# **Consolidated**
# Financial Statements

For the year 2017

Arion Bank

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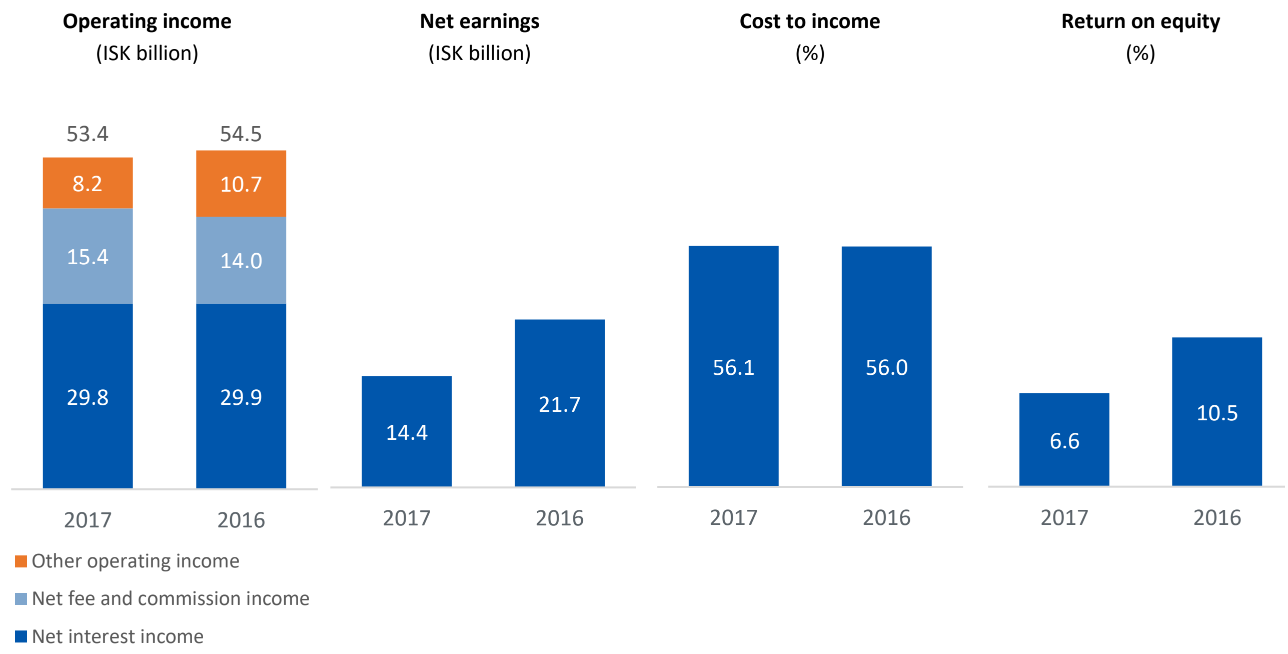
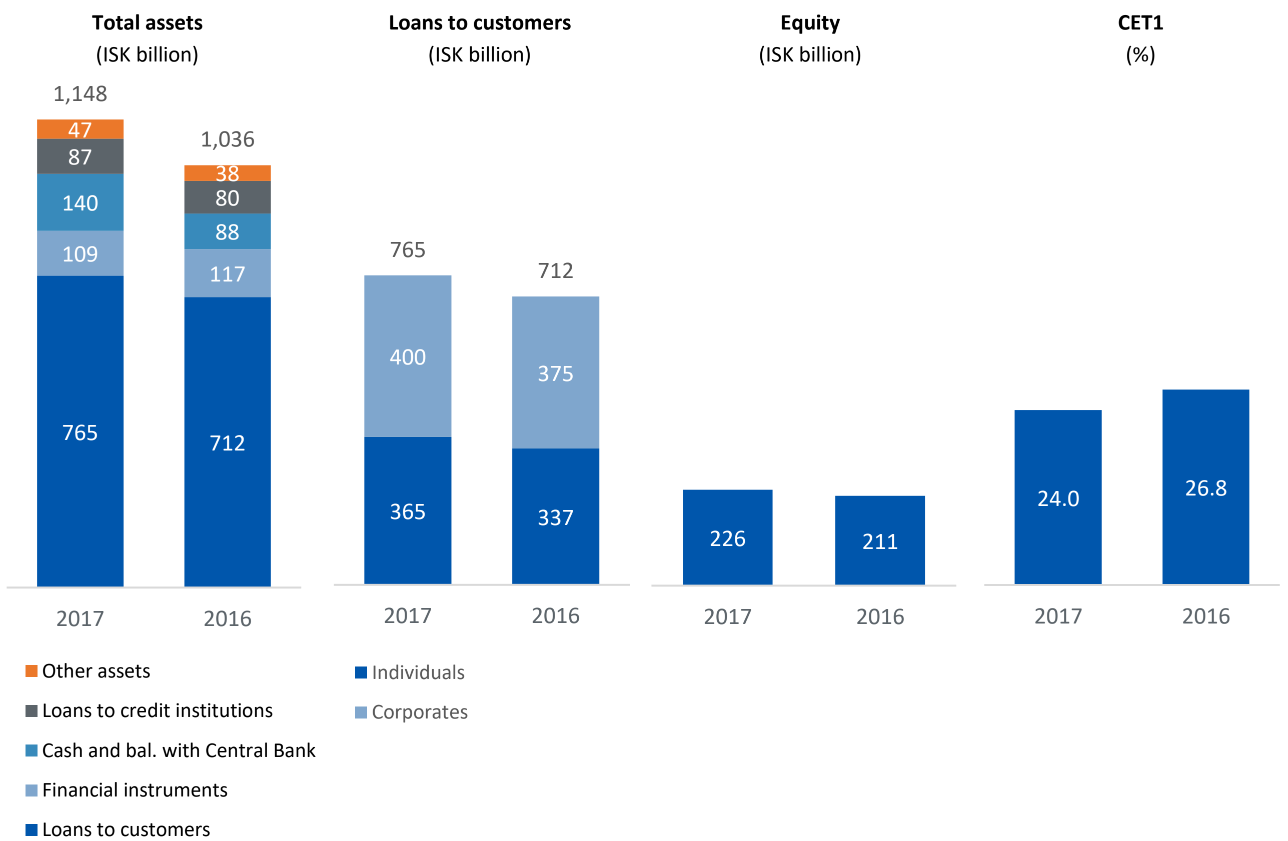
# Key figures

## Consolidated Statement of Comprehensive Income




## Consolidated Statement of Financial Position



# Endorsement and statement
## by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the period from 1 January to 31 December 2017 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

**Outlook**

Icelandic economy is doing well and GDP grew by 4.3% in the first nine months of 2017, fueled by soaring private consumption, and to a lesser extent, continued investment growth. In recent months signs have been emerging suggesting that the economy is reaching an equilibrium following a period of exceptional growth. A turning point was reached last year as housing investment took up the baton from business investment as the main driving force behind investment growth, while public investment also picked up steam. However, there was a substantial slow-down in both investment and export growth. It appears that tourism has passed its peak growth, at least for the time being, with more moderate growth on the horizon. Inflation remains below the Central Bank's inflation target, although inflationary pressure is picking up. Despite a slight depreciation last summer following the removal of nearly all capital controls, the króna has remained strong and fluctuations have somewhat decreased. The economic outlook is favorable and Arion Research predicts continued GDP growth, low unemployment but rising inflation as the year goes by, albeit still remaining within the Central Bank’s tolerance level.

**About Arion Bank**

Arion Bank is a leading, well balanced universal relationship bank operating on the Icelandic financial market. The Bank has a moderate risk profile and enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's subsidiaries further supplement its service offering. The largest subsidiaries are Valitor, Stefnir and Vördur tryggingar. Valitor is a market leader in Iceland in acquiring services and payment solutions and also has operations in Scandinavia and the United Kingdom. Stefnir is Iceland's largest fund management company and Vördur tryggingar is the fourth largest insurance company in Iceland and provides both non-life and life insurance services.

Arion Bank places great importance on innovation and efficiency in its operations. A key area of focus for many years has been developing online banking, and in recent years mobile banking has been a priority. The Bank has also set itself the goal of being the leading digital bank in Iceland and has become a market leader in digital solutions. Over the last two years the Bank has launched 15 digital solutions, particularly targeted at retail customers. These solutions have had a profound impact on the Bank's market position, for example in the mortgage market, where the Bank is in fierce competition with the pension funds which enjoy a far more beneficial regulatory and taxation environment. Arion Bank has been able to maintain and even increase its market share by competing on services and dealing swiftly with customer requests. New digital solutions have therefore already had, and will continue to have, a lasting impact on how the Bank meets the needs of its customers. The new solutions will furthermore reduce operating expenses across the Bank in the long term. The number of branches has been substantially reduced in recent years and the Bank will continue to seek ways to bring greater efficiency to the branch network.

Arion Bank will keep on offering 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 is financially robust which enables it to grow alongside its customers and to pay competitive dividends to its owners.

**Operations during the year**

Net earnings amounted to ISK 14,419 million for 2017, and the total equity amounted to ISK 225,734 million at the end of the year. Return on equity was 6.6% for the year. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 24.0% and the corresponding CET 1 ratio was 23.6%, when taking into account the foreseeable dividend payment and purchase of own shares in the coming weeks. This comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at year-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 52,185 million, or 59.5%, during the year. Loans to customers increased by ISK 52,679 million or 7.4%, deposits increased by ISK 50,097 million or 12.2% and borrowings grew by ISK 45,522 million or 13.4% during the year. The main reasons for the increase in cash are higher deposits in Retail Banking in 2017 and new borrowings, as well as the fact that no dividend has been paid for two years. New lending is mainly in the form of mortgages to retail customers and loans to corporates in the real estate and transportation sectors.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position in United Kingdom.

The Group had 1,284 full-time equivalent positions at the end of the year, compared with 1,239 at the end of 2016; 844 of these positions were at Arion Bank, compared with 869 at the end of 2016. The increase between years is mainly due to the acquisition of active companies within the Valitor group and the company's increased activities internationally. The decrease at the parent company can be attributed to the outsourcing of IT systems and streamlining measures taken in implementing the Bank's digital strategy.

# Endorsement and statement
## by the Board of Directors and the CEO

The tax environment did not change for Arion Bank during the year even though taxes paid by the main Icelandic banks are much higher than those paid by other companies. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion.

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**

Sameinad 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., exacerbated the problem.

United Silicon 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 were 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 monitored this analysis and in its assessment assumed that the plant would continue to operate, following additional investment. In light of this information, the Bank believed that the basis for running the plants operation was viable. However, in January 2018 it became clear that the Icelandic Environmental Agency did not agree with the remedial action proposed by the company following the aforesaid evaluation. The Agency found that further remedial action would need to be undertaken, some of which was likely to require an additional environmental impact study which, in turn, was likely to postpone the recommissioning of the plant by 18-20 months. Against this backdrop and without funds to sustain operations for this period, the board of directors of United Silicon declared the company bankrupt on 22 January 2018.

Arion Bank is United Silicon's primary lender and expects to enjoy a first lien position against all the operational assets of the company. As such the Bank will demand the transfer of these assets and accompanying rights to a newly established subsidiary of the Bank, Eignabjarg, established for this purpose. This transfer is expected to be effected in the first quarter of 2018. The Bank intends to either find buyers for this new subsidiary in its current form or proceed with the necessary remedial action and divest the plant thereafter. At year-end 2017, the Bank's holding in United Silicon was classified as a disposal group held for sale in accordance with IFRS, as reflected in Note 28.

In the Bank's view the work undertaken during United Silicon's moratorium dispelled some of the uncertainty regarding the operational status of its business and considerably simplified the recovery and divestment process ahead. On that basis, no further impairments against United Silicon's assets were made at the end of 2017. The book value of United Silicon's assets at year-end was ISK 5.4 billion and loan commitment and guarantees are an additional ISK 0.9 million.

**Funding and liquidity**

The Bank's liquidity position is strong, with a liquidity coverage ratio of 221%, see Note 42, well above the regulatory minimum of 100%. The strong liquidity position is partly due to pre-financing of upcoming maturities of bonds and planned dividend payments.

Deposits, which are the core of the Bank's funding, increased by ISK 50 billion or 12.2% during the year, mainly due to an increase in retail deposits. Long-standing economic growth and the increase in purchasing power of our customers is having a positive effect on deposit development.

At the beginning of 2017 Arion Bank tapped its outstanding five-year senior unsecured EUR 300 million (ISK 36 billion) bond originally issued in late 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. In June 2017, 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 year Arion Bank has issued EMTN private placements in NOK and SEK for an equivalent of ISK 19.6 billion, issued a total of ISK 29.9 billion of covered bonds and issued commercial paper amounting to ISK 20 billion.

# Endorsement and statement
## by the Board of Directors and the CEO

**Capital and dividend**

Arion Bank is financially robust, as reflected in its leverage ratio of 15.4%, see Note 43. Return on equity was 6.6% during the year. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 24.0% and the corresponding Tier 1 ratio was 23.6%. The decrease from the previous year is due to the decision taken at a shareholders' meeting on 12 February on a proposed dividend of ISK 25 billion, based on profit generated prior to 2017, to be paid over the next few weeks. The reason the Bank's capital position is so strong is that Kaupthing, the majority shareholder, has, until now, not wished to be paid a divided because of its agreement with the government. The Bank aims to reduce its CET 1 ratio to 17% over the next few years through further dividend payments or buying its own shares. The Bank will remain financially robust, both in terms of the requirements of regulators and by international standards. The debt ratio is expected to be at least 10% after the above reduction of CET 1.

The Board of Directors proposes that net earnings be added to equity and that no dividend be paid in 2018 for the fiscal year 2017, for now. The Board of Directors has the authority to propose that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting, prior to Annual general meeting in 2019, to propose a payment.

**Group ownership**

Kaupthing ehf. has a controlling share in Arion Bank hf through its subsidiary Kaupskil ehf. At the end of 2017 Kaupskil held 57.41% of share capital. Kaupskil ehf. also controls the 9.99% shareholding of Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. and 6.58% shareholding of Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group. Other shareholders are Attestor Capital LLP through Trinity Investment Designated Activity Company, which holds 10.44%, and Goldman Sachs International through ELQ Investors II Ltd, which holds holds 2.57%. Icelandic State Financial Investments holds 13.00% on behalf of the Icelandic government. On 14 February 2018 changes among the shareholders of the Bank were announced, see further information in Note 38.

The Board of Directors has eight members, four women and four men. Furthermore, three Alternate 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 the law which states that companies with more than 50 employees should ensure that the ratio of either gender on the Board of Directors should not be less than 40%. Six Directors are nominated by Kaupskil ehf., one by Attestor Capital LLP and one by 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. On 30 November Steinunn K. Thórdardóttir was elected as a new Director to the Board of Arion Bank replacing Gudrún Johnsen, who stepped down from the Board of Directors.

**Risk management**

The Group faces various risks arising from its day-to-day operations as a financial institution. 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 is the ability to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 40.

**Corporate governance**

The Board of Directors of Arion Bank is committed to good corporate governance and endeavours to promote responsible behavior and corporate culture within Arion Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. In December 2015 Arion Bank was recognized as a company which had achieved excellence in corporate governance. The recognition applies for three years unless significant changes are made to the Bank’s management or ownership.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders’ meetings. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are four Board subcommittees: the Board Audit Committee, the Board Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is one expert member on the Board Audit and Risk Committee.

# Endorsement and statement
## by the Board of Directors and the CEO

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The role of Compliance is to apply effective precautionary measures to ensure that Arion Bank complies at all times with the law, regulations and good business practices, and to foster an affirmative corporate culture in this respect.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the Financial Statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on legislation, regulations and recognized guidelines in force when the Bank's annual financial statements are adopted by Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with a few exceptions, which are explained in more detail in the Corporate Governance Statement.

**Sustainability**

Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. The employees are guided by the Bank's cornerstones: we make a difference, we say what we mean and we get things done. The Bank's code of ethics also serves as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Arion Bank has played an important role in the regeneration of the Icelandic economy, not least in the rebuilding of the Icelandic stock market. The Bank has played an active role in more than 60% of stock offerings in recent years, including all offerings since 2015. The Bank is dedicated to supporting the Icelandic business sector and with this aim in mind has actively supported innovation and it has helped to set up two business accelerators, Startup Reykjavík and Startup Energy Reykjavík, where entrepreneurs are given the opportunity to develop their business ideas. Startup Reykjavík is fully owned by Arion Bank, while Startup Energy Reykjavík is a joint project with several leading players on the Icelandic energy market. During the year Arion Bank invested in 9 startups which participated in the business accelerators and it has now invested in more than 80 such companies in the last few years. The Bank has also invested more than ISK 1 billion in the venture capital fund Eyrir Sprotar and supported innovation at primary and secondary level schools across Iceland.

Lean management has been introduced across the Bank with the aim of improving service and eliminating waste. Constant improvements are integral to the Bank's culture. Improvements are recorded, targets set and then followed up on. During the year an average of 7.5 improvements were made per employee. In keeping with lean management there has been a strong focus on increasing digital services and 10 new digital solutions for customers were introduced during the year. The principal objective of the Bank's digital solutions is to make things easier for the customer and to make banking more convenient. Digital solutions lessen the ecological footprint of the Bank and its customers by reducing the number of trips made by customers to branches and cutting back on the use of paper. The Bank also places great importance on being able to provide first-class advice at its branches and its employees also provide financial guidance to customers in order to help them gain a better understanding of their own finances.

Since the Bank was founded one its key objectives has been to run an efficient and profitable business and to safeguard the Bank's financial strength by meeting all capital and liquidity requirements. Internal control has been systematically reinforced and at the end of 2017 around 44 people worked in this area. Arion Bank has been recognized for good corporate governance. Arion Bank has been awarded Equal Pay Certification by the labour union VR and has implemented a quality system which aims to eliminate the gender pay gap.

In 2017 the Bank continued to implement its policy on sustainability, which was approved by the Board of Directors in late 2016 and presented to employees. Workshops were held during the year with employees to discuss the new sustainability policy and what employees could do in their day-to-day work to make the Bank an even more socially responsible business. The Bank also worked on devising a formal policy on responsible investments which will be implemented in the Bank's investment and lending processes. This work will continue in 2018. During the year the Bank became a signatory to the United Nations Principles on Responsible Investment.

In 2015 Arion Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and in in 2016 in collaboration with an Icelandic innovation company, Klappir Green Solutions, the Bank assessed its ecological footprint and set itself a target on how to reduce it. The Bank continued to work on these issues in 2017 and the 2017 annual report will again contain a detailed report on social responsibility and sustainability at the Bank. The report takes into account non-financial information highlighted by Nasdaq Iceland, the UN's global objectives and the 10 principles in the UN Global Compact in which Arion Bank became a participant in 2016. Arion Bank's 2017 annual report will provide more in-depth coverage of environmental, social and HR issues at the Bank as stipulated in Article 66 d of the Annual Accounts Act, and the risk report will as usual deal with the main risks connected with the Bank's operations.

# Endorsement and statement
## by the Board of Directors and the CEO

**Endorsement of the Board of Directors and the Chief Executive Officer**

The Financial Statements of Arion Bank for the year ended 31 December 2017 have been prepared in accordance with International Financial Reporting Standards 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 Financial Statements give a true and fair view of the financial performance of the Group for the year 2017 and its financial position as at 31 December 2017.

Furthermore, in our opinion the 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 Financial Statements of Arion Bank for the year 2017 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 14 February 2018

**Board of Directors**

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Jakob Már Ásmundsson

John P. Madden

Kirstín Th. Flygenring

Måns Höglund

Steinunn K. Thórdardóttir

Thóra Hallgrímsdóttir

**Chief Executive Officer**

Höskuldur H. Ólafsson

# Independent Auditor's report

To the Board of Directors and Shareholders of Arion Bank hf.

**Opinion**

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2017 which comprise the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2017, its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

**Basis for Opinion**

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of Arion Bank hf. in accordance with the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code) and the Icelandic Institute of State Authorized Public Accountants (FLE), Code of Ethics and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Key Audit Matters**

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Consolidated Financial Statements of the current period. These matters were addressed in the context of our audit of the Consolidated Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

| ***Key Audit Matters*** | ***How the matter was addressed in the audit*** |
|---|---|
| *Loan valuation and loss provisioning* | |
| Loans to customers is the largest class of asset on the Consolidated Statement of Financial Position. The management of the Bank exercise significant judgement when determining both when and how much to record as loan impairment provisions. Because of the significance of these judgements and the size of loans to customers, the audit of loan impairment provisions is a key audit matter.<br><br>The basis of the provisions is summarized in the accounting policies in note 54 ans 56 to the Consolidated Financial Statements. | We have examined loan valuation policies, tested the relevant controls over the impairment process and assessed the technique management uses to estimate incurred but not reported losses. This includes testing of controls the Bank has in place for capturing loans that needs to be reviewed for impairment and their forbearance strategy.<br><br>We selected a sample, of loans from the full population, both performing and non-performing loans. For selected sample we have challenged the appropriateness of management's key processes and assumptions used in the calculations of impairment for loans and advances and assessed whether the provisions are in accordance with IFRS. This included the impaired accounts and valuation of underlying collateral. |
| *Revenue recognition* | |
| Interest income and fee and commission income are key elements to the core business of the Bank. Those are the largest items of the Statement of Comprehensive Income.<br><br>Both revenue sources are subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income and fee and commission income as key audit matter.<br><br>The basis for revenue recognition and accounting policies are presented in note 49 to 50 the Consolidated Financial Statements. | We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income and fee and commission income. We have tested the appropriateness of the interest calculation in accordance with IAS 39.<br><br>We tested interest income by select sample of loans and compare the underlying data to the loans system. We also tested the interest income and fee income using analytical procedures.<br><br>We selected sample of loans to ensure that interest is being accrued correctly. |

| ***Key Audit Matters*** | ***How the matter was addressed in the audit*** |
|---|---|
| *IT controls* | |
| Arion Bank is significantly dependent on their IT-systems to, serve customers, support their business processes, ensure complete and accurate processing of financial transactions and support the overall internal control framework. Many of the Bank's internal controls over financial reporting are depending upon automated application controls and completeness and integrity of reports generated by the IT-systems. Given the high dependency on technology, we consider this a key audit matter for our audit. | We have reviewed the policies and processes related to IT applications. We have tested relevant controls related to change management, access rights and IT operation of material IT systems related to financial reporting.<br><br>A large majority of controls were operating effectively and did not require further action. For the remaining few, we performed additional testing in order to determine whether we could place reliance on the completeness and accuracy of system generated information. |

**Other information**

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Financial Statements, 5-year overview, key figures, unaudited quarterly statements in note number 5 and Endorsement and statements by the Board of Directors and the CEO.

Our opinion on the Consolidated Financial Statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except the confirmation regarding the Endorsement and statements by the Board of Directors and the CEO as stated below.

In connection with our audit of the Consolidated Financial Statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Consolidated Financial Statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information; we are required to report that fact. We have nothing to report in this regard.

In accordance with Paragraph 2 article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying the Endorsement and the statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statement Act that is not disclosed elsewhere in the Consolidated Financial Statements.

**Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements**

The Board of Directors and the CEO are responsible for the preparation and fair presentation of the Consolidated Financial Statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and the CEO determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Consolidated Financial Statements, the Board of Directors and the CEO are responsible for assessing Arion Bank hf.'s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so.

**Auditor's Responsibilities for the Audit of the Consolidated Financial Statements**

Our objectives are to obtain reasonable assurance about whether the Consolidated Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

# Independent Auditor's report

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Banks hf.'s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the Consolidated and Separate Financial Statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Board of Directors and the Board Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Board of Directors and the Board Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Board of Directors and the Board Audit committee, we determine those matters that were of most significance in the audit of the Consolidated Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Kópavogur, 14 February 2018

**Deloitte ehf.**

Páll Grétar Steingrímsson
State Authorized Public Accountant

Gunnar Thorvardarson
State Authorized Public Accountant

# Consolidated Statement of Comprehensive Income
## for the year 2017

| Income Statement | Notes | 2017 | 2016 |
|---|---|---|---|
| Interest income | | 57,089 | 61,655 |
| Interest expense | | (27,254) | (31,755) |
| **Net interest income** | 6 | 29,835 | 29,900 |
| Fee and commission income | | 29,777 | 23,887 |
| Fee and commission expense | | (14,420) | (9,909) |
| **Net fee and commission income** | 7 | 15,357 | 13,978 |
| Net financial income | 8 | 4,091 | 5,162 |
| Net insurance income | 9 | 2,093 | 1,395 |
| Share of profit of associates and net impairment | 25 | (925) | 908 |
| Other operating income | 10 | 2,927 | 3,203 |
| **Operating income** | | 53,378 | 54,546 |
| Salaries and related expense | 11 | (17,189) | (16,659) |
| Other operating expense | 12 | (12,772) | (13,881) |
| Bank levy | 13 | (3,172) | (2,872) |
| Net impairment | 14 | 186 | 7,236 |
| **Earnings before tax** | | 20,431 | 28,370 |
| Income tax expense | 15 | (5,806) | (6,631) |
| **Net earnings from continuing operations** | | 14,625 | 21,739 |
| Discontinued operations, net of tax | 16 | (206) | - |
| **Net earnings** | | 14,419 | 21,739 |
| ***Attributable to*** | | | |
| Shareholders of Arion Bank | | 14,400 | 21,147 |
| Non-controlling interest | 25 | 19 | 592 |
| **Net earnings** | | 14,419 | 21,739 |
| **Earnings per share from continuing operations** | | | |
| Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) | 17 | 7.30 | 10.57 |

### Other Comprehensive Income

| | | | |
|---|---|---|---|
| **Net earnings** | | 14,419 | 21,739 |
| Net gain on AFS financial assets, net of tax | | - | (2,903) |
| Exchange difference on translating foreign subsidiaries | 33 | (5) | 182 |
| **Net other comprehensive income to be reclassified to profit or loss in subsequent periods** | | (5) | (2,721) |
| **Total comprehensive income** | | 14,414 | 19,018 |
| ***Attributable to*** | | | |
| Shareholders of Arion Bank | | 14,395 | 18,426 |
| Non-controlling interest | | 19 | 592 |
| **Total comprehensive income** | | 14,414 | 19,018 |

Comparative figures have been changed, see Note 1.

