

ARION BANK'S FINANCIAL RESULTS FOR 2016

Arion Bank reported net earnings of ISK 21.7 billion, compared with ISK 49.7 billion in 2015. Return on equity was 10.5%, compared with 28.1% in 2015. Adjusted earnings amounted to ISK 9.7 billion, compared with ISK 14.1 billion in 2015. Adjusted return on equity was 4.7%, compared with 8.7% in 2015.

Total assets amounted to ISK 1,036.0 billion at the end of 2016, compared with ISK 1,011.0 billion at the end of 2015. Shareholders' equity totalled ISK 211.2 billion at the end of 2016, compared with ISK 192.8 billion at the end of 2015. The Bank enjoys a strong financial position and the focus in 2016 has been on maintaining good liquidity during the period leading up to the lifting of the capital controls.

The Bank's capital ratio at the end of the year was 27.1%, compared with 24.2% at the end of 2015. Tier 1 Capital increased during the year to 26.5%, compared with 23.4% at the end of 2015.

Highlights of the income statement and key performance indicators:

<i>In ISK million</i>	2016	2015	Q4 2016	Q4 2015
Net interest income	29,900	26,992	7,842	6,705
Net commission income	13,977	14,484	3,765	3,757
Net financial income	5,162	12,844	823	2,669
Net insurance income	1,395	761	731	216
Share of profit of associates	908	29,466	198	22,510
Other operating income	2,096	1,622	431	200
Operating income	53,438	86,169	13,790	36,057
Salaries and related expense	(16,659)	(14,891)	(4,407)	(4,571)
Other operating expenses	(13,881)	(12,917)	(3,803)	(4,169)
Bank levy	(2,872)	(2,818)	(682)	(650)
Net impairment	7,236	(3,086)	409	(2,972)
Net earnings before taxes	27,263	52,457	5,307	23,695
Income tax	(6,410)	(3,135)	(1,149)	504
Net gain from disc. operations	886	360	317	83
Net earnings	21,739	49,682	4,475	24,282
KPI's:				
Return on equity (ROE)	10.5%	28.1%	8.6%	51.6%
Net interest margin (int. bearing assets)	3.1%	3.0%	3.2%	2.9%
Cost-to-income ratio	57.2%	32.6%	59.5%	24.5%
Tier 1 ratio	26.5%	23.4%	26.5%	23.4%



HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK:

“Arion Bank’s financial results for 2016 were satisfactory and matched our expectations. The Bank performed well in its core operations and continued to consolidate its financial position. The capital ratio is 27.1% and the liquidity ratio is 171.3%, which is well above the regulatory requirements and very strong by international standards. Arion Bank is a universal financial institution, occupying a strong position on the retail and corporate markets, which is reflected by the structure of the Bank’s loan portfolio. The Bank’s strong standing on our chosen markets and the diverse service offering result in effective risk distribution. Furthermore, the Bank’s robust capital position gives the Bank a broad authority to pay dividends or other disbursement of equity.

A key feature of 2016 was investing for the future in services demanded by our customers. The Bank’s acquisition of the insurance company Vördur, which was completed during the year, is a prime example of this. Vördur enjoys a strong position on the insurance market, has a 10% market share and is popular among its customers. The insurance services offered by Vördur are therefore key to Arion Bank’s strategy of offering universal financial services to its customers.

Information technology played a central role during the year. We focused on the IT set-up at the Bank and in January 2017 an agreement to outsource some services to Nýherji was reached. Nýherji is one of Iceland’s leading IT companies and is now responsible for operating the Bank’s IT systems. We continue to have a dedicated team in the Bank’s IT division, the majority of whom are engaged in software development, and Arion Bank introduced a range of new digital solutions for its customers during the year. For example, customers can now obtain a confirmed credit appraisal via the Bank’s website in just a few minutes. We will continue in this direction as our customers want to be able to attend to their finances whenever and wherever it suits them and we will continue to do our utmost to meet their needs. Demand for financial services is thus evolving and we strive to develop alongside these changes.

