Arion Bank

Earnings Press Release, 31 October 2018

# ARION BANK'S Q3 2018 FINANCIAL RESULTS

## STABLE UNDERLYING OPERATIONS

Arion Bank reported net earnings of ISK 1.1 billion for the third quarter of 2018, compared with a loss of ISK 0.1 billion for the same period of 2017. Return on equity was 2.3% for the third quarter of 2018, compared with a negative return of 0.2% for the same period in 2017. During the first nine months of 2018 net earnings were ISK 6.2 billion and return on equity 3.9% compared with ISK 10.4 billion net earnings and 6.3% return on equity during the first nine months of 2017. Net earnings for the quarter and the first nine months are affected by impairments relating to Primera.

Total assets amounted to ISK 1,219.5 billion at the end of September 2018, compared with ISK 1,147.8 billion at the end of 2017. Shareholders' equity totalled ISK 199.3 billion, compared with ISK 225.6 billion at the end of 2017. Arion Bank paid dividend of ISK 10 billion at the end of September 2018.

The Bank's capital ratio at the end of September was 21.7%, compared with 24.0% at the end of 2017. The CET1 ratio was 21.6% at the end of September, compared with 23.6% at the end of 2017.

Highlights of the income statement and key income related performance indicators:

| *In ISK millions* | Q3 2018 | Q3 2017 | % diff. | 9M 2018 | 9M 2017 | % diff. |
|---|---|---|---|---|---|---|
| Net interest income | 7,445 | 7,250 | 3% | 21,966 | 22,570 | (3%) |
| Net commission income | 4,246 | 3,865 | 10% | 12,280 | 10,703 | 15% |
| Net financial income | 582 | (734) | - | 2,849 | 2,471 | 15% |
| Net insurance income | 984 | 716 | 37% | 1,885 | 1,769 | 7% |
| Share of profit of associates and impairment | 34 | 17 | 100% | 18 | (917) | - |
| Other operating income | 431 | 483 | (11%) | 1,310 | 2,858 | (54%) |
| **Operating income** | **13,722** | **11,597** | **18%** | **40,308** | **39,454** | **2%** |
| Salaries and related expenses | (4,168) | (3,841) | 9% | (13,815) | (12,624) | 9% |
| Other operating expenses | (3,817) | (3,699) | 3% | (11,777) | (8,756) | 35% |
| **Operating expenses** | **(7,985)** | **(7,540)** | **6%** | **25,592** | **21,380** | **20%** |
| Bank levy | (937) | (814) | 15% | (2,621) | (2,388) | 10% |
| Net impairment | (2,678) | (2,551) | 5% | (2,969) | (1,262) | 135% |
| **Net earnings before taxes** | **2,122** | **692** | **207%** | **9,126** | **14,424** | **(37%)** |
| Income tax expense | (973) | (805) | 21% | (3,078) | (4,071) | (24%) |
| Discontinued operations, net of tax | - | - | - | 112 | - | - |
| **Net earnings** | **1,149** | **(113)** | **-** | **6,160** | **10,353** | **(41%)** |
| **KPI's** | | | | | | |
| Return on equity | 2.3% | (0.2%) | | 3.9% | 6.3% | |
| Earnings per share (in ISK) | 0.63 | (0.06) | | 3.00 | 5.17 | |
| Cost to income ratio | 58.2% | 65.0% | | 63.5% | 54.2% | |

Highlights of the balance sheet and key performance indicators:

| *In ISK million* | 30.09.2018 | 31.12.2017 | Diff. | % diff. |
|---|---|---|---|---|
| Loans to customers | 819,965 | 765,101 | 54,864 | 7% |
| Other assets | 399,565 | 382,653 | 16,912 | 4% |
| Liabilities | 1,019,474 | 922,021 | 97,453 | 11% |
| Equity | 200,056 | 225,733 | (25,677) | (11%) |
| Loans to Deposits ratio | 169.2% | 165.5% | | |
| RWA / Total assets | 66.2% | 66.8% | | |
| CET 1 ratio | 21.6% | 23.6% | | |

For detailed information on the accounts please refer to Arion Bank's Consolidated Interim Financial Statements for the third quarter and the first nine months of 2018 on the Bank's website, www.arionbanki.is.

## HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK

The third quarter financial results were below expectations, with the bankruptcy of Primera Air being a key factor as the Bank needed to impair assets as a result. However, the Bank's underlying business remains strong. We see solid year-on-year growth in both commission income and income from insurance activities. At the same time the net interest margin is stable in a highly competitive environment. It is clear, however, in the near term that the Bank will be focusing more on the profitability of its loan portfolio, even at the expense of loan growth.

