

Interim Consolidated Financial Statements

1 January - 30 June 2016

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ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Interim Financial Statements of Arion Bank for the period from 1 January to 30 June 2016 include the Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

Iceland's economic indicators continue to be strong. Economic growth was 4.0% in 2015, inflation continues to be below the Central Bank's inflation target and unemployment measured 2.3% in June. Arion Research forecasts that economic growth will remain strong. Inflation is expected to rise more slowly than previously forecast and to peak at 3.6% in Q2 2017. The currency auction releasing offshore ISK has been finalized, and the first steps towards lifting the capital controls have been presented to the parliament and will probably be approved, before this autumn's general election.

Arion Bank has acquired all shares in the insurance company Vörður, which is the fourth largest insurance company in Iceland. The acquisition is subject to regulatory approval and the Bank expects a final decision on this matter to have been made by the autumn.

Kaupthing ehf., now a holding company, has expressed its interest in selling its 87% shareholding in Arion Bank, held by its subsidiary Kaupskil ehf. On 15 June Arion Bank and Kaupthing issued the following press release: "In the context of the continued strong development of the Icelandic economy, Arion Bank and Kaupthing, its majority owner, are currently assessing a range of strategic alternatives with regards to Kaupthing's shares held in the Bank. This may include a possible IPO; however, no decision has been made at this point in time with respect to any specific transaction and timing thereof".

Operations during the period

Net earnings amounted to ISK 9,759 million for the period ended 30 June 2016, and the Group's equity amounted to ISK 208,844 million at the end of the period. The capital ratio of the Group, based on the reported capital base on 30 June 2016, was 27.8% and the corresponding Tier 1 ratio was 26.8%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at period end and well above the regulatory minimum.

In June the Bank's subsidiary Valitor Holding hf. completed the sale of its shareholding in Visa Europe Ltd. to Visa Inc. The profit from the sale was ISK 5,291 million, after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The profit was recognized as Net financial income in the Statement of Comprehensive Income in the second quarter of 2016. The shareholding was classified as Financial assets available for sale at year-end 2015.

The main changes on the Balance Sheet from year end 2015 relate to changes in the structure of funding, increased lending and increased liquidity. Loans to customers have increased by ISK 32.8 billion or 4.8% during the period. New lending is mainly to corporates in several sectors, most in industry, energy and manufacturing and wholesale and retail.

The conditions on the Icelandic equity and bond markets were difficult during the first six months. The Bank holds substantial equity positions in listed companies on the Icelandic market and sustained some losses during the period after a number of favorable years. The Icelandic krona strengthened against most foreign currencies. The Group made a loss from foreign currency exchange of ISK 687 million during the period, compared with profit of ISK 622 million during the same period in 2015.

In January, the subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect from the sale was recognized as a valuation change in the Statement of Comprehensive Income in 2015. During the first quarter of 2016 the total effect through the Statement of Comprehensive Income was ISK 498 million.

One of Arion Bank's main tasks in recent years has been to improve the quality of its loan portfolio and to reduce the amount of problem loans. The Bank has succeeded in this respect as the distribution of loans between individuals and companies is satisfactory and the ratio of problem loans has decreased to 1.9%.

In recent years Arion Bank has made changes to the network of branches in Iceland in order to increase efficiency and reduce cost, e.g. in housing, changes in opening hours of the branches and sharing of services and other measures which increase operational synergies. In the first half of 2016 Arion Bank opened new and impressive branch at Keflavík international airport, which offers wide range of opportunities for services to increasing number of tourists. Arion Bank will continue to seek opportunities to change and increase efficiency in its network of branches.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of USD 747.8 million (ISK 97 billion). The bond was issued under Arion Bank's EMTN programme and is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% interest for the first two years and will then be repriced at market terms. The bond offsets loans in foreign currency, taken by Arion Bank from the Central Bank of Iceland and later purchased by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. The bond issue forms part of the capital control liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015.

In April Arion Bank issued a total of EUR 300 million (ISK 42 billion) in new senior unsecured bonds. Orders totaling over EUR 500 million from more than 70 investors were received. The 3-year bonds have a fixed coupon of 2.5% and were sold at rates corresponding to a 2.7% margin over interbank rates. This represents the second euro benchmark issue by Arion Bank. Part of the new issuance, EUR 221 million (ISK 31 billion), was used to partially prepay the EMTN bond held by Kaupthing.

In 2016 the Bank started to issue privately placed bonds under its EMTN programme. This is an important step for the Bank in diversifying its funding sources. Arion Bank will continue the issuance of private placements, depending on the prevailing market conditions and the Bank's funding needs.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In the first six months of 2016 the Bank issued a total of ISK 15.3 billion of covered bonds in the domestic market, of which ISK 6.8 billion were inflation-linked bonds and ISK 8.5 billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis on the domestic market in 2016.

The Group had 1,199 full-time equivalent positions at the end of the period compared with 1,147 at the end of 2015; 896 of these positions were at Arion Bank, compared with 876 at the end of 2015.

Group ownership

On behalf of its creditors, Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 87% of the shares in Arion Bank hf. The remaining shareholding of 13% is held by Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has seven members, four women and three men. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 people should ensure that the ratio of either sex on the board of directors should not be less than 40%. Six directors are appointed by Kaupskil ehf. and one by Icelandic State Financial Investments.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Interim Financial Statements of Arion Bank for the period ended 30 June 2016 have been prepared in accordance with International Financial Reporting Standards (IAS 34 Interim Financial Statements) as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 June 2016 and its financial position as at 30 June 2016.

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

The Board of Directors and the CEO have today discussed the Interim Financial Statements of Arion Bank for the period ended 30 June 2016 and confirm them by means of their signatures.

Reykjavík, 31 August 2016

Board of Directors



Monica Caneman
Chairman



Benedikt Olgeirsson



Guðrún Johnsen



Máns Höglund



Brynjólfur Bjarnason



Kirstín Þ. Flygenring



Þóra Hallgrímsdóttir

Chief Executive Officer



Höskuldur H. Ólafsson

REPORT ON REVIEW OF INTERIM CONSOLIDATED FINANCIAL STATEMENTS

To the Board of Directors and Shareholders of Arion Bank.

We have reviewed the accompanying Interim Consolidated Statement of Financial Position of Arion Bank and its subsidiaries (the "Group") as of 30 June 2016 and the related Interim Consolidated Statement of Comprehensive Income, Interim Consolidated Statement of Changes in Equity and Interim Consolidated Statement of Cash Flows for the six months then ended and a summary of significant accounting policies and other explanatory notes.

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

The Board of Directors and management are responsible for the preparation and fair presentation of this Interim Consolidated Financial Statements in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the EU.

Auditor's Responsibility

Our responsibility is to express a conclusion on this Interim Consolidated Financial Statements based on our review.

Scope of Review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Interim Consolidated Financial Statements do not give a true and fair view of the financial position of the Bank as at 30 June 2016, and of its financial performance and its cash flows for the six month period then ended in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the EU and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and Rules on Accounting for Credit Institutions.

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

Pursuant to the requirement of Paragraph 2 Article 104 of the Icelandic Act on Financial Statements 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 Act on Financial Statements that is not disclosed elsewhere in the Interim Consolidated Financial Statements.

Kópavogur, 31 August 2016

Deloitte ehf.



Páll Grétar Steingrímsson
State Authorised Public Accountant



Gunnar Þorvarðarson
State Authorised Public Accountant

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2016

	Notes	2016 1.1. -30.6.	2015 1.1. -30.6.	2016 1.4.-30.6.*	2015 1.4.-30.6.*
Interest income		31,395	27,660	16,525	16,016
Interest expense		(16,769)	(14,485)	(9,172)	(8,624)
Net interest income	6	<u>14,626</u>	<u>13,175</u>	<u>7,353</u>	<u>7,392</u>
Fee and commission income		11,245	10,236	6,005	5,179
Fee and commission expense		(4,498)	(2,802)	(2,477)	(1,502)
Net fee and commission income	7	<u>6,747</u>	<u>7,434</u>	<u>3,528</u>	<u>3,677</u>
Net financial income	8	3,495	9,723	3,796	2,184
Share of profit of associates	24	694	4,217	17	6
Other operating income	9	1,861	1,523	626	1,032
Operating income		<u>27,423</u>	<u>36,072</u>	<u>15,320</u>	<u>14,291</u>
Salaries and related expense	10	(8,426)	(7,167)	(4,318)	(3,675)
Other operating expense	11	(6,970)	(6,004)	(3,736)	(3,108)
Bank levy	12	(1,485)	(1,389)	(743)	(659)
Net impairment	13	945	(81)	1,448	(1,863)
Earnings before tax		<u>11,487</u>	<u>21,431</u>	<u>7,971</u>	<u>4,986</u>
Income tax expense	14	(2,091)	(2,367)	(1,354)	(647)
Net earnings from continuing operations		<u>9,396</u>	<u>19,064</u>	<u>6,617</u>	<u>4,339</u>
Net gain from discontinued operations, net of tax	15	363	262	259	79
Net earnings		<u>9,759</u>	<u>19,326</u>	<u>6,876</u>	<u>4,418</u>
Other comprehensive income					
Net gain on AFS financial assets, net of tax		(2,903)	-	(2,715)	-
Exchange difference on translating foreign subsidiaries	32	94	(230)	22	(225)
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		<u>(2,809)</u>	<u>(230)</u>	<u>(2,693)</u>	<u>(225)</u>
Total comprehensive income		<u>6,950</u>	<u>19,096</u>	<u>4,183</u>	<u>4,193</u>
Attributable to					
Shareholders of Arion Bank		6,453	19,067	4,085	4,208
Non-controlling interest		497	29	98	(15)
Total comprehensive income		<u>6,950</u>	<u>19,096</u>	<u>4,183</u>	<u>4,193</u>
Earnings per share from continuing operations					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	4.45	9.52	3.26	2.18

* The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditors.

