



## Condensed Consolidated Interim Financial Statements

1 January - 30 June 2010

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

Late 2008, at the height of the financial crisis, the Icelandic state took control of Kaupthing banki hf. under the Emergency Act and certain assets and liabilities were transferred from Kaupthing banki hf. to a new entity, now named Arion banki hf. The year 2009 was the first full operating year of Arion banki hf. The Bank is a group of financial undertakings which provide comprehensive services to companies, institutions and private customers. These services include corporate banking, retail banking, capital markets services, corporate financing and recovery, asset management and comprehensive wealth management for private banking clients.

On 1 June 2010 Höskuldur H. Ólafsson assumed the role as the new Chief Executive Officer of the Bank. He replaced Finnur Sveinbjörnsson.

Consolidated net earnings amounted to ISK 7,937 million for the period ended 30 June 2010. Consolidated total equity amounted to ISK 101,640 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 13.1%, exceeding the minimum legal requirement of 8%. The total Capital Adequacy ratio at 30 June 2010 was 16.4%. 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 June 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 8.3% against a trade weighted currency basket during the period. The principal reason for the net foreign exchange gain of ISK 983 million is changes in the net foreign exchange mismatch due to increased foreign currency subordinated loans and borrowings.

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.

## Outlook

The Bank's exposures are mostly concentrated within Iceland, a country which at year end 2008 experienced a financial crisis. Even though progress was made in 2009 the economic environment continues to pose a challenge to the operations of the bank. As a result the reconstruction of assets will continue to be of outmost importance for the performance of the Bank. The Bank's goal is to maximise the recovery of its assets at the same time as financially healthy and active corporations and households are returned back into the economy.

On 16 June 2010 the Icelandic Supreme Court ruled that foreign currency denominated auto-loans made by another Icelandic financial institution were in fact Icelandic Krona loans indexed to the exchange rate of foreign currencies. Such loans are prohibited according to Icelandic law on interest and indexing (30/2001). The bank discloses that although it has no auto-loans on its books, some of its foreign currency denominated loans could be vulnerable to similar interpretation. The uncertainties in relation the book value of currency-linked lending are described in note 55 to the Interim Financial Statements.

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.

The Bank continuously focuses on improving its services and building long term relationships with its customers; individuals as well as corporations. The Bank aims to excel in providing traditional banking services and channel savings to profitable investment opportunities benefitting not only our customers but the whole of the Icelandic economy.

# 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 June 2010 have been prepared in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting* as adopted by the EU except for the disclosure of certain comparative amounts as further described in note 2.

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 June 2010, its consolidated financial position as at 30 June 2010 and its consolidated cash flows for the period ended 30 June 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 June 2010 and confirm them by means of their signatures.

Reykjavík, 15 September 2010

### Board of Directors

Monica Caneman  
Chairman

Colin S. Smith

Steen Hemmingsen

Guðrún Johnsen

Theodór S. Sigurbergsson

Kristján Jóhannsson

### Chief Executive Officer

Höskuldur H. Ólafsson

# Report on Review of Condensed Consolidated Interim Financial Statements

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To the Board of Directors and Shareholders of Arion banki hf.

## Introduction

We have reviewed the accompanying Condensed Consolidated Interim Financial Statements of Arion banki hf. and its subsidiaries (the "Bank"), comprising the Consolidated Interim Statement of Financial Position as at 30 June 2010 and the related Consolidated Interim Statements of Comprehensive Income, Changes in Equity and Cash Flows for the six-month period then ended and explanatory notes. Management is responsible for the preparation and presentation of these Condensed Consolidated Interim Financial Statements in accordance with International Financial Reporting Standard IAS 34, *Interim Financial Reporting* ("IAS 34"). Our responsibility is to express a conclusion on these Condensed Consolidated Interim Financial Statements based on our review.

## Scope of review

We conducted our review in accordance with the International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

## Basis for qualified conclusion

The accompanying Consolidated Interim Statements of Comprehensive Income, Changes in Equity, Cash Flows and related notes include comparative figures for the year ended 31 December 2009. This is not in compliance with IAS 34, which requires these statements use comparative figures from the comparable interim period of the immediately preceding year, being the six-month period ended 30 June 2009.

