



Consolidated Financial Statements
for the year 2011

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

Contents

	page		page
Endorsement and Statement by the Board of Directors and the CEO	3-4	Consolidated Statement of Changes in Equity	8
Independent Auditor's Report	5	Consolidated Statement of Cash Flows	9
Consolidated Statement of Comprehensive Income	6	Notes to the Consolidated Financial Statements	10-77
Consolidated Statement of Financial Position	7		

Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2011 include the Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, capital markets services, corporate financing and asset management and comprehensive wealth management for private banking clients.

Kaupskil ehf., a company owned by the creditors of Kaupthing hf. (formerly Kaupthing Bank hf.), holds 87% of the shares in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State Financial Investments on behalf of the Icelandic government.

The number of full-time equivalent positions at the Group was 1,158 at year-end compared with 1,241 on 31 December 2010, of which 858 positions were at Arion Bank, compared with 936 at the end of December 2010.

Operations in 2011

Net earnings amounted to ISK 11,094 million for the year ended 31 December 2011. The Board of Directors proposes that profits will be added to equity and that no dividend will be paid. Total equity amounted to ISK 114,558 million at the end of the year, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 21.2%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") requires it to be no less than 16%. The Group's liquidity position was strong with the liquidity ratio and cash ratio being 35% and 15% respectively at the end of the year. This compares favourably with the regulatory minimum of 20% and 6% respectively.

Arion Bank performed well during the year and core banking activities continued to yield strong results. Substantial progress was made in reducing the Bank's currency imbalance during the year and the objective is to close the imbalance before the end of 2012. The Bank continued to make good progress in restructuring its loan book and other assets transferred from Kaupthing hf. As a result the Bank's knowledge of the value of the loan book is vastly improved. Recovery work was mainly completed by the end of the year.

Arion Bank undertook two major initiatives to improve the transparency of its balance sheet and improve its asset base during 2011. Firstly, on 30 June 2011 a Settlement and release of claims agreement was signed by Arion Bank and Kaupthing hf. to finalize a settlement of the Compensation Instrument and various other claims lodged against Kaupthing hf. by Arion Bank. Valuation changes in assets transferred from Kaupthing hf. upon the establishment of Arion Bank and the finalization of loan restructuring and the settlement of disputes made it possible to close the remaining balance of the Compensation Instrument. By signing the agreement the Compensation Instrument is terminated and neither Party shall have any payment obligations towards the other under the Instrument. The settlement was in the form of a transfer of loans and claims from Kaupthing hf. to Arion Bank and loans from Arion Bank to Kaupthing hf., which in most cases results in the total exposure to the customers being held wholly by either Arion Bank or Kaupthing hf. Secondly, at the end of the year Arion Bank acquired Kaupthing Mortgage Institutional Investor Fund which was a structured covered bond fund owned by the bankruptcy estate of Kaupthing hf. The mortgages within the portfolio are serviced by Arion Bank and are valued at around ISK 112 billion. The fund has been renamed and is called Arion Bank Mortgages Institutional Investor Fund (ABMIIF) and Arion Bank is the paying entity to bondholders instead of Kaupthing hf. The transaction strengthens the asset quality of the Group, improves the debt profile, and lastly strengthens the franchise value of the Group in the retail market as 40% of the loan portfolio are now loans to individuals. The effect on the loans-to-deposits ratio, changing it to 114.6% from 98.5%, is more than compensated for by the duration match of the portfolio and the covered bonds.

Early in 2011 Arion Bank's subsidiary Eignabjarg sold a 34% stake in Hagar plus a call option on an additional 10% to a diverse group of pension funds and professional investors. The sale price was ISK 4.1 billion. Later in the year the Corporate Advisory – Investment Banking division of Arion Bank successfully managed a public offering of shares in Hagar and the subsequent listing of the company on NASDAQ OMX Iceland. This is the first new listing on the stock exchange since 2008. The size of the offering represented 30% of the issued shares and the proceeds were ISK 4.9 billion. At the end of the year Eignabjarg still held 20% of shares in Hagar but 13.3% were sold through a private placement of shares at the end of February 2012.

Arion Bank actively sought to diversify its funding during 2011. Market conditions, however, remained challenging, partially due to the global economic situation. The Bank continued to work on an international covered bond programme which was signed in February 2012.

Risk Management

The Group faces various risks in its business activities, Managing risk is a core activity within the Group, the Group manages its risks through a process of ongoing risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and 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. Arion Bank's risk management structure, strategy and risk exposures are addressed in the notes, starting in Note 100.

Endorsement and Statement by the Board of Directors and the CEO

New FX rulings

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingabankinn. The Group has estimated that the loss to the Group's foreign loan portfolio arising from this judgement is ISK 13.8 billion, with an impairment charge for this amount included in Net Earnings as stated above. Further information regarding this judgement and methods used for the estimated effect is discussed in Note 95 in the Financial Statements.

Outlook

Arion Bank is heavily influenced by the domestic and international economic environment. The recovery in Iceland has started with GDP growth of 3.1% in 2011. Growth is forecast to be 2.4% in 2012 but the recovery remains fragile. Loan demand has been limited for some time but is expected to increase gradually from current levels. Capital market activities are expected to pick up from very low levels in line with the rebuilding of the equity market in Iceland. Arion Bank aims to have a fair market share as the capital markets improve. The Bank has no refinancing need in the near to medium term and is therefore not exposed to the situation in the global financial markets. However, the Bank's counterparty risk is likely to increase over time, and adverse developments in the global markets will have a negative effect on the Icelandic economy and the Bank's financial results. Arion Bank is, however, financially strong and well positioned to meet any challenges presented by the aforementioned situations. The Bank, furthermore, is in an ideal position to support the growth of the Icelandic economy over the coming years.

Statement by the Board of Directors and the CEO

The Consolidated Financial Statements for the year ended 31 December 2011 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance of the Group for the year 2011, its financial position as at 31 December 2011 and its cash flows in 2011.

Further, in our opinion the Consolidated 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 describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2011 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 13 March 2012

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Guðrún Johnsen

Måns Höglund

Guðrún Björnsdóttir

Jón G. Briem

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's Report

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion Bank and its subsidiaries (the "Group"), which comprise the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position as at 31 December 2011, the Consolidated Statement of Changes in Equity and the Consolidated Statement of Cash Flows for the year then ended, and the summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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

Opinion

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

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

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

Reykjavík, 13 March 2012

Ernst & Young ehf.

Margrét Pétursdóttir, Partner

Consolidated Statement of Comprehensive Income for the year 2011

	Notes	2011	2010
Interest income		46,433	52,369
Interest expense		(23,045)	(32,584)
Net interest income	42	23,388	19,785
Increase in book value of loans and receivables	43	38,368	40,269
Impairment of loans and receivables	44	(27,424)	(26,787)
Changes in compensation instrument	71	(19,593)	(11,604)
Net interest income less valuation changes on loans and receivables		14,739	21,663
Fee and commission income		16,862	10,373
Fee and commission expense		(6,177)	(3,507)
Net fee and commission income	45	10,685	6,866
Net financial income (expense)	46-49	511	402
Fair value change to Drómi bond		-	(3,500)
Net foreign exchange gain (loss)	50	1,836	4,459
Share of profit or loss of associates	73	8	556
Other operating income	51-52	5,497	5,177
Operating income		33,276	35,623
Salaries and related expense	54	(11,254)	(9,272)
Administration expense		(7,810)	(7,154)
Depositors' and investors' guarantee fund	90	(1,200)	(324)
Depreciation and amortisation	75	(956)	(819)
Other operating expense	57-58	(796)	(723)
Earnings before tax		11,260	17,331
Income tax expense	60	(1,912)	(3,481)
Bank Levy	61	(1,046)	(290)
Net earnings from continuing operations		8,302	13,560
Net gain (loss) from discontinued operations, net of tax	59	2,792	(1,003)
Net earnings		11,094	12,557
Attributable to:			
Shareholders of Arion Bank		10,493	12,381
Non-controlling interest		601	176
Net earnings		11,094	12,557
Other comprehensive income			
Exchange difference on translating foreign subsidiaries	88	112	(203)
Total comprehensive income for the year		11,206	12,354
Earnings per share			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	62	5.25	5.61

The notes on pages 10 to 77 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Financial Position

as at 31 December 2011

Assets	Notes	2011	2010
Cash and balances with Central Bank	63	29,200	30,628
Loans and receivables to credit institutions	64-65	69,103	67,846
Loans and receivables to customers	66-67,105	561,550	451,219
Bonds and debt instruments	68-69	140,568	120,112
Shares and equity instruments with variable income	68	14,045	10,316
Derivatives	68,86	674	1,126
Securities used for hedging	68	2,372	3,213
Compensation instrument	71	-	24,188
Investment property	72	27,100	27,642
Investments in associates	73	2,987	2,713
Property and equipment	74-75	6,271	7,365
Intangible assets	76	4,765	4,352
Tax assets	77-80	724	295
Non-current assets and disposal groups held for sale	81	23,886	44,464
Other assets	82	8,876	17,136
Total Assets		892,121	812,615
Liabilities			
Due to credit institutions and Central Bank	68	16,160	95,646
Deposits	68	489,995	457,881
Financial liabilities at fair value	68	4,907	999
Tax liabilities	77-80	3,421	4,454
Non-current liabilities and disposal groups held for sale	81	4,950	13,514
Other liabilities	83	38,822	39,050
Borrowings	68,84	187,203	65,278
Subordinated liabilities	68,85	32,105	26,257
Total Liabilities		777,563	703,079
Equity			
Share capital	87	2,000	2,000
Share premium	87	73,861	73,861
Other reserves	88	1,637	1,525
Retained earnings		32,950	28,531
Total Shareholders' Equity		110,448	105,917
Non-controlling interest		4,110	3,619
Total Equity		114,558	109,536
Total Liabilities and Equity		892,121	812,615

The notes on pages 10 to 77 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Changes in Equity for the year 2011

	Share capital and share premium	Other reserves	Retained earnings	Total Share- holders' equity	Non- controlling interest	Total equity
2011						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Dividend paid			(6,074)	(6,074)		(6,074)
Total comprehensive income for the year attributable to the shareholders of Arion Bank		112	10,493	10,605		10,605
Total comprehensive income for the year attributable to the non-controlling interest					601	601
Disposal of non-controlling interests					(110)	(110)
Equity 31 December 2011	75,861	1,637	32,950	110,448	4,110	114,558
2010						
Equity 1 January 2010	72,000	1,729	16,150	89,879	155	90,034
Redeemed share capital	(62,139)			(62,139)		(62,139)
Issued share capital	66,000			66,000		66,000
Total comprehensive income for the year attributable to the shareholders of Arion Bank		(204)	12,381	12,177		12,177
Total comprehensive income for the year attributable to the non-controlling interest					176	176
Non-controlling interests acquired during the year					3,288	3,288
Equity 31 December 2010	75,861	1,524	28,531	105,917	3,619	109,536

The notes on pages 10 to 77 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Cash Flows

for the year 2011

	Notes	2011	2010
Cash flows from (used in) operating activities:			
Earnings before income tax		11,260	17,331
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments	97	(1,623)	(6,386)
Changes in operating assets and liabilities	98	(13,443)	(7,991)
Income taxes paid		(3,232)	(748)
		(7,038)	2,206
Net cash from (used in) operating activities			
Cash flows from (used in) investing activities:			
Purchase of investment property		(2,160)	(1,120)
Investment in associated companies		(177)	(66)
Proceeds from sale of investment property		5,999	1,705
Proceeds from sale of associated companies		-	54
Purchase of intangible assets		(518)	(121)
Purchase of property and equipment		(667)	(381)
Proceeds from sale of property and equipment		158	110
Proceeds from sale of assets held for sale		-	706
Proceeds from the sale of individual properties included in discontinued operations		11,028	1,870
		13,663	2,757
Net cash from (used in) investing activities			
Net increase (decrease) in cash and cash equivalents		6,625	4,963
Cash and cash equivalents at beginning of the year		72,797	56,094
Cash and cash equivalents acquired through business combinations		11	18,110
Effect of exchange rate changes on cash and cash equivalents		3,382	(6,370)
		82,815	72,797
Cash and cash equivalents at the end of the year			
	99		
Non-cash investing and financing transactions:			
Tier II subordinated notes issued in settlement of dividend		(6,074)	-
Change in retained earnings for settlement of dividend with Icelandic State Financial Investments		6,074	-
Loans and receivables received through changes in capitalization		-	112,824
Bonds and debt instruments delivered through changes in capitalization		-	(32,595)
Liabilities due to credit institutions and Central Bank			
transferred due to changes in capitalization		-	14,428
Borrowings transferred due to changes in capitalization		-	(61,252)
Subordinated loans transferred due to changes in capitalization		-	(29,543)
Net changes in equity due to changes in capitalization		-	(3,862)
Assets acquired through foreclosure on collateral from legal entities with view to resale		8,825	9,816
Settlement of loans and receivables through foreclosure on collateral from subsidiaries			
with view to resale		(8,825)	(9,816)

The notes on pages 10 to 77 are an integral part of these Consolidated Financial Statements.

Notes to the Consolidated Financial Statements

Contents

	page		page
Accounting Policies			
General information	11	Non-current assets and disposal groups held for sale	48
Significant accounting policies	11-24	Other assets	49
Changes within the Group	24-25	Other liabilities	49
Operating Segment Reporting	26-27	Borrowings	49
Quarterly Statements	28	Subordinated liabilities	49
Notes to the Consolidated Statement of Comprehensive Income		Derivatives	50
Net interest income	29	Equity	
Increase in book value of loans and receivables	29	Share capital and share premium	50
Impairment of loans and receivables	29	Other reserves	50
Net fee and commission income	30	Off Balance Sheet information	
Net financial income	30-31	Obligations	51
Net foreign exchange gain (loss)	31	Operating lease commitments	51
Other operating income	31	Assets under management and and under custody	51
Personnel and salaries	32-33	Contingent liabilities	52
Auditor's fee	33	The uncertainty regarding the book value of Foreign currency lending	53
Other operating expense	34	Notes to the Consolidated Statement of Cash Flow	54
Net gain (loss) from discontinued operations net of tax	34	Risk Management Disclosures	
Tax expense	35	Introduction	55-56
Earnings per share	35	Credit risk	56-64
Notes to the Consolidated Statement of Financial Position		Market risk	64-70
Cash and balances with Central Bank	36	Liquidity risk	71-72
Loans and receivables to credit institutions	36	Operational risk	72-73
Loans and receivables to customers	36-37	Capital Adequacy and ICAAP Strategy	73-75
Financial assets and liabilities	38-43	Other information	
Compensation instrument	43-44	Related parties	76
Investment property	44	Events after the Balance Sheet date	77
Investment in associates	44-45	Subsidiaries	77
Property and equipment	45		
Intangible assets	46		
Tax assets and tax liabilities	47-48		

Notes to the Consolidated Financial Statements

General information

1. Reporting entity

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 Financial Statements for the year ended 31 December 2011 comprise the Parent Company and its subsidiaries (together referred to as "the Group"). The Group offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, retail banking, investment banking services, and asset management.

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 13 March 2012.

2. Basis of preparation

a) *Statement of compliance*

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards, as endorsed by the European Union.

b) *Basis of measurement*

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

- Financial assets/liabilities held for trading are measured at fair value;
- Financial assets/liabilities designated at fair value through profit and loss are measured at fair value;
- Investment properties are measured at fair value; and

Non-current assets (or disposal groups) classified as held for sale are stated at the lower of their carrying amount and fair value less costs to sell. Immediately before the initial classification, or where the assets and liabilities are not within the scope of IFRS 5, the carrying amounts are measured in accordance with applicable IFRSs.

c) *Functional and presentation currency*

The Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated.

d) *Use of estimates and judgements*

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, contingent liabilities as well as income and expenses in the Financial Statements presented. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the differences may be material to the Financial Statements.

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

Judgements made by management that have a significant effect on the Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in Notes 34, 70, 105, 106 and 107.

Significant accounting policies

The accounting policies adopted in the preparation of these Financial Statement are consistent with those followed in the preparation of the Group's annual Financial Statements for the year ended 31 December 2010.

3. 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.

Notes to the Consolidated Financial Statements

4. Principles underlying the consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Group holds more than 50% of the voting power of the entity. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The Financial Statements of subsidiaries are included in the 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.

The acquisition method of accounting is used to account for the acquisition of businesses and subsidiaries by the Group. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the Group measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition costs incurred are expensed and included in administrative expenses. If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date through profit or loss. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in the Statement of Comprehensive Income. After initial recognition, goodwill is measured at cost less any accumulated impairment losses.

Transactions eliminated on consolidation

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

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

b) *Non-controlling interest*

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. Losses within a subsidiary are attributed to the non-controlling interest even if that results in a deficit balance. Changes in the Group's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

c) *Funds management*

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

5. Associates

Associates are those entities over which the Group has 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 between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The Financial Statements include the Group's share of the total recognised 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 interest in an equity accounted 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 recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current asset held for sale. In instances where control of a subsidiary is lost and the Group retains an associate investment, a portion of the recognised gain or loss on sale is attributable to recognising the investment retained in the former subsidiary at its fair value at the date when control is lost. This gain or loss is recognised as either Other operating income (expense) or Net gain (loss) from discontinued operations in the Statement of Comprehensive Income.

Notes to the Consolidated Financial Statements

6. Foreign currency

a) *Functional currencies*

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

b) *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.

c) *Foreign operations*

The assets and liabilities of foreign operations are translated to Icelandic króna, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic króna at exchange rates approximating the exchange rates current at the dates of the transactions.

Foreign exchange differences arising on translation are recognised in the Statement of Comprehensive Income. When a foreign operation is disposed of, in part or in full, the cumulative amount of the exchange differences relating to that foreign operation which is recorded in comprehensive income and accumulated in the separate component of equity, is transferred to the Statement of Comprehensive Income when the gain or loss on disposal is recognised.

7. Income and Expense

a) *Interest income and expense*

Interest income and expense are recognised 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 liability and is not revised subsequently.