During the spring Arion Bank opened a branch at Keflavík International Airport and in doing so took over all financial services at the airport, one of Iceland’s largest market places. Tourism has undergone enormous growth in Iceland and so this represents an exciting opportunity for us.

Our subsidiaries are integral to the Bank’s strategy and product offering. Key subsidiaries besides Vördur are Iceland’s largest fund management company Stefnir and the payment services company Valitor. Valitor is vigorously expanding its operations in Denmark and the United Kingdom. Income from Valitor’s international operation grew by 50% in 2016 and now represents more than 60% of total revenue. The company has had a presence on these markets for many years and is now firmly establishing itself. By acquiring Vördur and investing in Valitor’s overseas business Arion Bank is laying stronger foundations for the Group and preparing for the future.

The Bank issued bonds in euros to a broad group of investors on two occasions during the year. At the beginning of 2017 the Bank tapped the second issue which now amounts to €500 million. The Bank’s terms on the international credit market have improved markedly recently, clear testament to the growing confidence of bond investors in the Bank and the Icelandic economy. Standard & Poor’s also upgraded the Bank’s credit rating from BBB-/A-3 to BBB/A-2 during the year.

It is disappointing that the authorities have decided to extend the bank levy, which was supposed to be a temporary measure but is now part of the long-term fiscal policy. The bank levy is a tax on banks’ funding. Other sectors in Iceland or international banks with operations in Iceland and which lend to Icelandic companies are not subject to such tax. This is a special tax which makes it difficult for banks to be competitive, both on the domestic market and also with international financial institutions on the Icelandic market. It means that banks are competing domestically with pension funds to provide mortgages, yet pension funds do not pay income tax, financial sector tax or the bank levy. It is clear that there is not a level playing field on this market with this kind of government intervention. In 2016 Arion Bank paid ISK 5 billion in taxes which other sectors are not subject to. The bank levy has had a limited impact on the banks’ pricing so far as it was only designed to be a temporary measure. As the bank levy is placed on the banks’ funding, it results in higher costs for customers and eventually leads to higher interest rates in Iceland. It is important that this form of taxation be reviewed.

Last summer Kaupthing hf, which owns 87% of Arion Bank, and Arion Bank issued a joint statement in which it was announced that Arion Bank and Kaupthing were examining the options regarding Kaupthing’s shareholding in the Bank. An IPO was cited as one of the options being examined. We and Kaupthing continue to explore all options with respect to its shareholdings.”



HIGHLIGHTS OF 2016

First quarter

- An agreement was reached with Kaupthing on the issue of a \$747 million (ISK 97 billion) bond to offset loans in foreign currency, taken by Arion Bank from the Central Bank of Iceland and later purchased by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. The bond bears floating LIBOR plus 2.6% margin for the first two years and will then be repriced at market terms.
- The subsidiary BG12 slhf. completed the sale of its 46% holding in Bakkavor Group Ltd. in a sale process arranged by Barclays.
- Ida Brá Benediktsdóttir was appointed managing director of Investment Banking at Arion Bank. Ida Brá has been with the Bank since 1999.

Second quarter

- In April the Bank issued €300 million in bonds. The 3-year instruments were priced at 2.7% margin over interbank rates and were heavily oversubscribed.
- At the beginning of May Arion Bank took over all banking operations at Keflavík International Airport. The new branch provides round the clock services during the peak season from May to October, resulting in the recruiting of dozens of new employees.
- In June the sale of Visa Europe Ltd. to Visa Inc. was announced. Valitor owned a stake in Visa Europe and this transaction generated considerable gains for the group. Arion Bank group netted ISK 5,291 million in the transaction after taking into account Landsbankinn's share of the proceeds. When Arion Bank acquired Landsbankinn's holding in Valitor at the end of 2014, an agreement was reached on the seller's share of the sale price in Visa Europe if the company were to be subsequently sold.

