Earnings release, 31 August 2016

ARION BANK'S H1 2016 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 9.8 billion for the first six months of 2016, compared with ISK 19.3 billion for the same period of 2015. Return on equity was 9.5%, compared with 22.8% for the first six months of 2015. Normalized earnings amounted to ISK 2.8 billion, compared with ISK 7.8 billion in the first half of 2015. Return on equity from normalized operations was 2.8%, compared with 9.8% for the same period last year.

Total assets amounted to ISK 1,035.0 billion at the end of June, compared with ISK 1,011.0 billion at the end of 2015. Shareholders' equity totaled ISK 199.2 billion at the end of June, compared with ISK 192.8 billion at the end of 2015. The Bank enjoys a strong financial position and there has been a focus on maintaining solid liquidity as the time for lifting the capital controls approaches.

The Bank's capital ratio at the end of the period was 27.8%, compared with 24.2% at the end of 2015. Tier 1 Capital increased during the year to 26.8%, compared with 23.4% at the end of 2015.

Highlights of the income statement and key performance indicators:

In ISK million	**H1 2016**	**H1 2015**	**Q2 2016**	**Q2 2015**
Net interest income	14,626	13,175	7,353	7,392
Net commission income	6,747	7,434	3,528	3,677
Net financial income	3,495	9,723	3,796	2,184
Share of profit of associates	694	4,217	17	6
Other operating income	1,861	1,523	626	1,032
Operating income	**27,423**	**36,072**	**15,320**	**14,291**
Salaries and related expense	(8,426)	(7,167)	(4,318)	(3,675)
Other operating expenses	(6,970)	(6,004)	(3,736)	(3,108)
Bank levy	(1,485)	(1,389)	(743)	(659)
Net impairment	945	(81)	1,448	(1,863)
Net earnings before taxes	**11,487**	**21,431**	**7,971**	**4,986**
Income tax	(2,091)	(2,367)	(1,354)	(647)
Net gain from disc. operations	363	262	259	79
Net earnings	**9,759**	**19,326**	**6,876**	**4,418**
KPI's:				
Return on equity (ROE)	9.5%	22.8%	13.3%	10.2%
Net interest margin (int. bearing assets)	3.1%	3.0%	3.1%	3.3%
Cost-to-income ratio	56.1%	36.5%	52.6%	47.5%
Tier 1 ratio	26.8%	21.8%	26.8%	21.8%

HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK:

"Arion Bank's financial results for the first half of 2016 did not meet expectations. The Bank nevertheless performed satisfactorily in its regular operations but external conditions had a negative impact. There was strong growth in loans, particularly to corporate clients. Corporate loans grew 8% during the first half of 2016 and net interest income was up 11%. Arion Bank is well prepared for the changes which the lifting of the capital controls will bring, being financially robust and with strong liquidity.

The conditions on the financial markets were negative for the Bank during the period. As a result, with the exception of Valitor's sale of its shareholding in Visa Europe, financial income was below expectations and the Bank recorded a substantial loss on its shareholdings in listed companies. Arion Bank arranged all IPOs in Iceland in 2015 but no new stock market listings have taken place this year and this affects the Bank's commission income. Operating expenses have increased. The main factor in this respect is higher salary expenses, particularly as a consequence of new collective wage agreements. A second reason is the growth in the number of employees, not least at the new branch at Keflavík International Airport which was opened in May and is now open round the clock every day of the year. The new branch represents a great opportunity for us. More employees were also hired at Valitor, which continues to invest in expanding its business internationally.

Arion Bank has been the leading Icelandic bank in terms of new funding on the international financial markets. In April Arion Bank issued its second bond in euros to a diverse group of investors at better terms than the bond issued a year earlier. These issues have met with great success and their performance on the secondary market has demonstrated that there is strong demand for bonds issued by Arion Bank. The Bank has also issued covered bonds and commercial paper on the Icelandic market and this has had a positive response."

CONFERENCE CALL IN ENGLISH

Arion Bank will be hosting a conference call in English on Thursday 1 September 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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INCOME STATEMENT

In ISK million	H1 2016	H1 2015	Diff	Diff%
Net interest income	14,626	13,175	1,451	11%
Net commission income	6,747	7,434	(687)	(9%)
Net financial income	3,495	9,723	(6,228)	(64%)
Share of profit of associates	694	4,217	(3,523)	(84%)
Other operating income	1,861	1,523	338	22%
Operating income	**27,423**	**36,072**	**(8,649)**	**-24%**
Salaries and related expense	(8,426)	(7,167)	(1,259)	18%
Other operating expenses	(6,970)	(6,004)	(966)	16%
Bank Levy	(1,485)	(1,389)	(96)	7%
Net change in valuation	945	(81)	1,026	-
Net earnings before taxes	**11,487**	**21,431**	**(9,944)**	**-46%**
Income tax	(2,091)	(2,367)	276	-12%
Net earnings from continuing operation	**9,396**	**19,064**	**(9,668)**	**-51%**
Net gain from disc. operations	363	262	101	39%
Net earnings	**9,759**	**19,326**	**(9,567)**	**-50%**

Operating income amounted to ISK 27.4 billion, compared with ISK 36.1 billion in the first six months of 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.

