



## Condensed Consolidated Interim Financial Statements

1 January - 30 September 2010

Unaudited

Arion banki hf.  
Borgartún 19  
105 Reykjavík  
Iceland

Reg. no. 581008 - 0150

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

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The Unaudited Condensed Consolidated Interim Financial Statements of Arion banki hf. for the period ended 30 September 2010 include the Interim Financial Statements of Arion banki hf. and its subsidiaries, together referred to as "the Bank".

Consolidated net earnings amounted to ISK 8,913 million for the period ended 30 September 2010. Consolidated total equity amounted to ISK 102,629 million at the end of the period, including share capital amounting to ISK 2,000 million. The Core Tier 1 ratio of the Bank, calculated in accordance with Article 84 of the Act on Financial Undertakings, was 14.5%, exceeding the minimum legal requirement of 8%. The total Capital Adequacy ratio at 30 September 2010 was 18.1%. The conditions of the Bank's operating license granted by the Financial Supervisory Authority ("FME") require the Bank to be capitalized with a minimum Capital Adequacy ratio of 16%, of which the Core Tier 1 ratio must be above 12%. The Bank complied with both conditions as at 30 September 2010.

A mismatch in Arion banki hf. foreign currency balance means that the net earnings are very sensitive to changes in the exchange rate. The ISK strengthened by 11.0 % against a trade weighted currency basket during the period resulting in a net foreign exchange loss of ISK 1,816 million. The bank's objective is to decrease the FX mismatch in the near term.

In 2009 the Bank was entirely owned by the Icelandic State. On 8 January 2010, following approval by the Annual Shareholders Meeting, an 87% shareholding was transferred from the Icelandic State to Kaupskil ehf. The Icelandic State remains a 13% shareholder of the Bank.

On 1 July 2010 Sparisjóður Mýrasýslu merged into Arion banki hf. This legal entity has been accounted for as a subsidiary in the Consolidated Financial Statements of the Bank and thus the merger has no financial effects on the Consolidated Interim Financial Statements for the period ended 30 September 2010.

On 24 August 2010 the Bank sold its 100% shareholding in Penninn Holding 1 Oy. The net income from this sale was 524 million ISK and is reflected through other income in the Consolidated Interim Statement of Comprehensive Income.

## **FX loan status**

The Bank faces uncertainty regarding FX denominated loans in Iceland. By two very similar judgements on 16 June 2010, the Supreme Court in Iceland stated that two car loans were in fact loans in ISK and exchange-rate linked (rather than loans agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation indeed made such indexation illegal. These judgements were mainly based on the wording of the respective loan documents involved. By a judgement on 16 September 2010, the Supreme Court stated that a loan agreement, which was thought to be in ISK and exchange-rate linked, should bear the non-indexed interest rates decided by the Central Bank of Iceland.

On 16 September 2010, the Minister of Business Affairs announced that he would put forward a bill of law regarding loans in foreign currency to individuals, in which it would be stated that these individuals should be treated in the same way, regardless of wording in their loan agreement.

On 11 November 2010, the proposed bill of law was put before Parliament, where it is expected to have majority backing. The bill is expected to address many uncertainties regarding the calculation of interest and the netting of overpayments against remaining principal, but it is not known which changes Parliament will make before the final vote.

## **Outlook**

The Bank's exposures are mostly concentrated within Iceland. The economic environment continues to pose a challenge to the operations of the bank and the reconstruction of assets will continue to be of utmost importance for the performance of the Bank.

The Bank has already made considerable progress in its reconstruction efforts and expects to have concluded work on larger companies in mid year 2011. The number of loans to individuals is substantially larger and reconstruction work thereon is expected to take more time. Despite the fact that the Bank's knowledge on these assets has appended there is still considerable uncertainty about the effect of their valuation on the Balance Sheet of the Bank.

Continuous efforts will be made to increase operational efficiency, to improve Corporate Governance procedures and to reduce the Bank's currency imbalance. Additionally the Bank will focus on diversifying both its loan portfolio as well as its funding sources and on extending the maturity profile of its funding.

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

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## Statement by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements for the period ended 30 September 2010 have been prepared in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting* as adopted by the EU.

It is our opinion that the Condensed Consolidated Interim Financial Statements give a true and fair view of the consolidated financial performance of the Bank for the period ended 30 September 2010, its consolidated financial position as at 30 September 2010 and its consolidated cash flows for the period ended 30 September 2010.

Further, in our opinion the Condensed Consolidated Interim Financial Statements and the Endorsement of the Board of Directors and the CEO gives a fair view of the development and performance of the Bank's operations and its position and describes the principal risks and uncertainties faced by the Bank.

The Board of Directors and the CEO have today discussed the Condensed Consolidated Interim Financial Statements of Arion banki hf. for the period ended 30 September 2010 and confirm them by means of their signatures.

Reykjavík, 22 November 2010

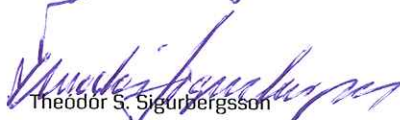
### Board of Directors



Monica Caneman  
Chairman



Guðrún Johnsen



Theodor S. Sigurbergsson



Kristján Jóhannsson



Guðrún Björnsdóttir



Jón G. Briem

### Chief Executive Officer



Höskuldur H. Ólafsson

# Consolidated Interim Statement of Comprehensive Income for the Period from 1 January to 30 September 2010

	Notes	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
Interest income .....		12,342	41,127	66,905
Interest expense .....		(6,283)	(24,770)	(54,759)
<b>Net interest income</b> .....	8	<u>6,059</u>	<u>16,357</u>	<u>12,146</u>
Increase in value of loans and receivables .....	9	3,131	11,832	20,199
FX (loss) gain on loans and receivables from ISK income customers .....	16	(5,822)	(6,508)	1,535
Impairment on loans and receivables .....	10	3,470	(783)	(11,474)
Changes in compensation instrument .....	33	-	(3,422)	(10,556)
<b>Net interest income after valuation changes on loans and receivables</b> .....		<u>6,838</u>	<u>17,476</u>	<u>11,850</u>
Fee and commission income .....		1,697	5,543	8,291
Fee and commission expense .....		(435)	(1,429)	(2,429)
<b>Net fee and commission income</b> .....	11	<u>1,262</u>	<u>4,114</u>	<u>5,862</u>
Net financial income (expense) .....	12-17	(92)	(354)	1,638
Net foreign exchange (loss) gain .....	16	(3,486)	(1,816)	8,715
Share of profit or loss of associates .....	35	147	290	369
Other operating income .....	17	5,021	17,695	21,201
<b>Operating income</b> .....		<u>9,690</u>	<u>37,405</u>	<u>49,635</u>
Salaries and related expense .....	19	(2,777)	(8,986)	(10,413)
Administration expense .....		(1,666)	(4,599)	(5,317)
Depositors' and investors' guarantee fund .....		54	(271)	(683)
Depreciation and amortisation .....		(300)	(886)	(1,161)
Other operating expense .....	20	(3,061)	(11,567)	(16,279)
Net gain (loss) on non-current assets and disposal groups held for sale .....		299	581	(375)
<b>Earnings before income tax</b> .....		<u>2,239</u>	<u>11,677</u>	<u>15,407</u>
Income tax expense .....	21	(1,263)	(2,764)	(2,536)
<b>Net earnings</b> .....		<u><u>976</u></u>	<u><u>8,913</u></u>	<u><u>12,871</u></u>
<b>Other comprehensive income</b>				
Exchange difference on translating foreign operations .....	45	(13)	(161)	(37)
<b>Total comprehensive income for the period</b> .....		<u><u>963</u></u>	<u><u>8,752</u></u>	<u><u>12,834</u></u>
<b>Attributable to:</b>				
Shareholders of Arion banki hf. ....		1,099	8,957	12,970
Non-controlling interest .....		(123)	(44)	(99)
<b>Net earnings</b> .....		<u><u>976</u></u>	<u><u>8,913</u></u>	<u><u>12,871</u></u>
<b>Earnings per share</b>				
Basic and diluted earnings per share attributable to shareholders of Arion banki hf. (ISK) .....	22	0.55	3.94	1.02

*The notes on pages 10 to 38 are an integral part of these Condensed Consolidated Interim Financial Statements.*

# Consolidated Interim Statement of Financial Position as at 30 September 2010

<b>Assets</b>	Notes	30.9.2010	31.12.2009
Cash and balances with Central Bank .....	23	33,372	41,906
Loans and receivables to credit institutions .....	24-25	61,942	38,470
Loans and receivables to customers .....	26-28	445,440	357,734
Bonds and debt instruments .....	31-32	132,257	173,482
Shares and equity instruments with variable income .....	31	8,732	7,078
Derivatives .....	31,42	1,404	6
Securities used for hedging .....	31	3,413	2,236
Compensation instrument .....	33	30,059	34,371
Investment property .....	34	25,229	22,947
Investments in associates .....	35	6,274	5,985
Property and equipment .....		10,760	10,700
Intangible assets .....		2,987	3,512
Tax assets .....	41	732	1,415
Non-current assets and disposal groups held for sale .....	36	36,129	41,527
Other assets .....	37	20,925	15,975
<b>Total Assets</b>		<u>819,655</u>	<u>757,344</u>
<b>Liabilities</b>			
Due to credit institutions and Central Bank .....	31	105,181	113,647
Deposits .....	31	477,773	495,465
Borrowings .....	31,39	64,224	11,042
Subordinated loans .....	31,40	25,493	-
Financial liabilities at fair value .....	31	3,702	88
Tax liabilities .....	41	4,873	2,841
Non-current liabilities and disposal groups held for sale .....	36	14,980	19,230
Other liabilities .....	43	20,800	24,997
<b>Total Liabilities</b>		<u>717,026</u>	<u>667,310</u>
<b>Equity</b>			
Share capital .....	44	2,000	12,646
Share premium .....	44	73,861	59,354
Other reserves .....	45	2,355	1,729
Retained earnings .....		24,320	16,150
<b>Total Shareholders' Equity</b>		<u>102,535</u>	<u>89,879</u>
Non-controlling interest .....		94	155
<b>Total Equity</b>		<u>102,629</u>	<u>90,034</u>
<b>Total Liabilities and Equity</b>		<u>819,655</u>	<u>757,344</u>