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

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

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- Interest on trading assets and liabilities on an accrual basis;
- Interest on financial assets and financial liabilities designated at fair value through profit or loss on an accrual basis; and
- Interest on derivatives on an accrual basis.

Interest income on non-performing assets are recognised in the Statement of Comprehensive Income using the effective interest method. The Group recognises losses for impaired loans to offset the recognised interest income when appropriate.

b) *Fee and commission income and expense*

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

Notes to the Consolidated Financial Statements

7. cont.

c) *Net financial income*

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value through profit or loss and Net gain on disposal of financial assets and liabilities not at fair value.

- i) Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities.
- ii) Net gain on financial assets and liabilities at fair value through profit or loss comprises: Net gain on trading portfolio, Net gain on assets and liabilities designated at fair value through profit or loss.

Net gain on trading portfolio

Net gains on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

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

Net gains on financial instruments designated at fair value through profit or loss comprise gains and losses related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

- iii) Net foreign exchange gains 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 financial statements.

Net foreign exchange gains 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 gains and losses are also recognised in profit or loss.

- iv) Net gain on financial assets and liabilities not at fair value through profit or loss relates to derecognition of certain financial assets and liabilities and comprises Net realised gain or loss on financial liabilities measured at amortised cost and other net realised gain or loss. It does not include either unrealised foreign exchange gains and losses or interest income and expense which are included in other line items.

d) *Income tax*

Income tax comprises current and deferred tax. Income tax is recognised in the Statement of Comprehensive Income except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised in other comprehensive income or equity.

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.

The deferred income tax asset / liability has been calculated and entered in the Statement of Financial Position. The calculation is based on the difference between Statement of Financial Position items as presented in the tax return on the one hand, and in the Financial Statements on the other. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Financial Statements, mostly because revenues and settlement is not expected at the same time. A deferred tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. 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 realised.

Notes to the Consolidated Financial Statements

8. Impairment of financial assets

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.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

a) *Impairment on loans and receivables*

The Group recognises losses for impaired loans when there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Group's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

- i) Significant financial difficulty of the borrower;
- ii) A breach of contract, such as a default on instalments or on interest or principal payments;
- iii) The Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;
- iv) It becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;
- v) Deterioration in collateral to loan ratio; or
- vi) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:
 - Adverse changes in the payment status of borrowers in the Group; or
 - General national or local economic conditions connected with the assets in the Group.

Individually assessed loans

Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Group assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, 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 realisable value of security (or other credit mitigates) and likelihood of successful repossession; and
- The likely deduction of any costs involved in recovery of amounts outstanding.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Statement of Comprehensive Income. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future. The estimated collective impairment loss is recognised through the use of an allowance account.

Notes to the Consolidated Financial Statements

8. cont.

The collective impairment loss is determined after taking into account:

- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the assets;
- Historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash; and
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period, for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to minimise any differences between loss estimates and actual losses.

Loan write-offs

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

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised or acquired impairment loss is reversed. The amount of any reversal is recognised in the Statement of Comprehensive Income.

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 recognised as increase in value of loans and receivables in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

Assets acquired in exchange for loans

Assets acquired in exchange for loans are recorded as non-current assets held for sale in the Statement of Financial Position if its sale is highly probable and management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan have been initiated. The non-current asset held for resale is recorded at the lower of its fair value less costs to sell, and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Statement of Comprehensive Income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Statement of Comprehensive Income.

b) *Calculation of recoverable amount*

The recoverable amount of the Group's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate, i.e. the effective interest rate computed at initial recognition of these financial assets.

c) *Impairment on investments in associates*

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognise 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 recognised 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.

Notes to the Consolidated Financial Statements

9. 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 recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised 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 recognised 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 amortisation, if no impairment loss had been recognised.

10. 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 recognised at fair value. Fair value changes are recognised in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and other gains and losses. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Derivatives and derivatives with negative fair values are recognised as Financial liabilities at fair value.

The fair value of derivatives is determined in accordance with the accounting policy presented in Note 13.

11. 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.

12. Loans and receivables

Loans and receivables 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.

When the Group purchases a financial 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 recognised in the Group's Financial Statements.

Loans and receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables.

13. Financial assets measured at fair value through profit and loss

a) *Trading assets*

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

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

Notes to the Consolidated Financial Statements

13. cont.

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

The Group classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Statement of Comprehensive Income as Net financial income if doing so results in more relevant information because:

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

The assets classified according to the above mentioned conditions 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.

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

14. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation models. The Group uses widely recognised 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.

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.

15. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Group commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

Financial assets are derecognised 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 recognised when the Group becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

16. Offsetting financial assets and financial liabilities

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 recognised amounts and intends either to settle on a net basis or to realise 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.

17. Amortised cost measurement of financial assets and financial liabilities

The amortised 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 amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

Notes to the Consolidated Financial Statements

18. Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets are not capitalised and expenditure is reflected in the Statement of Comprehensive Income in the period in which the expenditure is incurred.

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

a) *Subsequent expenditure*

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

b) *Amortisation*

Amortisation is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of intangible assets. Intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software.....	5 years
---------------	---------

19. 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 stated at fair value. The Group has not engaged independent property valuers to appraise the values of investment properties at year-end as management believe the valuation techniques as described below provide a more reliable estimate of fair value.

When determining the fair value of the properties, net present value of future cash flow over 30 years is calculated. When determining the cash flow general accepted valuation techniques are applied, such as international valuation standards, IVS no. 1 Market Value Basis of Valuation. The valuation model is based on estimated free cash flow to the owners and assumptions applied that reflect the market conditions at the accounting date. The cash flow of the properties is based on estimation of rental income less estimated expenses. There is great uncertainty about the actual fair value of investment properties, as further described in Note 34.

Rental income is estimated based on valid lease agreements. In the valuation model estimated market lease at the end of the current lease agreement is taken into consideration. Fundamental assumptions on estimated utilisation of the properties in the future, estimated discounts and loan provisioning are applied when estimating future rental income.

All related expenses, e.g. maintenance, real estate tax and other operating and financial expenses, is deducted from the estimated rental income. Real estate tax and insurances are based on historical data and foreseen future changes. Financial expense is estimated based upon market interest and expected interest yield (interest margin).

The net present value of free cash flow to owners, for each property, is determined by calculating the net present value of the cash flow with a factor representing current market uncertainty on amount and timing of the cash flow, including expected inflation. The CAPM model is used and the required rate of return is based on the risk free real interest on the accounting date, the risk factor of the real estate market and specific risk factors of each lessee.

When estimating the fair value of the investment properties' assets like fixtures, equipment and furniture are not accounted for separately as they are considered part of the fair value of the properties. The fair value of the properties does not reflect the possible future increase in the value due to further investments in the property.

20. Property and equipment

a) *Recognition and measurement*

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.

b) *Subsequent costs*

The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Group and its cost can be measured reliably. All other costs are recognised in the Statement of Comprehensive Income as an expense as incurred.

Notes to the Consolidated Financial Statements

20. cont.

c) *Depreciation*

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

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

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

21. 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 recognised 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 recognised in prior years.

22. Deposits

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

23. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised 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.

24. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 112. The subordinated liabilities have no maturity date and the Group may only retire them with the permission of the Financial Supervisory Authority. The liabilities qualify as Tier II capital in the calculation of the equity ratio.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognised in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

25. Financial liabilities at fair value

Trading liabilities

Trading liabilities primarily consist of derivatives with negative fair values. Hedging derivatives such as those used for internal risk control but not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain (loss) on financial assets and liabilities classified as held for trading. Interest expenses on trading liabilities are included in Interest expenses.

Notes to the Consolidated Financial Statements

26. Other assets and other liabilities

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

27. Equity

Dividends on shares

Dividends on shares are recognised in equity in the period in which they are approved by the Group'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 Group.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations.

28. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to equity holders of the Group by the weighted average number of ordinary shares outstanding during the year.

29. 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 recognised in the 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 recognised less, when appropriate, cumulative amortisation recognised 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 recognised in the Statement of Comprehensive Income in *Net fees and commission income* on a straight line basis over the life of the guarantee.

30. 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.

31. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contribution 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 recognised as an expense in the Statement of Comprehensive income when they become due. The Group has no defined benefit pension plan.

32. New standards and amendments to standards

a) New standards and amendments to standards effective in 2011

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS effective as of 1 January 2011:

IAS 24 Related Party Transactions (Amended)

The IASB issued an amendment to IAS 24 that clarifies the definitions of a related party. The new definitions emphasise a symmetrical view of related party relationships and clarifies the circumstances in which persons and key management personnel affect related party relationships of an entity. In addition, the amendment introduces an exemption from the general related party disclosure requirements for transactions with government and entities that are controlled, jointly controlled or significantly influenced by the same government as the reporting entity. The adoption of the amendment did not have any impact on the financial position or performance of the Group.

Notes to the Consolidated Financial Statements

32. cont.

Improvements to IFRS

In May 2010, the IASB issued its third omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. The adoption of the following amendments resulted in changes to accounting policies, but no impact on the financial position or performance of the Group.

- *IFRS 7 Financial Instruments — Disclosures*: The amendment was intended to simplify the disclosures provided by reducing the volume of disclosures around collateral held and improving disclosures by requiring qualitative information to put the quantitative information in context. The Group reflects the revised disclosure requirements in Note 105.

b) New standards and amendments to standards not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2011, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 7 Financial Instruments: Disclosures — Enhanced Derecognition Disclosure Requirements. The amendment requires additional disclosure about financial assets that have been transferred but not derecognised to enable the user of the Group's financial statements to understand the relationship with those assets that have not been derecognised and their associated liabilities. In addition, the amendment requires disclosures about continuing involvement in derecognised assets to enable the user to evaluate the nature of, and risks associated with, the entity's continuing involvement in those derecognised assets. The amendment becomes effective for annual periods beginning on or after 1 July 2011. The amendment affects disclosure only and has no impact on the Group's financial position or performance.

IFRS 9 Financial Instruments: Classification and Measurement. In November 2009, the IASB issued *IFRS 9 Financial instruments*, which includes new classification and measurement criteria for financial assets. The publication of *IFRS 9* represents the completion of the first part of a multi-stage project to replace *IAS 39 Financial instruments: recognition and measurement*. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Group is currently assessing the impact of the new standard on its financial statements. If endorsed by the EU, the effective date for mandatory adoption is 1 January 2015.

IFRS 10 Consolidated Financial Statements. *IFRS 10* replaces the portion of *IAS 27 Consolidated and Separate Financial Statements* that addresses the accounting for consolidated financial statements. It also includes the issues raised in *SIC-12 Consolidation — Special Purpose Entities*. *IFRS 10* establishes a single control model that applies to all entities including special purpose entities. The changes introduced by *IFRS 10* will require management to exercise significant judgement to determine which entities are controlled, and therefore, are required to be consolidated by a parent, compared with the requirements that were in *IAS 27*. If endorsed by the EU this standard becomes effective for annual periods beginning on or after 1 January 2013.

IFRS 12 Disclosure of Interests in Other Entities. *IFRS 12* includes all of the disclosures that were previously in *IAS 27* related to consolidated financial statements, as well as all of the disclosures that were previously included in *IAS 31* and *IAS 28*. These disclosures relate to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. A number of new disclosures are also required. If endorsed by the EU this standard becomes effective for annual periods beginning on or after 1 January 2013.

IFRS 13 Fair Value Measurement. *IFRS 13* establishes a single source of guidance under *IFRS* for all fair value measurements. *IFRS 13* does not change when an entity is required to use fair value, but rather provides guidance on how to measure fair value under *IFRS* when fair value is required or permitted. The Group is currently assessing the impact that this standard will have on the financial position and performance. If endorsed by the EU this standard becomes effective for annual periods beginning on or after 1 January 2013.

33. Segment reporting

The Group's segmental reporting is based on the management and internal reporting structure. The Group comprises six main business segments; Corporate Banking, Retail Banking, Asset Management & Stefmir, Investment Banking, Treasury and Other Divisions & Subsidiaries.

Notes to the Consolidated Financial Statements

34. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

These disclosures supplement the risk management disclosures, provided elsewhere in these Financial Statements.

Key sources of estimation uncertainty

i) Impairment losses on loans and receivables

The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Statement of Comprehensive Income, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

ii) Foreign currency linked loans

The Group is reviewing the impact of the Supreme Court judgment of 15 February 2012 on the currency-linked loan portfolio. The Group's preliminary evaluation is that currency linked loans can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland. However, if the borrower has paid according to the Bank's payment slips, then the Bank can not normally claim a larger amount of interest on the loan than the interest the borrower has actually paid.

As set out in Note 95 of these Financial Statements, the Group recognised impairment of the currency linked loan portfolio at year-end for the estimated loss arising from the above judgment. The Group remains exposed to significant uncertainty regarding foreign currency linked loans arising from firstly, uncertainty over its interpretation of this judgment and secondly, uncertainty over the outcome of future legal decisions and new or amended government legislation.

Management judgment is required in the determination of the individual borrowers that require recalculation, and the estimated loss is based on assumptions that may be revised when it becomes clear how to interpret the Supreme Court's judgement. In addition, the outcome of future legal decisions and new or amended government legislation may require recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

iii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

iv) Assets classified as held for sale

The Group classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. For the sale to be highly probable management must be committed to sell the assets and be actively looking for a buyer, the assets must be actively marketed at a price that is reasonable in relation to their fair value and the sale is expected to be completed within one year. An extension of the period required to complete a sale does not preclude an asset or disposal group from being classified as held for sale if the delay is caused by events or circumstances beyond the Group's control and there is sufficient evidence that the Group remains committed to its plan to sell the assets or disposal groups.

When classifying assets as held for sale the Group has determined that the requirements of IFRS 5 have been met.

As set out in Note 21 of these Financial Statements, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair values less costs to sell. For the most part, fair values at the date of classification of these legal entities were calculated using valuation models based on discounted 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), would have a significant impact on the fair value of these disposal groups.

Notes to the Consolidated Financial Statements

34. cont.

v) Fair value of Investment Property

As the property market in Iceland is relatively inactive and assets are often quite dissimilar it is difficult to obtain reliable estimates of fair values of investment properties. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to use prices from recent market transactions in order to determine values of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

vi) Intangible assets

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

Changes within the Group

35. Changes in ownership and capitalization of Arion Bank.

There were no changes in the ownership and capitalization of Arion Bank during the year. The shareholders in Arion Bank during the year and at 31 December 2011 were Kaupskil ehf. with an 87% shareholding, and the Icelandic State Financial Investments with a 13% shareholding.

Following an approval from the FME, the annual shareholders meeting of Arion Bank held on 8 January 2010 approved the transfer of 87% of the Icelandic State Financial Investments shareholding to Kaupskil ehf. In connection with the change in ownership of the Bank on this date were transactions with the Icelandic State Financial Investments and the Resolution Committee of Kaupthing hf. to contribute additional assets and liabilities to the Bank that resulted in a net increase in Group total assets of ISK 80,229 million, total liabilities of ISK 76,367 million and total equity of ISK 3,862 million.

During the year a special dividend amounting to ISK 6,500 million was settled with the Icelandic State Financial Investments. The dividend was deducted from retained earnings and settled following the fulfilment of certain conditions under the agreement with Arion Bank. The dividend payment was currency based and due to changes in the foreign exchange rate from the signing of the agreement the settlement amounted to ISK 6,074 million and was settled through the issuance of Tier II subordinated notes to the Icelandic State in March 2011.

36. Acquisition of mortgage portfolio

At year-end 2011 Arion Bank and Kaupthing hf. reached agreement for Arion Bank to acquire a mortgage portfolio which has been managed in a special fund owned by Kaupthing hf. The agreement also specifies that the deal will be funded by the assumption of covered bonds by Arion Bank.

Under the agreement Arion Bank will replace Kaupthing hf. as issuer of the covered bonds. The covered bonds will be listed on the Icelandic stock market in 2012.

The effect on the Consolidated Statement of Financial Position:

Assets:

Loans and receivables to customers.....	109,969
Non-current assets and disposal groups held for sale.....	445
Other assets.....	(16,014)
Total effect on assets:	<u>94,399</u>

Liabilities:

Deposits.....	(23,514)
Tax liabilities.....	(569)
Other liabilities.....	3,048
Borrowings.....	117,712
Total effect on liabilities	<u>96,677</u>

The effect on the Consolidated Statement of Comprehensive Income:

Impairment on loans and receivables *	(2,847)
Tax expense.....	569
Total effect on Net earnings	<u>(2,278)</u>

* Consideration paid for intangible asset not meeting the recognition criteria of IFRS and expensed immediately through the Statement of Comprehensive Income.

Notes to the Consolidated Financial Statements

37. Acquisition of subsidiaries

On 8 April 2011 the Group's shareholding in its associate KB Rádgjöf ehf. increased from 43.1% to 100.0%, resulting in a change in classification from associate to subsidiary and accounted for accordingly. As this entity is immaterial to the Group, further disclosure on this acquisition is not deemed necessary.

38. Disposal of subsidiaries.

On 11 February 2011 the Group sold a 35.3% effective share in its held for sale subsidiary Hagar hf. The sale agreement included a plan to list the company on the Nasdaq OMX stock exchange in Iceland and a right to the buyers to purchase an additional 10% share, which they did on 2 November 2011. In August 2011 the Bank signed an agreement with the management of Hagar hf. that entitled the company management to acquire a 1.4% share in two transactions, of which a 0.65% effective share was transferred in 2011. On 5 to 8 December 2011 an effective share of 30.8% was sold in a public offering followed by a listing of the company on NASDAQ OMX Iceland. An additional 1.5% was sold before year-end. At end of 2011 the Group holds 20.9% effective share in Hagar hf. and consequently it is an associate. As it is expected the Group's shareholding in Hagar will be sold in 2012, this investment in associate was classified as non-current assets and disposal groups held for sale at year-end 2011.

On 18 February 2011 the Group sold its 100.0% shareholdings in Hekla ehf. and Hekla fasteignir ehf. These legal entities were classified as non-current assets and disposal groups classified as held for sale at year-end 2010.