*The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.*

*Arion Bank Consolidated Financial Statements 2017* 12 *Amounts are in ISK millions*

# Consolidated Statement of Financial Position
## as at 31 December 2017

| Assets | Notes | 2017 | 2016 |
|---|---|---|---|
| Cash and balances with Central Bank | 18 | 139,819 | 87,634 |
| Loans to credit institutions | 19 | 86,609 | 80,116 |
| Loans to customers | 20 | 765,101 | 712,422 |
| Financial instruments | 21-23 | 109,450 | 117,456 |
| Investment property | 23 | 6,613 | 5,358 |
| Investments in associates | 25 | 760 | 839 |
| Intangible assets | 26 | 13,848 | 11,057 |
| Tax assets | 27 | 450 | 288 |
| Non-current assets and disposal groups held for sale | 28 | 8,138 | 4,418 |
| Other assets | 29 | 16,966 | 16,436 |
| **Total Assets** | | 1,147,754 | 1,036,024 |
| **Liabilities** | | | |
| Due to credit institutions and Central Bank | 22 | 7,370 | 7,987 |
| Deposits | 22 | 462,161 | 412,064 |
| Financial liabilities at fair value | 22 | 3,601 | 3,726 |
| Tax liabilities | 27 | 6,828 | 7,293 |
| Other liabilities | 30 | 57,062 | 54,094 |
| Borrowings | 22, 31 | 384,998 | 339,476 |
| **Total Liabilities** | | 922,020 | 824,640 |
| **Equity** | | | |
| Share capital and share premium | 33 | 75,861 | 75,861 |
| Other reserves | 33 | 16,774 | 19,761 |
| Retained earnings | | 132,971 | 115,590 |
| **Total Shareholders' Equity** | | 225,606 | 211,212 |
| Non-controlling interest | | 128 | 172 |
| **Total Equity** | | 225,734 | 211,384 |
| **Total Liabilities and Equity** | | 1,147,754 | 1,036,024 |

*The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.*

*Arion Bank Consolidated Financial Statements 2017* 13 *Amounts are in ISK millions*

# Consolidated Statement of Changes in Equity
## for the year 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 | - | - | 14,400 | 14,400 | 19 | 14,419 |
| Translation difference | - | (5) | - | (5) | - | (5) |
| **Total comprehensive income** | - | (5) | 14,400 | 14,395 | 19 | 14,414 |
| Reserve for investments in subsidiaries | - | (3,001) | 3,001 | - | - | - |
| Reserve for investments in associates | - | 16 | (16) | - | - | - |
| Reserve for investments in securities | - | 4 | (4) | - | - | - |
| Dividend to non-controlling interest | - | - | - | - | (63) | (63) |
| **Equity 31 December 2017** | 75,861 | 16,774 | 132,971 | 225,606 | 128 | 225,734 |
| **Equity 1 January 2016** | 75,861 | 4,548 | 112,377 | 192,786 | 9,108 | 201,894 |
| Net earnings | - | - | 21,147 | 21,147 | 592 | 21,739 |
| Net gain on AFS financial assets | - | (2,903) | - | (2,903) | - | (2,903) |
| Translation difference | - | 182 | - | 182 | - | 182 |
| **Total comprehensive income** | - | (2,721) | 21,147 | 18,426 | 592 | 19,018 |
| Reserve for investments in subsidiaries | - | 17,012 | (17,012) | - | - | - |
| Reserve for investments in associates | - | 23 | (23) | - | - | - |
| Reserve for investments in securities | - | 899 | (899) | - | - | - |
| Decrease due to sale of subsidiary | - | - | - | - | (141) | (141) |
| Disbursement of share capital and dividend to non-controlling interest | - | - | - | - | (9,387) | (9,387) |
| **Equity 31 December 2016** | 75,861 | 19,761 | 115,590 | 211,212 | 172 | 211,384 |

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 33.

*The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.*

*Arion Bank Consolidated Financial Statements 2017* 14 *Amounts are in ISK millions*

# Consolidated Statement of Cash flows
## for the year 2017

| Operating activities | 2017 | 2016 |
|---|---|---|
| Net earnings | 14,419 | 21,739 |
| Non-cash items included in net earnings and other adjustments | (25,372) | (30,516) |
| Changes in operating assets and liabilities | 47,923 | (3,404) |
| Interest received | 60,428 | 61,335 |
| Interest paid* | (28,623) | (30,926) |
| Dividend received | 320 | 2,280 |
| Income tax paid | (6,432) | (3,032) |
| Net cash from operating activities | 62,663 | 17,476 |
| **Investing activities** | | |
| Acquisition of associates | (961) | (76) |
| Acquisition of subsidiary | (2,123) | (5,300) |
| Cash and cash equivalents acquired through business combinations | 127 | 1,068 |
| Proceeds from sale of associates | 41 | 27,291 |
| Dividend received from associates | 74 | 153 |
| Disposal of subsidiary | - | 293 |
| Acquisition of intangible assets | (1,657) | (1,247) |
| Acquisition of property and equipment | (776) | (1,040) |
| Proceeds from sale of property and equipment | 239 | 224 |
| Net cash (to) from investing activities | (5,036) | 21,366 |
| **Financing activities** | | |
| Payment of subordinated liabilities | - | (8,785) |
| Disbursement of share capital and dividend to non-controlling interest | (63) | (9,386) |
| Net cash used in financing activities | (63) | (18,171) |
| Net increase in cash and cash equivalents | 57,564 | 20,671 |
| Cash and cash equivalents at beginning of the year | 123,933 | 110,000 |
| Effect of exchange rate changes on cash and cash equivalents | 401 | (6,738) |
| **Cash and cash equivalents** | 181,898 | 123,933 |
| **Non-cash investing transactions** | | |
| Assets acquired through foreclosure on collateral from customers with view to resale | 835 | 1,830 |
| Settlement of loans through foreclosure on collateral from customers with view to resale | (835) | (1,830) |
| **Non-cash changes due to acquisition of United Silicon** | | |
| Non-current assets and disposal groups held for sale | 4,537 | - |
| Borrowings | (4,537) | - |
| **Non-cash changes due to funding agreement with Kaupthing** | | |
| Deposits | - | 41,409 |
| Borrowings | - | (41,409) |

Financial effects due to the acquisition of Valitor Holding's subsidiaries, IPS and Chip and Pin, in 2017 and the acquisition of Vördur tryggingar hf. in 2016, see Note 3.

Comparative figures have been changed with immaterial effects on the Cash flow, see Note 1.

* Interest paid includes interest credited to deposit accounts at the end of the year.

*The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.*

*Arion Bank Consolidated Financial Statements 2017* 15 *Amounts are in ISK millions*

# Notes to the Consolidated Statement of Cash flows
## for the year 2017

| Non-cash items included in net earnings | 2017 | 2016 |
|---|---|---|
| Net interest income | (29,837) | (29,900) |
| Net impairment | (186) | (7,236) |
| Income tax expense | 5,806 | 6,631 |
| Bank levy | 3,172 | 2,872 |
| Net foreign exchange gain (loss) | (122) | 1,253 |
| Net gain on financial instruments | (3,649) | (4,135) |
| Depreciation and amortization | 2,132 | 1,842 |
| Share of profit of associates and net impairment | 925 | (908) |
| Investment property, fair value change | (1,036) | (290) |
| Revised Depositors' and Investors' Guarantee Fund expense | (2,669) | - |
| Discontinued operations, net of tax | 206 | - |
| Other changes | (114) | (645) |
| **Non-cash items included in net earnings** | (25,372) | (30,516) |

| Changes in operating assets and liabilities | | |
|---|---|---|
| Mandatory reserve with Central Bank | 108 | 3,303 |
| Loans to credit institutions, excluding bank accounts | (2,879) | (22,769) |
| Loans to customers | (59,413) | (46,537) |
| Financial instruments and financial liabilities at fair value | 15,512 | 11,854 |
| Investment property | (204) | 1,440 |
| Other assets | 993 | 481 |
| Due to credit institutions and Central Bank | (702) | (3,151) |
| Deposits | 50,653 | (9,586) |
| Borrowings | 42,071 | 68,016 |
| Other liabilities | 1,784 | (6,455) |
| **Changes in operating assets and liabilities** | 47,923 | (3,404) |

| Cash and cash equivalents | | |
|---|---|---|
| Cash and balances with Central Bank | 139,819 | 87,634 |
| Bank accounts | 51,303 | 45,631 |
| Mandatory reserve deposit with Central Bank | (9,224) | (9,332) |
| **Cash and cash equivalents** | 181,898 | 123,933 |

*The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.*

*Arion Bank Consolidated Financial Statements 2017* 16 *Amounts are in ISK millions*

# Notes to the Consolidated Financial Statements
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# Notes to the Consolidated Financial Statements

## General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31. December 2017 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

### 1. Basis of preparation

*Statement of compliance*

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), 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 Consolidated Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 14 February 2018.

The same accounting policies, presentation and methods of computation are followed in these Consolidated Financial Statements as were applied in the presentation of the Group's Consolidated Financial Statements for the year ended 31 December 2016. Amendments to IFRS effective for 2017 did not have a material effect on the results for the year 2017.

*Basis of measurement*

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

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

*Functional and presentation currency*

The Consolidated 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 year the exchange rate of the ISK against USD was 103.70 and 124.52 for EUR (31.12.2016: USD 112.90 and EUR 119.18).

*Comparative figures*

In the Statement of Comprehensive Income for 2017 net income from non-current assets held for sale are presented among other operating income. Prior to 2017 net income from non-current assets held for sale was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly by reducing discontinued operations, net of tax by ISK 886 million, increasing other operating income by ISK 1,107 million and increasing income tax by ISK 221 million.

The effects on the Statement of cash flow was shift between Non-cash items included in net earnings and other adjustments and Changes in operating assets and liabilities of ISK 1,107 million.

Methods used for calculation on Interest received and Interest paid in Statement of Cash flows were changed remotely and comparative figures were updated according. The effect were reclass beteween lines within the category Net cash from operating activities.

### 2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amount of revenues, expenses, assets and liabilities, and the accompanying disclosures, as well as the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

*Judgements*

The following are the critical judgements, apart from those involving estimations which are dealt with separately, that the directors have made in the process of applying the Group's accounting policies and that have the most significant effect on the amounts recognized in Financial Statements.

**2. Significant accounting estimates and judgements in applying accounting policies, continued**

- Fair value measurement of financial instruments

  When the fair values of financial assets and financial liabilities recorded in the Statement of Financial Position cannot be measured based on quoted prices in active markets, their fair value is measured using valuation techniques including the discounted cash flow model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgement is required in establishing fair values. Judgements include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions relating to these factors could affect the reported fair value of financial instruments.

- Impairment losses on loans

  The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. 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.

*Estimates and assumptions*

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the Consolidated Financial Statements were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

- Revaluation of investment properties

  The Group carries its investment properties at fair value, with changes in fair value being recognized in the statement of profit or loss. For investment properties, either a valuation methodology based on present value calculations, as there is a lack of comparable market data because of the nature of the properties, or the investment properties were valued by reference to transactions involving properties of a similar nature, location and condition.

- Impairment of intangible assets

  The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is indication of impairment. If any such indication exists the asset's recoverable amount is estimated. An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss. The recoverable amount of an assets is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

- Non-current assets and disposal groups held for sale

  Legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less cost to sell. For most part, fair value at the date of classification of these legal entities was calculated using valuation models based on discontinued future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed(representing the required rate of return on equity), could have impact on the value of these disposal groups.

  Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. Fair value at the date of classification is based on independent property values or management valuation. As the fair value measurement of real estates is based on valuation techniques there is uncertainty about the actual fair value of assets.

# Notes to the Consolidated Financial Statements

### 3. The Group

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

| | Operating activity | Currency | Equity interest 2017 | Equity interest 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% |
| Eignarhaldsfélagid 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, Hafnarfjördur, Iceland ........ | Payment solutions | ISK | 100.0% | 100.0% |
| Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland ........ | Insurance | ISK | 100.0% | 100.0% |

In addition the Bank holds the subsidiary United Silicon which is classified as Non-current assets and disposal groups held for sale, see Note 28.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies; IPS - International Payment Services 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 partnership in that market until now. Further information on intangible assets related to those two companies are in Note 26. The transactions are as follows:

| | |
|---|---|
| Purchase price, paid in cash ........ | 2,123 |
| **Asset and liabilities of IPS and Chip and Pin at fair value:** | |
| Loans to credit institutions (Bank accounts) ........ | 127 |
| Other assets (Accounts receivables) ........ | 758 |
| Other assets (Property and equipment) ........ | 21 |
| Intangible assets, other than goodwill ........ | 404 |
| Other liabilites (Accounts payable) ........ | (960) |
| **Fair value of asset and liabilities ........** | 350 |
| **Calculated goodwill ........** | 1,773 |

On 1 January 2017 Vördur tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition Vördur tryggingar merged its two life insurance subsidiaries under the name of Vördur líftryggingar hf. Combination of entities under common control, i.e. transactions in which all the combining entities are under the control of the Group both before and after the combination, and that control is not transitory, are outside the scope of the IFRS 3 Business combinations. Currently, there is no specific guidance for these transactions under IFRS, therefore, as permitted by IAS 8 Accounting policies, changes in accounting and errors, the Group has developed an accounting policy considering pronouncement of other standard-setting bodies. The assets and liabilities recognized as a result of transactions between entities under common control are recognized at the carrying value on the transferor's financial statements.

On 30 September 2016 Arion Bank acquired a 100% shareholding in the insurance company Vördur tryggingar hf. Vördur tryggingar hf. is classified as a subsidiary of Arion Bank from the day of acquisition. The transaction was as follows:

| | |
|---|---|
| Purchase price, paid in cash ........ | 5,300 |
| **Fair value of asset and liabilities of Vördur tryggingar** | |
| Loans to credit institutions (Bank accounts) ........ | 1,068 |
| Financial instruments ........ | 8,773 |
| Intangible assets, other than goodwill ........ | 2,045 |
| Tax assets ........ | 147 |
| Other assets ........ | 2,355 |
| Tax liabilities ........ | (409) |
| Other liabilities ........ | (9,175) |
| **Fair value of asset and liabilities of Vördur tryggingar ........** | 4,804 |
| **Calculated goodwill ........** | 496 |

*Arion Bank Consolidated Financial Statements 2017* 20 *Amounts are in ISK millions*

# Notes to the Consolidated Financial Statements

## Operating segment reporting

Segment information is presented in respect of the Group's operating segments based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax. In presenting the geographic information, segment revenue has been based on the geographic location of customers 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 listing of securities. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients and provide services regarding risk management products. Capital Markets also manages securities offerings for companies, 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 all around Iceland 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 five regions clusters, with the smaller branches capitalizing on the strength of larger units within each region. Retail Banking's brances 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 subsidiarie**s include Market Making in domestic securities and currencies. The subsidiaries are Valitor Holding hf., Vördur tryggingar hf., Okkar líftryggingar hf. (in 2016), Eignarhaldsfélagid 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 does not represent an operating segment.

# Notes to the Consolidated Financial Statements

### 4. Operating segments

| 2017 | Asset Manage-ment | Corporate Banking | Investment Banking | Retail Banking | Treasury | Other divisions and Sub-sidiaries | Head-quarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 502 | 6,002 | 240 | 15,502 | 6,536 | 1,269 | (216) | 29,835 |
| Net fee and commission income | 4,011 | 1,171 | 1,298 | 4,703 | (312) | 4,213 | 273 | 15,357 |
| Net financial income | 145 | 224 | (71) | 19 | (13) | 4,052 | (265) | 4,091 |
| Net insurance income | - | - | - | - | - | 2,224 | (131) | 2,093 |
| Share of profit of associates and net impairment | - | - | - | - | - | 15 | (940) | (925) |
| Other operating income | 19 | 1,146 | - | 927 | 5 | 478 | 352 | 2,927 |
| **Operating income (loss)** | 4,677 | 8,543 | 1,467 | 21,151 | 6,216 | 12,251 | (927) | 53,378 |
| Operating expense | (1,138) | (357) | (780) | (5,134) | 161 | (9,317) | (13,396) | (29,961) |
| Allocated expense | (1,019) | (2,424) | (652) | (5,905) | (887) | (15) | 10,902 | - |
| Bank levy | (182) | (671) | (39) | (1,097) | (1,183) | - | - | (3,172) |
| Net impairment | - | (1,794) | (53) | 2,489 | 70 | (527) | 1 | 186 |
| **Earnings (loss) before tax** | 2,338 | 3,297 | (57) | 11,504 | 4,377 | 2,392 | (3,420) | 20,431 |
| Net seg. rev. from ext. customers | 2,638 | 15,689 | 1,003 | 30,765 | (9,044) | 12,948 | (621) | 53,378 |
| Net seg. rev. from other segments | 2,039 | (7,146) | 464 | (9,614) | 15,260 | (697) | (306) | - |
| **Operating income (loss)** | 4,677 | 8,543 | 1,467 | 21,151 | 6,216 | 12,251 | (927) | 53,378 |
| Depreciation and amortization | 1 | - | - | 359 | - | 974 | 798 | 2,132 |
| **Total assets** | 75,564 | 274,917 | 16,165 | 527,652 | 483,794 | 89,936 | (320,274) | 1,147,754 |
| **Total liabilities** | 70,233 | 218,243 | 15,164 | 461,724 | 421,930 | 59,609 | (324,883) | 922,020 |
| **Allocated equity** | 5,331 | 56,674 | 1,001 | 65,928 | 61,864 | 30,327 | 4,609 | 225,734 |
| 2016 | | | | | | | | |
| Net interest income | 535 | 6,436 | 1,104 | 14,992 | 6,093 | 1,233 | (493) | 29,900 |
| Net fee and commission income | 3,863 | 1,082 | 1,808 | 3,537 | (345) | 3,885 | 148 | 13,978 |
| Net financial income | (67) | (12) | (100) | 115 | 332 | 4,617 | 277 | 5,162 |
| Net insurance income | - | - | - | - | - | 1,395 | - | 1,395 |
| Share of profit of associates and net impairment | - | - | 613 | - | - | 275 | 20 | 908 |
| Other operating income | 14 | 368 | 321 | 1,058 | 80 | 905 | 457 | 3,203 |
| **Operating income** | 4,345 | 7,874 | 3,746 | 19,702 | 6,160 | 12,310 | 409 | 54,546 |
| Operating expense | (1,422) | (605) | (939) | (6,134) | (189) | (7,061) | (14,190) | (30,540) |
| Allocated expense | (882) | (2,386) | (827) | (6,149) | (876) | (20) | 11,140 | - |
| Bank levy | (209) | (609) | (41) | (980) | (1,033) | - | - | (2,872) |
| Net impairment | - | 33 | 1,704 | 5,557 | 7 | (65) | - | 7,236 |
| **Earnings (loss) before tax** | 1,832 | 4,307 | 3,643 | 11,996 | 4,069 | 5,164 | (2,641) | 28,370 |
| Net seg. rev. from ext. customers | 1,908 | 15,919 | 3,225 | 31,064 | (11,647) | 12,875 | 1,202 | 54,546 |
| Net seg. rev. from other segments | 2,437 | (8,121) | 521 | (11,287) | 17,807 | (565) | (792) | - |
| **Operating income** | 4,345 | 7,798 | 3,746 | 19,777 | 6,160 | 12,310 | 410 | 54,546 |
| Depreciation and amortization | - | 1 | - | 336 | - | 727 | 778 | 1,842 |
| **Total assets** | 87,307 | 251,821 | 16,836 | 506,483 | 427,037 | 72,128 | (325,588) | 1,036,024 |
| **Total liabilities** | 81,733 | 193,571 | 13,856 | 433,074 | 394,797 | 43,722 | (336,113) | 824,640 |
| **Allocated equity** | 5,574 | 58,250 | 2,980 | 73,409 | 32,240 | 28,406 | 10,525 | 211,384 |

Income taxes and discontinued operations are excluded from the profit and loss segment information. From prior periods additional line of allocated expense from supporting divisions to business segments has been added. Those supporting divisions are Risk Management, Finance (excluding Treasury and Market Making), Legal, IT and Overhead. Bank levy has also been allocated to business segments. Comparative figures for 2016 have been updated accordingly.

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# Notes to the Consolidated Financial Statements

## 4. Operating segments, continued

*Geographic information*

| 2017 | Iceland | Nordic | United Kingdom | Other Europe | North America | Other | Total |
|---|---|---|---|---|---|---|---|
| Net interest income | 33,063 | 439 | 231 | (4,268) | 339 | 31 | 29,835 |
| Net fee and commission income | 12,578 | 253 | 313 | 2,194 | 16 | 3 | 15,357 |
| Net financial income | 2,228 | 143 | 411 | 339 | 961 | 9 | 4,091 |
| Net insurance income | 2,093 | - | - | - | - | - | 2,093 |
| Share of profit of associates and net impairment | (925) | - | - | - | - | - | (925) |
| Other operating income | 2,894 | - | 33 | - | - | - | 2,927 |
| **Operating income (loss)** | 51,931 | 835 | 988 | (1,735) | 1,316 | 43 | 53,378 |

| 2016 | Iceland | Nordic | United Kingdom | Other Europe | North America | Other | Total |
|---|---|---|---|---|---|---|---|
| Net interest income | 32,302 | 1,079 | 114 | (4,424) | 791 | 38 | 29,900 |
| Net fee and commission income | 11,815 | 548 | 50 | 1,495 | 62 | 8 | 13,978 |
| Net financial income | (500) | 79 | 5,242 | 323 | 19 | (1) | 5,162 |
| Net insurance income | 1,395 | - | - | - | - | - | 1,395 |
| Share of profit of associates and net impairment | 223 | - | 685 | - | - | - | 908 |
| Other operating income | 3,203 | - | - | - | - | - | 3,203 |
| **Operating income (loss)** | 48,438 | 1,706 | 6,091 | (2,606) | 872 | 45 | 54,546 |

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# Notes to the Consolidated Financial Statements

## Quarterly statements

### 5. Operations by quarters, unaudited

| 2017 | Q4 | Q3 | Q2 | Q1 | Total |
|---|---|---|---|---|---|
| Net interest income | 7,265 | 7,250 | 8,160 | 7,160 | 29,835 |
| Net fee and commission income | 4,654 | 3,865 | 3,508 | 3,330 | 15,357 |
| Net financial income | 1,620 | (734) | 1,975 | 1,230 | 4,091 |
| Net insurance income | 324 | 716 | 606 | 447 | 2,093 |
| Share of profit of associates and net impairment | (8) | 17 | (900) | (34) | (925) |
| Other operating income | 69 | 483 | 1,811 | 564 | 2,927 |
| **Operating income** | 13,924 | 11,597 | 15,160 | 12,697 | 53,378 |
| Salaries and related expense | (4,565) | (3,841) | (4,561) | (4,222) | (17,189) |
| Other operating expense | (4,016) | (3,699) | (1,223) | (3,834) | (12,772) |
| Bank levy | (784) | (814) | (777) | (797) | (3,172) |
| Net impairment | 1,448 | (2,551) | 409 | 880 | 186 |
| **Earnings before tax** | 6,007 | 692 | 9,008 | 4,724 | 20,431 |
| Income tax expense | (1,735) | (805) | (1,895) | (1,371) | (5,806) |
| **Net earnings from continuing operations** | 4,272 | (113) | 7,113 | 3,353 | 14,625 |
| Discontinued operations, net of tax | (206) | - | - | - | (206) |
| **Net earnings** | 4,066 | (113) | 7,113 | 3,353 | 14,419 |

| 2016 | Q4 | Q3 | Q2 | Q1 | Total |
|---|---|---|---|---|---|
| Net interest income | 7,842 | 7,432 | 7,353 | 7,273 | 29,900 |
| Net fee and commission income | 3,765 | 3,466 | 3,528 | 3,219 | 13,978 |
| Net financial income | 823 | 844 | 3,796 | (301) | 5,162 |
| Net insurance income | 731 | 272 | 247 | 145 | 1,395 |
| Share of profit of associates and net impairment | 198 | 16 | 17 | 677 | 908 |
| Other operating income | 826 | 693 | 607 | 1,077 | 3,203 |
| **Operating income** | 14,185 | 12,723 | 15,548 | 12,090 | 54,546 |
| Salaries and related expense | (4,407) | (3,826) | (4,318) | (4,108) | (16,659) |
| Other operating expense | (3,803) | (3,349) | (3,639) | (3,090) | (13,881) |
| Bank levy | (682) | (705) | (743) | (742) | (2,872) |
| Net impairment | 409 | 5,882 | 1,448 | (503) | 7,236 |
| **Earnings before tax** | 5,702 | 10,725 | 8,296 | 3,647 | 28,370 |
| Income tax expense | (1,227) | (3,222) | (1,419) | (763) | (6,631) |
| **Net earnings from continuing operations** | 4,475 | 7,503 | 6,877 | 2,884 | 21,739 |
| Discontinued operations, net of tax | - | - | - | - | - |
| **Net earnings** | 4,475 | 7,503 | 6,877 | 2,884 | 21,739 |

The half-year results were reviewed by the Bank's auditor. The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditor.

