.5% at the end of 2011, while customer deposits to customer loans was 82%. In the medium term, investors are expected to diversify into other investment products, leaving deposit-to-loan ratios at a level of 50-60%. The lowering of those ratios will come through both an increase in the size of the loan book and increased debt issuance by the Bank.

The Bank is not reliant on foreign currency funding and does not have a need to raise such funds in the short to medium term. The Bank has however been exploring its options and will take advantage of opportunities to fund a potential loan book growth should they arise.
The Bank issued covered bonds in December 2011 under Icelandic law with a maturity of 5 years pledged on a pool of consumer price indexed mortgage loans. The issuance in December totalled ISK 4bn and was followed by a further issuance of 7 and 12 year maturities of ISK 3.3bn in early 2012.

The ratio of cash and cash-like assets against demand deposits was 22% at year-end 2011 compared to the FME regulatory requirement of 5%. Liquid assets against total deposit ratio was 36% at year-end which is also well above the FME regulatory requirement of 20%. Additionally, at year-end, liquid assets and expected cash inflows covered 144% of expected outflows over the next three months compared to a Central Bank requirement of 100%. All internal liquidity measures were also well above internal guidelines at the end of 2011. The Bank of International Settlements (BIS) has issued new liquidity requirements which are focused on implementing common liquidity measures for all banks, i.e. the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). These measures have not yet been implemented into the Icelandic regulatory framework.



Outlook

Although the year 2011 was somewhat disappointing in terms of the recovery of the local financial markets, the Icelandic economy is showing the first signs of recovery driven by investment, consumption and exports. Increased purchasing power, lowered unemployment, historically low real interest rates and the financial restructuring of households and companies has facilitated private consumption and investment. Furthermore, the low real exchange rate of the ISK accompanied with high commodity prices has strengthened the position of the export sector. The solid results of export companies have a spill-over effect onto other sectors of the economy, especially those servicing them.

The economic and political environment in Iceland is somewhat unpredictable at present as authorities seem to be continually reaching into the pockets of credit institutions for funding of fiscal deficits. Taxation, which increased considerably in 2011, will thus further increase in 2012 with the introduction of new tax law, financial activities tax (FAT), on credit institutions. The financial activities tax comprises a new payroll tax of 5.45% and additional income tax of 6% on taxable profits over ISK 1 billion.

The Bank has continued growing on the back of strong earnings and enlarged customer base. The current capital base is solid with capital ratios well above minimum requirements. The Bank will endeavour to continue building trust in its operations and to continue its focus on providing customers with the best available service.

5.2 Retail

Retail Banking provides banking services to individuals, households and small and medium sized enterprises (SMEs). The division comprises 21 branches strategically located around the country, the call centre and Ergo, one of the strongest asset-based financing brands in the country. Following the Byr acquisition, the Bank's market share in retail banking grew substantially.

Restructuring starting to give way to more normalised operations

Whilst 2011 continued to be marked by the restructuring of household and corporate finances, several important steps were made in an effort to prepare the Bank for operations in a more normalised business environment.

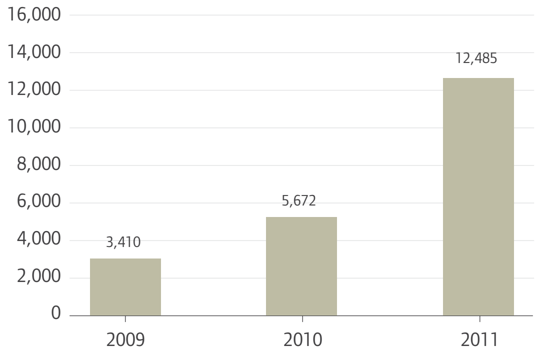
Íslandsbanki's asset-based financing business was rebranded to Ergo in July and was subsequently moved to new, more centrally located, premises.

Ergo has already established itself as a strong brand and surveys indicate that Ergo is the preferred choice for individuals seeking car financing. Ergo has enjoyed a prominent market presence throughout 2011 through its „green loans" – car loans for the purchase of environmentally-friendly cars. It also signed a number of large contracts with car rental agencies, in so doing supporting the country's vigorous tourism sector.

Íslandsbanki also acquired all shares in Kreditkort, the issuer of American Express and Mastercard credit cards in Iceland. The key objectives of this strategic acquisition were both to gain stronger market share in the credit card business and to improve efficiency in the Bank's overall retail operations. The merger is expected to be fully concluded in the second quarter of 2012.

In line with the Bank's efforts to streamline operations further and to increase efficiency, two branches in the Reykjavík area were merged in a prime location in Reykjavík to form a larger branch especially geared towards corporates. The merged branch also houses the Bank's asset-based financing unit, Ergo.

Ergo lending growth



Source: Íslandsbanki

Recalculation of residential mortgages was completed for the most part in 2011, whereby around 3,000 mortgages were recalculated and converted to ISK. In addition, around 3,000 customers participated in the 110% mortgage adjustment offer which allowed them to reduce outstanding mortgage balance as far down as 110% of the asset's tax value. Finally Ergo completed the recalculation of roughly 13,000 car loans to individuals and companies. The recalculation of non-mortgage FX loans also commenced in 2011 and is expected to conclude in the first half of 2012.[2]

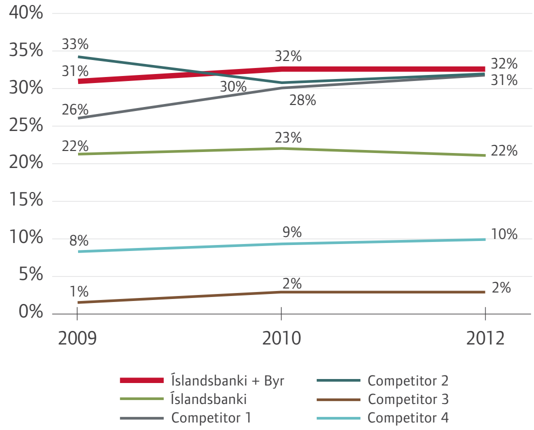
Byr – a synergy driven acquisition

A key event in the latter half of 2011 was the Byr acquisition. The bidding process started in June 2011 and was followed by a thorough due diligence and approval process. The merger was finally approved on 24 November and by early December the banks' head offices had been merged at Íslandsbanki's headquarters at 2 Kirkjusandur. Aiming for a smooth transition for all stakeholders, the Bank has given good notice to customers of impending changes, highlighting the fact that the merged company will adopt the best practices from both banks.

The Bank has tried its utmost to be sensitive of customer preference and access when designing the branch integration process. In total 4 branches were merged with existing Byr or Íslandsbanki locations and 2 Byr branches were rebranded, leaving Íslandsbanki with a total of 21 branches.

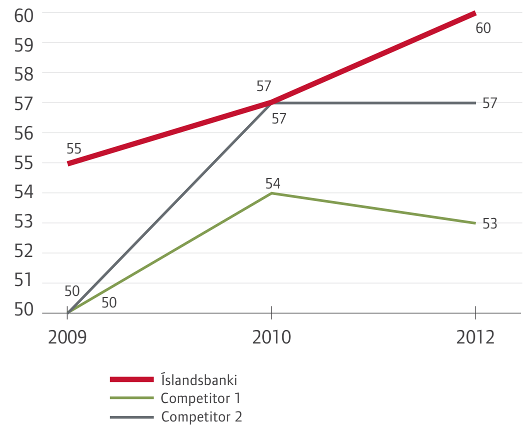
The Byr acquisition marks the end of a long process that was designed to increase the Bank's market share and strengthen its balance sheet. Byr was an excellent fit with Íslandsbanki's existing retail operations. The merger pushed the Bank's market share to over 32% and brings to bear valuable payroll and branch network synergies as there was only a net increase of one branch in the combined entity. This further improved efficiency in the Bank's branch network and in the overall banking market in Iceland.

Retail market share



Source: Capacent Gallup 2011

Customer satisfaction index



Capacent Gallup 2011 / European extended performance satisfaction index (EPSI)

[2] These recalculations may be subject to the Supreme Court ruling of 15. February 2012. See note 60 for details.

Continued emphasis on service excellence

Íslandsbanki continued its tradition of being leading in online banking when it was the first bank in Iceland to introduce an app for Android and iPhones. The app grants customers access to their current accounts, their credit card statements, enables them to make transactions and pay bills through the convenience of their mobile phones. The app was very well received and in 3 months, more than 6,000 users downloaded the application and the Bank has seen a dramatic increase in mobile traffic since the app was launched.

The Bank has also been leading, amongst Icelandic banks, in the use of social media tools to reach customers. Íslandsbanki was the first bank to use Facebook as a marketing and communications tool, and many branches already have active Facebook pages. This innovative method of reaching the market has opened up new and exciting opportunities to bring the branches closer to the customers.

In December 2011, a new approach to social media was launched whereby customers can interact with each other and swap financial advice, money saving tips etc, with the Bank supplying the platform.

Substantial effort, based on thorough research and data analysis, was dedicated to re-engineering the Bank's mortgage product offering. As a result, maximum loan-to-value for new lending was increased from 70% to 80%, and mortgages are now segmented according to the inherent risk at different leverage points instead of having a single loan for the entire structure. Furthermore, in response to market interest, Íslandsbanki continued on the path of offering non-CPI indexed loans that were first introduced in 2009.

The Bank carried on its work of helping customers to reduce charges and fees. To that effect it launched an initiative designed to help customers avoid unauthorised overdraft charges.

The Bank's vision is to be #1 in Service and to that end retail banking entered into collaboration with various stakeholders, including the Ministry for Economic Affairs and the Icelandic Financial Services Association, to establish a certified education programme for the Bank's financial advisors. The programme is offered under the auspices of three Icelandic universities which are responsible for its organisation and academic quality. The objective of the programme is to increase quality of financial advisory and better equip bank employees to effectively advise their customers.

To further solidify its commitment to service excellence retail banking employees participated in two seminars in 2011. One was a creative workshop where each branch and/or division met to define and discuss their approach to the #1 in Service vision, the other one was a two-day tailor made seminar conducted in participation with Dale Carnegie training and addressed the Bank's service policy and standards.

Íslandsbanki is concerned with the financial health of its customers. To this effect the Bank offered several courses on personal finances in 2011. Indeed the Bank, in 2009, was first in offering its customers access to Meniga, a powerful online personal finance software. Since then the Bank has hosted numerous seminars to teach customers to enjoy the software's full benefits. In addition to these courses the Bank maintains a thorough source of information on personal finances through its website.

5.3 Corporate

Corporate Banking provides lending and other credit services to medium and large corporates in Iceland, with a special focus on seafood, energy and municipalities. In addition, Corporate Banking has two specific units, Corporate Solutions who manage and lead the restructuring of the distressed large corporate portfolio, and Industry support, who provide industry analysis and research material to support the business.

Íslandsbanki is perceived to be the most professional banking partner and provide the best service to large corporations according to a Capacent survey among the 300 largest companies in Iceland. This is an important achievement and motivates the division to continue to service its customers even better.

Corporate restructuring on track

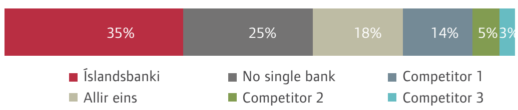
Activity during the first half of 2011 continued to be centred on large corporate restructurings, but the year also saw a gradual increase in new business. The division continued to work closely and strengthen its relationships with its customers, with the ambition of establishing Íslandsbanki as #1 in service for larger companies in Iceland. Increased focus was placed on business origination which resulted in new lending, cross-sales and new customer relationships. Despite the uncertainty in the environment, especially in the seafood, energy and construction sectors, the pipeline grew throughout the year and has not been stronger since 2008.

Íslandsbanki's annual Finance Forum was held in October. The forum is aimed at CEOs and CFOs from the Bank's corporate customer base. At the forum, Íslandsbanki's Research team presented their annual economic forecast intended to support customers' budget planning, and the Bank's CEO and employees, along with a few guest speakers from the Bank's corporate customer base, also gave presentations.

Corporate Solutions

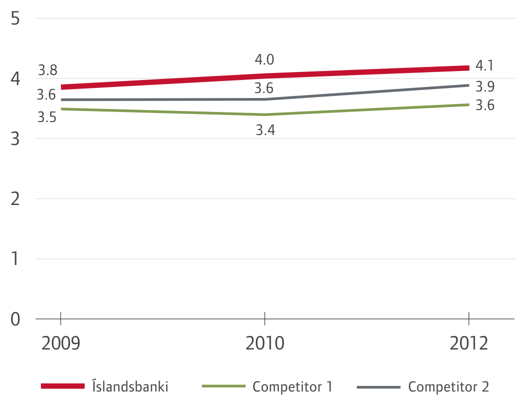
Measured by the number of completed projects, restructuring of the corporate loan portfolio reached its peak in 2011 whereby relatively few operating companies now remain to be restructured. A total of 76 projects were completed, including the

Which bank is overall the most professional?



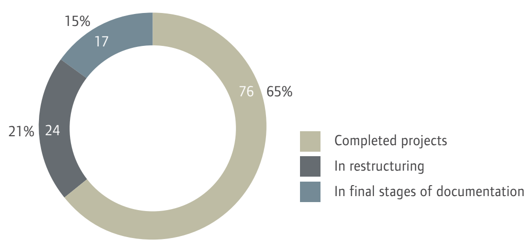
Source: Capacent Gallup November 2011
- Survey among 300 top corporates according to Frjáls Verslun

Corporate banking service score



Source: Capacent Gallup November 2011
- Survey among 300 top corporates according to Frjáls Verslun

Status of corporate restructuring portfolio



Source: Íslandsbanki

restructuring of leading oil and retail company in Iceland N1, and real estate development company Höfðatorg which are among the Bank's largest restructuring projects. Of the remaining 41 corporates on the restructuring list, 17 corporates are already in the final stages of documentation.[3]

Industry focused activities

In 2011, the division published three geothermal reports and three seafood reports, and launched so called seafood and geothermal dashboards which contain global data sets on both the Icelandic and US markets. All published material and the Industry Dashboards are available on the Bank´s website. The Corporate Banking team was also active in reaching out to its customer base and attended several industry specific events.

Currently, Íslandsbanki is participating in two cluster projects, "The Seafood Cluster Iceland" and "The Geothermal Cluster Iceland". These cluster projects are a collective of companies directly or indirectly active within these industries. The objective is to improve cooperation and increase value creation for corporates in these clusters. A successful example of another industry project is the partnership in tourism around the "Inspired by Iceland" initiative.

International focus on geothermal and seafood

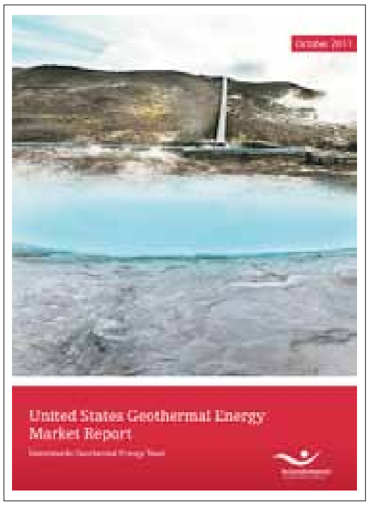
Íslandsbanki, building on a heritage of servicing Iceland's core industries, has developed an international reputation in servicing the geothermal energy and seafood sectors. Outside its domestic market, the Bank has emphasised its experienced advisory services, backed it with quality industry specific research material, and been very proactive in engaging with geothermal, energy and seafood customers.

As in previous years, North America is the core market for international activities in geothermal energy and seafood. In April 2011, the Bank´s New York based subsidiary, Glacier Securities, obtained a Broker-Dealer Licence which will further enhance the Bank´s international strategy in these specific sectors.

Glacier Securities was part of Corporate Banking until year-end 2011, but has been part of Markets since the start of 2012.

[3] Some of these recalculations may be subject to the Supreme Court ruling of 15. February 2012. See note 60 for details.

Advertisements made in the year 2011 focused on the main target business segments of seafood, energy and municipalities



Several geothermal and seafood reports were published as well as information dashboard

Highlights of completed Corporate Banking transactions in 2011

Smáralind
Íslandsbanki refinanced ISK 3.7 billion of Eignarhaldsfélagið Smáralind's debt with a 5 year facility. Eignarhaldsfélagið Smáralind is a holding company which owns and operates Smáralind, the largest shopping mall in Iceland.

Orkuveita Reykjavíkur
Íslandsbanki provided Iceland´s leading geothermal heating provider Orkuveita Reykjavíkur with an ISK 2.0 billion revolving credit facility to support day to day financing needs. Orkuveita Reykjavíkur is a public utility company providing electricity, geothermal water for heating, and cold water for consumption, and their service area extends to 20 communities, covering 67% of the Icelandic population.

Eimskip
Eimskipafélag Íslands hf., one of Iceland´s leading transportation companies, invested in two new container vessels for about USD 50 million in 2011. Íslandsbanki proudly supported Eimskip by providing a flexible financing solution for up to 30% of the investment during the construction period.

Landsvirkjun
Landsvirkjun, the largest Icelandic energy company, signed a three year revolving credit facility amounting to ISK 10.5 billion. The Facility was led and arranged by Íslandsbanki, Arion Banki and Landsbankinn. Furthermore, Íslandsbanki acted as a Facility Agent on behalf of Landsvirkjun in this landmark transaction.

Íslandsbanki also participated in one of the first syndicated bank facility of an Icelandic State owned entity since the financial crisis of 2008, when Landsvirkjun secured a three year USD 200 million multi-currency revolving credit facility.

N1
Íslandsbanki provided N1 hf., one of the largest Icelandic retail and service companies, with a three-year revolving credit facility to finance seasonal working capital needs.

5.4 Markets

Markets, Íslandsbanki's investment banking division, is built on long-term industry experience and provides customers with access to capital markets. Íslandsbanki is a leading player in the fields of fixed income, foreign exchange, debt capital markets, equities, research and corporate finance.

Comprehensive service offering

The principal roles within the Markets division are trading, sales, research, corporate finance and operations. The team attempts to derive synergies from their mutual collaboration based on extensive product knowledge and strong corporate and investor relationships.

Interbank Markets are responsible for trading in foreign currencies, bonds and equities as well as market making. The main customers are financial institutions and institutional investors both foreign and domestic. In addition, the Interbank Markets unit handles cash management, and is responsible for managing the Bank's short-term liquidity position and reserve requirements.

The sales units service pension funds, mutual funds and other professional investors as well as large corporations and financial institutions. They provide customers with trade execution as well as advice and trading ideas on equities, fixed income, currencies and derivatives.

Research provides macroeconomic research for the Bank and its customers. It further carries out in-depth market analysis and provides forecasts on main economic indicators. Research also issues the newsletter, Icelandic Market Daily, both in Icelandic and English. The newsletter reaches 8,000 subscribers and is the only daily market material provided in the Icelandic financial market today.

The Corporate Finance unit offers a range of M&A advisory services, including sale and buy-side transactions, rights issues and listings, as well as independent advice on restructuring. The unit targets medium and large Icelandic corporates.

The Markets division underwent several changes in 2011. Most noteworthy was the appointment of a new managing director, Tryggvi Björn Davidsson in September, who has broad experience of international financial markets. For the last seven years, Tryggvi was a Director of Distressed Debt at Barclays Capital in London. In December an experienced executive director of the Bank's Corporate Finance unit was hired, followed by the introduction of a new organisational structure of the Markets division, reflecting an increased focus on customized solutions for customers.

Challenging market environment

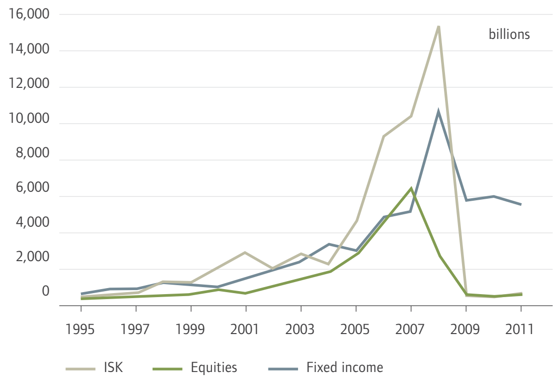
Markets operate in a competitive environment whereby both the large banks, smaller boutiques and late entrants are trying to establish themselves. External market conditions remained challenging throughout 2011. The equities market has not gained momentum since its collapse in 2008. The FX market is severely restricted and volume is low. The only fully functional market is the fixed income market.

Íslandsbanki was one of the leading players in the fixed income market in 2011 with a roughly 23% share in total turnover.

Restoration of the capital markets most urgent task

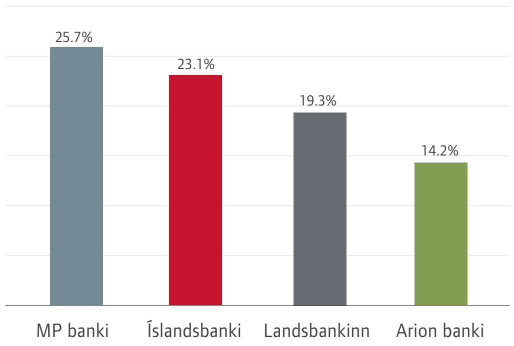
An effective capital market is the prerequisite for any investment bank. Íslandsbanki intends to leverage its strong market position and financial strength to take the lead in rebuilding liquidity in the most damaged sector, the stock market, and eventually resume bringing companies to market for listing. Capital controls are expected to ease to some extent in the year ahead, returning the FX market to a more normal state.

Turnover in major markets in Iceland



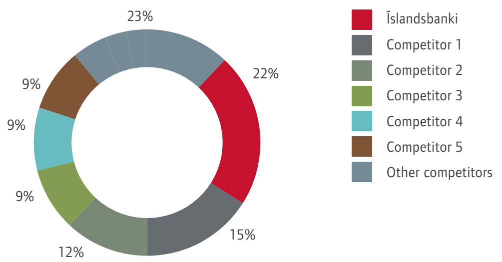
Source: NASDAQ OMX Iceland and Icelandic Central Bank

Market share in fixed income and related



Source: NASDAQ OMX Iceland.

Íslandsbanki´s Corporate Finance is leading in the Icelandic market



Source: Capacent Gallup.

In this respect Markets was proud to see that its Corporate Finance unit is considered leading in the market according to a survey conducted by Capacent among the managers of Iceland's 150 largest companies in late 2011.

Selected Corporate Finance transactions completed in 2011

One of the major projects of the year was advising Icelandair Group on a rights issue in January. The transaction marked the successful completion of the company's financial restructuring. Several M&A transactions were completed during the year, including advisory to the Icelandic Enterprise Investment Fund on the acquisition of shares in oil retailer N1, and advisory to Geysir Green Energy on Magma Energy's sale of its subsidiary Enex China, a district heating company.

In addition, the Corporate Finance team lead two open sales processes in 2011; the sale of Ingvar Helgason and B&L, both leading dealerships of new cars in Iceland, signed in late 2011, and the sales process of Jarðboranir, a geothermal drilling company, which commenced in 4Q 2011.

5.5 Wealth

The Wealth Management division offers, under the brand VIB, a comprehensive set of investment management services and products to both private investors and institutional clients. VIB provides advisory, investment, custody and pension services for retail investors as well as portfolio management services to affluent and institutional investors.

Mutual funds and discretionary portfolios for institutional clients are managed through an independent subsidiary, IS Funds, a market leader in mutual fund management in Iceland. The division is one of the largest investment managers providing universal investment management services in Iceland.

VÍB

Íslandsbanki's wealth management services were rebranded to VÍB in February 2011. The name VÍB has historical reasons, as the Bank's Wealth Management division operated under the name VÍB as a separate legal entity from its foundation in 1986 until 2001. The main reasons for the rebranding were twofold, firstly to demonstrate an arm's length separation from other Íslandsbanki divisions, and secondly giving the division a more independent voice in the public arena. In this regard, VÍB hosted 42 sessions and seminars for customers on savings and investments in 2011 where thousands of customers attended, as well as hosting larger events with foreign speakers focused on the economic situation in Iceland.

Good return in 2012

VÍB is the largest distributor of IS Funds Ltd., a management company fully owned by the Bank and consolidated in the financial figures of the Wealth Management division. IS Funds' assets under management went up by 50% over the last two years, from ISK 70 billion at year end 2009 to ISK 113 billion at year end 2011.

IS Funds manages the largest mutual fund in Iceland, the Long-Term Government Bond Fund (Fund 7), whose assets at year-end totalled ISK 42 billion. The fund's nominal return in 2011 was 13.5%. The second largest mutual fund in Iceland is also managed by IS Funds, the IS Government Bond Fund (Fund 5), with total assets of ISK 33.7 billion at year-end 2011, delivering a nominal return of 10%.

Strong product and service development

Two new funds were launched in 2011 to meet market demands. In March, the IS Asset Allocation - Government Fund was launched. This fund of funds invests mainly in mutual government funds and offers active indexing on government bonds. Launched in September, the IS Bond Fund was the first fund initiated in Iceland after 2008 that invests in corporate credit. The fund invests in bonds issued by the government, municipalities and financial institutions in addition to investing in corporate bonds and financial institutions´ deposits.

In 2011, VÍB also started the distribution of DNB's mutual funds in Iceland, which was a great addition to VÍB's exclusivity agreement to sell Vanguard's funds in Iceland.

Competition and market conditions

Traditionally, the market share of wealth and fund management companies closely corresponded to their market share in retail banking. However, over the last three years, there has been a marked increase in the number of small fund management companies and private banking boutiques starting up. In total, eleven financial institutions now offer a range of mutual and investment funds and wealth management services in Iceland.

VÍB's most important strengths are being one of the largest investment managers in Iceland providing universal investment management services and in particular, its prominence in fixed income products for the last 3 years. This provides VÍB with the opportunity of economies of scale, which together with access to a strong distribution network and credibility through Íslandsbanki's financial and strategic back up makes the division well positioned for growth.

Business Units

Private Banking

Private Banking services are aimed at affluent individuals, investment companies, funds and charities in the form of either discretionary asset management or investment advisory services. The services include portfolio management, banking facilities and financial planning tailored to the needs and preferences of each client. A dedicated personal relationship manager monitors the asset portfolio and suggests investment opportunities as they arise.

VÍB's Private Banking unit services individuals with monetary assets of ISK 15 million or more.

Institutional Services

The institutional sales team provides customised investment and discretionary asset management services for institutional investors, pension funds and municipalities. Their services include customised investment strategies, portfolio and risk management, custody services, clearing, and income collection. The client base consists of pension funds, insurance companies, municipalities, and other institutional clients.

Private Investment Services

Private Investment Services provides diverse securities and private pension (401k) services for individuals, including investment advisory, brokerage services, custody services and pension services. The team provides support to clients through Íslandsbanki's online banking facilities, where clients have real-time access to their portfolio holdings and cash accounts, in addition to online trading in domestic funds.

Third-Party Funds

VÍB offers global portfolio advisory and access to third-party funds such as Vanguard, DNB, Gartmore, Wegelin, Sparinvest and Skagen. Over 550 clients have assets in VÍB's third-party funds. At the moment clients cannot invest in foreign funds due to the capital controls, but VÍB continues to offer discretionary services and funds selection advisory to clients who are able to re-invest abroad.

VÍB has had a successful partnership with the Vanguard Group for 13 years, with an exclusive agreement to distribute Vanguard's funds in Iceland. Vanguard is one of the world's largest investment management companies, founded in 1975.

Since 2011, VÍB also has a distribution agreement with DNB Asset Management, which covers distribution of its products and services in the Icelandic market and will eventually cover distribution to all client segments, i.e. institutional investors, individuals and corporations.

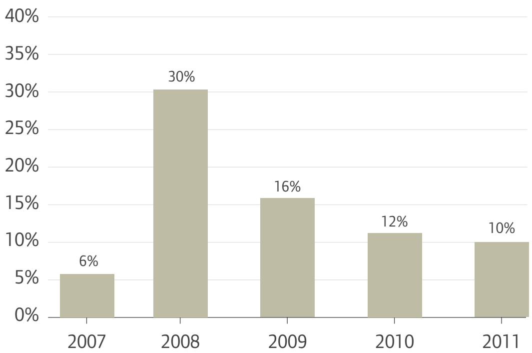
IS Funds

IS Funds (i. Íslandssjódir hf.) is a management company, an independent subsidiary of Íslandsbanki and a market leader in mutual fund management in Iceland. IS Funds manages mutual and investment funds under the supervision of the Icelandic FSA, as well as several UCITS and other collective investment funds.