On 21 June 2011 the Group sold its 100.0% shareholdings in Rekstrarfélagid tíu-ellefu ehf. The legal entity was classified as non-current assets and disposal groups classified as held for sale at year-end 2010.

The results from the disposal of these legal entities is included in net earnings from discontinued operations net of tax.

On 25 May 2011 the Group transferred its 55.9% share in Menntaskóli Borgarfjarðar to the non-controlling shareholder, the municipality Borgarbyggð.

On 14 June 2011 all assets and liabilities of the Group's subsidiary Kaupthing Advisory Company were transferred to the Group. Subsequently the subsidiary was liquidated.

Notes to the Consolidated Financial Statements

Operating Segment Reporting

39. 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.

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

Segment capital expenditure is the total cost incurred during the year to acquire property and equipment and intangible assets.

Operating segments

The Group comprises six main operating segments:

Corporate Banking serves large enterprises and professional investors. The role of the division is to provide universal financial services as well as tailored services to meet the needs of each customer. *Corporate Banking* is divided into a *Corporate Banking* unit, *Factoring* services and a *Corporate Recovery* unit. *Corporate Banking* and *Factoring* together provide a wide range of credit solutions while the *Recovery* unit is responsible for the financial restructuring of companies which need to reorganise their capital structure.

Retail Banking, Arion Bank Mortgages Institutional Investor Fund, AFL and Sparisjóður Ólafsfjardar provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 24 branches all around Iceland are over 100,000.

Asset Management and Stefmir hf. manage assets on behalf of its clients, who include institutional investors, corporations, high net wealth clients and retail investors. The entities offer clients variety of mutual funds, alternative vehicles, pension plan schemes and customized asset allocation strategies designed to meet the diverse needs of investors. The subsidiary Stefmir operates the fund management business.

Investment Banking is divided into Corporate Finance, Capital Markets and Research. *Corporate Finance* provides M&A advisory services and capital markets transaction services to corporate clients and investors. *Capital Markets* provides securities brokerage and FX sales for institutional investors and corporate clients. *Research* is split into Equity, Fixed Income and Macro Analysis with clients such as asset management companies, institutional investors, and other divisions of the Group.

Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency, liaison with other financial institutions, Proprietary trading and market making in domestic securities and currencies.

Other Divisions and Subsidiaries include Proprietary trading and the subsidiaries Eignabjarg ehf., Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Verdis hf., Valitor holding hf. and other smaller entities of the Group.

Headquarters: Overhead, Risk Management, Finance, Legal, Operations, Corporate Development and activities of other non-core entities.

Notes to the Consolidated Financial Statements

40. Summary of the Group's business segments:

2011	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	10,433	12,759	1,409	322	901	(2,530)	94	23,388
Other income	12,859	(14,310)	2,322	765	(2,872)	10,935	189	9,888
Operating income	23,292	(1,551)	3,731	1,087	(1,971)	8,405	283	33,276
Operating expense	(1,408)	(9,280)	(1,799)	(912)	(598)	(5,305)	(2,714)	(22,016)
Allocated cost	(688)	(734)	(90)	(71)	(288)	-	1,871	-
Earnings before tax	21,196	(11,565)	1,842	104	(2,857)	3,100	(560)	11,260
Net seg. rev. from ext. cust.	28,044	(5,958)	427	1,085	(2,818)	11,724	772	33,276
Net seg. rev. from oth. seg.	(4,752)	4,407	3,304	2	847	(3,319)	(489)	-
Operating income	23,292	(1,551)	3,731	1,087	(1,971)	8,405	283	33,276
Depreciation and amortisation	-	222	-	1	-	213	520	956
Total assets	271,207	299,208	3,621	16,477	207,099	94,509	-	892,121
Allocated equity	43,297	32,580	2,673	1,269	18,062	16,677	-	114,558
2010								
Net interest income	13,463	9,041	1,591	(527)	1,183	(4,823)	(143)	19,785
Other income	10,188	2,860	2,281	(1,432)	(4,121)	7,521	(1,459)	15,838
Operating income	23,651	11,901	3,872	(1,959)	(2,938)	2,698	(1,602)	35,623
Operating expense	(1,133)	(7,723)	(1,426)	(789)	(630)	(3,517)	(3,074)	(18,292)
Allocated cost	(536)	(750)	(171)	(167)	(519)	-	2,143	-
Earnings before tax	21,982	3,428	2,275	(2,915)	(4,087)	(819)	(2,533)	17,331
Net seg. rev. from ext. cust.	32,926	5,903	(152)	(1,552)	(1,104)	8,442	(7,344)	37,119
Net seg. rev. from oth. seg.	(9,275)	5,998	4,024	(407)	(1,834)	(5,744)	5,742	(1,496)
Operating income	23,651	11,901	3,872	(1,959)	(2,938)	2,698	(1,602)	35,623
Depreciation and amortisation	-	233	-	-	-	66	520	819
Total assets	269,002	194,956	3,214	7,492	222,092	114,979	880	812,615
Allocated equity	43,040	27,237	2,505	1,199	6,118	29,297	140	109,536

The vast majority of the revenues from external customers is attributable to customers in Iceland.

Operating segment reporting is based on the Group's management and internal reporting structure for 2011. Consequently, operating segment reporting for 2010, when only two operating segments were used, has been represented in accordance with the six operating segments for 2011.

Notes to the Consolidated Financial Statements

Quarterly Statements

41. Operations by quarters

2011	Q4	Q3 ¹	Q2 ¹	Q1 ¹	Total
Net interest income	6,552	5,676	5,274	5,886	23,388
Increase in value of loans and receivables	8,573	457	27,281	2,057	38,368
Impairment on loans and receivables	(20,981)	(642)	(6,241)	440	(27,424)
Changes in compensation instrument	-	-	(16,683)	(2,910)	(19,593)
Net fee and commission income	3,111	2,475	2,607	2,492	10,685
Net financial income (expense)	163	386	(767)	729	511
Net foreign exchange (loss) gain	(143)	2	2,289	(312)	1,836
Other operating income	2,028	1,127	1,251	1,099	5,505
Operating income	(697)	9,481	15,011	9,481	33,276
Administration expense	(6,069)	(4,880)	(5,316)	(4,955)	(21,220)
Other operating expense	(172)	(126)	(332)	(166)	(796)
Earnings before tax	(6,938)	4,475	9,363	4,360	11,260
Income tax expense	1,167	(562)	(1,472)	(1,045)	(1,912)
Bank Levy	(362)	(238)	(379)	(67)	(1,046)
Net earnings from continuing operations	(6,133)	3,675	7,512	3,248	8,302
Net gain (loss) from discontinued operations net of tax	3,579	(219)	(286)	(282)	2,792
Net earnings	(2,554)	3,456	7,226	2,966	11,094
2010					
Net interest income	3,428	6,060	4,662	5,635	19,785
Increase in value of loans and receivables	28,437	3,131	8,298	403	40,269
Impairment on loans and receivables	(19,496)	(2,351)	(4,106)	(834)	(26,787)
Changes in compensation instrument	(8,182)	-	(3,422)	-	(11,604)
Net fee and commission income	2,752	1,262	1,389	1,463	6,866
Net financial income (expense)	756	(92)	(447)	185	402
Fair value change to Drómi bond	(3,500)	-	-	-	(3,500)
Net foreign exchange (loss) gain	6,275	(3,485)	1,060	609	4,459
Other operating income	1,925	1,571	1,521	716	5,733
Operating income	12,395	6,096	8,955	8,177	35,623
Administration expense	(5,790)	(3,729)	(4,424)	(3,626)	(17,569)
Other operating expense	128	(500)	(219)	(132)	(723)
Earnings before tax	6,733	1,867	4,312	4,419	17,331
Income tax expense	(696)	(1,236)	(827)	(722)	(3,481)
Bank Levy	(290)	-	-	-	(290)
Net earnings from continuing operations	5,747	631	3,485	3,697	13,560
Net gain (loss) from discontinued operations net of tax	(2,103)	345	1,042	(287)	(1,003)
Net earnings	3,644	976	4,527	3,410	12,557

The half-year results were reviewed by the Bank's auditors.

1. The Q1, Q2, and Q3 results and the split between quarters were not audited or reviewed.

Notes to the Consolidated Financial Statements

Notes to the Statement of Comprehensive Income

Net interest income

42. Interest income and expense is specified as follows:

	Interest income	Interest expense	Net interest income
2011			
Cash and balances with Central Bank	486	-	486
Loans, receivables and deposits	37,410	18,338	19,072
Borrowings	-	2,597	(2,597)
Subordinated liabilities	-	1,830	(1,830)
Securities	7,690	-	7,690
Compensation instrument	322	-	322
Other	525	280	245
Interest income and expense	46,433	23,045	23,388
Interest income and expense from assets and liabilities at fair value	7,690	-	7,690
Interest income and expense from assets and liabilities not at fair value through profit or loss	38,743	23,045	15,698
Interest income and expense	46,433	23,045	23,388
2010			
Cash and balances with Central Bank	937	-	937
Loans, receivables and deposits	38,004	28,222	9,782
Borrowings	-	2,683	(2,683)
Subordinated loans	-	1,250	(1,250)
Securities	11,320	-	11,320
Compensation instrument	1,256	-	1,256
Other	852	429	423
Interest income and expense	52,369	32,584	19,785
Interest income and expense from assets and liabilities at fair value	11,320	-	11,320
Interest income and expense from assets and liabilities not at fair value through profit or loss	41,049	32,584	8,465
Interest income and expense	52,369	32,584	19,785

Increase in book value of loans and receivables

43. The increase in book value of loans and receivables is determined in accordance with the accounting policy presented in Note 8 a). Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment of loans and receivables

44. Impairment of loans and receivables is specified as follows:

	2011	2010
Impairment of loans and receivables to credit institutions	199	632
Impairment of loans and receivables to customers	27,225	26,155
Impairment of loans and receivables	27,424	26,787

Notes to the Consolidated Financial Statements

Net fee and commission income

45. Fee and commission income and expense is specified as follows:	2011	2010
Fee and commission income		
Asset management	2,716	2,447
Cards	10,031	3,975
Collection and payment services	1,164	1,066
Derivatives	179	169
Interbank clearing	682	651
Lending and guarantees	667	540
Security trading	250	189
Other fee and commission income	1,173	1,336
Fee and commission income	<u>16,862</u>	<u>10,373</u>
Fee and commission expense		
Asset management	105	177
Cards	4,892	2,215
Collection and payment services	32	42
Interbank clearing	708	703
Security trading	44	201
Other fee and commission expense	396	169
Fee and commission expense	<u>6,177</u>	<u>3,507</u>
Net fee and commission income	<u>10,685</u>	<u>6,866</u>

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.

Net financial income

46. Net financial income is specified as follows:	2011	2010
Dividend income	7	34
Net gain (loss) on financial assets and liabilities classified as held for trading	(959)	(531)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	1,463	899
Net financial income	<u>511</u>	<u>402</u>
47. Dividend income is specified as follows:		
Dividend income on trading assets	4	2
Dividend income on financial assets designated at fair value through profit or loss	3	32
Dividend income	<u>7</u>	<u>34</u>
48. Net gain (loss) on trading assets and liabilities is specified as follows:		
Net gain (loss) on equity instruments and related derivatives	250	251
Net gain (loss) on interest rate instruments and related derivatives	(668)	(1,038)
Net gain (loss) on other derivatives	(541)	256
Net gain (loss) on trading portfolio	<u>(959)</u>	<u>(531)</u>

Notes to the Consolidated Financial Statements

49. Net gain (loss) on assets/liabilities designated at fair value through profit or loss is specified as follows:	2011	2010
Net gain (loss) on interest rate instruments designated at fair value	930	(119)
Net gain (loss) on equity instruments designated at fair value	533	1,018
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	1,463	899

Net foreign exchange gain (loss)

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

FX gain (loss) of loans and receivables	9,118	(7,658)
FX gain (loss) on bank accounts	3,382	(6,370)
FX gain (loss) from deposits and borrowings	(8,751)	17,407
FX gain (loss) from subordinated liabilities	(955)	4,401
FX gain (loss) on bonds, equity and derivatives	(1,284)	(21)
FX gain (loss) from compensation instrument	325	(1,852)
FX gain (loss) on other assets and liabilities	1	(1,448)
Net foreign exchange gain (loss)	1,836	4,459

Other operating income

51. Other operating income is specified as follows:

Rental income from investment properties	2,146	2,050
Fair value changes on investment property	916	69
Realised gain on investment property	485	121
Earned premiums, net of reinsurance	864	851
Net gain (loss) on disposals of assets other than held for sale	293	578
Other income	793	1,508
Other operating income	5,497	5,177

52. Earned premiums, net of reinsurance:

Premium written	987	994
Outward reinsurance premiums	(93)	(99)
Change in the gross provision for unearned premiums	(30)	(44)
Earned premiums, net of reinsurance	864	851

Notes to the Consolidated Financial Statements

Personnel and salaries

53. The Group's total number of employees is as follows:	2011	2010
Average number of full time equivalent positions during the year	1,217	1,159
Full time equivalent positions at the end of the year	1,158	1,241

The Parent company's total number of employees is as follow:

Average number of full time equivalent positions during the year	928	956
Full time equivalent positions at the end of the year	858	936

54. Salaries and related expense are specified as follows:

Salaries	8,821	7,269
Defined contribution pension plans	1,191	981
Salary related expense	1,242	1,022
Salaries and related expense	11,254	9,272

Salaries and related expense for the Parent company are specified as follows:

Salaries	6,546	5,886
Defined contribution pension plans	884	795
Salary related expense	975	849
Salaries and related expense	8,405	7,530

55. Compensation of the key management personnel:

Salaries:	Period			2011
		Fixed remuneration ¹	Additional remuneration ²	Total
				2011
Höskuldur H. Ólafsson, CEO	01.01. - 31.12.2011			37.1
Agnar Kofoed-Hansen, Director	01.01. - 31.12.2011	3.3	1.4	4.7
Guðrún Björnsdóttir, Alternate Director	01.01. - 31.12.2011	1.6	-	1.6
Guðrún Johnsen, Vice-Chairman of the Board	01.01. - 31.12.2011	6.3	2.7	9.0
Jón G. Briem, Director	01.01. - 31.12.2011	3.9	4.0	7.9
Kristján Jóhannsson, Director	01.01. - 24.03.2011	1.0	-	1.0
Máns Höglund, Director	24.03. - 31.12.2011	6.3	2.7	9.0
Monica Caneman, Chairman of the Board	01.01. - 31.12.2011	14.7	1.4	16.1
Theodór S. Sigurbergsson, Director	01.01. - 05.09.2011	3.2	1.8	5.0
Other alternate directors of the Board	01.01. - 31.12.2011	1.3	-	1.3
Total remuneration		41.6	14.0	55.6

Nine managing directors of the Group's divisions being members of the Bank's Executive Committee 210.2

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

2. Additional remuneration represents Board Member compensation for their attendance at Board Committee meetings.

Commencing from 2011 Board Members have received remuneration for their involvement in board committees. In addition to 17 Board meetings, during the year 15 Board Credit Committee meetings, 8 Board Audit and Risk Committee meetings and 8 Board Remuneration committee meetings were held.

Notes to the Consolidated Financial Statements

55. cont.

The 2010 Annual General Meeting of the Bank held on 24 March 2011 approved the monthly salaries for 2011 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 700,000, ISK 525,000 and ISK 350,000 respectively. It was also approved that the salary of Alternative Board Members would be ISK 175,000 per meeting, up to a maximum of ISK 350,000 per month. For Board Members resident abroad, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 150,000 per month for each committee they serve on.

	Period	2010
Finnur Sveinbjörnsson, CEO	01.01. - 31.05.2010	15.9
Höskuldur H. Ólafsson, CEO	01.06. - 31.12.2010	30.0
Colin C. Smith, Director	20.05. - 30.09.2010	1.6
Drífa Sigfúsdóttir, Director	01.01. - 18.03.2010	0.4
Erna Bjarnadóttir, Chairman of the Board	01.01. - 18.03.2010	0.7
Gudrún Björnsdóttir, Alternate Director	18.03. - 31.12.2010	0.4
Gudrún Johnsen, Vice-Chairman of the Board	18.03. - 31.12.2010	5.0
Helga Jónsdóttir, Director	01.01. - 18.03.2010	0.4
Jón G. Briem, Alternate Director	18.03. - 31.12.2010	0.7
Jónína A. Sanders, Director	01.01. - 18.03.2010	0.4
Kristján Jóhannsson, Director	18.03. - 31.12.2010	3.3
Monica Caneman, Chairman of the Board	18.03. - 31.12.2010	6.6
Steen Hemmingsen, Director	18.03. - 10.11.2010	2.7
Theodór S. Sigurbergsson, Director	18.03. - 31.12.2010	3.3
Kaupthing hf*	01.01. - 18.03.2010	0.8
Ten managing directors of the Group's divisions being members of the Bank's Executive Committee		200.6

The members of the Bank's Executive Committee are considered to be key management personnel.

Remuneration to the Chairman of the Board, CEO and other key management personnel consist of salary and other benefits.

All compensation to key management personnel were short term employee benefits.

* Kaupthing hf assigned two directors to the board of Arion Bank, Theodór S. Sigurbergsson and Jóhannes Rúnar Jóhannesson for the period 03.09.2009 - 18.03.2010.