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# Notes to the Consolidated Financial Statements

## Notes to the Consolidated Statement of Comprehensive Income

### 6. Net interest income

| | 2017 | 2016 |
|---|---|---|
| *Interest income* | | |
| Cash and balances with Central Bank | 6,449 | 4,584 |
| Loans | 47,832 | 51,910 |
| Securities | 1,964 | 4,347 |
| Other | 844 | 814 |
| **Interest income** | 57,089 | 61,655 |
| *Interest expense* | | |
| Deposits | (12,725) | (16,278) |
| Borrowings | (14,449) | (14,858) |
| Subordinated liabilities | - | (529) |
| Other | (80) | (90) |
| **Interest expense** | (27,254) | (31,755) |
| **Net interest income** | 29,835 | 29,900 |
| Net interest income from financial assets and financial liabilities at fair value | 1,964 | 4,347 |
| Interest income from financial assets not at fair value | 55,125 | 57,308 |
| Interest expense from financial liabilities not at fair value | (27,254) | (31,755) |
| **Net interest income** | 29,835 | 29,900 |
| Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets) | 2.9% | 3.1% |

### 7. Net fee and commission income

| | 2017 | | | 2016 | | |
|---|---|---|---|---|---|---|
| | Income | Expense | Net income | Income | Expense | Net income |
| Asset management | 4,529 | (366) | 4,163 | 4,225 | (245) | 3,980 |
| Cards and payment solution | 19,309 | (13,177) | 6,132 | 14,268 | (8,975) | 5,293 |
| Collection and payment services | 1,563 | (94) | 1,469 | 1,478 | (80) | 1,398 |
| Investment banking | 808 | (43) | 765 | 1,039 | (46) | 993 |
| Lending and guarantees | 2,198 | - | 2,198 | 1,685 | - | 1,685 |
| Other | 1,370 | (740) | 630 | 1,192 | (563) | 629 |
| **Net fee and commission income** | 29,777 | (14,420) | 15,357 | 23,887 | (9,909) | 13,978 |

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.

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## 8. Net financial income

| | 2017 | 2016 |
|---|---|---|
| Dividend income | 320 | 2,280 |
| Net gain on financial assets and financial liabilities classified as held for trading | 155 | 363 |
| Net gain on fair value hedge of interest rate swap | 336 | - |
| Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss | 3,158 | (1,519) |
| Realized gain on financial assets available-for-sale | - | 5,291 |
| Net foreign exchange gain (loss) | 122 | (1,253) |
| **Net financial income** | 4,091 | 5,162 |

*Net gain on fair value hedge of interest rate swap*

| | 2017 | 2016 |
|---|---|---|
| Fair value change of interest rate swaps designated as hedging instruments | (400) | - |
| Fair value change on bonds issued by the Group attributable to interest rate risk | 736 | - |
| **Net gain on fair value hedge of interest rate swap** | 336 | - |

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

| | 2017 | 2016 |
|---|---|---|
| Equity instruments designated at fair value | 2,971 | (1,472) |
| Interest rate instruments designated at fair value | 187 | (47) |
| **Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss** | 3,158 | (1,519) |

## 9. Net insurance income

*Earned premiums, net of reinsurers' share*

| | 2017 | 2016 |
|---|---|---|
| Premiums written | 10,407 | 2,926 |
| Premiums written, reinsurers' shares | (428) | (196) |
| Change in provision for unearned premiums | (810) | 330 |
| Change in provision for unearned premiums, reinsurers' share | 1 | 1 |
| **Earned premiums, net of reinsurers' share** | 9,169 | 3,061 |

*Claims incurred, net of reinsurers' share*

| | 2017 | 2016 |
|---|---|---|
| Claims paid | (6,115) | (1,762) |
| Claims paid, reinsurers' share | 142 | 66 |
| Change in provision for claims | (1,057) | 33 |
| Changes in provision for claims, reinsurers' share | (46) | (3) |
| **Claims incurred, net of reinsurers' share** | (7,076) | (1,666) |
| **Net insurance income** | 2,093 | 1,395 |

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## 10. Other operating income

| | 2017 | 2016 |
|---|---|---|
| Fair value changes on investment property | 1,036 | 290 |
| Realized gain on investment property | 15 | 400 |
| Net gain on non-current assets held for sale | 958 | 1,107 |
| Other income | 918 | 1,406 |
| **Other operating income** | **2,927** | **3,203** |

*Net gain on non-current assets held for sale*

| | 2017 | 2016 |
|---|---|---|
| Income from real estates and other assets | 1,184 | 1,335 |
| Expense related to real estates and other assets | (226) | (228) |
| **Net gain on non-current assets held for sale** | **958** | **1,107** |

Net gain on non-current assets held for sale are classified as other operating income in the Consolidated Financial Statements 2017. In prior years it was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

## 11. Personnel and salaries

| | 2017 | 2016 |
|---|---|---|
| *Number of employees* | | |
| Average number of full-time equivalent positions during the year | 1,250 | 1,201 |
| Full-time equivalent positions at the end of the year | 1,284 | 1,239 |
| *Number of employees at Arion Bank* | | |
| Average number of full-time equivalent positions during the year | 830 | 889 |
| Full-time equivalent positions at the end of the year | 844 | 869 |
| *Salaries and related expense* | | |
| Salaries | 13,771 | 13,274 |
| Defined contribution pension plans | 1,963 | 1,885 |
| Salary-related expense | 1,802 | 1,884 |
| Capitalization of salaries, due to internally developed software | (347) | (384) |
| **Salaries and related expense** | **17,189** | **16,659** |
| *Salaries and related expense for Arion Bank* | | |
| Salaries | 9,123 | 9,690 |
| Defined contribution pension plans | 1,300 | 1,376 |
| Salary-related expense | 1,346 | 1,553 |
| **Salaries and related expense** | **11,769** | **12,619** |

In 2017 the Group made a provision of ISK 311 million (2016: ISK 395 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 223 million (2016: ISK 331 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 year the Group's accrual for performance plan payments amounted to ISK 942 million (31.12.2016: ISK 1,453 million), of which the Bank's accrual amounts to ISK 762 million (31.12.2016: ISK 1,177 million).

Arion Bank Consolidated Financial Statements 2017 27 Amounts are in ISK millions

## Notes to the Consolidated Financial Statements

### 11. Personnel and salaries, continued

| *Compensation of the Board of Directors* | 2017 Fixed remuneration* | 2017 Additional remuneration** | 2017 Total | 2016 Fixed remuneration* | 2016 Additional remuneration** | 2016 Total |
|---|---|---|---|---|---|---|
| Eva Cederbalk, Chairman of the Board from 23.6.2017 .......... | 10.4 | 0.2 | 10.6 | - | - | - |
| Brynjólfur Bjarnason, Vice Chairman of the Board ................. | 5.2 | 4.6 | 9.8 | 4.7 | 3.8 | 8.5 |
| Jakob Már Ásmundsson, Director from 9.3.2017 ................... | 4.2 | 1.2 | 5.4 | - | - | - |
| Kirstín Th. Flygenring, Director ............................................. | 5.0 | 4.0 | 9.0 | 4.7 | 3.3 | 8.1 |
| Måns Höglund, Director ........................................................ | 10.0 | 4.6 | 14.6 | 9.5 | 4.4 | 13.8 |
| Steinunn K. Thórdardóttir, Director from 30.11.2017 ............ | 0.4 | - | 0.4 | - | - | - |
| Thóra Hallgrímsdóttir, Director ............................................. | 5.0 | 4.4 | 9.4 | 4.7 | 3.8 | 8.5 |
| Monica Caneman, Chairman of the Board until 10.5.2017 ...... | 7.3 | 0.9 | 8.2 | 19.0 | 2.5 | 21.4 |
| Gudrún Johnsen, Director until 29.11.2017 ............................. | 7.2 | 4.2 | 11.4 | 7.1 | 4.4 | 11.5 |
| Benedikt Olgeirsson, Director until 9.3.2017 ......................... | 1.0 | 1.2 | 2.2 | 4.7 | 3.3 | 8.1 |
| Alternate directors of the Board ............................................ | 3.0 | - | 3.0 | 2.4 | - | 2.4 |
| **Total remuneration** ............................................................ | 58.7 | 25.3 | 84.0 | 56.9 | 25.4 | 82.3 |

John P. Madden, a member of the Board of Directors received no remunerations in 2017 (2016: nil).

| *Compensation of key management personnel* | 2017 Salaries | 2017 Performance-based payments | 2016 Salaries | 2016 Performance-based payments |
|---|---|---|---|---|
| Höskuldur H. Ólafsson, CEO .......................................................................... | 62.0 | 9.2 | 58.2 | 7.1 |
| Nine managing directors of the Bank's divisions who are members of the Bank's Executive Committee ........................................................... | 295.6 | 34.2 | 262.7 | 30.3 |

Performance based payments in 2017 are based on the Group's performance in 2016.

Board Members receive remuneration for their involvement in board committees. In addition to 16 Board meetings (2016: 13) during the year 16 Board Credit Committee meetings (2016: 10), 8 Board Audit Committee (2016: 8), 10 Board Risk Committee meetings (2016: 11) and 5 Board Remuneration Committee meetings (2016: 7) were held. Four committee meetings with alternate directors of the Board were held in 2017 (2016: 4).

The 2017 Annual General Meeting of the Bank held on 9 March 2017 approved the monthly salaries for 2017 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 849,647, ISK 637,447 and ISK 425,000 (2016: ISK 796,950; 597,700; 398,500) respectively. It was also approved that the salary of Alternate Board Members would be ISK 215,273 (2016: ISK 201,850) per meeting, up to a maximum of ISK 425,000 (2016: ISK 398,500) per month. For Board Members resident abroad, the aforementioned amounts are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 170,000 (2016: ISK 159,400) per month for each committee they serve on and the Chairman of the board committees ISK 220,765 (2016: ISK 207,000).

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.

** Additional remuneration represents Board Member compensation for their participation in Board Committees.

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# Notes to the Consolidated Financial Statements

## 12. Other operating expense

| | 2017 | 2016 |
|---|---|---|
| Administration expense | 12,388 | 11,186 |
| Depositors' and Investors' Guarantee Fund | (1,829) | 804 |
| Depreciation of property and equipment | 816 | 865 |
| Amortization of intangible assets | 1,316 | 977 |
| Other expense | 81 | 49 |
| **Other operating expense** | 12,772 | 13,881 |

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 35.

| *Auditor's fee* | 2017 | 2016 |
|---|---|---|
| Audit and review of the Consolidated Financial Statements for the relevant fiscal year | 185 | 140 |
| Other audit related services for the relevant fiscal year | 45 | 11 |
| **Auditor's fee** | 230 | 151 |
| Of which fee to others than the auditor of the Parent company | 4 | 12 |

## 13. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billion. The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

## 14. Net impairment

| | 2017 | 2016 |
|---|---|---|
| Net change in impairment of loans to corporates | (3,197) | (2,914) |
| Net change in impairment of loans to individuals | 168 | (2,248) |
| Net change in collective impairment on loans | 1,362 | 427 |
| **Provision for losses** | (1,667) | (4,735) |
| Other impairment | (3) | (9) |
| Increase in book value of loans to corporates | 364 | 2,990 |
| Increase in book value of loans to individuals | 1,492 | 8,990 |
| **Net impairment** | 186 | 7,236 |

Arion Bank Consolidated Financial Statements 2017 29 Amounts are in ISK millions

## 15. Income tax expense

| | 2017 | 2016 |
|---|---|---|
| Current tax expense | 6,132 | 6,784 |
| Deferred tax expense | (326) | (153) |
| **Income tax expense** | **5,806** | **6,631** |

| *Reconciliation of effective tax rate* | 2017 | | 2016 | |
|---|---|---|---|---|
| Earnings before tax | | 20,431 | | 28,370 |
| Income tax using the Icelandic corporate tax rate | 20.0% | 4,086 | 20.0% | 5,674 |
| Additional 6% tax on Financial Undertakings | 6.5% | 1,319 | 4.9% | 1,395 |
| Non-deductible expenses | 0.4% | 86 | 0.0% | 13 |
| Tax exempt revenue | (1.6%) | (333) | (4.4%) | (1,247) |
| Non-deductible taxes | 3.1% | 634 | 2.0% | 574 |
| Tax incentives not recognized in the Statement of Comprehensive Income | 0.6% | 118 | 0.0% | - |
| Other changes | (0.5%) | (104) | 0.8% | 222 |
| **Effective tax rate** | 28.4% | 5,806 | 23.4% | 6,631 |

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

Tax exempt revenues consist mainly of profit from equity positions.

## 16. Discontinued operations, net of tax

| | 2017 | 2016 |
|---|---|---|
| Loss on disposal groups held for sale | (254) | - |
| Income tax expense | 48 | - |
| **Discontinued operations, net of tax** | (206) | - |

Net gain on non-current assets held for sale are classified as other operating income in the Consolidated Financial Statements 2017. In prior years they were classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

## 17. Earnings per share

| | Continued operations | | Discontinued operations | | Continued and discontinued operations | |
|---|---|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Net earnings attributable to the shareholders of Arion Bank | 14,606 | 21,147 | (206) | - | 14,400 | 21,147 |
| Weighted average number of outstanding shares for the year, million | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 |
| **Basic earnings per share** | 7.30 | 10.57 | (0.10) | - | 7.20 | 10.57 |

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2016: none).

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## Notes to the Consolidated Statement of Financial Position

### 18. Cash and balances with Central Bank

| | 2017 | 2016 |
|---|---|---|
| Cash on hand | 9,954 | 7,448 |
| Cash with Central Bank | 120,641 | 70,854 |
| Mandatory reserve deposit with Central Bank | 9,224 | 9,332 |
| **Cash and balances with Central Bank** | 139,819 | 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

| | 2017 | 2016 |
|---|---|---|
| Bank accounts | 51,303 | 45,631 |
| Money market loans | 32,309 | 32,267 |
| Other loans | 2,997 | 2,218 |
| **Loans to credit institutions** | 86,609 | 80,116 |

### 20. Loans to customers

| | Individuals | | Corporates | | Total | |
|---|---|---|---|---|---|---|
| 2017 | Gross carrying amount | Book value | Gross carrying amount | Book value | Gross carrying amount | Book value |
| Overdrafts | 14,469 | 13,438 | 18,778 | 17,504 | 33,247 | 30,942 |
| Credit cards | 11,133 | 10,931 | 1,123 | 1,109 | 12,256 | 12,040 |
| Mortgage loans | 311,507 | 310,318 | 19,632 | 19,417 | 331,139 | 329,735 |
| Other loans | 33,629 | 30,600 | 368,312 | 361,784 | 401,941 | 392,384 |
| **Loans to customers** | 370,738 | 365,287 | 407,845 | 399,814 | 778,583 | 765,101 |
| 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 183 billion at the end of the year (31.12.2016: ISK 165 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

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### 20. Loans to customers, continued

*Changes in the provision for losses on loans to customers*

| 2017 | Specific | Collective | Total |
|---|---|---|---|
| Balance at the beginning of the year | 18,281 | 4,557 | 22,838 |
| Provision for losses | 3,029 | (1,362) | 1,667 |
| Write-offs | (8,723) | - | (8,723) |
| Effects due to acquisition of subsidiary* | (2,421) | - | (2,421) |
| Exchange difference | 3 | - | 3 |
| Payment of loans previously written off | 118 | - | 118 |
| **Balance at the end of the year** | 10,287 | 3,195 | 13,482 |

| 2016 | Specific | Collective | Total |
|---|---|---|---|
| Balance at the beginning of the year | 25,341 | 4,984 | 30,325 |
| Provision for losses | 5,162 | (427) | 4,735 |
| Write-offs | (11,283) | - | (11,283) |
| Exchange difference | (1,138) | - | (1,138) |
| Payment of loans previously written off | 199 | - | 199 |
| **Balance at the end of the year** | 18,281 | 4,557 | 22,838 |

*At the end of September 2017 Arion Bank became majority owner of United Silicon, see Note 28. Arion Bank had made provision for losses on loans to United Silicon which was eliminated on Group level when United Silicon became a subsidiary of Arion Bank.

### 21. Financial instruments

| | 2017 | 2016 |
|---|---|---|
| Bonds and debt instruments | 51,755 | 69,565 |
| Shares and equity instruments with variable income | 36,190 | 27,035 |
| Derivatives | 7,624 | 5,159 |
| Securities used for economic hedging | 13,881 | 15,697 |
| **Financial instruments** | 109,450 | 117,456 |

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## 22. Financial assets and financial liabilities

| 2017 | Amortized cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans* | | | | |
| Cash and balances with Central Bank | 139,819 | - | - | 139,819 |
| Loans to credit institutions | 86,609 | - | - | 86,609 |
| Loans to customers | 765,101 | - | - | 765,101 |
| **Loans** | 991,529 | - | - | 991,529 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 2,452 | 46,638 | 49,090 |
| Unlisted | - | 23 | 2,642 | 2,665 |
| **Bonds and debt instruments** | - | 2,475 | 49,280 | 51,755 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 1,677 | 5,380 | 7,057 |
| Unlisted | - | 1,303 | 10,397 | 11,700 |
| Bond funds with variable income, unlisted* | - | 1,782 | 15,651 | 17,433 |
| **Shares and equity instruments with variable income** | - | 4,762 | 31,428 | 36,190 |
| *Derivatives* | | | | |
| OTC derivatives | - | 7,544 | - | 7,544 |
| Derivatives used for hedge accounting | - | 80 | - | 80 |
| **Derivatives** | - | 7,624 | - | 7,624 |
| *Securities used for economic hedging* | | | | |
| Bonds and debt instruments, listed | - | 6,024 | - | 6,024 |
| Shares and equity instruments with variable income, listed | - | 7,846 | - | 7,846 |
| Shares and equity instruments with variable income, unlisted | - | 11 | - | 11 |
| **Securities used for economic hedging** | - | 13,881 | - | 13,881 |
| Other financial assets | 8,948 | - | - | 8,948 |
| **Financial assets** | 1,000,477 | 28,742 | 80,708 | 1,109,927 |
| *Liabilities at amortized cost* | | | | |
| Due to credit institutions and Central Bank | 7,370 | - | - | 7,370 |
| Deposits | 462,161 | - | - | 462,161 |
| Borrowings | 384,998 | - | - | 384,998 |
| **Liabilities at amortized cost** | 854,529 | - | - | 854,529 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 1,467 | - | 1,467 |
| Short position in equity | - | 67 | - | 67 |
| Derivatives | - | 1,722 | - | 1,722 |
| Derivatives used for hedge accounting | - | 345 | - | 345 |
| **Financial liabilities at fair value** | - | 3,601 | - | 3,601 |
| Other financial liabilities | 34,705 | - | - | 34,705 |
| **Financial liabilities** | 889,234 | 3,601 | - | 892,835 |

*Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

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## 22. Financial assets and financial liabilities, continued

| 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 economic 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 economic 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 |

*Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

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# Notes to the Consolidated Financial Statements

## 22. Financial assets and financial liabilities, continued

| *Bonds and debt instruments designated at fair value, specified by issuer* | 2017 | 2016 |
|---|---|---|
| Financial and insurance activities | 4,415 | 5,564 |
| Public sector | 38,389 | 51,860 |
| Corporates | 6,476 | 6,755 |
| **Bonds and debt instruments designated at fair value** | 49,280 | 64,179 |

The total amount of pledged bonds was ISK 13.4 billion at the end of the year (31.12.2016: ISK 15.6 billion). Pledged bonds comprised 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**

2017

| *Assets at fair value* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 32,452 | 19,264 | 39 | 51,755 |
| Shares and equity instruments with variable income | 4,140 | 30,920 | 1,130 | 36,190 |
| Derivatives | - | 7,544 | - | 7,544 |
| Derivatives used for hedge accounting | - | 80 | - | 80 |
| Securities used for economic hedging | 13,713 | 168 | - | 13,881 |
| Investment property | - | - | 6,613 | 6,613 |
| **Assets at fair value** | 50,305 | 57,976 | 7,782 | 116,063 |
| | | | | |
| *Liabilities at fair value* | | | | |
| Short position in bonds | 1,467 | - | - | 1,467 |
| Short position in equity | 67 | - | - | 67 |
| Derivatives | - | 1,722 | - | 1,722 |
| Derivatives used for hedge accounting | - | 345 | - | 345 |
| **Liabilities at fair value** | 1,534 | 2,067 | - | 3,601 |

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### 23. Fair value hierarchy, continued

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 economic 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 year (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.

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.

*Level 1: Fair value established from quoted market prices*
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.

Level 2 instruments include unlisted shares, unlisted funds with underlying bonds and equity holdings (share certificates), unlisted and less liquid listed bonds and all OTC derivatives.

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**23. Fair value hierarchy, continued**

*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 | | |
|---|---|---|---|---|
| 2017 | property | Bonds | Shares | Total |
| Balance at the beginning of the year | 5,358 | 89 | 18 | 5,465 |
| Net fair value changes | 1,036 | (617) | 23 | 442 |
| Net gain from disposals | 15 | - | - | 15 |
| Additions | 767 | - | 234 | 1,001 |
| Disposal | (563) | (147) | (15) | (725) |
| Transfers into Level 3* | - | 714 | 870 | 1,584 |
| **Balance at the end of the year** | 6,613 | 39 | 1,130 | 7,782 |

| | | | | |
|---|---|---|---|---|
| 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 | - | (13) | - | (13) |
| **Balance at the end of the year** | 5,358 | 89 | 18 | 5,465 |

*In a routine review of the portfolio the Bank reclassified a number of unlisted shares and bonds from Level 2 to Level 3. Presumptions for classification to Level 2 were no longer considered available.

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## 23. Fair value hierarchy, continued

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

| | Investment | Financial assets | | |
|---|---|---|---|---|
| 2017 | property | Bonds | Shares | Total |
| Net interest income | - | 27 | - | 27 |
| Net financial income | - | (645) | 23 | (622) |
| Other operating income | 1,051 | - | - | 1,051 |
| **Effects recognized in the Income Statement** | 1,051 | (618) | 23 | 456 |
| Net loss on AFS financial assets, net of tax | - | - | - | - |
| **Effects recognized in the Statement of Comprehensive Income** | 1,051 | (618) | 23 | 456 |
| 2016 | | | | |
| Net interest income | - | 2 | - | 2 |
| Net financial income | - | (9) | 5,259 | 5,250 |
| Other operating income | 690 | - | - | 690 |
| **Effects recognized in the Income Statement** | 690 | (7) | 5,259 | 5,942 |
| Net loss on AFS financial assets, net of tax | - | - | (2,903) | (2,903) |
| **Effects recognized in the Statement of Comprehensive Income** | 690 | (7) | 2,356 | 3,039 |

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

| 2017 | Carrying | Fair | Unrealized |
|---|---|---|---|
| *Financial assets not carried at fair value* | value | value | gain (loss) |
| Cash and balances with Central Bank | 139,819 | 139,819 | - |
| Loans to credit institutions | 86,609 | 86,609 | - |
| Loans to customers | 765,101 | 772,185 | 7,084 |
| Other financial assets | 8,948 | 8,948 | - |
| **Financial assets not carried at fair value** | 1,000,477 | 1,007,561 | 7,084 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central Bank | 7,370 | 7,370 | - |
| Deposits | 462,161 | 462,161 | - |
| Borrowings | 384,998 | 402,355 | (17,357) |
| Other financial liabilities | 34,705 | 34,705 | - |
| **Financial liabilities not carried at fair value** | 889,234 | 906,591 | (17,357) |

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### 23. Fair value hierarchy, continued

| 2016<br>*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 | 348,413 | (8,937) |
| Other financial liabilities | 36,350 | 36,350 | - |
| **Financial liabilities not carried at fair value** | 795,877 | 804,814 | (8,937) |

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value.

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.

| **Derivatives** | Notional | Fair value | |
|---|---|---|---|
| 2017 | value | Assets | Liabilities |
| Forward exchange rate agreements | 52,914 | 563 | 251 |
| Fair value hedge of interest rate swap | 99,613 | 80 | 345 |
| Interest rate and exchange rate agreements | 199,723 | 6,265 | 1,392 |
| Bond swap agreements | 1,818 | 1 | 15 |
| Share swap agreements | 8,270 | 701 | 64 |
| Options - purchased agreements | 1,219 | 14 | - |
| **Derivatives** | 363,557 | 7,624 | 2,067 |
| | | | |
| 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 fair value 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 31, arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017.

