Condensed Consolidated
Interim Financial Statements

1 January - 30 September 2017

Unaudited

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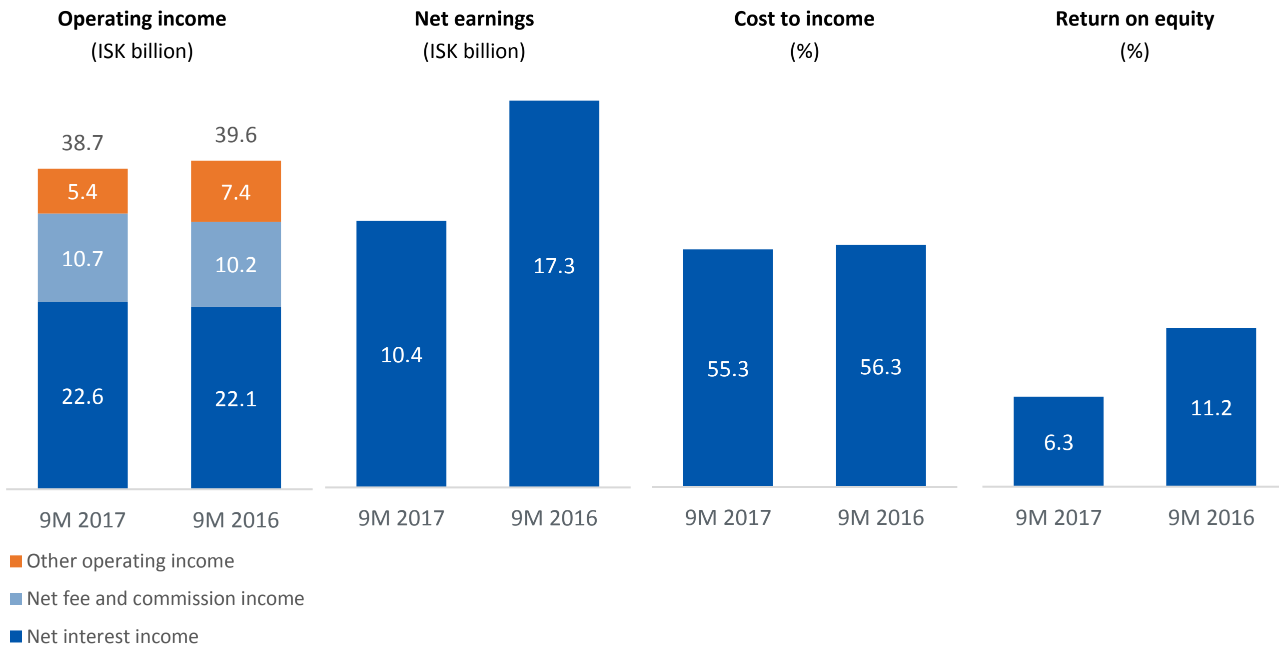
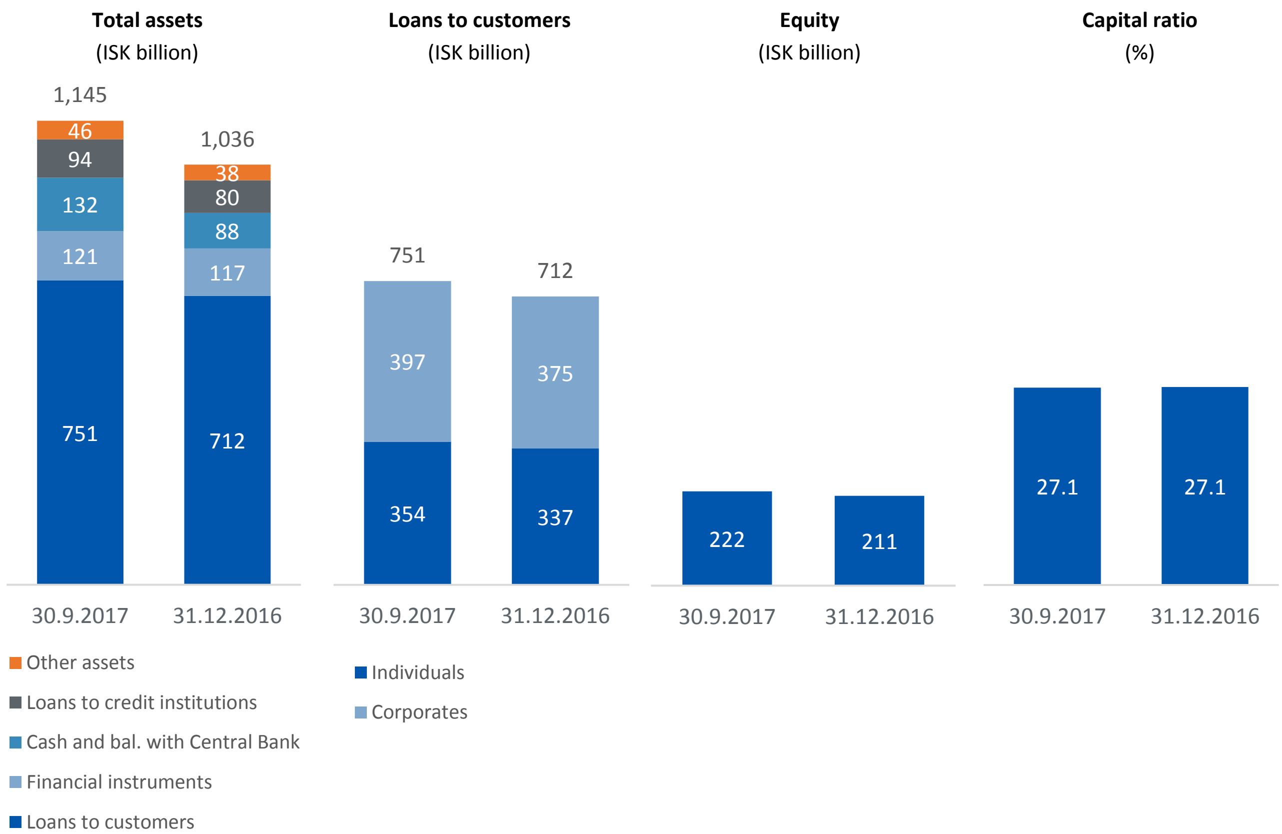


Condensed Consolidated Interim Statement of Financial Position



Endorsement and statement
by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period from 1 January to 30 September 2017 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

GDP growth measured 3.4% in the second quarter of 2017, compared to 5.0% growth in the first quarter. Despite slower growth the Icelandic economy continues to perform strongly with consumption, bolstered by low unemployment, and tourism at the forefront. Industrial and housing investments constituted the majority of investment growth in 2016 and will continue to do so in 2017, albeit at a slower pace. Inflation remains below the Central Bank's inflation target and the underlying inflationary pressure is low, if housing prices are excluded. Fluctuations in the exchange rate have increased after the removal of nearly all capital controls in March. Despite depreciating during the summer the ISK remains strong. The economic outlook is favorable and Arion Research predicts strong economic growth, low unemployment and low inflation throughout the year. Research expects GDP growth to slow down to 2.7% in 2018 and inflation to rise to 2.8%, still remaining within the Central Bank's tolerance level.

Arion Bank is financially robust, as demonstrated by a leverage ratio of 16.8% (see Note 42). The Bank's liquidity position is strong, with a liquidity coverage ratio of 229% (see Note 40). All the ingredients are in place to enable Arion Bank to continue to offer its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking. The Bank's financial strength enables it to grow alongside its customers and to pay competitive dividends to its owners.

Operations during the period

Net earnings amounted to ISK 10,353 million for the period ended 30 September 2017, and the total equity amounted to ISK 221,709 million at the end of the period. Return on equity was 6.3% for the period. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 27.1% and the corresponding Tier 1 ratio was 26.6%. According to the Financial Undertakings Act No. 161/2002 the official capital ratio shall be based on the audited or reviewed capital base. Since the interim financial statements for the first nine months are not audited the official capital ratio is based on the reviewed capital base on 30 June 2017 and risk-weighted assets on 30 September 2017. The official capital ratio on 30 September was 27.1% and the Tier 1 ratio was 26.6%, 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.

The main changes on the Balance Sheet from year-end 2016 relate to Cash and balance with the Central Bank, which have increased by ISK 44,682 million, or 51.0%, during the period. Deposits increased by ISK 33,917 million and borrowings by ISK 60,924 million during the period. The main reasons for this change are increased deposits in Retail Banking during the period and new borrowings. Loans to customers increased by ISK 38,525 million or 5.4%, and new lending is mainly to individuals in mortgages, corporates in real estate and transportation.

During the period the Bank's subsidiary Valitor Holding hf. acquired two companies: International Payment Solutions Ltd. (IPS) and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position.

The Group had 1,293 full-time equivalent positions at the end of the period, compared with 1,239 at the end of 2016; 842 of these positions were at Arion Bank, compared with 869 at the end of 2016.

In October Standard & Poor's upgraded Arion Bank's credit rating from BBB with a positive outlook to BBB+ with a stable outlook. The upgrade reflects Arion Bank's improved capital position, and the expectation that the Bank will maintain a very strong risk-adjusted capital ratio. It also reflects an improved view of the economic risks in the Icelandic banking sector, as the economic environment remains supportive following the release of capital controls earlier this year.

United Silicon

Sameinað sílikon hf. (United Silicon), a borrower of the Bank, was granted a moratorium on payments on 14 August 2017, the aim of which was enable an agreement to be reached with creditors over outstanding debts. The moratorium was granted owing to the operating difficulties experienced by the company following repeated shutdowns of production at the company's plant, which commenced operations in November 2016. A recent judgement on compensation from the company relating to a dispute over payments during the construction period to one of Iceland's largest contractors, ÍAV hf., has exacerbated the problem.

United Silicon has used the moratorium period to analyze the reasons for the operating difficulties at its plant and to negotiate deals with its creditors to defer payment or to convert debt. To analyze the operating difficulties at the plant, Icelandic and international specialists have been hired to evaluate, as far as possible, whether and how much additional investment is needed to bring the plant up to full production capacity, both in terms of the quantity and quality of the products. Arion Bank has monitored this analysis and in its assessment assumes that the plant will continue to operate, following significant additional investment. The advisers have also conducted a new evaluation of the financial position of United Silicon, taking into account new investment and other operating factors. In light of the above information, the Bank believes that the basis for running the plants operation is viable but it nevertheless exercises caution when evaluating outstanding loans, even though as a precautionary measure impairments were made in respect of significant amounts which had been injected into the company as equity and used to develop the plant. It is important that the plant operates in strict compliance with all environmental legislation and standards. The plant will only recommence operations once these objectives have been met.

From the outset, Arion Bank has been the main lender to United Silicon. The decision to participate in funding the construction of the plant was taken by the Bank in 2014, and since then the Bank, and others, has participated in the continued funding of the project. The company's total obligation to the Bank at the end of September amounted to ISK 9.1 billion, including outstanding loan commitments and guarantees. Assuming that operations at the plant will continue, the Bank considers an appropriate impairment in respect of these obligations to be ISK 3.7 billion; ISK 0.7 billion in respect of bonds and ISK 3.0 billion in respect of loans and receivables due for repayment during the third quarter.

United Silicon has now become a recovery case. The company is now a subsidiary of the Bank and is classified as a disposal group held for sale in accordance with IFRS 5, as reflected in Note 28. This is foreseen as a temporary measure and the aim is for United Silicon to get new owners in the near term. As part of this process, the Bank will transfer its holding in United Silicon into a holding entity, Eignabjarg ehf., a subsidiary of the Bank.

Funding

In the first week of January, Arion Bank tapped its outstanding five-year senior unsecured EUR 300 million (ISK 36 billion) bond issue from November 2016 for a further EUR 200 million (ISK 24 billion). The bonds were sold at rates corresponding to a 1.55% margin over interbank rates. On 20 June, Arion Bank issued new three-year senior unsecured bonds for a total of EUR 300 million (ISK 35 billion) in a transaction which was oversubscribed twofold. The bonds were sold at rates corresponding to a 0.88% margin over interbank rates.