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% during the first half of 2016, compared with 3.0% for the same period in 2015. The increase in 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 9% between years, primarily as a result of less activity in investment banking. 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 and the positive impact on net commission income will not materialize until the next few financial periods, as is generally the case for growth companies. The effect of the Bank's new branch at Keflavík International Airport has yet to fully emerge in commission income.

Net financial income amounted to ISK 3,495 million, compared with ISK 9,723 million for the first six months of 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 first half of 2016, which is partly off-set by loss from financial assets due to unfavorable market conditions and the strengthening of the krona during the period.

Share in the profit of associates amounts to ISK 694 million during the first half of 2016, compared with ISK 4,217 million during the same period of 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.

Other operating income increased by ISK 338 million from the previous year and amounted to ISK 1,861 million in the first half of 2016. The increase is mainly related to profits from the sale of assets during the period.

Operating expenses amounted to ISK 15,936 million during the first six months of 2016, compared with ISK 14,641 million during the same period of 2015. The Bank's cost-to-income ratio was 56.1% during the period, compared with 36.5% in 2015. This substantial increase in the cost-to-income ratio is almost entirely attributable to high income from valuation changes in equities and asset sales in the first half of 2015. The cost-to-assets ratio was 3.0%, compared with 2.7% for the first six months in 2015.

Salaries and related expenses amounted to ISK 8,426 million during the period, an increase of 18% from the first six months of 2015. The increase is mainly a result of renewed wage agreements and a rise in the number of employees. The average salary per employee increased by 14.3% from the same period in 2015 but at the same time the salary index rose by 13.1%. Full-time equivalent positions at the end of June were 1,199 at the Group, 76 more than at the end of June 2015. The increase is largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect are the growth of Valitor internationally and the opening of a new branch at Keflavik International Airport.

Net valuation change was positive by ISK 945 million during the first half of 2016. There were considerable valuation increases in loans to corporates as a result of settlement of loans, but this was partly offset by a valuation decrease in mortgages to individuals following the government's debt relief package at the beginning of 2015.

Income tax amounted to ISK 2,091 million, compared with ISK 2,367 million during the first six months of 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 institutions in excess of ISK 1 billion. The effective income tax rate was 18.2% during the first six months of 2016, compared with 11.0% in the same period of 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 remain higher than those paid by other companies operating in the Icelandic economy. Taxes paid specially by the Bank as a financial institution amount to ISK 2.4 billion.

Arion Bank's **normalized earnings** in the first half of 2016 were lower than the same period in 2015. 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 normalized operations Arion Bank makes adjustments for capital gains and valuation changes in acquired equity positions, the temporary bank levy, the effect of subsidiaries engaged in unrelated operations and partly valuation changes in loans. Taking the above factors into account, net earnings for the first half of 2016 decreased by ISK 6,944 million to ISK 2,185 million. Return on equity from normalized operations in the first half of 2016 was 2.8%, compared with 9.8% for the first half of 2015. The cost-to-income ratio for normalized operations was 65.6% during the first half of 2016, compared with 49.8% for the same period in 2015.

Second quarter of 2016

The financial results for the second quarter of 2016 were good. Return on equity was 10.2%, compared with 13.3% in the same period of 2015.

In ISK million	**Q2 2016**	**Q2 2015**	**Diff**	**Diff%**
Net interest income	7,353	7,392	(39)	(1%)
Net commission income	3,528	3,677	(149)	(4%)
Net financial income	3,796	2,184	1,612	74%
Share of profit of associates	17	6	11	183%
Other operating income	626	1,032	(406)	-39%
Operating income	**15,320**	**14,291**	**1,029**	**7%**
Salaries and related expense	(4,318)	(3,675)	(643)	17%
Other operating expenses	(3,736)	(3,108)	(628)	20%
Bank Levy	(743)	(659)	(84)	13%
Net change in valuation	1,448	(1,863)	3,311	-178%
Net earnings before taxes	**7,971**	**4,986**	**2,985**	**60%**
Income tax	(1,354)	(647)	(707)	109%
Net earnings from continuing operation	**6,617**	**4,339**	**2,278**	**53%**
Net gain from disc. operations	259	79	180	228%
Net earnings	**6,876**	**4,418**	**2,458**	**56%**

Operating income in the second quarter increased by 7% between years. Net interest income was similar to the second quarter of 2015 but net commission income decreased slightly. Net financial income was ISK 3,796 million and was positively affected by the sale of Valitor's shareholding in Visa Europe Ltd. to Visa Inc. in June. Net profit from the sale of the shareholding amounted to ISK 5,291 million but other equity holdings returned a net loss and there was a negative currency exchange difference during the period. Other operating income decreased between years, mainly due to higher income from investment property in 2015.