Third quarter

- At the end of July the Bank sold a major stake in its subsidiary Kolufell ehf., which owns land and building rights at Austurbakki 2 in Reykjavík, adjacent to the Harpa Concert Hall. Construction has commenced on the site and residential and commercial property will be built there over the next three years.
- At the end of September 46 employees from different divisions and locations at the Bank were made redundant. Changing financial services with increasing levels of automation and self-service necessitated changes and the redundancies were part of a broader range of measures to streamline the Bank's operations.
- Arion Bank acquired 100% of the share capital of the insurance company Vördur hf. In October 2015 a deal was reached on the Bank's acquisition of the company from the Faroese bank BankNordik. The agreement was subject to the approval of the regulatory authorities. All conditions were met at the end of September 2016.
- The Bank paid off in full its subordinated loan in foreign currency from the government which had been provided in connection with the recapitalization of the Bank at the beginning of 2010. Most of the loans granted by the authorities when the Bank was founded have now been repaid.

Fourth quarter

- At the end of November the Bank issued a 5-year bond in the amount of €300 million on the international markets. The bond was priced at 1.65% margin over interbank rates, considerably lower than in the last issue in euros.
- Only one new company, Skeljungur, was listed on the Icelandic stock market in 2016. Arion Bank arranged the listing in collaboration with Íslandsbanki at the end of November. The offering was oversubscribed threefold. A total of 31.5% in the company was sold to 2,000 investors.
- At the end of the year an agreement was reached with Nýherji on the operation and servicing of Arion Bank's IT systems. More than 20 employees from Arion Bank's IT division transferred to Nýherji at the beginning of 2017.

During the year

- Arion Bank continued to issue covered bonds and commercial paper on a regular basis. A total of ISK 24.8 billion were issued in covered bonds and ISK 24.5 billion in commercial paper during the year.
- The Bank has placed great importance on having a diverse funding base. To this end it has held smaller private placements to international investors in various currencies with durations of 1-5 years at favourable terms. These issues totalled ISK 11.1 billion in 2016.
- Arion Bank and its advisers made preparations for possible changes to the Bank's ownership structure. Kaupthing ehf. and Arion Bank are now evaluating the options for Kaupthing's 87% shareholding in Arion Bank. The situation is expected to be clarified in 2017.



INCOME STATEMENT

<i>In ISK million</i>	2016	2015	Diff	Diff%
Net interest income	29,900	26,992	2,908	11%
Net commission income	13,978	14,484	(506)	(3%)
Net financial income	5,162	12,844	(7,682)	(60%)
Net insurance income	1,395	760	635	84%
Share of profit of associates	908	29,466	(28,558)	(97%)
Other operating income	2,096	1,624	472	29%
Operating income	53,439	86,170	(32,731)	-38%
Salaries and related expense	(16,659)	(14,892)	(1,767)	12%
Other operating expenses	(13,880)	(12,919)	(961)	7%
Bank Levy	(2,872)	(2,818)	(54)	2%
Net change in valuation	7,236	(3,087)	10,323	-
Net earnings before taxes	27,264	52,454	(25,190)	-48%
Income tax	(6,410)	(3,135)	(3,275)	104%
Net earnings from continuing operation	20,854	49,319	(28,465)	-58%
Net gain from disc. operations	888	360	528	147%
Net earnings	21,742	49,679	(27,937)	-56%

Operating income amounted to ISK 53.4 billion, compared with ISK 86.2 billion in 2015. The main changes between years are in net financial income and the share of profit of associates which were significant in 2015 due to valuation changes and earnings from the sale of shareholdings in connection with the stock market listing and sale of the companies.

Net interest income increased by 11% from the previous year. The net interest margin as a percentage of average interest-bearing assets was 3.1% in 2016, compared with 3.0% in 2015. The growth of net interest income is mainly due to an increase in interest-bearing assets, new lending and cash for equity positions.

Net commission income decreased by 3% between years, primarily as a result of an exceptionally high level of activity in investment banking in 2015 following a number of IPOs and a difficult environment in the foreign operations of card and payment solutions at the subsidiary Valitor. Approximately 80% of net commission income originates from corporate clients. Valitor has greatly expanded its business in the Nordic countries and the United Kingdom. The company is experiencing rapid growth but the positive impact on net commission income will not materialize until the next few financial periods, as is generally the case with growth companies. There was an increase in commission income in retail banking from the previous year, partly due to the opening of a branch at Keflavík International Airport in early 2016.