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### 24. Offsetting financial assets and financial liabilities

*Financial assets subject to enforceable master netting arrangements and similar arrangements*

| 2017 | Assets subject to netting arrangements: Gross assets before balance sheet | Assets subject to netting arrangements: Balance sheet nettings with gross | Assets subject to netting arrangements: Assets recognized on balance | Netting potential not recognized in the balance sheet: Financial | Netting potential not recognized in the balance sheet: 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 ....... | 15,197 | - | 15,197 | (82) | - | 15,115 | - | 15,197 |
| Derivatives ....................................... | 6,350 | - | 6,350 | (1,210) | - | 5,140 | 1,274 | 7,624 |
| **Total assets ....................................** | 21,547 | - | 21,547 | (1,292) | - | 20,255 | 1,274 | 22,821 |
| **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*

| 2017 | Liabilities subject to netting arrangements: Gross liabilities before balance sheet | Liabilities subject to netting arrangements: Balance sheet nettings with gross | Liabilities subject to netting arrangements: Liabilities recognized on balance | Netting potential not recognized in the balance sheet: Financial | Netting potential not recognized in the balance sheet: Collateral pledged | Liabilities after consideration of netting potential | Liabilities not subject to enforceable netting arr-angements | Total liabilities recognized on balance sheet |
|---|---|---|---|---|---|---|---|---|
| Repurchase agreements ................... | 82 | - | 82 | (82) | - | - | - | 82 |
| Derivatives ....................................... | 1,299 | - | 1,299 | (1,210) | - | 89 | 768 | 2,067 |
| **Total liabilities ................................** | 1,381 | - | 1,381 | (1,292) | - | 89 | 768 | 2,149 |
| **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 |

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

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# Notes to the Consolidated Financial Statements

## 25. Investments in associates

| *The Group's interest in its principal associates* | 31.12.2017 | 31.12.2016 |
|---|---|---|
| Audkenni 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% |
| Urridaland ehf., Laugavegur 182, Reykjavík, Iceland | - | 41.4% |
| 220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland | 35.3% | 34.9% |

| *Investments in associates* | | |
|---|---|---|
| Carrying amount at the beginning of the year | 839 | 27,299 |
| Acquisitions | 961 | 76 |
| Dividend received | (41) | (153) |
| Disposals | (74) | (27,291) |
| Share of profit of associates and net impairment | (925) | 908 |
| **Investment in associates** | 760 | 839 |

In 2017 Arion Bank invested in United Silicon. With the investment United Silicon became associate of the Bank, see Note 28.

In November 2017 Eignarhaldsfélagid Landey ehf. sold its shareholding in the associated company Urridaland ehf. with minor effects on the Statement of Comprehensive Income.

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.

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## 26. Intangible assets

Intangible assets comprise following categories; Goodwill, which arises on business combinations; Infrastructure, Customer relationships and related agreements which are identified during the acquisition of subsidiaries and related to the activities of the businesses being acquired; and Software, which is either acquired (i.e. software licenses) or internally developed.

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 which the Bank acquired in subsidiaries and agreements bought. 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 relationship related to individual customers through Retail Banking. The customer relationships is tested for impairment and related agreements are amortized over a period of five years with one year remaining. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those agreements are assessed as having an identified useful lifetime.

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 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd., a UK based company that specializes in providing a payment terminal (POS) gateway for pan-European retailers, and Chip and Pin Solutions Ltd., one of the premier and highly regarded ISOs (Independent Sales Organizations) in the UK, selling POS terminals and acquiring services to thousands of small and medium size merchants. Valitor Holding hf. acquired controlling interest in both companies. The purpose of the acquisition is to strengthen Valitor's direct channel in-store market position in the UK as the focus has been on partnerships in that market until now. The total purchase price of the two companies was ISK 2,123 million and preliminary purchase price allocation estimated intangible assets in total ISK 2,177 million, which will be assigned to goodwill, customer relationship and related agreements and software. The allocation of purchase price has not been completed at year end but Valitor Holding hf. will complete it within the 12 months permitted from the acquisition date.

| *Policies applied to the Group's intangible assets:* | Goodwill and infrastructure | Customer relationship and related agreements | Software |
|---|---|---|---|
| Useful lives | Undefined | Finite 5-15 years and undefined | Finite 3-10 years |
| Amortization method | Impairment test | Straight-line basis over 5-15 years and impairment test | Straight-line basis over 3-10 years |
| Internally generated or acquired | Acquired | Acquired | Internally generated and acquired |

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### 26. Intangible assets, continued

| 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 | 1,773 | - | 297 | 107 | 2,177 |
| Additions and transfers | 174 | - | (125) | 1,310 | 1,359 |
| Additions, internally developed | - | - | - | 347 | 347 |
| Exchange difference | 166 | - | 20 | 41 | 227 |
| Impairment | - | - | (3) | - | (3) |
| Amortization | - | - | (305) | (1,011) | (1,316) |
| **Intangible assets** | 4,315 | 3,705 | 1,492 | 4,336 | 13,848 |

| 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.

*Impairment testing*

The methodology for impairment testing on the Infrastructure and Customer relationship, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 3 million was recognized in 2017 (2016: ISK 9 million).

| | 2017 | | 2016 | |
|---|---|---|---|---|
| *Discount and growth rates* | Discount rates | Growth rates | Discount rates | Growth rates |
| Asset Management operation | 15.2% | 2.5% | 15.1% | 2.5% |
| Payment solution and Credit card operation | 13.7% | 2.5% | 15.1% | 2-37% |
| Insurance operation | 13-13.9% | 2.5% | 14.6% | 2.5% |

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## 27. Tax assets and tax liabilities

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities |
| Current tax | - | 6,329 | - | 6,630 |
| Deferred tax | 450 | 499 | 288 | 663 |
| **Tax assets and tax liabilities** | 450 | 6,828 | 288 | 7,293 |

*Deferred tax assets and tax liabilities are attributable to the following:*

| | 2017 Assets | 2017 Liabilities | 2016 Assets | 2016 Liabilities |
|---|---|---|---|---|
| Foreign currency denominated assets and liabilities | 293 | - | 1 | (225) |
| Investment property and property and equipment | 68 | (1,050) | 40 | (689) |
| Financial assets | 468 | - | 475 | - |
| Other assets and liabilities | 124 | (383) | 266 | (407) |
| Deferred tax related to foreign exchange gain | - | (9) | - | (103) |
| Tax loss carry forward | 440 | - | 267 | - |
| | 1,393 | (1,442) | 1,049 | (1,424) |
| Set-off of deferred tax assets together with tax liabilities of the same taxable entities | (943) | 943 | (761) | 761 |
| **Deferred tax assets and tax liabilities** | 450 | (499) | 288 | (663) |

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 493 million (31.12.2016: ISK 464 million) that is not recognized in the Consolidated Financial Statements, due to uncertainty about the utilization possibilities of the loss.

| *Changes in deferred tax assets and tax liabilities* | At 1 Jan. | Addition related to Vördur | Recognized through equity | Recognized in profit or loss | At 31 Dec. |
|---|---|---|---|---|---|
| 2017 | | | | | |
| Foreign currency denominated assets and liabilities | (224) | - | - | 517 | 293 |
| Investment property and property and equipment | (649) | - | - | (333) | (982) |
| Financial assets | 475 | - | - | (7) | 468 |
| Other assets and liabilities | (141) | - | - | (118) | (259) |
| Deferred foreign exchange differences | (103) | - | - | 94 | (9) |
| Tax loss carry forward | 267 | - | - | 173 | 440 |
| **Change in deferred tax assets and tax liabilities** | (375) | - | - | 326 | (49) |
| 2016 | | | | | |
| Foreign currency denominated assets and liabilities | (218) | - | - | (6) | (224) |
| Investment property and property and equipment | (170) | (409) | - | (70) | (649) |
| Financial assets | (677) | 8 | 1,171 | (27) | 475 |
| Other assets and liabilities | (239) | - | - | 98 | (141) |
| Deferred foreign exchange differences | (141) | - | - | 38 | (103) |
| Tax loss carry forward | - | 147 | - | 120 | 267 |
| **Change in deferred tax assets and tax liabilities** | (1,445) | (254) | 1,171 | 153 | (375) |

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## 28. Non-current assets and disposal groups held for sale

| | 2017 | 2016 |
|---|---|---|
| Disposal groups held for sale | 5,219 | - |
| Real estate | 2,879 | 4,371 |
| Other assets | 40 | 47 |
| **Non-current assets and disposal groups held for sale** | 8,138 | 4,418 |

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

*United Silicon*

At 31 December 2016, the Bank held a loan of ISK 6,277 million against United Silicon, collateralized with shares in the company ans other asstes. The Bank also had a 6% equity interest in United Silicon and an unsecured bond in the amount of ISK 877 million. In the second quarter of 2017, Arion Bank invested ISK 907 million in United Silicon, obtaining an interest ownership of 16.3%, with voting rights of 23.9% and thus United Silicon became an associate of Arion Bank, accounted for according to the equity method, less impairment. The purpose of the investment was to support the company in operating difficulties. Due to operating difficulties the Bank fully provisioned for the equity holdings in United Silicon of ISK 1,164 million at the end of the second quarter; ISK 907 million through Share of profit of associates and ISK 257 million through Net financial income in the Statement of Comprehensive Income.

In September 2017 the Bank foreclosed on collateral and took possession of the shares in United Silicon and became the largest shareholder of the company, with an interest ownership of 66.58% and voting rights of 66.68%. With this transaction the Bank acquired the control of United Silicon and thus the company became a subsidiary of the Bank. The fair value calculation of the underlying assets resulted in a provision on loans of ISK 2,962 million recognized in Net impairment as well as fair value loss of unsecured bond of ISK 708 million recognized in Net financial income of the Statement of Comprehensive Income.

The book value of assets of United Silicon was ISK 5,219 million at year-end 2017. As the company was acquired exclusively with a view to resale, it has been classified as an asset held for sale and as a discontinued operations as of 31 December 2017 in accordance with IFRS 5.

The effects on the Statement of Financial Position when United Silicon became subsidiary of the Bank was as follows:

| | |
|---|---|
| Loans to customers | (4,535) |
| Non-current assets and disposal groups held for sale | 4,479 |
| Deposits | 56 |
| | - |

## 29. Other assets

| | 2017 | 2016 |
|---|---|---|
| Property and equipment | 6,561 | 6,723 |
| Accounts receivable | 6,531 | 5,373 |
| Unsettled securities trading | 481 | 712 |
| Investment for life assurance policyholders where risk is held by policyholder | 869 | 820 |
| Sundry assets | 2,524 | 2,808 |
| **Other assets** | 16,966 | 16,436 |

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### 29. Other assets, continued

| *Property and equipment* | Real estate | Equip-ment | Total 2017 | Total 2016 |
|---|---|---|---|---|
| Gross carrying amount at the beginning of the year | 6,114 | 7,587 | 13,701 | 12,903 |
| Acquisition | - | 776 | 776 | 1,010 |
| Acquisition through business combination | - | 21 | 21 | 62 |
| Disposals and transfers | (135) | (298) | (433) | (259) |
| Translation difference | - | 5 | 5 | (15) |
| **Gross carrying amount at the end of the year** | 5,979 | 8,091 | 14,070 | 13,701 |
| Accumulated depreciation at the beginning of the year | (1,728) | (5,250) | (6,978) | (6,137) |
| Depreciation | (143) | (673) | (816) | (865) |
| Disposals and transfers | 31 | 254 | 285 | 24 |
| **Accumulated depreciation at the end of the year** | (1,840) | (5,669) | (7,509) | (6,978) |
| **Property and equipment** | 4,139 | 2,422 | 6,561 | 6,723 |

The official real estate value (Registers Iceland) amounted to ISK 5,677 million at the end of the year (31.12.2016: ISK 4,905 million) and the insurance value amounts to ISK 10,066 million (31.12.2016: ISK 8,818 million).

### 30. Other liabilities

| | 2017 | 2016 |
|---|---|---|
| Accounts payable | 26,394 | 22,627 |
| Unsettled securities trading | 527 | 668 |
| Depositors' and Investors' Guarantee Fund* | 218 | 2,870 |
| Technical provision | 12,129 | 10,243 |
| Technical provision for life assurance policyholders were investment risk is held by policyholder | 869 | 820 |
| Withholding tax | 1,414 | 1,745 |
| Bank levy | 3,172 | 2,872 |
| Sundry liabilities | 12,339 | 12,249 |
| **Other liabilities** | 57,062 | 54,094 |

| *Technical provision* | Technical provision | Reinsurers' share | Total 2017 | Technical provision | Reinsurers' share | Total 2016 |
|---|---|---|---|---|---|---|
| Claims reported and loss adjustment expenses | 5,587 | (121) | 5,466 | 4,842 | (167) | 4,675 |
| Claims incurred but not reported | 1,664 | (99) | 1,565 | 1,352 | (99) | 1,253 |
| **Claims outstanding** | 7,251 | (220) | 7,031 | 6,194 | (266) | 5,928 |
| Provision for unearned premiums | 4,878 | (19) | 4,859 | 4,049 | (18) | 4,031 |
| **Own technical provision** | 12,129 | (239) | 11,890 | 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.

*In prior 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 35.

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# Notes to the Consolidated Financial Statements

### 31. Borrowings

| Currency, original nominal value | First issued | Maturity | Maturity type | Terms of interest | 2017 | 2016 |
|---|---|---|---|---|---|---|
| ARION CBI 19, ISK 4,500 million ........ | 2013 | 2019 | At maturity | Fixed, CPI linked, 2.50% ................. | 4,586 | 4,502 |
| ARION CB 19, ISK 2,740 million ......... | 2016 | 2019 | At maturity | Fixed, 5.50% ................................. | 1,789 | 580 |
| ARION CBI 21, ISK 10,220 million ...... | 2014 | 2021 | At maturity | Fixed, CPI linked, 3.50% ................. | 9,729 | 9,696 |
| ARION CB 22, ISK 23,660 million ....... | 2015 | 2022 | At maturity | Fixed, 6.50% ................................. | 23,339 | 19,596 |
| ARION CBI 25, ISK 23,080 million ...... | 2017 | 2025 | At maturity | Fixed, CPI linked, 3.00% ................. | 22,875 | - |
| ARION CBI 29, ISK 25,220 million ...... | 2014 | 2029 | At maturity | Fixed, CPI linked, 3.50% ................. | 26,243 | 23,524 |
| ARION CBI 34, ISK 2,500 million ........ | 2012 | 2034 | Amortizing | Fixed, CPI linked, 3.60% ................. | 2,152 | 2,207 |
| **Statutory covered bonds** ........................................ | | | | | 90,713 | 60,105 |
| ARION CB 1, ISK 21,877 million ......... | 2006 | 2033 | Amortizing | Fixed, CPI linked, 3.75% ................. | - | 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% ................. | 78,267 | 78,239 |
| **Structured Covered bonds** ........................................ | | | | | 78,267 | 101,172 |
| **Total Covered bonds** ........................................ | | | | | 168,980 | 161,277 |
| USD 30 million ................................. | 2016 | 2017 | At maturity | Floating, 3 month LIBOR +1.93% .... | - | 3,406 |
| EUR 21 million ................................. | 2009 | 2018 | Amortizing | Floating, EURIBOR +1.00% ............ | 348 | 662 |
| ISK 3,835 million ............................... | 2010 | 2018 | Amortizing | Floating, REIBOR +1.00% ............... | 531 | 1,063 |
| EUR 300 million ................................ | 2015 | 2018 | At maturity | Fixed, 3.125% ............................... | 25,461 | 36,610 |
| SEK 500 million ................................. | 2016 | 2018 | At maturity | Floating, 3 month STIBOR +1.09% .. | 6,348 | 3,113 |
| EUR 300 million ................................ | 2016 | 2019 | At maturity | Fixed, 2.50% ................................. | 37,957 | 36,307 |
| RON 35 million ................................. | 2016 | 2019 | At maturity | Fixed, 3.80% ................................. | 966 | 951 |
| SEK 275 million ................................. | 2016 | 2019 | At maturity | Floating, 3 month STIBOR +2.65% .. | 3,485 | 3,422 |
| SEK 100 million ................................. | 2017 | 2019 | At maturity | Fixed, 0.29% ................................. | 1,268 | - |
| NOK 800 million ............................... | 2015 | 2020 | At maturity | Floating, NIBOR +2.95% ................ | 10,236 | 10,617 |
| NOK 320 million ............................... | 2016 | 2020 | At maturity | Floating, NIBOR +1.95% ................ | 4,087 | 2,902 |
| EUR 300 million* .............................. | 2017 | 2020 | At maturity | Fixed, 0.75% ................................ | 37,356 | - |
| SEK 300 million ................................. | 2017 | 2020 | At maturity | Floating, 3 month STIBOR +1.35% .. | 3,811 | - |
| SEK 250 million ................................. | 2017 | 2020 | At maturity | Floating, 3 month STIBOR +0.75% .. | 3,173 | - |
| EUR 500 million* .............................. | 2016 | 2021 | At maturity | Fixed, 1.625% .............................. | 61,341 | 35,639 |
| USD 747 million ................................ | 2016 | 2023 | At maturity | Floating, 3 month LIBOR +2.60% .... | - | 29,317 |
| NOK 250 million ............................... | 2017 | 2023 | At maturity | Fixed, 3.02% ................................ | 3,231 | - |
| NOK 250 million ............................... | 2017 | 2027 | At maturity | Fixed, 3.40% ................................ | 3,240 | - |
| **Senior unsecured bonds** ........................................ | | | | | 202,839 | 164,009 |
| Bills issued ........................................ | | | | | 10,794 | 13,854 |
| Other ........................................ | | | | | 2,385 | 336 |
| **Other loans/bills** ........................................ | | | | | 13,179 | 14,190 |
| **Borrowings** ........................................ | | | | | 384,998 | 339,476 |

*The Group applies fair value hedge accounting to these bond issuances 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 these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 98,697 million and included in the amount are fair value changes amounting to ISK 736 million, see Note 8.

The book value of listed bonds was ISK 371 billion at the end of the year (31.12.2016: ISK 284 billion). The market value of those bonds was ISK 388 billion (31.12.2016: ISK 290 billion). The Group repurchased own debts in 2017 in the amount of ISK 20 billion (2016: nil) with minor effects on the Statement of Comprehensive Income.

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# Notes to the Consolidated Financial Statements

## 31. Borrowings, continued

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.

## 32. Pledged assets

| *Pledged assets against liabilities* | 2017 | 2016 |
|---|---|---|
| Assets, pledged as collateral against borrowings | 202,381 | 196,901 |
| Assets, pledged as collateral against loans from credit institutions and short positions | 13,364 | 15,644 |
| **Pledged assets against liabilities** | 215,745 | 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 202 billion at the end of the year (31.12.2016: ISK 197 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 169 billion at the end of the year (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.

## 33. 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) | 2017 | Number (million) | 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* | 2017 | 2016 |
|---|---|---|
| Statutory reserve | 1,637 | 1,637 |
| Reserve for investments in subsidiaries | 14,011 | 17,012 |
| Reserve for investments in associates | 39 | 23 |
| Reserve for investments in securities | 901 | 899 |
| Foreign currency translation reserve | 186 | 190 |
| **Other reserves** | 16,774 | 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 66.

## Other information

### 34. 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 year, the Group had several unresolved legal claims.

**Contingent liabilities**

*Legal proceedings regarding damages*

With a writ issued in June 2013, Kortathjónustan 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 Kortathjónustan 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. Kortathjónustan 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 defendants have brought forth a motion to dismiss. If the defendants would be ordered to pay damages they would be jointly responsible for the payment of damages. Therefore the Bank has not made any provision.

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 Fasteignafélagid 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 the compensatory damages described above. 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 2017 the Supreme Court, in respect of cases which did not involve the Bank, ruled in several cases regarding this issue. In the majority of those cases the Supreme Court invalidated a mortgage. The district court has ruled in several court cases involving the Bank regarding the aforementioned dispute. In the majority of those cases the district court invalidated a mortgage. 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.

*United Silicon*

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank has collateral in the company's assets. During the moratorium period three unsecured creditors of the company sent the Bank a letter in which they asked for the cooperation of creditors in order to solve issues related to the company but they also submitted observations on the Bank's lien on the assets of United Silicon and reserved the right to lodge claims against the Bank if these liens are invalid. The Bank has examined these criticisms and rejects them all.

# Notes to the Consolidated Financial Statements

## Off balance sheet information

### 35. Commitments

| | 2017 | 2016 |
|---|---|---|
| *Financial guarantees, unused overdraft and loan commitments the Group has granted its customers* | | |
| Financial guarantees | 13,224 | 15,270 |
| Unused overdrafts | 45,897 | 46,379 |
| Loan commitments | 87,942 | 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 would not be collected by the fund. Therefore the Bank reversed a previously expensed contribution to the Depositors' and Investors' Guarantee Fund amounting to ISK 2,669 million, in 2017.

### 36. Operating lease commitments

*Group as a lessee*

The Group has concluded lease agreements on some of the real estate it uses for its operations. These lease agreements are for a period of up to 10 years. The majority of the contracts include renewal options for various periods of time.

| | 2017 | 2016 |
|---|---|---|
| Less than one year | 547 | 507 |
| Over 1 year and up to 5 years | 1,481 | 1,371 |
| Over 5 years | 341 | 368 |
| **Future minimum lease payments under non-cancellable leases** | 2,369 | 2,246 |

*Group as a lessor*

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 9 years.

| | 2017 | 2016 |
|---|---|---|
| Less than one year | 69 | 68 |
| Over 1 year and up to 5 years | 233 | 147 |
| Over 5 years | 103 | 55 |
| **Future minimum lease payments under non-cancellable leases** | 405 | 270 |

### 37. Assets under management and under custody

| | | |
|---|---|---|
| Assets under management | 984,653 | 1,054,759 |
| Assets under custody | 1,620,355 | 1,532,860 |

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.

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### 38. Events after the reporting period

At a shareholders' meeting on 12 February 2018 the Board of Directors of Arion Bank was given a mandate and the authorization to acquire up to 10% of issued shares in the Bank, in one or more transactions. This authorization is valid until 15 April 2018.

At the same shareholders' meeting approval was given for a conditional dividend payment of up to ISK 25 billion, which is contingent on Kaupskil, which owns 57.41% of the issued share capital in the Bank, having previously sold no less than 2% in Arion Bank in a private placement. This conditional authorization is valid until 15 April 2018.

At the shareholders' meeting it was also approved that the aforementioned acquisition of shares and dividend would be a maximum of ISK 25 billion.

On 14 February 2018 an announcement was made on the sale by Kaupskil of 5.34% of outstanding shares in Arion Bank to a number of funds managed by four Icelandic fund management companies, who come on board as new investors, and Trinity Investments (Attestor Capital LLP) and Goldman Sachs, who are increasing their stakes in the Bank. The conditions for the aforementioned dividend payment is therefore fulfilled.

## Related party

### 39. 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. Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. holds 9.99% shareholding in Arion Bank and Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group manages 6.58% shareholding in Arion Bank, but the shareholding is managed by Kaupskil ehf. Taconic Capital Advisors UK LLP, TCA New Sidecar III S.A.R.L., Sculptor Investments S.A.R.L. and Och-Ziff Capital Management Group are thus defined as related party with control over the Group.

Attestor Capital LLP through Trinity Investment Designated Activity Company manages 10.44% shareholding in Arion Bank and Goldman Sachs International through ELQ Investors II Ltd. manages 2.57% shareholding in Arion Bank. Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13.00% shareholding in Arion Bank. All above-mentioned parties are defined as related party with influence over the Group.

Íslandsbanki hf. and Landsbankinn hf. are wholly owned by ISFI. 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.

2017

| *Balances with related parties* | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with control over the Group | 57 | (4,785) | (4,728) |
| Shareholders with influence over the Group | 423 | (151) | 272 |
| Board of Directors and key Management personnel | 183 | (101) | 82 |
| Associates and other related parties | - | (83) | (83) |
| **Balances with related parties** | 663 | (5,120) | (4,457) |

| *Transactions with related parties* | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | - | (480) | - | - |
| Shareholders with influence over the Group | 81 | - | 7 | - |
| Board of Directors and key Management personnel | 13 | (5) | 10 | (184) |
| Associates and other related parties | - | (3) | - | (1,260) |
| **Transactions with related parties** | 94 | (488) | 17 | (1,444) |

2016

| *Balances with related parties* | 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) |

| *Transactions with related parties* | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | 1 | (89) | 4 | - |
| Board of Directors and key Management personnel | 15 | (7) | - | - |
| Associates and other related parties | 28 | (4) | 2 | (216) |
| **Transactions with related parties** | 44 | (100) | 6 | (216) |

At the end of 2016 Kaupthing hf. held senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 29,317 million. The amount is not included in the table above. The bond was paid up in 2017.