The Notes on pages 12 to 58 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 2016

Assets	Notes	30.6.2016	31.12.2015
Cash and balances with Central Bank	17	77,108	48,102
Loans to credit institutions	18	85,607	87,491
Loans to customers	19	713,136	680,350
Financial instruments	20-22	121,246	133,191
Investment property	22	6,487	7,542
Investments in associates	24	904	27,299
Intangible assets	25	9,152	9,285
Tax assets	26	221	205
Other assets	27	21,142	17,578
Total Assets		<u>1,035,003</u>	<u>1,011,043</u>
Liabilities			
Due to credit institutions and Central Bank	21	8,018	11,387
Deposits	21	423,089	469,347
Financial liabilities at fair value	21	4,722	7,609
Tax liabilities	26	3,812	4,922
Other liabilities	28	47,080	49,461
Borrowings	21.29	329,885	256,058
Subordinated liabilities	21.30	9,553	10,365
Total Liabilities		<u>826,159</u>	<u>809,149</u>
Equity			
Share capital and share premium	32	75,861	75,861
Other reserves	32	1,739	4,548
Retained earnings		121,639	112,377
Total Shareholders' Equity		<u>199,239</u>	<u>192,786</u>
Non-controlling interest		9,605	9,108
Total Equity		<u>208,844</u>	<u>201,894</u>
Total Liabilities and Equity		<u>1,035,003</u>	<u>1,011,043</u>

The Notes on pages 12 to 58 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2016

	Share capital and share premium	Other reserves	Retained earnings	Total share- holders' equity	Non- controlling interest	Total equity
Equity 1 January 2016	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings	-	-	9,262	9,262	497	9,759
Other comprehensive income	-	(2,809)	-	(2,809)	-	(2,809)
Total comprehensive income	-	(2,809)	9,262	6,453	497	6,950
Equity 30 June 2016	<u>75,861</u>	<u>1,739</u>	<u>121,639</u>	<u>199,239</u>	<u>9,605</u>	<u>208,844</u>
Equity 1 January 2015	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings	-	-	19,297	19,297	29	19,326
Other comprehensive income	-	(230)	-	(230)	-	(230)
Total comprehensive income	-	(230)	19,297	19,067	29	19,096
Dividend paid	-	-	(12,809)	(12,809)	-	(12,809)
Acquisition of non-controlling interest	-	-	-	-	(54)	(54)
Equity 30 June 2015	<u>75,861</u>	<u>1,402</u>	<u>89,706</u>	<u>166,969</u>	<u>1,476</u>	<u>168,445</u>

In June 2016 the Icelandic parliament passed an amendment to the Icelandic Act on Financial Statements, with an effective date of 1 January 2016. The amendment will affect the presentation of Equity in the Financial Statements and thus may affect future dividend payments to shareholders of Arion Bank. The Group is currently assessing the impact of the amendment on the presentation of Equity. The Annual Financial Statements 2016 will present Equity in accordance with the amendments.

The Notes on pages 12 to 58 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2016

	2016	2015
	1.1.-30.6.	1.1.-30.6.
Operating activities		
Net earnings	9,759	19,326
Non-cash items included in net earnings and other adjustments	(15,573)	(16,460)
Changes in operating assets and liabilities	(3,703)	6,422
Interest received	23,810	18,542
Interest paid	(8,422)	(6,507)
Dividend received	600	6,798
Income tax paid	(2,136)	(1,523)
Net cash from operating activities	<u>4,335</u>	<u>26,598</u>
Investing activities		
Acquisition of associates	(13)	(115)
Proceeds from sale of associates	27,102	7,868
Dividends received from associates	-	506
Acquisition of intangible assets	(530)	(324)
Acquisition of property and equipment	(694)	(400)
Proceeds from sale of property and equipment	209	110
Net cash from investing activities	<u>26,074</u>	<u>7,645</u>
Financing activities		
Payment of subordinated liabilities	-	(19,883)
Dividend paid to shareholders of Arion Bank	-	(12,809)
Acquisition of non-controlling interest	-	(58)
Net cash used in financing activities	<u>-</u>	<u>(32,750)</u>
Net increase in cash and cash equivalents	30,409	1,493
Cash and cash equivalents at beginning of the year	110,000	91,715
Effect of exchange rate changes on cash and cash equivalents	(2,299)	535
Cash and cash equivalents	<u>138,110</u>	<u>93,743</u>
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	957	691
Settlement of loans through foreclosure on collateral from customers with view to resale	(957)	(691)
Non-cash changes due to funding agreement with Kaupthing		
Deposits	41,409	-
Borrowings	(41,409)	-

The Notes on pages 12 to 58 are an integral part of these Interim Financial Statements.

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2016

	2016 1.1.-30.6.	2015 1.1.-30.6.
Non-cash items included in net earnings and other adjustments		
Net interest income	(14,626)	(13,175)
Net impairment	(945)	81
Income tax expense	2,091	2,367
Bank levy	1,485	1,389
Net foreign exchange loss (gain)	687	(622)
Net gain on financial instruments	(3,582)	(2,303)
Depreciation and amortisation	862	834
Share of profit of associates and fair value change	(694)	(4,217)
Investment property, fair value change	(25)	-
Net gain from discontinued operations, net of tax	(363)	(262)
Other changes	(463)	(552)
Non-cash items included in net earnings and other adjustments	(15,573)	(16,460)
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	2,976	(51)
Loans to credit institutions, excluding bank accounts	(2,180)	(5,117)
Loans to customers	(30,912)	(9,876)
Financial instruments and financial liabilities at fair value	5,207	(14,397)
Investment property	1,509	(457)
Other assets	452	(1,889)
Due to credit institutions and Central Bank	(3,412)	(8,778)
Deposits	(8,130)	13,017
Borrowings	35,112	33,123
Other liabilities	(4,325)	847
Changes in operating assets and liabilities	(3,703)	6,422
Cash and cash equivalents		
Cash and demand deposits	77,108	33,189
Due from credit institutions	70,661	69,540
Mandatory reserve with Central Bank	(9,659)	(8,986)
Cash and cash equivalents	138,110	93,743

The Notes on pages 12 to 58 are an integral part of these Interim Financial Statements.

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Financial Statements for the period ended 30 June 2016 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Interim Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions. The Interim Financial Statements do not include all the information and disclosures required in the Annual Financial Statements, and should be read in conjunction with Arion Bank's Annual Financial Statements for the year 2015. The statements are available at Arion Bank's website www.arionbanki.is.

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 31 August 2016.

Basis of measurement

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

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Interim Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against the USD was 123.69 and 136.80 for the EUR (31.12.2015: USD 130.08 and EUR 141.28).

2. Significant accounting estimates and judgements in applying accounting policies

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

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

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses on loans.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

3. The Group

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

	Operating activity	Currency	Equity interest	
			30.6.2016	31.12.2015
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Kolufell ehf., Borgartún 19, Reykjavík, Iceland	Real estate	ISK	68.9%	68.9%
Okkar líftryggingar hf., Laugavegur 182, Reykjavík, Iceland	Life insurance	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland	Payment solutions	ISK	100.0%	100.0%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

Segment information is presented in respect of the Group's operating segments based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax. In presenting the geographic information, segment revenue has been based on the geographic location of customers.

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

Operating segments

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Corporate Banking provides comprehensive financial services and integrated solutions across the banks divisions, to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors. Corporate Finance advises on financial restructuring of companies and manages IPO's and stock market listings. Capital Markets buy and sell securities and FX for Arion bank's clients. Capital Markets manage securities issuance for clients and advise on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and securities markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services. This includes among other deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Retail Banking's 24 branches all around Iceland have a total of more than 100,000 customers.

Treasury has the overall responsibility for the Bank's liquidity, currency and interest rate management. Other functions of Treasury are funds transfer pricing and hedging and pricing of financial products.

Other divisions and Subsidiaries include market making in domestic securities and currencies. The subsidiaries are Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor Holding hf. BG12 slhf., EAB 1 ehf., Kolufell ehf and other smaller entities of the Group.

Headquarters include Overhead, Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

4. Operating segments

	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
1.1.-30.6.2016								
Net interest income	300	3,151	940	7,731	2,301	512	(309)	14,626
Net fee and commission income	1,865	497	771	1,562	(190)	1,949	293	6,747
Net financial income	(8)	(113)	(115)	69	(403)	4,920	(855)	3,495
Share of profit of associates	-	-	498	-	-	238	(42)	694
Other operating income	10	69	321	10	7	1,376	68	1,861
Operating income	2,167	3,604	2,415	9,372	1,715	8,995	(845)	27,423
Operating expense	(752)	(330)	(583)	(3,043)	(113)	(3,607)	(6,968)	(15,396)
Bank levy	-	-	-	-	-	-	(1,485)	(1,485)
Net impairment	-	1,405	1,446	(1,858)	3	(53)	2	945
Earnings before tax	1,415	4,679	3,278	4,471	1,605	5,335	(9,296)	11,487
Net seg. rev. from ext. customers	733	7,837	2,159	15,282	(7,301)	9,326	(613)	27,423
Net seg. rev. from other segments	1,434	(4,233)	256	(5,910)	9,016	(331)	(232)	-
Operating income	2,167	3,604	2,415	9,372	1,715	8,995	(845)	27,423
Depreciation and amortisation	-	-	-	158	-	328	376	862
30.6.2016								
Total assets	5,154	255,975	20,407	466,316	192,070	68,025	27,056	1,035,003
Total liabilities	460	201,706	17,474	406,994	166,830	15,585	17,110	826,159
Allocated equity	4,694	54,269	2,933	59,322	25,240	52,440	9,946	208,844
1.1.-30.6.2015								
Net interest income	213	2,780	(62)	6,832	3,216	199	(3)	13,175
Net fee and commission income	1,841	518	1,293	1,385	(113)	2,178	332	7,434
Net financial income	211	-	7,609	154	(57)	545	1,261	9,723
Share of profit of associates	-	-	304	-	-	414	3,499	4,217
Other operating income	4	43	290	8	-	966	212	1,523
Operating income	2,269	3,341	9,434	8,379	3,046	4,302	5,301	36,072
Operating expense	(732)	(262)	(544)	(2,922)	(131)	(2,797)	(5,783)	(13,171)
Bank levy	-	-	-	-	-	-	(1,389)	(1,389)
Net impairment	(3)	1,455	1,494	(2,342)	11	(743)	47	(81)
Earnings before tax	1,534	4,534	10,384	3,115	2,926	762	(1,824)	21,431
Net seg. rev. from ext. customers	1,032	7,131	9,860	14,754	(6,551)	4,539	5,299	36,072
Net seg. rev. from other segments	1,237	(3,790)	(426)	(6,375)	9,597	(237)	(6)	-
Operating income	2,269	3,341	9,434	8,379	3,046	4,302	5,293	36,072
Depreciation and amortisation	-	-	-	147	-	289	398	834
30.6.2015								
Total assets	5,129	247,406	46,901	420,226	190,676	46,336	18,137	974,811
Total liabilities	114	193,314	23,636	373,373	181,480	27,088	7,361	806,366
Allocated equity	5,015	54,092	23,265	46,853	9,196	19,248	10,776	168,445

