

Chairman of the meeting, Shareholders, ladies and gentlemen

Iceland is emerging from one of the greatest economic storms any western economy has ever experienced. With the collapse of the currency and the financial sector the challenges facing the people of Iceland over two years ago were enormous: to restore the economy and create a new financial sector. And the people of Iceland are indeed rising to the challenge. Impressive progress is being made and there is good reason to be optimistic about Iceland's future. Arion Bank, as one of Iceland's largest financial institutions, is playing an important role in the regeneration that is currently taking place.

The all important economic rebuilding process began immediately following the financial collapse of 2008. The economy is showing promising signs of recovery as the fiscal deficit is being addressed and the debt burden of households and corporations is being tackled. There are positive signs of economic growth, unemployment is falling, and Iceland has undergone the fourth review of its IMF program, a program scheduled for completion in August 2011.

Of course there is still some way to go for the Icelandic economy. Currency restrictions remain in place, the Icesave dispute lingers and foreign investment in Iceland is still too low, but good progress is being made that allows for optimism. Iceland is further along the path of economic recovery than many other nations which are still dealing with troubled financial sectors, fiscal deficits and unemployment. In fact, Iceland now has a banking system with no pressing external funding needs and a cleansed asset side.

However, one of the most important things the Icelandic financial sector lost in the crisis was trust; this can only be regained with time and effort. This also holds true about the Icelandic economy as a whole. Along with Arion Bank and other Icelandic financial institutions, the Icelandic government and governmental bodies play a crucial role in rebuilding trust on an international level. The integrity of the legal and regulatory environment needs to be unquestioned and political stability ensured for normality in international relations to be regained and for foreign investment in Iceland to increase.

A strong indication of how the financial system has changed in Iceland in the last couple of years is the great number of requests and inquiries financial institutions receive from different regulatory and supervisory authorities such as the Icelandic Financial Supervisory Authority (FME), the Central Bank of Iceland and the competition authorities. Additionally numerous governmental bodies as well as others continue to investigate the collapse of the financial system with the assistance of the financial sector. This is a very positive development. Nevertheless regulators, supervisory agencies and investigators are still finding their balance in this new reality. Increased cooperation and coordination between governmental bodies in this respect would be welcomed by financial institutions as the related costs are rising to proportionally unsustainable levels for a small financial system like Iceland. These factors, combined with the effect of falling interest rates and the overbanked system in general, will necessitate further rationalization at the Bank.

#### *Financial results*

Arion Bank generally performed well in 2010, despite the challenging economic environment. Its core banking performance was particularly strong in retail banking and asset management. The focus of corporate banking continued to be on recovery work which progressed well during the year. It was only in capital markets and investment banking activities where the performance fell below expectations, mainly as a consequence of the unusual market conditions.

The group structure underwent some changes during the year, the most important being the Bank's acquisition of a larger share in Valitor, during the fourth quarter. Valitor is now a subsidiary of the Bank.



Arion Bank reported a net profit of ISK 12.6 billion in 2010, with operating income increasing to ISK 35.6 billion. The net interest margin increased sharply during the year, primarily as a result of changes to the asset portfolio and falling interest rates. Return on equity was 13.4% during the period.

In the two years since Arion Bank was founded the Bank has established itself as one of Iceland's leading financial institutions. The Bank has 24 branches in Iceland, around 100,000 customers, assets of around ISK 813 billion and a capital ratio of 19%.

The FME has imposed strict conditions to be met by Icelandic financial institutions, including a minimum 16% capital ratio and 20% liquidity ratio. We are pleased to see that our focus on strengthening the Bank's capital base has yielded clear results in recent months. A strong capital ratio evidently reflects this achievement – in the second half of the year the Bank's capital ratio increased by 2.6 percentage points, from 16.4% to 19% and the Tier 1 ratio rose to 15.2%. The Bank's liquidity position is also solid. In fact Arion Bank surpasses all statutory requirements and requirements set by the FME by a comfortable margin.

#### *Uncertainty*

One of the main reasons why a strong capital ratio is important for Arion Bank, as well as other Icelandic financial institutions, is the fact that there still remains uncertainty within the Icelandic financial system.

In February 2011 the Supreme Court of Iceland issued two judgments on currency-linked loans to companies. The court decided that the loans were illegal in the same way as it had in the 2010 judgments which led to new legislation on mortgage loans to individuals. The new judgments create a number of uncertainties over currency-linked loans to smaller companies if such loans were taken to court. The Bank has already allowed for exchange rate adjustment in its accounts in relation to an agreement with the other banks and the authorities. However, if the corporate loans were to be largely deemed illegal the Bank would suffer substantial losses but this would not jeopardize the 16% capital ratio requirement. Again, one of the main reasons for why we have been amassing a capital buffer is to be able to meet such potential losses.