The proceeds of these issues were partly used to repay the resettable EMTN held by Kaupthing and to tender outstanding notes due in March 2018 for EUR 100 million from EUR 300 million to EUR 200 million, thereby reducing refinancing risk for 2018.

During the first nine months of 2017 Arion Bank has issued EMTN private placements in NOK and SEK for an equivalent of ISK 19 billion, issued a total of ISK 19 billion of covered bonds and issued commercial paper amounting to ISK 17 billion.

Group ownership

Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 57.87% of the shares in Arion Bank hf. The remaining shareholding is held by the Icelandic State Financial Investments which holds 13.00% on behalf of the Icelandic government, Attestor Capital LLP through Trinity Investment Designated Activity Company holds 10.44%, Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. holds 9.99%, Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group holds 6.58%, and Goldman Sachs International through ELQ Investors II Ltd. holds 2.57%. The option the investors had to acquire further 21.9% of issued shares of Arion Bank has expired.

Endorsement and statement
by the Board of Directors and the CEO

The Board of Directors comprises eight members, four women and four men. Furthermore, three Alternates Directors (two men and one woman) are elected and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. The ratio of men to women is therefore in compliance with legal requirements as well as the Bank's Articles of Association which states that the ratio of either gender on the Board of Directors should not be less than 40%. Seven Directors are nominated by Kaupskil ehf. and one by the Icelandic State Financial Investments. Seven Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders. On 10 May 2017 Monica Caneman, Chairman of the Board of Directors, decided to step down from the Board of Directors of Arion Bank. On 23 June 2017 Eva Cederbalk was elected as a new Director to the Board of Arion Bank and was elected Chairman of the Board on 26 June 2017. Gudrún Johnsen, the Vice Chairman of the Board, served as interim Chairman of the Board from May 2017 until June 2017.

Endorsement of the Board of Directors and the Chief Executive Officer

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 September 2017 have been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" (IAS 34) 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 Condensed Consolidated Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 September 2017 and its financial position as at 30 September 2017.

Furthermore, in our opinion the Condensed Consolidated 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 Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 September 2017 and confirm them by means of their signatures.

Reykjavík, 14 November 2017

Board of Directors

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Guðrún Johnsen

Jakob Már Ásmundsson

John P. Madden

Kirstín Þ. Flygenring

Måns Höglund

Þóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

Condensed Consolidated Interim Statement of Comprehensive Income
for the period from 1 January to 30 September 2017

Income Statement

	Notes	2017 1.1.-30.9.	2016 1.1.-30.9	2017 1.7.-30.9.*	2016 1.7.-30.9.*
Interest income		43,288	46,246	13,448	14,851
Interest expense		(20,718)	(24,188)	(6,198)	(7,419)
Net interest income	6	22,570	22,058	7,250	7,432
Fee and commission income		20,881	17,436	7,862	6,191
Fee and commission expense		(10,178)	(7,223)	(3,997)	(2,725)
Net fee and commission income	7	10,703	10,213	3,865	3,466
Net financial income	8	2,471	4,339	(734)	844
Net insurance income	9	1,769	663	716	272
Share of profit of associates and net impairment	25	(917)	710	17	16
Other operating income	10	2,088	1,665	238	435
Operating income		38,684	39,648	11,352	12,465
Salaries and related expense	11	(12,624)	(12,252)	(3,841)	(3,826)
Other operating expense	12	(8,756)	(10,079)	(3,699)	(3,349)
Bank levy	13	(2,388)	(2,190)	(814)	(705)
Net impairment	14	(1,262)	6,827	(2,551)	5,882
Earnings before tax		13,654	21,954	447	10,467
Income tax expense	15	(3,917)	(5,261)	(756)	(3,170)
Net earnings from continuing operations		9,737	16,693	(309)	7,297
Net gain from assets held for sale, net of tax	16	616	569	196	206
Net earnings		10,353	17,262	(113)	7,503
Attributable to					
Shareholders of Arion Bank		10,351	16,776	(113)	7,514
Non-controlling interest	25	2	486	-	(11)
Net earnings		10,353	17,262	(113)	7,503
Earnings per share from continuing operations					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	4.87	8.10	(0.15)	3.65

Other Comprehensive Income

	Notes	2017 1.1.-30.9.	2016 1.1.-30.9	2017 1.7.-30.9.*	2016 1.7.-30.9.*
Net earnings		10,353	17,262	(113)	7,503
Net gain on AFS financial assets, net of tax		-	(2,903)	-	-
Exchange difference on translating foreign subsidiaries	32	(27)	281	56	187
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		(27)	(2,622)	56	187
Total comprehensive income		10,326	14,640	(57)	7,690
Attributable to					
Shareholders of Arion Bank		10,324	14,154	(57)	7,701
Non-controlling interest		2	486	-	(11)
Total comprehensive income		10,326	14,640	(57)	7,690

*The Condensed Consolidated Interim Statements of Comprehensive Income for the three month periods ended 30 September 2017 and 30 September 2016 have not been reviewed by the Bank's auditors.

The Notes on pages 12 to 60 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Financial Position
as at 30 September 2017

Assets	Notes	30.9.2017	31.12.2016
Cash and balances with Central Bank	18	132,316	87,634
Loans to credit institutions	19	94,242	80,116
Loans to customers	20	750,947	712,422
Financial instruments	21-23	121,040	117,456
Investment property	23	6,903	5,358
Investments in associates	25	842	839
Intangible assets	26	12,755	11,057
Tax assets	27	286	288
Other assets	28	25,521	20,854
Total Assets		1,144,852	1,036,024
Liabilities			
Due to credit institutions and Central Bank	22	7,097	7,987
Deposits	22	445,981	412,064
Financial liabilities at fair value	22	3,551	3,726
Tax liabilities	27	9,303	7,293
Other liabilities	29	56,811	54,094
Borrowings	22, 30	400,400	339,476
Total Liabilities		923,143	824,640
Equity			
Share capital and share premium	32	75,861	75,861
Other reserves	32	15,001	19,761
Retained earnings		130,673	115,590
Total Shareholders' Equity		221,535	211,212
Non-controlling interest		174	172
Total Equity		221,709	211,384
Total Liabilities and Equity		1,144,852	1,036,024

The Notes on pages 12 to 60 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Changes in Equity
for the period from 1 January to 30 September 2017

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 1 January 2017	75,861	19,761	115,590	211,212	172	211,384
Net earnings	-	-	10,351	10,351	2	10,353
Translation difference	-	(27)	-	(27)	-	(27)
Total comprehensive income	-	(27)	10,351	10,324	2	10,326
Reserve for investments in subsidiaries	-	(4,839)	4,839	-	-	-
Reserve for investments in associates	-	26	(26)	-	-	-
Reserve for investments in securities	-	81	(81)	-	-	-
Equity 30 September 2017	75,861	15,001	130,673	221,535	174	221,709
Equity 1 January 2016	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings	-	-	16,776	16,776	486	17,262
Net gain on AFS financial assets	-	(2,903)	-	(2,903)	-	(2,903)
Translation difference	-	281	-	281	-	281
Total comprehensive income	-	(2,622)	16,776	14,154	486	14,640
Disposal of non-controlling interest	-	-	-	-	(9,528)	(9,528)
Equity 30 September 2016	75,861	1,926	129,153	206,940	66	207,006

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 32.

The Notes on pages 12 to 60 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 September 2017

	2017	2016
Operating activities	1.1.-30.9.	1.1.-30.9.
Net earnings	10,353	17,262
Non-cash items included in net earnings	(19,565)	(25,759)
Changes in operating assets and liabilities	49,582	3,352
Interest received	34,679	35,777
Interest paid	(7,586)	(11,466)
Dividend received	197	603
Income tax paid	(2,059)	(3,507)
Net cash from operating activities	65,601	16,262
Investing activities		
Acquisition of associates	(961)	(13)
Acquisition of subsidiary	(1,446)	(5,300)
Proceeds from sale of associates	-	27,112
Dividend received from associates	41	41
Disposal of subsidiary	-	293
Acquisition of intangible assets	(1,477)	(745)
Acquisition of property and equipment	(573)	(924)
Proceeds from sale of property and equipment	231	215
Net cash (to) from investing activities	(4,185)	20,679
Financing activities		
Payment of subordinated liabilities	-	(8,785)
Disbursement of share capital and dividend to non controlling interest	-	(9,386)
Net cash used in financing activities	-	(18,171)
Net increase in cash and cash equivalents	61,416	18,770
Cash and cash equivalents at beginning of the year	123,933	110,000
Cash and cash equivalents acquired through business combinations	128	1,068
Effect of exchange rate changes on cash and cash equivalents	992	(5,159)
Cash and cash equivalents	186,469	124,679
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	542	1,297
Settlement of loans through foreclosure on collateral from customers with view to resale	(542)	(1,297)
Non-cash changes due to funding agreement with Kaupthing		
Other assets	-	41,409
Borrowings	-	(41,409)
Non-cash changes due to acquisition of United Silicon		
Deposits	4,537	-
Borrowings	(4,537)	-

The Notes on pages 12 to 60 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 September 2017

Non-cash items included in net earnings	2017 1.1.-30.9.	2016 1.1.-30.9.
Net interest income	(22,570)	(22,058)
Net impairment	1,262	(6,827)
Income tax expense	3,917	5,261
Bank levy	2,388	2,190
Net foreign exchange gain	(80)	829
Net gain on financial instruments	(2,194)	(4,565)
Depreciation and amortization	1,555	1,346
Share of profit of associates and net impairment	917	(710)
Investment property, fair value change	(1,366)	(25)
Revised Depositors' and Investors' Guarantee Fund expense	(2,669)	-
Net gain from assets held for sale, net of tax	(616)	(569)
Other changes	(109)	(631)
Non-cash items included in net earnings	(19,565)	(25,759)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	56	3,240
Loans to credit institutions, excluding bank accounts	2,373	(7,625)
Loans to customers	(33,882)	(34,058)
Financial instruments and financial liabilities at fair value	4,232	6,133
Investment property	(164)	1,449
Other assets	2,541	1,123
Due to credit institutions and Central Bank	(1,149)	(1,922)
Deposits	27,133	638
Borrowings	47,769	42,682
Other liabilities	673	(8,308)
Changes in operating assets and liabilities	49,582	3,352

Cash and cash equivalents		
Cash and balances with Central Bank	132,316	85,645
Bank accounts	63,429	48,429
Mandatory reserve deposit with Central Bank	(9,276)	(9,395)
Cash and cash equivalents	186,469	124,679

The Notes on pages 12 to 60 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

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Notes to the Condensed Consolidated Interim 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 Condensed Consolidated Interim Financial Statements 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 Financial Statements Act, Financial Undertakings Act 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 ended 31 December 2016. The Consolidated Financial Statements are available at Arion Bank's website www.arionbanki.is.

The Interim Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 14 November 2017.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the presentation of the Bank's consolidated financial statements for the year ended 31 December 2016. Amendments to IFRSs effective for 2017 have not had a material effect on the results for the nine monts ended 30 September 2017.

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
- assets 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 USD was 106.23 and 125.37 for EUR (31.12.2016: USD 112.90 and EUR 119.18).

Comparison figures

In the Interim Financial Statements 30 June 2016 earned premium of the subsidiary Okkar líftrygginar hf. was classified as Other operating income and claims incurred as Other operating expense. After the acquisition of the subsidiary Vörður tryggingar hf. 30 September 2016 net insurance income was presented separately in the Statement of Comprehansive Income, due to increased weight in the operation of the Group. Comparison figures have been changed accordingly.

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. The estimates and associated assumptions area based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period or in the period of revision and future periods in the revision affects both current and future periods.

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

Notes to the Condensed Consolidated Interim Financial Statements

3. The Group

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

			Equity interest	
	Operating activity	Currency	30.9.2017	31.12.2016
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%
Okkar líftryggingar hf., Borgartún 25, Reykjavík, Iceland	Life insurance	ISK	-	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%
Vörður tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

On 1 January Vörður tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition the life insurance operation was merged under the name of Vörður líftryggingar hf.

During the period the Bank's subsidiary Valitor Holding hf. acquired two companies; International Payment Solutions Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor’s direct channel market position in the UK as the focus has been on prepaid and web solutions in that market until now.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim 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 or assets.