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

4. Operating segments, continued

Geographic information

	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
1.1.-30.6.2016							
Net interest income	15,636	433	67	(1,855)	329	16	14,626
Net fee and commission income	5,912	61	33	719	19	3	6,747
Net financial income	(1,520)	(5)	5,009	19	5	(13)	3,495
Share of profit of associates	196	-	498	-	-	-	694
Other income	1,861	-	-	-	-	-	1,861
Operating income	22,085	489	5,607	(1,117)	353	6	27,423
1.1.-30.6.2015							
Net interest income	12,219	666	13	232	34	11	13,175
Net fee and commission income	5,227	466	177	1,527	35	2	7,434
Net financial income	7,464	(48)	(141)	2,138	307	3	9,723
Share of profit of associates	4,217	-	-	-	-	-	4,217
Other income	1,523	-	-	-	-	-	1,523
Operating income	30,650	1,084	49	3,897	376	16	36,072

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

5. Operations by quarters

2016	Q2*	Q1*	Total
Net interest income	7,353	7,273	14,626
Net fee and commission income	3,528	3,219	6,747
Net financial income	3,796	(301)	3,495
Share of profit of associates	17	677	694
Other operating income	626	1,235	1,861
Operating income	15,320	12,103	27,423
Salaries and related expense	(4,318)	(4,108)	(8,426)
Other operating expense	(3,736)	(3,234)	(6,970)
Bank levy	(743)	(742)	(1,485)
Net impairment	1,448	(503)	945
Earnings before tax	7,971	3,516	11,487
Income tax expense	(1,354)	(737)	(2,091)
Net earnings from continuing operations	6,617	2,779	9,396
Net gain from discontinued operations, net of tax	259	104	363
Net earnings	6,876	2,883	9,759
2015			
Net interest income	7,392	5,783	13,175
Net fee and commission income	3,677	3,757	7,434
Net financial income	2,184	7,539	9,723
Share of profit of associates	6	4,211	4,217
Other operating income	1,032	491	1,523
Operating income	14,291	21,781	36,072
Salaries and related expense	(3,675)	(3,492)	(7,167)
Other operating expense	(3,108)	(2,896)	(6,004)
Bank levy	(659)	(730)	(1,389)
Net impairment	(1,863)	1,782	(81)
Earnings before tax	4,986	16,445	21,431
Income tax expense	(647)	(1,720)	(2,367)
Net earnings from continuing operations	4,339	14,725	19,064
Net gain from discontinued operations, net of tax	79	183	262
Net earnings	4,418	14,908	19,326

* The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditors.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.4.-30.6.	2015 1.4.-30.6.
<i>Interest income</i>				
Cash and balances with Central Bank	2,029	284	1,764	142
Loans	26,785	25,301	13,675	14,792
Securities	2,237	1,609	909	777
Other	344	466	177	305
Interest income	31,395	27,660	16,525	16,016
<i>Interest expense</i>				
Deposits	(8,744)	(7,460)	(4,605)	(4,313)
Borrowings	(7,810)	(6,494)	(4,461)	(4,100)
Subordinated liabilities	(186)	(503)	(91)	(197)
Other	(29)	(28)	(15)	(14)
Interest expense	(16,769)	(14,485)	(9,172)	(8,624)
Net interest income	14,626	13,175	7,353	7,392
Net interest income from assets and liabilities at fair value	2,237	1,609	909	777
Interest income from assets not at fair value	29,158	26,051	15,616	15,239
Interest expense from liabilities not at fair value	(16,769)	(14,485)	(9,172)	(8,624)
Net interest income	14,626	13,175	7,353	7,392
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	3.1%	3.0%	3.1%	3.3%

7. Net fee and commission income

	Income		Expense		Net	Net	
	1.1.-30.6.2016		1.1.-30.6.2015		income	Income	Expense
Asset management	2,038	(140)	1,898	2,071	(123)	1,948	
Cards	6,726	(4,023)	2,703	5,306	(2,499)	2,807	
Collection and payment services	722	(37)	685	661	(42)	619	
Investment banking	554	(24)	530	1,094	(21)	1,073	
Lending and guarantees	777	-	777	682	-	682	
Other	428	(274)	154	422	(117)	305	
Net fee and commission income	11,245	(4,498)	6,747	10,236	(2,802)	7,434	
	1.4.-30.6.2016		1.4.-30.6.2015				
Asset management	1,017	(67)	950	1,060	(51)	1,009	
Cards	3,585	(2,191)	1,394	2,816	(1,398)	1,418	
Collection and payment services	387	(22)	365	332	(22)	310	
Investment banking	373	(12)	361	419	(11)	408	
Lending and guarantees	390	-	390	375	-	375	
Other	253	(185)	68	177	(20)	157	
Net fee and commission income	6,005	(2,477)	3,528	5,179	(1,502)	3,677	

Asset management fees are earned by the Group on trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

8. Net financial income	2016	2015	2016	2015
	1.1.-30.6.	1.1.-30.6.	1.4.-30.6.	1.4.-30.6.
Dividend income	600	6,798	397	6,754
Net (loss) gain on financial assets and financial liabilities classified as held for trading .	(121)	86	(482)	142
Net (loss) gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,588)	2,217	(865)	(5,026)
Realised gain on financial assets available-for-sale	5,291	-	5,291	-
Net foreign exchange (loss) gain	(687)	622	(545)	314
Net financial income	3,495	9,723	3,796	2,184

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

Equity instruments designated at fair value	(1,248)	2,118	(712)	(5,096)
Interest rate instruments designated at fair value	(340)	99	(153)	70
Net (loss) gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,588)	2,217	(865)	(5,026)

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement on the acquisition by Visa Inc. of Visa Europe Ltd. Arion Bank was a member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. In June 2016 the sale was formally completed, resulting in a total profit of ISK 5,291 million after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The shareholding in Visa Europe Ltd. was classified as Financial assets available for sale.

9. Other operating income	2016	2015	2016	2015
	1.1.-30.6.	1.1.-30.6.	1.4.-30.6.	1.4.-30.6.
Fair value changes on investment property	25	426	-	387
Realised gain on investment property	429	126	81	126
Earned premiums, net of reinsurance	631	530	342	286
Other income	776	441	203	233
Other operating income	1,861	1,523	626	1,032

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

10. Personnel and salaries

	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.4.-30.6.	2015 1.4.-30.6.
<i>Number of employees</i>				
Average number of full time equivalent positions during the period	1,171	1,118	1,184	1,123
Full time equivalent positions at the end of the period	1,199	1,123	1,199	1,123
<i>The Bank's number of employees</i>				
Average number of full time equivalent positions during the period	885	850	891	849
Full time equivalent positions at the end of the period	896	840	896	840
<i>Salaries and related expense</i>				
Salaries	6,568	5,530	3,370	2,842
Defined contribution pension plans	935	789	477	405
Salary related expense	923	848	471	428
Salaries and related expense	8,426	7,167	4,318	3,675
<i>Salaries and related expense for the Bank</i>				
Salaries	4,965	4,074	2,568	2,082
Defined contribution pension plans	707	588	364	297
Salary related expense	752	622	388	322
Salaries and related expense	6,424	5,284	3,320	2,701

During the period the Group made a provision of ISK 213 million (H1 2015: ISK 131 million) for performance plan payments, including salary related expense, thereof the Bank made a provision of ISK 195 million (H1 2015: ISK 80 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. At the end of the period the Group's accrual for performance plan payments amounts to ISK 993 million (31.12.2015: ISK 1,056 million), thereof the Bank's accrual amounts to ISK 858 million (31.12.2015: ISK 852 million).

11. Other operating expense

	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.4.-30.6.	2015 1.4.-30.6.
Administration expense	5,416	4,573	2,984	2,431
Depositors' and investors' guarantee fund	421	420	202	203
Depreciation of property and equipment	442	460	227	286
Amortisation of intangible assets	420	374	212	103
Claims incurred, net of reinsurance	240	142	96	68
Other expense	31	35	15	17
Other operating expense	6,970	6,004	3,736	3,108

12. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions. Non-financial subsidiaries are exempt from this tax. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

13. Net impairment

	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.4.-30.6.	2015 1.4.-30.6.
Increase in book value of loans to corporates	1,828	2,024	271	65
Increase in book value of loans to individuals	1,577	988	934	590
Net change in impairment of loans to corporates	(546)	519	281	125
Net change in impairment of loans to individuals	(2,020)	(2,287)	(174)	(1,346)
Net change in collective impairment on loans	106	(1,300)	136	(1,297)
Impairment of intangible assets	-	(25)	-	-
Net impairment	945	(81)	1,448	(1,863)

14. Income tax expense

Current tax expense	2,283	2,420	1,354	1,196
Deferred tax expense	(192)	(53)	-	(549)
Income tax expense	2,091	2,367	1,354	647

Reconciliation of effective tax rate

	1.1.-30.6.2016		1.1.-30.6.2015	
Earnings before tax		11,487		21,431
Income tax using the Icelandic corporation tax rate	20.0%	2,297	20.0%	4,286
Additional 6% tax on financial institutions	4.2%	487	2.7%	569
Non-deductible expenses	0.5%	62	1.3%	281
Tax exempt revenue	(7.3%)	(843)	(12.9%)	(2,761)
Non-deductible taxes	2.6%	297	1.3%	275
Other changes	(1.8%)	(209)	(1.3%)	(283)
Effective tax rate	18.2%	2,091	11.0%	2,367

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

Tax exempt revenues consist mainly of profit from equity positions.

15. Net gain from discontinued operations, net of tax

	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.4.-30.6.	2015 1.4.-30.6.
Income from real estates and other assets	599	378	400	129
Expense related to real estates and other assets	(236)	(116)	(141)	(50)
Net gain from discontinued operations, net of tax	363	262	259	79

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2016 1.1.-30.6.	2015 1.1.-30.6.	2016 1.1.-30.6.	2015 1.1.-30.6.
Net earnings attributable to the shareholders of Arion Bank	8,899	19,035	9,262	19,297
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	4.45	9.52	4.63	9.65

There were no instruments at the end of the period that could potentially dilute basic earnings per share (31.12.2015: none).