Net financial income amounted to ISK 5,162 million, compared with ISK 12,844 million for 2015. Realized gain on the sale of Valitor's shareholding in Visa Europe Ltd. to Visa Inc. amounted to ISK 5,291 million in the second quarter of 2016. Net financial income from other financial assets was satisfactory during the second half and partly offsets the loss generated in the first half of 2016 due to challenging market conditions, particularly on equities. Dividend income amounted to ISK 2,280 million, compared with ISK 7,954 million for 2015. The appreciation of the Icelandic króna resulted in a foreign exchange loss of ISK 1,253 million in 2016, particularly by subsidiaries.

Net insurance income amounted to ISK 1,395 million, compared with ISK 760 million for 2015. The increase is because of the acquisition of the insurance company Vördur at the end of September 2016.

Share in the profit of associates amounted to ISK 908 million, compared with ISK 29,466 million in 2015. Last year this item was heavily influenced by valuation changes and the sale of shareholdings in connection with the stock market listing of companies in 2015, whereas the main factor this year is the profit from sale of a shareholding in Bakkavor Group Ltd. in the first quarter of 2016.

Other operating income increased by ISK 472 million from the previous year and amounted to ISK 2,096 million in 2016. The increase is mainly related to profits from the sale of assets during the period.



Operating expenses amounted to ISK 30,540 million, compared with ISK 27,811 million in 2015. The Bank's cost-to-income ratio was 57.2%, compared with 32.6% in 2015. This substantial increase in the cost-to-income ratio is mostly attributable to high income from valuation changes in equities and profits from the sale of assets in 2015. The cost-to-assets ratio was 3.0%, compared with 2.9% in 2015.

Salaries and related expenses amounted to ISK 16,659 million in 2016, an increase of 12% from the previous year. The increase is mainly a result of renewed wage agreements, a rise in the number of employees, partly related to acquisition of Vördur, as well as expenses in relation to the redundancy of 46 employees at the end of September. The average salary per employee increased by 7.1% from 2015, but at the same time the salary index rose by 11.3%. Full-time equivalent positions at the end of year totalled 1,239 at the Group, 92 more than at the end of 2015. The increase is largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect are the acquisition of the insurance company Vördur, the growth of Valitor internationally and the opening of a new branch at Keflavik International Airport.

Net valuation change was positive by ISK 7,236 million in 2016. The positive net impairment is in particular due to the revaluation of acquired mortgages in the third quarter.

Income tax amounted to ISK 6,410 million, compared with ISK 3,135 million in 2015. Income tax, as reported in the annual financial statements, comprises 20% income tax on earnings and a special 6% financial tax on the earnings of financial undertakings in excess of ISK 1 billion. The effective income tax rate was 23.5%, compared with 6.0% in 2015. The unusually low effective income tax rate in 2015 is mainly explained by tax exempt earnings at corporates relating to valuation changes and profits on equity positions. Total taxes paid by financial undertakings remain higher than those paid by other companies operating in Iceland. Taxes paid specifically by the Bank as a financial institution amount to ISK 5.0 billion.

Adjusted earnings

Arion Bank's **adjusted earnings** amounted to ISK 9,737 million in 2016.

	2016	Adjustment	Adjusted
Net interest income	29,900	530	30,430
Net commission income	13,978	81	14,059
Net financial income	5,162	(4,240)	922
Net insurance income	1,395	-	1,395
Share of profit of associates	908	(912)	(4)
Other operating income	2,096	(110)	1,986
Operating income	53,439	(4,651)	48,788
Salaries and related expense	(16,659)	320	(16,339)
Other operating expenses	(13,881)	1,474	(12,407)
Bank levy	(2,872)	-	(2,872)
Net impairment	7,236	(11,275)	(4,039)
Earnings before tax	27,263	(14,132)	13,131
Income tax	(6,410)	2,130	(4,280)
Net gain from disc. operations	886	-	886
Net earnings	21,739	(12,002)	9,737