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 Bank's divisions, to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts, payment solutions 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 such as financial restructuring, IPO's and stock market listings. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients. Capital Markets manages securities issuance for clients and advises on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services in it's 24 branches and also through leading digital solutions featured in both an app and internet bank. This includes deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six regions clusters, with the smaller branches capitalizing on the strength of larger units within each region. Retail Banking's 24 branches all around Iceland have a total of more than 100,000 customers.

Treasury is responsible 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 Valitor Holding hf., Vörður tryggingar hf., Okkar líftryggingar hf. (in 2016), Eignarhaldsfélagið Landey ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group.

In addition to the above operating segments, the Group presents information for the corporate **Headquarters** carrying out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The Headquarters information presented do not represents an operating segment.

4. Operating segments

1.1.-30.9.2017	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	399	4,777	182	11,818	4,626	941	(173)	22,570
Net fee and commission income	2,643	771	928	3,406	(248)	2,921	282	10,703
Net financial income	121	245	(59)	19	(340)	3,354	(869)	2,471
Net insurance income	-	-	-	-	-	1,833	(64)	1,769
Share of profit of associates and net impairment	-	-	-	-	-	4	(921)	(917)
Other operating income	17	1,091	-	14	5	619	342	2,088
Operating income (loss)	3,180	6,884	1,051	15,257	4,043	9,672	(1,403)	38,684
Operating expense	(753)	(239)	(558)	(3,319)	209	(6,585)	(10,135)	(21,380)
Bank levy	-	-	-	-	-	-	(2,388)	(2,388)
Net impairment	-	(2,436)	(18)	1,206	55	(70)	1	(1,262)
Earnings (loss) before tax	2,427	4,209	475	13,144	4,307	3,017	(13,925)	13,654
Net seg. rev. from ext. customers	1,581	12,044	684	22,333	(6,931)	10,197	(1,186)	38,722
Net seg. rev. from other segments	1,599	(5,160)	367	(7,076)	10,974	(525)	(217)	(38)
Operating income (loss)	3,180	6,884	1,051	15,257	4,043	9,672	(1,403)	38,684
Depreciation and amortization	1	-	-	268	-	702	584	1,555
30.9.2017								
Total assets	123,297	272,670	16,344	527,181	432,846	92,005	(319,491)	1,144,852
Total liabilities	118,604	216,137	15,044	461,541	375,975	60,813	(324,971)	923,143
Allocated equity	4,693	56,533	1,300	65,640	56,871	31,192	5,480	221,709
1.1.-30.9.2016								
Net interest income	415	4,915	1,031	11,444	3,818	866	(431)	22,058
Net fee and commission income	2,864	739	1,072	2,528	(258)	2,887	381	10,213
Net financial income	(86)	118	(103)	87	(178)	4,901	(400)	4,339
Net insurance income	-	-	-	-	-	663	-	663
Share of profit of associates and net impairment	-	-	613	-	-	155	(58)	710
Other operating income	12	69	321	16	85	833	329	1,665
Operating income (loss)	3,205	5,841	2,934	14,075	3,467	10,305	(179)	39,648
Operating expense	(1,039)	(451)	(747)	(4,577)	(151)	(4,804)	(10,562)	(22,331)
Bank levy	-	-	-	-	-	-	(2,190)	(2,190)
Net impairment	(1)	60	1,601	5,250	3	(87)	1	6,827
Earnings (loss) before tax	2,165	5,450	3,788	14,748	3,319	5,414	(12,930)	21,954
Net seg. rev. from ext. customers	1,268	11,765	2,732	22,561	(9,584)	10,721	185	39,648
Net seg. rev. from other segments	1,937	(5,924)	202	(8,486)	13,051	(416)	(364)	-
Operating income (loss)	3,205	5,841	2,934	14,075	3,467	10,305	(179)	39,648
Depreciation and amortization	-	-	-	238	-	504	604	1,346
30.9.2016								
Total assets	88,293	253,509	18,705	529,920	442,228	69,009	(363,184)	1,038,480
Total liabilities	83,547	194,998	15,911	459,320	410,738	39,552	(372,592)	831,474
Allocated equity	4,746	58,511	2,794	70,600	31,490	29,457	9,408	207,006

Following the acquisition of Vörður tryggingar hf. at 30 September 2016 the presentation of insurance income in the Statement of Comprehensive income was changed, see Note 1.

Assets held for sale are excluded from the profit and loss segment information.

Amounts are in ISK millions

4. Operating segments, continued

Geographic information

1.1.-30.9.2017	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	24,955	306	176	(3,226)	323	36	22,570
Net fee and commission income	8,778	183	184	1,540	14	4	10,703
Net financial income	1,126	(11)	240	224	883	9	2,471
Net insurance income	1,769	-	-	-	-	-	1,769
Share of profit of associates and net impairment	(917)	-	-	-	-	-	(917)
Other operating income	2,088	-	-	-	-	-	2,088
Operating income (loss)	37,799	478	600	(1,462)	1,220	49	38,684

1.1.-30.9.2016	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	23,746	845	89	(3,232)	582	28	22,058
Net fee and commission income	8,681	50	440	957	81	4	10,213
Net financial income	(966)	(12)	4,996	308	13	-	4,339
Net insurance income	663	-	-	-	-	-	663
Share of profit of associates and net impairment	212	-	498	-	-	-	710
Other operating income	1,665	-	-	-	-	-	1,665
Operating income (loss)	34,001	883	6,023	(1,967)	676	32	39,648

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Quarterly statements

5. Operations by quarters

2017	Q3	Q2	Q1	Total
Net interest income	7,250	8,160	7,160	22,570
Net fee and commission income	3,865	3,508	3,330	10,703
Net financial income	(734)	1,975	1,230	2,471
Net insurance income	716	606	447	1,769
Share of profit of associates and net impairment	17	(900)	(34)	(917)
Other operating income	238	1,470	380	2,088
Operating income	11,352	14,819	12,513	38,684
Salaries and related expense	(3,841)	(4,561)	(4,222)	(12,624)
Other operating expense	(3,699)	(1,223)	(3,834)	(8,756)
Bank levy	(814)	(777)	(797)	(2,388)
Net impairment	(2,551)	409	880	(1,262)
Earnings before tax	447	8,667	4,540	13,654
Income tax expense	(756)	(1,827)	(1,334)	(3,917)
Net earnings from continuing operations	(309)	6,840	3,206	9,737
Net gain from assets held for sale, net of tax	196	273	147	616
Net earnings	(113)	7,113	3,353	10,353

2016				
Net interest income	7,432	7,353	7,273	22,058
Net fee and commission income	3,466	3,528	3,219	10,213
Net financial income	844	3,796	(301)	4,339
Net insurance income	272	246	145	663
Share of profit of associates and net impairment	16	17	677	710
Other operating income	435	283	947	1,665
Operating income	12,465	15,223	11,960	39,648
Salaries and related expense	(3,826)	(4,318)	(4,108)	(12,252)
Other operating expense	(3,349)	(3,640)	(3,090)	(10,079)
Bank levy	(705)	(743)	(742)	(2,190)
Net impairment	5,882	1,448	(503)	6,827
Earnings before tax	10,467	7,970	3,517	21,954
Income tax expense	(3,170)	(1,354)	(737)	(5,261)
Net earnings from continuing operations	7,297	6,616	2,780	16,693
Net gain from assets held for sale, net of tax	206	259	104	569
Net earnings	7,503	6,875	2,884	17,262

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Consolidated Statement of Comprehensive Income

6. Net interest income

	2017	2016	2017	2016
Interest income	1.1.-30.9.	1.1.-30.9.	1.7.-30.9.	1.7.-30.9.
Cash and balances with Central Bank	5,059	3,249	1,653	1,220
Loans	35,963	39,097	11,155	12,312
Securities	1,624	3,401	427	1,164
Other	642	499	213	155
Interest income	43,288	46,246	13,448	14,851
Interest expense				
Deposits	(9,746)	(12,515)	(2,804)	(3,771)
Borrowings	(10,912)	(11,061)	(3,379)	(3,251)
Subordinated liabilities	-	(529)	-	(343)
Other	(60)	(83)	(15)	(54)
Interest expense	(20,718)	(24,188)	(6,198)	(7,419)
Net interest income	22,570	22,058	7,250	7,432
Net interest income from assets and liabilities at fair value	1,624	3,401	427	1,164
Interest income from assets not at fair value	41,664	42,845	13,021	13,687
Interest expense from liabilities not at fair value	(20,718)	(24,188)	(6,198)	(7,419)
Net interest income	22,570	22,058	7,250	7,432
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.9%	3.1%	2.7%	3.1%

7. Net fee and commission income

	1.1.-30.9.2017			1.1.-30.9.2016		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	3,024	(300)	2,724	3,101	(201)	2,900
Cards and payment solution	13,517	(9,239)	4,278	10,559	(6,515)	4,044
Collection and payment services	1,174	(72)	1,102	1,123	(59)	1,064
Investment banking	627	(33)	594	732	(36)	696
Lending and guarantees	1,529	-	1,529	1,180	-	1,180
Other	1,010	(534)	476	741	(412)	329
Net fee and commission income	20,881	(10,178)	10,703	17,436	(7,223)	10,213

	1.7.-30.9.2017			1.7.-30.9.2016		
Asset management	971	(91)	880	1,063	(61)	1,002
Cards and payment solution	5,298	(3,690)	1,608	3,833	(2,492)	1,341
Collection and payment services	426	(23)	403	401	(22)	379
Investment banking	199	(9)	190	178	(12)	166
Lending and guarantees	582	-	582	403	-	403
Other	386	(184)	202	313	(138)	175
Net fee and commission income	7,862	(3,997)	3,865	6,191	(2,725)	3,466

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

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

8. Net financial income

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Dividend income	197	603	7	3
Net gain on financial assets and financial liabilities classified as held for trading	(90)	(141)	(130)	(20)
Net gain on fair value hedge of interest rate swap	178	-	123	-
Net gain on financial assets and financial liabilities designated through profit or loss at fair value	2,106	(585)	(815)	1,004
Realised gain on financial assets available-for-sale	-	5,291	-	-
Net foreign exchange income	80	(829)	81	(143)
Net financial income	2,471	4,339	(734)	844
Net gain on fair value hedge of interest rate swap				
Fair value change of interest rate swaps designated as hedging instruments	(274)	-	238	-
Fair value change on bonds issued by the Group attributable to interest rate risk	452	-	(115)	-
Net gain on fair value hedge of interest rate swap	178	-	123	-
Net gain on financial assets and financial liabilities designated at fair value through profit or loss				
Equity instruments designated at fair value	2,150	(613)	(349)	636
Interest rate instruments designated at fair value	(44)	28	(466)	368
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	2,106	(585)	(815)	1,004

9. Net insurance income

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Earned premiums, net of reinsurers' share				
Premiums written	8,443	1,141	2,179	344
Premiums written, reinsurers' shares	(308)	(74)	(104)	(24)
Change in provision for unearned premiums	(1,334)	(91)	318	24
Change in provision for unearned premiums, reinsurers' share	1	1	-	(1)
Earned premiums, net of reinsurers' share	6,801	977	2,393	343
Claims incurre, net of reinsurers' share				
Claims paid	(4,346)	(368)	(1,438)	(135)
Claims paid, reinsurers' share	78	55	24	32
Change in provision for claims	(749)	-	(246)	69
Changes in provision for claims, reinsurers' share	(15)	(1)	(17)	(37)
Claims incurred, net of reinsurers' share	(5,032)	(314)	(1,677)	(71)
Net insurance income	1,769	663	716	272

Prior to the acquisition of Vörður tryggingar hf. at 30 September 2016 earned premiums of Okkar líftryggingar hf. was classified as Other operating income and claims incurred as Other operating expense, see Note 1.