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank	30.6.2016	31.12.2015
Cash on hand	6,772	4,921
Cash with Central Bank	60,677	30,546
Mandatory reserve deposit with Central Bank	9,659	12,635
Cash and balances with Central Bank	77,108	48,102

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

18. Loans to credit institutions

Bank accounts	70,661	74,533
Money market loans	7,370	7,976
Other loans	7,576	4,982
Loans to credit institutions	85,607	87,491

19. Loans to customers

30.6.2016	Individuals	Corporates	Total
Overdrafts	16,569	24,113	40,682
Credit cards	10,932	1,169	12,101
Mortgage loans	275,422	14,285	289,707
Other loans	35,198	361,062	396,260
Provision on loans	(11,225)	(14,389)	(25,614)
Loans to customers	326,896	386,240	713,136
31.12.2015			
Overdrafts	16,840	24,248	41,088
Credit cards	10,842	1,054	11,896
Mortgage loans	271,895	12,889	284,784
Other loans	38,058	334,849	372,907
Provision on loans	(13,016)	(17,309)	(30,325)
Loans to customers	324,619	355,731	680,350

The total book value of pledged loans that were pledged against amounts borrowed was ISK 147 billion at the end of the period (31.12.2015: ISK 199 billion). At the end of the period pledged loans comprised mortgage loans to individuals. At year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

19. Loans to customers, continued

Changes in the provision for losses on loans to customers

	Specific	Collective	Total
1.1.-30.6.2016			
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	2,566	(106)	2,460
Write-offs	(7,324)	-	(7,324)
Payment of loans previously written off	153	-	153
Balance at the end of the period	20,736	4,878	25,614
1.1.-30.6.2015			
Balance at the beginning of the year	22,214	4,467	26,681
Provision for losses	1,768	1,300	3,068
Write-offs	(2,755)	-	(2,755)
Payment of loans previously written off	195	-	195
Balance at the end of the period	21,422	5,767	27,189

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 54 in the Annual Financial Statements for 2015. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

20. Financial instruments

	30.6.2016	31.12.2015
Bonds and debt instruments	75,008	78,794
Shares and equity instruments with variable income	28,071	35,504
Derivatives	3,432	2,401
Securities used for hedging	14,735	16,492
Financial instruments	121,246	133,191

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities

30.6.2016	Amortised cost	Trading	Designated at fair value	Total
<i>Loans</i>				
Cash and balances with Central Bank	77,108	-	-	77,108
Loans to credit institutions	85,607	-	-	85,607
Loans to customers	713,136	-	-	713,136
Loans	875,851	-	-	875,851
<i>Bonds and debt instruments</i>				
Listed	-	3,695	69,648	73,343
Unlisted	-	108	1,557	1,665
Bonds and debt instruments	-	3,803	71,205	75,008
<i>Shares and equity instruments with variable income</i>				
Listed	-	3,170	9,286	12,456
Unlisted	-	613	11,742	12,355
Bond funds with variable income, unlisted	-	1,257	2,003	3,260
Shares and equity instruments with variable income	-	5,040	23,031	28,071
<i>Derivatives</i>				
OTC derivatives	-	3,432	-	3,432
Derivatives	-	3,432	-	3,432
<i>Securities used for hedging</i>				
Bonds and debt instruments, listed	-	3,134	-	3,134
Shares and equity instruments with variable income, listed	-	11,337	-	11,337
Shares and equity instruments with variable income, unlisted	-	264	-	264
Securities used for hedging	-	14,735	-	14,735
Other financial assets	7,903	-	-	7,903
Financial assets	883,754	27,010	94,236	1,005,000
<i>Liabilities at amortised cost</i>				
Due to credit institutions and Central Bank	8,018	-	-	8,018
Deposits	423,089	-	-	423,089
Borrowings	329,885	-	-	329,885
Subordinated liabilities	9,553	-	-	9,553
Liabilities at amortised cost	770,545	-	-	770,545
<i>Financial liabilities at fair value</i>				
Short position in bonds	-	2,480	-	2,480
Derivatives	-	2,242	-	2,242
Financial liabilities at fair value	-	4,722	-	4,722
Other financial liabilities	38,056	-	-	38,056
Financial liabilities	808,601	4,722	-	813,323

Financial assets classified as available for sale at year-end 2015 were sold in June 2016, see Note 8.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities, continued

31.12.2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
<i>Loans</i>					
Cash and balances with Central Bank	48,102	-	-	-	48,102
Loans to credit institutions	87,491	-	-	-	87,491
Loans to customers	680,350	-	-	-	680,350
Loans	815,943	-	-	-	815,943
<i>Bonds and debt instruments</i>					
Listed	-	2,526	74,757	-	77,283
Unlisted	-	99	1,412	-	1,511
Bonds and debt instruments	-	2,625	76,169	-	78,794
<i>Shares and equity instruments with variable income</i>					
Listed	-	2,138	13,869	-	16,007
Unlisted	-	1,668	10,665	5,852	18,185
Bond funds with variable income, unlisted	-	1,090	222	-	1,312
Shares and equity instruments with variable income	-	4,896	24,756	5,852	35,504
<i>Derivatives</i>					
OTC derivatives	-	2,401	-	-	2,401
Derivatives	-	2,401	-	-	2,401
<i>Securities used for hedging</i>					
Bonds and debt instruments, listed	-	1,519	-	-	1,519
Shares and equity instruments with variable income, listed	-	14,276	-	-	14,276
Shares and equity instruments with variable income, unlisted	-	697	-	-	697
Securities used for hedging	-	16,492	-	-	16,492
Other financial assets	4,581	-	-	-	4,581
Financial assets	820,524	26,414	100,925	5,852	953,715
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	11,387	-	-	-	11,387
Deposits	469,347	-	-	-	469,347
Borrowings	256,058	-	-	-	256,058
Subordinated liabilities	10,365	-	-	-	10,365
Liabilities at amortised cost	747,157	-	-	-	747,157
<i>Financial liabilities at fair value</i>					
Short position in bonds	-	4,616	-	-	4,616
Derivatives	-	2,993	-	-	2,993
Financial liabilities at fair value	-	7,609	-	-	7,609
Other financial liabilities	38,667	-	-	-	38,667
Financial liabilities	785,824	7,609	-	-	793,433

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities, continued

<i>Bonds and debt instruments designated at fair value specified by issuer</i>	30.6.2016	31.12.2015
Financial and insurance activities	6,946	9,258
Public sector	55,516	59,246
Corporates	8,743	7,665
Bonds and debt instruments designated at fair value	71,205	76,169

The total amount of pledged bonds was ISK 18.7 billion at the end of the period (31.12.2015: ISK 21.5 billion). Pledged bonds comprise Icelandic and foreign Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

22. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities by valuation technique:

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

Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and

Level 3: valuation techniques which include significant inputs that are not based on observable market data.

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

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

30.6.2016	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	29,318	45,529	161	75,008
Shares and equity instruments with variable income	12,139	15,893	39	28,071
Derivatives	-	3,432	-	3,432
Securities used for hedging	14,471	264	-	14,735
Investment property	-	-	6,487	6,487
Assets at fair value	55,928	65,118	6,687	127,733
<i>Liabilities at fair value</i>				
Short position in bonds	2,480	-	-	2,480
Derivatives	-	2,242	-	2,242
Liabilities at fair value	2,480	2,242	-	4,722

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

31.12.2015	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	32,813	45,799	182	78,794
Shares and equity instruments with variable income	14,331	15,299	5,874	35,504
Derivatives	-	2,401	-	2,401
Securities used for hedging	15,706	786	-	16,492
Investment property	-	-	7,542	7,542
Assets at fair value	62,850	64,285	13,598	140,733
<i>Liabilities at fair value</i>				
Short position in bonds	4,616	-	-	4,616
Derivatives	-	2,993	-	2,993
Liabilities at fair value	4,616	2,993	-	7,609

Transfers from Level 2 to Level 1 amounted to ISK 68 million during the period (2015: ISK 8,106 million). There have been no transfers from Level 1 to Level 2 during the period (2015: none).

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

<i>Movements in Level 3 assets measured at fair value</i>	Investment property		Financial assets		Total	
	30.6.2016	31.12.2015	30.6.2016	31.12.2015	30.6.2016	31.12.2015
Balance at the beginning of the year	7,542	6,842	6,056	1,276	13,598	8,118
Net fair value changes	25	422	2,843	5,857	2,868	6,279
Additions	584	1,026	-	77	584	1,103
Disposal	(1,664)	(843)	(8,700)	(1,154)	(10,364)	(1,997)
Transfers into Level 3	-	95	13	-	13	95
Transfers out of Level 3	-	-	(12)	-	(12)	-
Balance at the end of the period	6,487	7,542	200	6,056	6,687	13,598

<i>Line items where effects of Level 3 assets are recognised in the Interim Statement of Comprehensive Income</i>	2016		2015	
	1.1.-30.6.	1.1.-30.6.	1.1.-30.6.	1.1.-30.6.
Net interest income		2		18
Net financial income		5,270		(15)
Other operating income		454		552
Net loss on AFS financial assets, net of tax		(2,903)		-
Effects recognised in the Statement of Comprehensive Income		2,823		555

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

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

30.6.2016	Carrying value	Fair value	Unrealised gain (loss)
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	77,108	77,108	-
Loans to credit institutions	85,607	85,607	-
Loans to customers	713,136	723,476	10,340
Other financial assets	7,903	7,903	-
Financial assets not carried at fair value	883,754	894,094	10,340
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	8,018	8,018	-
Deposits	423,089	423,089	-
Borrowings	329,885	335,290	(5,405)
Subordinated liabilities	9,553	9,553	-
Other financial liabilities	38,056	38,056	-
Financial liabilities not carried at fair value	808,601	814,006	(5,405)
31.12.2015			
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	48,102	48,102	-
Loans to credit institutions	87,491	87,491	-
Loans to customers	680,350	688,196	7,846
Other financial assets	4,581	4,581	-
Financial assets not carried at fair value	820,524	828,370	7,846
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	11,387	11,387	-
Deposits	469,347	469,347	-
Borrowings	256,058	264,839	(8,781)
Subordinated liabilities	10,365	10,365	-
Other financial liabilities	38,667	38,667	-
Financial liabilities not carried at fair value	785,824	794,605	(8,781)

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

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are presented at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

<i>Derivatives</i>	Notional value	Fair value	
		Assets	Liabilities
30.6.2016			
Forward exchange rate agreements, unlisted	24,871	115	460
Interest rate and exchange rate agreements, unlisted	156,768	2,511	932
Bond swap agreements, unlisted	3,266	20	15
Share swap agreements, unlisted	11,544	786	754
Options - purchased agreements, unlisted	92	-	81
Derivatives	196,541	3,432	2,242
31.12.2015			
Forward exchange rate agreements, unlisted	49,435	231	287
Interest rate and exchange rate agreements, unlisted	103,369	1,948	710
Bond swap agreements, unlisted	3,811	43	28
Share swap agreements, unlisted	13,099	178	1,934
Options - purchased agreements, unlisted	66	1	34
Derivatives	169,780	2,401	2,993