*The notes on pages 10 to 38 are an integral part of these Condensed Consolidated Interim Financial Statements.*

# Consolidated Interim Statement of Changes in Equity for the Period from 1 January to 30 September 2010

	Share capital and share premium	Other reserves	Retained earnings	<b>Total Share- holders' equity</b>	Non- controlling interest	<b>Total equity</b>
<b>Changes in equity from 1 January to 30 September 2010:</b>						
Equity 1 January 2010 .....	72,000	1,729	16,150	89,879	155	90,034
Changes in share capital .....	3,861			3,861		3,861
Total comprehensive income for the period						
attributable to the shareholders of Arion banki hf. ....		(161)	8,957	8,796		8,796
Total other comprehensive income for the period						
attributable to the non-controlling interest .....					(44)	(44)
Transfer to statutory reserve .....		786	(786)	-		-
Non-controlling interests acquired during the period .....					(18)	(18)
<b>Equity 30 September 2010 .....</b>	<b>75,861</b>	<b>2,355</b>	<b>24,320</b>	<b>102,535</b>	<b>94</b>	<b>102,629</b>
<b>Changes in equity from 1 January to 31 December 2009:</b>						
Equity 1 January 2009 .....	72,000	129	4,817	76,946	-	76,946
Total comprehensive income for the year						
attributable to the shareholders of Arion banki hf. ....		(37)	12,970	12,933		12,933
Total other comprehensive income for the year						
attributable to the non-controlling interest .....					(99)	(99)
Transfer to statutory reserve .....		1,637	(1,637)	-		-
Non-controlling interests acquired during the period .....					254	254
<b>Equity 31 December 2009 .....</b>	<b>72,000</b>	<b>1,729</b>	<b>16,150</b>	<b>89,879</b>	<b>155</b>	<b>90,034</b>

*The notes on pages 10 to 38 are an integral part of these Condensed Consolidated Interim Financial Statements.*

# Condensed Consolidated Interim Statement of Cash Flows for the Period from 1 January to 30 September 2010

	Notes	2010 1.1.-30.9.	2009 1.1.-31.12.
Net cash provided by (used in) operating activities .....		19,745	(36,419)
Net cash flow used in investing activities .....		(604)	(3,506)
Net increase (decrease) in cash and cash equivalents .....		19,141	(39,925)
Cash and cash equivalents at beginning of the period .....		56,094	92,910
Cash and cash equivalents acquired through business combinations .....		-	804
Effect of exchange rate changes on cash held .....		(5,201)	2,305
<b>Cash and cash equivalents at end of the period .....</b>		<b>70,034</b>	<b>56,094</b>
<b>Cash and cash equivalents comprises</b>			
Cash in hand and demand deposits .....		33,372	41,906
Due from credit institutions .....		44,597	24,037
Mandatory reserve with Central Bank .....		(7,935)	(9,849)
Total cash and cash equivalents .....		70,034	56,094

#### Non-cash investing and financing transactions:

The following non-cash investing and financing transactions that occurred during the period have been excluded from the Condensed Consolidated Interim Statement of Cash Flows:

On 8 January 2010, following approval by the Annual Shareholders Meeting, an 87% shareholding was transferred from the Icelandic State to Kaupskil ehf. The impacts on the financial position of the Bank are exemplified in note 5.

*The notes on pages 10 to 38 are an integral part of these Condensed Consolidated Interim Financial Statements.*





# Notes to the Condensed Consolidated Interim Financial Statements

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## General information

### 1. Reporting entity

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The Bank was initially named New Kaupthing banki hf. but on 21 November 2009 the name was changed to Arion banki hf. The address of Arion banki hf.'s registered office is Borgartún 19, Reykjavík. The Condensed Consolidated Interim Financial Statements for the period ended 30 September 2010 comprise Arion banki hf. and its subsidiaries (together referred to as "the Bank"). The Bank offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, retail banking, capital markets services, corporate financing and recovery, asset management and comprehensive wealth management for private banking clients.

The Bank has acquired a number of subsidiaries exclusively with view to resale. The acquisitions were the result of foreclosures. As the operation of these subsidiaries is different to the Bank's core operations the effects only appear in limited number of line items in the Consolidated Interim Statement of Comprehensive Income and the Consolidated Interim Statement of Financial Position.

### 2. Basis of preparation

#### a) *Statement of compliance*

The Condensed Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting* as endorsed by the European Union. The Condensed Consolidated Interim Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with the Banks' annual Consolidated Financial Statements for the year 2009. The statements are available at the Banks' web site [www.arionbanki.is](http://www.arionbanki.is).

The Condensed Consolidated Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion banki hf. on 22 November 2010.

#### b) *Basis of measurement*

The Condensed Consolidated Interim 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

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 Condensed Consolidated Interim 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 Condensed Consolidated Interim 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 Condensed Consolidated Interim 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 Condensed Consolidated Interim Financial Statements.

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

Judgements made by management that have a significant effect on the Condensed Consolidated Interim Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in notes 4 and 51.

# Notes to the Condensed Consolidated Interim Financial Statements

## Significant accounting policies

The accounting policies adopted in the preparation of the Condensed Consolidated Interim Financial Statements are consistent with those followed in the preparation of the Bank's annual financial statements for the year ended 31 December 2009.

### 3. Going concern assumption

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue. The Consolidated Statement of Financial Position of the Bank presents uncertainty due to the asset-liability mismatches of significant risks as described in the Risk Management disclosures. A considerable portion of the purchased assets from Kaupthing banki hf. are denominated in low interest rate foreign currencies and are funded with deposits denominated in Icelandic króna, a high interest rate currency. Liquidity risk, as well as risks related to imbalances in currency, duration and interest rate base are outlined in the Risk Management disclosures. Whilst the Bank's stress testing has resulted in the Bank management's assessing that it is sufficiently capitalised to deal with market shocks, significant market shocks during the realignment period of the Bank's risk profile, poses some uncertainty.

The Bank is making progress in adapting to the economic situation in Iceland with a focus on strengthening the infrastructure and internal control. The main focus has been on safeguarding the value of the Bank's assets through the recovery process and a team of specialists has been put together to work with defaulting customers. A favourable outcome from this process will strengthen the Bank's business. Further information on risk factors in the Bank's operation are provided in the Risk Management Disclosures.

### 4. Critical accounting estimates and judgements in applying accounting policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. 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 condensed consolidated interim financial statements.

#### *Key sources of estimation uncertainty*

##### i) Impairment losses on loans and receivables

The Bank reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Consolidated Interim Statement of Comprehensive Income, the Bank 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) 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.

##### iii) Assets classified as held for sale

The Bank 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 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 Bank's control and there is sufficient evidence that the Bank remains committed to its plan to sell the assets or disposal groups.

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

# Notes to the Condensed Consolidated Interim Financial Statements

## 4. cont.

As set out in note 38, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair value less cost to sell. For the most part, fair values at the date of classification of these legal entities are 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.

### iv) Fair value of Investment Property

In Iceland, there is no third party that provides information on the market value of investment properties located in Iceland. As the market is relatively inactive and assets are often quite dissimilar it is difficult to obtain comparison. The international financial crises and the collapse of the Icelandic banks in 2008 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 determine prices of recent market transactions of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

### v) 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 Bank

### 5. Changes in capitalization of Arion banki hf.

On 3 September 2009, the Resolution Committee of Kaupthing banki hf., on behalf of Kaupskil ehf., signed an agreement with the Icelandic Ministry of Finance regarding capitalization and future ownership of Arion banki hf. Based on the agreement Kaupthing banki hf. acquired a majority shareholding of 87% in Arion banki hf. The remaining shareholding of 13% is held by the Icelandic State.

On 30 November 2009, the Resolution Committee of Kaupthing banki hf., on behalf of Kaupskil ehf., approved the decision to acquire the 87% shareholding in Arion banki hf.

Following an approval from FME, the annual shareholders meeting of Arion banki hf. held 8 January 2010 approved the transfer of 87% shareholding from the Icelandic State to Kaupskil ehf.

These Condensed Consolidated Interim Financial Statements reflect changes in capitalization following the changes in ownership of Arion banki hf. 8 January 2010.

Changes following shareholder approval 8 January 2010:

<b>Assets</b>	8.1.2010
Loans and receivables to customers .....	112,824
Bonds and debt instruments .....	(32,595)
<b>Total Assets</b>	<u>80,229</u>
<b>Liabilities</b>	
Due to credit institutions and Central Bank .....	(14,428)
Borrowings .....	61,252
Subordinated loans .....	29,543
<b>Liabilities</b>	<u>76,367</u>
<b>Equity</b>	
Share capital .....	(10,646)
Share premium .....	14,508
<b>Total Equity</b>	<u>3,862</u>
<b>Total Liabilities and Equity</b>	<u>80,229</u>

# Notes to the Condensed Consolidated Interim Financial Statements

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## 6. Acquisition of subsidiaries acquired exclusively with view to resale.