## Qualified conclusion

Based on our review, except for the effect on the Condensed Consolidated Interim Financial Statements of the matter described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements are not prepared, in all material respects, in accordance with IAS 34.

## Matters of emphasis

Without further qualifying our conclusion we draw your attention to:

Notes 2d), 4 and 51 to the Condensed Consolidated Interim Financial Statements concerning the carrying values of assets involving accounting estimates and judgements, and the sensitivity of these carrying values to changes in reasonably possible alternative assumptions and estimates. Actual amounts realised in the future from these assets could differ from current estimates and significant uncertainty exists over whether the differences may be material to the Condensed Consolidated Interim Financial Statements.

Note 55 to the Condensed Consolidated Interim Financial Statements concerning the uncertain outcome of future court rulings on foreign currency denominated loans and the alternative loan terms that may apply. Significant uncertainty exists over the impact of these future court rulings on the carrying value of the Bank's portfolio of foreign currency denominated loans, as well as on the shareholders' equity and capital adequacy ratios of the Bank.

Reykjavík, 15 September 2010

**Ernst & Young hf.**

Margrét Pétursdóttir, Partner

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

	Notes	2010 1.1.-30.6.	2009 1.1.-31.12.
Interest income .....		28,785	66,905
Interest expense .....		(18,488)	(54,759)
<b>Net interest income</b> .....	10	<u>10,297</u>	<u>12,146</u>
Increase in value of loans and receivables .....	11	8,701	20,199
FX gain (loss) on loans and receivables from ISK income customers .....	18	(686)	1,535
Impairment on loans and receivables .....	12	(4,254)	(11,474)
Changes in compensation instrument .....	35	(3,422)	(10,556)
<b>Net interest income after valuation changes on loans and receivables</b> .....		<u>10,636</u>	<u>11,850</u>
Fee and commission income .....		3,846	8,291
Fee and commission expense .....		(994)	(2,429)
<b>Net fee and commission income</b> .....	13	<u>2,852</u>	<u>5,862</u>
Net financial income (expense) .....	14-17	(262)	1,638
Net foreign exchange gain .....	18	1,669	8,715
Share of profit or loss of associates .....	37	143	369
Other operating income .....	19	12,710	21,201
<b>Operating income</b> .....		<u>27,748</u>	<u>49,635</u>
Salaries and related expense .....	21	(6,208)	(10,413)
Administration expense .....		(2,931)	(5,317)
Depositors' and investors' guarantee fund .....		(326)	(683)
Depreciation and amortisation .....		(586)	(1,161)
Other operating expense .....	22	(8,541)	(16,279)
Net gain (loss) on non-current assets and disposal groups classified as held for sale .....		282	(375)
<b>Earnings before income tax</b> .....		<u>9,438</u>	<u>15,407</u>
Income tax expense .....	23	(1,501)	(2,536)
<b>Net earnings</b> .....		<u><u>7,937</u></u>	<u><u>12,871</u></u>
<b>Other comprehensive income</b>			
Exchange difference on translating foreign operations .....	47	(174)	(37)
<b>Total comprehensive income for the period</b> .....		<u><u>7,763</u></u>	<u><u>12,834</u></u>
<b>Attributable to:</b>			
Shareholders of Arion banki hf. ....		7,859	12,970
Non-controlling interest .....		78	(99)
<b>Net earnings</b> .....		<u><u>7,937</u></u>	<u><u>12,871</u></u>
<b>Earnings per share</b>			
Basic and diluted earnings per share attributable to the shareholders of Arion banki hf. (ISK) .....	24	3.26	1.02

*The notes on pages 10 to 42 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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