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet		Assets after consideration of netting potential	Assets not subject to enforceable netting arrangements	Total assets recognised on balance sheet
	Gross assets before balance sheet	Balance sheet nettings with gross	Assets recognised on balance	Financial	Collateral received			
30.6.2016								
Reverse repurchase agreements	18,803	(84)	18,719	(3,286)	-	15,433	-	18,719
Derivatives	1,620	-	1,620	(705)	-	915	1,812	3,432
Total assets	20,423	(84)	20,339	(3,991)	-	16,348	1,812	22,151
31.12.2015								
Reverse repurchase agreements	22,100	(490)	21,610	(4,929)	-	16,681	-	21,610
Derivatives	964	-	964	(400)	-	564	1,437	2,401
Total assets	23,064	(490)	22,574	(5,329)	-	17,245	1,437	24,011

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet		Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arrangements	Total liabilities recognised on balance sheet
	Gross liabilities before balance sheet	Balance sheet nettings with gross	Liabilities recognised on balance	Financial	Collateral pledged			
30.6.2016								
Repurchase agreements	3,286	-	3,286	(3,286)	-	-	-	3,286
Derivatives	921	-	921	(705)	-	216	1,321	2,242
Total liabilities	4,207	-	4,207	(3,991)	-	216	1,321	5,528
31.12.2015								
Repurchase agreements	4,929	-	4,929	(4,929)	-	-	-	4,929
Derivatives	400	-	400	(400)	-	-	2,593	2,993
Total liabilities	5,329	-	5,329	(5,329)	-	-	2,593	7,922

Accounting policies for offsetting are provided in Note 54 in the Annual Financial Statements for 2015.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

24. Investments in associates

<i>The Group's interest in its principal associates</i>	30.6.2016	31.12.2015
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	22.4%	22.4%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	-	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	39.3%	39.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland	41.4%	41.4%
220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland	38.5%	38.5%
<i>Investments in associates</i>		
Carrying amount at the beginning of the year	27,299	21,966
Acquisitions	13	262
Dividend received	-	(611)
Transfers	-	(6,458)
Disposals	(27,102)	(17,148)
Exchange difference	-	(178)
Share of profit of associates and reversal of impairment	694	29,466
Investment in associates	904	27,299

In January 2016 the Bank's subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect related to the sale was a valuation change recognised in the Statement of Comprehensive Income in 2015. During the period the total effects from the sale through the Statement of Comprehensive Income was ISK 498 million.

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but the management is of the opinion that the impaired value is based on the most probable outcomes under current market conditions.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

25. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer relationships and related agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer relationships and related agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
30.6.2016					
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Additions and transfers	(130)	-	110	353	333
Additions, internally developed	-	-	-	197	197
Exchange difference	(183)	-	(6)	(54)	(243)
Amortisation	-	-	(110)	(310)	(420)
Intangible assets	2,094	3,021	848	3,189	9,152
31.12.2015					
Balance at the beginning of the year	2,171	3,046	1,539	2,840	9,596
Additions and transfers	506	-	(435)	530	601
Additions, internally developed	-	-	-	289	289
Exchange difference	(270)	-	(40)	(57)	(367)
Impairment	-	(25)	(2)	-	(27)
Amortisation	-	-	(208)	(599)	(807)
Intangible assets	2,407	3,021	854	3,003	9,285

26. Tax assets and tax liabilities

	30.6.2016		31.12.2015	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,509	-	3,272
Deferred tax	221	303	205	1,650
Tax assets and tax liabilities	221	3,812	205	4,922

27. Other assets

	30.6.2016	31.12.2015
Non-current assets and disposal groups held for sale	5,145	5,082
Property and equipment	6,843	6,766
Accounts receivable	3,608	2,433
Unsettled securities trading	2,529	685
Sundry assets	3,017	2,612
Other assets	21,142	17,578

Vast majority of the Non-current assets and disposal groups held for sale consist of real estates that are generally the result of foreclosures on companies and individuals.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

28. Other liabilities	30.6.2016	31.12.2015
Accounts payable	18,797	23,296
Provision for settled FX loans	-	2,882
Unsettled securities trading	627	754
Depositors' and investors' guarantee fund	2,879	2,873
Insurance claim	2,701	2,574
Withholding tax	655	1,643
Bank levy	4,303	2,811
Sundry liabilities	17,118	12,628
Other liabilities	47,080	49,461

29. Borrowings	First issued	Maturity	Maturity type	Terms of interest		
Covered bond in ISK	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,551	4,483
Covered bond in ISK	2014	2021	At maturity	Fixed, CPI linked, 3.50%	8,331	5,096
Covered bond in ISK	2015	2022	At maturity	Fixed, 6.50%	16,361	7,737
Covered bond in ISK	2014	2029	At maturity	Fixed, CPI linked, 3.50%	19,569	15,279
Covered bond in ISK	2005	2033	Amortizing	Fixed, CPI linked, 3.75%	16,977	17,108
Covered bond in ISK	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,237	2,249
Covered bond in ISK	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	6,214	6,182
Covered bond in ISK	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,351	77,916
Covered bonds					152,591	136,050
Senior unsecured bond in NOK	2013	2016	At maturity	Floating, NIBOR +5.00%	-	1,547
Senior unsecured bond in USD	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	3,728	-
Senior unsecured bond in EUR	2009	2018	Amortizing	Floating, EURIBOR +1.00%	950	1,177
Senior unsecured bond in ISK	2010	2018	Amortizing	Floating, REIBOR +1.00%	1,334	1,600
Senior unsecured bond in EUR	2015	2018	At maturity	Fixed, 3.125%	41,352	43,350
Senior unsecured bond in EUR	2016	2019	At maturity	Fixed, 2.50%	41,141	-
Senior unsecured bond in RON	2016	2019	At maturity	Fixed, 3.80%	1,076	-
Senior unsecured bond in SEK	2016	2019	At maturity	Floating, 3 month STIBOR +2.65% ..	4,004	-
Senior unsecured bond in NOK	2015	2020	At maturity	Floating, NIBOR +2.95%	11,924	11,900
Senior unsecured bond in USD	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	61,641	-
Bonds issued					167,150	59,574
Central Bank, secured, various curr. ..	2010	2022	At maturity	Floating, LIBOR + 3.00%	-	56,024
Bills issued					9,318	4,081
Other					826	329
Other loans/bills					10,144	60,434
Borrowings					329,885	256,058

Book value of listed bonds was ISK 260,331 million at the end of the period (31.12.2015: ISK 196,927 million). Market value of those bonds was ISK 263,628 million (31.12.2015: ISK 205,720 million).

The Group did not repurchase own debts during the period (2015: ISK 10 billion).

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

30. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	30.6.2016	31.12.2015
Tier II capital in various currencies	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00%	9,553	10,365
Subordinated liabilities					<u>9,553</u>	<u>10,365</u>

31. Pledged assets

Pledged assets against liabilities

Assets, pledged as collateral against borrowings	177,800	222,046
Assets, pledged as collateral against loans from credit institutions and short positions	18,719	21,611
Pledged assets against liabilities	<u>196,519</u>	<u>243,657</u>

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 178 billion at the end of the period (31.12.2015: ISK 222 billion). At the end of the period those assets were pool of mortgage loans to individuals but at year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies. The book value of those borrowings was ISK 153 billion at the end of the period (31.12.2015: ISK 192 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

32. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	30.6.2016	Number (million)	31.12.2015
Issued share capital	2,000	75,861	2,000	75,861

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

	30.6.2016	31.12.2015
<i>Other reserves</i>		
Statutory reserve	1,637	1,637
Available-for-sale reserve	-	2,903
Foreign currency translation reserve	102	8
Other reserves	<u>1,739</u>	<u>4,548</u>

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OTHER INFORMATION

33. Legal matters

The Group has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects which the claims may have on its financial standing. When the Group is of the opinion that it is to the detriment of the Group's case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the period, the Group had several unresolved legal claims.

Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank. The investigation was initiated by separate complaints from BYR hf. and MP Banki hf. made in 2010. The complaints from BYR hf. and MP Banki hf. concern the terms of the banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The ICA has sent the bank a letter proposing concluding the matter with an agreement. The Bank is looking into the conditions of the proposed agreement.

With a writ issued in June 2013, Kortabjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortabjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded the rejection of Kortabjónustan's claims. The case has been put on hold as Kortabjónustan's court-appointed evaluator prepares its report on Kortabjónustan's alleged loss.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes it likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

In its judgment in case No. 612/2012, pronounced on 24 April 2013, the Supreme Court ruled that Valitor hf. had not been authorized to rescind an agreement between the company and Datacell ehf. In January 2015 Datacell ehf. and Sunshine Press Productions ehf. brought legal action against Valitor hf. for the payment of compensation relating to damage which the companies considered they had sustained on account of the aforementioned rescinding by Valitor hf. of the agreement. Court-appointed assessors were subsequently asked to assess the damage in question at the request of the plaintiffs. The assessors announced their conclusions in March 2016. Valitor hf. disagrees with the assessors conclusion and will request for other court-appointed appraisers to gain a second opinion.

Other legal matters

Legal proceedings regarding CPI loans

Recently, three cases were heard by the Icelandic courts for the purpose of verifying the legitimacy and the presentation of loans linked to the Consumer Price Index (CPI). In short, the Supreme Court upheld the arguments of the lenders in two of those cases: case no 160/2015 and case no. 243/2015. In the third case, the District Court of Reykjavík acquitted a lender of a borrower's claim, on similar grounds to the two previous cases (judgment in case no E-338/2013). The case has been appealed to the Supreme Court. The Bank made no provision due to court cases regarding the CPI.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

33. Legal matters, continued

The uncertainty regarding the book value of foreign currency loans

Uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in certain respects, such as regarding the legality of particular loans. Nevertheless, the Group considers its portfolio of foreign currency linked loans to be fully provisioned for the most likely outcome.

Legal matters concluded

In April 2013 the ICA imposed an ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set out in an earlier decision of the ICA. The Supreme Court ruled in April 2016 on upholding the ICA's decision from April 2013. Valitor paid the fine in 2013.