IS Funds offers four different domestic government bond funds, one mixed bond fund, two domestic equity funds, and two domestic asset allocation funds, in addition to a global portfolio fund of funds, which is closed for new investments due to capital controls. Furthermore, IS Funds provides discretionary portfolio management to corporate and institutional clients.

During 2011, the trend of capital inflow into IS Funds' government bond funds continued. IS Funds' assets under management went up by 50% over the last two years, from ISK 70 billion at year end 2009 to ISK 113 billion at year end 2011. The four government bond funds managed by IS Funds performed well, with an average annual return for the four funds of 7.33% in 2011.

IS Government bond Fund 5 - nominal return



Source: Creditinfo Iceland /www.sjodir.is

6 Executive Board


Birna Einarsdóttir

Birna Einarsdóttir was appointed Chief Executive Officer of Íslandsbanki in October 2008. In 2007, she took up the position of Executive Vice President of Commercial Banking, after serving as Managing Director of Sales and Marketing from 2004. From 1998 to 2004, she was senior product manager at Royal Bank of Scotland. Previously, she held positions as branch manager and marketing director at Íslandsbanki. Birna has also held various roles in the Icelandic business sector, e.g. as Marketing Manager for the Icelandic Broadcasting Company Stöð 2 (Channel 2) and Íslensk Getspa. Birna first joined Íslandsbanki's predecessor Idnadarbankinn in 1987.

Birna holds a cand. oecon. degree in business administration from the University of Iceland and an MBA degree from the University of Edinburgh.


Jón Gudni Ómarsson

Jón Gudni Ómarsson was appointed Chief Financial Officer in October 2011. He was Head of Treasury at Íslandsbanki from 2008 and has held positions as Executive Director of Treasury and Leveraged Finance. Prior, he was an ALM consultant at SunGard in Boston.

Jón Gudni has a BSc degree in industrial engineering and a Masters degree in quantitative and computational finance from Georgia Institute of Technology in Atlanta. Jón Gudni is a CFA charter holder and a licenced securities broker.


Sigrídur Olgeirsdóttir

Sigrídur Olgeirsdóttir was appointed Chief Operating Officer in September 2010. She has extensive industry experience and has held varied positions within the IT industry from 1984, e.g. Executive Director of the IT Division of Tæknival hf, the Managing Director of Ax Business Intelligence A/S, Denmark as well as Ax Business Intelligence, Iceland.

Sigríður is a systems analyst from EDB skolen in Odense, Denmark, holds a diploma in business operations from the Institute of Continuing Education at the University of Iceland, as well as an MBA degree in international business management from Reykjavík University.


Stefán Sigurdsson

Stefán Sigurdsson was appointed Managing Director of Asset Management in October 2008. Prior, he was Managing Director of the Bank's Business Development division and a manager in the Corporate Finance unit in Copenhagen from 2006. He has worked in the financial sector since 1997 and has extensive experience of capital markets, treasury, corporate finance and business development.

Stefán holds a BSc degree in economics from the University of Iceland and an MSc degree in economics from the University of Copenhagen.

Sverrir Örn Thorvaldson

Sverrir Örn Thorvaldsson was appointed Chief Risk Officer in 2010. He joined Risk Management of Íslandsbanki in 2006 as Executive Director.
Prior, he worked for 6 years in research, data analysis and software development for Decode Genetics.

Sverrir Örn holds a a masters degree in financial mathematics from Stanford University and a B.S. degree in mathematics from the University of Iceland and. He is a licensed securities broker and a Financial Risk Management (FRM) specialist certified by the Global Association of Risk Professionals (GARP).

Tryggvi Björn Davídsson

Tryggvi Björn Davídsson was appointed Managing Director of Markets in September 2011. He has broad experience of international financial markets. For the last seven years he has served as a Director of Distressed Debt at Barclays Capital in London. Before his time at Barclays, he was an analyst in Asset Trading at Íslandsbanki-FBA, a research associate in the Central Bank of Iceland and a commercial Attaché for the Icelandic Ministry of Foreign Affairs in Paris.

Tryggvi Björn holds a BSc degree in economics from the University of Iceland, an MBA degree from INSEAD in France and Singapore, and a Masters degree in finance and econometrics from Université de Toulouse.

Una Steinsdóttir

Una Steinsdóttir was appointed Managing Director of Retail Banking in October 2008. She joined Íslandsbanki in 1991 and has a broad background from varied divisions within the Bank. Una was Managing Director of the Bank's branch network from 2007, the Keflavík Branch Manager from 1999, and worked as a specialist in the Bank's International Banking division, loan supervision and service management from 1991.

Una holds a cand. oecon. degree in business administration from the University of Iceland.

Vilhelm Már Thorsteinsson

Vilhelm Már Thorsteinsson was appointed Managing Director of Corporate Banking in October 2008. He first joined Íslandsbanki in 1999 and has held various positions in Capital Markets, Corporate Banking and the CEO's office. In 2005 he was appointed head of Strategic Growth working on the Bank's external growth , asset sales and funding.

Vilhelm Már holds a BSc degree in business administration from Reykjavík University, an MBA degree from Pace University New York, and is a licensed securities broker.

7 Human resources

Íslandsbanki appreciates that banking is essentially a people business. The Bank's overall human resources emphasis is on managerial support, training and development, effective flow of information, employee participation, social activities and the general wellbeing of employees.

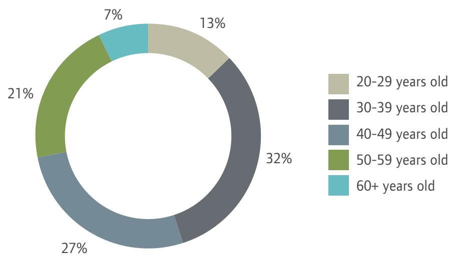
Íslandsbanki supports a performance-driven culture that celebrates achievement and gives recognition to employees for their success. Engagement and motivation is key, as job satisfaction has an intrinsic impact on job performance and the Bank's operations and profitability. Employees are furthermore encouraged to participate in the Bank's strategic development which fosters initiative and teamwork. The Bank continues to recruit ambitious staff from diverse backgrounds, as a team with varied education and experiences will achieve better results than a homogeneous one.

Training and development

Íslandsbanki puts great emphasis on quality training programmes and knowledge sharing. By focusing on employee development, the Bank ensures that employees have the opportunity to reach their full potential, thereby securing Íslandsbanki's competitive edge. In 2011, Íslandsbanki made significant investments in the development of employees' know-how through a broad range of training activities, based on systematic analysis of requirements and yearly employee performance evaluations. All in all, Íslandsbanki offered nearly 300 courses, with each employee attending an average of 4.5 courses.

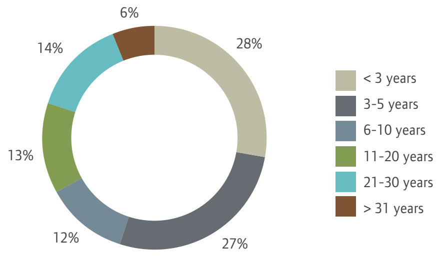
Íslandsbanki believes it especially important to welcome new employees properly in order for them to integrate with their team and the Bank successfully. All new employees are required to attend the orientation course "Íslandsbanki: My Company". Systematic training of new recruits plays a key role in reducing the time it takes for new employees to adapt and reach their full capacity.

Employee age



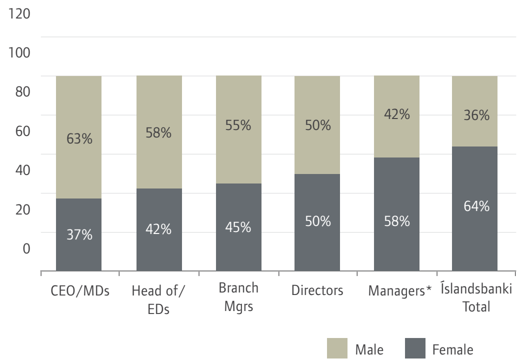
Source: Íslandsbanki

Employee tenure



Source: Íslandsbanki

Gender split



Source: Íslandsbanki - *Includes managers in branch network and team leaders

Íslandsbanki also has in place a structured leadership programme to support the Bank's management team, and a special competency model for managers, which defines the skills a leader needs in order to succeed as a manager. The leadership programme aims to strengthen managers in specifically defined competencies and enable them to fulfil their leadership roles successfully.

To standardise the role of financial advisors and provide them with the necessary skills and knowledge, 11 employees started a certification training programme for financial advisors in Retail Banking. This Certification Programme is a joint venture of The Icelandic Financial Services Association, The Confederation of Icelandic Bank & Finance Employees, Ministry of Economic Affairs, University of Iceland, Reykjavik University and Bifröst University.

Employee satisfaction

Employee satisfaction and wellbeing are highly emphasised at Íslandsbanki. A motivated and engaged workforce is the foundation of good service, customer satisfaction, efficient operations, and in the end, profitability. Íslandsbanki has participated in Capacent's annual workplace audit since 1997. Results from the November 2011 audit showed that, despite continued challenges in the Bank's operating environment, morale remained very high. Indeed, the number of employees willing to recommend Íslandsbanki as an excellent workplace to their friends went up from the previous year.

An important dimension of employee satisfaction and morale are social activities. In the spring of 2011, a variety of health related events were held to encourage a healthy lifestyle. In fact, Íslandsbanki took first prize in in the national initiative "cycle to work", both with regard to the number of days participated and number of kilometres cycled. In addition, over 400 employees took part in the Reykjavík Marathon and contributed to raising funds for charity. Employees' children came for a one-day workplace visit, bowling and golf tournaments were held and the hiking, golf, cooking, photography and sewing clubs were active.

In December employees from Byr joined Íslandsbanki when the two banks merged. The similarity of the two companies' corporate cultures made the integration process smooth and was eased by Byr employees participating in a tailor-made orientation programme.

8 Íslandsbanki in society

Íslandsbanki is one of Iceland´s leading companies as well as being one of the biggest workplaces with over a thousand employees. As a large employer with a broad customer base Íslandsbanki has made it a priority to maintain a good relationship with its immediate environment.

Responsible and forward-looking banking

Íslandsbanki has been adhering to the UN Global Compact for the past three years which sets the parameters within which Íslandsbanki works. By looking forward and being responsible in all its actions, Íslandsbanki believes itself to be a reliable bank that plays a proactive role in the enhancement of the community and the environment in which it operates.

The Bank's initiatives around social issues are based on Íslandsbanki´s Corporate Social Responsibility policy which covers four key areas: Business, human capital, community and the environment.

Business

Íslandsbanki is aware of its important role in the society in which it operates, especially when it comes to financial stability. Corporate social responsibility is an integral part of our business.

Íslandsbanki is committed to providing customers with active and open communications, greater transparency and equal treatment. The Bank places an emphasis on good service to customers to ensure customer satisfaction and trust in the Bank. The Bank also ensures that all customers, whatever their size, are treated equally and that they benefit from equal access to all the information they might need about the Bank. To that end, the Bank's procedures have been revised and clarified.

Debt relief for households and companies

Since the financial crisis, Íslandsbanki has made it a priority to finalise the financial restructuring of households and companies. To that effect, a number of debt relief options have been implemented, catering to all classes of customers.

Íslandsbanki endeavours to provide precise and accurate information on the different options available to customers. This applies to individuals with mortgages and car loans as well as small and

Four pillars of Corporate Social Responsibility

Business

Íslandsbanki endeavours to serve its customers through clear regulations, the efficient disclosure of information, increased transparency, and fair treatment of all its customers.

Human capital

The objective of Íslandsbanki is to recruit, strengthen and retain skilled and reliable employees with varied educational backgrounds and experiences. Íslandsbanki supports a performance-driven culture that celebrates achievement. Motivation is key, as job satisfaction has an intrinsic impact on job performance and in turn on the Bank's operations and profitability.

Community

Íslandsbanki seeks to work in harmony with the communities in which it operates, by supporting various social, artistic, cultural, and sporting projects as well as innovation and entrepreneurship.

Environment

Íslandsbanki makes it a priority to work in harmony with the environment, and this is reflected throughout the Bank's operational management as well as its investments.

large corporates that do business with the Bank. Thousands of individuals and corporates have received write-offs or some sort of debt-relief through a variety of means, e.g. via mortgage reduction, modification of terms and interest rate discounts. Íslandsbanki has in many cases gone beyond what is decreed by Icelandic law and court orders in its recalculations to the benefit of customers. By doing so, the Bank contributes to accelerating the restructuring of the Icelandic economy.

Disclosure and Communication policy

The Bank believes that open and transparent disclosure is essential in building confidence and maintaining good relations with its stakeholders. The Bank operates under the Basel II capital framework and to comply with the rules the Bank has in place a Disclosure & Communication Policy. The Policy defines the governing principles and framework for disclosure and communication, including the Bank's disclosure mission. The disclosure mission of Íslandsbanki is to make correct and sufficient disclosure of material information and keep the disclosure accessible to all relevant stakeholders in a compliant, reliable, useful, timely and consistent manner.

Risk Report

The Bank continues to increase the transparency of its operations and enhance information disclosure. Íslandsbanki was the first bank in Iceland to publish a special risk report which contains information on the Bank's risk management issues and risk assessments. This report on the Bank´s risk activities is part of the Bank´s fulfilment of Pillar 3 of the Basel II Framework and is modelled on the best practice of many of its international peers.

Code of Ethics and procedural rules

To maintain and strengthen the credibility and the reputation of the Bank, all employees were involved in formulating the Bank's Code of Ethics. The aim of the Code is to promote good operational and business practices, increase trust and guide employees in their daily work. The Code covers the importance of professionalism, customer equality and the confidentiality of employees. In addition to the Code of Ethics, new procedures were put in place, which prescribe the general duties of Íslandsbanki´s employees. The procedures are intended to support the Code of Ethics as well as other internal rules.

The Bank's Compliance department has held workshops introducing the Code of Ethics and the procedures. Attendance at these workshops is mandatory for all employees.

Centre for Corporate Social Responsibility

Íslandsbanki, together with five other companies, has established the Icelandic Centre for CSR. The Centre is intended to raise awareness and increase knowledge and the ability of companies to demonstrate social responsibility in their everyday business. The CSR Centre is located at the University of Reykjavik and is charged with promoting know-how of the subject with the goal of promoting learning and know-how related to corporate social responsibility.

Promoting financial understanding and dialogue

Íslandsbanki is committed to increase financial literacy in Iceland. In 2011 VÍB, the wealth management division of Íslandsbanki, hosted 42 sessions and seminars for customers on savings and investments. To date, over 2,800 customers have attended these events. Additionally, VÍB held a series of symposiums on personal finances in collaboration with the National Association of Senior Citizens. VÍB further invited two distinguished foreign speakers, at separate events, to address the economic situation in Iceland.

A simple overview of personal finances

Íslandsbanki wants to assist its customers in keeping their finances under control. The Bank and financial software company Meniga have been working together from 2009 to help customers attain a clear and simple overview of their spending. Meniga is a sophisticated personal finance software that reads and automatically categorises all transactions from users´ bank accounts and credit cards. Access to this software is free of charge for customers and will be fully integrated in Íslandsbanki´s online bank by early 2012.

Íslandsbanki also hosted several seminars, "Finance in simple terms", for customers on family budgeting. The course covered the importance of goal setting, savings, loans, investments, pensions and how to use Meniga.

Last but not least, Íslandsbanki was the first Icelandic bank to launch a mobile app for Android and iPhone smartphones to facilitate customer access and overview of their financial information. Through the app, users can pay bills, view accounts, transfer funds, get location of branches and ATMs, view exchanges rates and access a currency converter. The launch was a great success and underpinned by the large number of customers that have already downloaded it.

Entrepreneurs in the making

Íslandsbanki, FKA, The Icelandic Association of Women Entrepreneurs, and the Open University at Reykjavik University sponsored a course for entrepreneurs and an entrepreneurship competition for women. Íslandsbanki subsidised of the course fee. At the course, participants received lessons regarding innovation, the establishment of businesses, strategic planning, market analysis, finance and negotiation. The women made 30 new and innovative business plans that were later evaluated and the best five competed to win an ISK 2 million award from Íslandsbanki.

Innovation Centre for Entrepreneurs

Íslandsbanki and Innovation Centre Iceland launched Kvosin-Innovation Centre for entrepreneurs at one of the Bank´s branch buildings in Reykjavík in 2009. Kvosin provides assistance to individuals and groups to work on business ideas and found companies under the professional supervision of experts from the Innovation Centre. Around 80 entrepreneurial companies have benefited from Kvosin´s assistance.

Human capital

Íslandsbanki puts great emphasis on job satisfaction, the wellbeing of its team, a vigorous educational programme and open dialogue. The Bank aims at recruiting, motivating and retaining competent and reliable employees that possess superior knowledge or experience, are positive, professional and always seeking the best solutions for customers.

The Bank´s focus on safeguarding its human capital has been rewarded by high levels of job satisfaction: in 2011, 87% of employees said they are happy at work and 81% of employees are proud to be working for Íslandsbanki. In 2011, Íslandsbanki offered nearly 300 courses, with each employee attending 4.5 courses on average.

Breaking the glass ceiling

Íslandsbanki has signed the Women´s Empowerment Principles, a collaboration between the United Nations Development Fund for Women (UNIFEM) and the United Nations Global Compact, which offer guidance on how to empower women in the workplace, marketplace and community. Íslandsbanki is committed to show initiative and work towards improving gender equality within the organization. In 2011, FKA, The Icelandic Association of Women Entrepreneurs, awarded Íslandsbanki for excelling in motivating women working at the Bank. Further, FKA stated that Birna Einarsdóttir, CEO of Íslandsbanki, has managed to activate the power of both sexes, for the good of both employees and customers of the Bank.

Strategy summit
Íslandsbanki held its third Strategy Summit in January, where over 650 employees and 150 customers participated and shared their perspective on improvements in the services the Bank provides. These summits have played a key role in giving employees an opportunity to make their mark on how the Bank should move forward.

Community
Since established in 1904, Íslandsbanki and its predecessors have played a proactive role in society and worked in harmony with the communities in which it operates. Íslandsbanki supports various social, artistic, cultural and sporting projects as well as innovation and entrepreneurship. In 2011, Íslandsbanki supported worthy causes with contributions totalling ISK 120m.

Íslandsbanki Reykjavík Marathon
Íslandsbanki has been the main sponsor of the Reykjavik Marathon since 1997. This year, a record was set with 12,213 runners registering, compared to 11,000 the year before, and the increased number of overseas participants is a good indicator of the Marathon's gaining foothold internationally. The most important component of the Marathon is the sponsorship raised for charities by the runners themselves. In 2011, over ISK 43.5 million was raised for over 100 charities. The Bank also views the Reykjavik Marathon as an important public health initiative, whereby the whole family can participate in tailor-made distances suitable for each family member.

To celebrate its longstanding association with the Reykjavik Marathon and its dedication to running as a public health initiative, Íslandsbanki decided to sponsor runner Kári Steinn Karlsson on this path to prepare for the 2012 London Olympic Summer Games. Kári has enjoyed great success in his endeavours in the past years. He set a new Icelandic national record in the half marathon during the Reykjavik Marathon in 2011 finishing at an impressive 1:05:35. He followed up on this feat by setting another Icelandic national record in the full marathon during the Berlin Marathon in September the same year when he finished at 2:17:12. Íslandsbanki is proud to sponsor this great athlete and looks forward to follow his success at the Olympics later this year.

The Women of Achievement Fund
The Women of Achievement Fund sponsors women in sport with the objective of encouraging them to excel in their chosen fields. The Fund was founded in 2007 as a joint initiative of Íslandsbanki and the National Olympic and Sports Association of Iceland. Over 100 applications were received during the year, whereby a total of ISK 6.5 million was awarded to 10 women and two national teams.

Special Olympics

Íslandsbanki has for a number of years been one of the main sponsors of the Icelandic Special Olympics team. In the summer of 2011 a team of 38 athletes competed in 8 different sports at the Special Olympics Summer Games in Athens, Greece. It gives Íslandsbanki great pleasure to sponsor these fine representatives of Iceland to compete in the Games, an experience which gives the participants a sense of achievement while at the same time being enjoyable and unforgettable.

"What if?"

Íslandsbanki sponsored schools, parents´ associations, and colleges to 35 recitals of the play What if? The play focuses on preventive measures to drugs- and alcohol abuse, bullying, suicides and sexual violence by using the theatre, music, humour and poetry in a fun and innovative way. Around 20,000 Icelandic teenagers have now seen the play and been touched by its message that teenagers have choices and that one innocent rash decision can have serious consequences.

Give life

Íslandsbanki was a main sponsor of Life, a charity championing the improved facilitiies of the National University Hospital's neo-natal and maternity ward. The campaign, known as "Give life", collected over ISK 60 million during a live telecast and as a result a much needed renovation of the facilities has begun.

Various community projects

In 2011, various Íslandsbanki branches supported different organizations and charities in their communities while the Bank's headquarters has focused on supporting national organisations.

Íslandsbanki´s new branch at Suðurlandsbraut supported Throskahjálp, an umbrella organisation supporting people with disabilities. Throskahjalp is made up of 22 associations with 6,000 members.

VÍB, the wealth management division of Íslandsbanki, supported Iceland´s participation at the La biennale di Venezia where the Spanish-Icelandic art duo Libia Castro & Ólafur Ólafsson exhibited their work "Under Deconstruction".

Íslandsbanki and the Reykjavík City Theatre have enjoyed a successful cooperation since the Bank's foundation. Reykjavík City Theatre is among Iceland´s oldest and most prestigious cultural institutions.

Íslandsbanki annually grants scholarships to honour students. In 2011 the Bank awarded 10 exemplary students with grants in the total amount of ISK 2.4 million.

Environment

Íslandsbanki strives to work in harmony with the environment, a fact that is reflected in the Bank´s strategy as well as in it investments. Íslandsbanki has stressed the social and environmental benefits of investing in renewable energy sources and sustainable fisheries. Therefore the Bank plays a proactive role in the promotion of eco-friendly solutions and technologies that reduce pollution and energy consumption and supports sustainable fisheries.

Íslandsbanki has taken many steps to reduce its environmental impact by integrating environmental strategies into its daily operations, for example:

- Items are sorted and properly disposed of in Íslandsbanki´s canteen as well as in subsidiary Ergo's headquarters.
- The incorporation of a paper management system in February 2009 has resulted in a 66% reduction of the paper used by the Bank or by 56 tons.
- Color printing has also dramatically decreased with the introduction of the system, contracting from 25% to 6.5%.
- The number of printers has been reduced by approximately 400 machines resulting in a decrease of electricity consumption of 60 – 80 MW a year.
- The Bank places an emphasis on reducing its electricity consumption by for example ensuring that lights are turned off at the end of the day.
- A modification of the heating system in the Bank´s parking lot has allowed a decrease in hot water usage by 45,000m³ in the last three years.
- Íslandsbanki discontinued the distribution of annual bank statements in printed format to customers at the end of 2010.

Geothermal energy

Íslandsbanki is one of the founding members of the Icelandic geothermal cluster. Geothermal energy is a clean, renewable resource that can be tapped by many countries around the world. Íslandsbanki´s geothermal energy team combines years of experience in this field and is focused on providing the global community with business solutions and research material, including reports on the Icelandic, American, and Canadian geothermal markets.

Sustainable fishing and the seafood industry

Íslandsbanki and its predecessors have worked closely with the seafood industry for over a century, and financed the first Icelandic motorized trawler in 1904. Providing financial and expert advice on sustainability within the fishing industry is an important element of Íslandsbanki´s business opportunities.

Íslandsbanki is a founding member of the Icelandic Seafood Cluster. The objective is to map the possibilities inherent in the Cluster which consists of e.g. fisheries, processing, technology, services and knowledge based companies in the seafood industry.

Ergo - thinking green

The asset-based financing unit of Íslandsbanki was rebranded to Ergo in 2011. Since establishment, Ergo has focused on green thinking and providing loans for environmentally friendly vehicles. These green loans constitute about 50% of all new car loans at Ergo.

Consolidated Financial Statements 2011

Endorsement and Statement by the Board of Directors and the CEO

The consolidated financial statements of Íslandsbanki hf. for the period ended 31 December 2011 comprise the Financial Statements of Íslandsbanki hf. and its subsidiaries, together referred to as “the Bank”.

Foundation and ownership

The Bank was incorporated on 8 October 2008 and commenced trading on 15 October 2008 when it acquired the assets and liabilities of the domestic operations of Glitnir Banki hf. ("Glitnir") which had been taken into public ownership following the passing of an Emergency Act in October 2008.

On 15 October 2009 the Resolution Committee of Glitnir exercised an option to acquire 95% of the share capital of the Bank with effect from 11 September 2009. The government retains 5% of the share capital of the Bank.

The Bank's parent company is ISB Holding ehf. which is owned by a subsidiary of Glitnir (GLB Holding ehf.).

Six Board members are appointed by ISB Holding ehf. One Board member is appointed by the Icelandic State Financial Investments (Bankasýsla ríkisins).

Operations

The Bank is divided into six business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury and Midengi (an asset management company).

The Bank has roots tracing back to 1884 and is one of the largest banking and financial services groups in Iceland. The Bank is a universal bank offering Icelandic households, SMEs and corporations comprehensive financial services. The Bank has a 25% - 35% market share across all domestic franchise areas and operates one of the most efficient branch networks in Iceland.

Building on a heritage of industry lending in Iceland, the Bank has developed specific expertise in two industry sectors, seafood and geothermal energy, that together form the basis for its overseas strategy. With its focused approach in these fields, the Bank offers valuable services to industry players and investors.

At the reporting date there were 1,470 full-time employees at the Bank, thereof 1,098 were employees of the parent company.

Risk Management

The Bank is exposed to various risks through its use of financial instruments. Managing these risks is an integral part of the Bank's operations. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies. The Bank's risk management policies are discussed under note 62.

The reporting period

One of the key projects of the year 2011 was restructuring of the loan portfolio to individuals and companies. Great progress was made in 2011 with 12,800 loans and 3,720 mortgages having been recalculated. Approximately 3,000 households took up mortgage adjustment programmes and total debt forgiveness and write-offs to individuals in the year 2011 amounted to ISK 53 billion.

Restructuring of corporate loan facilities is also well under way, including the most complicated cases, and approximately 800 companies have already been through a principal adjustment programme. For the year 2011 the total debt forgiveness and write-offs for companies amounted to ISK 159 billion.

On 12 July 2011, the Bank signed a share purchase agreement with Byr Sparisjódur and the Ministry of Finance to acquire 100% of the share capital of the commercial bank Byr hf. (“Byr”). The total consideration transferred was 6,600 million. On 27 November 2011, following final approval by the Parliament, the Financial Supervisory Authority (“FME”), the Competition Authority (“SR”) and the EFTA Surveillance Authority (“ESA”), the Bank successfully merged with Byr.

Endorsement and Statement by the Board of Directors and the CEO

The merged banks will operate under the Íslandsbanki brand. Byr's operations were predominantly in retail banking with six branches operating in Akureyri, Reykjanesbær and the Reykjavík area. Four of these branches merged with the Bank's branches in the first quarter of 2012. The operations of Byr align well with the Bank's operations and the Bank expects that future synergies achieved with the integration of the two entities will assimilate the cost of the acquisition.

As a part of the merger, the Bank made a fair value measurement of Byr's net identifiable assets and liabilities based on the Bank's assumptions of expected future cash flows. The result of this measurement was a fair value adjustment of ISK 18,349 million, bringing the total goodwill arising on acquisition to 17,873 million. The entire goodwill was impaired in December 2011 and this had a substantial one-off impact on the Bank's earnings in 2011, although the capital ratios remain well above limits. The financial effects of the merger are further disclosed under note 4.