<b>Assets</b>	Notes	30.6.2010	31.12.2009
Cash and balances with Central Bank .....	25	33,259	41,906
Loans and receivables to credit institutions .....	26-27	42,803	38,470
Loans and receivables to customers .....	28-30	466,021	357,734
Bonds and debt instruments .....	33-34	150,503	173,482
Shares and equity instruments with variable income .....	33	8,329	7,078
Derivatives .....	33,44	1,347	6
Securities used for hedging .....	33	2,369	2,236
Compensation instrument .....	35	29,917	34,371
Investment property .....	36	25,308	22,947
Investments in associates .....	37	6,127	5,985
Property and equipment .....		11,119	10,700
Intangible assets .....		2,970	3,512
Tax assets .....	43	1,620	1,415
Non-current assets and disposal groups held for sale .....	38	38,456	41,527
Other assets .....	39	22,103	15,975
<b>Total Assets</b>		<b>842,251</b>	<b>757,344</b>
<b>Liabilities</b>			
Due to credit institutions and Central Bank .....	33	107,508	113,647
Deposits .....	33	493,438	495,465
Borrowings .....	33,41	67,480	11,042
Subordinated loans .....	33,42	26,084	-
Financial liabilities at fair value .....	33	5,522	88
Tax liabilities .....	43	4,466	2,841
Non-current liabilities and disposal groups held for sale .....	38	15,841	19,230
Other liabilities .....	45	20,272	24,997
<b>Total Liabilities</b>		<b>740,611</b>	<b>667,310</b>
<b>Equity</b>			
Share capital .....	46	2,000	12,646
Share premium .....	46	73,861	59,354
Other reserves .....	47	2,341	1,729
Retained earnings .....		23,223	16,150
<b>Total Shareholders' Equity</b>		<b>101,425</b>	<b>89,879</b>
Non-controlling interest .....		215	155
<b>Total Equity</b>		<b>101,640</b>	<b>90,034</b>
<b>Total Liabilities and Equity</b>		<b>842,251</b>	<b>757,344</b>

The notes on pages 10 to 42 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 June 2010

	Share capital and share premium	Other reserves	Retained earnings	Total Share- holders' equity	Non- controlling interest	Total equity
<b>Changes in equity from 1 January to 30 June 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. ....		(174)	7,859	7,685		7,685
Total other comprehensive income for the period						
attributable to the non-controlling interest .....					78	78
Transfer to statutory reserve .....		786	(786)			
Non-controlling interests acquired during the period .....					(18)	(18)
<b>Equity 30 June 2010 .....</b>	<b>75,861</b>	<b>2,341</b>	<b>23,223</b>	<b>101,425</b>	<b>215</b>	<b>101,640</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 42 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 June 2010

	Notes	2010 1.1.-30.6.	2009 1.1.-31.12.
Net cash provided by (used in) operating activities .....		1,263	(36,419)
Net cash flow used in investing activities .....		(839)	(3,506)
Net increase (decrease) in cash and cash equivalents .....		424	(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 .....		(1,894)	2,305
<b>Cash and cash equivalents at end of the period .....</b>		<b>54,624</b>	<b>56,094</b>
<b>Cash and cash equivalents comprises</b>			
Cash in hand and demand deposits .....		33,259	41,906
Due from credit institutions .....		29,582	24,037
Mandatory reserve with Central Bank .....		(8,217)	(9,849)
Total cash and cash equivalents .....		54,624	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 42 are an integral part of these Condensed Consolidated Interim Financial Statements.*

# Notes to the Condensed Consolidated Interim Financial Statements

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# 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 June 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 with the exception that comparative amounts in the Consolidated Interim Statement of Comprehensive Income, Consolidated Interim Statement of Changes in Equity and the Condensed Consolidated Interim Statement of Cash Flow and related notes are for the year ended 31 December 2009, IAS 34 requires comparative figures from the comparable interim period of the immediately preceding year, being the six month period ended 30 June 2009. 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 15 September 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 transferred assets from Kaupthing banki hf. are denominated in low interest rate foreign currencies and are funded with on demand 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 Banks 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 June 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 June 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 June 2010.

## 7. Changes in classification of subsidiaries acquired exclusively with view to resale.

The Bank holds 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 end of June 2010 this legal entity is considered to meet the requirements of IFRS 5 to be classified as non-current assets and disposal groups classified as held for sale and has been accounted for as such in these Condensed Consolidated Interim Financial Statements of the Bank.

# Notes to the Condensed Consolidated Interim Financial Statements

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## Operating Segment Reporting

8. Segment information is presented in respect of the Bank's operating segments based on the Bank's management and internal reporting structure.