34. Acquisition of the insurance company Vörður

In October 2015 Arion Bank concluded a conditional purchase agreement with BankNordik regarding the acquisition of a majority shareholding in the Icelandic insurer Vörður and full ownership in 2017. Following a review by the Icelandic authorities and referees, a new agreement was reached in April 2016 stating that Arion Bank would acquire a 100% shareholding in Vörður. The company will be classified as a subsidiary of Arion Bank. The purchase price is ISK 5.3 billion, conditional on the approval of the relevant Icelandic authorities. The Financial Supervisory Authority of Iceland and the Central Bank of Iceland have approved the acquisition and the Bank is now awaiting the approval of the Icelandic Competition Authority. Vörður reported net earnings of ISK 658 million in 2015 and total assets amounted to ISK 11,330 million at year end 2015. The sale is expected to be completed in the next few months.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OFF BALANCE SHEET INFORMATION

35. Obligations

<i>Financial guarantees, unused overdraft and loan commitments the Group has granted its customers</i>	30.6.2016	31.12.2015
Financial guarantees	17,371	19,162
Unused overdrafts	42,782	42,100
Loan commitments	62,419	126,068

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Even though the law has not been amended Icelandic bank's have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

36. Assets under management and under custody 30.6.2016 31.12.2015

Assets under management	992,740	996,648
Assets under custody	1,447,675	1,427,269

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

37. Events after Balance Sheet date

In July 2016 Arion Bank sold majority of shareholding in its subsidiary Kolufell ehf. The profit from the sale and valuation change on the remaining shareholding amounts to ISK 493 million and will be recognised in the Statement of Comprehensive Income in the third quarter of 2016. The remaining shareholding will be classified as Financial instruments.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RELATED PARTY

38. Related party

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

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

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

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

30.6.2016

	Assets	Liabilities	Net balance
<i>Balances with related parties</i>			
Shareholders with control over the Group	205	(13,617)	(13,412)
Board of Directors and key Management personnel	228	(141)	87
Associates and other related parties	153	(144)	9
Balances with related parties	586	(13,902)	(13,316)

31.12.2015

<i>Balances with related parties</i>			
Shareholders with control over the Group	212	(50,158)	(49,946)
Board of Directors and key Management personnel	232	(59)	173
Associates and other related parties	2,132	(241)	1,891
Balances with related parties	2,576	(50,458)	(47,882)

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. Landsbankinn hf. provides banking services to the Bank's subsidiary Valitor hf. and has a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 4,233 million (31.12.2015: ISK 14,038 million) by Landsbankinn hf. and liabilities amounting to ISK 3,503 million at the end of the period (31.12.2015: ISK 1,499 million). Those amounts are not included in the table above.

Kaupthing hf. holds senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 61,641 million at the end of the period. This amount is not included in the table above.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RISK MANAGEMENT DISCLOSURES

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

Further information regarding risk management is available in the Annual Financial Statements for 2015 and in the Pillar 3 Risk Disclosures for 2015, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

39. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off-balance sheet items such as commitments and financial guarantees.

Exposure to credit risk

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

	30.6.2016	31.12.2015
<i>Maximum exposure to credit risk related to on-balance sheet items</i>		
Cash and balances with Central Bank	77,108	48,102
Loans to credit institutions	85,607	87,491
Loans to corporates	386,240	355,731
Loans to individuals	326,896	324,619
Financial instruments	85,746	86,770
Other assets with credit risk	7,903	4,581
Total on-balance sheet maximum exposure to credit risk	969,500	907,294
<i>Maximum exposure to credit risk related to off-balance sheet items</i>		
Financial guarantees	17,371	19,162
Unused overdrafts	42,782	42,100
Loan commitments	62,419	126,068
Total off-balance sheet maximum exposure to credit risk	122,572	187,330
Maximum exposure to credit risk	1,092,072	1,094,624

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

<i>Loans to customers specified by sectors</i>	30.6.2016	31.12.2015
Individuals	45.8%	47.7%
Real estate activities and construction	15.5%	15.1%
Fishing industry	11.6%	11.1%
Information and communication technology	4.0%	4.7%
Wholesale and retail trade	8.4%	7.6%
Financial and insurance activities	4.9%	4.9%
Industry, energy and manufacturing	4.1%	3.1%
Transportation	0.9%	0.9%
Services	2.7%	2.9%
Public sector	1.2%	1.2%
Agriculture and forestry	0.9%	0.8%
	100.0%	100.0%

Collateral and other credit enhancements

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

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quota.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

Collateral held against different types of financial assets

30.6.2016	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	495	292,930	7	4,449	297,881
Real estate activities and construction	666	101,863	16	2,634	105,179
Fishing industry	64	8,417	65,861	6,068	80,410
Information and communication technology	163	2,448	-	17,957	20,568
Wholesale and retail trade	406	23,485	3	25,374	49,268
Financial and insurance activities	15,752	5,977	1	1,480	23,210
Industry, energy and manufacturing	29	14,410	-	6,450	20,889
Transportation	16	954	160	3,261	4,391
Services	33	5,432	16	3,386	8,867
Public sector	58	3,864	-	103	4,025
Agriculture and forestry	5	4,579	-	182	4,766
Financial instruments	7,357	-	-	-	7,357
Financial guarantees	830	4,076	1,144	2,109	8,159
Collateral held against different types of financial assets	25,874	468,435	67,208	73,453	634,970

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
31.12.2015					
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	428	289,862	24	4,107	294,421
Real estate activities and construction	1,032	89,039	8	1,025	91,104
Fishing industry	53	7,956	57,945	7,037	72,991
Information and communication technology	76	2,369	-	18,630	21,075
Wholesale and retail trade	210	20,424	7	22,912	43,553
Financial and insurance activities	15,947	4,367	-	1,577	21,891
Industry, energy and manufacturing	461	12,792	3	4,416	17,672
Transportation	91	875	173	3,891	5,030
Services	13	4,847	40	2,623	7,523
Public sector	73	3,732	-	99	3,904
Agriculture and forestry	5	3,493	-	112	3,610
Financial instruments	7,474	-	-	-	7,474
Financial guarantees	885	4,232	623	1,445	7,185
Collateral held against different types of financial assets	26,748	443,988	58,823	67,874	597,433

Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the period and still holds at period end amount to ISK 953 million (31.12.2015: ISK 2,761 million) and other assets ISK 4 million (31.12.2015: ISK 7 million). The assets are held for sale, see Note 27.

Credit quality

	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
<i>Credit quality by class of financial assets</i>				
30.6.2016				
Cash and balances with Central Bank	77,108	-	-	77,108
Loans to credit institutions	85,607	-	-	85,607
Loans to customers				
Loans to corporates	365,939	18,152	2,149	386,240
Loans to individuals	294,310	27,618	4,968	326,896
Financial instruments	81,574	-	-	81,574
Other assets with credit risk	7,903	-	-	7,903
Credit quality by class of financial assets	912,441	45,770	7,117	965,328
31.12.2015				
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Other assets with credit risk	4,581	-	-	4,581
Credit quality by class of financial assets	851,318	43,834	8,086	903,238

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

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

30.6.2016	Risk classification					Not rated	Total
	1	2	3	4	5		
Individuals	58,195	148,806	58,951	19,276	4,609	4,473	294,310
Real estate activities and construction	44,612	30,911	23,608	3,878	293	1,283	104,585
Fishing industry	21,393	44,021	10,174	4,825	418	4	80,835
Information and communication technology	16,751	6,245	6,016	193	-	39	29,244
Wholesale and retail trade	11,087	23,044	18,922	1,954	184	26	55,217
Financial and insurance activities	11,582	8,209	13,063	383	-	306	33,543
Industry, energy and manufacturing	9,389	14,888	2,658	381	30	-	27,346
Transportation	988	3,808	917	-	21	5	5,739
Services	2,221	5,484	7,304	740	311	44	16,104
Public sector	224	4,292	1,826	1,198	128	555	8,223
Agriculture and forestry	373	1,516	2,587	403	183	41	5,103
Neither past due nor impaired loans	176,815	291,224	146,026	33,231	6,177	6,776	660,249
31.12.2015							
Individuals	54,822	148,472	63,027	18,553	4,693	1,710	291,277
Real estate activities and construction	36,550	23,792	29,776	3,790	154	3,279	97,341
Fishing industry	21,807	33,232	7,657	5,415	1,249	1,341	70,701
Information and communication technology	17,346	4,252	8,949	126	-	-	30,673
Wholesale and retail trade	9,447	18,356	18,260	2,064	198	33	48,358
Financial and insurance activities	3,012	17,784	11,308	223	-	456	32,783
Industry, energy and manufacturing	3,088	14,256	2,930	324	135	-	20,733
Transportation	3,320	1,094	1,040	274	28	-	5,756
Services	2,326	4,805	9,918	539	19	-	17,607
Public sector	357	3,396	2,342	1,038	133	545	7,811
Agriculture and forestry	336	1,558	2,887	609	-	-	5,390
Neither past due nor impaired loans	152,411	270,997	158,094	32,955	6,609	7,364	628,430

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

Past due but not impaired loans by class of loans

	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
30.6.2016						
Loans to corporates	6,921	5,859	2,099	1,261	2,012	18,152
Loans to individuals	4,614	10,150	5,739	2,365	4,750	27,618
Past due but not impaired loans	11,535	16,009	7,838	3,626	6,762	45,770
31.12.2015						
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Past due but not impaired loans	13,344	13,216	6,918	1,216	9,140	43,834

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

<i>Impaired loans to customers specified by sector</i>	30.6.2016		31.12.2015	
	Impair- ment amount	Gross carrying amount	Impair- ment amount	Gross carrying amount
Individuals	8,858	13,826	10,593	17,403
Real estate activities and construction	1,647	2,038	1,515	1,867
Fishing industry	370	494	257	373
Information and communication technology	316	330	308	332
Wholesale and retail trade	654	938	681	893
Financial and insurance activities	400	422	5,953	6,011
Industry, energy and manufacturing	1,435	1,446	828	1,025
Transportation	4,591	4,598	4,433	4,440
Services	2,151	3,268	504	682
Public sector	132	202	143	215
Agriculture and forestry	182	291	126	186
Impaired loans to customers specified by sector	20,736	27,853	25,341	33,427

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base according to FME rule No. 625/2013. The legal maximum for individual large exposures is 25% of the capital base, net of eligible collateral.

The Group has no large exposure at the end of the period before taking account of eligible collateral (31.12.2015: One large exposure of ISK 22 billion without eligible collateral).