In order to secure assets placed as collateral against loans to customers the Bank was compelled to foreclose on two legal entities in the period 1 January to 30 September 2010.

The Bank holds 100% shareholding in Langalína 2 ehf. and B.M. Vallá ehf. These legal entities were acquired exclusively with view to resale.

### i) Langalína 2 ehf.

Langalína 2 ehf. was acquired 7 May 2010. The company holds number of real estates in Iceland. Langalína 2 ehf. meets the criteria in IFRS 5 to be classified as non-current asset and disposal groups held for sale and has been accounted for as such in the Condensed Consolidated Interim Financial Statements 30 September 2010, see Note 38.

### ii) B.M. Vallá ehf.

B.M. Vallá ehf. was acquired 21 May 2010. The company has been one of the leading companies within the Icelandic construction industry producing concrete, tiles and stones and a variety of other building materials. Due to the current market condition the timing of the ultimate disposal is uncertain and the requirements of IFRS 5 to classify the asset as held for sale can therefore not be met. B.M. Vallá ehf. was classified as a subsidiary at 30 September 2010.

## 7. Disposal of legal entity acquired exclusively with view to resale.

On 24 August 2010 the Bank sold its 100% shareholding in Penninn Holding 1 Oy. The legal entity was acquired exclusively with view to resale in 2009. Due to the market condition the timing of the ultimate disposal of the asset was uncertain at year end 2009 and the requirements of IFRS 5 to classify the asset as held for sale therefore not met. Thus this legal entity was classified as subsidiary and included in the Consolidated Financial Statements for 2009. At the end of June 2010 this legal entity was considered to meet the requirements of IFRS 5 and was classified as non current assets and disposal groups classified as held for sale.

# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Interim Statement of Comprehensive Income

### Net interest income

8. Interest income and expense is specified as follows:

	Interest income	Interest expense	Net interest income
1.1.-30.9.2010			
Cash and balances with Central Bank .....	927	-	927
Loans, receivables and deposits .....	28,790	22,310	6,480
Borrowings .....	-	1,558	(1,558)
Subordinated loans .....	-	872	(872)
Securities .....	9,751	-	9,751
Compensation instrument .....	931	-	931
Other .....	729	31	698
<b>Interest income and expense .....</b>	<b>41,127</b>	<b>24,770</b>	<b>16,357</b>
Interest income and expense from assets and liabilities at fair value .....	9,751	-	9,751
Interest income and expense from assets and liabilities not at fair value through profit or loss ....	31,376	24,770	6,606
<b>Interest income and expense .....</b>	<b>41,127</b>	<b>24,770</b>	<b>16,357</b>
1.7.-30.9.2010			
Cash and balances with Central Bank .....	356	-	356
Loans, receivables and deposits .....	7,843	5,345	2,498
Borrowings .....	-	640	(640)
Subordinated loans .....	-	291	(291)
Securities .....	3,250	-	3,250
Compensation instrument .....	266	-	266
Other .....	627	7	620
<b>Interest income and expense .....</b>	<b>12,342</b>	<b>6,283</b>	<b>6,059</b>
Interest income and expense from assets and liabilities at fair value .....	3,250	-	3,250
Interest income and expense from assets and liabilities not at fair value through profit or loss ....	9,092	6,283	2,809
<b>Interest income and expense .....</b>	<b>12,342</b>	<b>6,283</b>	<b>6,059</b>

# Notes to the Condensed Consolidated Interim Financial Statements

8. cont.

1.1.-31.12.2009	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank .....	2,793	-	2,793
Loans, receivables and deposits .....	45,408	53,060	(7,652)
Borrowings .....	-	1,564	(1,564)
Securities .....	10,934	17	10,917
Compensation instrument .....	2,411	-	2,411
Other .....	5,359	118	5,241
<b>Interest income and expense .....</b>	<b>66,905</b>	<b>54,759</b>	<b>12,146</b>
Interest income and expense from assets and liabilities at fair value .....	10,934	17	10,917
Interest income and expense from assets and liabilities not at fair value through profit or loss ....	55,971	54,742	1,229
<b>Interest income and expense .....</b>	<b>66,905</b>	<b>54,759</b>	<b>12,146</b>

## Increase in value of loans and receivables

9. The increase in value of loans and receivables is determined in accordance with accounting policy presented in note 8 a) in the annual financial statement 2009. Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

## Impairment on loans and receivables

10. Impairment on loans and receivables is specified as follows:	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
Impairment on loans and receivables to credit institutions .....	-	-	682
Impairment for unrealisable FX (loss) gains from FX loans to borrowers with ISK income .....	5,852	(6,508)	1,535
Impairment on loans and receivables to customers .....	(2,382)	7,168	8,317
Impairment on receivables and other assets .....	-	123	940
<b>Impairment .....</b>	<b>3,470</b>	<b>783</b>	<b>11,474</b>

Further information on the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 52 a).

# Notes to the Condensed Consolidated Interim Financial Statements

## Net fee and commission income

11. Fee and commission income and expense is specified as follows:

1.1.-30.9.2010	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
<b>Fee and commission income</b>				
Securities trading .....	-	-	133	133
Derivatives .....	126	-	-	126
Lending and guarantees .....	-	430	-	430
Asset management fees .....	-	-	1,985	1,985
Other fee and commission income - banking activities .....	-	-	2,443	2,443
Other fee and commission income .....	-	-	427	427
<b>Fee and commission income</b> .....	<b>126</b>	<b>430</b>	<b>4,988</b>	<b>5,543</b>
<b>Fee and commission expense</b>				
Purchased guarantees .....	11	-	-	11
Securities trading .....	-	-	151	151
Asset management fees .....	-	-	182	182
Other fee and commission income - banking activities .....	-	-	992	992
Other fee and commission expense .....	-	-	93	93
<b>Fee and commission expense</b> .....	<b>11</b>	<b>-</b>	<b>1,418</b>	<b>1,429</b>
<b>Net fee and commission income</b> .....	<b>115</b>	<b>430</b>	<b>3,570</b>	<b>4,114</b>

Asset management fees are earned by the Bank on trust and fiduciary activities where the Bank holds or invests assets on behalf of the customers.

1.7.-30.9.2010	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
<b>Fee and commission income</b>				
Securities trading .....	-	-	64	64
Derivatives .....	32	-	-	32
Lending and guarantees .....	-	115	-	115
Asset management fees .....	-	-	599	599
Other fee and commission income - banking activities .....	-	-	749	749
Other fee and commission income .....	-	-	138	138
<b>Fee and commission income</b> .....	<b>32</b>	<b>115</b>	<b>1,550</b>	<b>1,697</b>
<b>Fee and commission expense</b>				
Securities trading .....	-	-	54	54
Asset management fees .....	-	-	35	35
Other fee and commission income - banking activities .....	-	-	310	310
Other fee and commission expense .....	-	-	36	36
<b>Fee and commission expense</b> .....	<b>-</b>	<b>-</b>	<b>435</b>	<b>435</b>
<b>Net fee and commission income</b> .....	<b>32</b>	<b>115</b>	<b>1,115</b>	<b>1,262</b>



# Notes to the Condensed Consolidated Interim Financial Statements

11. cont.	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
1.1.-31.12.2009				
<b>Fee and commission income</b>				
Securities trading .....	-	-	285	285
Derivatives .....	373	-	-	373
Lending and guarantees .....	-	622	-	622
Asset management fees .....	-	-	2,968	2,968
Other fee and commission income - banking activities .....	-	-	3,476	3,476
Other fee and commission income .....	-	-	567	567
<b>Fee and commission income</b> .....	<b>373</b>	<b>622</b>	<b>7,296</b>	<b>8,291</b>
<b>Fee and commission expense</b>				
Securities trading .....	-	-	170	170
Asset management fees .....	-	-	637	637
Other fee and commission income - banking activities .....	-	-	1,324	1,324
Other fee and commission expense .....	-	-	298	298
<b>Fee and commission expense</b> .....	<b>-</b>	<b>-</b>	<b>2,429</b>	<b>2,429</b>
<b>Net fee and commission income</b> .....	<b>373</b>	<b>622</b>	<b>4,867</b>	<b>5,862</b>

## Net financial income

12. Net financial income is specified as follows:	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
Dividend income .....	4	31	29
Net (loss) gain on financial assets and liabilities classified as held for trading .....	(366)	(848)	1,240
Net gain on financial assets and liabilities designated at fair value through PL .....	270	463	369
<b>Net financial income</b> .....	<b>(92)</b>	<b>(354)</b>	<b>1,638</b>

## 13. Dividend income is specified as follows:

Dividend income on trading assets .....	-	2	20
Dividend income on assets designated at fair value through profit or loss .....	4	29	9
<b>Dividend income</b> .....	<b>4</b>	<b>31</b>	<b>29</b>

## 14. Net gain (loss) on trading portfolio are specified as follows:

Net gain on equity instruments and related derivatives .....	15	197	279
Net (loss) gain on interest rate instruments and related derivatives .....	(405)	(1,004)	194
Net (loss) gain on other derivatives .....	24	(41)	767
<b>Net (loss) gain on trading portfolio</b> .....	<b>(366)</b>	<b>(848)</b>	<b>1,240</b>

# Notes to the Condensed Consolidated Interim Financial Statements

15. Net gain on assets/liabilities designated at fair value through profit or loss are specified as follows:

	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
Net gain on interest rate instruments designated at fair value .....	79	239	230
Net gain on equity instruments designated at fair value .....	191	224	139
<b>Net gain on assets/liabilities designated at fair value through profit and loss .....</b>	<b>270</b>	<b>463</b>	<b>369</b>