Operating expenses increased between the quarters due to higher salary expenses as a result of renewed wage agreements and higher IT expenses, expenses on professional services and marketing expenses.

BALANCE SHEET

Arion Bank's ***total assets*** increased by 2% from year end 2015. The main changes result from increases in balances with Central Bank and loans to customers. Investments in associates and financial assets decreased, however.

In ISK million	**30.06.2016**	**31.12.2015**	**Diff**	**Diff%**
Cash & balances with CB	77,108	48,102	29,006	60%
Loans to credit institutions	85,607	87,491	(1,884)	(2%)
Loans to customers	713,136	680,350	32,786	5%
Financial assets	121,246	133,191	(11,945)	(9%)
Investment property	6,487	7,542	(1,054)	(14%)
Investments in associates	904	27,299	(26,395)	(97%)
Intangible assets	9,152	9,285	(133)	(1%)
Other assets	21,363	17,783	3,580	20%
Total assets	**1,035,003**	**1,011,043**	**23,959**	**2%**

Loans to customers totaled ISK 713,136 million at the end of June, a 5% increase from year end 2015. Loans to corporates increased by 8% during the first half of 2016 or by ISK 30 billion. These new loans are mainly in industry, energy and manufacturing, real estate activities and wholesale and retail. Mortgage loans to individuals were virtually unchanged from year end 2015. The quality of loans to customers continues to increase. The ratio of problem loans decreased from 2.5% to 1.9% during the first six months of 2016. 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 3.8% at the end of June 2016.

Financial assets amounted to ISK 121,246 million at the end of June, compared with ISK 133,191 million at the end of 2015 and decreased due to the sale of assets, including the sale of holdings in Visa Europe Ltd, and a decrease in market value.

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

Liabilities increased slightly between years, which is primarily a result of new borrowings. ***Equity and minority interest*** increased as a result of the first half 2016 financial results.

In ISK million	**30.06.2016**	**31.12.2015**	**Diff**	**Diff%**
Due to credit institutions & CB	8,018	11,387	(3,369)	(30%)
Deposits from customers	423,089	469,347	(46,258)	(10%)
Financial liabilities at fair value	4,722	7,609	(2,887)	(38%)
Other liabilities	50,892	54,383	(3,491)	(6%)
Borrowings	329,885	256,058	73,827	29%
Subordinated loans	9,553	10,365	(812)	(8%)
Shareholders equity	199,239	192,786	6,453	3%
Non-controlling interest	9,605	9,108	497	5%
Total liabilities and equity	**1,035,003**	**1,011,043**	**23,960**	**2%**

Borrowings amounted to ISK 329,885 million at the end of June. In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of $747.8 million (ISK 97 billion). The bond was issued under Arion Bank's EMTN programme and is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% interest for the first two years and will then be repriced at market terms. The bond offset loans in foreign currency taken by Arion Bank from the Central Bank of Iceland, owned by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank and explains the decrease in Deposits from customers from year end 2015. The bond issue forms part of capital controls liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015. In April the Bank issued €300 million in 3-year instruments under its EMTN programme. The bonds were issued with a 270 bps premium on Euribor but now have a premium of 130 bps on the secondary market. This is the lowest interest premium of any Icelandic bank. The Bank has continued to issue covered bonds to finance new mortgages and issued ISK 15.3 billion in such bonds in the first half of the year.

Shareholders' equity amounted to ISK 199,239 million at the end of June 2016, compared with ISK 192,786 million at the end of 2015. The increase is explained by the financial results for the period. The Tier 1 ratio was 26.8% at the end of June 2016, compared with 23.4% at the end of 2015.

KEY PERFORMANCE INDICATORS

	H1 2016	2015	H1 2015
Return on equity (ROE)	9.5%	28.1%	22.8%
Return on total assets (ROA)	1.9%	5.0%	4.0%
Net interest margin (int. bearing assets)	3.1%	3.0%	3.0%
Net interest margin (total assets)	2.9%	2.7%	2.7%
Cost-to-income ratio	56.1%	32.6%	36.5%
Cost-to-Total assets ratio	3.0%	2.9%	2.7%
Effective tax rate	18.2%	6.0%	11.0%
CAD ratio	27.8%	24.2%	23.3%
Tier 1 ratio	26.8%	23.4%	21.8%
Problem loans	1.9%	2.5%	3.3%
RWA/Total assets	71.8%	79.9%	74.5%
Loans to deposit ratio	168.6%	145.0%	141.2%
The Group's average number of employees	1,171	1,139	1,118
The Group's employees at the end of the period	1,199	1,147	1,123
The Parent's average number of employees	885	885	850
The Parent's employees at the end of the period	896	876	840

FINANCIAL CALENDAR FOR 2016 AND 2017

The Bank's interim financial statements are scheduled for publication as stated below.

Third quarter 2016	16 November 2016
Financial statements for 2016	23 February 2017
Annual general meeting 2017	16 March 2017
First quarter 2017	10 May 2017
Second quarter 2017	30 August 2017
Third quarter 2017	15 November 2017

This calendar may be subject to change.