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# Notes to the Consolidated Financial Statements

## Risk management disclosures

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

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk policies and governance for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Risk Committee (BRIC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital and liquidity adequacy assessment processes (ICAAP/ILAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Data Committee (DC) is responsible for ensuring that data is managed properly; and the Security Committee (SC) is responsible for security matters, both information security and physical security. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's own funds, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BAC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into three units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is responsible for the Bank's ICAAP and ILAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Data Officer is part of the Risk Management division.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, indexation risk and interest rate risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The Bank has no large exposure at the end of the year. The total sum of large exposures is therefore 0% as in the previous year. 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.

The Group's operations are subject to interest rate risk associated with mismatches in the fixing of interest rates between assets and liabilities. Prepayment risk has increased due to favorable refinancing spreads in the domestic market where interest rates have decreased. The Group is exposed to indexation risk as index-linked assets exceed index-linked liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 77% is on-demand or with less than 30 day term.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2017 and in the Pillar 3 Risk Disclosures for 2017. The Pillar 3 Risk Disclosures 2017 will be published in March 2018 and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not subject to external audit.

## 40. 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 guarantees.

Managing and analyzing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

## 40. Credit risk, continued

**Exposure to credit risk**

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2017

Maximum exposure to credit risk related to on-balance sheet assets

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ....... | - | - | - | - | - | 139,819 | - | - | - | - | - | 139,819 |
| Loans to credit institutions ...................... | - | - | - | - | - | 86,609 | - | - | - | - | - | 86,609 |
| Loans to customers ................................ | 365,287 | 128,153 | 78,937 | 22,020 | 57,432 | 34,138 | 29,452 | 17,111 | 18,157 | 7,824 | 6,590 | 765,101 |
| Financial instruments .............................. | 295 | 1,118 | 252 | - | 25 | 22,889 | 9,110 | 3 | 2,162 | 42,930 | - | 78,784 |
| Other assets with credit risk .................... | 2,380 | 324 | 93 | 24 | 43 | 5,542 | 118 | 213 | 156 | 54 | 1 | 8,948 |
| **Total on-balance sheet maximum exposure to credit risk .........................** | 367,962 | 129,595 | 79,282 | 22,044 | 57,500 | 288,997 | 38,680 | 17,327 | 20,475 | 50,808 | 6,591 | 1,079,261 |

*Maximum exposure to credit risk related to off-balance sheet items*

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial guarantees ............................... | 1,443 | 1,482 | 287 | 334 | 3,819 | 120 | 748 | 1,671 | 3,247 | 47 | 26 | 13,224 |
| Unused overdrafts .................................. | 28,898 | 2,462 | 640 | 546 | 4,511 | 1,058 | 2,200 | 380 | 2,330 | 2,453 | 419 | 45,897 |
| Loan commitments ................................ | 5,297 | 25,148 | 8,023 | 1,850 | 18,035 | 5,448 | 17,689 | 2,575 | 3,541 | - | 336 | 87,942 |
| **Total off-balance sheet maximum exposure to credit risk ........................** | 35,638 | 29,092 | 8,950 | 2,730 | 26,365 | 6,626 | 20,637 | 4,626 | 9,118 | 2,500 | 781 | 147,063 |
| **Maximum exposure to credit risk ...........** | 403,600 | 158,687 | 88,232 | 24,774 | 83,865 | 295,623 | 59,317 | 21,953 | 29,593 | 53,308 | 7,372 | 1,226,324 |

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### 40. Credit risk, continued

2016

*Maximum exposure to credit risk related to on-balance sheet assets*

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ........ | - | - | - | - | - | 87,634 | - | - | - | - | - | 87,634 |
| Loans to credit institutions ....................... | - | - | - | - | - | 80,116 | - | - | - | - | - | 80,116 |
| Loans to customers .................................. | 337,417 | 114,895 | 76,475 | 28,647 | 52,719 | 34,939 | 28,633 | 6,519 | 17,308 | 8,711 | 6,159 | 712,422 |
| Financial instruments ............................... | 307 | 1,106 | 261 | - | 7 | 18,865 | 10,942 | 3 | 557 | 59,253 | - | 91,301 |
| Other assets with credit risk .................... | 443 | 779 | 14 | 19 | 22 | 6,708 | 10 | 7 | 540 | 72 | 3 | 8,617 |
| **Total on-balance sheet maximum exposure to credit risk .........................** | 338,167 | 116,780 | 76,750 | 28,666 | 52,748 | 228,262 | 39,585 | 6,529 | 18,405 | 68,036 | 6,162 | 980,090 |

*Maximum exposure to credit risk related to off-balance sheet items*

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial guarantees ................................. | 1,394 | 1,967 | 1,573 | 1,039 | 2,416 | 1,333 | 1,880 | 978 | 2,643 | 35 | 12 | 15,270 |
| Unused overdrafts ................................... | 27,609 | 2,226 | 640 | 574 | 5,951 | 1,546 | 2,363 | 381 | 2,845 | 1,895 | 349 | 46,379 |
| Loan commitments ................................. | 33 | 15,276 | 16,756 | 540 | 24,249 | 7,154 | 13,155 | 2,399 | 2,659 | 38 | 9 | 82,268 |
| **Total off-balance sheet maximum exposure to credit risk .........................** | 29,036 | 19,469 | 18,969 | 2,153 | 32,616 | 10,033 | 17,398 | 3,758 | 8,147 | 1,968 | 370 | 143,917 |
| **Maximum exposure to credit risk ...........** | 367,203 | 136,249 | 95,719 | 30,819 | 85,364 | 238,295 | 56,983 | 10,287 | 26,552 | 70,004 | 6,532 | 1,124,007 |

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## 40. Credit risk, continued

| *Loans to customers specified by sectors* | 2017 | 2016 |
|---|---|---|
| Individuals | 47.7% | 47.4% |
| Real estate activities and construction | 16.7% | 16.1% |
| Fishing industry | 10.3% | 10.7% |
| Information and communication technology | 3.0% | 4.1% |
| Wholesale and retail trade | 7.5% | 7.4% |
| Financial and insurance activities | 4.5% | 4.9% |
| Industry, energy and manufacturing | 3.8% | 4.0% |
| Transportation | 2.2% | 0.9% |
| Services | 2.4% | 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*

| 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 | 195 | 326,456 | 16 | 8,413 | 335,080 |
| Real estate activities and construction | 371 | 115,467 | 208 | 1,928 | 117,974 |
| Fishing industry | 24 | 8,569 | 52,693 | 10,580 | 71,866 |
| Information and communication technology | 541 | 1,103 | - | 2,035 | 3,679 |
| Wholesale and retail trade | 208 | 32,294 | 12 | 16,131 | 48,645 |
| Financial and insurance activities | 13,440 | 4,184 | 681 | 6,174 | 24,479 |
| Industry, energy and manufacturing | 660 | 19,367 | - | 5,747 | 25,774 |
| Transportation | 3 | 973 | 278 | 1,395 | 2,649 |
| Services | 15 | 7,365 | 98 | 3,047 | 10,525 |
| Public sector | 114 | 3,657 | - | 92 | 3,863 |
| Agriculture and forestry | - | 5,966 | - | 248 | 6,214 |
| Financial instruments | 5,948 | - | - | - | 5,948 |
| Financial guarantees | 871 | 3,343 | 1,598 | 3,343 | 9,155 |
| **Collateral held against different types of financial assets** | 22,390 | 528,744 | 55,584 | 59,133 | 665,851 |

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### 40. Credit risk, continued

| 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 year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the year and still holds at the end of the year amount to ISK 833 million (31.12.2016: ISK 1,817 million) and other assets 2 million (31.12.2016: ISK 13 million). The assets are held for sale, see Note 29.

**Credit quality**

*Credit quality by class of financial assets*

| 2017 | Neither past due nor impaired | Past due but not impaired | Individually impaired | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | 139,819 | - | - | 139,819 |
| Loans to credit institutions | 86,609 | - | - | 86,609 |
| Loans to customers | | | | |
| Loans to corporates | 385,197 | 13,655 | 962 | 399,814 |
| Loans to individuals | 344,829 | 18,929 | 1,529 | 365,287 |
| Financial instruments | 78,784 | - | - | 78,784 |
| Other assets with credit risk | 8,948 | - | - | 8,948 |
| **Credit quality by class of financial assets** | 1,044,186 | 32,584 | 2,491 | 1,079,261 |

| 2016 | Neither past due nor impaired | Past due but not impaired | Individually 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 |

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### 40. Credit risk, continued

*Neither past due nor impaired loans*

The Bank uses internal credit rating models to monitor credit risk. The Bank rates customers with one of four statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. 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 | | | | | | |
|---|---|---|---|---|---|---|---|
| 2017 | 1 | 2 | 3 | 4 | 5 | Not rated | Total |
| Individuals | 176,980 | 116,296 | 36,507 | 9,953 | 2,238 | 2,855 | 344,829 |
| Real estate activities and construction | 28,508 | 51,363 | 40,327 | 3,013 | 83 | 479 | 123,773 |
| Fishing industry | 37,742 | 28,908 | 9,129 | 1,498 | 653 | - | 77,930 |
| Information and communication technology | 17,691 | 1,162 | 2,958 | 21 | - | 3 | 21,835 |
| Wholesale and retail trade | 19,996 | 20,822 | 9,368 | 2,117 | 563 | 141 | 53,007 |
| Financial and insurance activities | 14,638 | 3,708 | 15,103 | 105 | - | 10 | 33,564 |
| Industry, energy and manufacturing | 17,236 | 6,394 | 4,233 | 794 | 187 | - | 28,844 |
| Transportation | 10,644 | 3,713 | 2,201 | 48 | - | 65 | 16,671 |
| Services | 2,392 | 6,227 | 5,224 | 432 | 2,443 | 3 | 16,721 |
| Public sector | 1,730 | 4,938 | 862 | 108 | 47 | - | 7,685 |
| Agriculture and forestry | 863 | 1,740 | 1,816 | 585 | 163 | - | 5,167 |
| **Neither past due nor impaired loans** | 328,420 | 245,271 | 127,728 | 18,674 | 6,377 | 3,556 | 730,026 |
| | | | | | | | |
| 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.

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## 40. Credit risk, continued

| *Past due but not impaired loans by class of loans* 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 | 4,361 | 4,221 | 1,774 | 1,339 | 1,960 | 13,655 |
| Loans to individuals | 3,065 | 8,149 | 4,387 | 350 | 2,978 | 18,929 |
| **Past due but not impaired loans** | 7,426 | 12,370 | 6,161 | 1,689 | 4,938 | 32,584 |

| 2016 | Up to 3 days | 4 to 30 days | 31 to 60 days | 61 to 90 days | More than 90 days | Total |
|---|---|---|---|---|---|---|
| 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.

| | 2017 | | 2016 | |
|---|---|---|---|---|
| *Impaired loans to customers specified by sector* | Impair-ment amount | Gross carrying amount | Impair-ment amount | Gross carrying amount |
| Individuals | 4,010 | 5,539 | 7,069 | 10,372 |
| Real estate activities and construction | 467 | 762 | 770 | 1,056 |
| Fishing industry | 658 | 861 | 966 | 1,648 |
| Information and communication technology | 111 | 112 | 179 | 182 |
| Wholesale and retail trade | 490 | 702 | 540 | 868 |
| Financial and insurance activities | 297 | 314 | 261 | 298 |
| Industry, energy and manufacturing | 473 | 581 | 786 | 878 |
| Transportation | 1 | 1 | 4,301 | 4,307 |
| Services | 3,570 | 3,617 | 3,145 | 3,624 |
| Public sector | 45 | 45 | 89 | 113 |
| Agriculture and forestry | 165 | 244 | 175 | 284 |
| **Impaired loans to customers specified by sector** | 10,287 | 12,778 | 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 Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group had no large exposure at the end of the year before taking account of eligible credit risk mitigation (31.12.2016: no large exposure).

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## 41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates adversely affect the Group's earnings and equity position due to changes to the value and cash flows of its assets and liabilities.

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.

The Group keeps close track of market risk and separates its exposures for the trading book and the banking book. Market risk in the trading book arises from proprietary trading activities and non-strategic derivatives positions arising from the Bank's operations of meeting customers' investment and risk management needs. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately.

Market risk allowance is set by the Board in the Bank's risk appetite and limit frameworks are in place for each trading desk. The Asset and Liability Committee (ALCO) is responsible for managing the Bank's overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

### Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's 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 Group'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 interest rates, nominal and real, have fallen. 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 and mortgage refinancing.

### 41. Market risk, continued

*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 Consolidated Financial Statements. The fair value as of 31 December 2017 reflects the likelihood of prepayment. 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.

| 2017 | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| *Assets* | | | | | | |
| Balances with Central Bank | 129,864 | - | - | - | - | 129,864 |
| Loans to credit institutions | 86,609 | - | - | - | - | 86,609 |
| Loans to customers | 440,161 | 77,099 | 141,944 | 5,867 | 107,114 | 772,185 |
| Financial instruments | 27,342 | 3,033 | 8,186 | - | 1,866 | 40,427 |
| **Assets** | 683,976 | 80,132 | 150,130 | 5,867 | 108,980 | 1,029,085 |
| *Liabilities* | | | | | | |
| Due to credit institutions and Central Bank | 7,370 | - | - | - | - | 7,370 |
| Deposits | 427,393 | 19,453 | 13,083 | 1,343 | 889 | 462,161 |
| Borrowings | 64,533 | 6,637 | 187,998 | 31,293 | 111,946 | 402,407 |
| **Liabilities** | 499,296 | 26,090 | 201,081 | 32,636 | 112,835 | 871,938 |
| Derivatives and other off-balance sheet items (net position) | (99,372) | 114 | 102,038 | 1,548 | - | 4,328 |
| **Net interest gap** | 85,308 | 54,156 | 51,087 | (25,221) | (3,855) | 161,475 |

| 2016 | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| *Assets* | | | | | | |
| 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 | 129,424 | 348,413 |
| **Liabilities** | 447,216 | 29,789 | 139,286 | 21,933 | 130,240 | 768,464 |
| 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) | (742) | 167,898 |

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## 41. Market risk, continued

*Sensitivity analysis of interest rate risk in the banking book*

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. As mentioned above, behavioral maturities are taken into account in the NPV calculations at 31 December 2017, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however purely based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates.

Interest rates for foreign currencies are predominantly short term for the Group and hedging is applied for fixed rate borrowings. As a result the Group's effective interest income is marginally sensitive to changes to foreign currency interest rates. This is however not fully reflected in the NII variation analysis below as a part of the Group's liquid assets in foreign currency is invested in liquidity funds, the income of which is not recognized as interest income.

| | 2017 | | 2016 | |
|---|---|---|---|---|
| NPV change | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI index-linked | (1,465) | 2,411 | 414 | (63) |
| ISK, Non index-linked | (76) | 742 | 348 | (508) |
| Foreign currencies | 88 | (113) | 249 | (295) |

| | 2017 | | 2016 | |
|---|---|---|---|---|
| NII change | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI index-linked | (693) | 693 | (145) | 145 |
| ISK, Non index-linked | (429) | 429 | (536) | 536 |
| Foreign currencies | 353 | (353) | 94 | (94) |

*Sensitivity analysis of interest rate risk in the trading book*

The following table shows the interest sensitivity of the Group's net positions in the trading book by currencies. Sensitivity is quantified as the net change in value when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on duration and convexity in this table.

| | 2017 | | 2016 | |
|---|---|---|---|---|
| Currency | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI index-linked | 99 | (95) | 156 | (152) |
| ISK, Non index-linked | 19 | (14) | 127 | (64) |
| Foreign currencies | 27 | (27) | 2 | (33) |

Arion Bank Consolidated Financial Statements 2017 63 Amounts are in ISK millions

## 41. 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 annuities, 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. Financial instruments held for liquidity or market watch purposes are assumed to be on demand.

Book value and maturity profile of indexed assets and liabilities

| 2017<br>*Assets, CPI index-linked* | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| Loans to customers | 16,928 | 100,149 | 233,292 | 350,369 |
| Financial instruments | 6,659 | - | - | 6,659 |
| Off-balance sheet position | 4,667 | 2,096 | - | 6,763 |
| **Assets, CPI index-linked** | 28,254 | 102,245 | 233,292 | 363,791 |
| *Liabilities, CPI index-linked* | | | | |
| Deposits | 68,667 | 12,499 | 2,201 | 83,367 |
| Borrowings | 1,832 | 20,867 | 121,692 | 144,391 |
| Other | 982 | 203 | 1,369 | 2,554 |
| Off-balance sheet position | - | 539 | - | 539 |
| **Liabilities, CPI index-linked** | 71,481 | 34,108 | 125,262 | 230,851 |
| Net on-balance sheet position | (47,894) | 66,580 | 108,030 | 126,716 |
| Net off-balance sheet position | 4,667 | 1,557 | - | 6,224 |
| **CPI Balance** | (43,227) | 68,137 | 108,030 | 132,940 |

| 2016<br>*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 |

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## 41. 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

2017

| *Assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank . | 137,399 | 943 | 293 | 266 | 265 | 117 | 536 | 139,819 |
| Loans to credit institutions ................ | 17,678 | 15,033 | 27,117 | 8,518 | 1,910 | 10,621 | 5,732 | 86,609 |
| Loans to customers .......................... | 624,192 | 97,687 | 27,879 | 3,283 | 7,245 | 646 | 4,169 | 765,101 |
| Financial instruments ........................ | 56,240 | 39,891 | 11,309 | 102 | 9 | 1,691 | 208 | 109,450 |
| Other financial assets ........................ | 6,023 | 965 | 613 | 1,102 | 171 | 24 | 50 | 8,948 |
| **Assets ............................................** | 841,532 | 154,519 | 67,211 | 13,271 | 9,600 | 13,099 | 10,695 | 1,109,927 |
| *Liabilities and equity* | | | | | | | | |
| Due to credit inst. and Central Bank .. | 6,989 | 292 | 38 | 3 | - | 1 | 47 | 7,370 |
| Deposits ........................................... | 412,981 | 23,792 | 15,382 | 3,309 | 1,349 | 3,692 | 1,656 | 462,161 |
| Financial liabilities at fair value ......... | 2,253 | 1,183 | 34 | 27 | 32 | 35 | 37 | 3,601 |
| Other financial liabilities ................... | 20,150 | 3,870 | 2,183 | 5,505 | 1,393 | 565 | 1,039 | 34,705 |
| Borrowings ....................................... | 181,787 | 162,486 | 1,832 | 14 | - | 20,794 | 18,085 | 384,998 |
| **Liabilities and equity .......................** | 624,160 | 191,623 | 19,469 | 8,858 | 2,774 | 25,087 | 20,864 | 892,835 |
| Net on-balance sheet position .......... | 217,372 | (37,104) | 47,742 | 4,413 | 6,826 | (11,988) | (10,169) | |
| Net off-balance sheet position .......... | (536) | 34,743 | (46,994) | (1,557) | (9,142) | 12,331 | 11,155 | |
| **Net position ...................................** | 216,836 | (2,361) | 748 | 2,856 | (2,316) | 343 | 986 | |

Addition, for management reporting

| *Assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Investment property ......................... | 6,613 | - | - | - | - | - | - | 6,613 |
| Investments in associates .................. | 752 | 8 | - | - | - | - | - | 760 |
| Intangible assets ............................... | 13,848 | - | - | - | - | - | - | 13,848 |
| Tax assets ......................................... | 450 | - | - | - | - | - | - | 450 |
| Non-current assets and disposal groups held for sale ........................ | 8,138 | - | - | - | - | - | - | 8,138 |
| Other non financial assets ................. | 7,843 | 61 | 34 | 36 | 2 | 19 | 23 | 8,018 |
| **Assets ............................................** | 37,644 | 69 | 34 | 36 | 2 | 19 | 23 | 37,827 |
| *Liabilities and equity* | | | | | | | | |
| Tax liabilities ..................................... | 6,828 | - | - | - | - | - | - | 6,828 |
| Other non-financial liabilities ............ | 22,106 | 99 | 30 | 122 | 1 | - | (1) | 22,357 |
| Shareholders' equity ......................... | 225,606 | - | - | - | - | - | - | 225,606 |
| Non-controlling interest .................... | 128 | - | - | - | - | - | - | 128 |
| **Liabilities and equity .......................** | 254,668 | 99 | 30 | 122 | 1 | - | (1) | 254,919 |
| **Management reporting of currency risk* ...........................** | (188) | (2,391) | 752 | 2,770 | (2,315) | 362 | 1,010 | |

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### 41. Market risk, continued

| 2016<br>*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 |
| Other financial assets ....................... | 7,992 | 179 | 293 | 39 | 112 | - | 2 | 8,617 |
| **Assets ...........................................** | 796,741 | 97,562 | 61,948 | 12,093 | 9,757 | 12,424 | 15,720 | 1,006,245 |
| *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 |
| Other financial liabilities ................... | 27,457 | 2,546 | 1,066 | 4,251 | 754 | 229 | 47 | 36,350 |
| Borrowings ....................................... | 176,530 | 109,217 | 32,723 | - | - | 13,520 | 7,486 | 339,476 |
| **Liabilities and equity ......................** | 591,059 | 128,911 | 46,183 | 8,440 | 1,598 | 15,067 | 8,345 | 799,603 |
| Net on-balance sheet position .......... | 205,682 | (31,349) | 15,765 | 3,653 | 8,159 | (2,643) | 7,375 | |
| Net off-balance sheet position .......... | 279 | 31,775 | (15,315) | (3,232) | (8,579) | 2,335 | (7,263) | |
| **Net position ...................................** | 205,961 | 426 | 450 | 421 | (420) | (308) | 112 | |
| Addition, for management reporting | | | | | | | | |
| *Assets* | | | | | | | | |
| 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 |
| Non-current assets and disposal<br>groups held for sale ....................... | 4,418 | | | | | | | 4,418 |
| Other non-financial assets ................ | 6,946 | 471 | 263 | 103 | 23 | 13 | - | 7,819 |
| **Assets ...........................................** | 24,803 | 479 | 263 | 103 | 4,118 | 13 | - | 29,779 |
| *Liabilities and equity* | | | | | | | | |
| Tax liabilities ..................................... | 7,075 | - | - | - | 218 | - | - | 7,293 |
| Other non-financial liabilities ........... | 17,168 | 114 | 94 | 4 | 2 | - | 362 | 17,744 |
| Shareholders' equity ........................ | 211,212 | - | - | - | - | - | - | 211,212 |
| Non-controlling interest ................... | 172 | - | - | - | - | - | - | 172 |
| **Liabilities and equity ......................** | 235,627 | 114 | 94 | 4 | 220 | - | 362 | 236,421 |
| **Management reporting<br>of currency risk* ..........................** | (4,863) | 791 | 619 | 520 | 3,478 | (295) | (250) | |

*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.

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### 41. Market risk, continued

*Sensitivity analysis on currency risk*

The table below indicates the currencies to which the Group had significant exposure at the end of the year. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the Statement of Comprehensive income (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in the Statement of Comprehensive income or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

| | 2017 | | 2016 | |
|---|---|---|---|---|
| Currency | -10% | +10% | -10% | +10% |
| EUR | 239 | (239) | (79) | 79 |
| USD | (75) | 75 | (62) | 62 |
| GBP | (277) | 277 | (52) | 52 |
| DKK | 232 | (232) | (348) | 348 |
| NOK | (36) | 36 | 30 | (30) |
| Other | (101) | 101 | 25 | (25) |

**Equity risk**

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 29 and 22 respectively.

*Sensitivity analysis of equity risk*

The analysis below calculates the effect of a reasonable possible movement in equity prices on the Statement of Comprehensive Income. A negative amount in the table reflects a potential net reduction in the Statement of Comprehensive income or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded. The result of value-at-risk calculations for the trading book are shown in the Group's Pillar 3 Disclosures.

| | 2017 | | 2016 | |
|---|---|---|---|---|
| Equity | -10% | +10% | -10% | +10% |
| Trading book - listed | (166) | 166 | (295) | 295 |
| Banking book - listed | (540) | 540 | (913) | 913 |
| Banking book - unlisted | (1,170) | 1,170 | (1,193) | 1,193 |

**Derivatives**

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to reduce market risk on its balance sheet. Note 23 shows a breakdown of the Group's derivative positions by type.

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## 42. 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.

The Group's primary source of funding is deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 72% is on-demand.

Liquidity risk is one of the Group's most significant risk factors and a great deal of emphasis is placed on managing it. The Asset and Liability Committee (ALCO) is responsible for managing liquidity and funding risk within the risk appetite set by the Board of Directors. The Bank's Treasury manages liquidity positions on a day-to-day basis. Risk Management measures, monitors and reports the Bank's liquidity and funding risk on a daily basis.

The Group's strategy in relation to liquidity risk is to actively manage its liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Group seeks to maintain a stable funding profile which supports its business strategy and liquidity profile, ensuring that the Group can withstand periods of market turbulence, without reliance on volatile funding or external support.

### 42. Liquidity and Funding risk, continued

**Maturity analysis of assets and liabilities**

The maturity analysis is based on contractual cash flows. The amounts are not discounted and include future interest payments, but CPI-indexed amounts do not include accrued indexation due to future inflation. The total amount for each item is higher than the corresponding amount on the Bank's balance sheet, since the amounts on the balance sheet are either at amortized cost and do not contain future interest payments, or at fair value where future cash flows have been discounted.