16. Net gain (loss) on foreign exchange are specified as follows:

FX (loss) gain on loans and receivables .....	(5,445)	(11,660)	15,059
FX (loss) gain on bank accounts .....	(3,307)	(5,201)	2,305
FX gain (loss) from deposits and borrowings .....	5,938	18,554	(9,597)
FX (loss) gain on bonds, equity and derivatives .....	(238)	(93)	445
FX (loss) gain on other assets and liabilities .....	(433)	(3,416)	503
<b>Net (loss) gain on foreign exchange .....</b>	<b>(3,486)</b>	<b>(1,816)</b>	<b>8,715</b>
FX (loss) gain on loans and receivables from ISK income customers .....	(5,822)	(6,508)	1,535
<b>Total (loss) gain on foreign exchange .....</b>	<b>(9,308)</b>	<b>(8,324)</b>	<b>10,250</b>

## Other operating income

17. Other operating income is specified as follows:

Rental income from investment properties .....	458	1,497	1,183
Fair value changes on investment property .....	-	-	170
Realised gain on investment property .....	9	172	70
Earned premiums, net of reinsurance .....	216	623	822
Net gain on disposals of assets other than held for sale .....	514	550	44
Other income from subsidiaries acquired exclusively with view to resale .....	3,604	14,221	17,838
Other income .....	220	632	1,074
<b>Other operating income .....</b>	<b>5,021</b>	<b>17,695</b>	<b>21,201</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Personnel

18. The Bank's total number of employees is as follows:	30.9.2010	31.12.2009
Average number of full time equivalent positions during the period .....	1,141	1,177
Full time equivalent positions at the end of the period .....	1,124	1,157

Included in the average number of full time equivalent are Kaupthing banki hf. employees, total of 33 in the year 2009. At the end of 2009 no Kaupthing banki hf. employee was included in the number of full time equivalent positions, consequently there is no effect on employee numbers in 2010.

The number of employees of subsidiaries acquired exclusively with view to resale (excluded from numbers above) are as follows:

	30.9.2010	31.12.2009
Full time equivalent positions at the end of the period .....	554	584

19. Salaries and related expense are specified as follows:	2010	2010	2009
	1.7.-30.9.	1.1.-30.9.	1.1.-31.12.
Salaries .....	2,189	7,101	8,438
Defined contribution pension plans .....	296	958	1,123
Salary related expense .....	292	927	852
<b>Salaries and related expense .....</b>	<b>2,777</b>	<b>8,986</b>	<b>10,413</b>

Included in the total amount of salaries and related expenses are salaries of Kaupthing banki hf. employees amounting to nil in 2010 compared to ISK 309 million in 2009.

Salaries and related expense of subsidiaries acquired exclusively with view to resale (included in amounts above) are specified as follows:

	2010	2010	2009
	1.7.-30.9.	1.1.-30.9.	1.1.-31.12.
Salaries .....	719	2,136	1,949
Salary related expense .....	125	475	391
<b>Salaries and related expense .....</b>	<b>844</b>	<b>2,611</b>	<b>2,340</b>

## Other operating expense

20. Other operating expenses:

Direct operating expenses (including repairs and maintenance) arising on rental-earning investment properties .....	168	382	263
Fair value changes on investment property .....	277	241	-
Claims incurred, net of reinsurance .....	87	219	315
Other operating expenses from subsidiaries acquired exclusively with view to resale .....	2,524	10,711	15,686
Other operating expenses .....	5	14	15
<b>Other operating expenses .....</b>	<b>3,061</b>	<b>11,567</b>	<b>16,279</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Income tax expense

21. Income tax recognised in the Consolidated Interim Statement of Comprehensive Income is specified as follows:

	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
<i>Current tax expense</i>			
Current period .....	2,121	3,721	1,044
<i>Deferred tax expense</i>			
Changes in temporary differences .....	(857)	(957)	1,492
<b>Total income tax expense .....</b>	<b>1,263</b>	<b>2,764</b>	<b>2,536</b>

	1.1.-30.9.2010		1.1.-31.12.2009	
Reconciliation of effective tax rate:				
Earnings before income tax .....		11,677		15,407
Income tax using the Icelandic corporation tax rate .....	18.0%	2,102	15.0%	2,311
Non-deductible expense .....	0.1%	11	0.1%	9
Tax exempt revenues .....	(0.3%)	(36)	(0.8%)	(126)
Changes in deferred tax asset .....	6.9%	811	0.0%	-
Effect of increase in the income tax rate from 15% to 18% .....	0.0%	-	1.9%	297
Other changes .....	(1.1%)	(124)	0.3%	45
<b>Effective tax rate .....</b>	<b>23.7%</b>	<b>2,764</b>	<b>16.5%</b>	<b>2,536</b>

## Earnings per share

22. Earnings per share are specified as follows:

	2010 1.7.-30.9.	2010 1.1.-30.9.	2009 1.1.-31.12.
Net earnings attributable to the shareholders of Arion banki hf. ....	1,099	8,957	12,970
Weighted average share capital:			
Weighted average number of outstanding shares for the period, million .....	2,000	2,276	12,646
Basic earnings per share .....	0.55	3.94	1.02
Diluted earnings per share .....	0.55	3.94	1.02
Number of outstanding shares at the end of the period, million .....	2,000	2,000	12,646
Number of total shares at the end of the period, million, diluted .....	2,000	2,000	12,646

# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Interim Statement of Financial Position

### Cash and balances with Central Bank

23. Cash and balances with Central Bank are specified as follows:	30.9.2010	31.12.2009
Cash on hand .....	2,897	3,536
Cash with Central Bank .....	22,540	28,521
Mandatory reserve deposits with Central Bank .....	7,935	9,849
<b>Cash and balances with Central Bank .....</b>	<b>33,372</b>	<b>41,906</b>

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

### Loans and receivables to credit institutions

24. Loans and receivables to credit institutions specified by types of loans:

Bank accounts .....	44,597	24,037
Money market loans .....	4,907	4,733
Overdrafts .....	5,302	4,074
Other loans .....	7,136	5,626
<b>Loans and receivables to credit institutions .....</b>	<b>61,942</b>	<b>38,470</b>

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

Balance at the beginning of the period .....	727	44
Provision for losses during the period .....	-	683
<b>Balance at the end of the period .....</b>	<b>727</b>	<b>727</b>
Specific .....	727	727
Collective .....	-	-
	<b>727</b>	<b>727</b>

### Loans and receivables to customers

26. Loans and receivables to customers specified by types of loans:

Overdrafts .....	35,306	31,673
Subordinated loans .....	506	17
Other loans and receivables .....	439,140	354,780
Provision on loans and receivables .....	(29,512)	(28,736)
<b>Loans and receivables to customers .....</b>	<b>445,440</b>	<b>357,734</b>

# Notes to the Condensed Consolidated Interim Financial Statements

27. Loans and receivables to customers specified by sectors:	30.9.2010	31.12.2009
Individuals .....	25.1%	15.5%
Holding companies .....	7.0%	13.9%
Industry .....	25.2%	33.2%
Real estate .....	10.1%	15.2%
Service .....	28.5%	17.9%
Trade .....	3.7%	4.0%
Transportation .....	0.4%	0.3%
<b>Loans and receivables to customers .....</b>	<b>100.0%</b>	<b>100.0%</b>

28. Changes in the provision for losses on loans and receivables to customers are specified as follows:

Balance at the beginning of the period .....	28,736	18,905
Provision for losses during the period .....	7,394	8,317
Provision for unrealisable FX gains (losses) from FX denominated loans to borrowers with ISK income .....	(6,508)	1,535
Payment of loans previously written off .....	(110)	(21)
<b>Balance at the end of the period .....</b>	<b>29,512</b>	<b>28,736</b>
Specific .....	26,844	28,736
Collective .....	2,668	-
	<b>29,512</b>	<b>28,736</b>

## Additional information on loans and receivables

29. Additional information on loans and receivables to credit institutions and to customers:

1.1.-30.9.2010	Nominal value	Deep discount	Subsequent impairment	Book value
Loans and receivables to credit institutions .....	83,195	(20,526)	(727)	61,942
Loans and receivables to customers .....	1,196,679	(721,727)	(29,512)	445,440
<b>Balance at 30 September 2010 .....</b>	<b>1,279,874</b>	<b>(742,253)</b>	<b>(30,239)</b>	<b>507,383</b>
Loans and receivables to credit institutions .....	68,040	(28,843)	(727)	38,470
Loans and receivables to customers .....	1,136,370	(749,900)	(28,736)	357,734
<b>Balance at 31 December 2009 .....</b>	<b>1,204,409</b>	<b>(778,743)</b>	<b>(29,463)</b>	<b>396,204</b>

Majority of the loan book was acquired from Kaupthing banki hf. in October 2008. Book value represents the amortized cost of the loan portfolio at the end of the period.

## Renegotiated loans

30. The Bank has engaged in financial restructuring of customers that are experiencing financial difficulties.

In December 2009, the Bank announced a comprehensive program of standard solutions to assist individuals who have run into financial difficulties. These programs augmented a program which had previously been mandated by the government but which many individuals had opted out of. By period end, numerous individuals had been processed through these programs. In general, the write-offs associated with these programs are not expected to exceed the discount which was granted when the loans were purchased from Kaupthing banki hf. in 2008.