Auditor's fee

56. Auditor's fee is specified as follows:

2011	Ernst & Young	KPMG	Total
Audit and review of the Financial Statements	151	28	179
Other audit related services	28	11	39
Other service	-	20	20
Auditor's fee	179	59	238
2010			
Audit and review of the Financial Statements	118	66	184
Other audit related services	6	10	16
Other service	-	8	8
Auditor's fee	124	84	208

Notes to the Consolidated Financial Statements

Other operating expense

57. Other operating expense:	2011	2010
Direct operating expense (including repairs and maintenance) arising on rental-earning investment properties	497	449
Claims incurred, net of reinsurance	298	274
Other expense	1	-
Other operating expense	796	723
58. Claims incurred, net of reinsurance:		
Claims paid	346	279
Change in the provision for claims	21	117
Claims paid, net of reinsurers' share	(60)	(76)
Change in the provision for claims, reinsurers' share	(9)	(46)
Claims incurred, net of reinsurance	298	274

Net gain (loss) from discontinued operations net of tax

59. Net gain (loss) from discontinued operations net of tax is specified as follows:

Net gain (loss) from legal entities	3,867	799
Impairment loss on remeasurement to fair value of legal entities	(2,027)	(2,629)
Net loss on revaluation and disposal of real estate	(207)	(904)
Other assets	(103)	(286)
Effect of compensation instrument	1,262	2,017
Net gain (loss) from discontinued operations net of tax	2,792	(1,003)

Net gain (loss) from legal entities comprises the Group's share of net profit after tax from operations of legal entities that were classified as held for sale during the year. The 2011 amount predominantly comprises a gain of ISK 3,635 million arising on the sale of the Group's held for sale subsidiary Hagar hf. Included in this amount is a gain of ISK 1,256 million arising on the recognition at fair value of the investment retained in Hagar hf. at the date it became an associate of the Group in December 2011.

Notes to the Consolidated Financial Statements

Tax expense

60. Income tax recognised in the Statement of Comprehensive Income is specified as follows:	2011	2010
<i>Current tax expense</i>		
Current year	1,683	3,518
<i>Deferred tax expense</i>		
Changes in temporary differences	229	(37)
Total income tax expense	1,912	3,481

Reconciliation of effective tax rate:	2011	2010
Earnings before income tax	11,260	17,331
Income tax using the Icelandic corporation tax rate	20.0% 2,252	18.0% 3,120
Effect of tax rates in foreign jurisdictions	(0.9%) (103)	0.0% -
Non-deductible expense	(0.1%) (13)	0.3% 60
Tax exempt revenues	0.0% -	(1.6%) (283)
Changes in deferred tax asset	(0.6%) (73)	4.7% 811
Non-deductible taxes	(1.9%) (214)	0.0% -
Effect of increase in the income tax rate from 18% to 20%	0.0% -	0.4% 64
Other changes	0.6% 63	(1.7%) (291)
Effective tax rate	17.0% 1,912	20.1% 3,481

61. Bank Levy

Bank levy is calculated according to law. The levy is 0.1285% on total debt excluding tax liabilities at end of year. Non-financial subsidiaries are exempt from this tax.

Earnings per share

62. Earnings per share are specified as follows:	2011	2010
Net earnings attributable to the shareholders of Arion Bank	10,493	12,381
Weighted average share capital:		
Weighted average number of outstanding shares for the year, million	2,000	2,207
Basic earnings per share	5.25	5.61
Diluted earnings per share	5.25	5.61
Number of outstanding shares at the end of the year, million	2,000	2,000
Number of total shares at the end of the year, million, diluted	2,000	2,000

There were no instruments at year-end that could potentially dilute basic earnings per share.

Notes to the Consolidated Financial Statements

Notes to the Statement of Financial Position

Cash and balances with Central Bank

63. Cash and balances with Central Bank are specified as follows:	2011	2010
Cash on hand	2,954	9,609
Cash with Central Bank	17,686	13,250
Mandatory reserve deposit with Central Bank	8,560	7,769
Cash and balances with Central Bank	29,200	30,628

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

Loans and receivables to credit institutions

64. Loans and receivables to credit institutions specified by types of loans:		
Bank accounts	62,175	57,707
Money market loans	4,720	1,294
Overdrafts	19	29
Other loans	2,963	10,175
Provision on loans and receivables	(774)	(1,359)
Loans and receivables to credit institutions	69,103	67,846

65. Changes in the provision for losses on loans and receivables to credit institutions are specified as follows:

Balance at the beginning of the year	1,359	727
Provision for losses during the year	199	632
Write-offs during the year	(784)	-
Balance at the end of the year	774	1,359

Loans and receivables to customers

66. Loans and receivables to customers specified by types of loans:		
Overdrafts	43,178	37,390
Subordinated loans	550	499
Other loans and receivables	574,111	455,173
Provision on loans and receivables	(56,289)	(41,843)
Loans and receivables to customers	561,550	451,219

The total book value of pledged loans at year-end was ISK 171 billion (2010: ISK 74 billion). Pledged loans at year-end comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

Notes to the Consolidated Financial Statements

67. Changes in the provision for losses on loans and receivables to customers are specified as follows:	2011	2010
Balance at the beginning of the year	41,843	28,736
Provision for losses during the year	27,225	20,655
Write-offs during the year	(13,230)	(7,718)
Payment of loans previously written off	451	170
Balance at the end of the year	56,289	41,843
Specific	46,776	39,083
Collective	9,513	2,760
	56,289	41,843

Further information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in Note 107 c).

Notes to the Consolidated Financial Statements

Financial assets and liabilities

68. Financial assets and liabilities are specified as follows:

2011	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank	29,200	-	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	-	69,103
Loans and receivables to customers	561,550	-	-	-	561,550
Loans and receivables	659,853	-	-	-	659,853
<i>Bonds and debt instruments</i>					
Listed	-	2,919	52,688	-	55,607
Unlisted	-	44	84,917	-	84,961
Bonds and debt instruments	-	2,963	137,605	-	140,568
<i>Shares and equity instruments with variable income</i>					
Listed	-	153	1,163	-	1,316
Unlisted	-	657	8,382	-	9,039
Bond funds with variable income	-	1,774	1,916	-	3,690
Shares and equity instruments	-	2,584	11,461	-	14,045
<i>Derivatives</i>					
OTC derivatives	-	674	-	-	674
Derivatives	-	674	-	-	674
<i>Securities used for hedging</i>					
Bonds and debt instruments	-	1,922	-	-	1,922
Shares and equity instruments	-	450	-	-	450
Securities used for hedging	-	2,372	-	-	2,372
Other financial assets	-	-	-	8,004	8,004
Financial assets	659,853	8,593	149,066	8,004	825,516
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	-	-	-	16,160	16,160
Deposits	-	-	-	489,995	489,995
Borrowings	-	-	-	187,203	187,203
Subordinated liabilities	-	-	-	32,105	32,105
Liabilities at amortised cost	-	-	-	725,463	725,463
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading	-	3,711	-	-	3,711
Derivatives held for trading	-	1,196	-	-	1,196
Financial liabilities at fair value	-	4,907	-	-	4,907
Other financial liabilities	-	-	-	33,764	33,764
Financial liabilities	-	4,907	-	759,227	764,134

Notes to the Consolidated Financial Statements

68. cont.

2010	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank	30,628	-	-	-	30,628
Loans and receivables to credit institutions	67,846	-	-	-	67,846
Loans and receivables to customers	451,219	-	-	-	451,219
Loans and receivables	549,693	-	-	-	549,693
<i>Bonds and debt instruments</i>					
Listed	-	4,731	41,833	-	46,564
Unlisted	-	20	73,528	-	73,548
Bonds and debt instruments	-	4,751	115,361	-	120,112
<i>Shares and equity instruments with variable income</i>					
Listed	-	12	2,062	-	2,074
Unlisted	-	612	5,451	-	6,063
Bond funds with variable income	-	360	1,819	-	2,179
Shares and equity instruments	-	984	9,332	-	10,316
<i>Derivatives</i>					
OTC derivatives	-	1,126	-	-	1,126
Derivatives	-	1,126	-	-	1,126
<i>Securities used for hedging</i>					
Bonds and debt instruments	-	3,213	-	-	3,213
Securities used for hedging	-	3,213	-	-	3,213
Compensation instrument	-	-	24,188	-	24,188
Other financial assets	-	-	-	16,688	16,688
Financial assets	549,693	10,074	148,881	16,688	725,336
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	-	-	-	95,646	95,646
Deposits	-	-	-	457,881	457,881
Borrowings	-	-	-	65,278	65,278
Subordinated liabilities	-	-	-	26,257	26,257
Liabilities at amortised cost	-	-	-	645,062	645,062
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading	-	923	-	-	923
Derivatives held for trading	-	76	-	-	76
Financial liabilities at fair value	-	999	-	-	999
Other financial liabilities	-	-	-	34,048	34,048
Financial liabilities	-	999	-	679,110	680,109

Included in unlisted Bonds and debt instruments designated at fair value is Drómi bond, which the Group received when acquiring deposits from SPRON in March 2009.

Notes to the Consolidated Financial Statements

69. Bonds and debt instruments designated at fair value specified by issuer:	2011	2010
Financial institutions	70,640	74,626
Public	59,368	40,393
Corporates	7,597	342
Bonds and debt instruments designated at fair value	137,605	115,361

No bonds were pledged at year-end (2010: ISK 20,005 million). Pledged bonds at year-end 2010 comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank.

70. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments 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.

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

2011	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	6,222	140,844	2,000	149,066
Financial assets held for trading	5,391	3,181	21	8,593
	<u>11,613</u>	<u>144,025</u>	<u>2,021</u>	<u>157,659</u>
Financial liabilities held for trading	3,710	1,197	-	4,907
	<u>3,710</u>	<u>1,197</u>	<u>-</u>	<u>4,907</u>
2010				
Financial assets designated at FV through PL	3,063	119,962	1,668	124,693
Financial assets held for trading	7,956	2,098	20	10,074
Compensation instrument	-	-	24,188	24,188
	<u>11,019</u>	<u>122,060</u>	<u>25,876</u>	<u>158,955</u>
Financial liabilities held for trading	-	999	-	999
	<u>-</u>	<u>999</u>	<u>-</u>	<u>999</u>

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2011 is consistent with the classification used in 2010.

The following table shows transfers between Level 1 and Level 2 on the fair value hierarchy for financial assets and financial liabilities which are recorded at fair value:

	Transfers from Level 1 to Level 2	
Financial assets	2011	2010
Financial assets designated at FV through PL	886	1,146

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the year and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 in 2011 and 2010.

Notes to the Consolidated Financial Statements

70. cont.

The fair value of a financial instrument is the amount at which the instrument 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 financial assets and financial liabilities. If quoted prices for a financial instrument 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

Level 1: Fair value established from quoted market prices

The best evidence of the fair value of a financial instrument 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 the financial instrument in Note 68 is used as an approximation for the fair value of the instrument. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed under Bonds, Shares, Derivatives 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 financial instruments, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the 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 financial instruments for which quoted prices on active markets are not available, the fair values are 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.

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

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

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of financial instruments 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 organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

Movements in Level 3 financial instruments measured at fair value

The level of the fair value hierarchy of financial instruments is determined at the beginning of each reporting year. The following table shows a reconciliation of the opening and closing amounts of Level 3 financial assets and liabilities which are recorded at fair value.

Notes to the Consolidated Financial Statements

70. cont.

The following table shows the movements of Level 3 financial assets and liabilities (excluding the Compensation Instrument):

	2011	2010
Balance at the beginning of the year.....	1,688	2,678
Gain (loss) recognised in Statement of Comprehensive Income.....	771	(1,348)
Acquisition.....	160	376
Disposal.....	(598)	(18)
Balance at the end of the year.....	2,021	1,688

The following table shows the line items in the Statement of Comprehensive Income where gains (losses) related to fair value measurements in Level 3 are recognised:

	2011	2010
Net interest income.....	176	18
Net financial income (expense).....	520	(1,223)
Net foreign exchange gain (loss).....	75	(143)
Gain (loss) recognised in the Statement of Comprehensive Income.....	771	(1,348)

The following table presents the carrying amounts and fair values of financial assets and liabilities that are not carried at fair value in the financial statements. This table does not include the fair values of non-financial assets and non-financial liabilities.

2011	Carrying value	Fair value	Un-recognised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank.....	29,200	29,200	-
Loans and receivables to credit institutions.....	69,103	69,103	-
Loans and receivables to customers.....	561,550	562,940	1,390
Other financial assets.....	8,004	8,004	-
	<u>667,857</u>	<u>669,247</u>	<u>1,390</u>
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank.....	16,160	16,160	-
Deposits.....	489,995	489,995	-
Borrowings.....	187,203	187,067	136
Subordinated loans.....	32,105	32,105	-
Other financial liabilities.....	33,764	33,764	-
	<u>759,227</u>	<u>759,091</u>	<u>136</u>
Net unrecognised gain not recognised in the Statement of Comprehensive Income.....			1,526

Notes to the Consolidated Financial Statements

70. cont.

2010	Carrying value	Fair value	Un- recognised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	30,628	30,628	-
Loans and receivables to credit institutions	67,846	67,846	-
Loans and receivables to customers	451,219	451,219	-
Other financial assets	16,688	16,688	-
	566,381	566,381	-
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	95,646	95,646	-
Deposits	457,881	457,881	-
Borrowings	65,278	65,219	59
Subordinated loans	26,257	26,257	-
Other financial liabilities	34,048	34,018	-
	679,110	679,021	59
Net unrecognised gain not recognised in the Statement of Comprehensive Income			59

As financial assets and financial liabilities predominantly bear interest at floating rates, the difference between book value and fair value of financial assets and financial liabilities is deemed to be immaterial.

Compensation instrument

71. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing hf. to Arion Bank in accordance with the FME decision in 2008. The compensation instrument amounted to ISK 38,300 million and was originally denominated 50% in ISK and 50% in EUR and subject to floating rates of interest.

Related to the compensation instrument was the Escrow and Contingent Value Rights Agreement (ECVRA) where Kaupthing hf. received 80% of the appreciation of defined Arion Bank loans (the "ring-fenced assets"). The increase in value of the defined loans should decrease the balance of the compensation instrument. If the compensation instrument was finally settled due to an increase in the aggregate value of the ring-fenced assets (such increase being 125% of the compensation instrument) then 50% of the increase in value of ring-fenced assets above the amount needed for closing the compensation instrument would be passed onto Kaupthing hf. up to a cap of ISK 5 billion.

On 30 June 2011 a special agreement called Settlement and release of claims agreement was signed on behalf of Arion Bank and Kaupthing hf. to finalise a settlement of the ECVRA and various other claims lodged against Kaupthing hf. by Arion Bank. By signing the agreement the ECVRA is terminated and neither Party shall have any payment obligations towards the other under the ECRVA.

During the first half 2011 changes in those defined assets amounted to ISK 22,519 million, 80% of this increased value belonging to Kaupthing hf., ISK 18,015 million as presented in the Statement of Comprehensive Income, 20% belonging to Arion Bank as a part of the Statement of Comprehensive Income. The total face value of the defined loans was approximately ISK 474,000 million and the book value was approximately ISK 210,000 million at the end of June 2011.

The net effect for the recognition of items per the settlement and release of claims agreement was expensed through the Statement of Comprehensive Income.

Notes to the Consolidated Financial Statements

71. cont.

Compensation instrument is specified as follows:	2011	2010
Balance at the beginning of the year	24,188	34,371
Changes due to the Escrow and Contingent Value Rights Agreement		
Continuing operations	(19,593)	(11,604)
Discontinued operations	1,578	2,017
Accrued interest	322	1,256
Foreign exchange rate differences	325	(1,852)
Assets and liabilities upon settlement	(6,820)	-
Balance at the end of the year	-	24,188

Investment property

72. Investment property is specified as follows:	Investment		Total 2011	Total 2010
	Investment property	property in progress		
Balance at the beginning of the year	21,551	6,091	27,642	22,947
Acquisition through business combination	-	-	-	3,000
Additions during the year	2,893	634	3,527	3,187
Disposals during the year	(3,851)	(1,909)	(5,760)	(1,561)
Transferred from property and equipment	775	-	775	-
Fair value adjustments	582	334	916	69
Investment property	21,950	5,150	27,100	27,642

The official real estate value amounts to ISK 18,380 million at year-end (2010: ISK 18,227 million). The insurance value of real estate amounts to ISK 20,130 million at year-end (2010: ISK 18,535 million).

Investments in associates

73. The Group's interest in its principal associates are as follows:	2011	2010
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Borgarland ehf., Egilsholt 1, 310 Borgarnes, Iceland	-	42.0%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43.5%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland	30.0%	-
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	20.6%	20.6%
KB Rádgjöf ehf., Hlíðarsmári 17, 201 Kópavogur, Iceland	-	43.1%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	44.9%	-
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	25.0%	25.0%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	23.3%	21.7%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmiðjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	-
SMI ehf., Smáratorg 3, 210 Kópavogur, Iceland	39.1%	-
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	20.0%	20.0%

Notes to the Consolidated Financial Statements

73. cont.

Investments in associates are specified as follows:	2011	2010
Carrying amount at the beginning of the year	2,713	5,985
Additions during the year	2,854	115
Transferred to held for sale assets	(2,525)	(54)
Transferred from associates due to step acquisition	(9)	(3,889)
Impairment	(54)	-
Share of profit (loss)	8	556
Carrying amount at the end of the year	2,987	2,713

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

Total assets	209,229	113,296
Total liabilities	(170,788)	(95,176)
Net assets	38,441	18,120
Total revenue	15,114	13,116
Total profit in associates	4,491	2,489
Group's share of profit of associates	8	556

Property and equipment

74. Property and equipment are specified as follows:	Real estate	Equip-ment	Total 2011	Total 2010
Balance at the beginning of the year	5,767	2,805	8,572	11,808
Acquisitions through business combination	-	2	2	419
Additions during the year	-	667	667	381
Disposals during the year	(102)	(87)	(189)	(327)
Disposals through the sale of a subsidiary	-	(16)	(16)	(977)
Transfers to investment property	(839)	-	(839)	-
Transfers to assets held for sale	-	-	-	(2,732)
Gross carrying amount at the end of the year	4,826	3,371	8,197	8,572
Accumulated depreciation at the beginning of the year	297	910	1,207	1,108
Depreciation during the year	199	633	832	705
Disposals during the year	(8)	(41)	(49)	(178)
Disposals through the sale of a subsidiary	-	-	-	(274)
Transfers to investment property	(64)	-	(64)	-
Transfers to assets held for sale	-	-	-	(154)
Accumulated depreciation at the end of the year	424	1,502	1,926	1,207
Property and equipment	4,402	1,869	6,271	7,365

The official real estate value amounts to ISK 4,561 million at year-end. The insurance value of real estate amounts to ISK 8,518 million at year-end.