The Bank has a strong capital position despite substantial dividends and share buybacks totalling ISK 33 billion during the year. In September Arion Bank paid out a dividend of ISK 10 billon in accordance with the Bank's policy on reducing its capital. At the same time the Bank remains focused on achieving its stated targets on for example capital, cost-to-income ratio and profitability.

Arion Bank has been focused on cost control in an ever more complex operating environment. Managing costs is essential for returns going forward and the Bank is undertaking certain cost cutting initiatives. In recent years the Bank has successfully managed to adapt services to our customers' ever changing needs. Our key focus has been on digital solutions, developing the Arion Bank app, online banking and other online services to enable our customers to take care of their finances whenever and wherever it suits them. We have also continued to modify and adapt our branch network. This means both enhancing our core branches, which offer diverse banking and advisory services, and also redesigning our smaller branches, many of which have moved into commercial centres frequently visited by our customers. The latest example of this is the branch in the supermarket Hagkaup in Gardabaer. By merging and moving branches we have streamlined the branch structure, for example by substantially reducing the amount of office space we occupy.

Equality issues have been a key concern at the Bank for many years and we have achieved a great deal in this area. Arion Bank was recently the first bank and one of the largest companies in Iceland to receive permission to use the Ministry of Welfare's equal pay symbol. Arion Bank first introduced an equal pay management system in 2015 and subsequently received equal pay certification from the labour union VR. The equal pay management system is an important management tool and helps to ensure that people performing jobs of equal value are not discriminated against in terms of salary. We have also endeavoured to attain gender balance in the Bank's management team. Now that the Bank has been listed on the stock exchange in Stockholm, it is pleasing to see that we are at the forefront in this area compared with other listed companies in Sweden. On a list recently published by AllBright, a Swedish non-profit foundation working for equality and meritocracy in the business community, Arion Bank is in the 17th place out of 329 companies listed in Stockholm in terms of gender diversity in the management team. We will continue on this path with the aim of further improving gender equality at the Bank.

The cost-to-income ratio developed positively during the quarter. We are making systematic efforts to streamline the business and increase efficiency. The strategic journey we have embarked on with digital services and the evolving branch network is critical in this respect, as in the long term it will yield reduced costs and higher income. The Bank is also looking to outsource certain tasks and find strategic partners in order to share employees, materials and premises.

Valitor continues to expand internationally and offers its customers in the Nordic region and the United Kingdom diverse solutions in payment services. Strategic planning on the future ownership of the subsidiary has now been completed and Arion Bank is currently in the process of engaging an investment bank for the divestment of Valitor, either as a whole or in part. A decision on the next steps will be announced in the near future.

## INCOME STATEMENT

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff. | Q3 2017 | % diff. |
|---|---|---|---|---|---|
| Net interest income | 7,445 | 7,613 | (2%) | 7,250 | 3% |
| Net commission income | 4,246 | 4,492 | (5%) | 3,865 | 10% |
| Net financial income | 582 | 927 | (37%) | (734) | - |
| Net insurance income | 984 | 758 | 30% | 716 | 37% |
| Share of profit of associates and impairment | 34 | 2 | - | 17 | 100% |
| Other operating income | 431 | 610 | (29%) | 483 | (11%) |
| **Operating income** | **13,722** | **14,402** | **(5%)** | **11,597** | **18%** |
| Salaries and related expenses | (4,168) | (5,011) | (17%) | (3,841) | 9% |
| Other operating expenses | (3,817) | (3,964) | (4%) | (3,699) | 3% |
| **Operating expenses** | **(7,985)** | **(8,975)** | **(11%)** | **(7,540)** | **6%** |
| Bank levy | (937) | (880) | 6% | (814) | 15% |
| Net impairment | (2,678) | (192) | - | (2,551) | 5% |
| **Net earnings before taxes** | **2,122** | **4,355** | **(51%)** | **692** | **207%** |
| Income tax expense | (973) | (1,287) | (24%) | (805) | 21% |
| Discontinued operations, net of tax | - | (6) | - | - | - |
| **Net earnings** | **1,149** | **3,062** | **(62%)** | **(113)** | **-** |

***Operating income*** amounted to ISK 13.7 billion for the third quarter of 2018, compared with ISK 11.6 billion for the same period in 2017. Net interest income, net commission income, financial income and net insurance income increased between years, whereas other operating income decreased slightly. Operating income decreased slightly compared with the second quarter of 2018, in particular net financial income.