The Bank has not announced a general program for companies in financial straits. Instead, these companies' finances are restructured on a case-by-case basis using a transparent set of standard procedures. Good progress has been in restructuring of the medium to larger companies in the loan portfolio, which allows the bank to shift focus towards smaller entities in the coming months.

# Notes to the Condensed Consolidated Interim Financial Statements

## Financial assets and liabilities

31. Financial assets and liabilities are specified as follows:

30.9.2010	Loans and receivables	Designated Trading at fair value		Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank .....	33,372	-	-	-	33,372
Loans to credit institutions .....	61,942	-	-	-	61,942
Loans to customers .....	445,440	-	-	-	445,440
<b>Loans and receivables .....</b>	<b>540,754</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>540,754</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	8,199	42,099	-	50,298
Unlisted .....	-	385	81,574	-	81,959
<b>Bonds and debt instruments .....</b>	<b>-</b>	<b>8,584</b>	<b>123,673</b>	<b>-</b>	<b>132,257</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	23	1,145	-	1,168
Unlisted .....	-	678	4,679	-	5,357
Bond funds with variable income .....	-	355	1,852	-	2,207
<b>Shares and equity instruments .....</b>	<b>-</b>	<b>1,056</b>	<b>7,676</b>	<b>-</b>	<b>8,732</b>
<i>Derivatives</i>					
OTC derivatives .....	-	1,404	-	-	1,404
<b>Derivatives .....</b>	<b>-</b>	<b>1,404</b>	<b>-</b>	<b>-</b>	<b>1,404</b>
<i>Securities used for hedging</i>					
Bonds and debt instruments .....	-	3,413	-	-	3,413
<b>Securities used for hedging .....</b>	<b>-</b>	<b>3,413</b>	<b>-</b>	<b>-</b>	<b>3,413</b>
Compensation instrument .....	-	-	-	30,059	30,059
Other financial assets .....	-	-	-	14,469	14,469
<b>Financial assets .....</b>	<b>540,754</b>	<b>14,457</b>	<b>131,349</b>	<b>44,528</b>	<b>731,088</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	-	-	-	105,181	105,181
Deposits .....	-	-	-	477,773	477,773
Borrowings .....	-	-	-	64,224	64,224
Subordinated loans .....	-	-	-	25,493	25,493
<b>Liabilities at amortised cost .....</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>672,671</b>	<b>672,671</b>
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading .....	-	3,659	-	-	3,659
Derivatives held for trading .....	-	44	-	-	44
<b>Financial liabilities at fair value .....</b>	<b>-</b>	<b>3,703</b>	<b>-</b>	<b>-</b>	<b>3,703</b>
Other financial liabilities .....	-	-	-	3,596	3,596
<b>Financial liabilities .....</b>	<b>-</b>	<b>3,703</b>	<b>-</b>	<b>676,267</b>	<b>679,970</b>

# Notes to the Condensed Consolidated Interim Financial Statements

31. cont.

31.12.2009	Loans and receivables	Designated Trading at fair value		Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank .....	41,906	-	-	-	41,906
Loans to credit institutions .....	38,470	-	-	-	38,470
Loans to customers .....	357,734	-	-	-	357,734
<b>Loans and receivables</b> .....	<b>438,110</b>	-	-	-	<b>438,110</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	4,221	4,614	-	8,835
Unlisted .....	-	-	164,647	-	164,647
<b>Bonds and debt instruments</b> .....	-	<b>4,221</b>	<b>169,261</b>	-	<b>173,482</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	709	429	-	1,138
Unlisted .....	-	1,464	3,380	-	4,844
Bond funds with variable income .....	-	320	776	-	1,096
<b>Shares and equity instruments</b> .....	-	<b>2,493</b>	<b>4,585</b>	-	<b>7,078</b>
<i>Derivatives</i>					
OTC derivatives .....	-	6	-	-	6
<b>Derivatives</b> .....	-	<b>6</b>	-	-	<b>6</b>
<i>Securities used for hedging</i>					
Bonds and debt instruments .....	-	2,236	-	-	2,236
<b>Securities used for hedging</b> .....	-	<b>2,236</b>	-	-	<b>2,236</b>
Compensation instrument .....	-	-	-	34,371	34,371
Other financial assets .....	-	-	-	9,230	9,230
<b>Financial assets</b> .....	<b>438,110</b>	<b>8,956</b>	<b>173,846</b>	<b>43,601</b>	<b>664,513</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	-	-	-	113,647	113,647
Deposits .....	-	-	-	495,465	495,465
Borrowings .....	-	-	-	11,042	11,042
<b>Liabilities at amortised cost</b> .....	-	-	-	<b>620,154</b>	<b>620,154</b>
<i>Financial liabilities at fair value</i>					
Derivatives held for trading .....	-	88	-	-	88
<b>Financial liabilities at fair value</b> .....	-	<b>88</b>	-	-	<b>88</b>
Other financial liabilities .....	-	-	-	1,524	1,524
<b>Financial liabilities</b> .....	-	<b>88</b>	-	<b>621,678</b>	<b>621,766</b>
32. Bonds and debt instruments designated at fair value specified by issuer: 30.9.2010 31.12.2009					
Financial institutions .....				1,568	1,760
Governments .....				40,376	73,042
Corporates .....				81,723	94,454
Other .....				6	5
<b>Bonds and debt instruments designated at fair value</b> .....				<b>123,673</b>	<b>169,261</b>



# Notes to the Condensed Consolidated Interim Financial Statements

## Compensation instrument

33. The compensation instrument is originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing banki hf. to Arion banki hf. in accordance with the FME decision in 2008. The compensation instrument amounted to ISK 38,300 million and was denominated 50% in ISK and 50% in EUR and is subject to floating rates of interest. This instrument matures on 30 June 2012 and is a priority claim against Kaupthing banki hf.

Compensation instrument is specified as follows:	30.9.2010	31.12.2009
Balance at the beginning of the period .....	34,371	41,156
Changes due to the Escrow and contingent value rights agreement .....	(3,422)	(10,556)
Accrued interest .....	931	2,398
Foreign exchange rate differences .....	(1,821)	1,373
<b>Balance at the end of the period .....</b>	<b>30,059</b>	<b>34,371</b>

Related to the compensation instrument is the Escrow and contingent value rights agreement where Kaupthing banki hf. receives 80% of the appreciation of defined Arion banki hf. loans (the "ring-fenced assets"). The increase in value of the defined loans will decrease the value of the compensation instrument. If the compensation instrument is 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 will be passed onto Kaupthing banki hf. up to a cap of ISK 5 billion.

During the period changes in those defined loans amounted to ISK 4,278 million, 80% of this increased value belonging to Kaupthing banki hf., ISK 3,422 million as presented in the Consolidated Interim Statement of Comprehensive Income, 20% belonging to Arion banki hf. as a part of the Consolidated Interim Statement of Comprehensive Income. The total face value of the defined loans was approximately ISK 850,000 million and the book value was approximately ISK 210,000 million at the end of the period.

## Investment property

	Investment properties in progress	Investment properties	Subsidiaries acquired with view to resale		Total	30.9.2010	31.12.2009
			Investment properties	Investment properties in progress			
34. Investment property is specified as follows:							
Balance at the beginning of the period .....	15,354	2,177	2,715	2,701	22,947	12,079	
Acquisition through business combination .....	623	222	984	-	1,829	7,832	
Additions during the period .....	178	551	171	498	1,398	3,289	
Disposals during the period .....	-	(350)	-	-	(350)	(423)	
Fair value adjustments .....	14	322	(186)	(745)	(595)	170	
<b>Investment property .....</b>	<b>16,169</b>	<b>2,922</b>	<b>3,684</b>	<b>2,454</b>	<b>25,229</b>	<b>22,947</b>	

# Notes to the Condensed Consolidated Interim Financial Statements

## Investments in associates

35. The Bank's interest in its principal associates are as follows:

	Ownership at period end
Audkenni hf., Engjateigur 3, 105 Reykjavík, Iceland .....	25.0%
KB ráðgjöf ehf., Hlíðarsmári 17, 201 Kópavogur, Iceland .....	43.1%
Reiknistofa Bankanna, Kalkofnsvegur 1, 150 Reykjavík, Iceland .....	18.0%
Valitor Holding hf., Laugarvegur 77, 101 Reykjavík, Iceland .....	47.0%
Borgarland ehf., Egilsholt 1, 310 Borgarnes, Iceland .....	42.0%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland .....	42.7%

Investments in associates are specified as follows:	30.9.2010	31.12.2009
Carrying amount at the beginning of the period .....	5,985	2,843
Acquisition through business combination .....	-	2
Additions during the period .....	-	2,941
Sold during the period .....	-	(153)
Transferred from financial assets at fair value due to step acquisition .....	-	(17)
Share of profit .....	290	369
<b>Carrying amount at the end of the period .....</b>	<b>6,274</b>	<b>5,985</b>

## Non-current assets and disposal groups held for sale

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

Legal entities, total assets .....	33,932	38,922
Real estates .....	2,117	2,570
Other assets .....	80	35
<b>Non-current assets and disposal groups held for sale .....</b>	<b>36,129</b>	<b>41,527</b>

The legal entities were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5.

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:	30.9.2010	31.12.2009
Legal entities, total liabilities .....	14,980	19,230

Legal entities classified as non-current assets and disposal groups held for sale:

Hagar hf. which is a commercial enterprise operating in Iceland. Under the auspices of Hagar hf. there are numerous stores and few purchasing companies.

Langalína 2 ehf. holds number of real estates in Iceland.