75. Depreciation and amortisation in the Statement of Comprehensive Income is specified as follows:

	2011	2010
Depreciation of property and equipment	832	705
Amortisation of intangible assets	124	114
Depreciation and amortisation	956	819

Notes to the Consolidated Financial Statements

Intangible assets

76. Intangible assets comprise three categories: Infrastructure, Customer Relationship and Related Agreements, and Software. Infrastructure and Customer Relationship and Related Agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Bank's operations.

Infrastructure, which is capitalized as an intangible asset, is connected to two business segments at the Bank, namely Asset Management and Credit card operation at the Bank's subsidiary Valitor. In both cases 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 and this is described in more detail below.

Customer Relationship and Related Agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries bought in 2008-2009. 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 those of the subsidiaries Okkar líftryggingar, Ekort and KB Rádgjöf. Every year existing agreements are examined and compared with agreements which were valid at the time of acquisition. Impairment is made if agreements are closed, total of ISK 6 m during 2011.

Software is acquired computer software licenses and 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 - 5 years.

Intangible assets are specified as follows:

	Infra- structure	Customer relationship and related agreements	Software	Total
2011				
Balance at the beginning of the year	3,824	149	379	4,352
Additions during the year	62	-	481	543
Impairment	-	(6)	-	(6)
Amortisation	-	-	(124)	(124)
Intangible assets	3,886	143	736	4,765
2010				
Balance at the beginning of the year	1,957	399	1,156	3,512
Acquisition through business combination	-	-	17	17
Additions during the year	2,124	-	121	2,245
Disposals through the sale of a subsidiary	(257)	-	(576)	(833)
Transfers to assets held for sale	-	-	(225)	(225)
Impairment	-	(250)	-	(250)
Amortisation	-	-	(114)	(114)
Intangible assets	3,824	149	379	4,352

The methodology for impairment testing on the Infrastructure part of intangible assets is based on using a 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 no impairment was recognized for Asset Management and Credit card operation in 2011.

Below we see the Discount and Growth rates used for this calculation:

	2011		2010	
	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	10.8%	2.5%	10.8%	2.5%
Credit card operation	15.5%	4.5%	15.0%	4.0%

Notes to the Consolidated Financial Statements

Tax assets and tax liabilities

77. Tax assets and liabilities are specified as follows:

	2011		2010	
	Assets	Liabilities	Assets	Liabilities
Current tax	6	2,284	-	3,821
Deferred tax	718	1,137	295	633
Tax assets and liabilities	724	3,421	295	4,454

78. Deferred tax assets and liabilities are specified as follows:

2011

	Assets	Liabilities	Net
Balance at the beginning of the year	295	(633)	(338)
Acquisition through business combination	149	(1)	148
Income tax recognised in profit or loss	274	(503)	(229)
Net tax assets and (liabilities)	718	(1,137)	(419)

2010

Balance at the beginning of the year	1,415	(1,790)	(375)
Income tax recognised in profit or loss	(1,120)	1,157	37
Net tax assets and (liabilities)	295	(633)	(338)

Companies in the group own tax loss carry forward with asset value of the amount 2,514 million ISK that is not recognised in the accounts. The loss is not expected to be utilised due to 10 years time limits in Tax laws.

79. Changes in deferred tax assets and liabilities are specified as follows:

	At Jan. 1	Addition/ disposal during the year	Recognised in profit or loss	At Dec. 31
Foreign currency denominated assets and liabilities	(249)	-	27	(222)
Investment property and property and equipment	(139)	149	(539)	(529)
Financial assets	-	-	611	611
Other assets and liabilities	(37)	-	(5)	(42)
Deferred foreign exchange differences	(538)	(1)	(358)	(897)
Tax loss carry forward	625	-	35	660
Change in deferred tax	(338)	148	(229)	(419)

2010

Foreign currency denominated assets and liabilities	(200)	-	(49)	(249)
Investment property and property and equipment	(16)	-	(123)	(139)
Other assets and liabilities	2	-	(39)	(37)
Deferred foreign exchange differences	(1,430)	-	892	(538)
Tax loss carry forward	1,269	-	(644)	625
Change in deferred tax	(375)	-	37	(338)

Notes to the Consolidated Financial Statements

80. Deferred tax assets and liabilities are attributable to the following:

	2011		2010	
	Assets	Liabilities	Assets	Liabilities
Deferred tax related to foreign exchange gain	-	(897)	5	(543)
Foreign currency denominated assets and liabilities	-	(221)	-	(249)
Investment property and property and equipment	5	(534)	10	(149)
Financial assets	611	-	-	-
Other assets and liabilities	174	(217)	-	(37)
Tax loss carry forward	388	272	625	-
	<u>1,178</u>	<u>(1,597)</u>	<u>640</u>	<u>(978)</u>
Set-off of deferred tax assets together with liabilities of the same taxable entities	(460)	460	(345)	345
Deferred tax assets and liabilities	718	(1,137)	295	(633)

Non-current assets and disposal groups held for sale

81. Non-current assets and disposal groups held for sale are specified as follows:

	2011	2010
Legal entities	8,458	41,924
Associates	12,073	3
Real estates	2,875	2,456
Other assets	480	81
Non-current assets and disposal groups held for sale	23,886	44,464

The legal entities are subsidiaries that were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5. At year-end the largest entities were BM Vallá ehf., Fram Foods ehf. and Penninn á Íslandi ehf. All were held by the Group's holding company Eignabjarg ehf.

On 4 October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100.0% shareholding in B.M. Vallá ehf. A condition precedent for the sale is approval by the Icelandic Competition Authority, which was pending at year-end.

The associates classified as disposal groups held for sale in accordance with IFRS 5 are Hagar hf., HB Grandi hf. and N1 hf. It is expected that the associates Hagar hf. and HB Grandi hf. will be sold in 2012. Fair value of the Group's associate investment in Hagar hf. at year-end, as based upon the closing trading price of its shares on the NASDAQ OMX Iceland, was ISK 697 million higher than the carrying amount included above.

On 28 September 2011 an agreement to sell the Groups 38.9% shareholding in its associate N1 hf. was signed. A condition precedent for the sale is approval by the Icelandic Competition authority, which was pending at year-end.

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

Liabilities associated with the legal entities held for sale are as follows:

	2011	2010
Legal entities, total liabilities	4,950	13,514

Notes to the Consolidated Financial Statements

Other assets

82. Other assets are specified as follows:	2011	2010
Unsettled securities trading	708	366
Accounts receivable	6,511	14,312
Accrued income	455	802
Prepaid expenses	678	448
Sundry assets	524	1,208
Other assets	8,876	17,136

Unsettled securities trading was settled in less than three days from the reporting date.

Other liabilities

83. Other liabilities are specified as follows:		
Accounts payable	18,944	24,704
Kaupthing hf. due to investment in ABMIIF	3,048	-
Withholding tax	2,186	2,600
Depositors' and investors' guarantee fund	3,018	2,669
Insurance claim	2,023	1,992
Unsettled securities trading	132	110
Sundry liabilities	9,471	6,975
Other liabilities	38,822	39,050

Unsettled securities trading was settled in less than three days from the reporting date.

Borrowings

84. Borrowings are specified as follows:		
Bonds issued	124,524	7,156
Other loans	62,679	58,122
Borrowings	187,203	65,278

The Group has repurchased its own debt of value ISK 442 million during the year (2010: Nil).

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006. The bonds in question are covered bonds amounting to ISK 117.7 billion, net outstanding, with collateral in mortgages and bank deposits in a special fund, Arion Bank Mortgages Institutional Investor Fund. It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Current repayment of principal is currently approximately 2.3 billion a year, currently total payment including repayment of principal, indexation and interest is 7.2 billion a year.

Interest of other loans is 3 month Euribor/Libor +300 bps until the loans expires in 2016. The loan can be extended up to 2022 with same terms.

Subordinated liabilities

85. Subordinated liabilities are specified as follows:	2011	2010
Tier II capital	32,105	26,257
Subordinated liabilities	32,105	26,257

The interest on the loan is 3 month Euribor/Libor +400 bps to the year 2015 and thereafter 3 month Euribor/Libor +500 bps.

Notes to the Consolidated Financial Statements

Derivatives

86. Derivatives at fair value are specified as follows:

2011	Fair value	
	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	193	671
Interest rate and exchange rate agreements	463	415
	<u>656</u>	<u>1,086</u>
Bond derivatives:		
Bond swaps, agreements unlisted	18	110
Derivatives	<u>674</u>	<u>1,196</u>
2010		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	2	-
Interest rate and exchange rate agreements	1,100	-
	<u>1,102</u>	<u>-</u>
Bond derivatives:		
Bond swaps, agreements unlisted	24	75
Derivatives	<u>1,126</u>	<u>75</u>

Equity

Share capital and share premium

87. According to the Parent Company'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 declared from time to time and are entitled to one vote per share at Shareholders' meetings of the Group.

Issued share capital	Number		Number	
	(million)	2011	(million)	2010
At 1 January	2,000	75,861	12,646	72,000
Redeemed on 8 January 2010			(12,386)	(62,139)
Issued on 8 January 2010			1,740	66,000
	<u>2,000</u>	<u>75,861</u>	<u>2,000</u>	<u>75,861</u>

Share premium represents excess of payment above nominal value that Shareholders have paid for shares sold by the Group.

Other reserves

88. Other reserves are specified as follows:	2011	2010
Statutory reserve	1,637	1,637
Foreign currency translation reserve	-	(112)
Other reserves	<u>1,637</u>	<u>1,525</u>

Notes to the Consolidated Financial Statements

Off Balance Sheet information

Obligations

89. The Group has granted its customers guarantees, unused overdraft and loan commitments. These items are specified as follows:

	2011	2010
Guarantees	8,662	11,675
Unused overdrafts	34,258	40,896
Loan commitments	17,687	13,946

90. Depositors' and Investors' Guarantee fund

According to a provisional amendment to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Scheme the payments to a new division within the Depositors' and Investors' Guarantee Fund shall amount to a minimum of 0.3% of the amount of guaranteed deposits in the commercial bank concerned. Payment shall be made on a quarterly basis or 0.075% each quarter. In addition to the minimum fee the commercial bank concerned shall pay a variable fee based on risk indicator with value between zero and one as defined by the FME. The Group expensed ISK 1,200 million in the year ended 2011 for the amounts required under the provisional amendment. Due to uncertainty of the shape of final legislation on the Depositors' and Investors' Guarantee Fund the liability brought forward from previous year is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,187 million.

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund which, if passed, would entail a substantial increase in the size of the fund and related payments.

Operating lease commitments

91. Group as a lessee

The Group has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 24 years. The majority of the contracts include renewal options for various periods of time.

	2011	2010
Less than one year	243	213
Over 1 year and up to 5 years	787	644
Over 5 years	714	1,108
Minimum lease payments under non-cancellable leases	1,744	1,965

92. 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 22 years, with majority being non-cancellable agreements. The future minimum lease payments under non-cancellable leases are as follows:

	2011	2010
Less than one year	2,100	1,975
Over 1 year and up to 5 years	5,713	5,715
Over 5 years	2,605	4,269
Minimum lease payments under non-cancellable leases	10,418	11,959

Assets under management and under custody

93. Assets under management and assets under custody are specified as follows:

	31.12.2011	31.12.2010
Assets under management	659,024	618,062
Assets under custody	1,716,230	1,745,384

Notes to the Consolidated Financial Statements

Contingent liabilities

94. Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland the prospects of possible litigation against the Group has become more likely. 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 to account for any adverse effects which the claims may have on its financial standing. At year-end, the Group had several unresolved legal claims.

One significant court case is a case between Drómi and the Group. By means of a decision issued by the Icelandic Financial Supervisory Authority (FME) on 21 March 2009, the Group acquired the deposits of SPRON. According to the decision the resolution committee of SPRON should establish a specific limited liability company owned by SPRON, later Drómi, designed to receive all the assets of the savings banks and all security interests, including all liens, guarantees and other comparable interests linked to SPRON's claims. The subsidiary was then supposed to take over all SPRON's obligations to the Group relating to the acquisition of SPRON's deposits obligations and was supposed to issue a bond to the Group as compensation for the deposit obligations. Such obligation to the Group was documented with an agreement on repaying the debt. The agreement states that the interest rate on the debt principal shall be determined by the FME at any given time. The FME decided that the debt should bear a given annual interest rate plus an interest premium from that time until the debt has been paid in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months. In a letter dated 2 December 2009 Drómi insisted that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Group has brought legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011 Drómi brought legal action against the FME and the Group. Drómi principally demands the annulment of all decisions by the FME on interest rates and secondly demanding a different interest rate from the outset.

Arion Bank has made agreements with clients of Private Banking to buy their approved claims against the estate of Kaupthing hf. The claims relate to claims for damages by clients made against the estate of Kaupthing hf. These claims were initially rejected but Kaupthing hf. has since offered these parties a settlement. The claims involved are general claims against the Kaupthing hf. estate and as a compromise to the clients, Arion Bank has acquired the claims at 30% of the claim value and paid them immediately instead of making the clients wait until the estate has been wound up. ISK 90 million of claims have already been acquired and it is likely that a similar amount will be paid for claims which will probably be agreed to by Kaupthing hf. There is still uncertainty over the recovery of these claims from Kaupthing hf. when the company is wound up or makes composition with creditors.

A number of clients alleged that assets under management were improperly managed resulting in the clients suffering financial loss. Five of these claims were taken to court of law. On 13 May 2011 all of these claims were dismissed by the district court. On 15 June 2011 the Supreme Court upheld the previous decision of the district court.

There are also a number of court cases, to which the Group is a party, whereby the legality of the Group's FX loans are called into question. In some of the cases, the interest rate which is used in the recalculation of said loans is called into question, and also if the Group is obligated to reimburse borrowers because of foreign currency linked loans which the borrower had repaid in full before the Group was founded in October 2008. If the courts side with the borrowers in said cases, and e.g. state that the Group is obligated to reimburse borrowers which had repaid before the Group was founded, the impact on the Bank's loan portfolio would be significant.

The Group is party to a court case, whereby the claimant, a guarantor to a loan issued to the Group, claimed that the Group did not adhere to the rules of an agreement from 2001 on the use of guarantees for individual debts. According to the claimant, the Bank did not provide the claimant with a credit valuation of the debtor to be signed by the guarantor. With a judgment on 23 February 2012, the district court of Reykjavik sided with the Bank in the court case. The disputed amount in this case is not material for the Group but could affect the validity of guarantees held by the Group for a number of other loans to individuals.

The EFTA Surveillance Authority (ESA) has opened a formal investigation into the purchases of the assets of money market funds in the autumn of 2008. The investigation aims to clarify whether the purchase by Arion Bank of assets from the funds can be seen as government support in the understanding of Article 61 of the EEA Agreement. Stefmir hf. has communicated its remarks to the Ministry of Finance and a result was expected in the year 2011 but has not yet been received.

In 2011 Stefmir hf. received two demands for the rescission of contract from the winding-up committee of Landsbanki Íslands hf. Firstly, the rescission of the sale of bonds, issued by Eimskipafélag Íslands hf. and owned by Peningamarkadsjóður, to Landsbanki Íslands hf. less than a month before the collapse of the bank in 2008. The total amount involved is ISK 1,600 million plus interest. Secondly, the demand to rescind Landsbanki Íslands hf. payment of money market deposits which matured early in October 2008 to five funds managed by Stefmir hf. The amount involved is ISK 1,451 million plus interest and the winding-up committee has filed cases in court for two of these payments. The amount of those two cases is ISK 450 million plus interest. Stefmir hf. has protested against the claims and believes that they are unfounded.

Notes to the Consolidated Financial Statements

The uncertainty regarding the book value of Foreign currency lending

95. By two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic krona indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents. By a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic krona interest rate posted by the Central Bank of Iceland.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. Furthermore, the law requires that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed. In accordance with the act, the Group has now finished recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals was affected and as of March 2011 the book value of the loans reflected the result of the calculations.

By two similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans to small SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. The Court passed another two similar judgements on 8 March 2011 dealing with foreign currency loans. By a ruling on 9 June 2011, the Supreme Court, by a 4-3 vote, stated that a foreign currency loan to a corporate was in fact a loan in Icelandic krona and indexed to a foreign currency exchange rate.

Even though no foreign currency indexed ISK loans made by the Group have been deemed illegal by the Supreme Court, the Group announced on 15 June 2011 that recent rulings made by the Supreme Court provide a precedent for the Group to follow, and that the loans that fall under the conditions set forth by the Supreme Court in its rulings would be recalculated. The Group has thus recalculated around 2,000 loans, to both individuals and businesses.

The recalculation came in addition to the recalculation of foreign currency indexed ISK mortgage loans which was done last year. Therefore, the lion's share of the Group's foreign currency indexed ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of businesses it is important to point out that in the summer of 2010 the legality of the Group's FX loans to businesses was assessed by a team of experts at the Group based on FME guidelines. They concluded that the legality of some FX loans to companies was beyond doubt, while others were more vulnerable, as the recent rulings of the Supreme Court have confirmed.

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingarbankinn. As the judgment dealt with a dispute which rose from special circumstances, its precedent is not entirely clear. At this time the Bank is reviewing the judgment and evaluating its impact on the Bank. On first instance, it is likely the judgment does stipulate that loans, which are deemed to be currency-linked, can be recalculated with the un-indexed interest rate set by the Central Bank of Iceland, however the Bank cannot claim from the borrower a higher payment of interest of the loan than the interest the borrower actually paid, if the borrower has paid according to the Bank's payment slips. Therefore, it is likely that the recalculation of certain currency-linked loans will have to be modified in accordance with the judgment. This also means that certain currency-linked loans, which have already been recalculated, will have to be recalculated again. It is worth noting that the Bank's review of the judgment is not over, so the above-mentioned view of the judgment could change.