*Net interest income* increased by 3% compared with the third quarter of 2017. The net interest margin as a percentage of average interest-bearing assets was 2.7% during the third quarter of 2018, the same as during the third quarter of 2017. It was 2.8% during the second quarter of 2018. Average interest-bearing assets increased by 5.4% from the third quarter of 2017 and by approximately 3.4% from the second quarter of 2018. The slightly lower interest margin from the second quarter this year, despite higher inflation, is partly due to the higher proportion of cash and cash equivalents in foreign currency, which bear low interest rates, and to pressure on the Bank's interest rates in a highly competitive environment, both for corporates and retail customers.

*Net commission income* increased by 10% during the third quarter of 2018 compared with the same period in 2017 but decreased slightly from the second quarter 2018. The increase is primarily due to the rise in commission income from Investment Banking, increased business activity, and growing activity in cards and payment solutions, which increased by 18% from the same period in 2017. The decrease from the second quarter of 2018 is primarily due to the departure of a major client in the international operations of Valitor.

*Net financial income* amounted to ISK 582 million, compared with negative net financial income of ISK 734 million for the third quarter of 2017 and ISK 927 million for the second quarter of 2018. Positive market changes in foreign equity holdings are the main reason for the positive contribution from net financial income during the year and are mainly from sale redemption or changes in holdings of listed and unlisted equity holdings.

*Net insurance income* amounted to ISK 984 million, compared with ISK 716 million for the third quarter of 2017, and ISK 758 million during the second quarter of 2018. The increase from 2017 is primarily due to increasing premiums earned at the insurance company Vördur and a relatively low claim rate. Combined ratio in Q3 was 80.0% compared to 87.4% for the same period in 2017.

*Other operating income* was ISK 431 million during the third quarter, compared with ISK 483 million during the same period in 2017 and ISK 610 million during the second quarter of 2018. Higher fair value changes on investment property are the main reason for the fluctuations between quarters.

***Operating expenses*** amounted to ISK 7,985 million during the third quarter, compared with ISK 7,540 million in the same period in 2017 and ISK 8,975 million during the second quarter of 2018. The Bank's cost-to-income ratio was 58.2% for the third quarter, compared with 65.3% for the same period in 2017 and 62.3% during the second quarter of 2018. The Bank's cost-to-income ratio excluding Valitor was 49.5% for the third quarter, compared with 60.9% for the same period in 2017 and 57.6% during the second quarter of 2018. The cost-to-total assets ratio was 2.7% for the third quarter, the same as in the third quarter of 2017 and 3.1% during the second quarter of 2018.

*Salaries and related expenses* amounted to ISK 4,168 million for the third quarter of 2018, an increase of 9% from the same period in 2017 but decreased by 17% from the second quarter of 2018, mainly due to seasonal fluctuations. The increase from last year is mainly due to a general rise in salaries under labor agreements which came into effect in May 2018 and an increase in the number of employees at the subsidiary Valitor. The average salary per employee increased by 5.1% during the first nine months 2018, but at the same time the general salary index in Iceland rose by 6.4%. Full-time equivalent positions at the end of September totalled 1,322 at the Group, 41 more than at the end the third quarter of 2017 and an increase of 23 compared with year-end 2017. The increase is largely a result of Valitor's growth on the international market. The decrease in number of FTEs continues at the parent company, mainly due to the outsourcing of projects, e.g. the cash center.

*Other operating expenses* amounted to ISK 3,817 million during the third quarter of 2018, compared with ISK 3,699 million during the same period in 2017 and ISK 3,964 million during the second quarter of 2018. The increase from the third quarter of 2017 is mainly related to inflation and Valitor's growing operations.

*Net impairment* was negative by ISK 2,678 million during the third quarter of 2018, compared with a negative net impairment of ISK 3,840 million in the same period in 2017 and ISK 192 million in the second quarter of 2018. The bankruptcy of Primera Air was the main reason for the negative net impairment during the third quarter of 2018, as previously announced on 2 October 2018. Operational difficulties of United Silicon were the main reason for the impairment in the third quarter of 2017. During the second quarter of 2018 net impairment was immaterial.

*Income tax* amounted to ISK 973 million during the third quarter of 2018, compared with ISK 805 million in the same period in 2017 and ISK 1,287 million during the second quarter of 2018. Income tax, as reported in the financial statements, comprises 20% income tax on earnings and a special 6% financial tax on the earnings of financial undertakings of more than ISK 1 billion. The effective income tax rate was exceptionally high, or 45.9% for the third quarter of 2018, compared with 29.6% during the second quarter of 2018. The high income tax rate during the third quarter 2018 is mainly due to an operating loss at Valitor's subsidiaries in Denmark and UK which is unlikely to be subtracted in the tax base. Notice that bank levy is non-deductible from the tax base.