10. Other operating income

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Fair value changes on investment property	1,366	25	4	-
Realized gain on investment property	15	429	4	-
Other income	707	1,211	230	435
Other operating income	2,088	1,665	238	435

Prior to the acquisition of Vörður tryggingar hf. at 30 September 2016 earned premium of Okkar líftryggingar hf. was classified as Other operating income, see Note 1.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

11. Personnel and salaries

Number of employees	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Average number of full-time equivalent positions during the period	1,235	1,185	1,275	1,205
Full-time equivalent positions at the end of the period	1,293	1,189	1,293	1,189
Number of employees at Arion Bank				
Average number of full-time equivalent positions during the period	826	893	824	901
Full-time equivalent positions at the end of the period	842	887	842	887
Salaries and related expense				
Salaries	10,125	9,811	3,056	3,047
Defined contribution pension plans	1,441	1,391	431	456
Salary-related expense	1,312	1,336	430	412
Capitalization of salaries, due to internally developed software	(254)	(286)	(76)	(89)
Salaries and related expense	12,624	12,252	3,841	3,826
Salaries and related expense for Arion Bank				
Salaries	6,832	7,307	2,063	2,342
Defined contribution pension plans	973	1,036	291	329
Salary-related expense	1,004	1,101	307	348
Salaries and related expense	8,809	9,444	2,661	3,019

During the period the Group made a provision of ISK 406 million (9M 2016: ISK 294 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 338 million (9M 2016: ISK 264 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 amounted to ISK 1041 million (31.12.2016: ISK 1,453 million), of which the Bank's accrual amounts to ISK 880 million (31.12.2016: ISK 1,177 million).

12. Other operating expense

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Administration expense	9,182	8,096	2,940	2,680
Depositors' and Investors' Guarantee Fund	(2,045)	602	213	181
Depreciation of property and equipment	613	707	200	265
Amortization of intangible assets	942	639	332	219
Other expense	64	35	14	4
Other operating expense	8,756	10,079	3,699	3,349

Prior to the acquisition of Vörður tryggingar hf. at 30 September 2016 claims incurred of Okkar líftryggingar hf. was classified as Other operating expense, see Note 1.

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 34.

13. Bank levy

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

Amounts are in ISK millions

14. Net impairment

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Net change in impairment of loans to corporates	(3,215)	(1,973)	(3,519)	(1,427)
Net change in impairment of loans to individuals	(131)	(2,205)	50	(185)
Net change in collective impairment on loans	607	351	522	245
Provision for losses	(2,739)	(3,827)	(2,947)	(1,367)
Increase in book value of loans to corporates	347	2,129	9	301
Increase in book value of loans to individuals	1,130	8,525	387	6,948
Net impairment	(1,262)	6,827	(2,551)	5,882

15. Income tax expense

Current tax expense	4,287	5,318	689	3,035
Deferred tax expense	(370)	(57)	67	135
Income tax expense	3,917	5,261	756	3,170

Reconciliation of effective tax rate	1.1.-30.9.2017		1.1.-30.9.2016	
Earnings before tax		13,654		21,954
Income tax using the Icelandic corporate tax rate	20.0%	2,731	20.0%	4,391
Additional 6% tax on Financial Undertakings	6.7%	909	4.2%	1,132
Non-deductible expenses	0.1%	7	0.5%	91
Tax exempt revenue	(1.9%)	(257)	(3.6%)	(781)
Non-deductible taxes	3.5%	478	2.6%	438
Tax incentives not recognized in the Statement of Comprehensive Income	(0.1%)	(12)	(0.7%)	-
Other changes	0.4%	61	(0.0%)	(10)
Effective tax rate	28.7%	3,917	24.0%	5,261

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

Tax exempt revenues consist mainly of profit from equity positions.

16. Net gain from assets held for sale, net of tax

	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.7.-30.9.	2016 1.7.-30.9.
Income from real estates and other assets	966	925	311	325
Expense related to real estates and other assets	(196)	(213)	(66)	(67)
Net gain from assets held for sale	770	712	245	258
Income tax expense	(154)	(143)	(49)	(52)
Net gain from assets held for sale, net of tax	616	569	196	206

17. Earnings per share

	Net gain from assets held for sale			
	Excluded		Included	
	2017 1.1.-30.9.	2016 1.1.-30.9.	2017 1.1.-30.9.	2016 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	9,735	16,207	10,351	16,776
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	4.87	8.10	5.18	8.39

There were no instruments at the end of the period that could potentially dilute basic earnings per share (1.1.-30.9.2016: none).

Amounts are in ISK millions

Notes to the Consolidated Statement of Finanacial Position

18. Cash and balances with Central Bank

	30.9.2017	31.12.2016
Cash on hand	8,168	7,448
Cash with Central Bank	114,872	70,854
Mandatory reserve deposit with Central Bank	9,276	9,332
Cash and balances with Central Bank	132,316	87,634

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

19. Loans to credit institutions

	30.9.2017	31.12.2016
Bank accounts	63,429	45,631
Money market loans	30,029	32,267
Other loans	784	2,218
Loans to credit institutions	94,242	80,116

20. Loans to customers

	Individuals		Corporates		Total	
30.9.2017	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,863	13,657	20,745	19,326	35,608	32,983
Credit cards	10,078	9,873	1,177	1,157	11,255	11,030
Mortgage loans	302,406	300,338	18,300	18,065	320,706	318,403
Other loans	33,116	30,136	366,226	358,395	399,342	388,531
Loans to customers	360,463	354,004	406,448	396,943	766,911	750,947
31.12.2016						
Overdrafts	14,805	13,381	19,314	17,630	34,119	31,011
Credit cards	11,363	11,099	1,180	1,151	12,543	12,250
Mortgage loans	285,784	282,996	16,298	15,975	302,082	298,971
Other loans	34,777	29,940	351,739	340,250	386,516	370,190
Loans to customers	346,729	337,416	388,531	375,006	735,260	712,422

The total book value of pledged loans that were pledged against amounts borrowed was ISK 175 billion at the end of the period (31.12.2016: ISK 165 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

Amounts are in ISK millions

20. Loans to customers, continued

Changes in the provision for losses on loans to customers

1.1.-30.9.2017	Specific	Collective	Total
Balance at the beginning of the year	18,281	4,557	22,838
Provision for losses	3,346	(607)	2,739
Write-offs	(6,786)	-	(6,786)
Effects due to acquisition of subsidiary	(2,962)	-	(2,962)
Exchange difference	50	-	50
Payment of loans previously written off	85	-	85
Balance at the end of the period	12,014	3,950	15,964

1.1.-30.9.2016			
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	4,178	(351)	3,827
Write-offs	(8,686)	-	(8,686)
Exchange difference	(377)	-	(377)
Payment of loans previously written off	187	-	187
Balance at the end of the period	20,643	4,633	25,276

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 53 in the Annual Financial Statements for 2016. 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 realizable 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.

21. Financial instruments

	30.9.2017	31.12.2016
Bonds and debt instruments	61,262	69,565
Shares and equity instruments with variable income	36,553	27,035
Derivatives	7,721	5,159
Securities used for hedging	15,504	15,697
Financial instruments	121,040	117,456

Amounts are in ISK millions

22. Financial assets and financial liabilities

30.9.2017	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	132,316	-	-	132,316
Loans to credit institutions	94,242	-	-	94,242
Loans to customers	750,947	-	-	750,947
Loans	977,505	-	-	977,505
Bonds and debt instruments				
Listed	-	4,858	53,837	58,695
Unlisted	-	20	2,547	2,567
Bonds and debt instruments	-	4,878	56,384	61,262
Shares and equity instruments with variable income				
Listed	-	1,503	6,510	8,013
Unlisted	-	1,303	10,526	11,829
Bond funds with variable income, unlisted	-	1,339	15,372	16,711
Shares and equity instruments with variable income	-	4,145	32,408	36,553
Derivatives				
OTC derivatives	-	7,169	-	7,169
Derivatives used for hedge accounting	-	552	-	552
Derivatives	-	7,721	-	7,721
Securities used for hedging				
Bonds and debt instruments, listed	-	6,905	-	6,905
Shares and equity instruments with variable income, listed	-	8,553	-	8,553
Shares and equity instruments with variable income, unlisted	-	46	-	46
Securities used for hedging	-	15,504	-	15,504
Other financial assets	9,863	-	-	9,863
Financial assets	987,368	32,248	88,792	1,108,408
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,097	-	-	7,097
Deposits	445,981	-	-	445,981
Borrowings	400,400	-	-	400,400
Liabilities at amortized cost	853,478	-	-	853,478
Financial liabilities at fair value				
Short position in bonds	-	1,402	-	1,402
Derivatives	-	2,149	-	2,149
Financial liabilities at fair value	-	3,551	-	3,551
Other financial liabilities	32,507	-	-	32,507
Financial liabilities	885,985	3,551	-	889,536

Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

31.12.2016	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers	712,422	-	-	712,422
Loans	880,172	-	-	880,172
Bonds and debt instruments				
Listed	-	5,284	61,055	66,339
Unlisted	-	102	3,124	3,226
Bonds and debt instruments	-	5,386	64,179	69,565
Shares and equity instruments with variable income				
Listed	-	2,949	9,125	12,074
Unlisted	-	1,348	10,579	11,927
Bond funds with variable income, unlisted	-	1,027	2,007	3,034
Shares and equity instruments with variable income	-	5,324	21,711	27,035
Derivatives				
OTC derivatives	-	5,159	-	5,159
Derivatives	-	5,159	-	5,159
Securities used for hedging				
Bonds and debt instruments, listed	-	7,318	-	7,318
Shares and equity instruments with variable income, listed	-	8,365	-	8,365
Shares and equity instruments with variable income, unlisted	-	14	-	14
Securities used for hedging	-	15,697	-	15,697
Other financial assets	8,617	-	-	8,617
Financial assets	888,789	31,566	85,890	1,006,245
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,987	-	-	7,987
Deposits	412,064	-	-	412,064
Borrowings	339,476	-	-	339,476
Liabilities at amortized cost	759,527	-	-	759,527
Financial liabilities at fair value				
Short position in bonds	-	1,884	-	1,884
Derivatives	-	1,842	-	1,842
Financial liabilities at fair value	-	3,726	-	3,726
Other financial liabilities	36,350	-	-	36,350
Financial liabilities	795,877	3,726	-	799,603

Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value, specified by issuer	30.9.2017	31.12.2016
Financial and insurance activities	4,341	5,564
Public sector	45,398	51,860
Corporates	6,645	6,755
Bonds and debt instruments designated at fair value	56,384	64,179

The total amount of pledged bonds was ISK 14.0 billion at the end of the period (31.12.2016: ISK 15.6 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.

23. 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 recognized at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (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

30.9.2017

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	29,492	31,727	43	61,262
Shares and equity instruments with variable income	5,097	30,413	1,043	36,553
Derivatives	-	7,169	-	7,169
Derivatives used for hedge accounting	-	552	-	552
Securities used for hedging	15,458	46	-	15,504
Investment property	-	-	6,903	6,903
Assets at fair value	50,047	69,907	7,989	127,943
Liabilities at fair value				
Short position in bonds	1,402	-	-	1,402
Derivatives	-	2,149	-	2,149
Liabilities at fair value	1,402	2,149	-	3,551

Amounts are in ISK millions

23. Fair value hierarchy, continued

31.12.2016

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	22,787	46,689	89	69,565
Shares and equity instruments with variable income	11,863	15,154	18	27,035
Derivatives	-	5,159	-	5,159
Securities used for hedging	15,659	38	-	15,697
Investment property	-	-	5,358	5,358
Assets at fair value	50,309	67,040	5,465	122,814
Liabilities at fair value				
Short position in bonds	1,884	-	-	1,884
Derivatives	-	1,842	-	1,842
Liabilities at fair value	1,884	1,842	-	3,726

There was no transfer between Level 1 and Level 2 during the period (2016: No transfers).