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

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

### Business segments

The Bank comprises the following main business segments:

**Corporate Banking** provides general banking services to large companies in Iceland.

**Retail Banking** provides general banking services to retail customers and medium sized companies.

**Treasury and Capital Markets** is divided into three parts: Treasury, Capital Markets and Proprietary Trading. Treasury is responsible for inter bank trading and the Bank's funding. Capital Markets handles securities, derivatives and foreign exchange trading and brokerage for the Bank's clients. Proprietary Trading handles transactions for the Bank's own account in all major markets, as well as undertaking the Bank's market making for stocks and bonds.

**Corporate Finance** is divided into two parts: Corporate Advisory and Recovery. Corporate Advisory which provides various services to corporate clients through its four main products areas: M&A advisory, Capital Markets Advisory, Acquisition and Leverage Finance and Principal Investment. Recovery which is responsible for the financial restructuring of the numerous Icelandic corporates which are unable to meet their payment obligations towards the bank following the recent crisis in the Icelandic economy.

**Asset Management and Private Banking** manage financial assets for institutional, corporate and private clients. Asset Management is organised into three units: Alternative and Mutual Fund Management, Asset Management for Institutional Investors and Services for Institutional Investors. Private Banking consists of two units: Customer Relations and Portfolio Management.

**Other business segments** are: Overhead, Back Office, Risk Management, Finance, Legal Department, Information Technology, and Human Resources and activities of entities acquired exclusively with view to resale.

# Notes to the Condensed Consolidated Interim Financial Statements

## 9. Summary of the Bank's business segments:

1.1.-30.6.2010	Corporate Banking	Retail Banking	Treasury and Capital Markets	Corporate Finance	Asset Managem. and Private Banking	Other Divisions and Elimination	Total
Net interest income, incl. increase in loan value ..	10,578	6,212	4,198	(26)	627	(2,591)	18,998
Impairment on loans and receivables .....	(523)	(3,182)	(4)	(18)	(5)	(522)	(4,254)
Changes in compensation instrument .....	-	-	(3,422)	-	-	-	(3,422)
Net fee and commission income .....	264	1,059	114	38	1,035	342	2,852
Net financial income .....	16	158	(664)	68	49	111	(262)
Net foreign exchange gain .....	1	108	1,035	-	(85)	(76)	983
Other income .....	5	687	-	12	53	12,096	12,853
<b>Operating income .....</b>	<b>10,341</b>	<b>5,042</b>	<b>1,257</b>	<b>74</b>	<b>1,674</b>	<b>9,360</b>	<b>27,748</b>
Operating expense .....	(266)	(3,458)	(363)	(193)	(500)	(13,530)	(18,310)
<b>Earnings before cost allocation .....</b>	<b>10,075</b>	<b>1,584</b>	<b>894</b>	<b>(119)</b>	<b>1,174</b>	<b>(4,170)</b>	<b>9,438</b>
Allocated cost .....	(234)	(342)	(253)	(47)	(75)	951	-
<b>Earnings before income tax .....</b>	<b>9,841</b>	<b>1,242</b>	<b>641</b>	<b>(166)</b>	<b>1,099</b>	<b>(3,219)</b>	<b>9,438</b>
Net segment revenue from external customers ...	15,442	653	3,002	115	(698)	9,234	27,748
Net segment revenue from other segments .....	(5,101)	4,389	(1,745)	(41)	2,372	126	-
<b>Operating income .....</b>	<b>10,341</b>	<b>5,042</b>	<b>1,257</b>	<b>74</b>	<b>1,674</b>	<b>9,360</b>	<b>27,748</b>
Depreciation and amortisation .....	-	110	-	-	-	476	586
<b>Total assets .....</b>	<b>267,292</b>	<b>217,115</b>	<b>274,920</b>	<b>3,730</b>	<b>4,674</b>	<b>74,520</b>	<b>842,251</b>
Allocated equity .....	31,610	24,152	48,180	-	3,194	(5,497)	101,640

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



# Notes to the Condensed Consolidated Interim Financial Statements

9. cont.