## First nine months of 2018

| *In ISK millions* | **9M 2018** | **9M 2017** | **% diff.** |
|---|---|---|---|
| Net interest income | 21,966 | 22,570 | (3%) |
| Net commission income | 12,280 | 10,703 | 15% |
| Net financial income | 2,849 | 2,471 | 15% |
| Net insurance income | 1,885 | 1,769 | 7% |
| Share of profit of associates and impairm. | 18 | (917) | - |
| Other operating income | 1,310 | 2,858 | (54%) |
| **Operating income** | **40,308** | **39,454** | **2%** |
| Salaries and related expenses | (13,815) | (12,624) | 9% |
| Other operating expenses | (11,777) | (8,756) | 35% |
| **Operating expenses** | **25,592** | **21,380** | **20%** |
| Bank levy | (2,621) | (2,388) | 10% |
| Net impairment | (2,969) | (1,262) | 135% |
| **Net earnings before taxes** | **9,126** | **14,424** | **(37%)** |
| Income tax expense | (3,078) | (4,071) | (24%) |
| Discontinued operations, net of tax | 112 | - | - |
| **Net earnings** | **6,160** | **10,353** | **(41%)** |
| **KPI's** | | | |
| Return on equity | 3.9% | 6.3% | |
| Earnings per share (in ISK) | 3.00 | 5.17 | |
| Cost to income ratio | 63.5% | 54.2% | |

*Net earnings* during the first nine months of 2018 were significantly lower than during the same period in 2017, which can be explained by numerous one-offs during both years. Return on equity for the first nine months of 2018 was 3.9%, compared with 6.3% during the same period in 2017.

*Net interest margin* during the first nine months was relatively lower compared with the same period in 2017, which can mainly be explained by high liquidity in ISK in 2017, which was largely used to pay out dividends and to buy treasury stock in 2018. The loss from associates was relatively high in 2017, mainly due to the operational difficulties at United Silicon. Positive fair value changes in investment properties were extraordinary in 2017, which explains the significant deviations in other operating income.

*Operating expenses* increased as a result of the higher number of employees and growing operations but the main change is due to the reversal of a liability to the Depositors' and Investors' Guarantee Fund amounting to ISK 2,669 million, which had a significant effect on other operating expenses during 2017.

*Net impairment* was significant for both periods, due to Primera in 2018 and United Silicon in 2017. In 2017 there were significantly more positive changes in the loan book, partly due to prepayments of mortgages with the release of discounts and payments from composition and bankrupt estates.

The cost-to-income ratio increased, mainly due to the reversal of a liability to the Depositors' and Investor's Guarantee Fund in 2017.

## Earnings of operating segments

Arion Bank divides its operations into five profit centers plus subsidiaries and support units. The Bank's profit centers are Asset Management, Corporate Banking, Investment Banking, Retail Banking and Treasury.

All of the Bank's profit centers, except Corporate Banking, made a profit before income tax in the third quarter of 2018.

| ***3rd Quarter 2018***<br>*In ISK millions* | **Asset Manage-ment** | **Corporate Banking** | **Investment Banking** | **Retail Banking** | **Treasury** | **Other div., headq. and subsid.** | **Total** |
|---|---|---|---|---|---|---|---|
| Net interest income | 183 | 1,437 | 72 | 4,386 | 1,127 | 240 | 7,445 |
| Net commission income | 837 | 284 | 441 | 1,326 | (68) | 1,426 | 4,246 |
| Other income | 24 | (2) | (5) | 367 | 331 | 1,316 | 2,031 |
| **Operating income** | **1,044** | **1,719** | **508** | **6,079** | **1,390** | **2,982** | **13,722** |
| Operating expenses | (515) | (747) | (343) | (2,961) | (272) | (3,147) | (7,985) |
| Bank levy | (42) | (188) | (12) | (329) | (366) | 0 | (937) |
| Net impairment | 0 | (2,672) | 16 | (12) | 19 | (29) | (2,678) |
| **Earnings before taxes** | **487** | **(1,888)** | **169** | **2,777** | **771** | **(194)** | **2,122** |

| ***2nd Quarter 2018***<br>*In ISK millions* | **Asset Manage-ment** | **Corporate Banking** | **Investment Banking** | **Retail Banking** | **Treasury** | **Other div., headq. and subsid.** | **Total** |
|---|---|---|---|---|---|---|---|
| Net interest income | 175 | 1,464 | 94 | 4,310 | 1,189 | 381 | 7,613 |
| Net commission income | 865 | 305 | 425 | 1,235 | (82) | 1,744 | 4,492 |
| Other income | 43 | 18 | (1) | 74 | 143 | 2,020 | 2,297 |
| **Operating income** | **1,083** | **1,787** | **518** | **5,619** | **1,250** | **4,145** | **14,402** |
| Operating expenses | (630) | (878) | (398) | (3,398) | (313) | (3,358) | (8,975) |
| Bank levy | (41) | (180) | (14) | (312) | (333) | 0 | (880) |
| Net impairment | 0 | (413) | 0 | 238 | 10 | (27) | (192) |
| **Earnings before taxes** | **412** | **316** | **106** | **2,147** | **614** | **760** | **4,355** |