Fair value of assets and liabilities

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

Methods for establishing fair value

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

Level 1: Fair value established from quoted market prices

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

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

Level 2: Fair value established using valuation techniques with observable market information

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

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

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

Amounts are in ISK millions

23. Fair value hierarchy, continued

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

Level 3: Fair value established using valuation techniques with significant unobservable market information

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

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

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value

	Investment	Financial assets		
30.9.2017	property	Bonds	Shares	Total
Balance at the beginning of the year	5,358	90	18	5,466
Net fair value changes	1,366	(667)	24	723
Net gain from disposals	15	-	-	15
Additions	728	-	145	873
Disposal	(564)	(94)	(14)	(672)
Transfers into Level 3	-	714	870	1,584
Balance at the end of the period	6,903	43	1,043	7,989

31.12.2016				
Balance at the beginning of the year	7,542	182	5,874	13,598
Net fair value changes	290	(7)	2,835	3,118
Net gain from disposal	400	-	-	400
Additions	618	-	-	618
Disposal	(2,084)	(73)	(8,705)	(10,862)
Disposals through the sale of a subsidiary	(1,408)	-	-	(1,408)
Transfers into Level 3	-	-	13	13
Transfers out of Level 3	-	(12)	-	(12)
Balance at the end of the period	5,358	90	18	5,465

Amounts are in ISK millions

23. Fair value hierarchy, continued

Line items where effects of Level 3 assets are recognized in the Statement of Comprehensive Income

1.1.-30.9.2017	Investment property	Financial assets Bonds	Financial assets Shares	Total
Net interest income	-	27	-	27
Net financial income	-	(694)	24	(670)
Other operating income	1,381	-	-	1,381
Effects recognized in the Income Statement	1,381	(667)	24	738
Net loss on AFS financial assets, net of tax	-	-	-	-
Effects recognized in the Statement of Comprehensive Income	1,381	(667)	24	738
1.1.-30.9.2016				
Net interest income	-	2	-	2
Net financial income	-	(9)	5,259	5,250
Other operating income	454	-	-	454
Effects recognized in the Income Statement	454	(7)	5,259	5,706
Net loss on AFS financial assets, net of tax	-	-	(2,903)	(2,903)
Effects recognized in the Statement of Comprehensive Income	454	(7)	2,356	2,803

Carrying values and fair values of financial assets and financial liabilities not carried at fair value

30.9.2017	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	132,316	132,316	-
Loans to credit institutions	94,242	94,242	-
Loans to customers	750,947	756,086	5,139
Other financial assets	9,863	9,863	-
Financial assets not carried at fair value	987,368	992,507	5,139
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,097	7,097	-
Deposits	445,981	445,981	-
Borrowings	400,400	413,918	(13,518)
Other financial liabilities	32,507	32,507	-
Financial liabilities not carried at fair value	885,985	899,503	(13,518)

Amounts are in ISK millions

23. Fair value hierarchy, continued

31.12.2016 *Financial assets not carried at fair value*	Carrying value	Fair value	Unrealized gain (loss)
Cash and balances with Central Bank	87,634	87,634	-
Loans to credit institutions	80,116	80,116	-
Loans to customers	712,422	717,220	4,798
Other financial assets	8,617	8,617	-
Financial assets not carried at fair value	888,789	893,587	4,798
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,987	7,987	-
Deposits	412,064	412,064	-
Borrowings	339,476	348,412	(8,936)
Other financial liabilities	36,350	36,350	-
Financial liabilities not carried at fair value	795,877	804,813	(8,936)

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

Those Loans to customers which are retail mortgages at fixed interest rates are estimated by using the discounted 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.

The majority of Borrowings are listed bonds, issued by the Bank on the international and Icelandic markets. On international markets these bonds are quite liquid and the fair value is therefore easy to present, but the market for covered bonds in Iceland is not as liquid and therefore market-oriented inputs are used for fair value calculation of those bonds.

Derivatives	Notional	Fair value	
30.9.2017	value	Assets	Liabilities
Forward exchange rate agreements	57,487	562	466
Fair value hedge of interest rate swap	100,293	552	-
Interest rate and exchange rate agreements	202,341	5,590	1,496
Bond swap agreements	1,344	3	1
Share swap agreements	8,581	993	146
Options - purchased agreements	126	21	40
Derivatives	370,172	7,721	2,149
31.12.2016			
Forward exchange rate agreements	31,921	266	247
Interest rate and exchange rate agreements	210,143	4,288	1,104
Bond swap agreements	2,995	1	8
Share swap agreements	8,138	597	457
Options - purchased agreements	1,218	7	26
Derivatives	254,415	5,159	1,842

The Group applies hedge accounting only with respect to certain foreign currency denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate foreign currency denominated bonds (see Note 30) arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The Group applies fair value hedge accounting to the hedging relationships. The total fair value of the interest rate swaps at 30 September 2017 amounted to ISK 552 million. Their total notional values at period end amounted to ISK 100,293 million.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

24. 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				
30.9.2017	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognized on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets recognized on balance sheet
Reverse repurchase agreements	17,076	(290)	16,786	(1,145)	-	15,641	-	16,786
Derivatives	5,958	-	5,958	(878)	-	5,080	1,763	7,721
Total assets	23,034	(290)	22,744	(2,023)	-	20,721	1,763	24,507
31.12.2016								
Reverse repurchase agreements	15,644	(80)	15,564	(1,884)	-	13,680	-	15,564
Derivatives	4,100	-	4,100	(629)	-	3,471	1,059	5,159
Total assets	19,744	(80)	19,664	(2,513)	-	17,151	1,059	20,723

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
30.9.2017	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognized on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognized on balance sheet
Repurchase agreements	1,435	(290)	1,145	(1,145)	-	-	-	1,145
Derivatives	1,093	-	1,093	(878)	-	215	1,056	2,149
Total liabilities	2,528	(290)	2,238	(2,023)	-	215	1,056	3,294
31.12.2016								
Repurchase agreements	1,884	(80)	1,804	(1,884)	-	(80)	-	1,804
Derivatives	629	-	629	(629)	-	-	1,213	1,842
Total liabilities	2,513	(80)	2,433	(2,513)	-	(80)	1,213	3,646

Reserve repurchase agreements and repurchase agreements are recognized within the line items Financial instruments and Due to credit institutions and Central Bank respectively.

Amounts are in ISK millions

25. Investments in associates

The Group's interest in its principal associates	30.9.2017	31.12.2016
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
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	35.3%	34.9%

Investments in associates		
Carrying amount at the beginning of the year	839	27,299
Additions	961	76
Dividend received	(41)	(153)
Disposals	-	(27,291)
Share of profit of associates and net impairment	(917)	908
Investment in associates	842	839

At year end 2016 Arion Bank held a minor shareholding in United Silicon. In 2017 the Bank participated in a share capital increase and subsequently the shareholding was classified as Investment in associate. The Bank's investment in the company's share capital amounted to ISK 907 million and has been fully provisioned for in the Bank's Financial Statements. Arion Bank is the largest creditor of United Silicon. In September the Bank foreclosed on collateral and took possession of the shares of the company’s largest shareholder. United Silicon was subsequently classified as a subsidiary of the Bank and is classified as a disposal group held for sale in accordance with IFRS 5, see Note 28.

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

Amounts are in ISK millions

26. 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 are recognized upon acquisition in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation, payment solution and credit card operation and branding of the insurance operation. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements upon acquisition. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationships with individual customers through retail banking operations and the insurance operations. The customer relationship is tested for impairment and related agreements are amortized over a period of five years.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

In May and July the Bank’s subsidiary Valitor Holding hf. acquired two companies: International Payment Solutions Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor’s direct channel market position in the UK, as until now the focus has been on prepaid and web solutions in that market. The total purchase price of these two companies was ISK 1,446 million, with intangible assets of ISK 1,124 million in customer relationship and related agreements. The allocation of purchase price has not been completed at period end but Valitor Holding hf. will complete it within the 12 months permitted from the acquisition date.

30.9.2017	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,202	3,705	1,608	3,542	11,057
Acquisition through business combination	-	-	-	109	109
Additions	173	-	1,124	792	2,089
Additions, internally developed	-	-	-	254	254
Exchange difference	76	-	67	45	188
Amortization	-	-	(225)	(717)	(942)
Intangible assets	2,451	3,705	2,574	4,025	12,755

31.12.2016	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Acquisition through business combination	496	684	904	457	2,541
Additions and transfers	(271)	-	110	638	477
Additions, internally developed	-	-	-	384	384
Exchange difference	(430)	-	(32)	(182)	(644)
Impairment	-	-	(9)	-	(9)
Amortization	-	-	(219)	(758)	(977)
Intangible assets	2,202	3,705	1,608	3,542	11,057

Impairment is recognized in the line item Net impairment in the Statement of Comprehensive income.

Goodwill is recognized in the segment Other divisions and subsidiaries, see Note 4.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

27. Tax assets and tax liabilities

	30.9.2017		31.12.2016	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	9,012	-	6,630
Deferred tax	286	291	288	663
Tax assets and tax liabilities	**286**	**9,303**	**288**	**7,293**

28. Other assets

	30.9.2017	31.12.2016
Assets held for sale	7,352	4,418
Property and equipment	6,594	6,723
Accounts receivable	6,924	5,373
Unsettled securities trading	1,140	712
Investment for life assurance policyholders where risk is held by policyholder	847	820
Sundry assets	2,664	2,808
Other assets	**25,521**	**20,854**

Assets held for sale

	30.9.2017	31.12.2016
Legal entities	4,479	-
Real estates	2,832	4,371
Other assets	41	47
Assets held for sale	**7,352**	**4,418**

At the beginning of the year Arion Bank held approximately 7% of United Silicon's shares, with value of ISK 257 million that was fully impaired in the net financial income during the first quarter of the year. Following difficulties in the operation the Bank participated in a capital increase for the amount of ISK 907 million, an amount which has been fully impaired in the Bank's accounts. At the end of June the Bank held 23.9% voting rights and classified the shareholding as Investment in associate. In September 2017 Arion Bank, as the largest creditor of United Silicon, foreclosed on collateral and took possession of the shares of the company's largest shareholder with 66.58% shareholding and 80.71% of voting rights, based on different classes of share capital of United Silicon. As a result the company is now a subsidiary of the Bank and is classified as a disposal group held for sale in accordance with IFRS 5.

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

29. Other liabilities

	30.9.2017	31.12.2016
Accounts payable	24,268	22,627
Unsettled securities trading	1,999	668
Depositors' and investors' Guarantee Fund*	213	2,870
Technical provision	12,339	10,243
Technical provision for life assurance policyholders were investment risk is held by policyholder	847	820
Withholding tax	369	1,745
Bank levy	5,260	2,872
Sundry liabilities	11,516	12,249
Other liabilities	**56,811**	**54,094**

Technical provision	Technical provision	Reinsurers' share	Total 30.9.2017	Technical provision	Reinsurers' share	Total 31.12.2016
Claims reported and loss adjustment expenses	5,591	(152)	5,439	4,842	(167)	4,675
Claims incurred but not reported	1,352	(99)	1,253	1,352	(99)	1,253
Claims outstanding	6,943	(251)	6,692	6,194	(266)	5,928
Provision for unearned premiums	5,396	(19)	5,377	4,049	(18)	4,031
Own technical provision	12,339	(270)	12,069	10,243	(284)	9,959

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 34.

Amounts are in ISK millions

30. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	30.9.2017	31.12.2016
ARION CBI 19 (ISK 4,500 million)	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,535	4,502
ARION CB 19 (ISK 2,540 million)	2016	2019	At maturity	Fixed, 5.50%	1,609	580
ARION CBI 21 (ISK 10,220 million)	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,886	9,696
ARION CB 22 (ISK 23,040 million)	2015	2022	At maturity	Fixed, 6.50%	22,750	19,596
ARION CBI 25 (ISK 5,620 million)	2017	2025	At maturity	Fixed, CPI linked, 3.00%	12,022	-
ARION CBI 29 (ISK 25,220 million)	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,363	23,524
ARION CBI 34 (ISK 2,500 million)	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,123	2,207
Statutory covered bonds					79,288	60,105
ARION CB 1 (ISK 21,877 million)	2006	2033	Amortizing	Fixed, CPI linked, 3.75%	16,394	16,734
ARION CB 4 (ISK 15,500 million)	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	-	6,199
ARION CB 2 (ISK 51,125 million)	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,252	78,239
Structured Covered bonds					94,646	101,172
Total Covered bonds					173,934	161,277
USD 30 million	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	3,212	3,406
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	532	662
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	814	1,063
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	25,332	36,610
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	6,519	3,113
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	37,973	36,307
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	978	951
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,577	3,422
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,775	10,617
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,301	2,902
EUR 300 million	2017	2020	At maturity	Fixed, 0.75%	37,582	-
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,913	-
EUR 500 million*	2016	2021	At maturity	Fixed, 1.625%	62,735	35,639
USD 747 million	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	-	29,317
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,300	-
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,257	-
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,375	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,380	-
Senior unsecured bonds					209,555	164,009
Bills issued					14,033	13,854
Other					2,878	336
Other loans/bills					16,911	14,190
Borrowings					400,400	339,476

The book value of listed bonds was ISK 379 billion at the end of the period (31.12.2016: ISK 284 billion). The market value of those bonds was ISK 392 billion (31.12.2016: ISK 290 billion). The Group repurchased own debts during the period in the amount of ISK 20 billion (2016: nil) with minor effects on the Statement of Comprehensive Income.