# Notes to the Condensed Consolidated Interim Financial Statements

## Other assets

37. Other assets are specified as follows:	30.9.2010	31.12.2009
Unsettled securities trading .....	402	1,583
Accounts receivables .....	13,581	7,647
Accrued income .....	468	376
Prepaid expense .....	489	341
Sundry assets .....	1,828	236
Other assets from subsidiaries acquired exclusively with view to resale .....	4,157	5,792
<b>Other assets</b> .....	<b>20,925</b>	<b>15,975</b>

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

## 38. Provision for other assets

During the period no impairment on accounts receivables and accrued income was made compared to ISK 940 million in 2009.

## Borrowings

39. Borrowings are specified as follows:	30.9.2010	31.12.2009
Bonds issued .....	7,029	-
Other loans .....	57,195	11,042
<b>Borrowings</b> .....	<b>64,224</b>	<b>11,042</b>

## Subordinated loans

### 40. Subordinated loans are specified as follows:

Tier II capital .....	25,493	-
<b>Subordinated loans</b> .....	<b>25,493</b>	<b>-</b>

The loan is subject to Euribor rates of interests +400 basis point to the year 2015 and thereafter Euribor rates of interest + 500 basis point.

# Notes to the Condensed Consolidated Interim Financial Statements

## Tax assets and tax liabilities

41. Tax assets and liabilities are specified as follows:	30.9.2010		31.12.2009	
	Assets	Liabilities	Assets	Liabilities
Current tax .....	-	4,735	-	1,051
Deferred tax .....	732	138	1,415	1,790
<b>Tax assets and liabilities</b> .....	<b>732</b>	<b>4,873</b>	<b>1,415</b>	<b>2,841</b>

## Derivatives

42. Derivatives remaining maturity date of nominal and book value are specified as follows:

30.9.2010	Nominal			Total	Book value	
	Up to 3 months	Over 3 months and up to a year	Over 1 year		Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:						
Forward exchange rate agreements .....	3,327	-	-	3,327	3	19
Interest rate and exchange rate agreements .....	6	-	3,202	3,208	1,199	-
	<b>3,333</b>	<b>-</b>	<b>3,202</b>	<b>6,535</b>	<b>1,202</b>	<b>19</b>
Bond derivatives:						
Bond swaps, agreements unlisted .....	11,327	-	-	11,327	202	25
	<b>11,327</b>	<b>-</b>	<b>-</b>	<b>11,327</b>	<b>202</b>	<b>25</b>
<b>Derivatives</b> .....	<b>14,660</b>	<b>-</b>	<b>3,202</b>	<b>17,862</b>	<b>1,404</b>	<b>44</b>
31.12.2009						
Currency and interest rate derivatives, agreements unlisted:						
Forward exchange rate agreements .....	180	-	-	180	-	-
Interest rate and exchange rate agreements .....	-	-	2,147	2,147	-	71
	<b>180</b>	<b>-</b>	<b>2,147</b>	<b>2,327</b>	<b>-</b>	<b>71</b>
Bond derivatives:						
Bond swaps, agreements unlisted .....	4,927	-	-	4,927	6	17
	<b>4,927</b>	<b>-</b>	<b>-</b>	<b>4,927</b>	<b>6</b>	<b>17</b>
<b>Derivatives</b> .....	<b>5,107</b>	<b>-</b>	<b>2,147</b>	<b>7,254</b>	<b>6</b>	<b>88</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Other liabilities

43. Other liabilities are specified as follows:	30.9.2010	31.12.2009
Unsettled securities trading .....	2,603	1,134
Accounts payable .....	524	1,524
Withholding tax .....	469	2,743
Deposit and investor guarantee fund .....	2,640	3,041
Insurance claim .....	2,020	1,847
Other liabilities from subsidiaries acquired exclusively with view to resale .....	4,544	6,557
Sundry liabilities .....	8,000	8,151
<b>Other liabilities</b> .....	<b>20,800</b>	<b>24,997</b>

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

## Equity

### Share capital

44. According to the Parent Company's Articles of Association, total share capital amounts to ISK 2,000 million. 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 Bank.

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

On 8 January 2010 the Annual Shareholders Meeting approved a transfer of 87% shareholding from the Icelandic State to Kaupskil ehf. The impacts due to this agreement are described in note 5.

### Other reserves

45. Other reserves are specified as follows:	30.9.2010	31.12.2009
Statutory reserve .....	2,423	1,637
Foreign currency translation reserve .....	(68)	92
<b>Other reserves</b> .....	<b>2,355</b>	<b>1,729</b>

## Off Balance Sheet information

### Obligations

46. The Bank has granted its customers guarantees, unused overdrafts and loan commitments. These items are specified as follows:

	30.9.2010	31.12.2009
Guarantees .....	11,714	15,318
Unused overdrafts .....	41,118	45,132
Loan commitments .....	9,598	12,879

The Bank estimates possible loss of ISK 2,284 million in relation to guarantees transferred from Kaupthing banki hf. Should any of the guarantees default, Kaupthing banki hf. will pay compensation up to ISK 3,000 million to Arion banki hf., agreement thereon was signed in September 2009, see note 57.

# Notes to the Condensed Consolidated Interim Financial Statements

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## Assets under management and under custody

47. Assets under management and assets under custody are specified as follows:	30.9.2010	31.12.2009
Assets under management .....	613,664	580,523
Assets under custody .....	1,966,565	2,129,518

## Contingent liabilities

48. Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic and political climate in Iceland the prospects of possible litigation against the Bank has become more likely. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year end, the Bank had several unresolved legal claims.

There are two significant legal claims against the Bank. One is in respect of a few clients who have alleged that mistakes by employees of the Bank have resulted in the client suffering financial loss. A trial date has not yet been set and therefore it is not practical to state the timing of any payment. Due to uncertainty of amounts no provision for these claims has been made in these financial statements. The other significant legal claim is in respect of a number of clients who have alleged that assets under management were improperly managed resulting in the clients suffering financial loss. It is possible that some of these claims will be taken to court of law but due to uncertainty of amounts no provision for these claims has been made in these financial statements.

# Notes to the Condensed Consolidated Interim Financial Statements

## Risk Management Disclosures

### Risk Disclosures

#### 49. Credit Risk Disclosures

The valuation that occurred as the Bank's assets were transferred from Kaupthing banki hf. attempted to account for all realized and foreseen losses, which greatly reduces traditional credit risk in the Bank's loan portfolio. Nevertheless, the Bank is exposed to credit-type risks through the loan portfolio that are related to the accuracy of the asset valuation, the performance of the loan book and the success of the restructuring of non-performing loans. There is also risk associated with the credit concentration to single names and to business sectors.

#### Asset valuation

Asset valuation risk is the risk that assets transferred to the Consolidated Statement of Financial Position of the Bank were overvalued. This refers both to the assets that were transferred as part of the Bank's opening balance sheet and the assets which were transferred as part of the 8 January 2010 Kaupthing capitalization. Different valuation methods were used depending on the nature of the underlying assets and collateral. In the table below, the loan portfolio has been categorized in accordance with the valuation methods, shown by book value. Additionally, retail assets were valued on a homogeneous pool basis.

Asset valuation is subject to on-going revision as additional information about company performance and the Icelandic economy emerges. Numbers for year end 2009 shows distribution prior to the equity injection on 8 January 2010. No material changes have occurred since June 30 2010.

Category: Description (D) / Valuation method (V):	30.9.2010	31.12.2009*
	Value	Value
Higher discount factor:		
D: Loans where Arion banki hf. expects full recovery and the contractual cash flow is used.	44%	40%
V: Present value of discounted contractual cash flows at market interest rates.		
Collateral value:		
D: Loans where the underlying collateral value is greater than the value of future expected cash flow.	18%	21%
V: Assessment of underlying collateral.		
Real estate companies:		
D: Real estate companies.		
V: The Iceland Property Registry rate with a discount of approximately 8%.	16%	17%
EV/EBITDA multiples:		
D: Operating companies that generate positive cash flow, but are currently unable or are estimated to be unable to service their debt, and estimated value is greater than underlying collateral value.	20%	21%
V: EV/EBITDA multiples.		
Currently in recovery:		
D: Borrowers that either are currently in a recovery and restructuring process or have emerged from this process.		
V: Individual assessment using discounted cash flows, collateral value, multiples and other methods available.	2%	1%
	100%	100%

\* The 31.12.2009 numbers were restated due to error in consolidating the loans to overtaken subsidiaries with view to resale.

# Notes to the Condensed Consolidated Interim Financial Statements

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49. cont.

56% of loans to customers are valued using the methods in the table. The remainder comprises loans which have been valued as a homogeneous pool and, to a very small degree, loans granted after the establishment of the Bank. The homogeneous pool includes individuals and SMEs.

A discussion of the main sources of valuation risk follows:

Loans valued based on EV/EBIDTA multiples comprise approximately 7% of the total fair-value loan-book (12% of 60%). These loans are not cause for major concern because the experience of the loans in the category since 22 October 2008 has been that the valuation has been conservative. Furthermore, the valuation method is based on a diverse set of valuation multiples as opposed to the value being driven any specific economic parameter.

Among the risk parameters in the Collateral Value category are loans whose value has been linked to the price of fishing quotas. The Bank conservatively discounts the price of fishing quotas by 25% compared to market prices due to inactive prices, in order to perform the valuation of these loans. It is estimated that approximately 3% of the fair value loan book is directly sensitive to the price of fishing quotas. Consequently, an additional 20% reduction in the price of fishing quotas would translate into a 0.6% drop in the value of the loan book.