The Group currently estimates that the loss to the Group's foreign loan portfolio arising from the judgment of 15 February 2012 is ISK 13.8 bn. In calculating this estimate, the Group elected to follow a methodology prescribed in an impact analysis conducted by the FME. From the four scenarios prescribed in the FME's analysis, the Group has selected the one considered to be the most plausible interpretation of the judgement.

Despite the recognition of impairment for the above estimated loss, the Group remains exposed to significant uncertainty regarding foreign currency linked loans in two respects:

Firstly, the estimation uncertainty associated with the Group's interpretation of the impact of the Supreme Court judgment of 15 February 2012. Uncertainty exists with regard to firstly, the Group's preliminary determination of the specific loan customers that require recalculation and secondly, uncertainty with regard to assumptions used in the method of recalculation of loans to customers that were determined to fall within the judgment. As noted above, this uncertainty is somewhat mitigated by the use of an FME prescribed methodology. In the event the Group's interpretation of the judgment of 15 February 2012 were to change, the loss could be significantly greater or less than the current estimate of ISK 13.8 bn.

Secondly, the legal uncertainty over the outcome of future legal decisions and new or amended government legislation that may require recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

Significant uncertainty exists over the impact of the above matters on the carrying value of the Bank's portfolio of foreign currency linked loans at year-end.

Notes to the Consolidated Financial Statements

Notes to the Statement of Cash Flow

96. Operational cash flows from interest and dividends:	2011	2010
Interest paid	22,364	30,809
Interest received	39,653	44,783
Dividend received	7	34

Interest paid includes interest credited to deposit accounts at year-end.

97. Non-cash items included in net earnings before income tax and other adjustments:

Increase in value of loans and receivables	(38,368)	(40,269)
Impairment on loans and other credit risk provisions	27,424	26,787
Compensation instrument, revaluation and accrued interest	17,693	8,331
Depreciation and amortisation	957	819
Impairment on other assets	60	250
Share of profit of associates	(8)	(557)
Investment property, fair value change	(916)	263
Foreign exchange difference	(1,837)	(4,458)
Net loss (gain) on financial assets and liabilities at fair value through profit or loss	(1,463)	3,132
Net loss (gain) on disposal of legal entities acquired exclusively with a view to resale	(3,325)	(579)
Net loss (gain) on disposal of property and equipment	(16)	39
Impairment loss on remeasurement to fair value of HFS legal entities	2,027	-
Net loss (gain) on non-current assets classified as held for sale	(3,851)	(144)
	<u>(1,623)</u>	<u>(6,386)</u>

98. Changes in operating assets and liabilities specified as follows:

Mandatory reserve with Central Bank, net change	(791)	2,080
Loans and receivables to credit institutions	10,928	520
Loans and receivables to customers	16,280	22,243
Bonds and debt instruments	(18,845)	16,118
Shares and equity instruments	(762)	(1,280)
Derivatives and financial liabilities at fair value	3,302	(720)
Other assets	11,431	1,754
Due to credit institutions and Central Bank	(33,282)	(9,285)
Deposits	4,993	(20,511)
Borrowings	(107)	984
Subordinated loans	(1,181)	1,115
Other liabilities	(5,409)	(21,009)
	<u>(13,443)</u>	<u>(7,991)</u>

99. Cash and cash equivalents at the end of the year:

Cash in hand and demand deposits	29,200	30,628
Due from credit institutions	62,175	49,938
Mandatory reserve with Central Bank	(8,560)	(7,769)
Cash and cash equivalents at year-end	82,815	72,797

Notes to the Consolidated Financial Statements

Risk Management Disclosures

Introduction

The Group faces various risks in its business activities, the most important being credit risk, liquidity risk and currency risk that are to the largest extent encountered within the parent company. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities. Managing risk is a core activity within the Group, the Group manages its risks through a process of ongoing risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and 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 management of risks encountered within subsidiaries is carried out within each subsidiary. Arion Bank's risk management structure, strategy and risk exposures are addressed in the notes below.

100. Risk management structure

Board of Directors

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Group's risk exposure are in place. The Board of Directors allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board of Directors set the risk appetite. The risk appetite is translated into exposure limits and targets that are monitored by the Bank's Risk Management division, which reports its findings regularly to the Board of Directors. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board of Directors at least annually. The Board of Directors is also responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP).

CEO

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

The CEO of Arion Bank and all members of the Arion Bank Board of Directors are subject to a fit and proper examination by the FME.

Committee structure

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank's risk management framework, risk appetite and ICAAP. The BARC regularly reviews reports on the Bank's risk exposures. The Asset and Liability Committee (ALCO), chaired by the Chief Financial Officer, is responsible for managing asset-liability mismatch, liquidity risk, market risk, interest rate risk and capital management. The Bank operates four credit committees. The highest authority in credits is the Board Credit Committee (BCC) which decide on all major credit risk exposures. The next highest credit granting authority is the Arion Bank Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital. The ACC is chaired by the CEO or his designated representative. Corporate Banking and Retail Banking operate their individual credit committees, Corporate Credit Committee (CCC) and Retail Branch Committees (RBC), with tighter credit granting limits. The Bank also operates a temporary recovery committee that is focused on recovery cases. The recovery committee has authority to approve credit and write-offs, within its limits, in connection with recovery.

Risk Management

The Bank's Risk Management division is headed by the Chief Risk Officer (CRO). It is independent and centralized and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a risk appetite for the Bank's operations. The CRO and Risk Management are responsible for monitoring that the Bank is operating according to the risk appetite.

Internal Audit

The Bank's Internal Audit conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal Audit examines both the adequacy and completeness of the Bank's control environment and processes as well as the Bank's compliance with its procedures, internal rules and external regulations. Internal Audit discusses its results with management and reports its findings and recommendations to the BARC.

101. Organization of the Risk Management Department

The Risk Management division is divided into five units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Economic Capital, which is responsible for the Bank's ICAAP; Portfolio Risk, which monitors liquidity risk and risks in the Bank's Assets and Liabilities at the portfolio level; and Operational Risk which monitors risks associated with the daily operation of the Bank.

Notes to the Consolidated Financial Statements

102. Overview of the most material risks

The Bank faces traditional types of risks related to its business as a financial institution arising from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below.

Although much progress has been made in curtailing the large foreign exchange imbalance between foreign currency denominated loans to customers and Icelandic currency denominated customer deposits, work remains to be done in order to eliminate the remaining imbalance in 2012. At the end of the year 2011, the imbalance still exceeded the legal limit and dispensation from the Icelandic Central Bank was necessary.

The Bank faces legal risk related to recent court judgments on foreign currency loans, see Note 95.

Single name concentration in the Bank's loan book remains high; the total sum of large exposures net of eligible collateral at year-end 2011 was 87% of capital base, down from 94% at year-end 2010.

Credit risk

103. Credit risk

Credit Risk is the risk that the Bank will incur a loss because its customers or counterparties fail to discharge their contractual obligations. The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits.

Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance.

104. Credit risk strategy

The Bank recognizes that carefully monitored credit risk is a base for stable profits. Undertaking credit risk is a cornerstone in the Bank's strategy for maintaining the future profitability of the Bank. The main asset of the Bank is its loan portfolio, and therefore managing and analyzing the loan portfolio is of utmost importance. The emphasis is on keeping a high quality credit portfolio, by seeking business with strong parties, maintaining a strict credit process, critically inspecting loan applications, identifying and reacting to possible problem loans at an early stage and actively monitoring the credit portfolio.

a) Credit granting process

A fundamental requirement is to have a comprehensive structure for credits which is coherent across the Bank. This structure applies both for the granting of new credits and for the restructuring of impaired credits. The highest authority in credits is the BCC. The next highest credit granting authority is the ACC which operates within limits specified as a fraction of the Bank's capital. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The principle of central management of risk is maintained by having the Bank's CEO as a member of the BCC and the ACC, and by having the CRO, or his representative, attend the meetings of the ACC and CCC with the power to escalate decisions to the BCC. The CEO is responsible for maintaining the Bank's exposures within legal and policy limits.

The pricing of each new credit granted and the credits arising from the impaired loan restructuring process should reflect the risk taken. The client's interests must be protected at all times and there must be a high likelihood that the client will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

It is the aim of the credit strategy that, in the long run, write-offs should be less than 5% of net interest income. The credit process has been designed and implemented with this long term goal in mind.

Provisions for losses reflect the expected loss, both for loans for which specific provisions exist as well as for portfolios of performing loans. The collective assessment of such portfolios is based on default predictions and loss-given-default parameters.

The Bank 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.

Notes to the Consolidated Financial Statements

104. cont.

b) Recovery process

The Bank has developed numerous solution methods to assist customers that are experiencing payment difficulties. Members of the recovery team lead the restructuring work with support from Corporate Banking, Retail Banking and Legal. Restructuring of individuals and small companies is predominantly carried out by Retail Banking with assistance from the recovery team. Restructuring of larger companies is carried out by the recovery team.

c) Customer Credit Rating and Loan Portfolio Classification

The basic elements for the quantification of credit risk are the probability of default, the loss given default, and exposure at default. These quantities need to be measured with an effective and accurate credit rating system. Information, both quantitative and qualitative, must be gathered, both specifically in regard to the counterparty and to its general economic situation in order to estimate its creditworthiness. Furthermore, a facility rating should be performed to determine the loss parameters in case of a default.

The Bank uses an internal rating system to rate corporate loans and loans to individuals. The rating model for larger corporates bases its rating both on qualitative factors and quantitative factors. The rating model for smaller corporates and individuals are purely quantitative models. Internal rating is used in a credit quality classification to distinguish between performing, watch, sub-performing and non-performing customers in addition to other parameters, see Note 105 a).

The policy of the Bank is to continue to use credit models to monitor credit risk. These credit models will however not come into play in the application of the Basel II standardized approach to capital requirements calculations but they will be the basis for a future application of an internal rating based approach. Therefore, further development, implementation and application of these models is carried out in accordance with Basel II requirements. The credit models will become an integral component in the Bank's ICAAP strategy.

d) Loan provisioning

An allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the Statement of Financial Position, whereas for an off balance sheet item, such as a commitment, a provision for credit loss is reported in other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans.

Allowances and provisions for credit losses are evaluated at a counterparty specific level and a collective basis, based on the principles described below.

Individually assessed allowances

A claim is considered impaired when there is objective evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual credit exposures are evaluated based upon the borrower's character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, where applicable, the realizable value of any collateral.

The estimated recoverable amount is the present value, using the loan's original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount.

Upon impairment, the accrual of interest income based on the original terms of the claim is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

Impaired claims are reviewed and analyzed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of improved collection of principal and interest.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim.

Notes to the Consolidated Financial Statements

104. cont.

Collective assessed allowances

All loans for which no impairment is identified on a counterparty specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognized as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

e) Sources of credit risk

Loan portfolio

The main assets of the Bank are its loans. To maintain and further improve the quality of the loan portfolio it is imperative to constantly monitor loans, both individually and at the portfolio level. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

Commitments and guarantees

The Bank often commits itself to and ensures that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on checking accounts, credit cards and credit lines. Potential loss on these accounts is equal to the amount of the limits although they may only be partly used at any one time. In practice, the potential loss is less severe since many of these commitments can be recalled immediately by the Bank in case the clients do not meet credit standards.

Guarantees carry the credit risk to the full amount similar as loans, since they represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties.

Derivatives trading

The Bank offers financial derivatives instruments to professional investors, including, interest rate swaps and options and forwards on Treasury notes and housing financing bonds. Value-changes are in response to changes in interest rates and security prices. Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values. The Bank uses limits on total exposure and on the positive fair value net of collateral to control the Bank's risk towards these instruments. These limits are generally client specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Acceptable collateral for margin accounts is cash or Treasury bills. Should the net-negative position of the contract fall below a certain level, a call is made for added collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. This process is closely monitored within the Bank.

Master netting agreements

Frequently, exposure to credit losses is reduced by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. Master netting agreements do not generally result in an offset in the Statement of Financial Position of assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by these types of agreements since in the case of default all amounts of the counterparty are terminated and settled on a net basis.

Notes to the Consolidated Financial Statements

105. Credit risk disclosures

a) Loan portfolio classification

The Bank is highly focused on the performance of the loan book. The Bank's classification of the loan book seeks to capture the changes in the creditworthiness of counterparties as early as possible. The classification is based on classifying the loan portfolio into Performing, Watch, Sub-performing and Non-performing.

The current classification is based on the criteria outlined in the following table. A borrower who fails any single criterion is demoted to a lower status.

Status	Provision	Days in default	Debt/ EBITDA	LTV	Equity Ratio	Credit Rating	Covenant breach
Performing.....	No	<30 days	< 4-5	< 75/80%	> 15-25%	≥ B-	None
Watch.....	No	30 - 90 days	4-6	75/80%-90%	10-25%	CCC+	Minor
Sub-Performing.....	No	> 90 days	> 5-6	90%-100%	<10-20%	< CCC+	Serious
Non-Performing.....	Yes	> 90 days	> 5-6	>100%	<10-20%	< CCC+	Serious
< 100 million ISK.....	x	x		x		x	

For debt/EBITDA, LTV and equity ratios the condition varies based on industry sector and the underlying collateral type. LTV is used for classification of real estate and construction companies as well as mortgage loans to individuals.

The classification is made on a customer basis. All criteria must be met for a borrower to be able to be classified as performing. If one criterion is violated, the borrower is demoted to a lower status. Thus, for example, a borrower could be classified as Sub-Performing on the basis of LTV without being in default. Borrowers owing less than ISK 100 million are classified based on provisioning, days in default, LTV and credit rating.

The Credit Control department examines the need to provision for credit losses from loans to Sub-Performing and Non-Performing customers. Customers with sufficient collateral to cover existing loans and accrued interest are classified as Sub-Performing, otherwise a provision is made and the customer is classified as Non-Performing.

It is important to note that the classification is predominantly based on contractual loan terms and does not fully consider that some loans are deeply discounted. For instance, a borrower's debt and equity ratios do not reflect that banks are holding the borrower's debt at a discount. Also, a borrower who is making irregular payments may be in default relative to the contractual terms, but may be fulfilling the obligations anticipated for the discounted loan. More loans would be classified as Performing if this weaker standard was applied.

The following table shows a breakdown of the loan book based on these categories:	2011	2010
Performing	56%	38%
Watch	18%	10%
Sub-performing	13%	15%
Non-performing	13%	37%
Total	100%	100%

b) Maximum exposure to credit risk and credit concentration by industry sectors

The Bank seeks proper diversification in the granting of all new credits. Nevertheless, the loan portfolio which was transferred to Arion Bank from Kaupthing hf. suffers from material credit concentrations because only Icelandic assets were transferred to the Bank and assets were transferred at fair value resulting in a very different loan portfolio make-up.

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 reporting year before the effect of mitigation due to collateral agreements or other credit enhancements. The Bank uses ISAT 08 standard classification for its industry classification. ISAT 08 is based on the NACE Rev. 2 classification standard.

Notes to the Consolidated Financial Statements

105. cont.

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

2011

	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank	-	-	29,200	-	-	-	-	29,200
Loans & receivables to cr.inst.	-	-	69,102	-	-	-	1	69,103
Loans & receivables to customers	222,228	63,335	60,951	43,541	65,953	62,265	43,277	561,550
Overdrafts.....	19,951	2,048	8,609	2,218	2,427	715	2,917	38,885
Subordinated loans.....	-	-	-	-	508	-	42	550
Other loans.....	202,277	61,287	52,342	41,323	63,018	61,550	40,318	522,115
Bonds and debt instruments	-	10	70,946	7,455	-	-	62,157	140,568
Listed.....	-	10	1,716	6,841	-	-	47,047	55,614
Unlisted.....	-	-	69,230	614	-	-	15,110	84,954
Derivatives	8	92	53	7	39	-	475	674
Bonds & debt instrum., hedging	-	-	-	-	-	-	1,922	1,922
Listed.....	-	-	-	-	-	-	1,922	1,922
Other assets with credit risk	293	4,155	1,911	39	104	5	1,497	8,004
Total on balance sheet maximum exposure to credit risk	222,529	67,592	232,163	51,042	66,096	62,270	109,329	811,021

Maximum exposure to credit risk related to off balance sheet items:

Financial guarantees	417	1,023	1,590	528	1,045	125	3,934	8,662
Unused overdrafts	21,553	281	2,814	1,530	2,500	360	5,220	34,258
Loan Commitments	113	118	934	8,118	4,129	997	3,278	17,687
Total off balance sheet maximum exposure to credit risk	22,083	1,422	5,338	10,176	7,674	1,482	12,432	60,607
Maximum exposure to credit risk	244,612	69,014	237,501	61,218	73,770	63,752	121,761	871,628

I: Individuals

II: Real estate activities and construction

III: Financial and insurance activities

IV: Manufacturing, mining and other industry

V: Wholesale and retail trades, transport, accommodation and food service activities

VI: Agriculture, forestry and fishing

VII: Services*

*Includes business services, public administration, defence, education, human health and social work activities and other service.

Notes to the Consolidated Financial Statements

105. cont.