Net interest income and net commission income are relatively stable but income from shareholdings and bonds tends to fluctuate. There was a considerable year-on-year increase in operating expenses, which was mainly related to higher salaries under new wage agreements. In respect of adjusted operations Arion Bank makes adjustments for capital gains and valuation changes in acquired equity positions, the effect of subsidiaries engaged in unrelated operations, a one-off expense due to redundancies and professional services, and valuation changes in loans. Taking the above factors into account, net earnings in 2016 decreased by ISK 12,002 million to ISK 9,737 million. Return on equity from adjusted operations was 4.7%, compared with 8.7% in 2015. The cost-to-income ratio for adjusted operations was 58.3%, compared with 54.1% in 2015.



Fourth quarter of 2016

The financial results for the fourth quarter of 2016 were good but do not compare favourably with Q4 2015 where one-off items had a significant impact.

<i>In ISK million</i>	Q4 2016	Q4 2015	Diff	Diff%
Net interest income	7,842	6,705	1,137	17%
Net commission income	3,765	3,757	8	0%
Net financial income	823	2,669	(1,846)	(69%)
Net insurance income	731	216	515	238%
Share of profit of associates	198	22,510	(22,312)	(99%)
Other operating income	431	200	231	116%
Operating income	13,790	36,057	(22,267)	-62%
Salaries and related expense	(4,407)	(4,571)	164	(4%)
Other operating expenses	(3,803)	(4,169)	366	(9%)
Bank Levy	(682)	(650)	(32)	5%
Net change in valuation	409	(2,972)	3,381	-114%
Net earnings before taxes	5,307	23,695	(18,388)	-78%
Income tax	(1,149)	504	(1,653)	-328%
Net earnings from continuing operation	4,158	24,199	(20,041)	-83%
Net gain from disc. operations	317	83	234	282%
Net earnings	4,475	24,282	(19,807)	-82%

Operating income in the fourth quarter was ISK 13,790 million, considerably lower than in 2015, mainly due to positive fair value changes of Bakkavor Group Ltd. in the fourth quarter 2015 in connection with the sale of the company in early 2016. Net interest income increased by 17% between years but net commission income was the same. Net financial income was ISK 823 million as a result of solid returns on securities in general. Currency exchange difference was negative by ISK 424 million during the quarter.

Operating expenses decreased slightly between quarters due to a decrease in the main components, except for professional services.

Net change in valuation was positive in the fourth quarter and amounts to ISK 409 million, compared with a high negative amount in 2015.

BALANCE SHEET

Arion Bank's **total assets** increased by 2% from the previous year. The main changes result from increases in balances with the Central Bank and loans to customers. Loans to credit institutions, investments in associates and financial assets decreased, however.

<i>In ISK million</i>	31.12.2016	31.12.2015	Diff	Diff%
Cash & balances with CB	87,634	48,102	39,532	82%
Loans to credit institutions	80,116	87,491	(7,374)	(8%)
Loans to customers	712,422	680,350	32,072	5%
Financial assets	117,456	133,191	(15,735)	(12%)
Investment property	5,358	7,542	(2,184)	(29%)
Investments in associates	839	27,299	(26,461)	(97%)
Intangible assets	11,057	9,285	1,772	19%
Other assets	21,142	17,783	3,359	19%
Total assets	1,036,024	1,011,043	24,981	2%

Loans to customers totalled ISK 712,422 million at the end of 2016, a 5% increase from year-end 2015. Loans to corporates increased by 5%, or ISK 19 billion, during the year. These new loans are mainly in real estate activities and industry, energy and manufacturing. Mortgage loans to individuals increased by 5% in 2016. The quality of loans to customers continues to improve. The ratio of problem loans decreased from 2.5% to 1.6% during the



year. The Bank defines problem loans as the ratio of the book value of loans 90 days or more in default and loans for which special impairment is required to the Bank's total loans to customers. The proportion of impaired loans decreased from 4.7% at the end of 2015 to 3.2% at the end of 2016.