In December 2011, the Bank launched a successful ISK 4 billion issue of covered bonds. This transaction, one of the first public, liquid transaction to be listed in Iceland since 2008, marks an important achievement both for the Bank and for the revitalisation of Icelandic capital markets. The issue inaugurated the Bank's ISK 100 billion covered bond programme, which will see the Bank issue some ISK 10 billion annually to broaden its funding base.

In December 2011 the Bank was part of the syndicate for a USD 200 million revolving credit facility for Landsvirkjun, the national power company. The syndicate comprised two Icelandic banks and three overseas banks. This is the first syndicated facility of an Icelandic State owned entity involving foreign banks since the financial crisis in 2008 and indicates a growing confidence by international markets in the Icelandic economy.

Outlook

The year 2011 was somewhat disappointing in terms of the recovery of the local financial markets. Few companies were listed and the economic recovery in general was at a slower pace than had been anticipated. General volatility in international markets, particularly the sovereign debt crisis in Europe, have acted as a drag on growth.

The Icelandic economy, however, is experiencing the first signs of recovery. Unemployment is decreasing, house sales are gaining pace and GDP growth is on the increase powered by exports, increased private consumption, increase in tourism, historically low interest rates and increased investments. Exports, in particular, are benefitting from the low real exchange rate of the ISK accompanied with high commodity prices worldwide.

Icelandic households and companies are still relatively highly leveraged and therefore the economic recovery remains fragile. The capital controls are expected to remain in place for some time, limiting foreign investments and stifling the recovery of the capital markets, as access to funding in foreign currency will continue to be limited.

Although de-leveraging of household and company debt is expected to continue for some time with a corresponding slowdown in new lending activities, the first signs of recovery are evident with increased leasing activity and larger corporate credit facilities in the pipeline.

The Bank has a solid capital base and a good liquidity position which gives it an excellent base to continue supporting the recovery of the Icelandic economy.

Endorsement and Statement by the Board of Directors and the CEO

Accounting convention

The consolidated financial statements for the year ended 31 December 2011 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Profit from the Bank's operations for the year ended 31 December 2011 amounted to ISK 1,866 million, which corresponds to a 1.5% return on equity. The Board of Directors proposes to pay no dividend for the year 2011. Bank equity, according to the consolidated financial position, amounted to ISK 123,703 million at year end. The Bank's total capital ratio, calculated according to the Act on Financial Undertakings, was 22.6%. The Icelandic Financial Supervisory Authority (FME) requires the Bank to maintain a minimum Tier 1 ratio of 12% of risk weighted assets and a total capital ratio, allowing for subordinated Tier 2 debt, of 16%. The Bank's total assets amounted to ISK 795,915 million at year end.

The Board of Directors draws special attention to the risks relating to the political and legal environment in Iceland. Recent court rulings have affected the operations of the Bank and added to the uncertainty of how to value part of the loan portfolio. The Bank has in the financial statements 2011 made appropriate provisions to reflect the risk associated with those court rulings. The Board also notes that the Bank maintains a strong capital base and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 2.3, 2.4 and 60 for the principal risks and uncertainties currently faced by the Bank.

To the best of our knowledge, the consolidated financial statements provide a true and fair view of the Bank's operating profits and its financial position at 31 December 2011. It also describes the principal risks and uncertainties currently faced by the Bank.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's consolidated financial statements for the period 1 January to 31 December 2011 by means of their signatures.

Reykjavík, 19 March 2012

Board of Directors:

Fridrik Sophusson, Chairman
John E. Mack, Vice-Chairman
Árni Tómasson
Daniel Levin
Kolbrún Jónsdóttir
Neil Graeme Brown
Marianne Økland

Chief Executive Officer:

Birna Einarsdóttir

Independent Auditor's Report

To the Board of Directors and Shareholders of Íslandsbanki hf.

We have audited the accompanying consolidated financial statements of Íslandsbanki hf., which comprise the consolidated statement of financial position as at 31 December 2011, and consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's and the Board of directors Responsibility for the Consolidated Financial Statements

Management and the board of directors are responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

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

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

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

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view, of the consolidated financial position of Íslandsbanki hf. as of 31 December 2011, and its consolidated financial performance and its consolidated cash flows for the period then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Emphasis of Matter

Without qualifying our opinion we draw your attention to:

Notes 2.3 b) and 60 in the consolidated Financial Statements, which discuss the uncertainties relating to the interpretation of a recent Supreme Court ruling and describes the principal risks and uncertainties currently faced by the Bank.

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

Pursuant to the requirements of Item 5, Paragraph 1 of Article 106 of the Icelandic Financial Statements Act No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Kópavogur, 19 March 2012

Deloitte ehf.

Pálína Árnadóttir
State Authorised Public Accountant

Páll Grétar Steingrímsson
State Authorised Public Accountant

Consolidated Statement of Comprehensive Income for the year 2011

	Notes	2011	2010
Interest income		52,671	61,776
Interest expense		(21,446)	(26,902)
Net interest income	10	31,225	34,874
Net valuation changes on loans and receivables		(1,296)	14,507
Provision for latent impairment		76	(514)
Net valuation changes	11	(1,220)	13,993
Net interest income after net valuation changes		30,005	48,867
Fee and commission income		8,698	11,306
Fee and commission expense		(2,732)	(3,926)
Net fee and commission income	12	5,966	7,380
Net financial income (expenses)	13-15	2,649	(910)
Net foreign exchange gain (loss)	16	937	(963)
Other net operating income	17	894	1,186
Other net operating income		4,480	(687)
Total operating income		40,451	55,560
Administrative expenses	18-22	(19,870)	(17,866)
Impairment of goodwill	41	(17,873)	-
Contribution to the Depositors' and Investors' Guarantee Fund	57	(965)	(607)
Share of profit of associates	36	39	-
Profit before tax		1,782	37,087
Income tax	24	(75)	(7,214)
Bank tax	3.26	(682)	(221)
Profit for the year from continuing operations		1,025	29,652
Profit (loss) from discontinued operations, net of income tax	23	841	(283)
Profit for the year		1,866	29,369

The notes on pages 65 to 137 are an integral part of these consolidated financial statements.

The amounts are in ISK million

Consolidated Statement of Comprehensive Income for the year 2011 (continued)

	Notes	2011	2010
Other comprehensive income			
Foreign currency translation differences for foreign operations	56	163	(8)
Other comprehensive income for the year (net of tax)		163	(8)
Total comprehensive income for the year		2,029	29,361
Attributable to:			
Equity holders of Íslandsbanki hf.		1,958	29,418
Non-controlling interests		(92)	(49)
Profit for the year		1,866	29,369
Total comprehensive income attributable to:			
Equity holders of Íslandsbanki hf.		2,073	29,410
Non-controlling interests		(44)	(49)
Total comprehensive income for the year		2,029	29,361
Basic earnings per share			
From continuing operations		0.11	2.97
From discontinued operations		0.08	(0.03)
From profit for the year	25	0.19	2.94
Diluted earnings per share			
From continuing operations		0.11	2.97
From discontinued operations		0.08	(0.03)
From profit for the year	25	0.19	2.94

The notes on pages 65 to 137 are an integral part of these consolidated financial statements.

The amounts are in ISK million

Consolidated Statement of Financial Position as at 31 December 2011

	Notes	31.12.2011	31.12.2010
Assets			
Cash and balances with Central Bank	26	57,992	30,799
Derivatives	28	339	70
Bonds and debt instruments	29	58,662	68,024
Shares and equity instruments	30	11,107	3,022
Loans to credit institutions	31-32	43,655	30,870
Loans to customers	33-34	564,394	515,161
Investments in associates	36-37	1,070	354
Property and equipment	40	5,276	5,419
Intangible assets	41	544	187
Deferred tax assets	50-52	2,629	283
Non-current assets and disposal groups held for sale	42	42,690	23,489
Other assets	43	7,557	5,544
Total Assets		795,915	683,222
Liabilities			
Financial liabilities	44	9,346	9,090
Derivatives	28	4,027	429
Deposits from Central Bank	45	73	26
Deposits from credit institutions	45	62,772	96,212
Deposits from customers	46-47	462,943	327,158
Debt issued and other borrowed funds	48	63,221	55,425
Subordinated loans	49	21,937	21,241
Current tax liabilities	50-52	2,670	9,024
Deferred tax liabilities	50-52	17	18
Non-current liabilities and disposal groups held for sale	42	7,317	16,442
Other liabilities	54	37,889	26,694
Total Liabilities		672,212	561,759
Equity			
Share capital	55	10,000	10,000
Share premium	55	55,000	55,000
Other reserves	56	2,661	2,498
Retained earnings		55,133	53,174
Total equity attributable to the equity holders of Íslandsbanki hf.		122,794	120,672
Non-controlling interests		909	791
Total Equity		123,703	121,463
Total Liabilities and Equity		795,915	683,222

The notes on pages 65 to 137 are an integral part of these consolidated financial statements.

The amounts are in ISK million

Consolidated Statement of Changes in Equity for the year 2011

	Notes	Attributable to equity holders of Íslandsbanki hf. Share capital	Share premium	Other reserves	Retained earnings	Total	Non-controlling interests	Total equity
Equity as at 31.12.2009		10,000	55,000	2,059	24,204	91,262	840	92,103
Translation differences for foreign operations	56			(8)		(8)		(8)
Contribution to statutory reserve	56			447	(447)	-		-
Net income recognised directly in equity		-	-	439	(447)	(8)	-	(8)
Profit for the year					29,418	29,418	(49)	29,369
Total comprehensive income for the year		-	-	439	28,971	29,410	(49)	29,361
Equity as at 31.12.2010	55	10,000	55,000	2,498	53,174	120,672	791	121,463
Translation differences for foreign operations	56			163		163		163
Net income recognised directly in equity		-	-	163	-	163	-	163
Profit for the year					1,958	1,958	(92)	1,866
Total comprehensive income for the year		-	-	163	1,958	2,121	(92)	2,029
Acquisition of subsidiary with non-controlling interests						-	995	995
Decrease in non-controlling interests due to sale of subsidiaries						-	(785)	(785)
Equity as at 31.12.2011	55	10,000	55,000	2,661	55,133	122,794	909	123,703

The notes on pages 65 to 137 are an integral part of these consolidated financial statements.

The amounts are in ISK million

Consolidated Statement of Cash Flows for the year 2011

	Notes	2011	2010
Cash flows from operating activities:			
Profit for the year		1,866	29,369
Adjustments to reconcile profit for the year to cash flows provided by (used in) operating activities:			
Non-cash items included in profit for the year and other adjustments		18,559	5,027
Changes in operating assets and liabilities		29,868	(46,149)
Income tax paid		(9,585)	(3,573)
Net cash provided by (used in) operating activities		40,708	(15,326)
Cash flows from investing activities:			
Cash acquired through business combination	4.1	4,090	-
Disposal of subsidiary, net of cash sold	4.4	(3,750)	-
Acquisition of subsidiary, net of cash acquired	4.4	4,940	-
Investments in associated companies		-	(46)
Investment property		-	377
Purchase of property and equipment		(856)	(937)
Purchase of intangible assets	41	(143)	(118)
Net cash provided by (used in) investing activities		4,281	(724)
Cash flows from financing activities:			
Proceeds from borrowings		3,850	-
Repayment of borrowings		(7,445)	-
Net cash used in financing activities		(3,595)	-
Net increase (decrease) in cash and cash equivalents		41,394	(16,050)
Effects of exchange rate changes on cash and cash equivalents		25	(115)
Cash and cash equivalents at the beginning of the year		37,152	53,317
Cash and cash equivalents at year end		78,571	37,152

	Notes	2011	2010
Reconciliation of cash and cash equivalents:			
Cash on hand	26	1,976	1,833
Cash balances with Central Bank	26	49,646	23,217
Bank accounts	31	26,949	12,102
Total cash and cash equivalents		78,571	37,152

The Bank has prepared its consolidated statement of cash flows using the indirect method. The Statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year. Cash and cash equivalents consist of highly liquid assets that are readily convertible into cash and which are subject to an insignificant risk of change in value. These are cash in hand, unrestricted balances with Central Bank and demand deposits with credit institutions.

Interest received in 2011 was ISK 36,432 million and interest paid in 2011 was ISK 18,025 million (2010 not available). Interest is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 65 to 137 are an integral part of these consolidated financial statements

The amounts are in ISK million

Consolidated Statement of Cash Flows for the year 2011

Non-cash items included in net profit and other adjustments:	2011	2010
Depreciation and amortisation	709	623
Amortiation of intangible assets	17,873	-
Share of loss of associates	389	519
Interest and exchange loss on debt issued	2,437	-
Impairments of financial assets	16,468	28,312
Income due to revised estimated cash flows from loans	(15,248)	(32,664)
Unrealised foreign currency (loss) and gain	(944)	900
Unrealised fair value (gains) through profit and loss	(3,041)	(381)
Net (profit) loss on non-current assets classified as held for sale	(841)	283
Bank tax	682	221
Income tax	75	7,214
Non-cash items included in net profit and other adjustments	18,559	5,027

Changes in operating assets and liabilities:		
Mandatory reserve with Central Bank	(621)	839
Loans and receivables to credit institutions	7,452	(7,224)
Loans and receivables to customers	37,546	17,779
Trading assets	14,808	(2,857)
Other operating assets	7,159	3,217
Non-current assets and liabilities held for sale	(17,240)	(3,154)
Deposits with credit institutions and Central Bank	(11,272)	(42,854)
Deposits from customers	(13,959)	(4,387)
Debt issued and other borrowed funds	-	(13,074)
Trading financial liabilities	256	1,758
Derivatives	3,327	359
Other operating liabilities	2,412	3,449
Changes in operating assets and liabilities	29,868	(46,149)

Non-cash transactions 2011

During 2011 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) Deposits from Glitnir were reclassed from deposits to credit institutions to deposits to customers following a reclassification by the FME. The transaction had no cash effect on the Bank.

b) The Bank sold part of its shareholding in an associate held for sale and subsequently lost significant influence over the entity. The remaining equity shares were therefore reclassifed from non-current assets held for sale to financial instruments at fair value through profit and loss and are presented in shares and equity instruments in the statement of financial position. The Bank recognised a fair value gain of ISK 3 billion as part of this transaction. The transaction had no cash effect on the Bank.

c) The consideration for the business combination discussed under note 4.1 was in the form of bonds issued in the total amount of ISK 6.6 billion payble in 2014 and 2015 (see note 4). The transaction had no cash effect on the Bank.

Non-cash transactions 2010

During 2010 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) As part of its restructuring process, the Bank changed debt instruments to equity instruments for the sum of ISK 3.3 billion. The transaction had no cash effect on the Bank.

b) A government secured customer loan for the amount of ISK 45 billion and money market loans for ISK 5 billion were reclassed from loans to credit institutions to loans to customers due to a change in entities' operations. The transactions had no cash effect on the Bank.

The notes on pages 65 to 137 are an integral part of these consolidated financial statements

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. General information

Íslandsbanki hf., the parent company, is a limited company incorporated and domiciled in Iceland. The address of its registered office is Kirkjusandur 2, 155 Reykjavík, Iceland.

The consolidated financial statements for the year ended 31 December 2011 were prepared on a going concern basis and comprise Íslandsbanki hf. (the parent) and its subsidiaries (together referred to as "the Bank"). Comparative information refers to the year ended 31 December 2010.

The Bank was incorporated on 8 October 2008 and commenced trading on 15 October 2008 when it acquired assets and liabilities relating to the domestic operations of Glitnir Banki hf. ("Glitnir").

Ownership of the Bank is divided between 95% shareholding of ISB Holding ehf, owned by a subsidiary of Glitnir (GLB Holding ehf.), and 5% shareholding of the Icelandic government.

The Bank provides a wide range of financial services such as retail banking, corporate banking, brokerage services, investment management and asset-based financing. The Bank operates mainly in the Icelandic market, but provides advisory services in relation to seafood and geothermal energy in the USA.

The consolidated financial statements were approved and authorised for issue by the Board of Directors of Íslandsbanki hf. on 19 March 2011.

2. Basis of preparation

2.1 Statement of compliance

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Information about IFRS and amendmends to IFRS issued but not effective for the period ended 31 December 2011 is disclosed in note 3.32.

2.2 Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments and derivative financial instruments.

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell.

The consolidated financial statements are presented in Icelandic krona (ISK), which is the functional currency of the Bank. The amounts are presented in ISK million, unless otherwise mentioned.

2.3 Significant accounting judgements and estimates

The preparation of the consolidated financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses recognised in the consolidated financial statements. The accounting estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

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

The most significant accounting areas of estimation uncertainty and critical judgements in applying accounting policies relate to the following:

Notes to the Consolidated Financial Statements

2.3 Cont'd

a) *Going concern*

The Bank continues to monitor its loan portfolio closely in the context of developments within the Icelandic economy as well as in markets abroad and is working closely with customers who are experiencing payment difficulties, in order to ensure maximum recovery of assets. Uncertainties in relation to the valuation and recoverability of the assets acquired from Glitnir are discussed under note 2.4.

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue in business for the foreseeable future. Therefore, the financial statements continue to be prepared on a going concern basis.

b) *Legislative changes and court rulings on foreign currency-linked loans*

Several Supreme Court rulings in 2010 and 2011 have affected the Bank. Most important of these rulings was a ruling on the illegality of a principal in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates. Legislative changes were made as a result of these rulings stipulating that the lowest offered Central Bank rates for non-indexed loans should be applied to the contracts affected by these rulings. Based on the above, the Bank initiated a recalculation of all affected foreign currency-linked loan contracts with the aim of converting them to ISK.

A Supreme Court ruling on 15 February 2012 disputed the proposed recalculation methods set out in the legislative changes, as it violated the borrower's constitutional right to an adequate compensation for previously paid up principal. The interpretation of this ruling and how it affects the Bank is uncertain. Significant uncertainty remains on how the ruling should be interpreted. The Bank has therefore made an assessment based on certain assumptions and subsequently concluded that the impact from this court ruling would be a loss of ISK 12.1 billion, although the amount may change following further court rulings. The Bank recognised a provision at year end 2011 and the financial statements therefore reflect the impact of the court rulings. Affected loan contracts are likely to have to go through a recalculation in the coming months.

The Bank ascertains that the financial effects of the Supreme Court rulings and legislative changes based on known facts and the information to hand are reflected in the consolidated financial statements. Supreme Court rulings are discussed further under note 60.

c) *Determination of fair value*

The Bank determines the fair value of financial assets and financial liabilities that are not quoted in active markets by using valuation techniques as described in accounting policy note 3.5. To the extent that it is practical, models use only observable data. However, for financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument, such as credit risk (both own and counterparty).

d) *Impairment allowances for loans and receivables*

The Bank recognises allowances for impairment for loans and receivables. For this purpose the Bank's management reviews its loan portfolios on a quarterly basis to assess whether there is any objective evidence of impairment. In determining whether an impairment allowance should be recognised in the statement of comprehensive income, the Bank's management makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from loans and receivables. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group.

When scheduling its future cash flows the Bank's management uses estimates based on loans and receivables with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Impairment allowance for loans and receivables is disclosed in more detail in note 3.21.

e) *The application of the effective interest method*

The application of the effective interest method when calculating the amortised cost of financial assets and financial liabilities requires management to estimate future cash payments or receipts through the expected life of the financial instrument, considering all contractual terms of the financial instrument (for example, prepayment, call and similar options). Revisions to estimates of future cash flows, other than those arising from changes in market variables, generally result in the Bank having to adjust the carrying amount of the financial asset or financial liability to reflect actual and revised estimated cash flows. In such cases the adjustment is recognised as income or expense in profit or loss in the period in which the estimate is revised.

Notes to the Consolidated Financial Statements

2.3 Cont'd

f) *Liquidity*

The Bank manages its liquidity by maintaining an adequate portfolio of liquid assets against liabilities. Internal liquidity limits assume that liquid assets cover all liabilities expected to mature within the next 12 month period, even under stressed market conditions.

Large part of the Bank's funding is currently in the form of on-demand deposits. The Bank is confident that this will change over the coming years as investors' risk aversion reduces and they start seeking higher yielding investment opportunities. The Bank will focus on extending the maturities of its funding base and has, to this end, launched a ISK 100 billion covered bond programme, out of which the Bank plans to issue ISK 10 billion annually. The programme was inaugurated in December 2011 with an ISK 4 billion issuance and followed by an issuance of ISK 3.3 billion in March 2012. Access to funding in foreign currencies is expected to be limited in the short to medium term. This limits the Banks ability to extend loans in foreign currency, although the Bank does not have any material foreign currency obligations maturing until the end of 2015.

The expected maturity profile of the Bank's liabilities is based on analysis of the historical behaviour and other characteristics of the deposit base. The contractual maturity profile is set out in the liquidity risk disclosure in note 69. The table requires judgement with respect to whether assets can be considered liquid and when deposits will be withdrawn

2.4 Assumptions and uncertainties in relation to the acquired portfolio

There were uncertainties in input parameters and assumptions used in valuation of the assets acquired from Glitnir at a deep discount. The Bank's management based their initial value estimates on expected five-year cumulative losses with conservative estimates for collateral values and a prudent risk premium, known facts, their knowledge of the customers and the market and on official macroeconomic forecasts from the Central Bank of Iceland, the IMF and the OECD.

Factors that can affect the recovery value of the loan portfolio include macroeconomic parameters such as the unemployment rate, inflation and wage growth, as well as actions taken by the government to facilitate and ease debt service and legislation that lengthens the collection process or increases taxation and the extent of customer participation in flexible maturity and payment equalisation programmes.

At 31 December 2011 many of the uncertainties surrounding the valuation of the financial assets acquired at a deep discount and the economic environment were still present. The Bank's management is, however, confident that the Bank's capital base is robust enough to absorb reasonable variances in applied assumptions.

Critical assumptions used in the initial valuation are discussed in detail in the consolidated financial statements 2009. Contingencies relating to the acquired loan assets are discussed under note 60.

2.5 Financial effects of assets acquired at deep discount

a) *Deep discount*

A loan is defined as having been acquired at a deep discount when the fair value on acquisition is considerably lower than the balance according to the terms of the loan. The difference is explained by severe financial difficulties of the debtor which manifests itself in a higher credit spread when estimating the fair value of the loan and not because of changes in business environment since the terms of the loan were agreed, i.e. market interest and liquidity.

A large proportion of the Bank's current financial assets were acquired at a deep discount. Credit losses already incurred were reflected in the purchase price and included in the estimated future cash flows when computing the effective interest rate.

b) *Revised estimated future cash flows*

The Bank revises its estimates of payments or receipts, the Bank adjusts the carrying amount of the financial instrument to reflect actual and revised estimated cash flows. The carrying amount is recalculated by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised in profit or loss as income or expense. Thus the effective interest rate is kept constant.

Discount arising from the initial recognition of the acquired loans is included in the calculation of the effective interest rate and is amortised over the expected life of the financial instrument based on the difference between the calculated effective interest rate for a given period and the loan's coupon for that period.

Notes to the Consolidated Financial Statements

2.5 Cont'd

Any revisions to estimated future cash flows subsequent to the initial recognition, e.g. recovery of previously incurred credit losses, are recognised as part of the carrying amount of the financial asset with a corresponding amount recognised in profit or loss. Revisions to the estimated future cash flows are recognised immediately in profit or loss in the accounting period when the change in estimate was made.

Upwards changes in estimated future cash flows are first recognised as a reversal of incurred impairment losses. The remaining balance is recognised as income from revised estimated future cash flows from loans. Downwards revisions to estimated future cash flows are recognised as impairment.

c) *Impairment of foreign exchange gains*

The loan portfolio contains loans in foreign currencies to borrowers with ISK revenue and cash flow. The foreign exchange gain or loss on these loans is realised as net financial income. The Bank does not expect to recover foreign exchange gain relating to these loans and the foreign exchange gain is therefore fully impaired. If, in a subsequent period, the Bank incurs a foreign exchange loss, previous impairment of foreign exchange gain is reversed.

Critical assumptions used in the initial valuation are discussed in detail in the Bank's consolidated financial statements 2009.

d) *Changes in presentation*

The following comparative amounts have been changed due to adjustments between the years:

The Bank has changed its presentation in the consolidated statement of comprehensive income where subtotals have been added for Net valuation changes and Other net operating income. The Bank has also changed its presentation of Profit for discontinued operations and is now presenting it net of income tax. The comparable figures have been adjusted accordingly. In addition, contribution to the Depositors' and Investors' Guarantee Fund is shown separately in the statement.

Comparable information in the consolidated statement of cash flows has been changed whereas non-cash items included in profit for the year and other adjustments has reduced by ISK 221 million with a corresponding increase in changes in operating assets and liabilities.

At 31 December 2010, bonds designated at fair value through profit and loss totalling ISK 31.8 billion were categorised as being unlisted. The bonds were in fact listed in May 2010, although no transactions occurred with these bonds until April 2011. Comparable information in notes 7 and 29 has been amended accordingly.

Comparable information in note 21 has been changed as the table now shows salaries but excludes employer's pension contribution and other benefits which are reported in a single figure below the table. Comparable information for employer's pension contribution and other benefits now includes employer's pension contributions for Board members.

Comparable information under related party disclosures in note 39 has been changed, whereas balances with an associate of ISK 351 million were wrongly presented for Members of the Board instead of for Associated companies.

Comparative information in note 57 for credit card commitments has been changed from ISK 25.4 billion to ISK 17.9 billion as part of the commitments were duplicated in the consolidated financial statements 2010.

Comparable information in note 12 has been changed as fees totalling 2,743 million in the Bank's subsidiary Borgun have been reclassified from loans and guarantees to payment processing.

Notes to the Consolidated Financial Statements

3. Significant accounting policies

The accounting policies set out below have been applied consistently by the Bank's entities.

3.1 Basis of consolidation

a) *Business combinations*

Acquisitions of subsidiaries and businesses are accounted for using the acquisition method as at the acquisition date. The consideration for each acquisition is measured as the aggregate of the fair values at the date of exchange of assets given, liabilities incurred or assumed, and equity instruments issued by the Bank in exchange for control of the acquiree. Acquisition-related costs are recognised in profit or loss as incurred.

Steps in applying the acquisition method are:
1. Identification of the 'acquirer' – the combining entity that obtains control of the acquiree;
2. Determination of the 'acquisition date' – the date on which the acquirer obtains control of the acquiree;
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest (NCI, formerly called minority interest) in the acquiree;
4. Recognition and measurement of goodwill or a gain from a bargain purchase.

Where applicable, the consideration for the acquisition includes any asset or liability resulting from a contingent consideration arrangement, measured at its acquisition date fair value. Subsequent changes in such fair values are adjusted against the cost of acquisition where they qualify as measurement period adjustments. The measurement period is the period from the date of acquisition to the date the Bank obtains complete information about facts and circumstances that existed as at the acquisition date, subject to a maximum of one year. All other subsequent changes in the fair value of contingent consideration classified as an asset or liability are accounted for in accordance with relevant IFRSs. Changes in the fair value of contingent consideration classified as equity are not recognised.

Where a business combination is achieved in stages, the Bank's previously held interests in the acquired entity are revalued to fair value at the acquisition date (i.e. the date the Bank attains control) and the resulting gain or loss, if any, is recognised in profit or loss. Amounts arising from interests in the acquiree prior to the acquisition date that have previously been recognised in other comprehensive income are reclassified to profit or loss, where such treatment would be appropriate if that interest were disposed of.

The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 are recognised at their fair value at the acquisition date, except that:
• Deferred tax assets or liabilities and liabilities or assets related to employee benefit arrangements are recognised and measured in accordance with IAS 12 Income Taxes and IAS 19 Employee Benefits respectively;
• Liabilities or equity instruments related to the replacement by the Bank of an acquiree's share-based payment awards are measured in accordance with IFRS 2 Share-based Payment;
• Assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations are measured in accordance with that standard.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Bank reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period, or additional assets or liabilities are recognised, to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the amounts recognised as of that date.

b) *Acquisition of non-controlling interests*

Acquisition of non-controlling interests are accounted for as transactions with owners in their capacity as owners and therefore no goodwill is recognised as a result. Adjustments to non-controlling interest arising from transactions that do not involve the loss of control are based on a proportionate amount of the net assets of the subsidiary.

c) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds 50% or more of the voting power of the subsidiaries. In assessing control, potential voting rights that are currently exercisable or convertible, if any, are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances.