#### *Strategy*

The year 2010 was a positive and significant year in the history of Arion Bank. The ownership structure of the Bank was finalized and a new board of directors and CEO, Höskuldur H. Ólafsson, took the helm at the Bank. This was the year when the strategic direction for the new Bank was set after comprehensive groundwork done by the Bank's management team and employees.

According to the new strategy Arion Bank will remain a universal bank, providing a wide range of services and focusing on tailored and personalized solutions. Special emphasis will be placed on the Bank's ability to meet the needs of those customers, both personal and corporate, who require comprehensive and diverse services. The Bank's competitiveness will be honed by focusing on product offering, efficiency and profitability in operations. The new strategy is currently being implemented, a process which should largely be completed in 2011.

#### *Financial restructuring*

In 2010 one of the most important tasks facing the Icelandic financial sector was the restructuring of household and corporate debt. This is a complex and sensitive issue with a number of financial, economical and ethical considerations. Enormous progress was made in this respect and Arion Bank has been at the forefront of offering solutions to companies and personal customers. Arion Bank has played a key role and has in many ways been leading the way. A large number of Arion Bank's



customers require debt restructuring and it is important to get them back on track as soon as possible in order to further revitalize the economy.

An important milestone was reached in December 2010 when the authorities and credit institutions joined forces to devise ways to help personal banking customers and companies resolve their debt problems. Under this agreement, the debt recovery process will be sped up and a coordinated approach will be adopted to restructuring debt. Arion Bank had already been applying these methods for quite some time.

By the end of the year 563 clients, corporate and SMEs, had already entered the process, while a conclusion had been reached in the cases of 402 of them. We believe that up to 1,000 corporate clients will need to restructure their financing and at the end of February over 840 corporations had entered the process and conclusion had been reached in 640 of them. Our goal is clear: we intend to have completed the restructuring of our loan book, and consequently the debts of our customers, by the end of 2011.

In some cases Arion Bank has been required to take over companies at the end of the recovery process. The Bank has no intention of running companies in other lines of business and these companies are sold at the first feasible opportunity.

Approximately 4,000 private customers of the Bank have taken advantage of the solutions offered by the Bank and a further 10,000 have made use of government measures. Arion Bank has not auctioned any residential properties at distress sales since October 2009.

The solutions offered to individual customers and households experiencing financial difficulties had, by the end of 2010, resulted in ISK 12.8 billion of write-offs of the mortgage loans of these customers.

Arion Bank has also set up a new advisory service designed to help individuals in financial difficulties. Each customer is assigned their own advisor who works with them throughout the recovery process until they find an acceptable outcome. The aim is that within a few months everyone experiencing difficulties in paying their debts will have found a solution. This initiative by the bank has been well received by its customers and 80% of those that we have contacted have responded to that call. We believe that there are still 1500 households customers that will need some kind of financial restructuring.

### *Outlook*

The year 2010 was in many ways a positive one in Arion Bank's short history. We have set the strategic direction, we are well on our way in normalizing our loan book, and last but not least 2010 was the year when the final foundations were secured for the future of the new Bank.

The Bank's near-term prospects are to some extent contingent on its economic environment. Investments in Iceland have been very low in recent quarters but are expected to increase as the projected medium-term economic growth materializes. The progress made in recovery work relating to corporates and individuals will further stimulate growth and investments in the near term. The lifting of capital controls in the near to medium term is likely to have an impact on deposits. The Bank's objective is therefore to extend its funding profile in collaboration with Icelandic and international investors. The relaxation of the capital controls will have a positive effect on the Bank's



commission income through an increase in FX trading, an activity which has been at a low over the last two years.

In other respects the Bank's aim is to continue its success in core banking activities in the Icelandic market. This includes supporting customers with operations abroad. The Bank's strategy is to offer universal banking services to its clients and its business model will take full effect in 2011. We expect more traditional banking operations to play a greater role, and we are optimistic that in the next 12 to 18 months the Icelandic economy will have stabilized and will be on a much firmer footing.

The outlook for 2011 is therefore positive but we must acknowledge that our environment remains uncertain. We have to exercise caution in all our actions. Arion Bank is well positioned to meet the challenges of 2011 as a competitive bank with strong capital ratio which is a crucial factor in the opinion of the Board of Directors and management. In the short term financial strength is the priority, even at the expense of profitability.

We have been given a unique opportunity, and we have all the tools we need to secure Arion Bank's position as a leading player on the Icelandic market.

I wish to thank my co-directors, the management and all the employees of the Bank for their considerable contribution over the year.