| ***3rd Quarter 2017***<br>*In ISK millions* | **Asset Manage-ment** | **Corporate Banking** | **Investment Banking** | **Retail Banking** | **Treasury** | **Other div., headq. and subsid.** | **Total** |
|---|---|---|---|---|---|---|---|
| Net interest income | 124 | 1,582 | 50 | 3,919 | 1,300 | 275 | 7,250 |
| Net commission income | 867 | 314 | 291 | 1,258 | (91) | 1,226 | 3,865 |
| Other income | 70 | 80 | (21) | 252 | (18) | 119 | 482 |
| **Operating income** | **1,061** | **1,976** | **320** | **5,429** | **1,191** | **1,620** | **11,597** |
| Operating expenses | (546) | (662) | (297) | (3,037) | (272) | (2,726) | (7,540) |
| Bank levy | (118) | (171) | (6) | (448) | (71) | 0 | (814) |
| Net impairment | 0 | (3,268) | (39) | 804 | 0 | (48) | (2,551) |
| **Earnings before taxes** | **397** | **(2,125)** | **(22)** | **2,748** | **848** | **(1,154)** | **692** |

### *Asset Management*

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff | Q3 2017 | % diff |
|---|---|---|---|---|---|
| Net interest income | 183 | 175 | 4.6% | 124 | 47.6% |
| Net commission income | 837 | 865 | (3.2%) | 867 | (3.5%) |
| Other income | 24 | 43 | (44.2%) | 70 | - |
| **Operating income** | **1,044** | **1,083** | **(3.6%)** | **1,061** | **(1.6%)** |
| Operating expenses | (515) | (630) | (18.3%) | (546) | (5.7%) |
| Bank levy | (42) | (41) | 2.4% | (118) | (64.4%) |
| **Earnings before taxes** | **487** | **412** | **18.2%** | **397** | **22.7%** |

The operations of Asset Management are stable and net earnings are good. Fluctuations in operating income are usually due to changes in the market environment. Operating expenses decreased compared with the second quarter of 2018, mainly due to seasonal fluctuations. Assets under management at the end of September amounted to ISK 951 billion and decreased by 3.4% from year-end 2017.

### *Corporate Banking*

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff | Q3 2017 | % diff |
|---|---|---|---|---|---|
| Net interest income | 1,437 | 1,464 | (1.8%) | 1,582 | (9.2%) |
| Net commission income | 284 | 305 | (6.9%) | 314 | (9.6%) |
| Other income | (2) | 18 | - | 80 | (102.5%) |
| **Operating income** | **1,719** | **1,787** | **(3.8%)** | **1,976** | **(13.0%)** |
| Operating expenses | (747) | (878) | (14.9%) | (662) | 12.8% |
| Bank levy | (188) | (180) | 4.4% | (171) | 9.9% |
| Net impairment | (2,672) | (413) | 547.0% | (3,268) | - |
| **Earnings before taxes** | **(1,888)** | **316** | **-** | **(2,125)** | **(11.2%)** |

Net interest income at Corporate Banking is in line with the second quarter of 2018 but was 9% lower than in the third quarter of 2017, as a result of firm competition in the corporate market. Net commission income fluctuates with market activity in the corporate space which has slowed slightly compared with the previous year. Operating expenses were relatively higher in the third quarter of 2018 compared with the same period in 2017, in line with higher cost at the Bank, but the decrease compared with the second quarter of 2018 is mainly due to seasonal fluctuation. The negative net valuation changes in the loan portfolio can be primarily attributed to loans and claims against Primera as well as a substantial valuation change during the same period in 2017 related to United Silicon. Valuation changes during the second quarter of 2017 were immaterial.