Notes to the Consolidated Financial Statements

3.1 Cont'd

d) *Loss of control*

On the loss of control, the Bank derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss. If the Bank retains any interest in the previous subsidiary, then such interest is measured at fair value at the date that control is lost. Subsequently it is accounted for as an equity-accounted investee or as an available-for-sale financial asset depending on the level of influence retained.

e) *Non-controlling interests*

Non-controlling interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Bank and are presented separately in the statement of comprehensive income and within equity in the consolidated balance sheet, separately from the equity attributable to equity holders of the Bank. Disposals to non-controlling interests result in gains and losses for the Bank that is recorded in the statement of comprehensive income.

f) *Investments in associates*

Associates are those entities over which the Bank has significant influence, which is the power to participate in the financial and operating policy decisions of the entity but is not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights, if any.

Investments in associates are accounted for using the equity method and are initially recognised at cost. The investments include goodwill identified on acquisition. The carrying amount of the investments is adjusted for post-acquisition changes in the Bank's share of net assets of the associates and for impairment losses, if any. Therefore, the consolidated financial statements include the Bank's share of the total recognised gains and losses of associates, from the date that significant influence commences until the date that significant influence ceases. When the Bank's share of losses exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Bank resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

g) *Funds management*

The Bank manages and administers assets held in unit trusts and other investment vehicles on behalf of investors. The financial statements of these entities are not included in these consolidated financial statements except when the Bank controls the entity.

h) *Transactions eliminated on consolidation*

Intragroup balances, and any unrealised gains and losses or income and expenses arising from intrabank transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Bank's interest in them. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

3.2 Foreign currencies

a) *Foreign currency transactions*

Items included in the financial statements of each of the Bank's entities are measured using the functional currency of the respective entity. Transactions in foreign currencies are translated into functional currencies at the foreign exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are retranslated into functional currencies at the foreign exchange rate prevailing at that date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated into the functional currency at the spot exchange rate at the date that the fair value was determined. Foreign currency differences arising on retranslation are recognised in profit or loss.

b) *Foreign operations*

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on consolidation, are translated to the presentation currency, Icelandic krona (ISK), at foreign exchange rates prevailing at the balance sheet date. The revenues and expenses of foreign operations are translated to Icelandic krona at rates approximating the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on translation are recognised in other comprehensive income and accumulated directly in the translation reserve in equity. When a foreign operation is disposed of, in part or in full, the relevant amount in the translation reserve is transferred from equity and recognised in the statement of comprehensive income as part of the gain or loss on sale.

Notes to the Consolidated Financial Statements

3.3 Financial assets

For the purpose of measurement, the Bank classifies its financial assets at inception in the following categories:
• Loans and receivables; or
• Held to maturity; or
• Available-for-sale financial assets; or
• Financial assets designated at fair value through profit or loss, categorised as:
 - held for trading; or
 - designated at fair value through profit or loss.

a) *Loans and receivables*
Loans and receivables are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term, other than those that the Bank designates upon initial recognition as financial assets at fair value through profit or loss or available for sale. Loans and receivables include loans originated by the Bank to its customers and credit institutions, acquired loans and participations in loans from other lenders.

Loans and receivables are recognised when cash is advanced to borrowers. They are measured at fair value on initial recognition, which is the cash given to originate the loan, including any transaction costs, and are subsequently measured at amortised cost using the effective interest method, less allowance for impairment. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees and costs that are an integral part of the effective interest rate. Accrued interest is included in the carrying amount of the loans and receivables in the balance sheet.

Gains and losses on loans and receivables are recognised in the statement of comprehensive income in Interest income and Interest expense when the loans and receivables are derecognised and in Net foreign exchange difference when the loans and receivables are re-measured for foreign exchange differences. The losses arising from impairment are recognised in the statement of comprehensive income in Valuation changes on loans and receivables.

b) *Financial assets designated at fair value through profit or loss*
The Bank classifies certain financial assets upon their initial recognition as financial assets at fair value through profit or loss when doing so results in more relevant information because:
• It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
• Financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank's risk management or investment strategy, and information about it is provided internally on that basis to the Bank's key management personnel; or
• The financial assets and/or financial liabilities contain an embedded derivative that significantly modifies the cash flows that would otherwise have been required under the contract.

Assets classified according to the above-mentioned conditions consist of:
• Fixed interest rate loans originated by the Bank whose fixed interest has been swapped into floating by entering into corresponding interest rate swaps;
• Debt and equity instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial assets designated at fair value through profit or loss are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the statement of comprehensive income in "Net financial income", except for interest earned, which is recognised as "Interest income" on an accrual basis.

Financial assets held for trading
Financial assets held for trading are financial assets acquired principally for the purpose of selling or repurchasing in the near term, or for holding as part of a portfolio that is managed together for short-term profit or position taking. Financial assets held for trading consist of bonds and debt instruments, shares and equity instruments, and derivatives with positive fair value which are not designated as hedging instruments.

Financial assets held for trading are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the statement of comprehensive income in "Net financial income", except for interest earned, which is recognised as "Interest income" on an accrual basis.

Notes to the Consolidated Financial Statements

3.4 Financial liabilities

For the purpose of measurement, the Bank's management determines the classification of financial liabilities at initial recognition and classifies them in the following categories:
• Financial liabilities held for trading; or
• Financial liabilities designated at fair value through profit or loss; or
• Financial liabilities measured at amortised cost.

a) *Financial liabilities held for trading*
Financial liabilities held for trading are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities held for trading consist of short positions in equity and bond instruments, and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities held for trading are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the statement of comprehensive income in "Net financial income", except for interest incurred, which is recognised as "Interest expense" on an accrual basis.

b) *Financial liabilities measured at amortised cost*
Financial liabilities measured at amortised cost are non-derivative financial liabilities which are not classified as financial liabilities held for trading or financial liabilities designated at fair value through profit or loss. Financial liabilities measured at amortised cost include deposits, debt issued and other borrowed funds and subordinated loans.

Financial liabilities measured at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any discount or premium on the issue and fees and costs that are an integral part of the effective interest rate. Accrued interest is included in the carrying amount of the liabilities in the balance sheet.

3.5 Determination of fair value of financial assets and financial liabilities

A number of the Bank's accounting policies and disclosures require the determination of fair value for measurement and/or disclosure purposes. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction at the reporting date.

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. If a market for a financial instrument is not active, the Bank establishes fair value using valuation techniques. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Periodically, the Bank calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument, without modification or repackaging, or based on any available observable market data.

For more complex financial instruments, the Bank uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, in which case the inputs are derived from market prices or rates or estimated based on assumptions. The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value on the balance sheet.

Notes to the Consolidated Financial Statements

3.5 Cont'd

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Bank recognises the difference between the transaction price and fair value in the statement of comprehensive income in "Net financial income" on initial recognition of the financial instrument. In cases where use is made of data which is not from observable markets, the difference between the transaction price and the value produced by the valuation technique, if any, is recognised in the statement of comprehensive income in "Net financial income", depending upon individual facts and circumstances of each transaction and not later than when the data becomes observable.

3.6 Recognition and derecognition of financial assets and financial liabilities

The Bank uses trade date accounting to recognise purchases and sales of financial assets, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans, which are recognised on the date when cash is advanced to the borrowers. For a financial asset purchased, the Bank recognises on the trade date a financial asset to be received and a financial liability to pay. For a financial asset sold, the Bank derecognises the asset on the trade date, recognises any gains or losses on disposal and recognises a receivable from the buyer.

The Bank derecognises financial assets when the contractual rights to the cash flows from the financial assets expire or when the Bank transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Bank is recognised as a separate asset or liability.

The Bank recognises financial liabilities held for trading and financial liabilities designated at fair value through profit or loss on the trade date at which the Bank becomes a party to the contractual provisions of the financial instrument. The Bank recognises financial liabilities measured at amortised cost on the date when they originated. The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

The Bank enters into transactions whereby it transfers assets recognised on its balance sheet, but retains either all risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognised from the balance sheet. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Bank does not derecognise from the balance sheet securities which the Bank sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Bank recognises the cash received as a liability on its balance sheet. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest rate method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected on the balance sheet if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

3.7 Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

3.8 Derivative financial instruments

The Bank uses derivatives for trading. Derivatives which do not classify as equity instruments of the Bank are classified as financial assets or financial liabilities, measured at fair value and presented in the balance sheet as assets or liabilities, depending on whether their fair value at the balance sheet date is positive (assets) or negative (liabilities).

Notes to the Consolidated Financial Statements

3.8 Cont'd

The method of recognising changes in fair value of derivatives depends on whether the derivatives are designated as hedging instruments, and if so, the nature of the item being hedged. Derivatives which the Bank does not designate or are not effective hedging instruments are classified as financial assets or financial liabilities held for trading and are accounted for in accordance with note 3.3(b) and 3.4(a).

The Bank did not apply hedge accounting for the year ended 31 December 2011, nor for the comparative period.

3.9 Leases

The Bank classifies leases based on the extent of the transfer of risks and rewards incidental to ownership of leased assets. A lease is classified as operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

a) *Operating leases*

Lease payments under operating leases where the Bank is the lessee are recognised as an expense on a straight-line basis over the lease term.

Where the Bank is part of an arrangement in the legal form of a lease, which in substance does not involve a lease, lease accounting is not applied and the lease agreement is classified as loans and receivables.

3.10 Investment property

The Bank holds certain properties as investments to earn rental income, for capital appreciation or both. Investment property is measured initially at cost, including transaction costs. Subsequently, investment property is measured at fair value, which reflects market conditions at the balance sheet date. Changes in the fair values are included in the statement of comprehensive income in "Other net operating income".

3.11 Property and equipment

a) *Owned assets*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses, according to the cost model in IAS 16.

Where parts of an item of property and equipment have different useful lives, those components are accounted for as separate items of property and equipment.

b) *Subsequent costs*

The Bank recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Bank and the cost of the item can be measured reliably. The decision if subsequent costs is added to the acquisition cost of the property or equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are recognised in profit or loss as incurred.

c) *Depreciation*

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

Buildings	50 years
Fixtures	6 - 12 years
Machinery and equipment	4 years
Vehicles	3 years

The residual value is reassessed annually.

Notes to the Consolidated Financial Statements

3.12 Intangible assets

a) Goodwill

Business combinations are accounted for by applying the acquisition method. Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. The Bank measures goodwill at the acquisition date as:

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

When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss. Where goodwill arises, it is recognised as an asset in relation to the acquisition of businesses, for example through purchase of shares of subsidiaries or net assets of another entity. Goodwill relating to acquisition of associates is not recognised separately as an asset but is included in the carrying amount of investments in associates in the statement of financial position.

Goodwill is allocated to cash-generating units (CGUs) and is subsequently measured at cost less accumulated impairment losses. It is tested annually for impairment or whenever there is an indication that the asset or CGUs may be impaired.

b) Other intangible assets

Intangible assets other than goodwill, e.g. capitalised software, that are acquired by the Bank are measured at cost less accumulated amortisation and impairment losses.

c) Subsequent expenditure

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

d) Amortisation

Amortisation of intangible assets is charged to the statement of comprehensive income on a straight-line basis over the estimated useful live of the asset, from the date that it is available for use. The Bank ascertains that the estimated average useful life of a software is four years. Goodwill is not amortised, but it is tested annually for impairment and more frequently if required.

3.13 Non-current assets and disposal groups held for sale

Non-current assets, or disposal groups, comprising assets and liabilities, including non-current assets, or disposal groups, acquired in a business combination, are classified as held for sale if the Bank expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable. Immediately before classification as held for sale, the assets, or components of a disposal group, are remeasured in accordance with the Bank's accounting policies, except for non-current assets, or disposal groups, acquired in a business combination, which are recognised at fair value less costs to sell. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell.

Any impairment loss on a disposal group is allocated first to goodwill, and then to the remaining assets and liabilities on a pro rata basis, except for that no loss is allocated to inventories, financial assets, deferred tax assets, employee benefit assets and investment property. Impairment losses on initial classification as held for sale or distribution and subsequent gains and losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

3.14 Financial guarantees

Financial guarantees are contracts that require the Bank to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Bank to its credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities. Financial guarantees issued by the Bank are initially recognised at their fair value, being the premium received. The financial guarantee is subsequently carried at the higher of the amortised premium and the best estimate of the expenditure required to settle any financial obligation arising as a result of the guarantee at the reporting date. The estimates are determined based on experience of similar transactions and history of past losses, supplemented by a judgement by the management.

Any increase in the liability relating to financial guarantees is recognised in the consolidated statement of comprehensive income. The premium received is amortised on a straight line basis over the life of the guarantee and recognised in the consolidated statement of comprehensive income under "Net fees and commission income".

Notes to the Consolidated Financial Statements

3.15 Provisions

Provisions are recognised when the Bank has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Bank will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the balance sheet date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

The Bank recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be requierd to settle the obligation.

3.16 Subordinated loans

Subordinated loans are financial liabilities of the Bank which consist of liabilities in the form of subordinated loan capital which, in case of the Bank's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio the subordinated loans are included within Tier II. Subordinated loans usually have a maturity of a minimum of 10 years and to ensure that the amount of capital outstanding doesn't fall sharply once a Tier II issue matures, the regulator demands that the Tier II capital is amortised on a straight line basis in the remaining 5 years from its maturity.

3.17 Share capital

a) *Share capital*
The Bank has one class of ordinary shares which carry no right to fixed income.

b) *Dividends on shares*
Dividends are recognised as a deduction to equity in the period in which they are approved by the Bank's shareholders. Dividends declared after the balance sheet date are not recognised as a liability at the balance sheet date.

3.18 Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash in hand, treasury bills, demand deposits with the Central Bank and with other credit institutions, short term loans to credit institutions and other liquid debt securities at floating interest rates. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, and are used by the Bank in the management of its short-term commitments.

3.19 Interest income and expense

For all financial assets and financial liabilities measured at amortised cost and for debt instruments classified as financial assets available-for-sale, interest income and expense is recognised through profit or loss using the effective interest method. For all financial assets and financial liabilities held for trading and for all financial assets and liabilities designated at fair value through profit or loss, interest income and expense is recognised through profit or loss on an accrual basis.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

Notes to the Consolidated Financial Statements

3.19 Cont'd

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or expense. For floating rate instruments, interest income or expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate. Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

Interest income and expense include gains and losses on derecognition of loans and receivables and financial liabilities measured at amortised cost.

3.20 Net valuation changes

Net valuation changes on loans and receivables is the net amount realised in the income statement following a revaluation of loans and receivables. It is made up of income due to revised estimated future cash flows and individually and collectively assessed impairment, but excludes impairment or impairment loss reversal of foreign exchange gain from customers with cash flows in ISK.

Provision for latent impairment losses reflects impairment losses that have been incurred but not identified in the reporting period.

3.21 Impairment

The carrying amounts of the Bank's assets, other than tax assets and financial assets measured at fair value with changes recognised through profit and loss, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised in profit and loss whenever the carrying amount of a tangible or intangible asset or of a cash-generating unit exceeds its recoverable amount.

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

a) *Impairment of loans and receivables*

If there is objective evidence that an impairment loss has been incurred on loans and receivables, their carrying amount is reduced through the use of an allowance account to the present value of expected future cash flows, discounted at their original effective interest rate. Losses expected as a result of future events, no matter how likely, are not recognised.

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:
- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (for example, equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the borrower's competitive position;
- Deterioration in the value of collateral;
- Downgrading of an asset.

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in profit or loss.

The Bank's management first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Loans and receivables that are not impaired individually become a part of a portfolio which is assessed for impairment. Collective assessment based on a portfolio assumes that loans and receivables have similar credit risk characteristics. Objective evidence of impairment of a group of loans and receivables exists if objective data indicates a decrease in expected future cash flows from a portfolio of loans and the decrease can be measured reliably but cannot be identified with the individual loans in the portfolio.

Interest income on impaired loans and receivables is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring impairment losses.

Notes to the Consolidated Financial Statements

3.21 Cont'd

b) *Impairment of non-financial assets*

The carrying amounts of the Bank's non-financial assets, other than investment property and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. For goodwill and intangible assets that have indefinite useful lives or that are not yet available for use, the recoverable amount is estimated each year at the same time. An impairment loss is recognised if the carrying amount of an asset exceeds its estimated recoverable amount.

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

c) *Calculation of recoverable amount*

The recoverable amount of the Bank's loans and receivables is calculated as the present value of estimated future cash flows. The discount rate used for fixed rate loans and receivables is the effective interest rate computed at initial recognition. For variable rate loans and receivables the discount rate is the current effective interest rate.

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Loan write-offs:

When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined.

d) *Reversals of impairment*

An impairment loss in respect of financial assets carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

When a financial asset is acquired at a deep discount, credit losses have already occurred and are reflected in the purchase price. Such incurred credit losses are included in the estimated cash flows when computing the effective interest rate. Any adjustments arising from revisions to estimated cash flows subsequent to initial recognition, e.g. recovery of previously incurred credit losses, are recognised as part of the carrying amount of the financial asset with a corresponding amount recognised in profit or loss.

An impairment loss in respect of goodwill is not reversed.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

e) *Renegotiated loans*

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment.

Notes to the Consolidated Financial Statements

3.22 Net fee and commission income

Fees and commissions are generally recognised on an accrual basis when the service has been provided.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate on the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised on a straight-line basis over the commitment period. Loan syndication fees are recognised as revenue when the syndication has been completed and the Bank has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party – such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses – are recognised on completion of the underlying transaction. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis. Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria is fulfilled.

3.23 Net financial income

Net financial income consists of net gains on financial instruments held for trading, net gains on financial instruments designated at fair value through profit or loss and fair value adjustments in hedge accounting.

a) *Net gain (loss) on financial instruments held for trading*
Net gain (loss) on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and include all realised and unrealised fair value changes, except for interest (which is included in Interest income and Interest expense) and foreign exchange gains and losses (which are included in Net foreign exchange gain as described below). Dividend income from financial assets held for trading is recognised in the statement of comprehensive income when the Bank's right to receive payment is established.

Gain and loss arising from changes in the fair value of derivatives that are classified as held for trading and which are economic hedges of financial assets or financial liabilities designated at fair value through profit or loss are included in "Net gain on financial instruments designated at fair value through profit or loss".

b) *Net gain (loss) on financial instruments designated at fair value through profit or loss*
Net gain (loss) on financial instruments designated at fair value through profit or loss comprise gain and loss related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and loss (which are included in Net foreign exchange gain). Dividend income from financial assets designated at fair value through profit or loss is recognised in the statement of comprehensive income when the Bank's right to receive payment is established.

Net gain on financial instruments designated at fair value through profit or loss also include gain and losses arising from changes in the fair value of derivatives that are classified as held for trading and which are economic hedges of financial assets or financial liabilities designated at fair value through profit or loss.

3.24 Net foreign exchange gain (loss)

Net foreign exchange gain (loss) comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in previous financial statements, except for differences arising on financial instruments designated as hedging instruments of net investments in foreign operations.

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

On the face of the income statement, net foreign exchange gain (loss) is offset by impairment losses due to impairment of foreign exchange gain from loans in foreign currencies to borrowers with ISK revenue and cash flows, as the Bank does not expect to recover the foreign exchange gain on these loans.

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3.25 Income tax

Income tax on the profit or loss for the period comprises current and deferred tax. Income tax is recognised in the statement of comprehensive income except to the extent that it relates to items recognised directly in other comprehensive income.

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

The deferred income tax asset/liability has been calculated and entered in the statement of financial position. The calculation is based on the difference between balance sheet items as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration a carry forward tax loss. This difference is due to the fact that tax assessments are based on premises that differ from those governing the financial statements, mostly because revenues, especially of financial assets, are recognised earlier in the financial statements than in the tax return. A calculated tax asset is offset against income tax liability only if both are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. A deferred tax asset is reduced to the extent that it is no longer probable that the related tax benefit will be realised.

3.26 Bank tax

Bank tax is a tax on credit institutions which was implemented for the tax year ended 31 December 2010. The stated purpose of this tax is to create revenues for the government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, it is intended as a deterrent to increased risk appetite. The tax is calculated as 0.041% of the previous year's total liabilities. The Bank tax is shown in a separate line on the face of the statement of comprehensive income.

Also recognised under bank tax is a temporary tax on financial institutions to finance tax credits on mortgage interest payable to borrowers. The tax is applicable for the tax years ended 31 December 2012 and 31 December 2013, but is payable one year in advance and is charged to the profit and loss accordingly. The tax is calculated as 0.0875% of the previous year's total liabilities.

3.27 Administrative expenses

Administrative expenses consist of salaries and related expenses, depreciation of property and equipment, amortisation of intangible assets and other administrative expenses, such as housing costs, advertising expenses and IT-related expenses.

3.28 Segment reporting

A business segment is a component of the Bank that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Bank's other components. Each business segment is engaged in providing products or services which are subject to risk and return that are different from those of other business segments, that are subject to regular review by the Bank's Board and Chief Executive Officer for the purpose of allocating resources and assessing performance. The Bank is organised into six main business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury and Midengi.

3.29 Initial application of new standards and amendments to standards which had an effect on the consolidated financial statements of the Bank

The initial application of the following new standards and amendments to standards which became effective for the Bank on 1 January 2011 affected the consolidated financial statements of the Bank as follows:

Amendment to IFRS 7 Financial Instruments: Disclosures resulting from the Improvements to IFRSs (May 2010), which requires disclosure of a quantification of the extent to which collateral and other credit enhancements mitigate credit risk arising from financial assets. The application of that amendment has resulted only in disclosures provided by the Bank in the notes about the extent to which collateral and other credit enhancements mitigate credit risk arising from the financial assets of the Bank as at 31 December 2011. Comparable information as at 31 December 2010 is not disclosed.

Notes to the Consolidated Financial Statements

3.30 New standards and amendments to standards which became effective for the Bank on 1 January 2011 but had no effect on the consolidated financial statements of the Bank

The following new standards and amendments to standards which became effective on or after 1 January 2011 had no effect on the consolidated financial statements of the Bank:

a) Improvements to IFRSs (May 2010), except for the amendment to IFRS 7 Financial Instruments: Disclosures resulting from the Improvements to IFRSs (May 2010) (see Note 3.29 (a));

b) Amendment to IAS 32 Financial Instruments: Recognition and Measurement – Classification of Rights Issues;

c) IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments;

d) Amendments to IFRIC 14 IAS 19 – The Limit on a Defined Benefit Assets, Minimum Funding Requirements and their Interaction;

e) IAS 24 Related Party Disclosures (as revised in 2009)

3.31 New standards and amendments to standards adopted in advance by the Bank

The Bank did not early adopt any standards or amendments to standards which become effective after 1 January 2011.

3.32 New standards and amendments to standards which become effective for the Bank for annual periods beginning on or after 1 January 2012 and which have not been adopted in advance by the Bank

The following new standards and amendments to standards become effective for annual periods beginning on or after 1 January 2012 and have not been early adopted by the Bank:

a) Amendments to IAS 12 Income Taxes – Deferred Tax: Recovery of Underlying Assets introduce an exception to the current measurement principles of deferred tax assets and liabilities arising from investment property measured using the fair value model in accordance with IAS 40 Investment Property. The exception also applies to investment properties acquired in a business combination accounted for in accordance with IFRS 3 Business Combinations provided they are subsequently measured by applying the fair value model. In these specified circumstances the measurement of deferred tax liabilities and deferred tax assets should reflect a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale. The presumption is rebutted only if the investment property is depreciable and held within a business model whose objective is to consume substantially all of the asset's economic benefits over the life of the asset. If endorsed by the EU, these amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2012, with retrospective application required. The Bank does not expect the amendments to have a material impact on its consolidated financial statements.

b) Amendments to IFRS 7 Financial Instruments: Disclosures – Transfers of Financial Assets, which require disclosure of information that enables users of financial statements (i) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and (ii) to evaluate the nature of, and risks associated with, an entity's continuing involvement in derecognised financial assets. These amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2012. Disclosures required by these amendments are not required for any periods presented that begin before the date of initial application of the amendments. The Bank is currently in the process of evaluating the possible impact of these amendments on its consolidated financial statements.

c) Amendments to IAS 1 – Presentation of Items of Other Comprehensive Income, which require additional disclosures to be made in the other comprehensive income section such that items of other comprehensive income are grouped into two categories: (a) items that will not be reclassified subsequently to profit or loss; and (b) items that will be reclassified subsequently to profit or loss when specific conditions are met. Income tax on items of other comprehensive income is required to be allocated on the same basis. If endorsed by the EU, these amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required. The Bank does not plan to early adopt these amendments, which are otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

Notes to the Consolidated Financial Statements

3.32 Cont'd

d) IAS 19 Employee Benefits (as amended in 2011), which changes the accounting for defined benefit plans and termination benefits. The most significant change relates to the accounting for changes in defined benefit obligations and plan assets. The amendments require the recognition of changes in defined benefit obligations and in fair value of plan assets when they occur, and hence eliminate the “corridor approach” permitted under the current version of IAS 19 (as revised in 2004) and accelerate the recognition of past service costs. The amendments require all actuarial gains and losses to be recognised immediately through other comprehensive income in order for the net pension asset or liability recognised in the consolidated statement of financial position to reflect the full value of the plan deficit or surplus. If endorsed by the EU, the revised IAS 19 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required with certain exceptions. The Bank does not plan to early adopt IAS 19 (2011), which is otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

e) IFRS 10 Consolidated Financial Statements, which supersedes the requirements in IAS 27 Consolidated and Separate Financial Statements (as amended in 2008) relating to consolidated financial statements and SIC-12 Consolidation – Special Purpose Entities. IFRS 10 includes a revised definition of control that contains three elements: (a) power over an investee, (b) exposure, or rights, to variable returns from its involvement with the investee, and (c) the ability to use its power over the investee to affect the amount of the investor's returns. Extensive application guidance has been included in IFRS 10 to deal with complex circumstances, including guidance on how to determine when an investor holding less than a majority of the voting rights has de facto power over an investee. IFRS 10 carries forward the consolidation procedures from IAS 27 (2008). If endorsed by the EU, IFRS 10 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required with certain exceptions. The Bank does not plan to early adopt IFRS 10 and it is currently in the process of evaluating the possible impact of IFRS 10 on its consolidated financial statements. The application of IFRS 10 may result in the Bank no longer consolidating some of its investees and consolidating investees that were not previously consolidated.

f) IFRS 11 Joint Arrangements, which supersedes IAS 31 Interests in Joint Ventures and establishes principles for financial reporting by all entities that have interests in arrangements that are controlled jointly. Under IFRS 11, joint arrangements must be classified and accounted for either as joint operations or joint ventures. In contrast, under IAS 31, there are three types of joint arrangements: jointly controlled entities, jointly controlled assets and jointly controlled operations. In addition, joint ventures under IFRS 11 are required to be accounted for using the equity method of accounting, whereas jointly controlled entities under IAS 31 can be accounted for using either the equity method of accounting or proportionate accounting. Under IFRS 11, joint arrangements are classified depending on the rights and obligations of the parties to the arrangements. Joint operations arise where a joint operator has rights to the assets and obligations relating to the arrangement and hence accounts for its interest in assets, liabilities, revenue and expenses. Joint ventures arise where the joint operator has rights to the net assets of the arrangement and hence equity accounts for its interest. If endorsed by the EU, IFRS 11 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required with certain exceptions. The Bank does not plan to early adopt IFRS 11, which is otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

g) IFRS 12 Disclosure of Interests in Other Entities, which includes all the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. In general, the disclosure requirements in IFRS 12 are more extensive than those in the current standards. The disclosures required by IFRS 12 must enable users of an entity's financial statements to evaluate (a) the nature of, and risks associated with, the entity's interests in other entities; and (b) the effects of those interests on the entity's financial position, financial performance and cash flows. If endorsed by the EU, IFRS 12 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required. The Bank does not plan to early adopt IFRS 12 and it is currently in the process of evaluating the impact of IFRS 12 on its consolidated financial statements. More disclosures are however already anticipated.