In January 2016 the Bank reached an agreement with Kaupthing under which FX deposits held at Arion Bank would be converted into issued EMTN bond in USD and Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion. The total issue was ISK 97 billion (USD 747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of USD 165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and thus a prepayment of ISK 57 billion (USD 489 million) was made in 2016. The remaining outstanding amount of ISK 29 billion (USD 258 million) was prepaid in June 2017.

*The Group applies hedge accounting to this bond issuance and uses certain foreign currency denominated interest rate swaps as hedging instruments (see Note 23). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate foreign currency denominated bond arising from changes in interest rates. The Group started to apply hedge accounting during the first quarter of 2017. The Group applies fair value hedge accounting to the hedging relationships. The total carrying amount of the bond issuance is ISK 62,735 million and included in the amount are fair value changes amounting to ISK 452 million (see Note 8).

Amounts are in ISK millions

31. Pledged assets

Pledged assets against liabilities	30.9.2017	31.12.2016
Assets, pledged as collateral against borrowings	203,332	196,901
Assets, pledged as collateral against loans from credit institutions and short positions	13,984	15,644
Pledged assets against liabilities	217,316	212,545

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 203 billion at the end of the period (31.12.2016: ISK 197 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 174 billion at the end of the period (31.12.2016: ISK 161 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)	30.9.2017	Number (million)	31.12.2016
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.

Other reserves	30.9.2017	31.12.2016
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	12,173	17,012
Reserve for investments in associates	49	23
Reserve for investments in securities	979	899
Foreign currency translation reserve	163	190
Other reserves	15,001	19,761

In June 2016 the Icelandic parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 65 in the Annual Financial Statements for 2016. There is some uncertainty over the interpretation and implementation of the amendments and thus the Note may be subject to change in the near term.

Notes to the Condensed Consolidated Interim 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

Legal proceedings regarding damages

With a writ issued in June 2013, Kortaþjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortaþjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June the Supreme Court dismissed the case on procedural grounds. Kortaþjónustan hf. issued a new writ in September 2017 regarding the same matter of dispute this time claiming damages in the amount of ISK 922 million plus interest from the same defendants.

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 that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses The district court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. has requested a new assessment, which will examine particular aspects which have not yet been assessed. The district court has not ruled on this motion.

When Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014-2015, the Bank signed agreements with the sellers (Landsbankinn and two savings banks) concerning losses which Valitor may potentially sustain in relation to these compensatory damages. Thus the Group may lodge a claim against the sellers for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

Other legal matters

Mortgage documents

Courts cases are being prosecuted against the Bank in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. In May and June 2017 the Supreme Court, in respect of cases which did not involve the Bank, ruled in two cases regarding this issue. In one of those cases the Supreme Court invalidated a mortgage. The district court has ruled in four separate court cases involving the Bank regarding the aforementioned dispute. In three of those cases the district court invalidated a mortgage, while in one case the Bank was acquitted. The Bank is awaiting further rulings from the Supreme Court to assess the possible impact of a negative outcome on the Bank's loan portfolio.

Off balance sheet information

34. Commitments

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

	30.9.2017	31.12.2016
Financial guarantees	13,417	15,270
Unused overdrafts	47,093	46,379
Loan commitments	91,654	82,268

Depositors' and Investors' Guarantee Fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter. Even though the law has not been amended Icelandic banks have made quarterly payments to a separate division within the fund since 2010. The calculated liability from 2010 which is according to the old act, was ISK 2,669 million. At the end of June 2017 the Bank received confirmation from the Depositors' and Investors' Guarantee Fund that this liability and issued guarantee for obligation of ISK 3,210 million would not be collected by the fund. Therefore the Bank reversed a previously expensed contribution to the Depositors' and Investors' Guarantee Fund in the second quarter amounting to ISK 2,669 million.

36. Assets under management and under custody

	30.9.2017	31.12.2016
Assets under management	1,029,267	1,054,759
Assets under custody	1,418,668	1,356,997

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.

Amounts are in ISK millions

Related party

37. Related party

The Group has a related party relationship with Kaupskil ehf., which is the ultimate controlling party with a 57.41% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., which is the parent company of Kaupskil ehf.

Attestor Capital LLP through Trinity Investment Designated Activity Company manages 10.44% stake in Arion Bank, Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. manages 9.99%, Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group manages 6.58%, Goldman Sachs International through ELQ Investors II Ltd. manages 2.57% and Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13.00% stake in Arion Bank, and are all defined as related party with influence over the Group.

Icelandic government and government related entities, including ISFI are defined as related party of the Group. The Group applies the partial exemption for government-related entities as described in IAS 24, paragraphs 25-27.

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.

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.

Balances with related parties

30.9.2017	Assets	Liabilities	Net balance
Shareholders with control over the Group	463	(3,613)	(3,150)
Board of Directors and key Management personnel	212	(181)	31
Associates and other related parties	-	(168)	(168)
Balances with related parties	675	(3,962)	(3,287)

31.12.2016	Assets	Liabilities	Net balance
Shareholders with control over the Group	192	(7,255)	(7,063)
Board of Directors and key Management personnel	255	(242)	13
Associates and other related parties	181	(369)	(188)
Balances with related parties	628	(7,866)	(7,238)

Amounts are in ISK millions

Risk Management disclosures

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

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

38. 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 Condensed Consolidated 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.

Maximum exposure to credit risk related to on-balance sheet items	30.9.2017	31.12.2016
Cash and balances with Central Bank	132,316	87,634
Loans to credit institutions	94,242	80,116
Loans to corporates	396,943	375,006
Loans to individuals	354,004	337,416
Financial instruments	88,691	91,301
Other assets with credit risk	9,863	8,617
Total on-balance sheet maximum exposure to credit risk	1,076,059	980,090
Maximum exposure to credit risk related to off-balance sheet items		
Financial guarantees	13,417	15,270
Unused overdrafts	47,093	46,379
Loan commitments	91,654	82,268
Total off-balance sheet maximum exposure to credit risk	152,164	143,917
Maximum exposure to credit risk	1,228,223	1,124,007

Amounts are in ISK millions

38. Credit risk, continued

Loans to customers specified by sectors	30.9.2017	31.12.2016
Individuals	47.1%	47.4%
Real estate activities and construction	16.7%	16.1%
Fishing industry	10.6%	10.7%
Information and communication technology	3.6%	4.1%
Wholesale and retail trade	7.3%	7.4%
Financial and insurance activities	4.7%	4.9%
Industry, energy and manufacturing	3.9%	4.0%
Transportation	1.9%	0.9%
Services	2.3%	2.4%
Public sector	1.0%	1.2%
Agriculture and forestry	0.9%	0.9%
	100.0%	100.0%

Collateral and other credit enhancements

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

- Retail loans to individuals: Mortgages 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 quotas.

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

30.9.2017	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	128	312,046	15	8,178	320,367
Real estate activities and construction	3,519	110,381	32	2,079	116,011
Fishing industry	1,083	8,200	51,461	9,626	70,370
Information and communication technology	30	1,100	-	544	1,674
Wholesale and retail trade	436	29,804	2	19,198	49,440
Financial and insurance activities	14,532	4,351	699	5,740	25,322
Industry, energy and manufacturing	2,511	16,124	-	5,514	24,149
Transportation	2	874	278	1,531	2,685
Services	83	7,034	86	3,052	10,255
Public sector	110	3,593	-	203	3,906
Agriculture and forestry	-	5,579	-	337	5,916
Financial instruments	5,886	-	-	-	5,886
Financial guarantees	1,326	3,123	1,512	3,196	9,157
Collateral held against different types of financial assets	29,646	502,209	54,085	59,198	645,138

Amounts are in ISK millions

38. Credit risk, continued

31.12.2016	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	481	297,974	5	7,419	305,879
Real estate activities and construction	581	106,770	34	1,444	108,829
Fishing industry	564	8,100	57,092	8,041	73,797
Information and communication technology	27	2,598	-	18,363	20,988
Wholesale and retail trade	410	26,570	8	19,988	46,976
Financial and insurance activities	14,826	7,620	-	807	23,253
Industry, energy and manufacturing	3,287	15,332	-	6,875	25,494
Transportation	73	892	278	3,622	4,865
Services	20	7,221	71	3,650	10,962
Public sector	7	3,811	-	179	3,997
Agriculture and forestry	5	5,128	-	327	5,460
Financial instruments	5,953	-	-	-	5,953
Financial guarantees	1,038	3,871	1,249	2,375	8,533
Collateral held against different types of financial assets	27,272	485,887	58,737	73,090	644,986

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 the end of the period amount to ISK 541 million (31.12.2016: ISK 1,817 million) and other assets ISK 1 million (31.12.2016: ISK 13 million). The assets are held for sale, see Note 28.

Credit quality

Credit quality by class of financial assets

30.9.2017	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	132,316	-	-	132,316
Loans to credit institutions	94,242	-	-	94,242
Loans to customers				
Loans to corporates	375,121	19,801	2,021	396,943
Loans to individuals	333,828	18,108	2,068	354,004
Financial instruments	75,336	-	-	75,336
Other assets with credit risk	9,863	-	-	9,863
Credit quality by class of financial assets	1,020,706	37,909	4,089	1,062,704

31.12.2016	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers				
Loans to corporates	358,709	14,251	2,046	375,006
Loans to individuals	312,259	21,854	3,303	337,416
Financial instruments	82,042	-	-	82,042
Other assets with credit risk	8,617	-	-	8,617
Credit quality by class of financial assets	929,377	36,105	5,349	970,831

Amounts are in ISK millions

38. 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 four 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 that has been found to be predictive. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. 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.

	Risk classification						
30.9.2017	1	2	3	4	5	Not rated	Total
Individuals	175,890	107,003	34,267	10,761	2,705	3,202	333,828
Real estate activities and construction	28,254	47,231	26,344	2,533	285	15,385	120,032
Fishing industry	39,982	21,651	3,758	911	728	9,315	76,345
Information and communication technology	17,746	1,146	5,856	48	-	1,622	26,418
Wholesale and retail trade	13,130	18,102	9,383	1,911	595	5,566	48,687
Financial and insurance activities	15,933	3,108	7,952	83	-	6,093	33,169
Industry, energy and manufacturing	17,575	5,716	3,711	616	168	428	28,214
Transportation	8,347	3,478	1,476	93	-	479	13,873
Services	2,303	5,785	5,131	518	2,405	2	16,144
Public sector	571	4,630	713	4	48	1,413	7,379
Agriculture and forestry	540	1,896	1,696	544	184	-	4,860
Neither past due nor impaired loans	320,271	219,746	100,287	18,022	7,118	43,505	708,949
31.12.2016							
Individuals	68,538	162,930	55,500	17,036	4,331	3,924	312,259
Real estate activities and construction	43,172	33,819	24,557	5,679	348	3,184	110,759
Fishing industry	24,480	36,143	9,700	2,579	604	79	73,585
Information and communication technology	18,372	3,207	966	5,476	-	12	28,033
Wholesale and retail trade	11,342	19,302	16,890	2,244	208	-	49,986
Financial and insurance activities	9,669	2,210	15,623	207	-	5,730	33,439
Industry, energy and manufacturing	7,908	7,854	10,101	719	635	351	27,568
Transportation	958	3,753	989	433	20	-	6,153
Services	2,303	5,312	7,263	847	28	3	15,756
Public sector	377	4,425	1,874	1,146	53	656	8,531
Agriculture and forestry	478	1,147	2,029	1,227	18	-	4,899
Neither past due nor impaired loans	187,597	280,102	145,492	37,593	6,245	13,939	670,968

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable. Unrated exposures on 30. September 2017 are elevated because during Q3 ratings often expire and are not renewed before end-of-quarter.