Contractual cash flows differ in many ways from expected cash flows. The difference is most significant for deposits on the liability side and bonds on the asset side. Deposits are always assumed to be withdrawn at the earliest possible date, despite the fact that a large part of the deposit base is considered to be stable funding where behavioral maturity considerably exceeds contractual maturity. Furthermore, although contractual cash flows are presented for bonds held by the Bank, a large portion of the bonds are a part of the Bank's liquidity buffer and are considered to be highly liquid and can be sold and/or pledged to the Central Bank of Iceland and thus converted into cash at very short notice.

Contractual cash flow of assets and liabilities

| 2017<br>*Assets* | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 31,281 | 99,340 | 9,362 | - | - | - | 139,983 | 139,819 |
| Loans to credit institutions ............... | 52,320 | 34,294 | - | - | - | - | 86,614 | 86,609 |
| Loans to customers .......................... | 2,908 | 107,790 | 90,076 | 336,545 | 568,833 | - | 1,106,152 | 765,101 |
| Financial instruments ........................ | 8,512 | 15,082 | 14,641 | 20,028 | 5,926 | 44,047 | 108,236 | 109,450 |
| *Derivatives - assets leg .................* | *1,436* | *38,718* | *18,153* | *71,627* | *678* | - | *130,612* | 126,111 |
| *Derivatives - liabilities leg .............* | *(1,423)* | *(37,084)* | *(18,084)* | *(68,879)* | *(585)* | - | *(126,055)* | (118,487) |
| Other financial assets ........................ | 1,535 | 5,103 | 2,224 | 86 | - | - | 8,948 | 8,948 |
| **Assets ............................................** | 96,556 | 261,609 | 116,303 | 356,659 | 574,759 | 44,047 | 1,449,933 | 1,109,927 |
| *Liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank ... | 7,658 | - | 26 | - | - | - | 7,684 | 7,370 |
| Deposits ........................................... | 331,796 | 86,524 | 30,244 | 13,071 | 2,246 | - | 463,881 | 462,161 |
| Financial liabilities at fair value ......... | - | 2,182 | (102) | 593 | (273) | - | 2,400 | 3,601 |
| *Derivatives - assets leg .................* | - | *(20,039)* | *(11,449)* | *(14,407)* | *(1,557)* | - | *(47,452)* | (40,930) |
| *Derivatives - liabilities leg .............* | - | *20,688* | *11,347* | *15,000* | *1,284* | - | *48,319* | 42,998 |
| *Short position bonds and derivatives* | - | *410* | - | - | - | - | *410* | 410 |
| *Short position securities used for economic hedging ................* | - | *1,124* | - | - | - | - | *1,124* | 1,124 |
| Other financial liabilities ................... | 25,538 | 7,296 | 28 | 1,843 | - | - | 34,705 | 34,705 |
| Borrowings ....................................... | - | 37,110 | 23,066 | 239,210 | 175,845 | - | 475,231 | 384,998 |
| **Liabilities ........................................** | 364,992 | 133,112 | 53,262 | 254,717 | 177,818 | - | 983,901 | 892,835 |
| **Net position for assets and liabilities** | (268,436) | 128,497 | 63,041 | 101,942 | 396,941 | 44,047 | 466,032 | 217,092 |
| *Off-balance sheet items* | | | | | | | | |
| Financial guarantees ........................ | 2,918 | 2,852 | 3,164 | 2,827 | 1,463 | - | 13,224 | 13,224 |
| Unused overdraft ............................. | - | 45,897 | - | - | - | - | 45,897 | 45,897 |
| Loan commitments .......................... | 2,966 | 45,788 | 17,751 | 9,559 | 11,878 | - | 87,942 | 87,942 |
| **Off-balance sheet items ..................** | 5,884 | 94,537 | 20,915 | 12,386 | 13,341 | - | 147,063 | 147,063 |
| **Net contractual cash flow ................** | (274,320) | 33,960 | 42,126 | 89,556 | 383,600 | 44,047 | 318,969 | 70,029 |

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# Notes to the Consolidated Financial Statements

### 42. Liquidity and Funding risk, continued

| 2016<br>*Assets* | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank . | 6,091 | 72,233 | 9,472 | - | - | - | 87,796 | 87,634 |
| Loans to credit institutions ................ | 54,104 | 26,013 | - | - | - | - | 80,117 | 80,116 |
| Loans to customers ........................... | 3,844 | 107,623 | 75,111 | 323,941 | 525,432 | - | 1,035,951 | 712,422 |
| Financial instruments ........................ | 12,715 | 2,485 | 4,466 | 56,547 | 81,098 | 35,414 | 192,725 | 117,456 |
| *Derivatives - assets leg* ................. | - | *28,323* | *20,388* | *33,816* | *579* | - | 83,106 | *75,527* |
| *Derivatives - liabilities leg* ............. | - | *(27,689)* | *(19,906)* | *(28,877)* | *(279)* | - | (76,751) | *(70,368)* |
| Other financial assets ........................ | 2,687 | 3,882 | 1,303 | 745 | - | - | 8,617 | 8,617 |
| **Assets** ............................................ | 79,441 | 212,236 | 90,352 | 381,233 | 606,530 | 35,414 | 1,405,206 | 1,006,245 |
| *Liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank ... | 7,602 | - | 326 | 26 | - | - | 7,953 | 7,987 |
| Deposits ........................................... | 288,388 | 80,876 | 32,336 | 12,558 | 2,106 | - | 416,264 | 412,064 |
| Financial liabilities at fair value ......... | - | 2,403 | 523 | 3,232 | 384 | - | 6,542 | 3,726 |
| *Derivatives - assets leg* ................. | - | *(14,008)* | *(4,642)* | *(42,184)* | *(745)* | - | (61,579) | *(57,923)* |
| *Derivatives - liabilities leg* ............. | - | *14,528* | *5,166* | *45,416* | *1,129* | - | 66,239 | *59,765* |
| *Short position securities used for economic hedging* ................ | - | *1,884* | - | - | - | - | 1,884 | *1,884* |
| Other financial liabilities ................... | 21,824 | 7,414 | 3,446 | 3,660 | 6 | - | 36,350 | 36,350 |
| Borrowings ....................................... | - | 13,568 | 20,956 | 189,073 | 219,346 | - | 442,943 | 339,476 |
| **Liabilities** ........................................ | 317,814 | 104,262 | 57,587 | 208,548 | 221,841 | - | 910,052 | 799,603 |
| **Net position for assets and liabilities** | (238,373) | 107,974 | 32,765 | 172,685 | 384,689 | 35,414 | 495,154 | 206,642 |
| *Off-balance sheet items* | | | | | | | | |
| Financial guarantees ......................... | 2,893 | 4,032 | 4,136 | 2,538 | 1,671 | - | 15,270 | 15,270 |
| Unused overdraft .............................. | - | 46,379 | - | - | - | - | 46,379 | 46,379 |
| Loan commitments ........................... | 48 | 46,931 | 10,250 | 21,040 | 4,000 | - | 82,268 | 82,268 |
| **Off-balance sheet items** .................. | 2,941 | 97,342 | 14,386 | 23,578 | 5,671 | - | 143,917 | 143,917 |
| **Net contractual cash flow** ................ | (241,314) | 10,633 | 18,379 | 149,107 | 379,018 | 35,414 | 351,237 | 62,725 |

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## 42. 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. 1032/2014. 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 ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

| 2017 | ISK | Foreign currency | Total |
|---|---|---|---|
| Available stable funding | 663,850 | 199,770 | 863,620 |
| Required stable funding | 577,761 | 110,473 | 688,234 |
| Foreign currency balance | | 7 | |
| **Net stable funding ratio** | 115% | 181% | 125% |

| 2016 | ISK | Foreign currency | Total |
|---|---|---|---|
| Available stable funding | 612,964 | 169,821 | 782,785 |
| Required stable funding | 544,854 | 87,010 | 631,864 |
| Foreign currency balance | | (4,019) | |
| **Net stable funding ratio** | 113% | 191% | 124% |

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### 42. 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, repo-able 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 by currencies. All amounts are weighted by their respective LCR weights. The figures at 31 December 2017 are based on rules No. 266/2017 while the figures at 31 December 2016 are based on rules No. 1031/2014.

| 2017 | ISK | Foreign currency | Total |
|---|---|---|---|
| Liquid assets level 1 * | 131,197 | 27,716 | 158,913 |
| Liquid assets level 2** | - | - | - |
| **Liquid Assets** | 131,197 | 27,716 | 158,913 |
| Deposits | 108,442 | 24,738 | 133,180 |
| Borrowing | 2,426 | 96 | 2,522 |
| Other cash outflows | 6,067 | 9,500 | 15,567 |
| **Cash outflows** | 116,935 | 34,334 | 151,269 |
| Short-term deposits with other banks *** | 1,048 | 59,528 | 60,576 |
| Other cash inflows | 12,232 | 6,540 | 18,772 |
| **Cash inflows** | 13,280 | 66,068 | 79,348 |
| **Liquidity coverage ratio (LCR) ****** | 127% | 323% | 221% |

| 2016 | ISK | Foreign currency | 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 |
| 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.

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## 42. Liquidity and Funding risk, continued

*Composition of liquid assets*

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

| 2017 | ISK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 137,399 | 293 | 943 | 1,184 | 139,819 |
| Short-term deposits in other banks | 1,048 | 24,796 | 15,334 | 19,398 | 60,576 |
| Domestic bonds eligible as collateral at the Central Bank | 3,022 | - | - | - | 3,022 |
| Foreign government bonds | - | 6,401 | 16,291 | - | 22,692 |
| Covered bonds with a minimum rating of AA- | - | - | 1,262 | 1,538 | 2,800 |
| **Liquidity reserve** | 141,469 | 31,490 | 33,830 | 22,120 | 228,909 |

| 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 |

*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. 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 | | | | | |
|---|---|---|---|---|---|---|
| 2017 | Less Stable | Weight (%) | Stable | Weight (%) | Term deposits* | Total deposits |
| Retail | 163,542 | 11% | 52,401 | 5% | 68,741 | 284,684 |
| Corporations | 51,968 | 40% | 811 | 20% | 5,757 | 58,536 |
| Sovereigns, central banks and PSE | 14,583 | 40% | - | - | 1,383 | 15,966 |
| Pension funds | 53,116 | 100% | - | - | 15,391 | 68,507 |
| Domestic financial entities | 23,175 | 100% | - | - | 15,949 | 39,124 |
| Foreign financial entities | 2,714 | 100% | - | - | - | 2,714 |
| **Total** | 309,098 | | 53,212 | | 107,221 | 469,531 |

| 2016 | Less Stable | Weight (%) | Stable | Weight (%) | Term deposits* | Total deposits |
|---|---|---|---|---|---|---|
| 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.

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## 43. Capital management

### Capital adequacy

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.

As at 31 December 2017, the Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation without Vördur Insurance (Vördur). As the full accounting consolidation has been applied in prior statements, the figures as at 31 December 2016 are adjusted to reflect the defined consolidated situation. The capital position and solvency requirements of Vördur should be viewed independently from capital adequacy for the Group's consolidated situation. An adjustment is made to the Group's Pillar 2 requirements as the latest SREP result is based on the accounting consolidation which includes an add-on due to the solvency requirements of Vördur.

The Group's own funds at 31 December 2017 are affected by the foreseeable dividend distribution and purchase of own shares as mandated by the Bank's shareholders on 12 February 2018. For further details, see Note 38.

| *Own funds* | 2017 | 2016 |
|---|---|---|
| Total equity | 225,734 | 211,384 |
| Deductions related to the consolidated situation | (8,635) | (8,126) |
| Non-controlling interest not eligible for inclusion in CET1 capital | (128) | (172) |
| **Common Equity Tier 1 capital before regulatory adjustments** | 216,971 | 203,086 |
| Intangible assets | (11,125) | (8,201) |
| Tax assets | (357) | (198) |
| Cash flow hedges | 265 | (22) |
| Foreseeable dividend | (25,000) | - |
| Additional value adjustments | (119) | (127) |
| **Common equity Tier 1 capital** | 180,635 | 194,538 |
| Non-controlling interest not eligible for inclusion in CET1 capital | 128 | 172 |
| **Tier 1 capital** | 180,763 | 194,710 |
| General credit risk adjustments | 3,195 | 4,557 |
| **Tier 2 capital** | 3,195 | 4,557 |
| **Total own funds** | 183,958 | 199,267 |

| *Risk-weighted assets* | | |
|---|---|---|
| Credit risk, loans | 605,058 | 577,470 |
| Credit risk, securities and other | 56,979 | 55,036 |
| Counterparty credit risk | 5,844 | 5,550 |
| Market risk due to currency imbalance | 4,895 | 5,449 |
| Market risk other | 5,473 | 12,966 |
| Credit valuation adjustment | 2,506 | 2,678 |
| Operational risk | 86,013 | 86,490 |
| **Total risk-weighted assets** | 766,768 | 745,639 |

| *Capital ratios* | | |
|---|---|---|
| CET1 ratio | 23.6% | 26.1% |
| Tier 1 ratio | 23.6% | 26.1% |
| Capital adequacy ratio | 24.0% | 26.8% |

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### 43. Capital management, continued

Under the accounting standard IAS 39, the Bank's general provisions account as Tier 2 capital as stipulated in CRR. This applies to financial institutions that use the standardized approach as the capital requirement should reflect unexpected losses less expected losses as inherent in IRB methods. As of 1 January 2018, IAS 39 is replaced by IFRS 9 which introduces new methods for estimating expected future losses. The European Banking Authority (EBA) has issued an opinion* which states that "EBA believes that all IFRS 9 provisions should be considered SCRA [special credit risk adjustment]" as they “will not be freely and fully available to meet losses that subsequently materialize, as these provisions are ascribed to particular assets, whether individual or grouped”. FME has adopted EBA's opinion and as a result the Group's own funds will no longer include general credit risk adjustments and these shall be treated as SCRA, effectively reducing risk-weighted assets. Taking into account the expected changes to allowance from the adoption of IFRS 9, see Note 71, the Group's total capital ratio between 31 December 2017 and 1 January 2018 is reduced from 24.0% to 23.7%.

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 own funds 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.

*EBA/OP/2017/02, 06 March 2017, Opinion of the European Banking Authority on transitional arrangements and credit risk adjustments due to the introduction of IFRS 9

**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.

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## 43. Capital management, continued

| *Total capital requirement, % of RWA* | 2017 |
|---|---|
| Pillar 1 capital requirement | 8.0% |
| Pillar 2R capital requirement * | 3.4% |
| Combined buffer requirement | 8.4% |
| **Total regulatory capital requirement** | 19.8% |
| Available capital | 24.0% |

| *CET1 requirement, % of RWA* | |
|---|---|
| Pillar 1 CET1 requirement | 4.5% |
| Pillar 2R CET1 requirement * | 1.9% |
| Combined buffer requirement | 8.4% |
| **CET1 regulatory capital requirement** | 14.8% |
| Available CET1 capital | 23.6% |

* The SREP result based on the Group's financial statement at 31.12.2016. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidated situation under CRR, which excludes Vördur Insurance, the requirement is 3,4%.

**Leverage ratio**

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The figures for 31 December 2017 take into account a foreseeable dividend and share buyback of ISK 25 billion, see Note 38. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

| | 2017 | 2016 |
|---|---|---|
| On-balance sheet exposures | 1,074,207 | 995,063 |
| Derivative exposures | 10,957 | 8,226 |
| Securities financing transaction exposures | 8,925 | 9,330 |
| Off-balance sheet exposures | 83,058 | 83,156 |
| **Total exposure** | 1,177,147 | 1,095,775 |
| **Tier 1 capital** | 180,763 | 194,710 |
| Leverage ratio | 15.4% | 17.8% |

**Solvency II**

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was 2,923 million at 31 December 2017 and calculated solvency of Vördur Group was ISK 4,971 million. The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 170.1% at 31 December 2017.

At the end of 2016 the Bank held the insurance companies Vördur tryggingar and Okkar líftryggingar. On 1 January 2017 Vördur tryggingar acquired the entire shareholding in Okkar líftryggingar and following the acquisition Vördur tryggingar merged its two life insurance subsidiaries. The solvency capital requirements as well as calculated solvency for Vördur Group is not available for 31 December 2016. The solvency capital requirement of Vördur was ISK 2,489 million at the end of 2016 and Okkar ISK 574 million and calculated solvency of Vördur was ISK 3,609 million and Okkar ISK 1,236 million. The solvency ratio of Vördur was 145.0% and Okkar 215,0% at the end of 2016.

## 44. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Group's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. The operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the standardized approach for the calculation of capital requirements for operational risk.

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## Significant accounting policies

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Group's Consolidated Financial Statements for the year ended 31 December 2016 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2017, see Note 71, and amendments to Icelandic Annual Accounts Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

### 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 Consolidated Financial Statements are prepared on a going concern basis.

### 46. Principles underlying the consolidation

*Subsidiaries*

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

*Business combinations*

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:

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

When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

*Non-controlling interests*

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

# Notes to the Consolidated Financial Statements

### 46. Principles underlying the consolidation, continued

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

*Loss of control*

On the loss of control, the Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognized in profit or loss.

*Transactions eliminated on consolidation*

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements.

If an investment in a subsidiary is classified as held for sale the investment is accounted for as non-current asset and disposal groups held for sale from the date of classification.

*Funds management*

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

### 47. Associates

Associates are those entities over which the Group has a significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognized at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group's investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognized income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

Upon loss of significant influence over the associate, the Group measures and recognizes any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognized in profit or loss.

*Impairment on investments in associates*

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognize any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognized in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

### 48. Foreign currency

Items included in the Consolidated Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

*Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

### 49. Interest

Interest income and expense are recognized in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortized cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

### 50. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate Banking, Retail Banking, Capital Markets, Corporate Finance, Asset Management and Private Banking. Fees earned from services that are provided over a certain period of time are recognized as the services are provided. Fees earned from transaction type services are recognized when the service has been completed. Fees that are performance linked are recognized when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

### 51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognized when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realized and unrealized fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Consolidated Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognized in profit or loss.

# Notes to the Consolidated Financial Statements

## 52. Net insurance income

Premiums recognized as income comprise the premiums contracted during the fiscal year including premiums transferred from last years but excluding next periods premiums, which are recognized as provision for unearned premiums. Provision for unearned premiums is a part of the technical provision in the Statement of Financial Position.

Claims recognized in the Statement of Comprehensive Income are the periods claims including increases or decreases due to claims from previous fiscal years. Outstanding claims included in technical provision in the Statement of Financial Position are the total amount of reported but unpaid claims as well as actuarial provision for claims occurred but unreported.

## 53. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognized in the Consolidated Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Taxable profit may differ from earnings before tax as reported in the statement of comprehensive income as it may exclude income or expense that is deductible in other years and it excludes income or expense that are never taxable or deductible.

Current and deferred tax relating to items recognized directly in equity is recognized in equity and not in the statement of profit or loss.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from the initial recognition (other than in a business combination) of assets and liabilities in transaction that affects neither the taxable profit nor the accounting profit. In addition, tax liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill.

## 54. Financial assets and financial liabilities

*Recognition*

The Group initially recognizes loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

## 54. Financial assets and financial liabilities, continued

*Classification*

The Group classifies its financial assets in one of the following categories:

- amortized cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss; or
- AFS financial assets at fair value through other comprehensive income.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortized cost or held for trading.

*Designation at fair value through profit or loss*

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

*Derecognition*

Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognized when the obligation of the Group specified in the contract is discharged or cancelled or expires.

*Offsetting*

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognized amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

*Amortized cost measurement*

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

*Fair value measurement*

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognized valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

### 54. Financial assets and financial liabilities, continued

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

*Identification and measurement of impairment*

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

- the Group's aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely distribution available on liquidation or bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realizable value of collateral (or other credit mitigates) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. one-year probability of default (PD) and loss given default (LGD). By using one-year probability of default the Bank assumes loss emergence period of one year. The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Clients in risk class 5 are examined for specific impairment. If they do not require specific impairment, this is because there is a good level of collateral and any collective provisions would be minimal. Larger clients who are examined for specific impairment and are not in risk class 5 still contribute to collective impairment, if specific impairment is deemed unnecessary.

## 54. Financial assets and financial liabilities, continued

Impairment losses are recognized in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognized as an increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when there is a decrease in carrying amount.

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralized loans, when the proceeds from the realization of collateral have been received.

*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.

## 55. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortized cost in the Statement of Financial position.

## 56. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognized and presented within loans.

When the Group purchases an asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognized in the Group's Consolidated Financial Statements.

## 57. Financial instruments

*Trading assets and liabilities*

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, short positions in listed bonds and derivative financial instruments.

Securities used for economic hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts. Those assets are not subject to hedge accounting.

*Financial assets designated at fair value through profit or loss*

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognized in profit or loss. All changes in fair value are recognized as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

*Available-for-sale financial assets designated at fair value through Other comprehensive income*

AFS financial assets include equity investments. Equity investments classified as AFS are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, AFS financial assets are subsequently measured at fair value with unrealized gains or losses recognized in OCI and credited in the AFS reserve until the investment is derecognized, at which time, the cumulative gain or loss is recognized in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the AFS reserve to the statement of profit or loss in finance costs.

## 58. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognized at fair value. Fair value changes are recognized in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognized on an accrual basis. Derivatives with positive fair values are recognized as Financial instruments and derivatives with negative fair values are recognized as Financial liabilities at fair value.

## 59. Intangible assets

*Goodwill*

Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

*Infrastructure and customer relationship*

Infrastructure and customer relationship and related agreements are measured at cost less any accumulated impairment losses.

*Software*

Software acquired by the Group is measured at cost less accumulated amortization and any accumulated impairment losses.

Subsequent expenditure on software is capitalized only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

*Amortization of intangible assets*

Amortization of intangible assets is recognized in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

## 60. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

## 61. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

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

An impairment loss in respect of other assets, where impairment losses have been recognized in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

# Notes to the Consolidated Financial Statements

### 62. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortized cost using the effective interest method.

### 63. Borrowings

Borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

### 64. Non-current assets and disposal groups held for sale

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognized at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

### 65. Other assets and other liabilities

*Property and equipment*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalized only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

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

| | |
|---|---|
| Buildings ........................................ | 33-50 years |
| Equipment ........................................ | 3-7 years |

The depreciation methods, useful lives and residual values are reassessed annually.

*Other assets and other liabilities*

Other assets and other liabilities are stated at cost less impairment.

*Insurance claim*

Estimate is made in accordance with Solvency II rules. Data from the company's claim system are extrapolated to predict the final amount of the claims that will be paid at the end of the reporting period with corresponding expected payments from reporting date until the settlement of claims that occurred prior to the reporting date. In addition, estimation of settlement cost, risk and other factors is made in accordance with the instructions in Solvency II rules. This approach is consistent with the valuation of insurance liabilities in IFRS 4.

## 66. Equity

*Dividends*

Dividends on shares are recognized in equity in the period in which they are approved by Arion Bank's shareholders.

*Statutory reserve*

According to the Icelandic Companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

*Reserve for investments in subsidiaries and associates*

According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted shareholding equity reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the shareholding equity reserve shall be released and the amount transferred to retained earnings.

*Reserve for investments in securities*

According to the Financial Statements Act No. 3/2006 fair value changes of financial assets from the initial reporting, shall be transferred from retained earnings to a fair value equity reserve, net of tax. The fair value equity reserve is not subject to dividend payments. The fair value equity reserve shall be released in accordance with fair value changes recognized when financial asset is sold or redeemed or the assumptions for the fair value change is no longer in force.

*Available-for-sale reserve*

AFS reserve comprises all unrealized gain or losses related to fair value measurements of AFS financial assets.

*Foreign currency translation reserve*

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Consolidated Financial Statements of foreign operations.

# Notes to the Consolidated Financial Statements

## 67. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

## 68. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognized in the Consolidated Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognized less, when appropriate, cumulative amortization recognized in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognized in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

## 69. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

## 70. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognized as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

## 71. New standards and amendments to standards

The Consolidated Financial Statements are presented in accordance with the new and revised IFRS standards and new interpretations (IFRIC), applicable in the year 2017. These new and revised IFRSs did not have material effect on amounts nor information reported in the Consolidated Financial Statements.

Amendments to IAS 12 Income Taxes clarify that an entity needs to consider whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of deductible temporary difference related to unrealized losses. Furthermore, the amendments provide guidance on how an entity should determine future taxable profits and explain the circumstances in which taxable profit may include the recovery of some assets for more than their carrying amount. The amendments had no effect on the Group’s financial position and performance as the Group has no deductible temporary differences or assets that are in the scope of the amendments.

Amendments to IAS 7 Statement of Cash Flows require entities to provide disclosure of changes in their liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes (such as foreign exchange gains or losses). The amendment was effective from 1 January 2017 but did not have major impacts on the Consolidated Financial Statements.

## 71. New standards and amendments to standards, continued

*A number of new standards , amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2017, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Group's reporting are:*

**IFRS 9 Financial Instruments**

**Financial impacts of Adoption of IFRS 9**

The IASB issued IFRS 9: Financial Instruments in July 2014. The standard replaces IAS 39 Financial instruments: Recognition and measurement and takes effect for annual periods beginning on or after 1 January 2018, with early adoption permitted. The Arion Bank Group (‘the Group’) will apply IFRS 9 from 1 January 2018.