### *Investment Banking*

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff | Q3 2017 | % diff |
|---|---|---|---|---|---|
| Net interest income | 72 | 94 | (23.4%) | 50 | 44.0% |
| Net commission income | 441 | 425 | 3.8% | 291 | 51.5% |
| Other income | (5) | (1) | - | (21) | - |
| **Operating income** | **508** | **518** | **(1.9%)** | **320** | **58.8%** |
| Operating expenses | (343) | (398) | (13.8%) | (297) | 15.5% |
| Bank levy | (12) | (14) | (14.3%) | (6) | 100.0% |
| Net impairment | 16 | 0 | - | (39) | - |
| **Earnings before taxes** | **169** | **106** | **59.4%** | **(22)** | **-** |

Activities at Investment Banking have increased considerably during 2018, compared with the same period last year. During the third quarter the listing of the bond issue of Reginn and N1’s acquisition of Festir, were completed. Corporate Finance has continued to be actively engaged in internal projects at the Bank, such as resolving complex recovery cases, but has also increased the number of market transactions in which it is involved. Revenues from equities and fixed income brokerage at Capital Markets have been strong and the Bank has been a leader in terms of turnover on Nasdaq Iceland in recent years.

### *Retail Banking*

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff | Q3 2017 | % diff |
|---|---|---|---|---|---|
| Net interest income | 4,386 | 4,310 | 1.8% | 3,919 | 11.9% |
| Net commission income | 1,326 | 1,235 | 7.4% | 1,258 | 5.4% |
| Other income | 367 | 74 | 395.9% | 252 | 45.6% |
| **Operating income** | **6,079** | **5,619** | **8.2%** | **5,429** | **12.0%** |
| Operating expenses | (2,961) | (3,398) | (12.9%) | (3,037) | (2.5%) |
| Bank levy | (329) | (312) | 5.4% | (448) | (26.6%) |
| Net impairment | (12) | 238 | (105.0%) | 804 | (101.5%) |
| **Earnings before taxes** | **2,777** | **2,147** | **29.3%** | **2,748** | **1.1%** |

Operating income increased by 8% between the third quarter of 2018 and the second quarter of 2018 and by 12% compared with the third quarter of 2017. The increase can be attributed to growth in the loan book, both loans to individuals and SMEs, as well as to the strong focus over the last few years on fee generating operations.

Operating expenses are in line with the previous year, and reflect the strategic development of the branch network to align to changing customer behavior and the Bank's digital solutions.

Net impairment was minor during the period but prepayments of mortgages, as a result of the favorable the interest environment, continue and have a positive effect.

### *Treasury*

| *In ISK millions* | Q3 2018 | Q2 2018 | % diff | Q3 2017 | % diff |
|---|---|---|---|---|---|
| Net interest income | 1,127 | 1,189 | (5.2%) | 1,300 | (13.3%) |
| Net commission income | (68) | (82) | (17.1%) | (91) | (25.3%) |
| Other income | 331 | 143 | - | (18) | - |
| **Operating income** | **1,390** | **1,250** | **11.2%** | **1,191** | **16.7%** |
| Operating expenses | (272) | (313) | (13.1%) | (272) | - |
| Bank levy | (366) | (333) | 9.9% | (71) | 415.5% |
| Net impairment | 19 | 10 | 90.0% | 0 | - |
| **Earnings before taxes** | **771** | **614** | **25.6%** | **848** | **(9.1%)** |

Operating income from Treasury increased during the third quarter of 2018 compared with the same period of 2017 and the second quarter of 2018. The increase is mainly due to net financial income from derivatives and FX. Net interest income has decreased, mainly due to less liquid assets in ISK and more in foreign currencies, which bear lower interest.

## BALANCE SHEET

Arion Bank's ***total assets*** increased by 6% from year-end 2017 and 4% the last quarter.

| *In ISK millions* | 30.09.2018 | 31.12.2017 | Diff. | % diff. | 30.06.2018 | % diff. |
|---|---|---|---|---|---|---|
| Cash & balances with CB | 99,525 | 139,819 | (40,294) | (29%) | 112,996 | (12%) |
| Loans to credit institutions | 123,446 | 86,609 | 36,838 | 43% | 113,546 | 9% |
| Loans to customers | 819,965 | 765,101 | 54,864 | 7% | 803,694 | 2% |
| Financial assets | 109,374 | 109,450 | (76) | (0%) | 95,265 | 15% |
| Investment property | 7,044 | 6,613 | 431 | 7% | 7,027 | 0% |
| Investments in associates | 862 | 760 | 102 | 13% | 743 | 16% |
| Intangible assets | 14,039 | 13,848 | 191 | 1% | 13,858 | 1% |
| Other assets | 45,273 | 25,555 | 19,718 | 77% | 27,715 | 63% |
| **Total assets** | **1,219,529** | **1,147,754** | **71,775** | **6%** | **1,174,844** | **4%** |

*Cash and balances with the Central Bank* amounted to ISK 99,525 million at the end of the period, compared with ISK 139,819 million at the end of 2017. The decrease is partly due to the buyback of own shares and dividend payments totalling ISK 33.3 billion during the period.