Amounts are in ISK millions

38. Credit risk, continued

Past due but not impaired loans by class of loans

30.9.2017	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	6,814	6,719	1,874	1,473	2,921	19,801
Loans to individuals	3,034	7,476	3,841	567	3,190	18,108
Past due but not impaired loans	9,848	14,195	5,715	2,040	6,111	37,909
31.12.2016						
Loans to corporates	5,388	4,282	1,589	1,211	1,781	14,251
Loans to individuals	3,196	8,708	4,989	391	4,570	21,854
Past due but not impaired loans	8,584	12,990	6,578	1,602	6,351	36,105

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.

	30.9.2017		31.12.2016	
Impaired loans to customers specified by sector	Impair-ment amount	Gross carrying amount	Impair-ment amount	Gross carrying amount
Individuals	4,686	6,754	7,069	10,372
Real estate activities and construction	571	942	770	1,056
Fishing industry	981	2,030	966	1,648
Information and communication technology	111	112	179	182
Wholesale and retail trade	555	790	540	868
Financial and insurance activities	313	314	261	298
Industry, energy and manufacturing	810	946	786	878
Transportation	-	-	4,301	4,307
Services	3,763	3,890	3,145	3,624
Public sector	59	59	89	113
Agriculture and forestry	165	266	175	284
Impaired loans to customers specified by sector	12,014	16,103	18,281	23,630

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and Rules No. 233/2017. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group has one large exposure of ISK 26 billion at the end of the period, before taking account of eligible credit risk mitigation (31.12.2016: no large exposure).

	30.9.2017		31.12.2016	
No.	Gross	Net	Gross	Net
1	12%	11%	<10%	<10%
Sum of large exposure gross and net > 10%	12%	11%	0%	0%

The sum of exposures exceeding 10% of the eligible capital is 12% for the Group, before eligible credit risk mitigation.

Amounts are in ISK millions

39. 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 market rates adversely affect net interest and fair value of interest-bearing instruments on the Balance Sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, 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.

The Group's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Group has applied cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common, and this especially applies to indexed mortgages issued between 2004 and 2006. The fixing profile of indexed mortgages is however matched by that of the Bank's structured covered bonds issues, which serves as a hedge against repricing risk. The Group has been able to manage relatively small interest fixing gaps.

In the past few years domestic rates, nominal and real, have fallen considerably. Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable. Prepayment risk is mitigated by prepayment fees and the Group’s own prepayment options. The Group's prepayment of structured covered bonds is a reaction to mortgage prepayments.

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 23, 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.

30.9.2017 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	124,147	-	-	-	-	124,147
Loans to credit institutions	94,242	-	-	-	-	94,242
Loans to customers	446,582	56,077	136,091	6,178	111,158	756,086
Financial instruments	28,445	8,094	4,154	5,569	1,913	48,175
Assets	693,416	64,171	140,245	11,747	113,071	1,022,650
Liabilities						
Due to credit institutions and Central Bank	7,097	-	-	-	-	7,097
Deposits	388,078	42,682	13,047	1,317	857	445,981
Borrowings	60,660	34,586	187,187	19,133	112,352	413,918
Liabilities	455,835	77,268	200,234	20,450	113,209	866,996
Derivatives and other off-balance sheet items (net position)	(126,391)	26,098	103,393	1,483	-	4,583
Net interest gap	111,190	13,001	43,404	(7,220)	(138)	160,237

Amounts are in ISK millions

39. Market risk, continued

31.12.2016 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	80,186	-	-	-	-	80,186
Loans to credit institutions	80,116	-	-	-	-	80,116
Loans to customers	382,928	63,694	138,540	4,457	127,601	717,220
Financial instruments	41,495	1,695	5,182	6,349	1,897	56,618
Assets	584,725	65,389	143,722	10,806	129,498	934,140
Liabilities						
Due to credit institutions and Central Bank	7,962	25	-	-	-	7,987
Deposits	376,424	21,111	12,450	1,263	816	412,064
Borrowings	62,830	8,653	126,836	20,670	129,423	348,412
Liabilities	447,216	29,789	139,286	21,933	130,239	768,463
Derivatives and other off-balance sheet items (net position)	(107,799)	(916)	111,083	(146)	-	2,222
Net interest gap	29,710	34,684	115,519	(11,273)	(741)	167,899

Interest rate risk in the trading book

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

	30.9.2017			31.12.2016		
Trading financial instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI index-linked	9,429	2.8	(2.7)	8,084	2.2	(1.8)
ISK, Non index-linked	15,801	0.5	(0.9)	10,992	1.0	(1.1)
FX	59,557	-	0.3	37,399	(0.5)	2.0
Total	84,787	0.4	(3.3)	56,475	0.2	(0.9)
Trading financial instruments, short positions						
ISK, CPI index-linked	530	3.8	(0.2)	518	4.7	(0.2)
ISK, Non index-linked	24,350	0.3	(0.7)	15,680	0.3	(0.4)
FX	49,413	(0.1)	0.7	29,847	(0.8)	2.4
Total	74,293	0.1	(0.2)	46,045	(0.4)	1.8

Amounts are in ISK millions

39. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). Index-linked loans and borrowings are typically annuitites, where the principal and monthly payments change in the same proportion as the CPI. The Group is exposed to indexation risk as indexed assets exceed indexed liabilities.

Transaction maturity profile of indexed assets and liabilities

30.9.2017 *Assets, CPI index-linked*	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	15,715	98,013	229,280	343,008
Financial instruments	8,114	-	-	8,114
Off-balance sheet position	4,050	3,148	-	7,198
Assets, CPI index-linked	27,879	101,161	229,280	358,320
Liabilities, CPI index-linked				
Deposits	66,872	12,504	2,139	81,515
Borrowings	18,191	20,840	111,077	150,108
Other	987	196	1,361	2,544
Off-balance sheet position	-	530	-	530
Liabilities, CPI index-linked	86,050	34,070	114,577	234,697
Net on-balance sheet position	(62,221)	64,473	114,703	116,955
Net off-balance sheet position	4,050	2,618	-	6,668
CPI Balance	(58,171)	67,091	114,703	123,623

31.12.2016 *Assets, CPI index-linked*	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	12,911	97,225	218,981	329,117
Financial instruments	7,100	-	-	7,100
Off-balance sheet position	851	6,619	-	7,470
Assets, CPI index-linked	20,862	103,844	218,981	343,687
Liabilities, CPI index-linked				
Deposits	69,621	12,121	2,050	83,792
Borrowings	2,253	24,437	114,747	141,437
Off-balance sheet position	-	518	-	518
Other	395	692	893	1,980
Liabilities, CPI indexed linked	72,269	37,768	117,690	227,727
Net on-balance sheet position	(52,258)	59,975	101,291	109,008
Net off-balance sheet position	851	6,101	-	6,952
CPI Balance	(51,407)	66,076	101,291	115,960

Amounts are in ISK millions

39. 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

30.9.2017

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	129,353	1,001	722	349	228	127	536	132,316
Loans to credit institutions	22,718	22,327	23,777	7,280	2,241	7,864	8,035	94,242
Loans to customers	614,359	91,215	29,730	3,333	7,195	733	4,382	750,947
Financial instruments	72,464	37,226	9,545	101	17	1,660	27	121,040
Other financial assets	8,152	445	296	828	117	8	17	9,863
Assets	847,046	152,214	64,070	11,891	9,798	10,392	12,997	1,108,408
Liabilities and equity								
Due to credit inst. and Central Bank ..	6,579	463	39	3	-	1	12	7,097
Deposits	398,867	22,055	17,212	3,264	1,655	1,416	1,512	445,981
Financial liabilities at fair value	2,380	700	298	67	45	57	4	3,551
Other financial liabilities	20,672	2,940	2,056	4,973	820	496	550	32,507
Borrowings	190,262	164,185	3,581	1,976	-	21,830	18,566	400,400
Liabilities and equity	618,760	190,343	23,186	10,283	2,520	23,800	20,644	889,536
Net on-balance sheet position	228,286	(38,129)	40,884	1,608	7,278	(13,408)	(7,647)	
Net off-balance sheet position	(7,626)	36,511	(39,181)	(1,897)	(9,991)	13,537	8,647	
Net position	220,660	(1,618)	1,703	(289)	(2,713)	129	1,000	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	6,903	-	-	-	-	-	-	6,903
Investments in associates	834	8	-	-	-	-	-	842
Intangible assets	8,517	-	-	1,400	2,838	-	-	12,755
Tax assets	286	-	-	-	-	-	-	286
Other non financial assets	15,339	84	32	167	25	10	1	15,658
Assets	31,879	92	32	1,567	2,863	10	1	36,444
Liabilities and equity								
Tax liabilities	9,303	-	-	-	-	-	-	9,303
Other non-financial assets	24,138	99	37	30	2	-	(2)	24,304
Shareholders' equity	221,535	-	-	-	-	-	-	221,535
Non-controlling interest	174	-	-	-	-	-	-	174
Liabilities and equity	255,150	99	37	30	2	-	(2)	255,316
Management reporting of currency risk*	(2,611)	(1,625)	1,698	1,248	148	139	1,003	

*The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

39. Market risk, continued

31.12.2016 *Assets*	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	85,052	775	627	364	197	108	511	87,634
Loans to credit institutions	18,946	16,963	17,444	8,522	1,826	10,064	6,351	80,116
Loans to customers	593,185	66,242	34,012	2,857	7,378	7	8,741	712,422
Financial instruments	91,566	13,403	9,572	311	244	2,245	115	117,456
Investment property	5,358	-	-	-	-	-	-	5,358
Investments in associates	831	8	-	-	-	-	-	839
Intangible assets	6,978	-	-	-	4,079	-	-	11,057
Tax assets	272	-	-	-	16	-	-	288
Other assets	19,356	650	556	142	135	13	2	20,854
Assets	821,544	98,041	62,211	12,196	13,875	12,437	15,720	1,036,024
Liabilities and equity								
Due to credit inst. and Central Bank	6,857	978	84	3	-	1	64	7,987
Deposits	377,195	15,762	12,038	4,186	844	1,301	738	412,064
Financial liabilities at fair value	3,020	408	272	-	-	16	10	3,726
Tax liabilities	7,075	-	-	-	218	-	-	7,293
Other liabilities	44,625	2,660	1,160	4,255	756	229	409	54,094
Borrowings	176,530	109,217	32,723	-	-	13,520	7,486	339,476
Shareholders' equity	211,212	-	-	-	-	-	-	211,212
Non-controlling interest	172	-	-	-	-	-	-	172
Liabilities and equity	826,686	129,025	46,277	8,444	1,818	15,067	8,707	1,036,024
Net on-balance sheet position	(5,142)	(30,984)	15,934	3,752	12,057	(2,630)	7,013	
Net off-balance sheet position	279	31,775	(15,315)	(3,232)	(8,579)	2,335	(7,263)	
Net position	(4,863)	791	619	520	3,478	(295)	(250)	