Another risk parameter of concern is the price of real estate. The fair value valuation of the real estate related loans was based on a forecast of the real estate market by the Central Bank of Iceland and the official real estate values. Real estate prices affect value in the Collateral Value and the real estate company categories. Approximately 8-14% of the book value of the loan book is estimated to be directly sensitive to the real estate-price parameter. Thus, a 20% additional reduction in real estate price would lead, approximately, to a 1.7% reduction in the loan book value.

The largest contribution to the value of the loan book is the category referred to as Higher Discount Factor. This category was applied to loans to companies with an ability to service debt. The discounted fair value of these loans was based on the Bank's higher cost of funding. The valuation risk is that the cost of funding is even greater than was assumed during the valuation. Each 1.0% increase in the funding cost of the Bank, compared to the valuation assumptions would lead to a 1.3% reduction in this portion of the portfolio, for a 0.3% reduction of the value of the loan book.

To put the aforementioned sensitivity study into perspective, it must be taken into consideration that each 1.0% loss in value of the loan book would correspond to approximately 0.5% point reduction in the Bank's Tier 1 capital ratio.



# Notes to the Condensed Consolidated Interim Financial Statements

## 50. Market Risk Disclosures

### a) Currency Risk Disclosures

The Bank has a high exposure to currency risk, due to the large currency imbalance between assets and liabilities, brought about by the method in which the Consolidated Statement of Financial Position of the Bank was created following the collapse of Kaupthing banki hf. The liabilities of the Bank are predominantly ISK denominated deposits whereas the Bank's assets consist largely of foreign currency denominated loans to customers.

Breakdown of assets and liabilities by currency:

<b>Assets</b>	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank .....	14,214	5,578	3,863	536	3,475	251	5,456	33,372
Loans to credit institutions .....	9,871	9,903	13,396	429	6,773	1,317	20,253	61,942
Loans and receivables to customers ..	187,060	69,642	39,465	63,732	14,443	50,150	20,948	445,440
Bonds and debt instruments .....	131,237	991	29	-	-	-	-	132,257
Shares and equity instruments .....	5,616	2,451	65	-	1	-	600	8,732
Derivatives .....	1,404	-	-	-	-	-	-	1,404
Securities used for hedging .....	3,413	-	-	-	-	-	-	3,413
Compensation instruments .....	21,934	8,125	-	-	-	-	-	30,059
Investment property .....	25,229	-	-	-	-	-	-	25,229
Investments in associates .....	6,078	196	-	-	-	-	-	6,274
Property and equipment .....	10,330	430	-	-	-	-	-	10,760
Intangible assets .....	2,527	460	-	-	-	-	-	2,987
Tax assets .....	732	-	-	-	-	-	-	732
Non-current assets held for sale .....	35,563	9	-	557	-	-	-	36,128
Other assets .....	18,382	719	1,344	65	85	14	315	20,925
<b>Total assets 30.9.2010 .....</b>	<b>473,590</b>	<b>98,506</b>	<b>58,162</b>	<b>65,318</b>	<b>24,776</b>	<b>51,732</b>	<b>47,572</b>	<b>819,655</b>
<b>Liabilities</b>								
Due to credit inst. and Central Bank ..	78,973	3,602	3,911	1,434	333	438	16,490	105,181
Deposits .....	416,638	30,757	8,756	350	8,456	737	12,079	477,773
Borrowings .....	8,419	12,988	22,886	8,158	6,298	5,476	-	64,224
Subordinated loans .....	-	25,493	-	-	-	-	-	25,493
Financial liabilities at fair value .....	3,702	-	-	-	-	-	-	3,702
Tax liabilities .....	4,873	-	-	-	-	-	-	4,873
Non-current liabilities held for sale ....	14,980	-	-	-	-	-	-	14,980
Other liabilities .....	15,949	2,763	1,481	18	279	-	310	20,800
Equity .....	102,629	-	-	-	-	-	-	102,629
<b>Total liabilities 30.9.2010 .....</b>	<b>646,163</b>	<b>75,602</b>	<b>37,034</b>	<b>9,960</b>	<b>15,366</b>	<b>6,651</b>	<b>28,880</b>	<b>819,655</b>
Net on balance sheet position .....	(172,573)	22,904	21,128	55,358	9,410	45,082	18,693	
Net off balance sheet position .....	(3,004)	305	751	281	-	1,667	-	
Net position 30.9.2010 .....	(175,577)	23,208	21,879	55,639	9,410	46,749	18,693	
Net position 31.12.2009 .....	(190,666)	43,493	32,687	53,497	5,505	33,573	21,910	
Loans to custom. with ISK income .....	145,061	(33,671)	(16,116)	(44,879)	(4,900)	(37,372)	(8,123)	
Net real position 30.9.2010 .....	(30,516)	(10,463)	5,763	10,760	4,510	9,377	10,570	
Net real position 31.12.2009 .....	(49,623)	13,513	17,258	11,057	566	1,074	6,155	

# Notes to the Condensed Consolidated Interim Financial Statements

50. cont.

## *A natural hedge for currency risk*

The currency risk is mitigated by the specific nature of foreign currency loans to customers with ISK income. We refer 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 banki 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 banki hf. 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. This strength of the natural hedge is different at different times. Since the 8 January 2010 Kaupthing capitalization the effective FX risk of the book of FX loans to customers with ISK income has been estimated at 35% of full FX risk. The effective FX risk due to customers with FX income is always 100%.

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

## b) Interest Rate Risk Disclosures

The Bank's Consolidated Statement of Financial Position is subject to various interest rate risk associated with mismatches between interest bearing assets and interest bearing liabilities. These mismatches are characterized by a large maturity gap between its assets and liabilities (see asset and liability maturity table in Liquidity Risk Disclosure section) 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.

The following table shows the sensitivity of the fair value to changes in interest rate by currency and maturity in millions of ISK in the Bank. Risk is quantified by assuming a 100bp simultaneous upward shift in all yield curves in the relevant duration band.

30.9.2010

		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked .....	ISK	238	(147)	(312)	(4,849)	(64)
Non Indexed linked .....	ISK	28	(240)	170	(186)	(199)
	EUR	(34)	(22)	-	-	-
	Other	(323)	(32)	-	-	-

31.12.2009

CPI Indexed linked .....	ISK	152	178	(80)	(418)	(363)
Non Indexed linked .....	ISK	(50)	(24)	(26)	(81)	(19)
	EUR	2	(18)	-	-	-
	Other	(4)	-	-	-	-

The Bank is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets of the Bank amounted to ISK 102.7 billion (2009: ISK 70.7 billion) and the total amount of indexed liabilities amounted to ISK 85.5 billion (2009: ISK 85.4 billion), respectively, at year end. On 8 January 2010 the total amount of indexed asset of the Bank amounted to ISK 104.6 billion and indexed liabilities amounted to ISK 86.3 billion.

# Notes to the Condensed Consolidated Interim Financial Statements

## 51. Liquidity Risk Disclosures

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.

### a) Maturity on book value

The following presents cash flows by maturity on book value at period end.

The breakdown by maturity on book value of assets and liabilities:

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total
<b>Assets</b>							
Cash with Central Bank .....	25,155	-	8,217	-	-	-	33,372
Loans to credit institutions .....	36,411	12,876	7,005	4,728	922	-	61,942
Loans and receivables to customers .....	-	8,371	43,847	233,514	159,708	-	445,440
Bonds and debt instruments .....	1,505	3,727	83	82,399	44,543	-	132,257
Shares and equity instruments .....	-	-	-	-	-	8,732	8,732
Derivatives .....	-	210	-	1,194	-	-	1,404
Securities used for hedging .....	3,413	-	-	-	-	-	3,413
Compensation instrument .....	-	-	-	30,059	-	-	30,059
Investment property .....	-	-	-	-	-	25,229	25,229
Investments in associates .....	-	-	-	-	-	6,274	6,274
Property and equipment .....	-	-	-	-	-	10,760	10,760
Intangible assets .....	-	-	-	-	-	2,987	2,987
Tax assets .....	-	-	-	-	-	732	732
Non-current assets held for sale .....	-	-	-	-	-	36,129	36,129
Other assets .....	402	3,492	11,517	1,114	-	4,400	20,925
<b>Total assets 30.9.2010 .....</b>	<b>66,886</b>	<b>28,676</b>	<b>70,669</b>	<b>353,008</b>	<b>205,173</b>	<b>95,243</b>	<b>819,655</b>
Total assets 31.12.2009 .....	75,718	18,744	60,602	327,547	175,776	98,957	757,344
<b>Liabilities</b>							
Due to credit inst. and Central Bank .....	64,383	33	2	40,763	-	-	105,181
Deposits .....	332,567	67,003	54,884	18,368	4,951	-	477,773
Borrowings .....	393	35	24	68	63,704	-	64,224
Subordinated loans .....	-	-	-	-	25,493	-	25,493
Financial liabilities at fair value .....	3,658	44	-	-	-	-	3,702
Tax liabilities .....	-	-	-	-	-	4,873	4,873
Non-current liabilities held for sale .....	-	-	-	-	-	14,980	14,980
Other liabilities .....	2,603	8,446	1,128	1,475	581	6,567	20,800
<b>Total liabilities 30.9.2010 .....</b>	<b>403,604</b>	<b>75,561</b>	<b>56,038</b>	<b>60,674</b>	<b>94,729</b>	<b>26,420</b>	<b>717,026</b>
Total liabilities 31.12.2009 .....	554,405	33,366	20,105	16,564	13,097	29,773	667,310
<b>Assets - liabilities 30.9.2010 .....</b>	<b>(336,718)</b>	<b>(46,885)</b>	<b>14,631</b>	<b>292,334</b>	<b>110,444</b>	<b>68,823</b>	<b>102,629</b>
Assets - liabilities 31.12.2009 .....	(478,687)	(14,622)	40,497	310,983	162,679	69,184	90,034

### b) Secured liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balance with the Icelandic Central Bank, Treasury notes and Housing Fund bonds and other eligible assets for repo transactions with the Central Bank and compares it with the total deposits.