2010

	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank	-	-	30,628	-	-	-	-	30,628
Loans & receivables to cr.inst.	-	-	67,846	-	-	-	-	67,846
Loans & receivables to customers	111,354	69,637	63,484	59,829	44,713	50,229	51,973	451,219
Overdrafts.....	12,315	2,289	14,831	1,711	2,274	780	3,190	37,390
Subordinated loans.....	-	-	-	-	493	-	6	499
Other loans.....	99,039	67,348	48,653	58,118	41,946	49,449	48,777	413,330
Bonds and debt instruments	-	223	74,635	11	27	-	45,216	120,112
Listed.....	-	-	1,384	11	27	-	45,143	46,565
Unlisted.....	-	223	73,251	-	-	-	73	73,547
Derivatives	10	-	14	732	-	-	370	1,126
Bonds & debt instrum., hedging	-	-	-	-	-	-	3,213	3,213
Listed.....	-	-	-	-	-	-	3,213	3,213
Compensation instrument	-	-	24,188	-	-	-	-	24,188
Other assets with credit risk	274	331	15,075	267	27	20	694	16,688
Total on balance sheet maximum exposure to credit risk	111,638	70,191	275,870	60,839	44,767	50,249	101,466	715,020

Maximum exposure to credit risk related to off balance sheet items:

Financial guarantees	407	2,825	1,958	724	1,693	920	3,148	11,675
Unused overdrafts	23,068	734	9,358	1,405	1,895	287	4,149	40,896
Loan Commitments	443	-	454	2,331	1,256	3,216	6,246	13,946
Total off balance sheet maximum exposure to credit risk	23,918	3,559	11,770	4,460	4,844	4,423	13,543	66,517
Maximum exposure to credit risk	135,556	73,750	287,640	65,299	49,611	54,672	115,009	781,537

I: Individuals

II: Real estate activities and construction

III: Financial and insurance activities

IV: Manufacturing, mining and other industry

V: Wholesale and retail trades, transport, accommodation and food service activities

VI: Agriculture, forestry and fishing

VII: Services*

*Includes business services, public administration, defence, education, human health and social work activities and other service.

c) 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:

- For retail lending, mortgages over residential properties;
- For corporate lending, charges over real estate properties, fixed and current assets, inventory and trade receivables; and
- For derivative exposure, cash or treasury bills.

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.

Notes to the Consolidated Financial Statements

105. cont.

d) Credit quality by class of financial assets

The table below shows the credit quality of loans and receivables:

	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired	Total
2011				
Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers				
Loans to corporates	274,604	17,758	46,252	338,614
Loans to individuals	182,089	23,117	17,730	222,936
Bonds and debt instruments	140,568	-	-	140,568
Derivatives	674	-	-	674
Securities used for hedging	1,922	-	-	1,922
Total	698,160	40,875	63,982	803,017
2010				
Cash and balances with Central Bank	30,628	-	-	30,628
Loans and receivables to credit institutions	63,451	-	4,395	67,846
Loans and receivables to customers				
Loans to corporates	119,655	51,405	168,805	339,865
Loans to individuals	67,127	14,581	29,646	111,354
Bonds and debt instruments	120,112	-	-	120,112
Derivatives	1,126	-	-	1,126
Securities used for hedging	3,213	-	-	3,213
Total	405,312	65,986	202,846	674,144

Restructuring of loans to customers is now finalised for the major part of the loan book which makes it possible for the Bank to look at impairment on loans on a loan basis rather than customer basis, which was the method used until now. For these two reasons individually impaired loans are considerably lower than before. Different method and progress made in the restructuring of loans also affects the figure for Neither Past due nor impaired which is considerably higher than at year-end 2011.

e) Past due but not impaired loans by class of loans and receivables:

	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
2011					
Loans to corporates	5,649	824	834	10,451	17,758
Loans to individuals	2,950	3,422	2,512	14,233	23,117
Total	8,599	4,246	3,346	24,684	40,875
2010					
Loans to corporates	6,063	949	7,112	37,281	51,405
Loans to individuals	2,594	3,237	1,792	6,958	14,581
Total	8,657	4,186	8,904	44,239	65,986

The majority of the loans have been acquired at discount and are in process of being restructured or in a recovery process.

Notes to the Consolidated Financial Statements

105. cont.

f) Collateral repossessed

During the year, the Group took possession of real estates with the carrying value of ISK 1,724 million and other assets with the value of ISK 4.8 million, all which the Bank is in the process of selling, see Note 81.

g) Loans and receivables to customers specified by sectors:	2011	2010
Individuals	39.7%	24.7%
Financial and insurance activities	10.8%	14.1%
Manufacturing, mining and other industry	7.7%	13.3%
Real estate activities	9.8%	13.0%
Agriculture, forestry and fishing	11.1%	11.1%
Wholesale and retail trades, transport, accommodation and food service activities	11.7%	9.9%
Business services	5.3%	8.3%
Construction	1.5%	2.4%
Public administration, defence, education, human health and social work activities	1.2%	1.8%
Other services	1.2%	1.4%
Loans and receivables to customers	100.0%	100.0%

h) Impaired loans and receivables to customers by sector:	2011		2010	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals	12,662	30,392	5,472	35,118
Financial and insurance activities	6,098	11,498	4,673	24,228
Manufacturing, mining and other industry	1,911	11,112	2,136	19,095
Real estate activities	5,441	11,058	7,568	48,686
Agriculture, forestry and fishing	4,531	10,507	2,606	22,184
Wholesale and retail trades, transport, accommodation and food service activities	5,295	19,335	3,294	28,604
Business services	8,278	9,090	10,562	45,022
Construction	1,348	4,766	2,349	9,501
Public administration, defence, education, human health and social work activities	754	1,706	77	2,558
Other services	458	1,294	346	2,538
Impairment on loans and receivables to customers	46,776	110,758	39,083	237,534

Notes to the Consolidated Financial Statements

105. cont.

i) Large Exposure Disclosures

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base net of eligible collateral according to FME rules No 216/2007.

The legal maximum for individual large exposures is 25% of capital base and the sum of all large exposures cannot exceed 800% of capital base.

The maximum exposure to a group of connected clients at year-end was ISK 33 billion (2010: ISK 36 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has five large exposures at year-end (2010: seven exposures) net of eligible collateral.

no.	2011		2010	
	Gross	Net	Gross	Net
1	49%	0%	57%	1%
2	23%	23%	28%	19%
3	20%	20%	26%	18%
4	19%	19%	13%	13%
5	14%	14%	12%	8%
6	11%	11%	11%	11%
Sum of exposure gross > 10%	136%	87%	147%	70%

No large exposure exceeds the legal limit of 25% of the group's capital base at year-end. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi. The FME has ruled that the Group can use the hold harmless statement as a credit enhancement towards the claim on Drómi ehf. Consequently, the Group finds that the net exposure on Drómi is zero, or 0.3% when taking into consideration financial related parties.

The sum of all large exposures is 136% before collateral mitigation or 87% net of eligible collateral, which is well below the 800% legal maximum and the Group's internal 150% limit net of collateral.

Market risk

106. Market risk

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

107. Market risk strategy

The Bank'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. The Bank keeps firm track of the market risk and separates its exposure to market risk into trading book and non-trading book i.e. banking book. The market risk in the trading book arises from proprietary trading activities. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. The market risk in the trading book and in the banking book are managed separately by Treasury and monitored by Risk Management.

Fair value of financial instruments is disclosed in Note 70.

Market risk - trading book

In the case of proprietary trading the CEO decides the total market risk exposure of the book and per asset class, expressed as maximum overnight exposure. The Bank trading book's main exposures are listed Icelandic Treasury notes and bonds and Housing Fund bonds and to a very limited extent listed equities.

Fair values of bonds and debt instruments and shares and equity instruments are disclosed in Note 69.

Notes to the Consolidated Financial Statements

107. cont.

Derivatives

The Bank's use of derivatives is through derivative sales and trading portfolios. The types of derivative currently offered by the Bank are interest rate swaps and options and forwards on Treasury notes and housing financing bonds.

The Bank is not materially exposed to derivative instruments at year-end 2011.

Market risk - banking book

a) Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The Bank's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. These mismatches are characterized by a large maturity gap between assets and liabilities where a large amount of liabilities is on demand but the duration of interest bearing assets are much higher resulting in a yield curve risk for the Bank. The Bank also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies.

Interest rate risk strategy

The Bank's strategy for managing its interest rate risk is to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rate by currency and maturity in million of ISK in the Group. Risk is quantified by assuming a 200 bps simultaneous upward shift in all yield curves in the relevant duration band. The sensitivity does not relate to variation of annual net interest income.

2011		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	40	(1,509)	(1,016)	(14,001)	7,684
Non Indexed linked	ISK	(418)	(1,390)	(701)	(265)	(388)
	EUR	15	(5)	-	-	-
	Other	(27)	(785)	(109)	-	-
2010						
CPI Indexed linked	ISK	486	(160)	(673)	(10,833)	(78)
Non Indexed linked	ISK	(73)	(577)	(376)	(364)	(67)
	EUR	(65)	(26)	-	-	-
	Other	(584)	(40)	-	-	-

Notes to the Consolidated Financial Statements

107. cont.

The table below analyses the Group's assets and liabilities at carrying amount by residual maturity.

2011	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	29,200	20,640	-	8,560	-	-	-
Due from banks	69,103	62,155	6,703	-	245	-	-
Loans and receivables to customers	561,550	13,694	49,872	71,108	230,773	196,103	-
Bonds and debt instruments	140,568	3,994	515	15,256	80,125	40,678	-
Shares and equity instruments	14,045	-	-	-	-	-	14,045
Derivatives	674	-	188	3	483	-	-
Assets leg	9,589	-	5,603	299	3,687	-	-
Liabilities leg	(8,915)	-	(5,415)	(296)	(3,204)	-	-
Securities used for hedging	2,372	1,922	-	-	-	-	450
Investment property	27,100	-	-	-	-	-	27,100
Investments in associates	2,987	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	23,886
Other assets	8,876	598	5,446	492	843	68	1,429
Total assets 31.12.2011	892,121	103,003	62,724	95,419	312,469	236,849	81,657
Liabilities							
Due to credit inst. and Central Bank	16,160	10,341	231	5,588	-	-	-
Deposits	489,995	377,063	58,708	24,371	27,117	2,736	-
Financial liabilities at fair value	4,907	-	4,492	-	415	-	-
Assets leg	(35,374)	-	(34,697)	-	(677)	-	-
Liabilities leg	36,571	-	35,479	-	1,092	-	-
Short position bonds & derivatives	3,710	-	3,710	-	-	-	-
Tax liabilities	3,421	-	-	2,284	-	-	1,137
Non-current liabilities held for sale	4,950	-	-	-	-	-	4,950
Other liabilities	38,822	2,020	8,235	20,157	2,686	219	5,505
Borrowings	187,203	-	3,885	2,595	13,297	167,426	-
Subordinated liabilities	32,105	-	-	-	-	32,105	-
Total liabilities 31.12.2011	777,563	389,424	75,551	54,995	43,515	202,486	11,592
Off balance sheet items							
Guarantees	8,662	343	420	1,273	5,108	1,518	-
Unused overdraft	34,258	808	7,685	12,465	13,272	28	-
Loan commitments	17,687	1	2,892	8,385	4,409	2,000	-
Total off balance sheet items	60,607	1,152	10,997	22,123	22,789	3,546	-
Net interest sensitivity gap	53,951	(287,573)	(23,824)	18,301	246,165	30,817	70,065

Notes to the Consolidated Financial Statements

107. cont.

2010	Carrying	On	Up to 3	3-12	1-5	Over 5	With no
Assets	amount	demand	months	months	years	years	maturity
Cash and balances with Central Bank	30,628	22,859	-	7,769	-	-	-
Due from banks	67,846	49,572	15,372	691	1,803	408	-
Loans and receivables to customers	451,219	-	8,155	43,902	236,701	162,461	-
Bonds and debt instruments	120,112	6,467	-	32	73,984	39,629	-
Shares and equity instruments	10,316	-	-	-	-	-	10,316
Derivatives	1,126	-	44	262	820	-	-
Assets leg	5,687	-	2,447	538	2,702	-	-
Liabilities leg	(4,561)	-	(2,403)	(276)	(1,882)	-	-
Securities used for hedging	3,213	3,213	-	-	-	-	-
Compensation instrument	24,188	-	-	-	24,188	-	-
Investment property	27,642	-	-	-	-	-	27,642
Investments in associates	2,713	-	-	-	-	-	2,713
Property and equipment	7,365	-	-	-	-	-	7,365
Intangible assets	4,352	-	-	-	-	-	4,352
Tax assets	295	-	-	-	-	-	295
Non-current assets held for sale	44,464	-	-	-	-	-	44,464
Other assets	17,136	368	2,915	13,220	186	-	447
Total assets 31.12.2010	812,615	82,479	26,486	65,876	337,682	202,498	97,594
Liabilities							
Due to credit inst. and Central Bank	95,646	58,985	3,508	5,153	28,000	-	-
Deposits	457,881	327,824	27,974	78,307	18,823	4,953	-
Financial liabilities at fair value	999	923	76	-	-	-	-
Assets leg	(4,283)	-	(4,283)	-	-	-	-
Liabilities leg	5,282	923	4,359	-	-	-	-
Tax liabilities	4,454	-	-	3,821	-	-	633
Non-current liabilities held for sale	13,514	-	-	-	-	-	13,514
Other liabilities	39,050	110	31,644	-	1,970	-	5,326
Borrowings	65,278	600	501	32	4,349	59,796	-
Subordinated liabilities	26,257	-	-	-	-	26,257	-
Total liabilities 31.12.2010	703,079	388,442	63,703	87,313	53,142	91,006	19,473
Off balance sheet items							
Guarantees	11,675	67	1,029	2,173	7,347	1,059	-
Unused overdraft	40,896	40,896	-	-	-	-	-
Loan commitments	13,946	13,946	-	-	-	-	-
Total off balance sheet items	66,517	54,909	1,029	2,173	7,347	1,059	-
Net interest sensitivity gap	43,019	(360,872)	(38,246)	(23,610)	277,193	110,433	78,121

Notes to the Consolidated Financial Statements

107. cont.

b) Inflation risk

The Group is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 230.7 billion (2010: ISK 106.4 billion) and the total amount of indexed liabilities amount to ISK 218.5 billion (2010: ISK 87.8 billion).

2011	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets - CPI indexed linked				
Loans and receivables to customers	110	40,869	183,760	224,739
Bonds and debt instruments	37	28	2,221	2,286
Off balance sheet position	-	3,650	-	3,650
Total	147	44,547	185,981	230,675
Liabilities - CPI indexed linked				
Deposits	55,486	30,191	1,749	87,426
Borrowings	3,084	15,804	112,205	131,093
Total	58,570	45,995	113,954	218,519
Net on balance sheet position	(58,423)	(5,098)	72,027	8,506
Net off balance sheet position	-	3,650	-	3,650
Total CPI Balance	(58,423)	(1,448)	72,027	12,156
Total CPI Balance 31.12.2010	(56,094)	8,579	66,180	18,665

c) Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Bank are predominantly ISK denominated deposits whereas the Bank's assets consist largely of foreign currency denominated loans to customers.

Currency risk strategy

The Bank's strategy for reducing its currency imbalance is twofold: The systematic ISK redenomination of foreign currency loans to customers which have ISK income (the naturally hedged currency imbalance), and hedging of its real currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers. The task of redenominating loans to customers with ISK income was hampered by the uncertain legal status of foreign currency loans. The December 2010 legislation regarding the treatment of foreign currency loans to individuals and subsequent court decisions on certain loans to SMEs has accelerated the redenomination of the corresponding loans to ISK. Net exposures per currency are monitored centrally in the Bank.

Notes to the Consolidated Financial Statements

107. cont.

The following table shows the breakdown of assets and liabilities by currency at year-end:

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	12,238	317	10,678	828	3,670	574	895	29,200
Loans to credit institutions	23,725	9,288	10,813	1,010	8,055	3,249	12,963	69,103
Loans and receivables to customers	393,093	48,344	20,998	34,298	10,957	27,824	26,036	561,550
Bonds and debt instruments	128,853	352	11,363	-	-	-	-	140,568
Shares and equity instruments	9,931	2,534	899	-	276	-	405	14,045
Derivatives	458	8	1	8	14	185	-	674
Securities used for hedging	2,372	-	-	-	-	-	-	2,372
Investment property	27,100	-	-	-	-	-	-	27,100
Investments in associates	2,986	1	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	-	23,886
Other assets	8,469	245	68	-	12	-	82	8,876
Total assets 31.12.2011	644,871	61,089	54,820	36,144	22,984	31,832	40,381	892,121
Liabilities								
Due to credit inst. and Central Bank	15,188	261	69	-	304	11	327	16,160
Deposits	399,616	26,869	16,880	6,664	7,464	5,253	27,249	489,995
Financial liabilities at fair value	3,856	23	430	2	113	378	105	4,907
Tax liabilities	3,421	-	-	-	-	-	-	3,421
Non-current liabilities held for sale	4,950	-	-	-	-	-	-	4,950
Other liabilities	34,339	1,027	2,587	8	397	-	464	38,822
Borrowings	126,311	3,090	19,833	20,281	6,720	10,968	-	187,203
Subordinated loans	-	25,869	2,446	-	3,790	-	-	32,105
Equity	114,558	-	-	-	-	-	-	114,558
Total liabilities 31.12.2011	702,239	57,139	42,245	26,955	18,788	16,610	28,145	892,121
Net on balance sheet position	(57,368)	3,950	12,575	9,189	4,196	15,222	12,236	
Net off balance sheet position	14,737	4,660	(3,075)	-	(1,312)	(9,437)	(5,573)	
Net position 31.12.2011	(42,631)	8,610	9,500	9,189	2,884	5,785	6,663	
Net position 31.12.2010	(170,263)	24,097	23,018	55,109	7,896	46,627	13,516	
Loans to customers with ISK income	18,440	(2,822)	(1,224)	(8,164)	(91)	(5,907)	(232)	
Net real position 31.12.2011	(24,191)	5,788	8,276	1,025	2,793	(122)	6,431	
Net real position 31.12.2010	(48,556)	(8,817)	11,247	17,999	4,109	15,969	8,049	

Notes to the Consolidated Financial Statements

107. cont.

The table below indicates the currencies to which the Group had significant exposure at 31 December 2011. 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 income statement (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 income statement 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).