*Loans to customers* totalled ISK 819,965 million at the end of the period, representing a 7% increase from year-end 2017 and 2% increase in the last twelve months. Loans to corporates increased by 5.6% during the first nine months, mainly loans to wholesale and retail on the one hand and real estate and construction on the other. Loans to individuals increased by 8.1%, primarily mortgage loans, as the Bank's market share remains stable despite strong competition in the mortgage market. During the period the Bank had to make impairments in relation to the bankruptcy of Primera Air. The remaining exposure to the airline industry, i.e. relating to a few clients, is ISK 4.3 billion at the end of September 2018, or 2.5% of own funds.

*Financial assets* amounted to ISK 109,374 million at the end of the period, compared with ISK 109,450 million at the end of 2017. The combination of securities held by the Bank is heavily related to the liquidity position at any given time. Transfers from international debt funds to highly rated foreign currency bonds during the first nine months of 2018 represent part of the Bank's liquidity management but the Bank has also sold a significant part of its listed and unlisted equity holdings during that period.

| *In ISK millions* | 30.09.2018 | 31.12.2017 | Diff. | % diff. | 30.06.2018 | % diff. |
|---|---|---|---|---|---|---|
| Bonds | 64,256 | 51,755 | 12,501 | 24% | 49,659 | 29% |
| Shares and instruments w. variable income | 21,348 | 36,190 | (14,842) | (41%) | 20,801 | 3% |
| Derivatives | 6,353 | 7,624 | (1,271) | (17%) | 5,130 | 24% |
| Securities used for hedging | 17,417 | 13,881 | 3,536 | 25% | 19,675 | (11%) |
| **Securities total** | **109,374** | **109,450** | **(76)** | **(0%)** | **95,265** | **15%** |

***Liabilities*** increased by 11% from year-end 2017 and 6% during the last quarter. ***Equity*** decreased due to the purchase of treasury stock and dividend payments during the period, totalling ISK 33.3 billion. Net earnings for the period and the effects of the adoption of IFRS 9 partly offset the decrease.

| *In ISK millions* | 30.09.2018 | 31.12.2017 | Diff. | % diff. | 30.06.2018 | % diff. |
|---|---|---|---|---|---|---|
| Due to credit institutions & CB | 15,370 | 7,370 | 8,000 | 109% | 6,336 | 143% |
| Deposits from customers | 484,569 | 462,161 | 22,408 | 5% | 476,182 | 2% |
| Financial liabilities at fair value | 3,381 | 3,601 | (220) | (6%) | 3,895 | (13%) |
| Other liabilities | 90,552 | 63,890 | 26,662 | 42% | 70,027 | 29% |
| Borrowings | 425,601 | 384,998 | 40,603 | 11% | 410,773 | 4% |
| Shareholders equity | 199,317 | 225,606 | (26,289) | (12%) | 206,890 | (4%) |
| Non-controlling interest | 739 | 128 | 611 | 477% | 741 | (0%) |
| **Total liabilities and equity** | **1,219,529** | **1,147,754** | **71,775** | **6%** | **1,174,844** | **4%** |

*Deposits from customers* amounted to ISK 484,569 million at the end of September 2018 and had increased by 5% from year-end 2017, primarily due to deposits from individuals and SMEs through Retail Banking. Deposits remain the most important source of funding for Arion Bank and the Bank will aim to maintain as strong a position as possible on the deposits market.

*Borrowings* amounted to ISK 425,601 million at the end of September 2018. In March Arion Bank issued a new 5-year EUR 300 million bond on the international markets (ISK 37 billion). The Bank has also continued to issue covered bonds on the Icelandic market, a total of approximately ISK 21 billion during the first nine months of 2018, as well as commercial papers for a total of ISK 26 billion.

*Shareholders' equity* amounted to ISK 199,317 million at the end of September 2018, compared with ISK 225,605 million at the end of 2017. The decrease is explained by a buyback of shares during the first quarter of 2018 and dividend payments during the first and the third quarters of 2018, which is partly offset by an increase in equity due to the adoption of IFRS 9 and the financial results for the period. The CET 1 ratio was 21.6% at the end of September 2018, compared with 23.4% at year-end 2017.