Notes to the Consolidated Financial Statements

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h) IAS 28 Investments in Associates and Joint Ventures (as amended in 2011), which supersedes IAS 28 Investments in Associates (as revised in 2003) and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. The majority of the amendments made to IAS 28 in 2011 result from the incorporation of the requirements for joint ventures into the standard. The fundamental approach to accounting for equity-accounted investments has not been changed. Accordingly, IAS 28 (2011) requires an entity with significant influence over, or joint control of, an investee to account for the investment in the associate or joint venture using the equity method, except when the investment qualifies for certain exemptions. IAS 28 (2011) clarifies that either the entire investment in an associate or a portion of it may be measured by the investor at fair value through profit or loss in accordance with IAS 39 Financial Instruments: Recognition and Measurement (or IFRS 9 Financial Instruments if adopted) if certain criteria are met. IAS 28 (2011) contains more specific provisions with respect to investments in associates and joint ventures which meet the criteria to be classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. If endorsed by the EU, IAS 28 (2011) will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required. The Bank does not plan to early adopt IAS 28 (2011), which is otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

i) IFRS 13 Fair value measurement, which defines fair value, establishes a single comprehensive framework for measuring fair value and sets out related disclosure requirements. IFRS 13 provides detailed fair value measurement application guidance and replaces the guidance currently included in individual IFRSs. In general, the disclosure requirements in IFRS 13 are more extensive than those required in the current standards. IFRS 13 must be applied to both financial and non-financial items whenever other IFRSs require or permit their measurement at fair value, except in specified circumstances. If endorsed by the EU, IFRS 13 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013. The Bank will have to apply the measurement requirements of IFRS 13 prospectively as of the beginning of the annual period in which it will apply IFRS 13 initially and it will have a choice as to whether it provides the disclosures required by IFRS 13 for comparative periods before the period of initial application. The Bank does not plan to early adopt IFRS 13 and it is currently in the process of evaluating the possible impact of IFRS 13 on its consolidated financial statements. More disclosures are however already anticipated.

j) Amendments to IAS 32 and IFRS 7 – Offsetting Financial Assets and Financial Liabilities. The amendments to IAS 32 clarify that an entity currently has a legally enforceable right to set-off if that right is (a) not contingent on a future event; and (b) enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all counterparties. The amendments to IFRS 7 contain new requirements for disclosure of information that would enable users of financial statements to evaluate the effect or potential effect on an entity’s financial position resulting from netting arrangements, including rights of set-off associated with the entity’s recognised financial assets and recognised financial liabilities. If endorsed by the EU, the amendments to IAS 32 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014 and the amendments to IFRS 7 starting with its consolidated annual and interim financial statements for the year 2013. Retrospective application is required for both amendments to IAS 32 and IFRS 7. The Bank does not plan to early adopt these amendments and it is currently in the process of evaluating their impact on its consolidated financial statements. More disclosures are however already anticipated.

k) IFRS 9 Financial Instruments replaces those parts of IAS 39 Financial Instruments: Recognition and Measurement relating to the classification and measurement of financial assets and financial liabilities. The key features of IFRS 9 are the following:

• Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.
• An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest. All other debt instruments are to be measured at fair value through profit or loss.
• All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There will be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

Notes to the Consolidated Financial Statements

3.32 Cont'd

• Derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not to be separated; instead the hybrid financial instrument is to be assessed in its entirety as to whether it should be measured at amortised cost or fair value.

• IFRS 9 (2010) generally requires that the amount of change in fair value attributable to changes in the credit risk of liabilities designated by an entity as at fair value through profit or loss be presented in other comprehensive income, with only the remaining amount of the total gain or loss included in profit or loss. The amounts presented in other comprehensive income may not be subsequently reclassified to profit or loss but may be transferred within equity. However, if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, then the whole fair value change must be presented in profit or loss. Additionally, all fair value gains and losses continue to be included in profit or loss for loan commitments and financial guarantee contracts designated as fair value through profit or loss.

Currently, IASB has issued two versions of IFRS 9. The first version was issued in 2009 and the second version was issued in 2010. The 2010 version includes all the requirements of the 2009 version without amendment, but in addition, it also includes the requirements with respect to the classification and measurement of financial liabilities and the derecognition of financial assets and financial liabilities. The 2010 version supersedes the 2009 version. However, for annual periods beginning before 1 January 2015, an entity may elect to apply the 2009 version rather than the 2010 version.

If endorsed by the EU, IFRS 9 will become mandatory for the Bank starting with its consolidated financial statements for the year 2015. Upon initial application of IFRS 9 the Bank will have a choice as to whether it will restate prior periods or not and it will need to provide certain disclosures about the transition from IAS 39 to IFRS 9. The Bank does not plan to early adopt IFRS 9 and it is currently in the process of evaluating the potential effect of this standard. Given the nature of the Bank's operations, the standard is expected to have a pervasive impact on the consolidated financial statements of the Bank.

Notes to the Consolidated Financial Statements

Business combination

4. **Acquisition of group undertakings**

4.1 **Acquisition of Byr hf.**

a) *Background*

On 8 July 2011, the Bank made a binding offer to subscribe for the issuance of new shares in the commercial bank Byr hf. ("Byr"). The subscription process was initiated pursuant to a process letter issued in June 2011. On 12 July 2011 the Bank signed a share purchase agreement with Byr Sparisjódur which held 88.2% of the share capital of Byr and the Ministry of Finance which held 11.8%.

On 27 November 2011, following final approval by the Parliament, Financial Supervisory Authority ("FME"), the Competition Authority ("SR") and the EFTA Surveillance Authority ("ESA"), the Bank acquired 100% of the share capital of Byr.

The Byr operations were merged with the Bank's operations from 1 December 2011 and the combined entities will operate under the Íslandsbanki brand. Byr's operations were predominantly in retail banking with six branches operating in Akureyri, Reykjanesbær and the Reykjavík area. Four of these branches merged with the Bank's branches in the first first quarter of 2012.

b) *Identification of the business acquired*

The Bank aquired Byr and its investments in subsidiaries and associates as follows:

Fully consolidated subsidiaries:	Description of a subsidiary	Share of voting rights acquired
D-1 ehf.	Real estate company	100%
Hringur eignarhaldsfélag ehf.	Holding company	100%
Allianz Ísland hf.	Insurance sales company	100%
Landkostaland ehf.	Real estate company	100%
Njardarnes ehf.	Real estate company	100%
Rekstrarfélag Byrs hf.	Fund Management company	100%
Sparibréf ehf.	Real estate company	100%
Sparvernd ehf.	Investment company	100%
SPK Fjárfesting ehf.	Investment company	100%
SPN Fjárfesting ehf.	Investment company	100%
SPV Fjárfesting hf.	Investment company	100%
StjórnarZ ehf.	No trading	100%

Subsidiaries held exclusively with a view to subsequent disposal (one line consolidation):

Básbryggja ehf.	Real estate company	100%
Bréfabær ehf.	Real estate company	100%
Fjárvari ehf.	Real estate company	100%
Costa Properties ehf.	Real estate company	100%
Lava Capital ehf.	Investment company	100%
Lava Capital Ltd.	Investment company	100%

Subsidiaries are consolidated even if they are held exclusively with a view to disposal and classified as held for sale according to IFRS 5.

In addition, the Bank acquired five dormant companies as part of the merger with Byr.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

4.1 Cont'd

Associates acquired as part of the business combination:	Description of an associate	Share of voting rights acquired
Teris	IT company	42.85%
Íslensk verdbréf hf.	Fund company	27.51%
FSP Holding ehf.	Holding company	26.80%
Grófargil ehf.	Bookkeeping services	25.00%
Eignarhaldsfélagid ehf.	Holding company	24.99%
Borgun hf.	Credit card settlement company	22.00%
Reiknistofa bankanna hf.	Bank transaction settlement company	7.21%

Borgun hf. ("Borgun") was an associate of the Bank prior to the merger with Byr. The combined shareholding in Borgun after the merger is 61.3%. The Bank therefore effectively gained control over the entity through its combined voting power and subsequently reclassified Borgun as a subsidiary.

c) *Identification of acquired assets and liabilities*
The Bank has performed a fair value measurement of the business combination which takes into account the condition of and uncertainties in relation to the underlying assets and liabilities.
The fair value of the identifiable assets and liabilities acquired is as follows:

	Fair value at the date of acquisition
Byr net identified assets and liabilities	
Cash and balances with Central Bank	4,090
Bonds and debt instruments	7,614
Shares and equity instruments	1,773
Loans to credit institutions	853
Loans to customers	82,703
Investments in associates	1,121
Investments in subsidiaries	1,983
Property and equipment	1,086
Non-current assets held for sale	3,050
Other assets	8,775
Assets	113,048
Deposits from Central Bank	55
Deposits from credit institutions	5,701
Deposits from customers	117,705
Debt issued and other borrowed funds	82
Current tax liabilities	122
Guarantees granted to customers	68
Other liabilities	587
Liabilities	124,320
Fair value of net identifiable assets and liabilities	(11,273)
Total consideration transferred	(6,600)
Goodwill recognised	(17,873)

The amounts are in ISK million

Notes to the Consolidated Financial Statements

4.1 Cont'd

The goodwill recognised as a result of the acquisition is attributable mainly to the synergies expected to be achieved from integrating the Byr operations into the Bank's existing operations. The entire goodwill recognised was impaired at year end 2011 (see note 41) and is deductible for tax purposes spread over a 5 year period.

The total fair value of loans and receivables is ISK 83,556 million with a gross contractual amount of ISK 148,755 million, of which ISK 65,199 million is expected to be uncollectible.

d) Identification of the cost of the business combination

The total consideration payble by the Bank of ISK 6,600 million was in the form of bonds issued to Byr Sparisjódur and the Ministry of Finance. The amount can be lowered for loans or other valid claims held by Byr which are paid by way of set off with claims against Byr Sparisjódur. Furthermore, the amount can be lowered if one or more of the Byr Sparisjódur and Ministry of Finance representations and warranties prove to be incorrect, incomplete or misleading, or the information in the Byr data room is proven to have been incorrect, incomplete or misleading.

The Bank incurred acquisition related costs of ISK 743 million relating to external legal fees, additional audit expenses, IT services, etc. These costs have been recognised in administrative expenses in the Bank's consolidated statement of comprehensive income.

e) The financial effects of the business combination recognised in the current period

Byr's operations merged with the Bank's operations and therefore the contribution to total operating income and profit recognised in the current period is not identifiable.

Since the merge of operations on 1 December 2011, fully consolidated subsidiaries acquired as part of the merger with Byr have contributed a total operating income of ISK 119 million and a total profit of ISK 59 million to the Bank's results. Disposal groups held for sale contributed net profit of 184 million.

4.2 Aquisition of subsidiaries held exclusively with a view to disposal

On 12 January 2011, the Bank obtained control of Jardboranir ehf., a geothermal drilling company, by exercising its option to acquire 100% of its shareholding. The option was part of restructuring of the previous owner, Atorka. The entity qualified as being held for sale in accordance with IFRS 5 and was therefore classified as a disposal group held for sale. The Bank signed a sales agreement for the sale of 82% of its shareholding in Jardboranir in January 2012. The sale is due to complete in the first quarter of 2012.

On 4 February 2011, the Bank acquired 62.9% shareholding in Bifreidar og landbúnadarvélar ehf., a car and farm vehicle dealership, and 62.9% shareholding in Ingvar Helgason ehf., a car dealership, through its 100% owned holding company, BLIH ehf. The acquisition arose as a result of foreclosures necessary to secure assets placed as collateral against loan assets. Both entities qualified as being held for sale in accordance with IFRS 5 and were therefore classified as disposal groups held for sale. The holding company BLIH ehf. was sold on 17 November 2011.

On 28 February 2011, following financial restructuring of Icelandair Group hf., where the Bank had a leading position, the Bank's asset management company Midengi ehf. acquired 71.1% shareholding in Bláfugl ehf., an aviation service company and 71.1% shareholding in IG Invest ehf., an aircraft brokerage and leasing company, through its 100% owned holding company, SPW ehf. Both entities qualified as being held for sale in accordance with IFRS 5 and were therefore classified as disposal groups held for sale.

On 22 December 2011, the Bank obtained control of Höfdatorg ehf., owner of an office tower in the Reykjavik finance district. The acquisition arose as a result of foreclosures necessary to secure assets placed as collateral against loan assets. The entity qualified as being held for sale in accordance with IFRS 5 and was therefore classified as a disposal group held for sale.

4.3 Acquisition of non-controlling interests

During the accounting period the Bank acquired 45% additional shareholding in Kreditkort hf. bringing its total shareholding to 100%. The consideration was in the form of 15.71% shareholding in Borgun. The Bank recognised a decrease in non-controlling interest of ISK 230 million as a result of the transaction.

4.4 Change in subsidiary ownership

During the accounting period the Bank disposed of 15.71% of its shareholding in Borgun as consideration for 45% shareholding in Kreditkort hf. As a result of this transaction the Bank lost control over its subsidiary Borgun as the Bank's shareholding in Borgun reduced to 39.29% and the company was subsequently classified as an associate of the Bank.

Notes to the Consolidated Financial Statements

4.4 Cont'd

The Bank recognised a loss from disposal in the amount of ISK 58 million and included it in the statement of comprehensive income in the line item "Net financial expenses". Comparative information in the statement of comprehensive income and the consolidated statement of financial position has not been restated.

On 27 November 2011, as part of the merger with Byr, the Bank aquired a 22% share in its associate Borgun bringing its total shareholding to 61.3%. The Bank effectively regained control over Borgun through its majority shareholding and reclassified Borgun as a subsidiary. Borgun is part of the consolidated Bank at year end 2011 and has contributed total operating income of ISK 561 million and profit of ISK 15 million to the Bank's results in the period.

4.5 Sale of subsidiaries

On 28 March 2011 the Bank sold its 100% shareholding in Steypustödin hf. The entity was classified as a non-current asset and disposal group held for sale and the results from the disposal are included under profit from discontinued operations, net of income tax.

On 30 June 2011 the Bank sold its 90% shareholding in Eik Fasteignafélag ehf. The entity was classified as a non-current asset and disposal group held for sale and the results from the disposal are included under profit from discontinued operations, net of income tax.

On 17 November 2011 the Bank sold its 100% shareholding in BLIH ehf. The entity was classified as a non-current asset and disposal group held for sale and the results from the disposal are included under profit from discontinued operations, net of income tax.

On 22 December 2011 the Bank sold its 100% shareholding in Hlídarsmári 3 ehf. The entity was classified as a non-current asset and disposal group held for sale and the results from the disposal are included under profit from discontinued operations, net of income tax.

Notes to the Consolidated Financial Statements

Business segments

5. A business segment is a distinguishable component of the Bank that is engaged in providing products or services that are subject to risks and rewards that may be different from those of other business segments. Transactions between the business segments are on normal commercial terms and conditions. No single customer generates 10% or more of the combined revenue of the Bank.

The accounting policies for the reportable segments are in line with the Bank's accounting policies. The segment profit presented is the profit reported to the chief operating decision maker (CEO) and the Board for the purpose of resource allocation and assessment of segment performance.

The Bank is organised into six main business segments based on products and services:

a) Retail Banking operates branches and asset-based financing. The branches provide services to individuals and small and medium-sized enterprises from 26 branches in Iceland.

b) Corporate Banking provides lending and other credit services to medium and large corporates in Iceland. In addition, Corporate Banking's Corporate Solutions unit, manages and leads restructuring of the distressed large corporate portfolio.

c) Markets incorporates brokerage services in securities, foreign currencies and derivatives as well as providing money market lending and interbank services. The division further offers an extensive range of corporate finance services locally as well as to the international seafood sector.

d) Wealth Management offers a range of wealth and asset management products and services for individuals, corporations and institutional investors. The Wealth Management unit consists of VÍB which offers a broad range of asset management products and services and the fund management company Íslandssjódir. Net valuation changes in Wealth Management derive from a small loan book in a winding down process.

e) Midengi is an asset management company managing businesses which the Bank has acquired through repossessions following loan defaults, debt restructuring and bankruptcies of its customers. The aim is to divest the businesses at the earliest opportunity.

f) Treasury incorporates unallocated capital and is responsible for the Bank's funding and liquidity management as well as management of the Bank's shares and equity instruments.

Cost centres comprise Head Office, Human Resources, Risk Management & Credit Control, Legal, Finance, IT & Operations.

Capital is allocated to business segments based on the minimum Core Tier 1 ratio requirements set by the Financial Supervisory Authority (FME) of 12% of average risk weighted assets on which the segments receive risk free interest return. The remaining capital balance is reported under the Treasury unit.

Below is an overview showing the Bank's performance with a breakdown by business segments.

The year 2011

Operations	Retail Banking	Corporate Banking	Markets	Wealth Management	Midengi	Treasury	Cost centres & eliminations	Total
Net interest income	17,923	7,985	137	965	(818)	5,936	(903)	31,225
Net valuation changes	(6,921)	7,447	-	(1,863)	403	-	(286)	(1,220)
Net fee and commission income	3,071	186	1,179	1,404	(31)	(105)	262	5,966
Net other income (expenses)	47	2,550	(96)	172	(4)	591	1,221	4,480
Operating income	14,119	18,168	1,220	678	(450)	6,423	293	40,451
Administrative expenses	(6,221)	(835)	(757)	(836)	(177)	(169)	(10,875)	(19,870)
Insurance fund	(855)	(0)	(0)	(63)	-	(46)	(1)	(965)
Impairment of goodwill	-	-	-	-	-	-	(17,873)	(17,873)
Share of profit of associates	-	-	-	-	-	39	-	39
Profit (loss) before tax	7,043	17,333	463	(222)	(628)	6,247	(28,455)	1,782
Net segment revenue from external customers	18,203	25,423	1,156	91	(450)	(4,608)	636	40,451
Net segment revenue from other segments	(4,084)	(7,254)	64	587	-	11,030	(343)	0

The amounts are in ISK million

Notes to the Consolidated Financial Statements

5. Cont'd

	Retail Banking	Corporate Banking	Markets	Wealth Management	Midengi	Treasury	Cost centres & eliminations	Total
At 31 December 2011								
Total segment assets	380,905	183,908	1,099	7,175	26,820	193,311	2,697	795,915
Total segment liabilities	396,606	207	1,608	28,401	21,401	243,623	(19,634)	672,212

The year 2010

Operations	Retail Banking	Corporate Banking	Markets	Wealth Management	Midengi	Treasury	Cost centres & eliminations	Total
Net interest income	19,183	10,300	370	1,513	(380)	4,440	(553)	34,874
Net valuation changes	2,028	12,715	10	(229)	(408)	45	(168)	13,993
Net fee and commission income	3,970	302	1,625	1,404	(55)	(19)	153	7,380
Net other (expenses) income	(188)	506	87	1	238	(1,015)	(317)	(687)
Operating income	24,994	23,823	2,093	2,689	(604)	3,450	(885)	55,560
Administrative expenses	(5,882)	(796)	(496)	(811)	(219)	(304)	(9,358)	(17,866)
Insurance fund	(430)	(1)	(0)	(29)	-	(147)	0	(607)
Impairment of goodwill	-	-	-	-	-	-	-	-
Share of profit of associates	-	-	-	-	-	-	-	-
Profit (loss) before tax	18,682	23,026	1,597	1,849	(824)	3,000	(10,243)	37,087
Net segment revenue from external customers	25,825	23,493	9,879	2,677	(604)	(5,149)	(561)	55,560
Net segment revenue from other segments	(831)	330	(7,786)	12	-	8,599	(324)	(0)
At 31 December 2010								
Total segment assets	297,747	175,907	255	10,231	9,161	181,862	8,059	683,222
Total segment liabilities	292,385	929	468	19,195	6,236	240,154	2,392	561,759

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters:

2011	Q4	Q3*	Q2*	Q1*	Total
Net interest income	7,074	7,848	8,242	8,061	31,225
Net valuation changes	(465)	(576)	409	(664)	(1,296)
Provision for latent impairment	64	167	16	(171)	76
Net fee and commission income	1,600	1,353	1,298	1,715	5,966
Net financial income (expenses)	2,986	131	(330)	(138)	2,649
Net foreign exchange gain	529	72	134	202	937
Other net operating (expenses) income	(74)	312	297	359	894
Administrative expenses	(6,118)	(4,378)	(4,671)	(4,703)	(19,870)
Impairment of goodwill	(17,873)	-	-	-	(17,873)
Contribution to the Depositors' and Investors' Guarantee Fund	(281)	(252)	35	(467)	(965)
Share of profit of associates	39	-	-	-	39
(Loss) profit before tax	(12,519)	4,677	5,430	4,194	1,782
Income tax	3,022	(1,030)	(1,202)	(865)	(75)
Bank tax	(173)	(165)	(289)	(55)	(682)
(Loss) profit for the period from continuing operations	(9,670)	3,482	3,939	3,274	1,025
Profit (loss) for the period from discontinued operations	190	(198)	537	312	841
(Loss) profit for the period	(9,480)	3,284	4,476	3,586	1,866

* The half year results were reviewed by the Bank's auditors, with an emphasis on the loan portfolio, but the splits between quarters were not audited. The legislation for the Depositors' and investors' guarantee fund was changed in June 2011 which resulted in an amendment to charged amounts.

2010	Q4	Q3*	Q2*	Q1*	Total
Net interest income	9,128	8,308	8,289	9,149	34,874
Net valuation changes	12,267	2,714	702	(1,176)	14,507
Provision for latent impairment	(41)	137	(49)	(561)	(514)
Net fee and commission income	2,146	1,902	1,708	1,624	7,380
Net financial (expenses) income	(548)	72	(49)	(385)	(910)
Net foreign exchange gain (loss)	1,391	(2,406)	179	(127)	(963)
Other net operating income	490	217	392	87	1,186
Administrative expenses	(4,795)	(4,339)	(4,690)	(4,042)	(17,866)
Contribution to the Depositors' and Investors' Guarantee Fund	270	(314)	(251)	(312)	(607)
Share of profit of associates	-	(50)	50	-	-
Profit before tax	20,308	6,241	6,281	4,257	37,087
Income tax	(3,323)	(1,544)	(1,540)	(807)	(7,214)
Bank tax	(221)	-	-	-	(221)
Profit for the period form continuing operations	16,764	4,697	4,741	3,450	29,652
(Loss) profit for the year form continuing operations	(545)	164	(35)	133	(283)
Profit for the period	16,219	4,861	4,706	3,583	29,369

* The half year results were reviewed by the Bank's auditors, but the splits between quarters were not audited.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Financial assets and liabilities

7. The following tables show the carrying value of financial assets and financial liabilities according to their IAS 39 classification.

At 31 December 2011	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Other amortised cost	Total carrying amount
Cash and balances with Central Bank	26	-	-	57,992	-	57,992
Loans and receivables						
Loans to credit institutions	31-32	-	-	43,655	-	43,655
Loans to customers	33-34	-	-	564,394	-	564,394
Loans and receivables		-	-	666,041	-	666,041
Bonds and debt instruments						
Listed		23,095	31,610	-	-	54,705
Unlisted		-	3,957	-	-	3,957
Bonds and debt instruments	29	23,095	35,567	-	-	58,662
Shares and equity instruments						
Listed		1,079	5,207	-	-	6,286
Unlisted		-	4,821	-	-	4,821
Shares and equity instruments	30	1,079	10,028	-	-	11,107
Derivatives	28	339	-	-	-	339
Total financial assets		24,513	45,595	666,041	-	736,149
Financial liabilities	44	9,346	-	-	-	9,346
Derivatives	28	4,027	-	-	-	4,027
Deposits from Central Bank	45	-	-	-	73	73
Deposits from credit institutions	45	-	-	-	62,772	62,772
Deposits from customers	46-47	-	-	-	462,943	462,943
Debt issued and other borrowed funds	48	-	-	-	63,221	63,221
Subordinated loans	49	-	-	-	21,937	21,937
Total financial liabilities		13,373	-	-	610,946	624,319

The amounts are in ISK million

Notes to the Consolidated Financial Statements

7. Cont'd

At 31 December 2010	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Other amortised cost	Total carrying amount
Cash and balances with Central Bank	26	-	-	30,799	-	30,799
Loans and receivables						
Loans to credit institutions	31-32	-	-	30,870	-	30,870
Loans to customers	33-34	-	-	515,161	-	515,161
Loans and receivables		-	-	576,830	-	576,830
Bonds and debt instruments						
Listed		36,201	30,338	-	-	66,539
Unlisted		-	1,485	-	-	1,485
Bonds and debt instruments	29	36,201	31,823	-	-	68,024
Shares and equity instruments						
Listed		411	51	-	-	462
Unlisted		-	2,560	-	-	2,560
Shares and equity instruments	30	411	2,611	-	-	3,022
Derivatives	28	70	-	-	-	70
Total financial assets		36,682	34,434	576,830	-	647,946
Financial liabilities	44	9,090	-	-	-	9,090
Derivatives	28	429	-	-	-	429
Deposits from Central Bank	45	-	-	-	26	26
Deposits from credit institutions	45	-	-	-	96,212	96,212
Deposits from customers	46-47	-	-	-	327,158	327,158
Debt issued and other borrowed funds	48	-	-	-	55,425	55,425
Subordinated loans	49	-	-	-	21,241	21,241
Total financial liabilities		9,519	-	-	500,062	509,581

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Fair value information for financial instruments

8. The fair value of a financial instrument is the transaction price that would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Where a market price is not readily available, the Bank applies valuation techniques based on estimates and assumptions that are consistent with that which market participants would use in setting a price for the financial instrument. In some instances the Bank uses approximation methods. These approximation methods are explained in more detail below.

Financial instruments carried at amortised cost

Loans that are carried at amortised cost on the Bank's balance sheet consist of three components: the loan portfolio acquired from Glitnir, the loan portfolio acquired from Byr and new loans originated within the Bank.

Loans in the portfolio acquired from Glitnir are discounted using an effective interest rate determined at the time of acquisition. In light of the remaining uncertainty in the economic environment, as well as legal and political uncertainty, for example relating to foreign currency loans and the fishing quota system, the Bank believes that at this time it is not appropriate to reconsider the required yield for the acquired portfolio. This provides a conservative estimate of the fair value of the acquired portfolio.

The loan portfolio recently acquired from Byr was recognised at fair value on acquisition date. Therefore, its carrying amount fully represents its fair value.

The vast majority of new loans carry floating interest rates. These loans have recently been issued and there have since not been any significant changes in the clients' credit quality. Thus, their fair value is fully represented by their carrying amount.

Based on the above, it is the Bank's opinion that the fair value of the loan portfolios equals their carrying amount.

Most deposits carry floating interest rates and their fair value equals their carrying amount. For longer term fixed rate deposits, the Bank calculates the fair value with a duration approach, using the difference in each liability's current rate from the estimated rate that a similar product would carry today. For Debt issued and other borrowed funds the Bank uses an observed market value of each debt or of similar debt where it is available while other debt is valued in the same manner as deposits.

For Cash and balances with Central Bank the fair value is well approximated by the carrying amount since they are short term in nature. The liabilities in Subordinated loans carry floating interest rates and the Bank believes there has been no change in the funding premium from the time of issuance of these loans. Thus their fair value equals their carrying amount.

The following table shows the fair value of the Bank's assets and liabilities carried at amortised cost:

	Carrying amount 2011	Fair value 2011	Carrying amount 2010	Fair Value 2010
Financial assets:				
Cash and balances with Central Bank	57,992	57,992	30,799	30,799
Loans to credit institutions	43,655	43,655	30,870	30,870
Loans to customers	564,394	564,394	515,161	515,161
Total financial assets	666,041	666,041	576,830	576,830
Financial liabilities:				
Deposits from Central Bank	73	73	26	26
Deposits from credit institutions	62,772	62,778	96,212	96,366
Deposits from customers	462,943	463,197	327,158	327,341
Debt issued and other borrowed funds	63,221	64,725	55,425	57,619
Subordinated loans	21,937	21,937	21,241	21,241
Total financial liabilities	610,946	612,710	500,062	502,593

The amounts are in ISK million

Notes to the Consolidated Financial Statements

9. Fair value hierarchy

The table below analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)

Level 3: Inputs for the assets or liabilities that are not based on observable market data (unobservable inputs)

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities carried at fair value in the consolidated balance sheet are categorised as at 31 December 2011:

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	55,359	887	2,416	58,662
Shares and equity instruments	1,421	-	9,686	11,107
Derivative instruments	153	-	186	339
Total financial assets	56,933	887	12,288	70,108
Financial liabilities:				
Financial liabilities held for trading	9,346	-	-	9,346
Derivative instruments	337	-	3,690	4,027
Total financial liabilities	9,683	-	3,690	13,373

One government bond (RIKH 18 1009) has been transferred from level 2 to level 1 since 31 December 2010 as it had been incorrectly categorised as level 2. No other bonds have been transferred between categories.