Financial assets amounted to ISK 117,456 million at the end of 2016, compared with ISK 133,191 million at the end of 2015. Financial assets decreased due to the sale of assets, including the sale of holdings in Visa Europe Ltd. as well as due to a decrease in market value. Changes in financial assets are also related to liquidity management.

Investment in associates decreased significantly from year-end 2015, mainly due to the sale of shareholdings in Bakkavor Group Ltd. in January 2016.

Liabilities increased between years, which is primarily a result of new borrowings. **Equity** increased as a result of the financial results in 2016. **Non-controlling interest** decreased due to the disbursement of share capital and dividend payment of the subsidiary BG12 (owner of shareholding in Bakkavor Group Ltd.) and due to the sale of a large shareholding in the subsidiary Kolufell in 2016.

<i>In ISK million</i>	31.12.2016	31.12.2015	Diff	Diff%
Due to credit institutions & CB	7,987	11,387	(3,400)	(30%)
Deposits from customers	412,064	469,347	(57,283)	(12%)
Financial liabilities at fair value	3,726	7,609	(3,883)	(51%)
Other liabilities	61,387	54,383	7,004	13%
Borrowings	339,476	256,058	83,418	33%
Subordinated loans	-	10,365	(10,365)	(100%)
Shareholders equity	211,212	192,786	18,426	10%
Non-controlling interest	172	9,108	(8,936)	(98%)
Total liabilities and equity	1,036,024	1,011,043	24,980	2%

Borrowings amounted to ISK 339,476 million at the end of the year. In January 2016 the Bank reached an agreement with Kaupthing regarding FX deposits held at Arion Bank to be converted into an issued EMTN bond in US dollars and that Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion at year-end 2015. The total issue was ISK 97 billion (\$747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of \$165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and therefore prepayments of ISK 57 billion (\$490 million) were made in 2016. At year-end outstanding bonds held by Kaupthing amounted to ISK 29.3 billion (\$258 million).

The Bank issued a new 3-year €300 million bond in April and 5-year €300 million bond in November, which have been trading favourably on the market as other bonds issued by Arion Bank. The Bank has also continued to issue covered bonds in the Icelandic market, a total of ISK 24.8 billion during the year.

Subordinated loans were paid up at the end of third quarter. Approximately 2/3 of the loan had been prepaid in 2015 and the remaining part was paid up in 2016 following a successful issue of bonds in the international market during the year.

Shareholders' equity amounted to ISK 211,212 million at the end of 2016, compared with ISK 192,786 million at the end of 2015. The increase is explained by the financial results for the year. The Tier 1 ratio was 26.5% at the end of 2016, compared with 23.4% at the end of 2015. No dividends were paid during 2016.



KEY PERFORMANCE INDICATORS

	2016	2015
Return on equity (ROE)	10.5%	28.1%
Return on total assets (ROA)	2.1%	5.0%
Net interest margin (int. bearing assets)	3.1%	3.0%
Net interest margin (total assets)	2.9%	2.7%
Cost-to-income ratio	57.2%	32.6%
Cost-to-Total assets ratio	3.0%	2.9%
Effective tax rate	23.5%	6.0%
CAD ratio	27.1%	24.2%
Tier 1 ratio	26.5%	23.4%
Problem loans	1.6%	2.5%
Gross impaired loans/Gross loans	3.2%	4.7%
RWA/Total assets	72.7%	79.9%
Loans to deposit ratio	172.9%	145.0%
The Group's average number of employees	1,201	1,139
The Group's employees at the end of the period	1,239	1,147
The Parent's average number of employees	889	885
The Parent's employees at the end of the period	869	876

CONFERENCE CALL IN ENGLISH

Arion Bank will be hosting a conference call in English on Tuesday 14 February at 1:00 pm GMT, where Stefán Pétursson, Chief Financial Officer, will discuss the highlights of the Bank's financial results. People interested in participating can contact ir@arionbanki.is to obtain dial-in information.

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FINANCIAL CALENDAR FOR 2017

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

Annual general meeting 2017	9 March 2017
First quarter 2017	11 May 2017
Second quarter 2017	23 August 2017
Third quarter 2017	14 November 2017

This calendar may be subject to change.