## KEY PERFORMANCE INDICATORS

| | Q3 2018 | Q2 2018 | Q3 2017 | 9M 2018 | 9M 2017 |
|---|---|---|---|---|---|
| Return on equity (ROE) | 2.3% | 5.9% | (0.2%) | 3.9% | 6.3% |
| Return on total assets (ROA) | 0.4% | 1.1% | 0.0% | 0.7% | 1.2% |
| Net interest margin (int. bearing assets) | 2.7% | 2.8% | 2.7% | 2.7% | 2.9% |
| Net interest margin (total assets) | 2.5% | 2.6% | 2.6% | 2.5% | 2.7% |
| Cost-to-income ratio | 58.2% | 62.3% | 65.0% | 63.5% | 54.2% |
| Cost-to-Total assets ratio | 2.7% | 3.1% | 2.7% | 2.9% | 2.6% |
| Effective tax rate | 45.9% | 29.6% | 116.3% | 33.7% | 28.7% |
| CAD ratio | 21.7% | 21.9% | 27.1% | 21.7% | 27.1% |
| CET 1 ratio | 21.6% | 21.8% | 26.6% | 21.6% | 26.6% |
| Share of stage 3 loans, gross* | 2.9% | 3.0% | - | 2.3% | - |
| RWA/Total assets | 66.2% | 67.8% | 68.4% | 66.2% | 68.4% |
| Loans to deposit ratio | 169.2% | 168.8% | 168.4% | 169.2% | 168.4% |
| The Group's average number of employees | 1,311 | 1,313 | 1,275 | 1,305 | 1,235 |
| The Group's employees at the end of the period | 1,334 | 1,309 | 1,293 | 1,334 | 1,293 |
| The Parent's average number of employees | 810 | 829 | 824 | 824 | 826 |
| The Parent's employees at the end of the period | 822 | 823 | 842 | 822 | 842 |

* Following the implementation of IFRS 9 on 1 January 2018 a new measurement is used:
(Gross loans in stage 3 + POCI loans in RISK class 5) / Gross carrying amount of loans to customers

## FINANCIAL TARGETS

In late 2016 Arion Bank approved the following medium-term targets for the next four to five years.

- ***RoE*** Exceed 10%
- ***CET 1*** Reduce to circa 17%
- ***Loan growth*** Prudent lending in line with economic growth
- ***Dividend policy*** Pay-out ratio of circa 50% on net earnings attributable to shareholders
- ***Cost to Income ratio*** Reduce to circa 50%

## CONFERENCE CALL IN ENGLISH

Arion Bank will be hosting a meeting / webcast on Thursday 1 November at 8:30 GMT / 9:30 CET where CEO Höskuldur H. Ólafsson and CFO Stefán Pétursson will present the results and answer questions from participants. The meeting will take place in English at the Bank's headquarters, Borgartún 19, and will be streamed live.

Those attending the meeting in Borgartún 19 need to register here. To participate in the webcast via telephone and to submit questions please call in using the relevant number indicated below before the start of the webcast:

*IS: 800 7417*
*SE: +46 856 642 665*
*UK: +44 20 3008 9808*

The webcast will be accessible live on financialhearings.com and a link will also be made available on the Bank's website under Investor Relations.

*For further information please contact Sture Stolen, head of Arion Bank's Investor Relations at ir@arionbanki.is or Theódór Fridbertsson at Investor Relations at theodor.fridbertsson@arionbanki.is, tel. +354 444 6760.*

*This is information that Arion Bank hf. is obliged to make public pursuant to the EU Market Abuse Regulation. The information was submitted for publication, through the agency of the contact persons set out above.*

## FINANCIAL CALENDAR 2018-2019

The Bank's Financial Statements are scheduled for publication as stated below.

| | |
|---|---|
| Full year 2018 and fourth quarter 20189 | 13 February 2019 |
| AGM 2019 | 13 March 2019 |
| First quarter 2019 | 8 May 2019 |
| Second quarter 2019 | 8 August 2019 |
| Third quarter 2019 | 30 October 2019 |

This calendar may be subject to change.

**Forward-looking statements**

This release contains forward-looking statements that reflect management's current views with respect to certain future events and potential financial performance. The information in the release is based on company data available at the time of the release. Although Arion Bank believes that the expectations reflected in such forward-looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. Accordingly, results could differ materially from those set out in the forward-looking statements as a result of various factors. The most important factors that may cause such a difference for Arion Bank include, but are not limited to: a) the macroeconomic development, b) change in inflation, interest rate and foreign exchange rate levels, c) change in the competitive environment and d) change in the regulatory environment and other government actions. This release does not imply that Arion Bank has undertaken to revise any forward-looking statements, beyond what is required by applicable law or applicable stock exchange regulations if and when circumstances arise that will lead to changes after the date when this release was made. Arion Bank assumes no responsibility or liability for any reliance on any of the information contained herein. It is prohibited to distribute or publish any information in this release without Arion Bank's prior written consent.