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities carried at fair value in the consolidated balance sheet are categorised as at 31 December 2010:

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	35,627	30,591	1,806	68,024
Shares and equity instruments	362	50	2,610	3,022
Derivative instruments	12	-	58	70
Total financial assets	36,001	30,641	4,474	71,116
Financial liabilities:				
Financial liabilities held for trading	9,090	-	-	9,090
Derivative instruments	44	313	72	429
Total financial liabilities	9,134	313	72	9,519

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Net interest income

10. Net interest income is specified as follows:

	2011	2010
Interest income:		
Cash and balances with Central Bank	1,449	1,189
Loans and receivables	49,217	57,517
Financial assets held for trading	541	860
Financial assets designated at fair value through profit or loss	1,336	2,116
Other assets	128	94
Total interest income	52,671	61,776
Interest expense:		
Deposits from credit institutions and Central Bank	(1,789)	(5,084)
Deposits from customers	(12,149)	(16,396)
Borrowings	(5,668)	(3,564)
Subordinated loans	(1,207)	(1,060)
Financial liabilities held for trading	(392)	(425)
Other interest expense	(241)	(373)
Total interest expense	(21,446)	(26,902)
Net interest income	31,225	34,874
Interest spread (as the ratio of net interest income to the average carrying amount of total assets)	4.5%	5.0%

Net valuation changes

11. Net valuation changes:

	2011	2010
Impairment charged to comprehensive income:		
Specific impairment losses on financial assets	(16,545)	(27,798)
(Impairment) reversal of impairment of foreign exchange gain	(5,081)	8,297
Net specific impairment losses on financial assets	(21,626)	(19,501)
Provision for latent impairment	76	(514)
Total impairment charged to comprehensive income (see note 35)	(21,550)	(20,015)
Net valuation changes on loans and receivables:		
Income due to revised estimated future cash flow from loans	15,249	42,305
Net specific impairment losses on financial assets	(21,626)	(19,501)
Foreign exchange gain (loss) (see note 16)	5,081	(8,297)
Net valuation changes on loans and receivables	(1,296)	14,507

Foreign exchange gain from customers with foreign exchange loans and cash flows in ISK is impaired and offset against total foreign exchange gain (loss) as per note 16. Foreign exchange loss is recognised after previously impaired gain has been reversed. Impairment of foreign exchange gain is further discussed under note 2.5 (d).

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Net fee and commission income

12. Net fee and commission income is specified as follows:

	2011	2010
Fee and commission income:		
Asset management	1,205	1,265
Securities brokerage	315	426
Payment processing	4,214	6,477
Loans and guarantees	906	873
Foreign currency brokerage commission	860	1,192
Advisory	279	555
Other fees and commissions income	919	518
Total fees and commission income	8,698	11,306
Commission expenses:		
Interbank charges	(536)	(931)
Brokerage	(143)	(16)
Clearing and settlement	(1,968)	(2,799)
Other commission expenses	(85)	(180)
Total commission expenses	(2,732)	(3,926)
Net fee and commission income	5,966	7,380

Net financial income (expenses)

13. Net financial income (expenses) is specified as follows:

	2011	2010
Net loss on financial instruments held for trading	(429)	(12)
Net gain (loss) on financial instruments designated at fair value through profit or loss	3,136	(898)
Net loss on loss of control over subsidiary	(58)	-
Net financial income (expenses)	2,649	(910)

Net loss on financial instruments held for trading

14. Net loss on financial instruments held for trading are specified as follows:

	2011	2010
Shares and related derivatives	52	91
Bonds and related derivatives	(533)	(95)
Other derivatives	52	(8)
Net loss on financial instruments held for trading	(429)	(12)

Net gain (loss) on financial instruments designated at fair value through profit or loss

15. Net gain (loss) on financial instruments designated at fair value through profit or loss are specified as follows:

	2011	2010
Shares	3,151	(898)
Bonds	(15)	-
Net gain (loss) on financial instruments designated at fair value through profit or loss	3,136	(898)

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Net foreign exchange gain (loss)

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

	2011	2010
Assets:		
Cash and balances with Central Bank	25	(115)
Financial assets held for trading	(1,448)	(2,360)
Loans to credit institutions	2,217	(4,535)
Loans to customers	10,099	(14,569)
Other assets	52	(107)
Total	10,945	(21,686)
Liabilities:		
Deposits from credit institutions	(299)	691
Deposits from customers	(3,861)	8,114
Subordinated loan	(696)	3,602
Other liabilities	(71)	19
Total	(4,927)	12,426
Unadjusted net foreign exchange gain (loss)	6,018	(9,260)
Foreign exchange reversal on loans to customers with ISK cash flow*	(5,081)	8,297
Net foreign exchange gain (loss)	937	(963)

*Further discussed under note 2.5 (d)

Other net operating income

17. Other net operating income is specified as follows:

	2011	2010
Agency fees and service level agreement fees	314	393
Rental income from real estate	127	122
Rental income from foreclosed assets	235	205
Legal cost and fees	83	148
Realised (loss) gain on property and equipment	(4)	425
Other net operating income (expenses)	139	(107)
Other net operating income	894	1,186

Administrative expenses

18. Administrative expenses are specified as follows:

	2011	2010
Salaries and related expenses	10,531	9,207
Other administrative expenses	8,630	8,036
Depreciation	633	585
Amortisation	76	38
Administrative expenses	19,870	17,866

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Salaries and related expenses

19. Salaries and related expenses are specified as follows:

	2011	2010
Salaries	8,456	7,429
Pension and similar expenses	1,152	1,000
Social security charges	780	670
Other	143	108
Salaries and related expenses	10,531	9,207

Salaries include one-off redundancy payments of ISK 496 million due to layoffs surrounding the Byr merger. The Bank made a provision of ISK 152 million for potential workload payments. In accordance with the FME rules 700/2011, part of the payment is deferred for no less than 3 years. Salary related expenses are included in the amount.

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

	At 31 December 2011		At 31 December 2010	
	Parent Company	The Bank	Parent Company	The Bank
Average number of employees	1,003	1,344	933	1,080
Positions at the end of the year	1,098	1,470	943	1,093

Average number of employees for the Bank in 2011 includes 246 employees in disposal groups held for sale, whose salaries are not included in the salaries and related expenses.

Employment terms for the Board of Directors, the CEO and Management Board

21. Employment terms for the Board of Directors, the CEO and Management Board are specified as follows:

2011	Salaries
Birna Einarsdóttir, CEO	29.7
Fridrik Sophusson, Chairman of the Board	6.3
Kolbrún Jónsdóttir, member of the Board	4.2
Neil Graeme Brown, member of the Board	4.6
John E. Mack, member of the Board	4.7
Árni Tómasson, member of the Board	4.2
Daniel Levin, member of the Board	3.3
Marianne Økland, member of the Board	4.7
Alternate board members	2.8
7 Managing Directors	145.2
Total	209.7

2010	Salaries
Birna Einarsdóttir, CEO	25.2
Fridrik Sophusson, Chairman of the Board	6.3
Vilhjálmur H. Vilhjálmsson, former Chairman of the Board	0.3
Martha Eiríksdóttir, former member of the Board	3.2
Kolbrún Jónsdóttir, member of the Board	1.2
Neil Graeme Brown, member of the Board	4.2
John E. Mack, member of the Board	4.2
Raymond J. Quinlan, member of the Board	3.9
Árni Tómasson, member of the Board	4.2
Marianne Okland, member of the Board	4.2
Alternate board members	1.1
7 Managing Directors	128.7
Total	186.6

The employer's contribution to pension funds and other benefits for the Board, the CEO and Management Board amounted to ISK 40.6 million in 2011 (2010: ISK 29.7 million). There were no share based payments in the years 2011 and 2010.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Auditors' fees

22. Auditors' fees are as follows:

	2011	2010
Audit of the annual accounts	112	146
Review of interim accounts	31	28
Other services	29	10
Auditors' fees	172	184
Thereof remuneration to others than the auditors of the parent company	25	27

The Bank accrued ISK 98 million in audit fees relating to the audit of the annual accounts 2011. Thereof, ISK 25 million relate to the audit of the Byr acquisition (see note 4). Accrued audit fees for the audit of the annual accounts 2010 amounted to ISK 50 million. Audit fees recognised in 2010 included fees relating to the audit of the annual accounts 2009.

Net gain (loss) on non-current assets and disposal groups held for sale

23. Net gain (loss) on non-current assets and disposal groups held for sale are specified as follows:

	2011	2010
Net profit from sale of foreclosed mortgages	436	40
Net share of loss from disposal groups held for sale	(840)	(347)
Net profit from sale of subsidiaries and associates	1,245	24
Net gain (loss) on non-current assets and disposal groups held for sale	841	(283)

Effective income tax

24. The corporate income tax rate in Iceland changed from 18% in 2010 to 20% from 1 January 2011. The effective income tax rate in the Bank's Income Statement for 2011 is 4.2%. The difference is specified as follows:

	2011		2010	
Profit before tax	1,782		37,087	
20% income tax calculated on the profit of the year (2010: 18%)	356	20.0%	6,676	18.0%
Effect of tax rates in foreign jurisdictions	(38)	(2.1%)	1	0.0%
Tax recognised outside profit and loss	-	0.0%	23	0.1%
Correction in accordance with ruling on prior years' taxable income	27	1.5%	344	0.9%
Effect of increase in the income tax rate	-	0.0%	(18)	(0.0%)
Income not subject to tax	(638)	(35.8%)	(3)	(0.0%)
Non-deductable expenses	144	8.1%	218	0.6%
Other differences	224	12.6%	(27)	(0.1%)
Effective income tax	75	4.2%	7,214	19.5%

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Earnings per share

25. Earnings per share are specified as follows:

	2011	2010
Basic earnings per share, ISK		
Profit attributable to ordinary shareholders	2011	2010
Profit attributable to equity holders of the company for the year	1,117	29,701
Profit (loss) from discontinued operation attributable to equity holders of the company	841	(283)
	1,958	29,418
Average outstanding shares:		
Weighted average number of outstanding shares for the period, million	10,000	10,000
From continuing operations	0.11	2.97
From discontinued operations	0.08	(0.03)
From profit for the year	0.19	2.94
Diluted earnings per share, ISK		
Profit attributable to ordinary shareholders (diluted)		
Average outstanding shares for the calculation of diluted earnings per share	10,000	10,000
Number of total shares at the end of the period, million, diluted	10,000	10,000
From continuing operations	0.11	2.97
From discontinued operations	0.08	(0.03)
From profit for the year	0.19	2.94

Cash and balances with Central Bank

26. Specification of cash and balances with Central Bank:

	31.12.2011	31.12.2010
Cash on hand	1,976	1,833
Balances with Central Bank other than mandatory reserve deposits	14,587	16,352
Certificates of deposit	35,059	6,865
Included in cash and cash equivalents	51,622	25,050
Mandatory reserve deposits with Central Bank	6,370	5,749
Cash and balances with Central Bank	57,992	30,799

Mandatory reserve deposits are not available for use in the Bank's day-to-day operations.

Certificates of deposit (CDs) are short term instruments issued by the Central Bank at predetermined interest rates. CDs are issued solely to deposit money banks and other financial institutions and are not transferable except to other comparable institutions.

Pledged assets

		31.12.2011	31.12.2010
27.	Financial assets which have been pledged as collaterals for liabilities	76,597	58,469

In December 2011, the Bank issued covered bonds under Icelandic law with maturity of up to 12 years which are pledged on a pool of consumer price indexed mortgage loans. The underlying cover pool must withstand a weekly stress test with regards to interest rates and exchange rates. The Bank also pledged a pool of loans to customers as collateral for an assets backed bond issued to the Central Bank of Iceland for the purpose of liquidity management. The bond has a maturity date in July 2019. The Bank has further pledged a pool of foreign currency assets as collateral for a currency swap agreement with the Central Bank and cash collateral in Euros for International Swaps and Derivatives Association (ISDA) agreements with foreign financial institutions.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Derivative financial instruments

28. Derivatives held for trading:

	Assets	Notional values related to assets 31.12.2011	Liabilities	Notional values related to liabilities 31.12.2011
Interest rate swap	25	3,100	107	10,750
Cross currency interest rate swaps	186	11,239	3,690	51,600
Equity forwards	6	82	6	30
Equity options	-	-	-	-
Foreign exchange forward	45	15,566	98	2,449
Foreign exchange swaps	59	4,889	13	1,516
Bond forwards	18	955	39	400
Bond options	-	-	74	25,000
Derivatives held for trading	339	35,831	4,027	91,745

Derivatives held for trading:

	Assets	Notional values related to assets 31.12.2010	Liabilities	Notional values related to liabilities 31.12.2010
Interest rate swap	-	-	-	-
Cross currency interest rate swaps	-	-	312	48,217
Equity forwards	-	-	-	-
Equity options	58	500	-	-
Foreign exchange forward	12	3,453	44	8,859
Foreign exchange swaps	-	231	-	1,537
Bond forwards	-	-	-	-
Bond options	-	-	73	25,000
Derivatives held for trading	70	4,184	429	83,613

Bonds and debt instruments

29. Specification of bonds and debt instruments:

	31.12.2011	31.12.2010
Listed	54,705	66,539
Unlisted	3,957	1,485
Bonds and debt instruments	58,662	68,024

Shares and equity instruments

30. Specification of shares and equity instruments:

	31.12.2011	31.12.2010
Listed	6,286	462
Unlisted	4,821	2,560
Shares and equity instruments	11,107	3,022

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Loans

31. Loans to credit institutions:

	31.12.2011	31.12.2010
Money market loans	16,706	17,788
Bank accounts	26,949	12,102
Repo loans	-	980
Loans to credit institutions	43,655	30,870

32. Loans to credit institutions at amortised cost:

			31.12.2011			31.12.2010
	Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance	Carrying amount
Loans to credit institutions:						
Loans	44,210	(555)	43,655	31,456	(586)	30,870
Total	44,210	(555)	43,655	31,456	(586)	30,870

33. Loans to customers:

	31.12.2011	31.12.2010
Loans to customers at amortised cost	564,394	515,161
Loans to customers	564,394	515,161

34. Loans to customers at amortised cost:

			31.12.2011			31.12.2010
	Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance	Carrying amount
Loans to customers:						
Individuals	235,088	(6,900)	228,188	181,566	(8,853)	172,713
Commerce and services	69,239	(5,284)	63,955	63,068	(11,922)	51,146
Construction	18,389	(3,690)	14,699	21,091	(4,003)	17,088
Energy	3,677	(172)	3,505	2,233	(111)	2,122
Financial institutions	1,406	(6)	1,400	4,257	(9)	4,248
Government secured customer loan	38,798	-	38,798	52,182	-	52,182
Industrials	37,429	(3,459)	33,970	23,670	(3,020)	20,650
Investment companies	28,670	(4,278)	24,392	55,495	(13,507)	41,988
Public sector and non-profit organisations	9,737	(198)	9,539	11,061	(496)	10,565
Real estate	90,524	(15,195)	75,329	92,456	(17,932)	74,524
Seafood	73,040	(2,421)	70,619	69,797	(1,862)	67,935
Total	605,997	(41,603)	564,394	576,876	(61,715)	515,161

The internal industry classification was changed in the first half of the year making comparison with the credit risk notes in the annual accounts 2010 inappropriate. This change included a reclassification of some of the Bank's customers resulting in a shift between reported industries, for example was a part of the exposure to Investment companies reclassified to Commerce and services and Industrials.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

35. Financial assets - impairments

The following table shows the movement in the provision for impairment losses for loans and receivables.

	Individually assessed	Collectively assessed	Latent	Total
At 1 January	45,623	15,687	991	62,301
Reclass transaction 1 January	1,220	-	-	1,220
Amounts written-off	(31,132)	(1,071)	-	(32,203)
Period adjustments	(1,242)	93	-	(1,149)
Recoveries of amounts previously written-off	1,291	-	-	1,291
Principal credit adjustment	(3,248)	(7,604)	-	(10,852)
Charged to the comprehensive Income	20,223	1,403	(76)	21,550
At 31 December 2011 *	32,735	8,508	915	42,158

	Individually assessed	Collectively assessed	Latent	Total
At 1 January	49,519	22,395	477	72,391
Amounts written-off	(25,468)	(372)	-	(25,840)
Recoveries of amounts previously written-off	402	-	-	402
Principal credit adjustment	(1,198)	(3,469)	-	(4,667)
Charged to the comprehensive Income	22,368	(2,867)	514	20,015
At 31 December 2010 *	45,623	15,687	991	62,301

*The provision for impairment losses at 31 December 2011 includes ISK 555 million relating to loans to credit institutions (2010: ISK 586 million).

	2011	2010
Impairment losses charged to the comprehensive income:		
Loans to customers	21,580	18,615
Loans to credit institutions	(30)	1,400
Impairment losses charged to the comprehensive income	21,550	20,015

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Investment in associates

36. Changes in investment in associates:

	31.12.2011	31.12.2010
Investments in associates at the beginning of the year	354	827
Acquisition of shares in associates	677	54
Sales of shares in associates	-	(8)
Revaluation	-	(519)
Share of results	39	-
Investment in associates	1,070	354

37. The Bank's interest in its principal associates are as follows:

	Ownership at year end
Eignarhaldsfélagid Fasteign hf., Bíldshöfda 9, 110 Reykjavík	40.4%
BNT ehf., Kirkjusandi 2, 155 Reykjavík	29.4%
Teris, Hlídasmára 19, 201 Kópavogur	42.9%
Atorka Group hf., Túngötu 14, 101 Reykjavík	29.7%
Reiknistofa bankanna hf., Kalkofnsvegi 1, 150 Reykjavík	30.7%
Eignarhaldsfélagid ehf., Sigtúni 42, 105 Reykjavík	25.0%
Audkenni hf., Borgartúni 31, 105 Reykjavík	22.2%
6 other associates	

Summarised financial information in respect of the Bank's associates is set out below:

	31.12.2011	31.12.2010
Total assets	158,906	77,900
Total liabilities	(165,769)	(64,327)
Net assets	(6,863)	13,573
Bank's share of net assets of associates	1,070	354

	2011	2010
Total revenue	5,231	1,815
Total loss in associates for the year	(2,383)	(2,428)

When the Bank's share of losses in an associate exceeds its interest in the associate, the carrying amount of the investment is reduced to zero and the recognition of further losses is discontinued, except to the extent that the Bank has an obligation or has made payments on behalf of the associate.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Investment in subsidiaries

38. Significant subsidiaries:

	Location	Ownership
Kreditkort hf., Ármúla 28, 108 Reykjavík	Iceland	100%
Borgun hf., Ármúla 30, 108 Reykjavík	Iceland	61.3%
Íslandssjódir hf., Kirkjusandi 2, 105 Reykjavík	Iceland	100%
Midengi ehf., Lækjargötu 12, 155 Reykjavík	Iceland	100%
Jardboranir ehf., Hlídasmári 1, 201 Kópavogur	Iceland	100%
Höfdatorg ehf., Skúlagötu 63, 105 Reykjavík	Iceland	72.5%
Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
Bréfabær ehf., Borgartúni 18, 105 Reykjavík	Iceland	100%
Fjárvari ehf., Borgartúni 18, 105 Reykjavík	Iceland	100%
Island Fund S.A. (formerly Glitnir Asset Management), 5 Allée Scheffer L-2520 Luxembourg	Luxembourg	99.9%
Glacier Geothermal and Seafood Corporation, 7 Times Square, Suite 1605 New York	USA	100%
32 other subsidiaries (SME)		

Related party disclosures

39. Ultimate controlling party

The Bank has determined that ISB Holding is the ultimate controlling party of the Bank with GLB Holding having significant influence. This is reflected in related party transactions.

Entities which are controlled, jointly controlled or significantly influenced by the government (state-controlled entities) are not considered as being a related party if neither entity actually influenced the other and if the state did not actually influence either entity with regards to transactions between them. The Bank's transactions with state-controlled entities during the year were based on general business terms of the Bank.

Related party transactions

The Bank has a related party relationship with its associates, the Board of Directors of the parent company and the ulitmate controlling party, the executive vice presidents of the Bank, close family members of individuals referred to herein and entities with significant influence as the largest shareholders of the Bank.

All loans to employees are provided on general business terms of the Bank. Included in assets are loans to key management.

Related parties have transacted with the Bank during the period as follows:

	31.12.2011			31.12.2010		
	Assets	Liabilities	Total	Assets	Liabilities	Total
CEO and Man. Directors (incl. comp. owned by them)	116	(279)	(163)	142	(201)	(59)
Members of the Board (incl. comp. owned by them)	376	(458)	(82)	522	(1,339)	(817)
Associated companies and other related parties	17,896	(11,012)	6,884	26,199	(5,052)	21,147
Total	18,388	(11,749)	6,639	26,863	(6,592)	20,271

	31.12.2011	31.12.2010
Guarantees	59	55
Loan commitments, overdraft and credit card commitments	145	187

Impairment allowances of ISK 4.1 billion were recognised in the year against balances outstanding with associated companies. No share option programmes were operated during 2011. For related party remuneration see note 21.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Property and equipment

40. Property and equipment are specified as follows:

At 31 December 2011	Real estate	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	3,377	3,628	7,005
Additions during the year	-	874	874
Additions from acquired companies	242	4	246
Net acquisition through business combinations	972	114	1,086
Disposals during the year (write - offs)	-	(444)	(444)
Reclassifications	(1,650)	-	(1,650)
Balance at 31. December 2011	2,941	4,176	7,117
Accumulated depreciation			
Balance at the beginning of the year	(8)	(1,579)	(1,587)
Depreciation during the year	(6)	(627)	(633)
Disposals during the year	-	379	379
Balance at 31. December 2011	(14)	(1,827)	(1,841)
Net book value at 31. December 2011	2,927	2,349	5,276
Depreciation rates	2%	8-33%	

Official real estate value of buildings and leased land	2,146
Insurance value of buildings as at 31.12.2011	3,791
Insurance value of fixtures, equipment and vehicles as at 31.12.2011	2,723

At 31 December 2010	Real estate	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	132	2,673	2,805
Additions during the year	74	1,001	1,075
Transferred from Investment property	1,572	-	1,572
Additions from acquired companies	1,650	-	1,650
Disposals during the year (write - offs)	(51)	(46)	(97)
Balance at 31. December 2010	3,377	3,628	7,006
Accumulated depreciation			
Balance at the beginning of the year	(7)	(1,027)	(1,034)
Depreciation during the year	(1)	(584)	(585)
Disposals during the year	-	32	32
Balance at 31. December 2010	(8)	(1,579)	(1,587)
Net book value at 31. December 2010	3,369	2,049	5,419
Depreciation rates	2%	8-33%	

Official real estate value of buildings and leased land	2,080
Insurance value of buildings as at 31.12.2010	3,299
Insurance value of fixtures, equipment and vehicles as at 31.12.2010	1,813

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Intangible assets

41. Intangible assets are specified as follows:

At 31 December 2011

	Goodwill	Software	Total
Historical cost			
Balance at the beginning of the year	-	245	245
Additions	-	143	143
Acquistion through business combinations	18,163	-	18,163
Balance at 31. December 2011	18,163	388	18,551
Accumulated amortisation			
Balance at the beginning of the year	-	(58)	(58)
Amortisation during the year	-	(76)	(76)
Impairment of goodwill	(17,873)	-	(17,873)
Balance at 31. December 2011	(17,873)	(134)	(18,007)
Net book value at 31. December 2011	290	254	544
Amortisation rates		25%	

The impaired goodwill arose from the acquisition of Byr and consisted largely of the synergies and economies of scale expected from combining the operations of Byr and the Bank. At present, due to the economic and political environment, there is considerable uncertainty surrounding the recoverability of assets. Based on these indicators, the Bank performed an impairment test at year end 2011 and subsequently impaired the entire goodwill from the acquisition.

At 31 December 2010

	Software	Total
Historical cost		
Balance at the beginning of the year	127	127
Additions	118	118
Balance at 31. December 2010	245	245
Accumulated amortisation		
Balance at the beginning of the year	(20)	(20)
Amortisation during the year	(38)	(38)
Balance at 31. December 2010	(58)	(58)
Net book value at 31. December 2010	187	187
Amortisation rates	25%	

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Non-current assets and disposal groups held for sale

42. Specification of non-current assets and disposal groups held for sale:

	31.12.2011	31.12.2010
Repossessed collateral	10,467	7,435
Assets of disposal groups classified as held for sale	32,223	16,054
Total	42,690	23,489

Repossessed collateral:

	31.12.2011	31.12.2010
Residential property	7,683	4,880
Industrial property	95	75
Equipment	84	160
Shares and equity instruments	2,182	2,067
Other assets	423	253
Total	10,467	7,435

The Bank classified the assets and liabilities of its subsidiaries Höfdatorg ehf., Jardboranir hf., Fastengi ehf., Hafnargata 7 ehf., B37 ehf., Bláfugl ehf., IG Invest ehf., Costa Properties ehf., Lava Capital ehf., Fjárvari ehf., Básbryggja ehf., Bréfabær ehf., Air Atlanta Properties Ltd. and Lava Capital Ltd. as assets and liabilities of disposal groups held for sale. A sale agreement for the sale of 82% of the shareholding in Jardboranir was signed in January 2012.

Shares and equity instruments comprise shares in the Bank's associates N1 hf. and Íslensk verdbréf hf. claissfied as non-current assets held for sale. Comparable amounts relate to shares in Icelandair Group hf.

Assets of disposal groups classified as held for sale:

	31.12.2011	31.12.2010
Cash	1,212	5
Investment properties	12,263	15,086
Properties	558	-
Equipment	2,299	609
Receivables	2,090	98
Tax assets	697	-
Inventory	2,056	157
Assets classified as held for sale	6,129	-
Other assets	4,919	99
Total	32,223	16,054

Liabilities associated with assets classified as held for sale:

Payables	1,237	59
Deferred tax liabilities	823	-
Borrowings	2,352	16,383
Other liabilities	2,905	-
Total	7,317	16,442

Other assets

43. Other assets are specified as follows:

	31.12.2011	31.12.2010
Receivables	3,351	1,532
Unsettled securities transactions	2,199	687
Accruals	494	620
Prepaid expenses	311	303
Inventory (real estate)	534	1,889
Other assets	668	513
Other assets	7,557	5,544

Inventory consists of real estate valued at the lower of cost and net realisable value.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Financial liabilities

44. Financial liabilities balances:

	31.12.2011	31.12.2010
Short positions in listed bonds	9,346	9,090
Financial liabilities	9,346	9,090

Short positions are in listed government bonds. As a primary dealer the Bank has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the short positions have a maturity of less than a year and can be settled with cash on maturity of the bonds.