On 30 September the secured liquid assets were 26.1% (2009: 22.8%) of deposits which would enable the Bank to withstand an instantaneous deposit outflow in excess of the FME requirement of 20%.

# Notes to the Condensed Consolidated Interim Financial Statements

## 52. Capital Adequacy Disclosures

Equity base at 30 September 2010 amounts to ISK 120,781 million. The core Tier 1 capital ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 14.5%, exceeding the minimum legal requirement of 8%.

On 12 August 2009 the Financial Supervisory Authority, FME, defined conditions for granting Arion banki hf. an operating license as a financial undertaking. According to these conditions, Arion banki hf. must be capitalized with a minimum Capital Adequacy ratio of 16% of which Core Tier 1 ratio of must be above 12%. This must be maintained for at least 3 years after the initial capitalization unless revised by the FME. The Bank complies with both conditions.

### a) Pillar 1

Risk weighted assets ("RWA") are calculated based on Basel II capital requirements directive (CRD). The standardized approach is used for calculating credit and market risk and the basic indicator approach for operational risk.

A remark about capital requirements for currency imbalance is in order. As indicated in our 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 the 35% effective contribution of the corresponding portion of the FX imbalance has been accounted for at year end 2009. After the 8 January 2010 capital injection, the effective contribution remains at 35% as explained in note 52.

The table shows the Bank's RWA calculations for September 30 2010 and the RWA for the end of year 2009. Also shown is the effect of the 8 January 2010 capital injection on the capital ratios. The capital injection replaces government equity in the form of risk free government bonds with various risky assets with an attendant increase in credit risk weighted assets. The capital injection is accompanied by 4% Tier 2 capital.

RWA	30.9.2010	8.1.2010	31.12.2009
Credit risk .....	525,239	574,943	480,374
Market risk .....	100,426	109,210	104,082
Operational risk .....	43,279	51,055	51,055
<b>Risk weighted assets</b> .....	<b>668,944</b>	<b>735,208</b>	<b>635,511</b>
<b>Capital Requirement (Pillar 1)</b> .....	<b>53,515</b>	<b>58,817</b>	<b>50,841</b>
Tier 1 Capital .....	97,099	90,846	86,984
Tier 2 Capital .....	23,682	29,543	-
<b>Total own funds</b> .....	<b>120,781</b>	<b>120,389</b>	<b>86,984</b>
Tier 1 ratio .....	14.5%	12.4%	13.7%
Capital adequacy ratio .....	18.1%	16.4%	13.7%

### b) Pillar 2

The Bank has developed methods to calculate concentration risk for single name concentration and sector concentration. Evaluation of other Pillar 2 risks will be developed in line with further enhancements of the Bank's economic capital model.

The Bank is exposed to relatively high concentration in the loan portfolio. According to the Bank's ICAAP, single name concentration and sector concentration lead to an add-on of 1.7% and 1.8% respectively, on top of the capital requirement for credit risk.

No Pillar 2 adjustments are made for FX risk, as it is the Bank's opinion that the effects of the natural hedge on the FX risk are adequately and appropriately addressed in Pillar 1.

# Notes to the Condensed Consolidated Interim Financial Statements

## Other information

### The uncertainty regarding the book value of currency-linked lending

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

On 16 September 2010, the Minister of Business Affairs announced that he would put forward a bill of law regarding loans in foreign currency to individuals, in which it would be stated that these individuals should be treated in the same way, regardless of how their loan agreement was drafted.

On 11 November 2010, the proposed bill of law was put before Parliament, where it is expected to have majority backing. The bill is expected to address many uncertainties regarding the calculation of interest and the netting of overpayments against remaining principal, but it is not known which changes Parliament will make before the final vote.

Loans to corporates are addressed in the bill primarily in the context of dispute resolution for loans in restructuring. The legitimacy of other foreign currency loans to corporate will likely have to be resolved in the Courts.

It is the opinion of the Bank that greater clarity has been brought to the FX situation over the past quarter. The Bank is no longer expected to be exposed to the risk that foreign currency interest rates will be applied to Icelandic Krona loans. Furthermore, the category of loan documents, classified in Q2 2010 as lowest risk is now believed to be risk-free, following an opinion of legal counsel to the FME.

The Bank continues to base its calculation of legal risk from foreign currency denominated lending on a framework set by the FME in the summer of 2010. The Bank's exposure is mainly twofold. First, there is likelihood that a bill of law will require the Bank to recalculate all mortgage loans for personal residence using an un-indexed ISK interest rate and second, the Bank estimates that it may have possible losses from vulnerable foreign currency loans to SME's and corporates.

Both of the above will have a negative effect on the P/L and the Balance Sheet of the Bank if realised, as writedowns will amount to several billions of Icelandic krona. However, even in a worst-case scenario losses will result in a mitigation of credit risk and currency imbalance. As a result, the Bank's capital ratios will remain above the 16% limit which is currently mandated by the FME.

## Related parties

54. The Bank has a related party relationship with Kaupskil ehf., Kaupthing Bank hf., the Icelandic state, the Banks associates, the Board of Directors of Arion banki hf., the key management personnel of the Bank and close family members of individuals referred to above. Loans to related parties are reported in the Consolidated Interim Statement of Financial Position.

No unusual transactions took place with related parties in the period. Transaction with related parties have been conducted on arm's length basis.

Information on other related party balances at period end is shown below:	30.9.2010	31.12.2009
Total assets .....	52,870	56,680
Total liabilities .....	64,784	66,280
<b>Net liabilities against related parties .....</b>	<b>11,914</b>	<b>9,600</b>

Comparative balances at 31 December 2009 were revised during the period to include related party balances of associates that had previously been omitted. The effect of this change is to decrease the net liability due to related parties at 31 December 2009 by ISK 12,200 million.

# Notes to the Condensed Consolidated Interim Financial Statements

## Offsetting agreement between Arion banki hf. and Kaupthing banki hf.

55. According to the FME decision of 22 October 2008, the customers of Kaupthing banki hf. are allowed to offset their debt against assets transferred to Arion banki hf. The claim registration period for customers of Kaupthing banki hf. ended on 30 December 2009. The amount of possible set off is still unknown but the effect on the Consolidated Statement of Financial Position will principally be a reclassification of assets from *Loans and receivables* to *Accounts receivable* within *Other assets*. Although the claim registration period is due the customers of Kaupthing banki hf. still have the right to request set off, thus the amounts are unknown.

An agreement signed on 3 September 2009 relating to certain aspects of the financial settlement between the banks sets out the way guarantees, shared collateral and claims subject to set off are treated. There is uncertainty regarding compensation for interest recognised on the transferred asset from Kaupthing banki hf. from the time the transaction took place until the set off process is finalized. The amount for interest recognised in 2009 is considered immaterial in these financial statements.

## Events after the Balance Sheet date

56. In October 2010 the Bank's shareholding in its associate Valitor holding hf. increased to from 46,97% to 52,27% resulting in a change in classification of the shareholding in the Financial Statements of the Bank. After the increase in shareholding Valitor holding hf. will be classified as subsidiary of the Bank and accounted for accordingly.

## Subsidiaries

57. Shares in subsidiaries are specified as follows:

Company:	Country	Currency	Activity <sup>1</sup>	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	CF	100.0
AFL - sparisjóður, Adalgata 34, 580 Siglufjörður .....	Iceland	ISK	RB	94.5
Arion Verðbréfavarsla hf., Ármúli 13, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Eignabjarg ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Ekort ehf., Gardatorg 5, 210 Gardabær .....	Iceland	ISK	RB	100.0
ENK 1 ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Gen hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	AM & PB	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town. ....	Cayman Isl.	EUR	AM & PB	100.0
Kaupthing Advisory Company S.A., 35a, avenue J.F. Kennedy .....	Luxemb.	EUR	AM & PB	100.0
Kaupthing Management Comp S.A., 35a, avenue J.F. Kennedy .....	Luxemb.	EUR	AM & PB	100.0
Landey ehf., Borgartún 26, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landfestar ehf., Borgartún 26, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landsel ehf., Borgartún 26, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Nidurskógur ehf., Digranesgata 2, 310 Borgarnes .....	Iceland	ISK	OD	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Sparisjóður Ólafsfjardar, Adalgata 14, 625 Ólafsfjörður .....	Iceland	ISK	RB	100.0
SPM ehf., Digranesgata 2, 310 Borgarnes .....	Iceland	ISK	RB	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	AM & PB	100.0
Vesturland hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	CF	100.0
Subsidiaries acquired exclusively with view to resale:				
B.M. Vallá ehf., Bíldshöfði 7, 110 Reykjavík .....	Iceland	ISK	OD	100.0
Drög ehf., Hátún 2b, 105 Reykjavík .....	Iceland	ISK	OD	82.1
Hafrahlid ehf., Laugavegur 174, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Icecorp Ltd., Earlsfort Terrace, Dublin .....	Ireland	EUR	OD	100.0
Penninn á Íslandi ehf., Pósthólf 8280, 128 Reykjavík .....	Iceland	ISK	OD	100.0

1. RB: Retail Banking, CF: Corporate Finance, AM & PB: Asset Management and Private Banking, OD: Other Divisions.