Amounts are in ISK millions

40. 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

30.9.2017 *Assets*	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	132,316	123,040	-	9,276	-	-	-
Loans to credit institutions	94,242	75,258	18,984	-	-	-	-
Loans to customers	750,947	14,536	44,081	96,726	252,991	342,613	-
Financial instruments	121,040	11,822	3,725	9,487	39,144	11,711	45,151
Derivatives - assets leg	*118,466*	-	*32,836*	*13,949*	*71,041*	*640*	-
Derivatives - liabilities leg	*(110,745)*	-	*(31,621)*	*(12,063)*	*(66,450)*	*(611)*	-
Investment property	6,903	-	-	-	-	-	6,903
Investments in associates	842	-	-	-	-	-	842
Intangible assets	12,755	-	-	-	-	-	12,755
Tax assets	286	-	-	-	286	-	-
Other assets	25,521	1,271	5,280	2,750	561	-	15,659
Assets	1,144,852	225,927	72,070	118,239	292,982	354,324	81,310
Liabilities							
Due to credit institutions and Central Bank	7,097	7,072	-	-	25	-	-
Deposits	445,981	314,549	75,468	40,149	13,553	2,262	-
Financial liabilities at fair value	3,551	-	1,997	337	1,076	141	-
Derivatives - assets leg	*(59,261)*	-	*(29,931)*	*(8,052)*	*(19,975)*	*(1,303)*	-
Derivatives - liabilities leg	*61,410*	-	*30,526*	*8,389*	*21,051*	*1,444*	-
Short position bonds and derivatives	*228*	-	*228*	-	-	-	-
Short position securities used for hedging	*1,174*	-	*1,174*	-	-	-	-
Tax liabilities	9,303	-	4,503	2,487	2,313	-	-
Other liabilities	56,811	24,529	6,329	3,001	3,906	-	19,046
Borrowings	400,400	-	12,720	38,644	220,158	128,878	-
Liabilities	923,143	346,150	101,017	84,618	241,031	131,281	19,046
On-balance sheet items	221,709	(120,223)	(28,947)	33,621	51,951	223,043	62,264
Off-balance sheet items							
Financial guarantees	13,417	2,744	2,141	5,738	1,763	1,031	-
Unused overdraft	47,093	1,512	9,451	18,230	17,900	-	-
Loan commitments	91,654	4	27,335	19,337	43,164	1,814	-
Off-balance sheet items	152,164	4,260	38,927	43,305	62,827	2,845	-
Net assets (liabilities)	69,545	(124,483)	(67,874)	(9,684)	(10,876)	220,198	62,264

Amounts are in ISK millions

40. Liquidity and Funding risk, continued

31.12.2016 *Assets*	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	87,634	78,302	-	9,332	-	-	-
Loans to credit institutions	80,116	54,104	26,012	-	-	-	-
Loans to customers	712,422	9,051	54,203	79,205	253,938	316,025	-
Financial instruments	117,456	12,715	2,100	3,670	51,729	11,828	35,414
Derivatives - assets leg	*75,527*	-	*28,038*	*19,179*	*27,825*	*485*	-
Derivatives - liabilities leg	*(70,368)*	-	*(27,300)*	*(17,927)*	*(24,886)*	*(255)*	-
Investment property	5,358	-	-	-	-	-	5,358
Investments in associates	839	-	-	-	-	-	839
Intangible assets	11,057	-	-	-	-	-	11,057
Tax assets	288	-	-	-	288	-	-
Other assets	20,854	2,687	3,883	1,303	745	-	12,236
Assets	1,036,024	156,859	86,198	93,510	306,700	327,853	64,904
Liabilities							
Due to credit institutions and Central Bank	7,987	7,636	-	326	25	-	-
Deposits	412,064	288,390	74,202	37,769	10,088	1,615	-
Financial liabilities at fair value	3,726	-	2,400	127	895	304	-
Derivatives - assets leg	*(57,923)*	-	*(13,857)*	*(3,960)*	*(39,388)*	*(718)*	-
Derivatives - liabilities leg	*59,765*	-	*14,373*	*4,087*	*40,283*	*1,022*	-
Short position bonds used for hedging	*1,884*	-	*1,884*	-	-	-	-
Tax liabilities	7,293	-	-	6,626	667	-	-
Other liabilities	54,094	21,837	7,414	3,446	3,660	6	17,731
Borrowings	339,476	-	10,293	13,371	153,607	162,205	-
Liabilities	824,640	317,863	94,309	61,665	168,942	164,130	17,731
On-balance sheet items	211,384	(161,004)	(8,111)	31,845	137,758	163,723	47,173
Off-balance sheet items							
Financial guarantees	15,270	2,893	4,032	4,136	2,538	1,671	-
Unused overdraft	46,379	1,460	9,098	18,305	17,516	-	-
Loan commitments	82,268	1,348	38,757	17,075	21,088	4,000	-
Off-balance sheet items	143,917	5,701	51,887	39,516	41,142	5,671	-
Net assets (liabilities)	67,467	(166,705)	(59,998)	(7,671)	96,616	158,052	47,173

Amounts are in ISK millions

40. 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. The NSFR for foreign currency 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.

30.9.2017	ISK	FX	Total
Available stable funding	646,137	203,786	849,923
Required stable funding	576,757	111,194	687,951
FX imbalance		(377)	
Net stable funding ratio	112%	183%	124%

31.12.2016			
Available stable funding	612,964	169,821	782,785
Required stable funding	544,854	87,010	631,864
FX imbalance		(4,019)	
Net stable funding ratio	113%	191%	124%

Amounts are in ISK millions

40. 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.

On 31 March 2017, new liquidity rules no. 266/2017 took effect. The rules are issued by the Central Bank of Iceland and effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR), replacing the previous LCR rules no. 1031/2014. The Bank is required to maintain a 100% minimum LCR ratio for both foreign currencies and all currencies.

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. The figures at 30 September 2017 are based on rules no. 266/2017 while the figures at 31 December 2016 are based on rules no. 1031/2014.

30.9.2017	ISK	FX	Total
Liquid assets level 1 *	135,499	23,507	159,006
Liquid assets level 2	-	-	-
Liquid Assets	135,499	23,507	159,006
Deposits	90,717	22,482	113,199
Market Borrowing	19,216	3,369	22,585
Other Cash outflows	6,637	6,688	13,325
Cash outflows	116,570	32,539	149,109
Short-term deposits with other banks ***	2,344	62,688	65,032
Other Cash inflows	11,185	3,343	14,528
Cash inflows	13,529	66,031	79,560
Liquidity coverage ratio (LCR) ******	132%	289%	229%

31.12.2016	ISK	FX	Total
Liquid assets level 1 *	112,770	13,026	125,796
Liquid assets level 2 **	-	2,932	2,932
Liquid Assets	112,770	15,958	128,728
Deposits	93,584	16,885	110,469
Market Borrowing	3,192	371	3,563
Other Cash outflows	12,426	7,013	19,439
Cash outflows	109,202	24,269	133,471
Short-term deposits with other banks ***	1,688	51,779	53,467
Other Cash inflows	3,843	1,011	4,854
Cash inflows	5,531	52,790	58,321
Liquidity coverage ratio (LCR) ******	109%	263%	171%

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules no. 266/2017 the Group's covered bonds also classify as Level 1 assets and receive 93% weight.

** 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 = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

Amounts are in ISK millions

40. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Group's liquidity buffer.

30.9.2017	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	129,353	722	1,001	1,240	132,316
Short-term deposits in other banks	2,344	21,234	22,919	18,535	65,032
Domestic bonds eligible as collateral at the Central Bank	15,422	-	-	-	15,422
Foreign government bonds	-	4,426	13,431	-	17,857
Covered bonds with a minimum rating of AA-	-	-	1,269	1,620	2,889
Liquidity reserve	147,119	26,382	38,620	21,395	233,516

31.12.2016	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	85,053	627	775	1,179	87,634
Short-term deposits in other banks	1,688	16,018	14,090	21,671	53,467
Domestic bonds eligible as collateral at the Central Bank	27,718	-	-	-	27,718
Foreign government bonds	-	5,536	4,908	-	10,444
Covered bonds with a minimum rating of AA-	-	-	1,202	2,247	3,449
Liquidity reserve	114,459	22,181	20,975	25,097	182,712

Amounts are in ISK millions

40. 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 combined in a single line item. 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					
30.9.2017	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	156,443	11%	50,001	5%	68,508	274,952
Corporations	51,478	40%	841	20%	9,061	61,380
Sovereigns, central banks and PSE	17,511	40%	-	-	1,924	19,435
Pension funds	38,889	100%	-	-	16,118	55,007
Domestic financial entities	20,647	100%	-	-	19,230	39,877
Foreign financial entities	2,427	100%	-	-	-	2,427
Total	287,395		50,842		114,841	453,078
31.12.2016						
Retail	137,055	10%	44,331	5%	63,106	244,492
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central banks and PSE	11,653	40%	-	-	1,379	13,032
Pension funds	31,157	100%	-	-	15,959	47,116
Domestic financial entities	24,310	100%	-	-	16,730	41,040
Foreign financial entities	2,150	100%	-	-	-	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	265,885		48,528		105,312	419,725

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

Amounts are in ISK millions

42. Capital management

Capital ratio

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

Capital Base	30.9.2017	31.12.2016
Total equity	221,709	211,384
Non-controlling interest not eligible for inclusion in CET1 capital	(174)	(172)
Intangible assets	(12,755)	(11,057)
Tax assets	(286)	(288)
Cash flow hedges	(552)	(22)
Additional value adjustments	(132)	(127)
Common equity Tier 1 capital	207,810	199,718
Non-controlling interest not eligible for inclusion in CET1 capital	174	172
Tier 1 capital	207,984	199,890
General credit risk adjustments	3,950	4,557
Tier 2 capital	3,950	4,557
Total capital base	211,934	204,447

Risk-weighted assets		
Credit risk, loans	609,559	577,661
Credit risk, securities and other	65,359	62,524
Counterparty credit risk	6,268	5,550
Market risk due to currency imbalance	4,250	5,449
Market risk other	8,237	12,966
Credit valuation adjustment	2,583	2,678
Operational risk	86,490	86,490
Total risk-weighted assets	782,746	753,318

Capital ratios		
CET1 ratio	26.6%	26.5%
Tier 1 ratio	26.6%	26.5%
Capital adequacy ratio	27.1%	27.1%
CET1 ratio, based on reviewed retained earnings at 30 June	26.6%	
Tier 1 ratio, based on reviewed retained earnings at 30 June	26.6%	
Capital adequacy ratio, based on reviewed retained earnings at 30 June	27.1%	

Amounts are in ISK millions

42. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement, % of RWA	1.1.2017	1.3.2017	1.11.2017
Capital conservation buffer	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%	3.00%
Countercyclical capital buffer *	-	1.00%	1.25%
Combined capital buffer requirement	7.50%	8.50%	8.75%

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance with its risk profile. The 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.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET1 capital.

Total capital requirement, % of RWA	Current	Fully implemented 1.11.2017
Pillar 1 capital requirement	8.0%	8.0%
Pillar 2R capital requirement **	3.7%	3.7%
Combined buffer requirement	8.2%	8.4%
Total regulatory capital requirement	19.9%	20.1%
Available capital	27.1%	27.1%
CET1 requirement, % of RWA		
Pillar 1 CET1 requirement	4.5%	4.5%
Pillar 2R CET1 requirement **	2.1%	2.1%
Combined buffer requirement	8.2%	8.4%
CET1 regulatory capital requirement	14.8%	15.0%
Available CET1 capital	26.6%	26.6%

*The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

** The SREP result based on the Group's financial statement of 31.12.2016.

Amounts are in ISK millions

42. Capital management, continued

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	30.9.2017	31.12.2016
On-balance sheet exposures	1,114,525	1,011,735
Derivative exposures	12,802	8,226
Securities financing transaction exposures	10,987	9,330
Off-balance sheet exposures	97,323	83,156
Total exposure	1,235,637	1,112,447
Tier 1 capital	207,984	199,890
Leverage ratio	16.8%	18.0%

Solvency II

At the end of the year 2016 the Bank held the insurance companies Vörður tryggingar and Okkar líftryggingar. On 1 January 2017 Vörður tryggingar acquired the entire shareholding in Okkar líftryggingar and following the acquisition Vörður tryggingar merged its two life insurance subsidiaries. The solvency capital requirements as well as calculated solvency for Vörður Group is not available for 31 December 2016.

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vörður Group was 2,923 million at 30 September 2017 (31.12.2016: Vörður tryggingar ISK 2,489 million and Okkar líftryggingar ISK 574 million) and calculated solvency of Vörður Group was ISK 5,788 million at 30 September 2017 (31.12.2016: Vörður tryggingar ISK 3,609 million and Okkar líftryggingar ISK 1,236 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements, of Vörður Group was 198.0% at 30 September 2017 (31.12.2016: Vörður tryggingar 145.0% and Okkar líftryggingar 215,0%).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim 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 ended 31 December 2016.

Hedge accounting

During the first quarter of 2017, the Group started applying fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 8, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

45. Going concern assumption

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