Deposits from Central Bank and credit institutions

45. Deposits from Central Bank and credit institutions are specified as follows:

	31.12.2011	31.12.2010
Repurchase agreements with Central Bank	73	26
Deposits from credit institutions	62,772	96,212
Deposits from Central Bank and credit institutions	62,845	96,238

Deposits from customers

46. Deposits from customers are specified by type as follows:

	31.12.2011	31.12.2010
Demand deposits	259,994	214,597
Time deposits	202,949	112,561
Deposits from customers	462,943	327,158

47. Deposits from customers are specified by owners as follows:

		31.12.2011		31.12.2010
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	14,362	3%	4,065	1%
Municipalities	7,054	2%	4,927	2%
Other companies	257,842	56%	185,886	57%
Individuals	183,685	40%	132,280	40%
Deposits from customers	462,943	100%	327,158	100%

Debt issued and other borrowed funds

48. Specification of debt issued and other borrowed funds:

	31.12.2011	31.12.2010
Non-listed issued bonds	55,742	52,717
Listed issued bonds	3,855	-
Loans from credit institutions	333	353
Other debt securities	3,291	2,355
Debt issued and other borrowed funds	63,221	55,425

Non-listed bonds includes an asset backed bond issued to the Central Bank of Iceland with maturity date in July 2019 which is pledged on a pool of loans to customers. Listed bonds are covered bonds issued under Icelandic law with maturity of 5 years which are pledged on a pool of consumer price indexed mortgage loans.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Subordinated loans

49. Specification of subordinated loans:

	Currency	Interest	Maturity date	Book value 31.12.2011
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	EUR	5.4%	31.12.2019	21,937
Tier 2				21,937
Subordinated loans				21,937

	Currency	Interest	Maturity date	Book value 31.12.2010
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	EUR	5.0%	31.12.2019	21,241
Tier 2				21,241
Subordinated loans				21,241

Subordinated loans consists of a Tier 2 government bond of EUR 138 million.

Tax assets and tax liabilities

50. Tax in the balance sheet:

		31.12.2011		31.12.2010
	Assets	Liabilities	Assets	Liabilities
Current tax	-	2,670	-	9,024
Deferred tax	2,629	17	283	18
Tax in the balance sheet	2,629	2,687	283	9,042

The deferred tax assets are mainly due to the write-off of goodwill in relation to the acquisition of Byr in December 2011. The goodwill is deductible for tax purposes over a period of 5 years.

51. Changes in the deferred tax assets and the tax liabilities during the year are as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2010	84	354
Transferred deferred tax liabilities to deferred tax assets 1.1.2010	(277)	(277)
Transferred from the Group	-	(4)
Calculated income tax for 2010	(6,781)	47
Income tax payable in 2011	8,618	(92)
Effect of the increase in tax rate	13	2
Deferred foreign exchange difference, correction due to 2009	(1,374)	(12)
Deferred tax assets and tax liabilities 1.1.2011	283	18
Acquisition through business combination	46	39
Calculated income tax for 2011	39	68
Income tax payable in 2012	2,299	(108)
Income tax 2011 correction due to 2010	(38)	-
Deferred tax assets and tax liabilities 31.12.2011	2,629	17

The amounts are in ISK million

Notes to the Consolidated Financial Statements

52. The Bank's deferred tax assets and tax liabilities are attributable to the following balance sheet items:

	31.12.2011			31.12.2010		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Property and equipment	(171)	19	(190)	(134)	22	(156)
Shares in other companies	5	-	5	4	-	4
Assets and liabilities denominated in foreign currencies	(150)	-	(150)	(176)	-	(176)
Other intangible assets	2,844	-	2,844	(11)	-	(11)
Deferred foreign exchange difference	(217)	1	(218)	443	1	442
Other items	1	(3)	4	85	(4)	89
Tax loss carry forwards	317	-	317	72	(1)	73
	2,629	17	2,612	283	18	265

53. Movements in temporary differences during the year were as follows:

2011	Balance at 1.1.	Recognised in profit or loss	Changes from prior year	Balance at 31.12.
Property and equipment	(156)	(34)	-	(190)
Shares in other companies	4	1	-	5
Assets and liabilities denominated in foreign currencies	(176)	26	-	(150)
Other intangible assets	(11)	2,855	-	2,844
Deferred foreign exchange difference	442	(660)	-	(218)
Other items	89	(85)	-	4
Tax loss carry forwards	73	198	46	317
Total	265	2,301	46	2,612

2010	Balance at 1.1.	Recognised in profit or loss	Changes from prior year	Balance at 31.12.
Property and equipment	(69)	(87)	-	(156)
Shares in other companies	-	4	-	4
Assets and liabilities denominated in foreign currencies	(155)	(21)	-	(176)
Effect of the increase in tax rate	(45)	45	-	-
Other intangible assets	(3)	(8)	-	(11)
Deferred foreign exchange difference	-	442	-	442
Other items	2	87	-	89
Tax loss carry forwards	-	73	-	73
Total	(270)	535	-	265

Other liabilities

54. Specification of other liabilities:

	31.12.2011	31.12.2010
Accruals	3,452	1,951
Liabilities to retailers for credit card provision	13,585	12,921
Provision for effects of court rulings	10,489	1,431
Guarantees	578	1,664
Chargeable gain tax	1,888	1,357
Unsettled securities transactions	3,047	1,386
Deferred income	215	345
Sundry liabilities	4,635	5,639
Other liabilities	37,889	26,694

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Equity

55. Share capital

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2011 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank.

Issued share capital

	31.12.2011	31.12.2010
Ordinary fully paid shares of ISK 1 krona each	10,000	10,000
Share capital	10,000	10,000

The Bank has one class of ordinary shares which carry no right to fixed income.

Share premium account

	31.12.2011	31.12.2010
Premium arising on issue of equity shares	55,000	55,000
Share premium account	55,000	55,000

Total share capital

	31.12.2011	31.12.2010
Ordinary share capital	10,000	10,000
Share premium account	55,000	55,000
Total share capital	65,000	65,000

56. Other reserves are specified as follows:

	Other reserves
Other reserves as at 1.1.2010	2,059
Translation differences	(8)
Contribution to statutory reserve	447
Other reserves as at 31.12.2010	2,498
Translation differences	163
Other reserves as at 31.12.2011	2,661

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Off balance sheet items

57. Obligations:

The Bank has granted its customers guarantees, overdraft facilities and loan commitments as follows:

	31.12.2011	31.12.2010
Financial guarantees	6,893	8,404
Undrawn loan commitments	12,592	13,453
Undrawn overdrafts	21,449	17,186
Credit card commitments	22,202	17,916
The Depositors' and Investors' Guarantee Fund (TIF) – declaration of guarantee	3,724	3,689

The Depositors' and Investors' Guarantee Fund

According to a provisional amendment applied in May 2011 to Act no. 98/1999 on Deposit Guarantees and Investor Compensation Schemes, the payments to a new division within the Depositors' and Investors' Guarantee Fund (the Fund) shall amount to a minimum of 0.3% of the total amount of guaranteed deposits. Payments shall be made on a quarterly basis, or 0.075% per quarter. In addition to the minimum fee, variable contributions are determined on a quarterly basis based on the risk rating of the Bank provided by the Icelandic Financial Supervisory Authority in Iceland.

The Bank recognised a total premium of ISK 965 million for the year 2011 under the provisional amendment. The Bank has signed a declaration of guarantee for the amount of ISK 3,724 million exercisable in the event of the Fund being emptied.

A new Act for the Depositors' and Investors' Guarantee Fund is currently under discussion in Parliament. If agreed, this could increase the required size of the fund and related premiums.

Operating lease commitments

58. Future non-cancellable minimum operating lease payments, where the Bank is the lessee, are due as follows:

	31.12.2011	31.12.2010
Up to 1 year	534	422
1-5 years	2,579	2,110
Later than 5 years	4,611	4,405
Operating lease commitments	7,724	6,937

Balance of custody assets

59. Balance of custody assets:

	31.12.2011	31.12.2010
Custody assets	746,574	642,502

Custody assets are under custody, but not managed by the Bank.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Contingencies

60. **Litigation threats**

Several former customers of Glitnir private banking services have threatened litigation against the Bank in order to claim compensation for alleged mistakes made by former employees of Glitnir. A few of those customers have already filed lawsuits against the Bank with the Reykjavík District Court. The Bank has not accepted liability and will challenge these lawsuits on the grounds that these claims relate to events that happened prior to the incorporation of the Bank and the assignment of related liabilities and assets and are therefore not the responsibility of the Bank in any way. The District Court has now ruled in favour of the Bank in one of these cases stating that the Bank cannot be held responsible for a mistake made by a former employee of Glitnir. This ruling was not appealed. The Bank estimates the total amount of compensation liabilities currently claimed by customers of Glitnir to be ISK 5.5 billion.

Netting agreement

When certain assets and obligations were transferred from Glitnir to the Bank, the FME (Financial Supervisory Authority) ruled that customers would, upon liquidation of Glitnir, maintain their right to claim netting of assets and liabilities held by Glitnir prior to the Bank's acquisition.

The Bank made an agreement with Glitnir that the latter will compensate the Bank for any losses incurred as a result of netting of assets and liabilities. The claims in question are priority claims on the liquidated assets of Glitnir and the netting exercise is therefore unlikely to affect either the net asset value or the earnings of the Bank.

Allocation of liens, guarantees and comparable rights

When certain assets and obligations were transferred from Glitnir to the Bank, the FME ruled that the Bank would take over all rights used to secure the performance of obligations of the debtors of Glitnir, including all liens, guarantees and other comparable rights connected to the claims of the Bank.

The Bank should, however, be accountable to Glitnir for specific collateral of its customers, as applicable, due to claims and derivatives which were not transferred to the Bank. The Bank has, in accordance with this decision, transferred to Glitnir certain collateralised obligations of customers. One customer filed a lawsuit against the Bank with the Reykjavík District Court challenging the Bank's decision to transfer the customer's money market deposit to Glitnir which the Bank, in good faith, identified as collateral for a foreign exchange future contract. The claim was for approximately ISK 450 million. The District Court ruled in favour of the Bank and the case has now been appealed to the Iceland Supreme Court. Any future allocation of collaterals will be made under an agreement with Glitnir, whereby Glitnir indemnifies the Bank against any future claims arising from the transfer of such rights.

Indexed loans and foreign currency loans

In order to address the uncertainty surrounding which foreign currency loans should be deemed to be illegally linked to foreign currency, the Parliament introduced in 2010 a new legislation proposing a change to the Interest Law 38/2001. The legislation was passed as Amendment to the Interest Law 151/2010, taking effect on 28 December 2010. Based on the context of this new law, the Bank treated all foreign currency dominated mortgages and car loans according to the method previously set forth in a September 2010 ruling of the Supreme Court concerning car loans/leasing contracts. All customers with foreign currency mortgages were presented with an offer of having their mortgage recalculated according to a similar formula, regardless of the validity of the contract in question. The definition of a mortgage in the new legislation refers to tax law. The recalculation had to be offered if the debtor was eligible for a refund in part of paid interest (interest subsidy) of the loan. The Bank decided to expand this definition to cover all residential loans to individuals, although the debtors were not obliged to accept the offer. The interest rate on car loans going forward will, according to the law, be replaced by non-indexed CPI-rate. The same goes for mortgages for the first five years, in addition to a choice of indexed CPI rate. At the end of the five year term, mortgages will revert back to market rates.

On 15 February 2012, the Supreme Court in Iceland passed a ruling (no. 600/2011) that affects the recalculation of loans that are illegally linked to the value of foreign currencies. The ruling states that Act 151/2010, which the Icelandic Parliament passed in December 2010 and instructed banks on how to recalculate foreign currency linked mortgages, violates the provisions of the Icelandic constitution that protects the freedom to hold private property, as the legislator cannot pass a law that retroactively deprives a person of an asset without adequate compensation. Significant uncertainty remains on how the ruling should be interpreted. The Bank has therefore made an assessment based on certain assumptions and subsequently concluded that the impact from this court ruling would be a loss of ISK 12.1 billion, although the amount may change following further court rulings. The Bank recognised a provision at year end 2011 and the financial statements therefore reflect the impact of the court rulings. The Bank has a strong capital base and, in case of the most unfavourable outcome from this ruling materialising, the Bank would still maintain a capital ratio above the minimum requirement of 16% set by the Icelandic Financial Supervisory Authority.

In April 2011, the District Court of Reykjavík ruled on a dispute regarding the nature of a financial leasing contract between the Bank and a customer. The court ruled that although the contract had the form of a lease, it was by nature a loan contract, thereby subject to the Interest Law 38/2001. The contract was denominated in foreign currency, and the court further ruled that the contract had an illegal foreign currency indexation, citing the precedent set by the Supreme Court in June 2010. In October 2011, the District Court ruling was confirmed by the Supreme Court. The ruling will affect, by precedent, approximately 4,100 similar contracts with a book value of approximately ISK 10.2 billion. Each affected contract will be recalculated as a result of the ruling.

Notes to the Consolidated Financial Statements

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The ruling on financial leasing contracts does not appear to set new precedent affecting other loan contracts, as the dismissal of the disputed contract's currency indexation is based on the Supreme Court's ruling from June 2010. It should also be noted that although the currency indexation has been deemed illegal, the customer's debt obligation in ISK at the signing of the contract is still valid. It should also be noted that for contracts signed before 2004 – 2005, the effect of recalculation is minimal.

The District Courts have ruled in favour of the Bank in a few cases regarding disputed foreign currency denominated loan contracts, thereby confirming that the disputed loans were indeed legitimate foreign currency loans. These rulings are somewhat offset by the June 2011 Supreme Court's ruling on a case regarding a disputed loan contract between Landsbankinn and a customer (Landsbankinn vs. MótorMax). Although the case did not involve Íslandsbanki, the disputed contract in the case must be regarded as typical of many foreign currency corporate loans granted by Íslandsbanki. In the ruling, the Supreme Court set new precedent by deciding that the disputed contract contained an illegal foreign currency indexation. Following the June 2011 ruling, the Bank has evaluated all corporate contract forms and assessed which forms are affected by the ruling and which are, by the Bank's estimation, legal foreign currency loan contracts.

On 3 November 2011, the Supreme Court ruled on an appeal of a District Court's decision to dismiss a case involving a disputed foreign currency bond. The Supreme Court ruled that because the disputed bond was by its nature not affected by the Supreme Court's previous rulings (including the June 2010 and 2011 rulings) the District Court should hear the case and pass a ruling of its own. The Supreme Court specifically mentions in the ruling that the bond's principal is stated in foreign currencies, and reiterates that a correctly written foreign currency debt agreement is not prohibited by the Interest Law 38/2001.

Based on precedents already set, and assumptions made by inferences from the Supreme Court's latest ruling, the Bank will estimate the financial effect of remaining lawsuits. In its estimates, the Bank will take into account that customers have already been offered principal adjustment of foreign currency debt, and that a ruling has been made by the Supreme Court on replacement interest rates. The Bank has divided all foreign currency loans into four categories, depending on the risk of the loans being deemed illegal. The Bank holds provisions for the expected financial effect for the highest risk category. The work on processing each category is in its initial stages. Meanwhile, customers whose contracts are eligible for recalculation will have the option of fixed payments until the recalculations have been completed.

Final judgements for most types of Íslandsbanki's loan contracts are expected to emerge before the summer recess of the Supreme Court in July 2012.

Formal investigation by the EFTA Surveillance Authority regarding alleged government aid granted by the Icelandic government to investment funds and associated fund management companies connected to the three failed Icelandic banks Glitnir, Kaupthing and Landsbanki

At the height of the financial crisis in Iceland, in early October 2008, investment funds suspended redemption of unit certificates in order to protect the equality of unit certificate holders. The funds were subsequently wound-up and the unit certificate holders paid out the value of their unit shares. This was partly achieved by the banks buying the assets (mainly domestic bonds) held by the funds and adding the proceeds from that sale to assets already held in the form of deposits. The price paid for the assets was decided by the boards of the newly restored banks, based on internal valuations and valuations of external consultants (audit firms).

In this case, it is alleged that management companies of the investment funds and depositories of the three major Icelandic banks received unlawful government aid from the Icelandic authorities in October 2008. It is alleged that the government influenced the decisions of the new banks to purchase assets from the funds (managed by their subsidiaries) on favourable terms and, thus, enabling them to wind-up the funds and repay investors when there was no effective market for the assets.

The Icelandic government and the banks claim that the transactions were neither influenced by the government nor funded by its resources. Even if the Banks were public undertakings, the acquisition was decided on independently by each bank and based on commercial motives. The assets acquired were valued in a professional manner, albeit in a period of uncertainty.

Formal investigation by the EFTA Surveillance Authority into government aid granted in the restoration of certain operations of Glitnir and the establishment and capitalisation of Íslandsbanki

The EFTA Surveillance Authority (Authority) decided to open formal investigations into the government aid granted in October 2008 and September 2009 to rescue domestic operations of the three main Icelandic banks: Glitnir, Kaupthing and Landsbanki, and to establish and capitalise new successor banks, now called Íslandsbanki, Arion Banki and Landsbankinn respectively.

The measures to restore certain operations of the old Icelandic banks and to establish and capitalise new banks should have been notified prior to their implementation. The Icelandic authorities should also have submitted detailed restructuring plans outlining viable futures for the Banks without a need for a government support.

The Authority has to assess whether the government aid granted to the Banks adequately addresses each bank's situation without unduly distorting competition. In order to do so, it is imperative that detailed restructuring plans are submitted. As part of the investigation, the Authority will assess e.g. potential aid to the new banks in the form of a special liquidity facility. Also under scrutiny is the transfer of assets and deposit liabilities from Straumur to Íslandsbanki.

Notes to the Consolidated Financial Statements

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The Icelandic authorities and the Bank claim that the measures are compatible with the functioning of the EEA Agreement Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy. The Icelandic authorities have stressed that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the Icelandic economy.

The Bank has submitted a detailed restructuring plan to the Authority outlining viable futures for the Bank without a need for a government support.

Events after the balance sheet date

61. Events after the balance sheet date

The Bank has announced its intention to merge with its 100% owned subsidiary Kreditkort hf. in the second quarter of 2012. The purpose of the merger is to achieve synergies through integration of operations by making them more efficient.

The Bank signed a sales agreement for the sale of 82% of its shareholding in Jardboranir in January 2012. The sale is due to complete in the first quarter of 2012.

The Icelandic Tax Authorities have introduced new tax law, financial activities tax (FAT), applicable for credit institutions with value added tax (VAT) exempt operations, except for pension funds and public entities. The former is calculated as 5.45% of total salaries payable one month after each salary date and the latter is calculated as 6% of taxable profits above ISK 1 billion payable in advance with monthly instalments based on the previous years' profits. Both tax laws become applicable for periods after 1 January 2012.

Notes to the Consolidated Financial Statements

Risk management

62. Risk governance
The Bank is exposed to various risks through its use of financial instruments. Managing these risks is an integral part of the Bank's operations.

The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies and risk appetite statement.

The implementation of the risk management framework, limit setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee (ALCO) and the Executive Board. The members of those boards are appointed by the CEO.

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks on a consolidated basis. The Risk Committee governs the Bank's credit policies and procedures. The Risk Committee can delegate authorisation power to its subcommittees.

The ALCO supervises the Bank's other financial risks including market risk, liquidity risk, and the Bank's capitalisation. The ALCO decides on and sets limits for these risks and the Bank's capital allocation framework.

The Executive Board is responsible for the operational risk framework and for managing other risk factors such as reputational risk and business risk.

The Chief Risk Officer (CRO) is a member of the Executive Board and is responsible for the risk management organisation within Íslandsbanki. The CRO heads the Risk Management and Credit Control department. The CRO is also responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills.

The compliance function is responsible for ensuring that the processes and the business conducted within the Bank are in accordance with external laws and regulations and internal directives and instructions.

Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

Credit risk

63. Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or to otherwise fail to perform as agreed.

This risk comprises default risk, recovery risk, country risk, settlement risk and credit concentration risk.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Credit risk arises principally from the Bank's loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as guarantees, loan commitments and derivatives.

The Bank has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Bank's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Bank measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

The loan portfolio acquired from Glitnir is the largest part of the credit exposure of the Bank. Due to the extraordinary circumstances in the Icelandic economy and the fact that the loan portfolio was acquired at a deep discount, care must be taken when interpreting conventional measures of credit risk.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

64. Maximum credit exposure

The Bank's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position. The maximum exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. The maximum credit exposure for a derivative contract is calculated by adding future credit exposure to the market value of the contract as described in Annex III of the European Parliament directive 2006/48/EC (Basel II).

The industry breakdown shows the Bank's credit exposure by industry classification. The breakdown follows an internal industry classification which is based on the Icelandic ISAT2008 that derives from the European NACE Rev. 2 classification standard.

The industry classification was changed in the first half of the year making the comparison to the credit risk notes in the 2010 annual accounts inappropriate. This change included a reclassification of some of the Bank's customers resulting in a shift between industries, for example a part of the exposure to Investment companies has moved to Commerce and services and to Industrials to better reflect the underlying risk factors.

The Bank's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

Notes to the Consolidated Financial Statements

Credit risk exposure

64. Maximum credit exposure

Maximum credit exposure 31.12.2011

	Individuals	Central Governments	Commerce and Services	Construction	Energy	Financial institutions	Government secured customer loan	Industrials	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	57,992	-	-	-	-	-	-	-	-	-	-	57,992
Loans to credit institutions	-	-	-	-	-	43,655	-	-	-	-	-	-	43,655
Loans to customers:	228,189	-	63,956	14,699	3,505	1,399	38,798	33,970	24,391	9,539	75,329	70,619	564,394
Overdrafts	14,506	-	6,636	3,522	28	1,185	-	3,557	488	1,287	1,073	1,200	33,482
Credit cards	15,769	-	1,566	129	5	17	8	194	22	117	39	29	17,895
Mortgages	140,517	-	-	-	-	-	-	-	-	-	-	-	140,517
Leases	11,177	-	8,906	2,744	16	7	-	3,703	193	772	1,188	551	29,257
Other loans	46,220	-	46,848	8,304	3,456	190	38,790	26,516	23,688	7,363	73,029	68,839	343,243
Bonds and debt instruments	-	52,217	282	-	-	4,077	-	-	1,137	89	849	11	58,662
Derivatives	10	58	71	54	2	1,161	-	13	41	-	1	70	1,481
Financial guarantees	1,058	-	1,443	1,577	4	1,012	-	1,055	12	73	339	320	6,893
Undrawn loan commitments	-	-	2,017	-	5,345	5,000	-	225	-	-	-	5	12,592
Undrawn overdraft	9,797	-	4,343	1,083	203	1,363	-	1,993	72	1,096	513	986	21,449
Credit card commitments	19,392	-	1,521	272	5	48	10	352	81	380	68	73	22,202
Total maximum credit exposure	258,446	110,267	73,633	17,685	9,064	57,715	38,808	37,608	25,734	11,177	77,099	72,084	789,320

The amounts are in ISK million

Notes to the Consolidated Financial Statements

64. Cont'd

Maximum exposure 31.12.2010

	Individuals	Central Governments	Commerce and Services	Construction	Energy	Financial institutions	Government secured customer loan	Industrials	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	30,799	-	-	-	-	-	-	-	-	-	-	30,799
Loans to credit institutions	-	-	-	-	-	30,870	-	-	-	-	-	-	30,870
Loans to customers:	172,713	-	50,888	17,089	2,122	4,248	52,182	20,955	42,123	10,384	74,523	67,934	515,161
Overdrafts	7,943	-	3,963	2,794	254	1,046	-	3,037	676	1,347	605	973	22,638
Credit cards	14,307	-	710	94	0	15	6	229	16	76	33	26	15,512
Mortgages	105,637	-	-	-	-	-	-	-	-	-	-	-	105,637
Leases	11,678	-	6,835	2,337	19	55	-	3,955	208	843	2,068	248	28,246
Other loans	33,148	-	39,380	11,864	1,849	3,132	52,176	13,734	41,223	8,118	71,817	66,687	343,128
Bonds and debt instruments	-	64,087	-	-	324	2,129	-	-	659	-	825	-	68,024
Derivatives	16	15	1	-	-	155	-	2	6	-	-	16	211
Financial guarantees	920	-	1,308	2,499	-	-	-	2,266	82	22	700	607	8,404
Undrawn loan commitments	-	-	1,072	-	5,044	5,000	-	1,827	-	-	510	-	13,453
Undrawn overdraft	7,945	-	3,339	644	202	1,239	-	1,458	529	944	434	452	17,186
Credit card commitments	15,829	-	1,052	197	1	50	10	316	48	304	49	60	17,916
Total maximum credit exposure	197,423	94,901	57,660	20,429	7,693	43,691	52,192	26,824	43,447	11,654	77,041	69,069	702,024

The amounts are in ISK million

Notes to the Consolidated Financial Statements

65. Collateral

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. In the case of corporate entities the Bank takes a charge over assets such as real estate, fishing vessels, cash and securities and as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured. Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

In some cases the Bank uses guarantees as a credit enhancement but since guarantees do not represent a reduction in exposure to credit risk the financial effect is considered to be zero. Covenants in loan agreements are also an important credit enhancement but have no financial effect.

Valuation of collateral is based on market price, official valuation from the Iceland Property Registry or expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation. Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Bank's actual maximum exposure to credit risk.

An estimate of the collateral held by the Bank against credit exposure is shown below:

At 31 December 2011	Real estate	Fishing vessels	Cash & Securities	Other collateral	Total collateral
Loans and commitments to credit institutions	-	-	-	-	-
Loans and commitments to customers:	268,925	62,382	51,530	19,021	401,858
Individuals	170,491	71	1,148	3	171,713
Commerce and services	15,728	-	725	10,504	26,957
Construction	7,757	-	457	1,270	9,484
Energy	2,517	-	83	149	2,749
Financial institutions	44	-	47	-	91
Government secured customer loan	-	-	38,799	-	38,799
Industrial	7,362	-	294	5,703	13,359
Investment companies	2,933	-	8,901	389	12,223
Public sector and non-profit organisations	3,455	-	9	200	3,664
Real estate	54,679	154	675	-	55,508
Seafood	3,959	62,157	392	803	67,311
Bonds and debt instruments	-	-	-	-	-
Derivatives	-	-	600	-	600
Total	268,925	62,382	52,130	19,021	402,458

The financial effect of collateral is now disclosed for the first time due to changes in IFRS 7. The Bank is still in the process of finalising the registration of the necessary collateral information for this purpose e.g. is collateral for loans recently acquired from Byr (see note 4) only included in respect of mortgage loans. Therefore, the table understates the value of the Bank's total collateral. Comparative information is not available.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

66. Credit quality of financial assets

Loans are classified as impaired loans if contractual cash payments are not expected to be fulfilled and if financial restructuring of the obligor is expected to lead to a loss on that particular loan. In most cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio.

Loans are also classified as impaired if the Bank has made impairments to offset currency movements. For individuals and smaller companies this is the main reason for loans being classified as impaired. This impairment does not signal a loss from the deep discount.

The full carrying amount of all loans which give rise to individual impairment or collective impairment is included in impaired loans, even if parts are covered by collateral.

At 31 December 2011	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	57,992	-	-	57,992
Loans to credit institutions	43,655	-	-	43,655
Loans to customers:	408,462	70,963	84,969	564,394
Individuals	177,724	40,138	10,327	228,189
Commerce and services	43,465	7,055	13,435	63,955
Construction	5,509	4,830	4,360	14,699
Energy	2,921	28	556	3,505
Financial institutions	164	177	1,059	1,400
Government secured customer loan	38,798	-	-	38,798
Industrial	24,688	2,779	6,502	33,969
Investment companies	8,453	3,431	12,508	24,392
Public sector and non-profit organisations	5,667	422	3,449	9,538
Real estate	36,343	9,235	29,751	75,329
Seafood	64,730	2,868	3,022	70,620
Bonds and debt instruments	58,662	-	-	58,662
Derivatives	1,481	-	-	1,481
Total	570,252	70,963	84,969	726,184

At 31 December 2010	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	30,799	-	-	30,799
Loans to credit institutions	30,842	8	20	30,870
Loans to customers:	322,093	39,557	153,511	515,161
Individuals	123,086	21,194	28,433	172,713
Commerce and services	25,075	3,442	22,369	50,886
Construction	8,326	2,680	6,082	17,088
Energy	1,003	15	1,104	2,122
Financial institutions	4,229	8	11	4,248
Government secured customer loan	52,182	-	-	52,182
Industrial	7,858	1,727	11,370	20,955
Investment companies	12,423	1,409	28,292	42,124
Public sector and non-profit organisations	6,255	1,549	2,579	10,383
Real estate	25,653	6,582	42,290	74,525
Seafood	56,003	951	10,981	67,935
Bonds and debt instruments	68,024	-	-	68,024
Derivatives	211	-	-	211
Total	451,969	39,565	153,531	645,065

The amounts are in ISK million

Notes to the Consolidated Financial Statements

67. Past due but not impaired loans

Past due but not impaired loans are loans where contractual interest or principal payments have passed due date without the obligor making full payment, but where specific impairment is not appropriate. These loans are expected to be restructured without any loss to the Bank. In some cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio. In other cases, there is sufficient collateral or the assessment is that contractual payments will be fulfilled.