No.	30.6.2016		31.12.2015	
	Gross	Net	Gross	Net
1	<10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	0%	0%	11%	11%

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk

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

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

Interest rate risk

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

Interest rate risk in the banking book

The following table shows the Group's interest bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 22, and are therefore different from the amounts shown in these Interim Financial Statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

30.6.2016	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	70,336	-	-	-	-	70,336
Loans to credit institutions	85,607	-	-	-	-	85,607
Loans to customers	376,720	75,484	131,186	4,100	135,986	723,476
Financial instruments	48,294	6,936	6,624	6,856	204	68,914
Assets	580,957	82,420	137,810	10,956	136,190	948,333
Liabilities						
Due to credit institutions and Central Bank	7,990	-	28	-	-	8,018
Deposits	376,380	32,235	12,446	1,235	793	423,089
Borrowings	88,464	5,651	89,735	25,152	126,288	335,290
Subordinated liabilities	-	9,553	-	-	-	9,553
Liabilities	472,834	47,439	102,209	26,387	127,081	775,950
Derivatives and other off-balance sheet items (net position) ..	(85,979)	(1,395)	88,529	-	-	1,155
Net interest gap	22,144	33,586	124,130	(15,431)	9,109	173,538

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

31.12.2015	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
<i>Assets</i>						
Balances with Central Bank	43,181	-	-	-	-	43,181
Loans to credit institutions	87,491	-	-	-	-	87,491
Loans to customers	347,571	64,594	127,907	5,255	142,869	688,196
Financial instruments	43,925	10,002	8,556	7,786	242	70,511
Assets	522,168	74,596	136,463	13,041	143,111	889,379
<i>Liabilities</i>						
Due to credit institutions and Central Bank	11,387	-	-	-	-	11,387
Deposits	464,998	3,501	848	-	-	469,347
Borrowings	72,010	4,509	48,705	12,982	126,633	264,839
Subordinated liabilities	10,365	-	-	-	-	10,365
Liabilities	558,760	8,010	49,553	12,982	126,633	755,938
Derivatives and other off-balance sheet items (net position) ..	(46,330)	(1,802)	49,346	-	-	1,214
Net interest gap	(82,922)	64,784	136,256	59	16,478	134,655

Interest rate risk in the trading book

The following table shows the total basis point value (BPV) of the Group's bond and derivatives in the trading book at market value (MV). BPV denotes the change in value given a basis point (0.01%) yield change.

<i>Trading financial instruments, long positions</i>	30.6.2016			31.12.2015		
	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI Indexed linked	4,685	3.6	(1.7)	4,544	3.6	(1.6)
ISK, Non Indexed linked	9,222	(1.7)	1.6	5,849	(1.8)	1.1
FX	68,219	(0.7)	4.8	64,226	(0.6)	3.9
Total	82,126	(0.6)	4.7	74,619	(0.5)	3.4
<i>Trading financial instruments, short positions</i>						
ISK, CPI Indexed linked	-	-	-	393	9.7	(0.4)
ISK, Non Indexed linked	10,461	0.4	(0.4)	7,953	0.3	(0.3)
FX	66,847	(0.6)	3.9	64,172	(0.5)	2.9
Total	77,308	(0.5)	3.5	72,518	(0.3)	2.3

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

Indexation risk

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities.

Transaction maturity profile of indexed assets and liabilities

30.6.2016	Up to 1 year	1 to 5 years	Over 5 years	Total
<i>Assets, CPI indexed linked</i>				
Loans to customers	11,516	94,662	205,773	311,951
Financial instruments	4,223	-	-	4,223
Off-balance sheet position	845	6,488	-	7,333
Assets, CPI indexed linked	16,584	101,150	205,773	323,507
<i>Liabilities, CPI indexed linked</i>				
Deposits	71,358	12,173	2,003	85,534
Borrowings	2,197	14,532	119,827	136,556
Other	395	686	794	1,875
Liabilities, CPI indexed linked	73,950	27,391	122,624	223,965
Net on-balance sheet position	(58,211)	67,271	83,149	92,209
Net off-balance sheet position	845	6,488	-	7,333
CPI Balance	(57,366)	73,759	83,149	99,542
31.12.2015				
<i>Assets, CPI indexed linked</i>				
Loans to customers	13,629	76,393	209,485	299,507
Financial instruments	3,412	-	-	3,412
Off-balance sheet position	749	7,940	-	8,689
Assets, CPI indexed linked	17,790	84,333	209,485	311,608
<i>Liabilities, CPI indexed linked</i>				
Deposits	72,352	12,899	1,916	87,167
Borrowings	2,128	14,164	112,350	128,642
Off-balance sheet position	-	-	782	782
Liabilities, CPI indexed linked	74,480	27,063	115,048	216,591
Net on-balance sheet position	(57,439)	49,330	94,437	86,328
Net off-balance sheet position	749	7,940	-	8,689
CPI Balance	(56,690)	57,270	94,437	95,017

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are a primary source of funding for the Group whereas a substantial part of the Group's assets consists of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

Breakdown of assets and liabilities by currency

30.6.2016

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	75,849	375	341	137	94	38	274	77,108
Loans to credit institutions	28,523	21,458	11,186	7,872	2,004	8,869	5,695	85,607
Loans to customers	579,913	68,159	39,909	4,012	8,971	173	11,999	713,136
Financial instruments	80,960	20,755	13,343	2,832	88	3,265	3	121,246
Investment property	6,487	-	-	-	-	-	-	6,487
Investments in associates	904	-	-	-	-	-	-	904
Intangible assets	5,673	-	-	-	3,479	-	-	9,152
Tax assets	221	-	-	-	-	-	-	221
Other assets	19,398	1,164	429	85	25	35	6	21,142
Assets	797,928	111,911	65,208	14,938	14,661	12,380	17,977	1,035,003
<i>Liabilities and equity</i>								
Due to credit inst. and Central Bank ..	6,520	86	106	4	-	1	1,301	8,018
Deposits	387,009	13,902	11,118	6,324	2,821	1,144	771	423,089
Financial liabilities at fair value	3,589	730	116	-	-	1	286	4,722
Tax liabilities	3,556	-	-	-	255	-	1	3,812
Other liabilities	36,076	3,461	2,114	3,600	624	583	622	47,080
Borrowings	165,145	83,443	65,369	-	-	11,924	4,004	329,885
Subordinated liabilities	-	3,817	2,475	3,261	-	-	-	9,553
Shareholders' equity	199,239	-	-	-	-	-	-	199,239
Non-controlling interest	9,605	-	-	-	-	-	-	9,605
Liabilities and equity	810,739	105,439	81,298	13,189	3,700	13,653	6,985	1,035,003
Net on-balance sheet position	(12,811)	6,472	(16,090)	1,749	10,961	(1,273)	10,992	
Net off-balance sheet position	8,779	(5,729)	16,474	(273)	(9,903)	1,292	(10,640)	
Net position	(4,032)	743	384	1,476	1,058	19	352	

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

31.12.2015

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	47,357	252	167	37	96	37	156	48,102
Loans to credit institutions	20,923	24,741	19,478	7,260	3,182	4,125	7,782	87,491
Loans to customers	568,196	44,532	37,395	6,487	11,357	9	12,374	680,350
Financial instruments	84,752	24,852	13,227	6,145	63	3,248	904	133,191
Investment property	7,542	-	-	-	-	-	-	7,542
Investments in associates	1,043	-	-	26,256	-	-	-	27,299
Intangible assets	5,575	-	-	-	3,710	-	-	9,285
Tax assets	205	-	-	-	-	-	-	205
Other assets	16,711	482	170	177	22	14	2	17,578
Assets	752,304	94,859	70,437	46,362	18,430	7,433	21,218	1,011,043
<i>Liabilities and equity</i>								
Due to credit inst. and Central Bank ..	9,471	381	74	6	1	-	1,454	11,387
Deposits	388,228	18,041	50,913	6,865	1,523	2,156	1,621	469,347
Financial liabilities at fair value	6,790	584	104	10	4	-	117	7,609
Tax liabilities	4,501	-	-	-	422	-	(1)	4,922
Other liabilities	41,098	2,648	1,484	1,432	832	347	1,620	49,461
Borrowings	142,060	44,526	33,442	8,511	-	13,447	14,072	256,058
Subordinated liabilities	-	3,942	2,603	3,820	-	-	-	10,365
Shareholders' equity	192,786	-	-	-	-	-	-	192,786
Non-controlling interest	9,108	-	-	-	-	-	-	9,108
Liabilities and equity	794,042	70,122	88,620	20,644	2,782	15,950	18,883	1,011,043
Net on-balance sheet position	(41,738)	24,737	(18,183)	25,718	15,648	(8,517)	2,335	
Net off-balance sheet position	9,619	(13,684)	20,273	(1,470)	(17,856)	5,481	(2,363)	
Net position	(32,119)	11,053	2,090	24,248	(2,208)	(3,036)	(28)	

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk

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

Maturity gap analysis

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

30.6.2016	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	77,108	67,449	-	9,659	-	-	-
Loans to credit institutions	85,607	40,855	41,243	3,509	-	-	-
Loans to customers	713,136	13,694	36,198	97,108	256,275	309,861	-
Financial instruments	121,246	7,009	4,763	9,080	50,768	9,954	39,672
<i>Derivatives - assets leg</i>	66,034	-	20,889	21,218	23,586	341	-
<i>Derivatives - liabilities leg</i>	(62,602)	-	(20,146)	(20,527)	(21,814)	(115)	-
Investment property	6,487	-	-	-	-	-	6,487
Investments in associates	904	-	-	-	-	-	904
Intangible assets	9,152	-	-	-	-	-	9,152
Tax assets	221	-	-	-	221	-	-
Other assets	21,142	350	5,916	725	715	197	13,239
Assets	1,035,003	129,357	88,120	120,081	307,979	320,012	69,454
Liabilities							
Due to credit institutions and Central Bank	8,018	7,951	-	42	25	-	-
Deposits	423,089	267,684	92,535	47,997	12,820	2,053	-
Financial liabilities at fair value	4,722	-	3,751	47	646	278	-
<i>Derivatives - assets leg</i>	(35,238)	-	(22,499)	(1,133)	(11,272)	(334)	-
<i>Derivatives - liabilities leg</i>	37,479	-	23,769	1,180	11,918	612	-
<i>Short position bonds and derivatives</i>	440	-	440	-	-	-	-
<i>Short position bonds used for hedging</i>	2,040	-	2,040	-	-	-	-
Tax liabilities	3,812	-	1,170	2,339	303	-	-
Other liabilities	47,080	16,526	19,614	569	1,340	6	9,025
Borrowings	329,885	-	7,719	7,671	118,278	196,217	-
Subordinated liabilities	9,553	-	-	-	3,817	5,736	-
Liabilities	826,159	292,161	124,789	58,665	137,229	204,290	9,025
Off-balance sheet items							
Financial guarantees	17,371	3,267	2,276	7,364	2,676	1,788	-
Unused overdraft	42,782	814	7,918	16,235	17,503	312	-
Loan commitments	62,419	4,019	9,614	20,042	23,507	5,237	-
Off-balance sheet items	122,572	8,100	19,808	43,641	43,686	7,337	-
Net assets (liabilities)	86,272	(170,904)	(56,477)	17,775	127,064	108,385	60,429