Currency	2011	
	-10%	+10%
EUR	(579)	579
USD	(828)	828
CHF	(103)	103
GBP	(279)	279
JPY	12	(12)
Other	(643)	643

A natural hedge for currency risk

The currency risk is mitigated by the specific nature of foreign currency loans to customers with ISK income. The Bank refers to this as a natural hedge because the loans do not generate profit and loss for small to moderate fluctuations in the exchange rate. These loans were purchased from Kaupthing hf. at a fair value which is based on the customer's ability to repay the loan, which is largely unaffected by changes in the exchange rate. IFRS accounting rules stipulate that the depreciation of the ISK against the loan currency be classified as an impairment event rather than a gain in the loan value if the borrower's ability to repay the loan remains unchanged. Conversely, an appreciation of the ISK is an impairment reversal and that this reversal may be made in certain situations up to the gross value of the loan, which may be significantly higher than the fair value at which the loan was transferred to Arion Bank. The Bank has modelled the effect of this mitigating effect and has presented the relevant authorities with its measure of the effective currency risk which is attributed to this portfolio of loans. The 31 December 2011 values of the foreign currency imbalance are shown in the following table with year-end 2010 values by comparison. The book value refers to the value of the imbalance without accounting for the natural hedge whereas the effective value takes into consideration the mitigating effect of the natural hedge, as modelled by the Bank. This strength of the natural hedge is different at different times. Previously, the natural hedge effect was applied on a portfolio level, but is now applied on a loan-by-loan basis.

	2011		2010	
	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income	24,191	24,191	48,556	48,556
FX imbalance due to customers with ISK income	18,440	6,823	121,707	48,683

The effective FX imbalance due to customers with ISK income during the year was 37% (2010: 40%), whereas the effective FX imbalance due to customers with FX income is always 100%.

The relevant authorities have granted temporary dispensation from rules regarding the currency imbalance.

Equity price risk

Equity price 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. The non-trading equity price risk exposure is mainly due to restructuring of the Bank's assets i.e. restructuring of troubled companies which the Bank has taken over. For information on assets seized and held for sale, see Note 81.

Prepayment risk

Prepayment risk is the risk that the Bank will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Bank is not materially exposed to prepayment risk at year-end 2011.

Notes to the Consolidated Financial Statements

Liquidity risk

108. Liquidity risk

Liquidity risk is defined as the risk that the Bank will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources. The funding liquidity risk limit is quantified by secured liquidity ratio as well as applying stress tests to identify scenarios of possible liquidity strain.

The Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, the majority of which is on demand.

109. Liquidity risk strategy

The Bank's strategy is to lengthen the maturity profile on the liability side, e.g. by converting on-demand deposits to term deposits. At 31 December 2011 77% of the Bank's deposits were on-demand.

Secured liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balances with the Central Bank of Iceland, Treasury notes and Housing Fund bonds which are held specifically as liquidity reserves and other eligible assets for repo transactions with the Central Bank and compare it with the total interest bearing liabilities.

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The high liquidity reserve required by the FME reflects the uncertainty of the deposit's stickiness of the Icelandic banks and the fact that a large part of the Bank's liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is much higher. The Bank actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base. The ratios during the year were as follows:

	Liquidity ratio	Cash ratio
Year-end	35%	15%
Maximum	39%	20%
Minimum	29%	12%
Average	34%	15%

Deposit stickiness

The Group's deposit base has been split into seven different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described as being sticky if it has shown to be a stable funding for the Group in the past and is expected to remain stable in the future. Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Group and the maturity of the deposit. These criteria's are based both on qualitative and quantitative methods.

- Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls;
- Resolution process: Deposits from customers in a resolution process;
- Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate;
- Deposits - legal entities: Deposits from legal entities with no other business relationship with the Group and not quantified as an active investor;
- Deposits - retail individual: Deposits from retail individual with no other business relationship with the Group and not quantified as an active investor;
- Deposits - legal entities with business relationship: Deposits from legal entities with business relationship with the Group; and
- Deposits - retail individual with business relationship: Deposits from retail individual with business relationship with the Group.

Notes to the Consolidated Financial Statements

109. cont.

The table below shows the split between different levels of the Bank's deposit stickiness at year-end, according to the Bank's classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky.

% of deposit base:

Stickiness rating	2011		2010	
1 Capital controls	9%	43,977	7%	39,932
2 Resolution process	11%	58,315	9%	48,718
3 Investors	25%	124,596	29%	160,437
4 Deposits - legal entities	16%	80,494	9%	49,817
5 Deposits - retail individuals	11%	57,559	12%	66,423
6 Deposits - legal entities with business relationship	11%	57,664	17%	94,100
7 Deposits - retail individuals with business relationship	17%	83,550	17%	94,100
Total	100%	506,155	100%	553,527

The Bank's stress tests are primarily focused on the effect of lifting the capital controls in Iceland on the deposit base and its liquidity buffer. A stress test below shows the effect on the secured liquidity and cash ratios if unpledged deposit in stickiness's categories Capital controls and Resolution process are withdrawn immediately taking into account expected cash flow from assets and expenses.

Liquidity stress test for the year 2012

	Jan	Feb	Mar	Apr	May	Jun	Jul
Secured liquidity ratio.....	18.8%	19.1%	19.8%	19.7%	20.4%	20.9%	21.0%
Cash ratio.....	0.0%	0.4%	1.4%	1.3%	2.2%	3.0%	3.1%

Operational risk

110. Operational risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business areas and in the ancillary divisions.

Operational risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank can reduce its exposure to operational risk with selection of internal control and quality management, well educated and qualified staff. The Bank can choose to transfer operational risk through outsourcing the activity or to transfer the financial consequences through insurance programs.

Notes to the Consolidated Financial Statements

111. Operational risk strategy

The Bank keeps a firm track of the operational risk that the Bank is exposed to. Identification and measurements are made by the means of Risk Control Self Assessment, registration of loss events, near misses and quality deficiencies and by monitoring potential risk indicators and other early warning signals. Operational risk is reduced through staff training, process redesign and enhancement of the control environment.

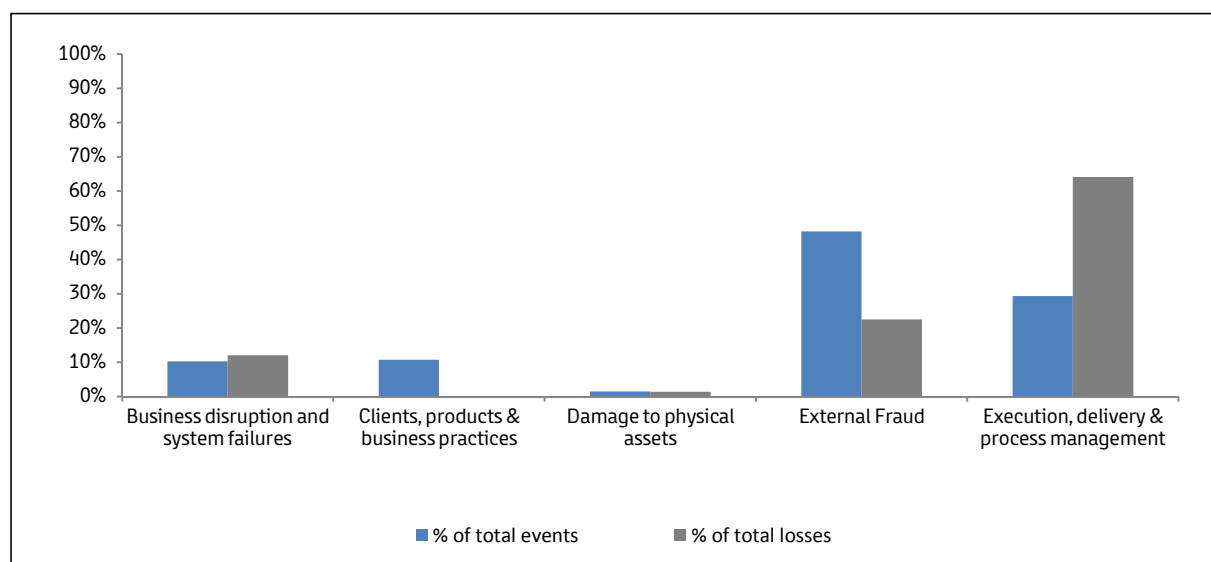
The Bank aims to maintain an open, no blame, operational risk culture and to seek to get to the point of no surprises by utilizing the Bank's operational tools and processes to the fullest extent possible. The Bank operates no tolerance policy for internal fraud.

The Bank uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk but manages it in accordance with the standardized approach. Capital base for operational risk is measured 15% of the average over three years of the sum of net interest income and net non interest income, outlined in the EU's Capital Requirements Directive (CRD).

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analyzed to understand the cause of the event, control failure and amendments made where applicable to reduce the risk of the event happening again.

Losses of ISK 76,7 million were registered in the loss database for the year 2011. Failure in execution, delivery and process management accounted for 64,1% of the total loss amount.

Figure show the breakdown of loss events and amount by Basel categories in 2011:



Capital Adequacy and ICAAP Strategy

112. The Group's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long term capital planning for the Group is currently based on a benchmark minimum Core Tier 1 capital ratio of 12.5% and a Capital adequacy ratio of 16.5%. On the 8th of January 2010 additional capital was injected by the Ministry of Finance as Tier 2 capital in the form of a subordinated loan, at the discretion of the FME. FME supervises the Group, receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole.

a) Capital adequacy

Capital requirements according to Pillar 1 are based on the sum of risk weighted assets (RWA) for credit risk, market risk and operational risk, computed using formulas from the EU's CRD. The CRD offers different approaches for calculating RWA for these risk types:

Credit Risk

Standard approach, Foundation IRB approach, and Advanced IRB approach.

Market Risk

Standardised approach and Internal value at risk model.

Notes to the Consolidated Financial Statements

112. cont.

Operational Risk

Basic indicator approach, Standardised approach, and AM approach.

Banking operations are categorised as either trading book or banking book and the calculation of risk weighted assets is conducted differently for the assets in different books. Banking book risk weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account eligible collateral or guarantees. Banking book off balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned risk weights appropriate to the category of the counterparty, again accounting for eligible collateral or guarantees. Trading book risk weighted assets are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

The Group uses the following approaches for capital requirement calculations:

- Standardized approach to calculate the capital requirements for credit risk;
- Standardized method to calculate the capital requirements for market risk; and
- Basic indicator approach for operational risk.

The Group will use the Basel II standardized method to calculate the capital requirements for credit risk under Pillar 1.

The Bank uses credit rating models for its corporate and retail portfolio but will be focusing on recalibrating those models for the post-crisis business environment and deploying them in its internal risk capital management and ICAAP. When the consistent fidelity of the credit rating models can be demonstrated they will be submitted to the FME as part of an application to use the Foundation Internal Ratings Based (FIRB) approach to calculating the capital requirements for credit risk.

The Bank has implemented methods and tools for operational risk management based on the minimal requirements for the standardised approach. The Bank will continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Internal capital adequacy assessment process

The ICAAP is an ongoing process that ensures that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile.

To measure the Pillar 2 capital requirement the Bank uses an internal capital model (economic capital model). This model is based on Pillar 1 calculations, using internal models for credit risk calculations, and takes into consideration risks that are not covered under Pillar 1, e.g. concentration risk, residual risk, country risk, settlement risk, fx risk, liquidity risk, interest rate risk in the banking book, reputation risk, legal and compliance risk, business risk and strategic risk.

The Bank has implemented methods to calculate, for Pillar 2, concentration risk for single name concentration and sector concentration in addition the Bank is applying methods to include valuation risk, interest rate risk in the banking book, legal risk and business risk. Methods for evaluating other Pillar 2 risks will be developed in line with further development of the Bank's economic capital model.

Stress tests are an important part of the ICAAP and show how the Group's capital could be affected by sharp macro economic changes, downswings in the Group's core business or other major events. The Bank is currently running, under the ICAAP, stress testing scenarios on its business plan and planned capital needs.

Notes to the Consolidated Financial Statements

112. cont.

b) Capital adequacy disclosures

Capital base at 31 December 2011 amounts to ISK 141,174 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 21.2%, exceeding the minimum legal requirement of 8%.

The Group, parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (2010: the same).

A remark about capital requirements for currency imbalance is in order. As indicated in the discussion about currency risk, there exists a risk mitigation in the form of a natural hedge when the imbalance is due to an FX loan to a borrower with ISK income. The effect of this natural hedge is reflected in the RWA for market risk where on average a 37% effective contribution of the corresponding portion of the FX imbalance has been accounted for at year-end 2011 (2010: 40%).

The table shows the Group's RWA calculations:	2011	2010
Capital Base		
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve	1,637	1,525
Retained earnings	32,950	28,531
Non-controlling interests	4,110	3,619
Total Equity	114,558	109,536
Deduction from Tier 1 capital	5,489	4,647
Total Tier 1 capital	109,069	104,889
Tier 2 capital	32,105	26,257
Total Capital base	141,174	131,146
Risk weighted assets		
Credit risk	543,233	513,328
Market risk FX	31,990	97,657
Market Risk Other	30,757	20,397
Operational risk	58,976	57,267
Total Risk weighted assets	664,956	688,649
Tier 1 ratio	16.4%	15.2%
Capital adequacy ratio	21.2%	19.0%

Notes to the Consolidated Financial Statements

Other information

Related parties

113. The Group has a related party relationship with Kaupskil ehf., Kaupthing hf., the Group's associates, the Board of Directors of Arion Bank, the key management personnel of the Group and close family members of individuals referred to above.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) holds a 13% stake in the Group and the Ministry of Finance is the holder of all subordinated notes that represent Tier 2 capital of the Group. Accordingly the Ministry of Finance, ISFI and government entities related to them are related parties and balances and transactions with these entities are included in the tables below under "shareholders with significant influence over the Group". For 2010 this information was not reflected, consequently the tables below have been revised to include 2010 related party balances and transactions with these government related entities.

No unusual transactions took place with related parties during the year. 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 other than the one related to the compensation instrument as disclosed in Note 71.

Balances with related parties:

2011	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	1,730	(1,730)
Shareholders with control over the Group	493	41,376	(40,883)
Board of Directors and key Management personnel	104	367	(263)
Associates and other related parties	74,135	29,088	45,047
	<u>74,732</u>	<u>72,561</u>	<u>2,171</u>

Transactions with related parties:

	Interest income	Interest expenses	Other income	Other expenses	Change in compens. instrum.
Shareholders with significant influence over the Group	-	28	-	-	-
Shareholders with control over the Group	322	887	47	-	18,015
Board of Directors and key Management personnel	6	12	31	-	-
Associates and other related parties	3,273	352	1,359	25	-
	<u>3,601</u>	<u>1,279</u>	<u>1,437</u>	<u>25</u>	<u>18,015</u>

2010

	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	8	1,690	(1,682)
Shareholders with control over the Group	36,440	65,170	(28,730)
Board of Directors and key Management personnel	348	903	(555)
Associates and other related parties	20,603	2,416	18,187
	<u>57,399</u>	<u>70,179</u>	<u>(12,780)</u>

Transactions with related parties:

	Interest income	Interest expenses	Other income	Other expenses	Change in compens. instrum.
Shareholders with significant influence over the Group	1	54	-	-	-
Shareholders with control over the Group	1,256	2,088	23	-	9,587
Board of Directors and key Management personnel	45	32	-	-	-
Associates and other related parties	1,444	108	499	263	-
	<u>2,746</u>	<u>2,282</u>	<u>522</u>	<u>263</u>	<u>9,587</u>

Comparative balances at 31 December 2010 were revised during the year to exclude related party balances of shareholders with control that had previously been included. The effect of this change was to increase the net liability amount due to shareholders with control at 31 December 2010 by ISK 6,165 million.

Notes to the Consolidated Financial Statements

Events after Balance Sheet date

114. Events after Balance Sheet date

a) Hagar hf.

On 29 February 2012 the Group sold 13.3% of issued shares in Hagar hf. for ISK 2.8 billion through a private placement of shares. The gain on sale from this transaction will be recognized in Q1 of 2012.

b) Verdis hf.

In March 2011 Arion Bank and Landsbanki Íslands hf. signed a letter of intent whereby Landsbanki Íslands hf. would purchase new equity issued by Verdis hf., currently a wholly owned subsidiary of Arion Bank. After the issuance of new equity Arion Bank will hold a 75.5% share in Verdis hf. Following this agreement the intention is to increase the number of shareholders and within three years the total shareholding of Arion Bank and Landsbanki Íslands hf. should be less than 50%. The letter of intent was signed with the preconditions of due diligence and approval by the Icelandic Competition Authority. The matter was initially rejected by the Icelandic Competition Authority on 17 October 2011, however this was successfully appealed on 16 February 2012 and a new ruling is currently pending.

c) Refund

In January 2012 Arion Bank refunded customers who serviced their loans on a timely basis a proportion of the amount they paid to the Bank in 2011. In most cases borrowers were refunded part of repayments made on mortgages, or 16.7% of their payments in 2011. In addition a 30% refund was made on last year's interest payments on overdrafts.

d) Index linked covered bonds issued by Arion Bank admitted to trading on Nasdaq OMX Iceland

On 22 February 2012 Arion Bank's covered bond series, Arion CBI 34, was admitted for trading on the bond market of Nasdaq OMX Iceland and the Luxembourg Stock Exchange. The series has a nominal value of ISK 2,500 million and is the first issuance under the Bank's EUR 1 billion Covered Bond Programme. The bonds are inflation-indexed with fixed 3.6% interest and mature in 2034.

Subsidiaries

115. Shares in subsidiaries in which Arion Bank held a direct interest at year-end were as follows:

Company:	Country	Currency	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
AFL - sparisjóður, Adalgata 34, 580 Siglufjörður	Iceland	ISK	94.5
EAB 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Eignabjarg ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
Ekort ehf., Gardatorg 5, 210 Gardabær	Iceland	ISK	100.0
ENK 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Gen hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town.	Cayman Isl.	ISK	100.0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	100.0
KB Rádgjöf ehf., Hlíðasmári 17, 201 Kópavogur	Iceland	ISK	100.0
Landey ehf., Hátún 2b, 105 Reykjavík	Iceland	ISK	100.0
Landfestar ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
NS1 ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík	Iceland	ISK	100.0
Sparisjóður Ólafsfjardar, Adalgata 14, 625 Ólafsfjörður	Iceland	ISK	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Valitor Holding hf., Laugavegur 77, 101 Reykjavík	Iceland	ISK	53.6
Verdis hf., Ármúli 13, 108 Reykjavík (former Arion verdbréfavarsla hf.)	Iceland	ISK	100.0
Vesturland hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0