Note that the loan portfolio acquired from Byr was measured at fair value on acquisition and has therefore not been specifically impaired by the Bank after the acquisition. However a large part of the portfolio is past due and, therefore, the past due but not impaired loans have increased between reporting dates.

Amounts reported as past due refer to the total loan exposure and not only the payment or sum of payments that are past due. Past due but not impaired loans are as follows:

At 31 December 2011	Past due up to 30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to credit institutions	-	-	-	-	-
Loans to customers:					
Individuals	12,856	4,198	2,011	21,073	40,138
Commerce and services	1,969	394	435	4,257	7,055
Construction	1,912	290	287	2,341	4,830
Energy	14	-	-	14	28
Financial institutions	55	-	-	122	177
Government secured customer loan	-	-	-	-	-
Industrial	675	377	110	1,617	2,779
Investment companies	380	41	5	3,005	3,431
Public sector ad non-profit organisations	289	24	11	98	422
Real estate	898	247	335	7,755	9,235
Seafood	118	29	66	2,655	2,868
Total	19,166	5,600	3,260	42,937	70,963

At 31 December 2010	Past due up to 30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to credit institutions	8	-	-	-	8
Loans to customers:					
Individuals	5,189	2,577	685	12,743	21,194
Commerce and services	713	243	85	2,401	3,442
Construction	335	94	136	2,115	2,680
Energy	14	1	-	0	15
Financial institutions	1	0	1	6	8
Government secured customer loan	-	-	-	-	-
Industrial	383	153	192	999	1,727
Investment companies	56	553	8	792	1,409
Public sector ad non-profit organisations	1,355	103	72	19	1,549
Real estate	2,754	386	259	3,183	6,582
Seafood	44	227	20	660	951
Total	10,852	4,337	1,458	22,918	39,565

The amounts are in ISK million

Notes to the Consolidated Financial Statements

68. Large exposure disclosure

When the Bank's total exposure to a group of connected clients exceeds 10% of the Bank's capital base it is considered a large exposure. The exposure is evaluated net of credit risk mitigating effects eligible according to FME rules 216/2007.

When assessing the exposure, both on-balance sheet and off-balance sheet items from all types of financial instruments are included as defined by the FME rules. The Bank has an internal criteria that defines connections between clients. This criteria reflect the Bank's interpretation of Article (1)(a) of law 161/2002 on Financial Undertakings, where groups of connected clients are defined.

The following table shows the Bank's large exposures as a percentage of the Bank's capital base, gross and net of eligible credit risk mitigating effects.

	31.12.2011		31.12.2010	
Client groups	Gross	Net	Gross	Net
Group 1	56%	0%	44%	0%
Group 2	27%	0%	37%	1%
Group 3	15%	15%	15%	15%

The Bank has one large exposure to a group of connected clients that amounts to 15% of the Bank's capital base which is below the aggregated 400% limit set by the law. No large exposure exceeds the maximum 25% set by the law.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Liquidity risk

69. The Bank defines liquidity risk as the risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

Liquidity risk management

The Bank's main source of funding is customer deposits. The Bank's Treasury is responsible for the Bank's funding and liquidity management within the limits approved by the Board and the Asset and Liability Committee. The Interbank desk manages the Bank's intraday liquidity.

Risk management is responsible for measuring, monitoring and reporting on the Bank's liquidity position.

The Bank's liquidity risk policy assumes that the Bank has at all times sufficient liquidity to meet liabilities and other obligations over the next twelve months.

The tables below show the contractual payments of principal and interest for the Bank's financial liabilities. Thus, the total figures for each liability class are higher than the respective balance sheet amount. Cash flows for payments of unknown nature, such as for floating rate, CPI linked or foreign currency denominated instruments, are based on internal yield curves and forecasts.

For dated financial liabilities the amounts are grouped into maturity buckets according to contractual maturities of principal and estimated contractual payments of interest. For demand deposits or other non-dated liabilities, the figures are grouped according to the first possible required payment date.

In relation to the merger of Byr and Íslandsbanki the depositors of Byr had the right to withdraw their term deposits before the contractual maturity date over the period 5 December 2011 until 3 January 2012 according to article 106 of law 161/2002. Therefore, all deposits acquired from Byr are classified in the "on demand" bucket at year end 2011.

Maturity analysis 31 December 2011

Financial Liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	9,346	-	-	-	-	-	9,346
Deposits from Central Bank	73	-	-	-	-	-	73
Deposits from credit institutions	49,527	12,209	1,077	-	-	-	62,813
Deposits from customers	351,478	53,730	28,670	25,411	12,907	-	472,196
Debt issued and other borrowed funds	333	2,226	7,108	43,423	27,381	2,145	82,616
Subordinated loans	-	298	559	6,124	38,288	-	45,269
Other financial liabilities	22,379	13,188	3,156	570	392	148	39,833
Total financial liabilities	433,136	81,651	40,570	75,528	78,968	2,293	712,146

Off-balance sheet liabilities show the amount of contractual obligations that the Bank has taken towards customers, either by committing to lend out money in the future or as third party guarantees. The amounts shown reflect the maximum amount, not taking into account the Bank's ability to reduce overdraft or credit card limits before the current undrawn amount is fully utilised by the customer. These obligations all fall into the first time bucket since contractually, on a case by case basis, the Bank could be required to fulfil these obligations instantaneously.

Off balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	6,893	-	-	-	-	-	6,893
Undrawn loan commitments	12,592	-	-	-	-	-	12,592
Undrawn overdraft	21,449	-	-	-	-	-	21,449
Credit card commitments	22,202	-	-	-	-	-	22,202
Total	63,136	-	-	-	-	-	63,136

Total non-derivative financial liabilities and off-balance sheet liabilities	496,272	81,651	40,570	75,528	78,968	2,293	775,282

The amounts are in ISK million

Notes to the Consolidated Financial Statements

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The table below shows the contractual cash flow of the Bank's derivative liabilities, i.e. derivatives that have a negative carrying amount at the date of reporting. Derivatives with a positive carrying amount are detailed separately. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	6,258	2,498	78,562	25,000	-	112,318
Outflow	-	(6,131)	(2,979)	(94,688)	(25,074)	-	(128,872)
Total	-	127	(481)	(16,126)	(74)	-	(16,554)
Net settled derivatives	-	(38)	-	-	-	-	(38)
Total	-	89	(481)	(16,126)	(74)	-	(16,592)

Maturity classification of assets is based on contractual maturity. For loans that were acquired at a deep discount and have not yet been restructured, the contractual amount is scaled to reflect the carrying amount of the claim. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity dates while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	22,937	35,055	-	-	-	-	57,992
Bonds and debt instruments	6,617	16,494	82	152	31,361	3,956	58,662
Shares and equity instruments	-	-	525	48	-	10,534	11,107
Loans to credit institutions	22,027	21,556	-	-	72	-	43,655
Loans to customers	-	50,523	46,877	169,833	297,161	-	564,394
Other financial assets	-	2,567	237	2	-	380	3,186
Total financial assets	51,581	126,195	47,721	170,035	328,594	14,870	738,996
Derivative financial assets							
Gross settled derivatives							
Inflow	-	8,069	773	33,058	-	-	41,900
Outflow	-	(7,976)	(692)	(32,860)	-	-	(41,528)
Total	-	93	81	198	-	-	372
Net settled derivatives	-	21	-	-	-	-	21
Total	-	114	81	198	-	-	393

The tables below show the comparative amounts for financial assets and liabilities at year end 2010. In the consolidated financial statements 2010, the signs were reversed for the inflow and outflow of derivative financial liabilities and credit card commitments were overestimated. This has been corrected in the tables below.

Maturity analysis 31 December 2010

Financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	9,090	-	-	-	-	-	9,090
Deposits from Central Bank	26	-	-	-	-	-	26
Deposits from credit institutions	58,439	18,419	11,051	8,705	-	-	96,614
Deposits from customers	243,797	39,600	3,965	36,165	8,716	-	332,243
Debt issued and other borrowed funds	1,899	2,084	6,458	33,754	29,887	-	74,082
Subordinated loans	-	266	822	6,019	29,671	-	36,778
Other financial liabilities	15,712	6,687	9,237	527	507	1,011	33,681
Total financial liabilities	328,963	67,056	31,533	85,170	68,781	1,011	582,514

The amounts are in ISK million

Notes to the Consolidated Financial Statements

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Off balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	8,404	-	-	-	-	-	8,404
Undrawn loan commitments	13,453	-	-	-	-	-	13,453
Undrawn overdraft	17,186	-	-	-	-	-	17,186
Credit card commitments	17,916	-	-	-	-	-	17,916
Total	56,959	-	-	-	-	-	56,959
Total non-derivative financial liabilities and off-balance sheet liabilities	385,922	67,056	31,533	85,170	68,781	1,011	639,473

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	10,811	1,267	57,837	25,000	-	94,915
Outflow	-	(10,797)	(1,403)	(60,757)	(25,113)	-	(98,070)
Total	-	14	(136)	(2,920)	(113)	-	(3,155)
Net settled derivatives	-	-	-	-	-	-	-
Total	-	14	(136)	(2,920)	(113)	-	(3,155)

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	23,934	6,865	-	-	-	-	30,799
Bonds and debt instruments	4,492	30,378	1	4	31,111	2,038	68,024
Shares and equity instruments	-	-	-	-	-	3,022	3,022
Loans to credit institutions	7,027	23,501	-	-	342	-	30,870
Loans to customers	4,542	57,662	36,782	156,700	259,475	-	515,161
Other financial assets	-	1,235	766	30	513	548	3,092
Total financial assets	39,995	119,641	37,549	156,734	291,441	5,608	650,968
Derivative financial assets							
Gross settled derivatives							
Inflow	-	3,685	-	-	-	-	3,685
Outflow	-	(3,672)	-	-	-	-	(3,672)
Total	-	13	-	-	-	-	13
Net settled derivatives							
Total	-	13	-	-	-	-	13

As a part of managing liquidity risk, the Bank holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Bank's liquidity back-up at the end of 2010 and end of 2011.

Composition and amount of liquidity back-up	31.12.2011	31.12.2010
Cash and balances with Central Bank	57,992	30,799
Domestic bonds eligible as collateral against borrowing at the Central Bank	55,024	54,881
Foreign government bonds	16,323	30,378
Short-term placements with credit institutions	36,695	28,332
Government liquidity facility	25,000	25,000
Composition and amount of liquidity back-up	191,034	169,390

The amounts are in ISK million

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Market risk

70. Market risk is the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices, commodity prices and foreign exchange rates.

Market risk management

The Bank's market risk appetite is determined by the Board of Directors. The Asset and Liability Committee (ALCO) decides on limits for portfolios and products in accordance with the market risk policy approved by the Board. Risk management is responsible for monitoring and reporting on the Bank's overall market risk positions and compliance to limits. The objective of market risk management is to manage and control market risk exposures within acceptable parameters.

The Bank separates exposures to market risk into trading book and banking book (non-trading portfolios). The Bank's primary sources of market risk in the trading portfolio are shares, debt instruments and foreign currency positions. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. Market risk in the banking book is mainly due to mismatches in interest rate terms and denomination currency of assets and liabilities. These mismatches are reported to management and are subject to regulatory and internal limits.

Interest rate risk

71. Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates.

The Bank uses sensitivity measures like Basis Point Value (BPV) to measure and manage risk arising from its fixed income exposures. The BPV measures the effect of a 0.01% upward parallel shift in the yield curve on the fair value of these exposures.

72. Interest rate risk in the trading portfolio

The fixed income trading unit invests mainly in government bonds and bonds issued by the Housing Financing Fund (HFF), which are guaranteed by the Icelandic government. These positions can include short positions. Government bonds are either indexed to the Icelandic Consumer Price Index (CPI) or non-indexed, with duration up to 10 years. HFF bonds are CPI linked and have duration up to 14 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day. In addition to BPV limits short and long positions in each instrument are subject to separate limits. Risk management monitors these limits and reports all breaches to ALCO.

Trading bonds and debt instruments, long positions		31.12.2011			31.12.2010	
	MV	Duration	BPV	MV	Duration	BPV
Indexed	379	9.22	(0.35)	2,124	9.01	(1.91)
Non-Indexed	17,231	0.32	(0.55)	34,078	0.86	(2.92)
Total	17,610	0.51	(0.90)	36,202	1.33	(4.83)

Trading bonds and debt instruments, short positions		31.12.2011			31.12.2010	
	MV	Duration	BPV	MV	Duration	BPV
Indexed	962	7.89	0.76	1,129	4.74	0.54
Non-Indexed	364	8.17	0.30	7,961	1.32	1.05
Total	1,326	7.97	1.06	9,090	1.75	1.59

Net position of trading bonds and debt instruments	16,284	(0.09)	0.16	27,112	1.20	(3.24)

The amounts are in ISK million

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The Bank holds a significant amount of highly liquid foreign government bills in its liquidity portfolio. The investments in the portfolio are subject to a minimum credit rating of AA-. The duration of these instruments ranges up to six months and the sensitivity measured in BPV is ISK -0.3 million (31 December 2010: ISK -0.6 million).

Foreign government bills	31.12.2011		31.12.2010	
Country	Market value	BPV	Market value	BPV
Denmark	3,205	(0.08)	-	0.00
Finland	794	(0.00)	-	0.00
France	1,588	(0.01)	5,380	(0.06)
Germany	-	0.00	3,844	(0.04)
Netherlands	3,179	(0.05)	5,379	(0.10)
Norway	2,033	(0.06)	1,953	(0.06)
UK	-	0.00	3,473	(0.02)
USA	5,522	(0.13)	10,695	(0.34)
Total	16,321	(0.33)	30,724	(0.62)

73. Sensitivity analysis for interest rate risk for trading portfolios

For sensitivity analysis in the trading portfolio the Bank applies a 100 bps shift in ISK, non-indexed and indexed interest rates. Shifts in rates in other currencies are scaled down in accordance with lower volatility. The following table demonstrates the sensitivity of the Bank's equity and income statement to a reasonable change in interest rates, all other risk factors held constant.

Sensitivity analysis for trading bonds and debt instruments		31.12.2011		31.12.2010	
		Profit or loss			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	(41)	41	138	(138)
ISK, non-indexed	100	(7)	7	125	(125)
CHF	40	-	-	-	-
EUR	20	1	(1)	4	(4)
GBP	40	-	-	1	(1)
JPY	20	-	-	-	-
USD	40	5	(5)	13	(13)
Other total	40	6	(6)	3	(3)
Total		(36)	36	284	(284)

The amounts are in ISK million

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74. Interest rate risk in the non-trading portfolio

Interest rate risk in the banking book arises from the Bank's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as interest rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Bank holds a government bond designated at fair value amounting to ISK 30.8 billion (2010: ISK 30.3 billion). The bond pays floating rates and carries relatively low interest rate risk.

The Bank uses traditional measures for assessing the sensitivity of the Bank's financial assets, financial liabilities and earnings to changes in the underlying interest rates.

Non-trading portfolio interest rate adjustment periods 31 December 2011

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Cash and balances with Central Bank	56,016	-	-	-	-	-	56,016
Bonds and debt instruments	32,218	1,153	1,069	370	1,398	4,458	40,666
Loans to credit institutions	43,551	104	-	-	-	-	43,655
Loans to customers	420,171	27,158	35,739	63,895	1,914	15,517	564,394
Total assets	551,956	28,415	36,808	64,265	3,312	19,975	704,731
Off balance sheet items	59,201	-	10,007	3,115	113	-	72,436
Liabilities							
Short positions	-	3,567	1,815	477	-	-	5,859
Deposits from Central Bank	73	-	-	-	-	-	73
Deposits from credit institutions	61,711	1,061	-	-	-	-	62,772
Deposits from custumers	456,329	3,383	759	807	1,665	-	462,943
Debt issued and other borrowed funds	7,221	-	-	6,679	49,133	188	63,221
Subordinated loans	21,937	-	-	-	-	-	21,937
Total liabilities	547,271	8,011	2,574	7,963	50,798	188	616,805
Off-balance sheet items	62,484	-	9,862	3,070	-	-	75,416
Net interest gap on 31 December 2011	1,402	20,404	34,379	56,347	(47,373)	19,787	84,946

The amounts are in ISK million

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Non-trading portfolio interest rate adjustment periods 31 December 2010

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Cash and balances with Central Bank	28,966	-	-	-	-	-	28,966
Bonds and debt instruments	31,142	659	-	-	-	22	31,823
Loans to credit institutions	30,520	350	-	-	-	-	30,870
Loans to customers	389,089	37,855	9,481	60,557	2,572	15,607	515,161
Total assets	479,717	38,864	9,481	60,557	2,572	15,629	606,820
Off balance sheet items	47,903	-	-	-	-	-	47,903
Liabilities							
Deposits from Central Bank	26	-	-	-	-	-	26
Deposits from credit institutions	86,856	1,037	8,319	-	-	-	96,212
Deposits from customers	322,274	2,521	-	1,420	943	-	327,158
Debt issued and other borrowed funds	432	-	-	808	52,639	1,546	55,425
Subordinated loans	21,241	-	-	-	-	-	21,241
Total liabilities	430,829	3,558	8,319	2,228	53,582	1,546	500,062
Off balance sheet items	48,216	-	-	-	-	120	48,336
Net interest gap on 31 December 2010	48,575	35,306	1,162	58,329	(51,010)	13,963	106,327

75. Sensitivity analysis for interest rate risk for non-trading portfolios

For sensitivity analysis in the banking book a 100 bps shift is applied for non-indexed ISK interest rates. Shifts in other currencies are chosen using the same scaling factors as in the trading portfolio. CPI-linked ISK rate shifts are also scaled down to reflect significantly stronger mean reversion than for non-indexed rates. The table shows how applied shifts would affect the fair value of the Bank's banking book.

Sensitivity analysis for non-trading bonds and debt instruments		31.12.2011		31.12.2010	
		Profit or loss			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	40	935	(935)	684	(684)
ISK, non-indexed	100	487	(487)	(62)	62
CHF	40	(5)	5	5	(5)
EUR	20	(3)	3	(3)	3
GBP	40	1	(1)	-	-
JPY	20	3	(3)	2	(2)
USD	40	8	(8)	(1)	1
Other	40	(1)	1	(1)	1
Total		1,425	(1,425)	624	(624)

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Currency risk

76. Currency risk is the risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or due to mismatch in the currency composition of assets or liabilities.

The analysis of the Bank's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements. Most of the net non-adjusted currency imbalance is due to loans with a non-ISK contractual currency to customers with ISK income. As a part of the transfer of assets from Glitnir, the Bank determined that these loans have a recovery value that is limited in ISK terms. To reflect the ISK based recovery value of these loans the Bank has impaired fully the foreign exchange gains on these assets since the date of transfer. Should there be an appreciation of the ISK there will be a corresponding reversal of the impairment charge. This is in accordance with IFRS accounting standards. The Bank's regulators allow for an adjustment of the contractual currency imbalance to reflect the recovery of foreign currency denominated loans to customers with ISK income. The tables below summarise the Bank's exposure to currency risk at 31 December 2011 and 31 December 2010, based on contractual currencies, off-balance sheet items along with the currency adjustment, but excluding assets categorised as held-for-sale.

Currency analysis 31 December 2011

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank	491	124	63	36	10	226	950
Bonds and debt instruments	5,919	5,890	-	-	-	5,238	17,047
Shares and equity instruments	630	122	213	-	-	-	965
Loans to credit institutions	18,866	10,355	1,492	1,236	382	5,220	37,551
Loans to customers	60,941	18,176	4,813	22,681	25,082	2,473	134,166
Investments in associates	20	433	-	-	-	-	453
Other assets	-	-	-	-	-	-	-
Total assets	86,867	35,100	6,581	23,953	25,474	13,157	191,132
Liabilities							
Deposits from credit institutions	2,511	380	135	11	2	95	3,134
Deposits from customers	21,307	19,451	4,557	725	536	8,547	55,123
Debt issued and other borrowed funds	-	-	-	-	-	14	14
Subordinated loans	21,937	-	-	-	-	-	21,937
Other liabilities	-	-	-	-	-	-	-
Total liabilities	45,755	19,831	4,692	736	538	8,656	80,208
Non-adjusted foreign exchange on-balance sheet imbalance	41,112	15,269	1,889	23,217	24,936	4,501	110,924
Adjustment of currency imbalance for FX/ISK loans	16,007	3,075	806	12,638	13,210	912	46,648
Adjusted imbalance	25,105	12,194	1,083	10,579	11,726	3,589	64,276
Off-balance sheet items							
Off-balance sheet assets	4,265	17,238	38	239	2,459	76	24,315
Off-balance sheet liabilities	21,176	25,427	294	11,106	15,011	1,891	74,905
Net off-balance sheet items	(16,911)	(8,189)	(256)	(10,867)	(12,552)	(1,815)	(50,590)
Net currency imbalance on 31 December 2011	8,194	4,005	827	(288)	(826)	1,774	13,686

The amounts are in ISK million

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Currency analysis 31 December 2010

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank	405	191	114	38	15	349	1,112
Bonds and debt instruments	15,018	10,695	3,473	-	-	1,953	31,139
Shares and equity instruments	12	51	-	-	-	-	63
Loans to credit institutions	16,620	6,403	1,173	30	200	2,589	27,015
Loans to customers	67,094	26,092	5,333	41,579	36,613	3,501	180,212
Investments in associates	218	-	-	-	-	-	218
Other assets	195	373	42	-	-	3	613
Total assets	99,562	43,805	10,135	41,647	36,828	8,395	240,371
Liabilities							
Deposits from credit institutions	7,701	6,920	5,412	-	11	590	20,635
Deposits from customers	15,791	13,165	2,732	465	1,202	4,935	38,290
Debt issued and other borrowed funds	134	-	-	-	-	32	166
Subordinated loans	21,241	-	-	-	-	-	21,241
Other liabilities	647	696	302	-	-	45	1,689
Total liabilities	45,514	20,781	8,446	465	1,213	5,602	82,021
Non-adjusted foreign exchange on-balance sheet imbalance	54,048	23,024	1,689	41,182	35,615	2,793	158,350
Adjustment of currency imbalance for FX/ISK loans	37,057	12,362	1,551	26,412	24,194	1,620	103,196
Adjusted imbalance	16,991	10,662	138	14,770	11,421	1,173	55,155
Off-balance sheet items							
Off-balance sheet assets	3,877	5,995	1,151	1,258	2,578	156	15,015
Off-balance sheet liabilities	24,945	22,015	1,280	6,967	13,514	688	69,409
Net off-balance sheet items	(21,069)	(16,020)	(129)	(5,709)	(10,936)	(532)	(54,394)
Net currency imbalance on 31 December 2010	(4,078)	(5,358)	9	9,061	485	641	759

The amounts are in ISK million

Notes to the Consolidated Financial Statements

77. Sensitivity analysis towards currency risk

The table below shows how the adjusted imbalance is affected by either depreciation or appreciation of each currency assuming other risk factors being held constant. The shift number is the 99% percentile of a 10-day return distribution for each currency for the previous 365 days. The adverse movement of each currency is applied for the impact of the shift and demonstrates how equity and income statement would be affected by the shifts.

Sensitivity towards currency risk 31 December 2011

Currency (shift)	Shift Effect
EUR (2%)	(164)
USD (3%)	(120)
CHF (9%)	(26)
GBP (2%)	(17)
JPY (5%)	(41)
Oher (4%)	(71)
Total	(439)

Sensitivity towards currency risk 31 December 2010

Currency (shift)	Shift Effect
EUR (4%)	(163)
USD (4%)	(214)
CHF (4%)	(362)
GBP (4%)	-
JPY (4%)	(19)
Other (5%)	(32)
Total	(790)

Shares and equity instruments

78. The Bank's equity exposure in the trading book arises from flow trading, mainly in shares denominated in ISK. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the equity risk and concentration risk in the Bank's portfolio. Shares and equity instruments in the banking book are designated at fair value through profit or loss or are classified as held-for-sale.

79. Sensitivity analysis for shares and equity instruments
The following table demonstrates how reasonable shifts in the prices of trading and banking book would affect the equity and net financial income. Shifts applied for the trading and banking book are 20% and 40% respectively.

Sensitivity analysis for equities		31.12.2011		31.12.2010	
		Profit or loss			
Portfolio (ISK million)	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading	20%	(79)	79	(85)	85
Non-trading	40%	(5,117)	5,117	(1,045)	1,045
Total		(5,196)	5,196	(1,130)	1,130

Derivatives

80. The Bank uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. The Bank carries relatively low indirect exposure due to margin trading with clients and the Bank holds collaterals for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

Inflation risk

81. The Bank is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 31 December 2011 the CPI gap amounted to ISK 22.2 billion (31 December 2010: ISK 25.1 billion). Thus, a 1% increase in the index would have a positive impact on the profit and loss account to the amount of ISK 222 million in profit and a 1% decrease would result in a corresponding loss, other risk factors held constant.

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Capital management

82. Risk exposure and capital base

Icelandic capital adequacy rules are based on the EU Capital Requirements Directives (CRD). The capital adequacy rules require an absolute minimum capital of 8% of risk weighted assets.

As part of the conditions for granting the Bank an operating license as a financial undertaking, the Icelandic Financial Supervisory Authority (FME) requires the Bank to maintain a minimum Tier 1 ratio of 12% of risk weighted assets and a total capital ratio, allowing for subordinated Tier 2 debt, of 16%.

The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach. Market risk exposure for currency risk is based on the adjusted currency imbalance described in note 76.

The table below shows the capital base, risk weighted assets and capital ratios of the Bank at 31 December 2011 and 31 December 2010.

	2011	2010
Tier 1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,661	2,498
Retained earnings	55,133	53,174
Non-controlling interests	909	791
Tax assets	(2,629)	(283)
Intangible assets	(544)	(187)
Total Tier 1 capital	120,530	120,993
Tier 2 capital		
Qualifying subordinated liabilities	21,937	21,241
Total regulatory capital	142,467	142,234
Risk weighted assets		
- due to credit risk	532,301	440,586
- due to market risk:	16,695	14,766
Market risk, trading book	1,895	4,583
Currency risk FX	14,800	10,183
- due to operational risk	80,423	79,079
Total risk weighted assets	629,419	534,431
Capital ratios		
Tier 1 ratio	19.1%	22.6%
Total capital ratio	22.6%	26.6%

In addition to maintaining capital according to the requirement set by the FME, the Bank must make an Internal Capital Adequacy Assessment (ICAAP). Such an assessment is an integral part of the Bank's capital and risk management.

The FME reviewed the last ICAAP report as a part of the Supervisory Review Process (SREP). The results from this review process were presented to the Bank during 2011 and show that the current capitalisation levels are well above of both internal and regulatory requirements.

Article 86 of the act on Financial Undertakings (161/2002) details the measures taken in the case of insufficient own funds of a financial undertaking. If the board or managing directors of a financial undertaking have reason to expect that its own funds will be less than the minimum required by law, they must immediately notify the Financial Supervisory Authority (FME) thereof. The FME may grant the financial undertaking concerned a time limit of up to six months to increase its own funds to the minimum provided. If the remedies are not satisfactory in the opinion of the FME, or if the time limit provided for expires, the operating licence of the financial undertaking shall be revoked.

The amounts are in ISK million

Notes to the Consolidated Financial Statements

Operational risk

83. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Bank's definition of operational risk includes reputational risk as well as legal and compliance risk.

    The Bank has implemented a framework to manage operational risk. Under this framework, operational risk management is carried out in a consistent manner across all business units in the Bank with the primary responsibility for the assessment and management of operational risk residing within each business unit.

    The Bank uses the basic indicator approach of the capital requirements directive (CRD) to calculate the capital requirements for operational risks.