Changes in accounting policies resulting from the adoption of IFRS 9 will be applied retrospectively. The Group will take advantage of the exemption allowing it not to restate comparative information for prior periods. Differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9 will be recognized in retained earnings and other reserves as at 1 January 2018.

The following assessments have to be made on the basis of the facts and circumstances that exist at the date of initial application:

– the determination of the business model within which a financial asset is held;
– the designation and revocation of previous designations of certain financial assets and financial liabilities as measured at FVPL;
– the designation of certain investments in equity instruments not held for trading at FVOCI. For a financial liability designated at FVPL,
– FVPL, the determination of whether presenting the effects of changes in the financial liability´s credit risk in OCI would create or enlarge an accounting mismatch in profit or loss.

Based on the Group’s assessment up to date, the total estimated adjustment (net of tax) resulting from the adoption of IFRS 9 on the opening balance equity of the Group at 1 January 2018 is approximately ISK 1.0 billion, comprised of:

– Increase of approximately ISK 0.6 billion because of reduction in impairment due to changes in impairment calculations.
– Increase of approximately ISK 0.4 billion due to changes in classification and measurement requirements, other than impairment.

During the implementation phase the Group set up a multidisciplinary implementation team ('the Team') with members from Risk, Finance and other relevant divisions to prepare for IFRS 9 implementation ('the Project'). The IFRS 9 steering committee consists of Chief Risk and Finance officers as well as senior managers from Corporate Banking and Retail Banking, who regularly report to the Bank's Audit Committee (BAC). The steering committee will continue its role as a governing body following the implementation date for all matters related to IFRS 9, such as IFRS 9 impairment model oversight, review and approval.

**Classification**

*Financial assets*

From a classification and measurement perspective, the new standard requires debt instruments to be classified based on their business model and cash flows characteristics, rather than based on reasons for individual purchases. IFRS 9 is combined of three classification categories: amortized cost, fair value through other comprehensive income (FVOCI) and fair value through profit and loss (FVPL). They replace the IAS 39 classification categories held to maturity, loans and receivables, available for sale, held for trading and designated at fair value through profit or loss (FVPL). The Group makes an assessment of the objective of the business model in which a financial asset is held at portfolio level.

A debt instrument is measured at amortized cost only if it meets both of the following conditions and is not designated as at FVPL:

– it is held within a business model whose objective is to collect contractual cash flows; and
– its contractual cash flows are solely payments of principal and interest (SPPI).

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVPL:

– it is held within a business model whose objective is to collect contractual cash flows and selling financial assets; and
– its contractual cash flows are solely payments of principal and interest (SPPI).

All other debt instruments are carried at FVPL.

## 71. New standards and amendments to standards, continued

IFRS 9 allows entities to irrevocably designate, at initial recognition, instruments that qualify for amortized cost or fair value through OCI instruments as FVPL, if doing so eliminates or significantly reduces a measurement or recognition inconsistency.

Equity instruments must be measured at FVPL unless other IFRS standards apply or are irrevocably designated as FVOCI, with no subsequent reclassification of gains or losses to the Statement of Comprehensive Income.

*Financial liabilities*

IFRS 9 largely retains the existing requirements of IAS 39 for the classification of financial liabilities. However, under IAS 39 all fair value changes of financial liabilities designated as at FVPL are recognized in profit or loss, whereas under IFRS 9 the fair value changes attributable to own credit risk will be presented in OCI, and the remaining amount will be presented in profit and loss, unless an accounting mismatch in profit or loss would arise. As of 1 January 2018 no liabilities within the Group will be designated at FVPL.

*Classification impact assessment*

Having completed its initial assessment, the Group has concluded that:

- all loans to credit institutions and loans to customers that are classified as loans and receivables under IAS 39 will be measured at amortised cost under IFRS 9,
  - Loans that have failed the SPPI test will be held at FVPL. Such instruments are uncommon.
- financial assets and liabilities held for trading and financial assets and liabilities designated at FVPL are expected to be measured at FVPL,
- all debt instruments held by Arion Bank hf. treasury will be re-classified from FVPL to FVOCI; and
- all equity investments and derivatives will be measured at FVPL.

The Group has estimated that, on the date of adoption of IFRS 9, the impact of these changes will be an increase in the Group's equity of ISK 0.4 billion net of tax.

**Impairment**

IFRS 9 replaces the "incurred credit loss" model used under IAS 39 with an "expected credit loss" (ECL) model. The changes from incurred to expected losses requires professional judgement over various factors used in the calculation of ECLs. Such as, how macroeconomic scenarios affect the ECL calculation. The new "expected credit" impairment models apply to financial assets that are debt instruments (including loans to customers) measured at amortized cost or FVOCI, lease receivables, loan commitments and financial guarantee contracts. Equity instruments are not subject to impairment. The application of the IFRS 9 impairment requirements might increase volatility in profit and loss of the Group.

*Definition of default*

The Group considers a financial assets to be in default when:

- the borrower is more than 90 days past due, or
- the borrower is considered to be unlikely to pay.

In assessing whether a borrower is unlikely to pay, the Group considers both qualitative and quantitative indicators, e.g. overdue status, debt and equity ratios, market circumstances and other data developed internally or obtained from external sources.

For corporate counterparties it is assumed that if one exposure is in default, all other exposures to that counterparty are also in default (cross-default). For individuals however, mortgages and other exposures are assessed separately, meaning that if an individual is in default on a mortgage, his other exposures are not assumed to be in default, and vice versa. A default event for a mortgage can however be an indicator on the likelihood of default for the borrower's other exposures, and vice versa.

Frequent default events within a year are treated as a single default event. A defaulted exposure is considered to be cured if it has returned to non-default state, with no amount in arrears, within 12 months from default and without any incurred loss for the Group.

## 71. New standards and amendments to standards, continued

*Probability of default and credit risk rating*

The Group allocates to each exposure a credit risk rating (e.g. A+, A, A-, BBB+, etc.) based on the calculated 12 month probability of default ('the PD'). The PD is assessed through the Group's credit rating models or based on external ratings if available. The Group's credit rating models are statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Factors vary depending on the nature of the exposure and the profile of the borrower. The PD estimates used for the purpose of calculating IFRS 9 impairments are point-in-time, i.e. dependent on the economic cycle. The Group's credit rating models are subject to annual performance tests and are recalibrated on a regular basis if needed.

The Group's rating scale is shown below.

| Risk class | Rating | Lower PD | Upper PD |
|---|---|---|---|
| *1* | A+ | 0.00% | 0.07% |
| | A | 0.07% | 0.11% |
| | A- | 0.11% | 0.17% |
| | BBB+ | 0.17% | 0.26% |
| | BBB+ | 0.26% | 0.41% |
| | BBB- | 0.41% | 0.64% |
| *2* | BB+ | 0.64% | 0.99% |
| | BB | 0.99% | 1.54% |
| | BB- | 1.54% | 2.40% |
| *3* | B+ | 2.40% | 3.73% |
| | B+ | 3.73% | 5.80% |
| | B- | 5.80% | 9.01% |
| *4* | CCC+ | 9.01% | 31.00% |
| | CCC- | 31.00% | 99.99% |
| *5* | DD | 100.00% | 100.00% |

Each exposure is allocated a credit risk rating at initial recognition. The calculations are based on rules and available information at the time of origination. Exposures are continuously monitored and revaluated, which may result in transitions between risk ratings. The monitoring typically involves the use of credit history, audited financial statements, management accounts, budgets, KPI's, projections, quality of management, data from credit reference agencies, overdue status and other qualitative and quantitative information available.

*PD term structures*

In addition to calculating PD and allocating a credit risk rating to each exposure, the Group calculates the lifetime probability of default (LPD), which is an assessment of the probability that a default event occurs over the lifetime of the exposure. The LPD incorporates management's view of possible future macroeconomic developments and the likelihood of rating transitions over the lifetime of the exposure. For the determination of LPD, the Bank calculates PD term structures – which effectively provides the probability of default for any given time period, one for each rating grade, PD model and economic scenario. The annualized lifetime probability of default (ALPD) of an exposure is the fixed 12 month PD (without transitions) that corresponds to the exposure's LPD. The credit risk rating that corresponds to the ALPD is defined as the lifetime credit risk rating.

Arion Bank Consolidated Financial Statements 2017 91 Amounts are in ISK millions

### 71. New standards and amendments to standards, continued

The assessed 12 months PDs are the basis for the determination of the term structure of PDs for exposures. The Group applies transition models, developed on the basis of historical data, to predict the development of risk grades for periods that exceed one year. The Group has separated transition behaviour due to specific and general risk and applies its macro-economic forecasts to the latter. The analysis of credit rating transitions due to general risk includes the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors. Unemployment rate is the predominant predictive variable. Among other indicators examined are GDP growth and benchmark interest rates.

Assumptions on key macro-economic indicators are on an ongoing basis estimated based on internal and external information available at each time. The Group formulates a 'base case' view of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios. The Group uses these forecasts to adjust its estimates of lifetime probability of default and other factors that affect the lifetime expected credit loss.

*Significant increase in credit risk*

In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk at 1 January 2018, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

For a given exposure, the Group considers a significant increase in credit risk to have occurred if one of the following holds:

- the exposure's credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk rating compared to the credit risk rating at origination;
- the exposure's lifetime credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk grade (two or more) compared to the lifetime credit risk rating at origination. As the Group does not have the benefit of hindsight, this comparison is only used for exposures that originate on or after 1 January 2018;
- the number of days in arrears exceeds 30 days; or
- the exposure is on the Group's watch list.

The Group monitors the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that the criteria is capable of identifying significant increases in credit risk before an exposure is in default and there is no unwarranted volatility in loss allowance from transfers between 12-month ECL (stage 1) and lifetime ECL (stage 2).

*Staging allocation*

The Group's staging criteria is the following:

| Stage | Criteria | Assessment of expected credit |
|---|---|---|
| *1* | Exposures not in default and with no significant increase in credit risk | 12 month expected credit loss |
| *2* | Exposures not in default with significant increase in credit risk | Lifetime expected credit loss |
| *3* | Exposures in default | Lifetime expected credit loss |

# Notes to the Consolidated Financial Statements

## 71. New standards and amendments to standards, continued

*Expected credit loss measurement*

The expected credit loss (ECL) calculations are based on three main components:

- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

Each component is derived from internally generated models, apart from external credit ratings. The models are developed with statistical methods and/or expert judgement supported by historical data and adjusted for expected macro-economic effects.

The Group's PDs and PD term structures are based on both quantitative and qualitative factors and in some cases external ratings are used. PD's are re-assessed on a regular basis with different frequencies depending on the type of counterparty and/or exposure.

The LGD is an assessment of loss conditional on a default occurrence. The Group splits LGD into three components; the probability of cure, the expected recovery from liquidation of collateral, and the recovery rate for the unsecured part of the exposure. The collateral gap assessment is the outcome of The Group's collateral allocation algorithm, where haircuts are applied to different types of collaterals. Such models are based on expert judgement, supported by historical data, and takes into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations.

The EAD represents the expected exposure at the event of a default. For a given exposure, The Group derives the EAD from the contractual amortization schedule and taking into account the likelihood of pre-payments, drawdowns, rollovers, extensions and use of unused allowance in the period leading up to default. These behavioral estimates, which are based on historical observations and forward-looking forecasts, apply differently to each type of exposure.

The Group measures ECL considering the risk of default over the maximum contractual period (including any extension periods) over which it is exposed to credit risk. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee. However, for overdrafts and credit card facilities that include both a loan and an undrawn commitment component, the Group measures ECL over a period longer than the maximum contractual period if the Group's contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group's exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period is estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECL. These include a reduction in limits, cancellation of the facility and/or turning the outstanding balance into a loan with fixed repayment terms. The ECL calculations involve discounting using the exposures' effective interest rates.

*Forward-looking scenarios*

The ECL for an exposure is the weighted average of the expected credit loss for different macro-economic scenarios provided by the Group's management. The Group currently considers three scenarios: 'base case', 'optimistic' and 'pessimistic' and assign its best estimate of likelihood of occurrence to each one. The development of macro-economic variables and the corresponding weights are based on expert judgement supported by historical data. The Group incorporates forward-looking macro-economic information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition (via the lifetime credit risk rating comparison) and its measurement of ECL as the PD term structures, LGD and EAD include macro-economic adjustments for each of the scenarios.

The predominant macro-economic variable used is the unemployment rate in Iceland, as measured by the Directorate of Labour. The default rate observed for the Group's exposures has been shown to be highly correlated with unemployment rate. Collateral haircuts are adjusted for different scenarios. Exit and pre-payment rates, which affects EAD, are dependent on refinancing spreads and due to the correlation between interest rates and unemployment rate they are adjusted for different scenarios.

### 71. New standards and amendments to standards, continued

*Impairment impact assessment*

As of 1 January 2018, the collective provisions are effectively replaced by the IFRS 9 impairments in stage 1 and 2. The impact is largely twofold; impairments generally increase for exposures in stage 2 as the ECL is assessed by lifetime calculations under IFRS 9, while impairments generally decrease as a result of a more refined assessment of risk through increased number of risk factors and better information around various inputs into the impairment calculations needed to comply with the IFRS 9 expected credit loss model. The impact is a reduction in impairments of ISK 0.6 billion net of tax.

*Impact on regulatory capital*

Under the Basel III regulatory capital framework, general provisions (general credit risk adjustments in Act No. 161/2002 on Financial Undertakings) are eligible as Tier 2 capital for financial institutions that apply the standardized approach for capital requirement calculations. General provisions reduce Common Equity Tier 1 capital through reduction of assets but are effectively reintroduced into own funds through Tier 2 capital as they are loss absorbing. In contrast, for financial institutions that apply internal models (IRB) for capital requirement calculations, expected loss reduces risk-weights as capital is meant to meet unexpected losses in excess of expected losses as the latter should be accounted for in the pricing of credit exposures. Any excess of accounting allowances to expected losses under IRB is included as Tier 2 capital for IRB banks.

The European Banking Authority (EBA) has issued an opinion stating that "EBA believes that all IFRS 9 provisions should be considered SCRA [special credit risk adjustment]" as they “will not be freely and fully available to meet losses that subsequently materialize, as these provisions are ascribed to particular assets, whether individual or grouped”. The Financial Supervisory Authority in Iceland has adopted this opinion and as a result, as of 1 January 2018, the Group's own funds will no longer include general credit risk adjustments. All impairments under IFRS 9 shall be treated as SCRA and changes to IFRS 9 provisions will be directly reflected in the Common Equity Tier 1 (CET1) capital, without re-adjustment through Tier 2 capital.

Transitional rules that mitigate the impact of IFRS 9 on own funds have been introduced into European law through Regulation (EU) 2017/2395. The arrangements have not been adopted in Iceland and therefore the Group does not apply transitional rules but recognizes the full impact on 1 January 2018.

**Hedge accounting**

When initially applying IFRS 9, the Group may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements in Chapter 6 of IFRS 9. The Group has elected to continue to apply IAS 39. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9’s amendments to IFRS 7, as the accounting policy election does not provide an exemption from the new disclosure requirements under IFRS 7.

**Disclosures**

IFRS 9 will require extensive new disclosures, in particular about hedge accounting, credit risk and ECL’s that will be included in the Group’s first reporting period after the adoption of the standard.

**IFRS 15 Revenue from Contracts with Customers**

The standard defines principles for recognizing revenue and establishes a five-step model to account for revenue arising from contracts with customers. However, interest and fee income integral to financial instruments and leases will continue to fall outside the scope of IFRS 15 and will be regulated by the other applicable standards. Under IFRS 15, revenue is recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to customer. The standard specifies a comprehensive set of disclosure requirements. The standard is effective from 1 January 2018. Based on analysis performed to assess the impacts of implementation of the standard it is considered to have minor impacts on the Statement of Comprehensive Income.

**IFRS 16 Leases**

The standard does not significantly change the accounting for leases for lessors. However, it does require lessees to recognize most leases on their balance sheet as lease liabilities, with the corresponding right-to-use assets. Lessees must apply a single model for all recognized leases, but will have the option not to recognize short-term leases and leases of low-value assets. The standard is effective for annual periods beginning 1 January 2019. The Group is currently assessing the potential effect of the new standard.

# 5-year overview

## Statement of Comprehensive Income

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Net interest income | 29,835 | 29,900 | 26,992 | 24,220 | 23,800 |
| Net fee and commission income | 15,357 | 13,978 | 14,484 | 13,309 | 11,223 |
| Net financial income | 4,091 | 5,162 | 12,844 | 7,290 | 1,675 |
| Net insurance income | 2,093 | 1,395 | 760 | 664 | 750 |
| Share of profit of associates and net impairment | (925) | 908 | 29,466 | 3,498 | 1,986 |
| Other operating income | 2,927 | 3,203 | 2,074 | 5,347 | 4,777 |
| **Operating income** | 53,378 | 54,546 | 86,620 | 54,328 | 44,211 |
| Salaries and related expense | (17,189) | (16,659) | (14,892) | (13,979) | (13,537) |
| Other operating expense | (12,772) | (13,881) | (12,919) | (12,722) | (11,535) |
| Bank levy | (3,172) | (2,872) | (2,818) | (2,643) | (2,872) |
| Net impairment | 186 | 7,236 | (3,087) | 2,135 | (680) |
| **Earnings before tax** | 20,431 | 28,370 | 52,904 | 27,119 | 15,587 |
| Income tax expense | (5,806) | (6,631) | (3,225) | (4,815) | (3,180) |
| **Net earnings from continuing operations** | 14,625 | 21,739 | 49,679 | 22,304 | 12,407 |
| Discontinued operations, net of tax | (206) | - | - | 6,290 | 250 |
| **Net earnings** | 14,419 | 21,739 | 49,679 | 28,594 | 12,657 |
| Net other comprehensive income | - | (2,721) | 2,916 | (5) | (2) |
| **Total comprehensive income** | 14,419 | 19,018 | 52,595 | 28,589 | 12,655 |

## Statement of Financial Position

| **Assets** | 31.12.2017 | 31.12.2016 | 31.12.2015 | 31.12.2014 | 31.12.2013 |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 139,819 | 87,634 | 48,102 | 21,063 | 37,999 |
| Loans to credit institutions | 86,609 | 80,116 | 87,491 | 108,792 | 102,307 |
| Loans to customers | 765,101 | 712,422 | 680,350 | 647,508 | 635,774 |
| Financial instruments | 109,450 | 117,456 | 133,191 | 101,828 | 86,541 |
| Investment property | 6,613 | 5,358 | 7,542 | 6,842 | 28,523 |
| Investments in associates | 760 | 839 | 27,299 | 21,966 | 17,929 |
| Intangible assets | 13,848 | 11,057 | 9,285 | 9,596 | 5,383 |
| Tax assets | 450 | 288 | 205 | 655 | 818 |
| Non-current assets and disposal groups held for sale | 8,138 | 4,418 | 5,082 | 3,958 | 10,046 |
| Other assets | 16,966 | 16,436 | 12,496 | 11,528 | 13,530 |
| **Total Assets** | 1,147,754 | 1,036,024 | 1,011,043 | 933,736 | 938,850 |
| **Liabilities and Equity** | | | | | |
| Due to credit institutions and Central Bank | 7,370 | 7,987 | 11,387 | 22,876 | 28,000 |
| Deposits | 462,161 | 412,064 | 469,347 | 454,973 | 471,866 |
| Financial liabilities at fair value | 3,601 | 3,726 | 7,609 | 9,143 | 8,960 |
| Tax liabilities | 6,828 | 7,293 | 4,922 | 5,123 | 4,924 |
| Other liabilities | 57,062 | 54,094 | 49,461 | 47,190 | 43,667 |
| Borrowings | 384,998 | 339,476 | 256,058 | 200,580 | 204,568 |
| Subordinated liabilities | - | - | 10,365 | 31,639 | 31,918 |
| **Total liabilities** | 922,020 | 824,640 | 809,149 | 771,524 | 793,903 |
| Shareholders' equity | 225,606 | 211,212 | 192,786 | 160,711 | 140,089 |
| Non-controlling interest | 128 | 172 | 9,108 | 1,501 | 4,858 |
| **Total equity** | 225,734 | 211,384 | 201,894 | 162,212 | 144,947 |
| **Total Liabilities and Equity** | 1,147,754 | 1,036,024 | 1,011,043 | 933,736 | 938,850 |

*Arion Bank Consolidated Financial Statements 2017* 95 *Amounts are in ISK millions*

# Appendix

Unaudited

Arion Bank


# Corporate Governance Statement

Corporate governance statement of Arion Bank for 2017

Arion Bank – for the future

Good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision-making, with the objective of generating lasting value. The Board of Directors places great importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognized guidelines on corporate governance.

The Corporate Governance Statement of Arion Bank hf. (Arion Bank or the Bank) is based on the legislation, regulations and recognized guidelines which are in force at the time the Bank's financial statement is adopted by the Board of Directors.

## Excellence in corporate governance

In December 2015 Arion Bank was recognized as a company which has achieved excellence in corporate governance following a formal assessment based on the Icelandic Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland. Arion Bank received this recognition following an in-depth survey of corporate governance at the Bank, including governance by the Board of Directors, sub-committees and management, performed by KPMG ehf. in the autumn of 2015. The recognition applies for three years unless significant changes are made to the Bank's management or ownership.

## Compliance with guidelines on good corporate governance

According to the Financial Undertakings Act No. 161/2002 Arion Bank is obliged to comply with recognized guidelines on good corporate governance. The Bank complies with the fifth edition of the Icelandic Guidelines on Corporate Governance issued by Iceland Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland, published in May 2015 and viewable on the website www.leidbeiningar.is. According to the guidelines a company shall state whether it has deviated from the guidelines, if so, which parts and also explain why it has done so. The Bank complies with the guidelines but because of its shareholder structure certain deviations have been made from the guidelines. The section below specifies in which instances the Bank has deviated from the guidelines.

Article 1.1.6 states that the board of a company shall post certain information on the candidates to the board on the company's website before the annual general meeting (AGM). The information in question was sent directly to all shareholders and published on the Bank's website before the last AGM. The information on candidates up for election at the extraordinary shareholders' meetings convened in 2017 were sent directly to all shareholders before the meetings and published on the Bank's website following the election.

Article 1.5. states that a shareholders' meeting shall appoint a nomination committee or decide how it should be appointed. Kaupskil, the Bank's majority shareholder appoints six out of eight Board members, Attestor Capital LLP appoints one Board member and the Icelandic State Financial Investments appoints the eighth member. The Bank has not considered it necessary to appoint a nomination committee given its shareholder structure.

Article 5.1.2. states that the rules of procedure of sub-committees of the Board shall be posted on the Bank's website. The rules of the Board Credit Committee have not been published on the Bank's website with respect to their nature.

## Legal framework for the Bank's operation

Arion Bank is a financial institution which operates in accordance with the Financial Undertakings Act No. 161/2002. Acts of law which also apply to the Bank's operations include e.g. the Securities Transactions Act No. 108/2007 and Public Limited Companies Act No. 2/1995.

The Bank is a universal bank which provides a comprehensive range of financial services relating to savings, loans, asset management, corporate finance and capital markets. The Bank has issued financial instruments which have been admitted for trading on regulated securities markets in Iceland, Norway and Luxembourg, and is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act and the rules of the relevant stock exchanges.

The Financial Supervisory Authority (FME) supervises the operations of Arion Bank in accordance with the provisions of Act No. 87/1998 on the Official Supervision of Financial Operations. Further information on the FME and an overview of the legal and regulatory framework applicable to the Bank, and the FME's guidelines, can be seen on the FME's website, www.fme.is. Numerous other pieces of legislation apply to the operations of financial undertakings.

## Internal controls, auditing and accounting

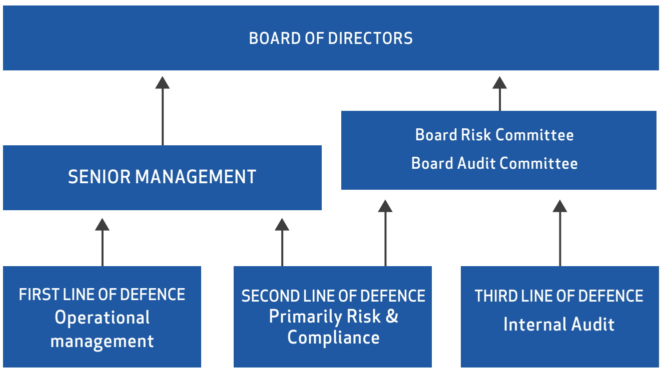
### Internal control

Internal control at Arion Bank is organized into three lines of defence with the aim of ensuring effectiveness, defining responsibility and coordinating risk management. This structure is also designed to foster a sense of risk awareness and responsibility among all employees of the Bank.

The set-up distinguishes between the following roles:

- People who bear responsibility for risk and manage risk
- People who monitor and check internal controls
- People who perform independent surveys of the effectiveness of internal controls

The first line of defence is made up of people who have day-to-day supervision of operations and its organization. They are responsible for establishing and maintaining effective internal controls and managing risk in day-to-day operations. This involves identifying and evaluating risk and putting in place appropriate countermeasures to reduce risk. The first line of defense is responsible for supervising the implementation of internal rules and processes in compliance with the law, regulations and the Bank's strategy and it must ensure that all actions are in compliance with established procedures and that corrective action is taken if any deficiencies are detected.