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

31.12.2015	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	48,102	35,467	-	12,635	-	-	-
Loans to credit institutions	87,491	50,151	37,340	-	-	-	-
Loans to customers	680,350	3,984	42,429	90,014	234,035	309,888	-
Financial instruments	133,191	4,765	1,711	10,861	54,392	10,985	50,477
<i>Derivatives - assets leg</i>	56,171	-	24,671	1,478	29,509	513	-
<i>Derivatives - liabilities leg</i>	(53,770)	-	(24,262)	(1,421)	(27,688)	(399)	-
Investment property	7,542	-	-	-	-	-	7,542
Investments in associates	27,299	-	-	-	-	-	27,299
Intangible assets	9,285	-	-	-	-	-	9,285
Tax assets	205	-	-	-	205	-	-
Other assets	17,578	1,017	2,592	174	793	-	13,002
Assets	1,011,043	95,384	84,072	113,684	289,425	320,873	107,605
Liabilities							
Due to credit institutions and Central Bank	11,387	9,881	-	1,481	25	-	-
Deposits	469,347	268,727	95,191	89,937	13,575	1,917	-
Financial liabilities at fair value	7,609	-	6,346	536	631	96	-
<i>Derivatives - assets leg</i>	(49,199)	-	(36,552)	(5,662)	(6,518)	(467)	-
<i>Derivatives - liabilities leg</i>	52,192	-	38,282	6,198	7,149	563	-
<i>Short position bonds and derivatives</i>	1,309	-	1,309	-	-	-	-
<i>Short position bonds used for hedging</i>	3,307	-	3,307	-	-	-	-
Tax liabilities	4,922	-	-	3,274	1,648	-	-
Other liabilities	49,461	17,002	14,724	5,192	3,529	6	9,008
Borrowings	256,058	-	7,081	4,308	69,933	174,736	-
Subordinated liabilities	10,365	-	-	-	3,942	6,423	-
Liabilities	809,149	295,610	123,342	104,728	93,283	183,178	9,008
Off-balance sheet items							
Financial guarantees	19,162	3,402	2,371	7,589	3,954	1,846	-
Unused overdraft	42,100	842	10,071	14,984	15,768	435	-
Loan commitments	126,068	-	50,628	35,542	34,506	5,392	-
Off-balance sheet items	187,330	4,244	63,070	58,115	54,228	7,673	-
Net assets (liabilities)	14,564	(204,470)	(102,340)	(49,159)	141,914	130,022	98,597

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. In 2016, the ratio for foreign currency shall be at least 90% and from 2017 the ratio shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator. The FX imbalance discrepancy between the Group's official FX imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive FX imbalance but are settled in ISK.

	ISK	FX	Total
30.6.2016			
Available stable funding	591,199	183,631	774,830
Required stable funding	554,483	104,180	658,663
FX imbalance		(5,630)	
Net stable funding ratio	107%	171%	118%
31.12.2015			
Available stable funding	540,864	129,273	670,137
Required stable funding	539,841	95,511	635,352
FX imbalance		(11,363)	
Net stable funding ratio	100%	123%	105%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set rules for minimum LCR. In 2016 the LCR requirement is 100% in foreign currency and 90% in total (ISK and foreign currency). The latter requirement will be 100% from 2017.

The following table shows the breakdown for the Group's LCR calculations broken down on currencies; ISK, FX and total. All amounts are weighted by their respective LCR weights as defined by the Central Bank.

	ISK	FX	Total
30.6.2016			
Liquid assets level 1 *	130,364	22,366	152,730
Liquid assets level 2 **	-	6,064	6,064
Liquid Assets	130,364	28,430	158,794
Deposits	103,986	18,562	122,548
Market Borrowing	3,281	617	3,898
Other Cash outflows	14,061	8,025	22,086
Cash outflows	121,328	27,204	148,532
Short term deposits with other banks ***	4,142	44,356	48,498
Other Cash inflows	7,640	4,058	11,698
Cash inflows	11,782	48,414	60,196
Liquidity coverage ratio (LCR) ****	119%	418%	180%
31.12.2015			
Liquid assets level 1 *	99,483	24,088	123,571
Liquid assets level 2 **	-	5,869	5,869
Liquid Assets	99,483	29,957	129,440
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
Cash outflows	140,073	56,511	196,584
Short term deposits with other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
Cash inflows	12,961	87,338	100,299
Liquidity coverage ratio (LCR) ****	78%	212%	134%

* Level 1 assets receive a 100% weight in LCR calculations and include the Group's Cash and balances with Central Bank, domestic bonds eligible as collateral at the Central Bank, foreign government bonds and the liquidity facility from the Icelandic government.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

*** Short term deposits in other banks are defined as cash inflows in LCR calculations.

**** LCR is defined as: $LCR = \text{Weighted liquid assets} / (\text{weighted cash outflows} - \text{weighted cash inflows})$ where weighted cash inflows are capped at 75% of weighted cash outflows.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Bank's liquidity buffer. The Bank's liquidity facility with the Icelandic Government is set to expire at year-end 2016, which will affect the Bank's LCR.

	ISK	USD	EUR	Other	Total
30.6.2016					
Cash and balances with Central Bank	74,139	-	375	2,594	77,108
Short term deposits in other banks	4,142	7,667	18,236	18,453	48,498
Domestic bonds eligible as collateral at the Central Bank	25,003	-	-	-	25,003
Foreign government bonds	-	10,338	9,934	835	21,107
Government liquidity facility	29,512	-	-	-	29,512
Covered bonds with a minimum rating of AA-	-	-	2,073	5,061	7,134
Liquidity reserve	132,796	18,005	30,618	26,943	208,362
31.12.2015					
Cash and balances with Central Bank	47,357	167	252	326	48,102
Short term deposits in other banks	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligible as collateral at the Central Bank	22,614	-	-	-	22,614
Foreign government bonds	-	10,658	8,700	3,984	23,342
Government liquidity facility	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA-	-	-	2,122	4,783	6,905
Liquidity reserve	103,252	27,566	31,898	29,409	192,125

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

LCR deposit categorization

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

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days				Term deposits*	Total deposits
	Less Stable	Weight (%)	Stable	Weight (%)		
30.6.2016						
Retail	87,689	10%	37,213	5%	57,118	182,020
SME	38,166	10%	4,107	5%	4,639	46,912
Operational relationship	-	25%	-	5%	-	-
Corporations	41,905	40%	923	20%	4,461	47,289
Sovereigns, central-banks and PSE	19,731	40%	-	-	1,302	21,033
Financial entities being wound up	16,294	100%	-	-	3,617	19,911
Pension funds	29,019	100%	-	-	30,973	59,992
Domestic financial entities	25,931	100%	-	-	16,042	41,973
Foreign financial entities	2,459	100%	-	-	-	2,459
Other foreign parties	4,085	100%	3,231	25%	2,162	9,478
Total	265,279		45,474		120,314	431,067
31.12.2015						
Retail	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
Operational relationship	-	25%	-	5%	-	-
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central-banks and PSE	11,900	40%	-	-	1,304	13,204
Financial entities being wound up	16,948	100%	-	-	47,062	64,010
Pension funds	41,609	100%	-	-	35,104	76,713
Domestic financial entities	32,727	100%	-	-	11,016	43,743
Foreign financial entities	5,193	100%	-	-	-	5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	272,363		47,609		159,280	479,252

* Here term deposits refer to deposits with maturities greater than 30 days.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

42. Capital management

Capital ratio

The capital base amounts to ISK 206,490 million at the end of the period. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 27.8%, exceeds the minimum legal requirement of 14.3%, which includes the combined effective capital buffer levels at the end of the period. With fully loaded capital buffers as of 1 March 2017, the legal capital requirement will reach 16.0%. Note that the systemic risk buffer and countercyclical buffer only apply to domestic exposures.

The Group uses the standardised approach to calculate the capital requirements for credit risk, market risk and operational risk. The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements.

<i>Capital Base</i>	30.6.2016	31.12.2015
Total equity	208,844	201,894
Non-controlling interest not eligible for inclusion in CET1 capital*	(9,605)	(9,108)
Intangible assets	(9,152)	(9,285)
Tax assets	(221)	(205)
Other statutory deductions	(515)	(3,151)
Common equity Tier 1 capital*	<u>189,351</u>	<u>180,145</u>
Non-controlling interest not eligible for inclusion in CET1 capital*	9,605	9,108
Tier 1 capital	<u>198,956</u>	<u>189,253</u>
Subordinated liabilities	9,553	10,365
Regulatory adjustments to Tier 2 capital**	(1,504)	(771)
Other statutory deductions	(515)	(3,118)
Tier 2 capital	<u>7,534</u>	<u>6,476</u>
Total capital base	<u><u>206,490</u></u>	<u><u>195,729</u></u>
<i>Risk weighted assets</i>		
Credit risk	647,815	681,034
Market risk FX	4,046	38,401
Market risk other	9,509	7,035
Operational risk	81,441	81,441
Total risk weighted assets	<u>742,811</u>	<u>807,911</u>
<i>Capital ratios</i>		
CET1 ratio using current RWA *	25.5%	22.3%
Tier 1 ratio	26.8%	23.4%
Capital adequacy ratio	27.8%	24.2%

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

** Straight-line amortization for maturities within five years.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

42. Capital management, continued

Leverage ratio

As part of the Basel III regulatory framework, the leverage ratio is seen as a complementary measure to the risk-based Capital adequacy ratio.

	30.6.2016	31.12.2015
On-balance sheet exposures	1,010,894	982,348
Derivative exposures	4,171	3,789
Securities financing transaction exposures	12,665	16,287
Off-balance sheet exposures	71,987	127,675
Total exposure	1,099,717	1,130,099
Tier 1 capital	198,956	189,253
Leverage ratio	18.1%	16.7%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year 2015.

43. Going concern assumption

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