The second line of defence is set up to ensure that the first line of defence has established adequate internal controls which work as intended. Risk Management and Compliance are the main participants in the second line of defence, although other units may also be assigned specific monitoring roles.

The third line of defence is Internal Audit, which keeps the Board and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

### Compliance

The Compliance unit is an independent control function which reports directly to the CEO, in accordance with the Compliance Charter issued by the Board of Directors. The role of Compliance is to ensure that Arion Bank operates in accordance with law, rules and good business conduct, and endorsing a good corporate culture in that regard.

- Compliance provides oversight of regulatory requirements and responsibility, and assists employees in understanding applicable requirements at any given time, by providing access to appropriate training, advice and information
- Compliance contributes to ensuring efficient internal controls, and to ensuring that appropriate actions are taken to address any deficiencies
- Compliance safeguards the Bank from the possible abuse of its services, and ensures that the Bank knows its counterparties, the nature of each business relationship, and its obligations thereto
- Compliance promotes transparency, and the providing of adequate information to customers, investors and authorities
- Compliance promotes the responsible handling of confidential information

### Risk Management

A central feature of the activities of all financial companies is carefully calculated risk-taking according to a predetermined strategy. Arion Bank thus takes risk compatible with its risk appetite, which is regularly reviewed and approved by the Board of Directors. The Bank's risk appetite, set by the Board, is translated into exposure limits and targets that are monitored by Risk Management. The Board is responsible for Arion Bank's internal capital adequacy assessment process, the main objective of which is to ensure that Arion Bank understands its risk profile and has systems in place to assess, quantify and monitor its total risk exposure.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. Risk Management comprises three departments whose role is to analyze, monitor and regularly report to the CEO and Board of Directors on the risks faced by the Bank.

Further information on risk management and capital management is contained in the Bank's annual report and the Bank's risk report.

### Internal Audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter which lays out the responsibilities associated with the position and the scope of the work. The mission of the Internal Auditor is to provide independent and objective assurance and advice designed to add value and improve the Bank's operations. The scope of the audit is the Bank, its subsidiaries and pension funds serviced by Arion Bank.

The audit is governed by the audit charter, directive No. 3/2008 issued by the FME on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by the Internal Audit every quarter.

### Auditing and accounting

The Bank's Finance division is responsible for preparing the accounts and this is done in accordance with the International Financial Reporting Standards (IFRS). The Bank publishes its financial statement on a quarterly basis and management statements are generally submitted to the Board ten times a year. The Board Audit Committee examines the annual financial statement and interim financial statements, while the external auditors review and audit the accounts twice a year. The Board Audit Committee gives its opinion on the accounts to the Board of Directors, which then approves and endorses the accounts.

## Customers' Ombudsman

The Customers' Ombudsman is appointed by, and responsible to, the CEO. The role of the Ombudsman is to ensure that the business of customers is handled fairly and objectively, prevent discrimination against customers and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 162 cases in 2017, compared with 160 cases in 2016 and 185 cases in 2015.

## Cornerstones, code of ethics and corporate social responsibility

Arion Bank's cornerstones is the name used to describe the Bank's core values. The cornerstones are designed to provide guidance when making decisions and in everything else employees say and do. They refer to the Bank's role, attitude and conduct. Arion Bank's cornerstones are we make a difference, we get things done and we say what we mean.

The management and employees of Arion Bank are conscious of the fact that the Bank's activities affect different stakeholders and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Arion Bank underlines its status as a sustainable bank by making a difference to its customers and performing its role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in its society and development. Financial institutions are one of the pillars of society and their role is to help our customers, both individuals and companies, reach their goals. Arion Bank places great importance on doing things fairly with the interests of its customers, employees, shareholders and the community at heart.

In 2017 the Bank continued to implement its policy on sustainability, which was approved by the Board of Directors in late 2016 and presented to employees. The policy is entitled *Together we make good things happen.* In late 2017 Arion Bank became a signatory to the United Nations Principles on Responsible Investment (UN PRI) and since 2016 has been a signatory to the UN Global Compact. Arion Bank is also governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, covers the status and influence of the Bank in respect of environmental, social and human resources issues.

Further information can be found in the Bank's annual report.

## Board of Directors and committees

The main duty of the Board of Directors of Arion Bank is to manage the Bank between shareholders' meetings according to applicable laws, regulations and articles of association. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. One of the Board's main duties is to supervise the Bank's activities. The Board's work, duties and role are defined in detail in the rules of procedure of the Board of Directors, which have been established on the basis of Article 54 of the Financial Undertakings Act, Article 70 of the Public Limited Companies Act No. 2/1995, FME Guidelines No. 1/2010, and the articles of association of the Bank. The rules of procedure of the Board of Directors can be found on the Bank's website.

The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The Board of Directors and the Chief Executive Officer shall carry out their duties with integrity and ensure that the Bank is run in a sound and reasonable manner in the interests of the customers, the community, the shareholders and the Bank itself, cf. Article 1 (1) of the Financial Undertakings Act. The Chief Executive Officer shall ensure that the Board receives sufficient support to carry out its duties.

The Board of Directors is generally elected for a term of one year at the Bank's annual general meeting. At Arion Bank's annual general meeting on 9 March 2017, eight Directors and three Alternates were elected to the Board of Directors. At the Bank's shareholders' meeting on 23 June 2017 Eva Cederbalk was elected to replace Monica Canemen on the Board and Thórarinn Thorgeirsson replaced Björg Arnardóttir as an Alternate. Furthermore, Steinunn Kristín Thórdardóttir replaced Gudrún Johnsen on the Board when she was elected at a shareholders' meeting on 30 November.

Kaupskil, the Bank's majority shareholder appoints six out of eight Board members, Attestor Capital appoints one Board member and the Icelandic state appoints the eighth member. When electing the Board care is taken to ensure at least 40% representation of each gender among directors and alternates. Currently the Board consists of four men and four women and the Chairman is a woman. The elected Board Directors have diverse backgrounds and extensive skills, experience and expertise.

Information on the independence of Directors was sent to shareholders before the shareholders' and annual general meeting and the information was published on the Bank's website before the annual general meeting. The minutes of the AGM and shareholders' meetings are sent to shareholders following the meeting but have not been published on the Bank's website because of the shareholder structure.

The Board of Directors meets at least ten times a year. In 2017 the Board met on 16 occasions. The Chairman of the Board is responsible for ensuring that the Board performs its role in an efficient and organized manner. The Chairman chairs Board meetings and ensures that there is enough time allocated to the discussion of important issues and that strategy issues are discussed thoroughly. The Chairman is not permitted to undertake any other work for the Bank unless part of the normal duties of the Chairman.

According to the Board's Rules of Procedure the Board is permitted to establish committees to discuss particular areas of the Bank's operations. At the first scheduled meeting of the new Board following the AGM the Board appoints members to each of its sub-committees and assesses whether it is necessary to appoint external members to certain committees in order to bring in a greater level of expertise. One of the committee members in the Board Audit Committee, Heimir Thorsteinsson, is not a Board Director and is independent of the Bank and its shareholders. Heimir replaced Lúdvík Karl Tómasson in the Board Audit Committee when Lúdvík resigned from the Board Audit and Board Risk Committee in May 2017.

The Board sub-committees are as follows:

- Board Audit Committee: Its main task is, inter alia, to try and guarantee the quality of the financial statement and other financial information from the Bank and the independence of its auditors.
- Board Risk Committee: The Committee's main role is, inter alia, to evaluate the Bank's risk policy and risk appetite and to have a thorough knowledge of the risk assessments and methods used to manage risk employed by the Bank.
- Board Credit Committee: Its main task is to attend to credit issues which exceed the credit limits of its sub-committees.
- Board Remuneration Committee: The Committee's main task is to advise the Board on the terms of remuneration to the Chief Executive Officer and other employees hired directly by the Board. Regular tasks at committee meetings are to review the remuneration policy, the human resources policy, salary distribution and the incentive system if one is in place. The Bank's remuneration policy shall be examined and approved by a shareholders' meeting annually.

Sub-committees regularly inform the Board of their activities. Furthermore, the Board has access to all material used by the sub--committees and their minutes.

The Board Audit Committee met eight times during the year, the Board Risk Committee met 10 times, the Board Credit Committee met 16 times and the Board Remuneration Committee met five times. Below is an overview of the attendance of individual Directors and committee member:

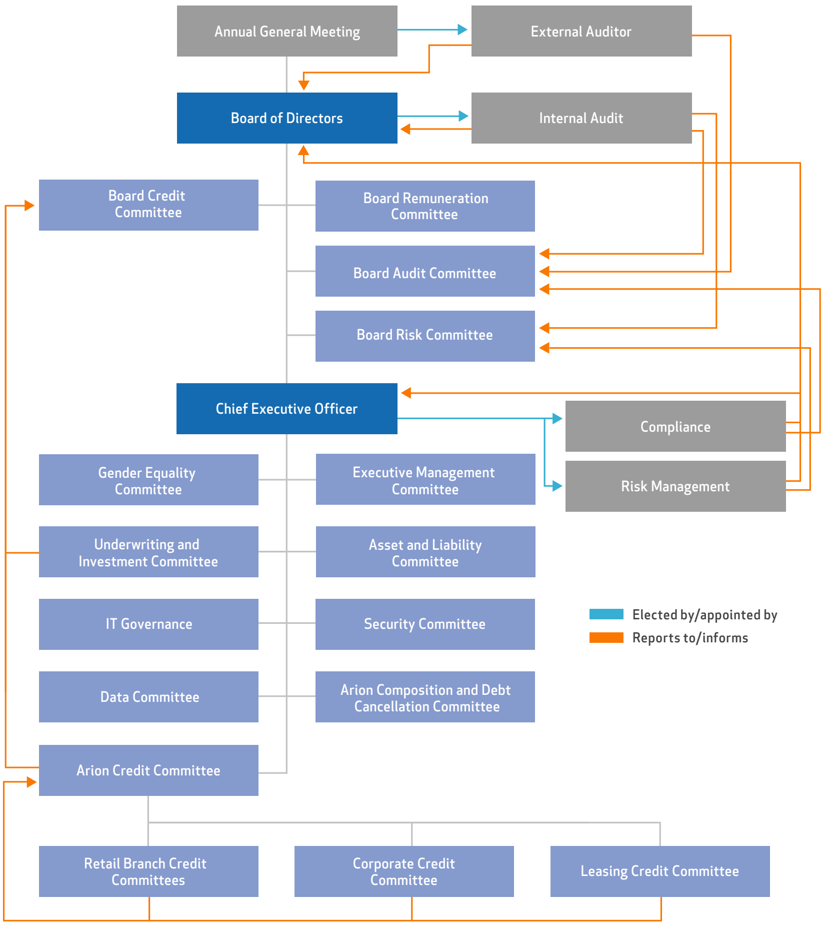
| Director | Period | Board (16) | BAC (8) | BRIC (10) | BCC (16) | BRC (5) |
|---|---|---|---|---|---|---|
| Monica Caneman (1) | 1 Jan - 10 May | 6 | - | - | 4 | - |
| Eva Cederbalk (2) | 23 June – 31 Dec | 8 | - | - | 5 | - |
| Gudrún Johnsen (3) | 1 Jan - 29 Nov | 14 | - | 8 | 11 | 2 |
| Brynjólfur Bjarnason | 1 Jan - 31 Dec | 14 | 8 | - | 14 | - |
| Benedikt Olgeirsson (4) | 1 Jan - 9 March | 3 | - | 3 | 3 | - |
| Jakob M. Ásmundsson (5) | 9 March – 31 Dec | 11 | - | 4 | - | - |
| John P. Madden (6) | 1 Jan - 31 Dec | 16 | - | 4 | - | 1 |
| Kirstín Th. Flygenring | 1 Jan - 31 Dec | 16 | 7 | - | - | 4 |
| Måns Höglund | 1 Jan - 31 Dec | 16 | - | 10 | 14 | - |
| Steinunn Kr. Thórdardóttir (7) | 30 Nov – 31 Dec | 1 | - | - | - | - |
| Thóra Hallgrímsdóttir | 1 Jan - 31 Dec | 14 | 8 | - | - | 5 |
| Björg Arnardóttir (8) | 1 Jan - 19 June | - | - | - | - | - |
| Ólafur Ö. Svansson (9) | 1 Jan - 31 Dec | 3 | - | - | - | - |
| Sigurbjörg Á. Jónsdóttir | 1 Jan - 31 Dec | - | - | - | - | - |
| Thórarinn Thorgeirsson (10) | 23 June - 31 Dec | - | - | - | - | - |
| Heimir Thorsteinsson | 26 July – 31 Dec | - | 4 | - | - | - |
| Lúdvík K. Tómasson (11) | 1 Jan - 8 May | - | 3 | 5 | - | - |

The Board and its sub-committees carry out an annual performance appraisal, at which it assesses its work, the necessary number of Board Directors, the Board composition with respect to experience and skills, working procedures and methods, the performance of the CEO, their achievements and the work of the subcommittees with respect to the aforementioned. This appraisal was last performed by the Board and its sub-committees during the period 15 December 2017 to 18 January 2018.

**(1)** Monica Caneman resigned from the Board on 10 May. **(2)** Eva Cederbalk was elected to the Board at the Bank's shareholders' meeting on 23 June and appointed to the Board Credit Committee in December. **(3)** Gudrún Johnsen resigned from the Board Remuneration Committee in April and was appointed to the Board Credit Committee at the same time. Gudrún resigned from the Board and the Board Credit Committee on 29 November. **(4)** Benedikt Olgeirsson resigned from the Board on 9 March. **(5)** Jakob M. Ásmundsson was elected to the Board at the Bank's annual general meeting on 9 March and appointed to the Board Risk Committee in June. **(6)** John P. Madden was appointed to the Board Risk Committee and Board Remuneration Committee in April. **(7)** Steinunn Kr. Thórdardóttir was elected as Director at the Bank's a shareholders' meeting on 30 November. **(8)** Björg Arnardóttir resigned as an Alternate on 19 June. **(9)** Ólafur Ö. Svansson attended two Board meetings as an alternate for Jakob M. Ásmundsson and one Board meeting as an alternate for Monica Caneman. **(10)** Thórarinn Thorgeirsson was elected as an Alternate at a shareholders' meeting on 23 June. **(11)** Lúdvík K. Tómasson resigned form the Board Audit Committee and Board Risk Committee in May and Heimir Thorsteinsson took his place at the Board Audit Committee in July.

# The Board of Directors of Arion bank

ARION BANK GOVERNANCE OVERVIEW



## Eva Cederbalk, Chairman

Eva was born in 1952. She is Swedish and lives in Sweden. She was first elected as a Director at a shareholders' meeting on 23 June 2017. She is not a shareholder of Arion Bank and is an independent Director. Eva is Chairman of the Board of Directors and the Chairman of the Board Credit Committee. Eva has an MSc in economics from the Stockholm School of Economics.

She is currently chief executive officer of Cederbalk Consulting AB. Eva previously worked for Skandinaviska Enskilda Banken AB and If Skadeförsäkring AB. She was CEO of Netgiro Systems AB and SBAB Bank AB and managing director at and Dial Försäkring AB. She has served on numerous boards of directors and was chairman of Klarna AB and was a director at Gimi AB between and Íslandsbanki. Eva is currently a member of the board of directors of Bilia AB, National Bank of Greece Group, Svolder and Ikano Group S.A.

## Brynjólfur Bjarnason, Vice Chairman

Brynjólfur was born in 1946. He was first elected as a Director at a shareholders' meeting on 20 November 2014. He is not a shareholder of Arion Bank and is an independent Director. Brynjólfur is Chairman of the Board Audit Committee and a member of the Board Credit Committee. Brynjólfur graduated with an MBA from the University of Minnesota in 1973 and a cand. oecon. degree in business studies from the University of Iceland in 1971. Brynjólfur currently serves on several boards.

Brynjólfur previously worked as the managing director of the Enterprise Investment Fund and as the CEO of Skipti, Síminn and Grandi hf. He has also worked as managing director of the publisher AB bókaútgáfa and was head of the economics department of VSÍ. Brynjólfur has broad experience as a director and has served on numerous boards and been chairman of several.

## Jakob M. Ásmundsson

Jakob was born in 1975. He was first elected as a Director at the Bank's annual general shareholders' meeting on 9 March 2017. He is not a shareholder of Arion Bank and is an independent Director. Jakob is a member of the Board Risk Committee. Jakob was awarded a PhD in industrial engineering in 2002 from Purdue University and gained an MSc in the same subject in 2000 from the University of Illinois at Urbana-Champaign. Jakob received a BSc in mechanical and industrial engineering from the University of Iceland in 1998.

Jakob is currently an assistant professor of finance at the University of Iceland. He previously worked for Straumur Investment Bank, first as chief financial officer and then as CEO. Before that he was chief financial & operating officer at ALMC hf. and chief risk officer at Straumur-Burdarás Investment Bank. Jakob also worked at Intel Corporation. He was a board member at the Icelandic Financial Services Association from 2013 to 2015 and is currently a board member at Solid Clouds ehf. and Jakás ehf. and a member of the examination committee on securities trading.

## John P. Madden

John P. Madden was born in 1973. John is a dual US and British citizen and he lives in the United Kingdom. He was first elected as a Director at a shareholders' meeting on 15 September 2016. He is not a shareholder of Arion Bank and is a dependent Director. John is a member of the Board Risk Committee and Board Remuneration Committee. He gained a BA in political economy from Williams College in Massachusetts in 1996.

John is a managing director at Kaupthing ehf., which is the majority shareholder of Arion Bank through its subsidiary Kaupskil ehf. He has also worked at BC Partners, Arle, ICG since 2014. Previously John worked at Arcapita, first in the United States, then in the United Kingdom. Prior to that he was at Lehman Brothers, New York. John is currently on the board of directors at Fairhold Securitisation Limited and Noreco.

## Kirstín Th. Flygenring

Kirstín was born in 1955. She was first elected to the Board as an Alternate at a shareholders' meeting on 22 March 2012. She was elected to the Board as a Director at the Bank's annual general meeting on 20 March 2014. She is not a shareholder of Arion Bank and is an independent Director. Kirstín is a member of the Board Audit Committee and the Board Remuneration Committee. Kirstín completed an MA in economics from Northwestern University in Illinois in 1983. In 1980 she graduated with a cand. oecon. degree from the University of Iceland. She has completed a course in practical media studies at the University of Iceland and gained a diploma in European competition law from Kings College London.

Kirstín currently works as an independent consultant. She has previously served as a member of the Icelandic parliament's investigative committee on the Housing Financing Fund and has worked as a part-time lecturer and adjunct at the University of Iceland, specialist at the Institute for Research in Finance and Economics at Reykjavík University and as an economist at the National Economic Institute, the Department of Economics at the Central Bank of Iceland, and for the OECD. Kirstín has also held several positions on boards and committees and has served on the Post and Telecommunications Arbitration Committee since 2008.

## Måns Höglund

Måns was born in 1951. He is Swedish and lives in Portugal. He was first elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder of Arion Bank and is an independent Director. Måns is Chairman of the Board Risk Committee and a member of the Board Credit Committee. He graduated with a BSc in business and economics from the Stockholm School of Economics in 1975.

Måns previously worked for Swedish Export Credit Corporation (SEK) as executive director and head of corporate and structured finance and was a member of SEK's Executive Committee. He has worked for

Unibank as head of the Sweden operation and Nordea as Head of Private Banking, Sweden as well as Swedbank where his roles included being head of the corporate division. Måns worked at Götabanken in London and Stockholm and had various positions at Hambros Bank in London. . Måns has also worked as a lecturer and researcher at the Stockholm School of Economics.

## Steinunn Kristín Thórdardóttir

Steinunn was born in 1972. She was first elected as a Director at a shareholders' meeting on 30 November 2017. She is not a shareholder of Arion Bank and is an independent Director. Steinunn has a Master degree in international management from Thunderbird, Arizona and a BA in international business and politics from University of South Carolina.

Steinunn was previously a partner and CEO of Beringer Finance Norway and global head of food and seafood. She founded Akton AS, a management consulting company in Norway where she worked as a managing director until 2015. Steinunn worked at Íslandsbanki (later Glitnir) as executive director of International Corporate Credit and later as managing director and head of the bank's UK operations. Steinunn was previously a board member of Silver Green AS and Silver Green TC AS in Norway, Versobank AS in Estonia, board member of the Icelandic State Financial Investment (ISFI) and alternate board member at Kredittbanken, later Glitnir Norway. Steinunn is currently a member of Exedra, a discussion forum for women in leadership in various sectors, as well as a board member of Cloud Insurance AS, Acton Capital AS, Akton AS and the British-Icelandic Chamber of Commerce and vice chairman of the Norwegian-Icelandic Chamber of Commerce.

## Thóra Hallgrímsdóttir

Thóra was born in 1974. She was first elected as an Alternate Director at a shareholders' meeting on 24 March 2011. She was elected as a Director at a shareholders' meeting on 21 March 2013. She is not a shareholder of Arion Bank and is an independent Director. Thóra is a member of the

Board Audit Committee and the Board Remuneration Committee. Thóra completed an MA in law at the University of Iceland in 2000 and qualified as an attorney to the district court in 2002. Since 2011 she has worked as a specialist in the faculty of law at Reykjavík University in insurance law, contract law and law of tort.

Before that Thóra worked as a lawyer for two Icelandic insurance companies: Tryggingamidstödin hf. and Sjóvá-Almennar tryggingar hf. Thóra is currently a board member of the rehabilitation fund Virk--Starfsendurhæfingarsjódur ses. and the Association of Icelandic Lawyers and is the CEO for the Icelandic Law Journal (Tímarit Lögfraedinga). Thóra serves as chairman of the insurance complaints committee chairman of the seamen and fishermen's arbitration committee and chairman of the committee on reimbursement for film production..

## Alternate directors:

Ólafur Örn Svansson, Supreme Court attorney, Sigurbjörg Ásta Jónsdóttir, lawyer and Thórarinn Thorgeirsson, attorney at law.

More information on the Board of Directors can be found on the Bank's website.

### Communications between the Shareholders and the Board of Directors

The Bank's ownership underwent a change in March when Kaupskil reduced its holding by almost 30%. Four new shareholders came on board: three international investment funds and Goldman Sachs. At the end of 2017 Kaupthing ehf., through its subsidiary Kaupskil ehf., held 57.41% of the shares in Arion Bank hf. Kaupskil ehf. also controlled the 9.99% shareholding of Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. and 6.58% shareholding of Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group. The remaining shareholding was held by the Icelandic State Financial Investments which held 13.00% on behalf of the Icelandic government, Attestor Capital LLP through Trinity Investment Designated Activity Company held 10.44% and Goldman Sachs International through ELQ Investors II Ltd. held 2.57%.

The main venue at which the Board and the Bank report information to the shareholders is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meeting. Shareholders have, at the Board's request, also arranged quarterly meetings at which the Chief Executive Officer presents the interim financial results.

## Chief Executive Officer

### Höskuldur H. Ólafsson

Höskuldur was born in 1959. He was appointed CEO of Arion Bank in June 2010. Höskuldur is not a shareholder of Arion Bank and no stock option agreements have been entered into with him. Höskuldur joined the Bank from Valitor hf. where he had been CEO since 2006. Prior to that he worked at the Icelandic transportation company Eimskip hf. for 17 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987. The CEO and the executive committee carry out the Bank's daily operations in accordance with a strategy set out by the Board. The CEO shall provide the Board with reports on the Bank's operations and financial position and all important issues which may affect the Bank's operations and finances. With respect to other duties responsibilities and duties of the CEO please refer to Chapter VII of the Financial Undertakings Act and Chapter IX of the Public Limited Companies Act. The duties of the CEO and his responsibilities take into account the legal environment in which the Bank operates at any given time and the rules which the Board of Directors may establish.Executive Committee

### Executive Committee

The Bank's Executive Committee consists of ten people, including the CEO, Höskuldur H. Ólafsson; Freyr Thórdarson, Managing Director of Corporate Banking, Gísli S. Óttarsson, Chief Risk Officer, Ida Brá Benediktsdóttir, Managing Director of Retail Banking, Lýdur Thór Thorgeirsson, Managing Director of Investment Banking, Jónína S. Lárusdóttir, Managing Director of Legal Division, Margrét Sveinsdóttir, Managing Director of Asset Management, Rakel Óttarsdóttir, Managing Director of IT Stefán Pétursson, Chief Financial Officer and Sture Stölen, Head of Investor Relations.

More information on the Executive Committee can be found on the Bank's website.

## Information on violations of laws and regulations.

Arion Bank has not been denied registration, authorization, membership or permission to conduct certain business, activity or operations. The Bank has not been subject to withdrawal, revocation or dismissal of registration, authorization, membership or permission. Information on legal cases relating to Arion Bank can be found in the notes to the annual financial statement.

*The Board of Directors annually reviews and approves the Corporate Governance Statement.*

*This Corporate Governance Statement was examined and approved at a meeting of the Board of Directors on 14 February 2018.*

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