1.1.-31.12.2009	Corporate Banking	Retail Banking	Treasury and Capital Markets	Corporate Finance and recovery	Asset Managem. and Private Banking	Other Divisions and Elimination	Total
Net interest income, incl. increase in loan value ..	14,458	8,896	8,108	(84)	1,585	(618)	32,345
Impairment on loans and receivables .....	(10,201)	(1,801)	557	(2)	-	(27)	(11,474)
Changes in compensation instrument .....	-	-	(10,556)	-	-	-	(10,556)
Net fee and commission income .....	526	1,751	533	320	1,846	886	5,862
Net financial income .....	(47)	451	1,351	331	(265)	(183)	1,638
Net foreign exchange gain .....	1,550	335	8,303	(32)	150	(56)	10,250
Other income .....	8	1,416	6	49	177	19,914	21,570
<b>Operating income .....</b>	<b>6,294</b>	<b>11,048</b>	<b>8,302</b>	<b>582</b>	<b>3,493</b>	<b>19,916</b>	<b>49,635</b>
Operating expense .....	(33)	(5,848)	(417)	(255)	(1,017)	(26,658)	(34,228)
<b>Earnings before cost allocation .....</b>	<b>6,261</b>	<b>5,200</b>	<b>7,885</b>	<b>327</b>	<b>2,476</b>	<b>(6,742)</b>	<b>15,407</b>
Allocated cost .....	(345)	(511)	(372)	(69)	(110)	1,407	-
<b>Earnings before income tax .....</b>	<b>5,916</b>	<b>4,689</b>	<b>7,513</b>	<b>258</b>	<b>2,366</b>	<b>(5,335)</b>	<b>15,407</b>
Net segment revenue from external customers ...	28,441	(12,686)	17,212	757	(5,131)	21,042	49,635
Net segment revenue from other segments .....	(22,147)	23,734	(8,910)	(175)	8,624	(1,126)	-
<b>Operating income .....</b>	<b>6,294</b>	<b>11,048</b>	<b>8,302</b>	<b>582</b>	<b>3,493</b>	<b>19,916</b>	<b>49,635</b>
Depreciation and amortisation .....	1	278	1	1	-	880	1,161
<b>Total assets .....</b>	<b>233,603</b>	<b>137,364</b>	<b>306,856</b>	<b>5,404</b>	<b>3,963</b>	<b>70,154</b>	<b>757,344</b>
Allocated equity .....	29,682	14,671	45,788	(665)	2,995	(2,437)	90,034

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

# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Interim Statement of Comprehensive Income

### Net interest income

10. Interest income and expense is specified as follows:

	Interest income	Interest expense	Net interest income
1.1.-30.6.2010			
Cash and balances with Central Bank .....	571	-	571
Loans, receivables and deposits .....	20,946	16,964	3,982
Borrowings .....	-	918	(918)
Subordinated loans .....	-	581	(581)
Securities .....	6,501	-	6,501
Compensation instrument .....	665	-	665
Other .....	102	25	77
<b>Interest income and expense .....</b>	<b>28,785</b>	<b>18,488</b>	<b>10,297</b>
Interest income and expense from assets and liabilities at fair value .....	6,501	-	6,501
Interest income and expense from assets and liabilities not at fair value through profit or loss ....	22,284	18,488	3,796
<b>Interest income and expense .....</b>	<b>28,785</b>	<b>18,488</b>	<b>10,297</b>
1.1.-31.12.2009			
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

11. 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.

# Notes to the Condensed Consolidated Interim Financial Statements

## Impairment on loans and receivables

12. Impairment on loans and receivables is specified as follows:	2010	2009
	1.1.-30.6.	1.1.-31.12.
Impairment on loans and receivables to credit institutions .....	-	682
Impairment for unrealisable FX (loss) gains from FX denominated loans to borrowers with ISK income .....	(686)	1,535
Impairment on loans and receivables to customers .....	4,817	8,317
Impairment on receivables and other assets .....	123	940
<b>Impairment</b> .....	<u>4,254</u>	<u>11,474</u>

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

## Net fee and commission income

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

1.1.-30.6.2010	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 .....	-	-	69	69
Derivatives .....	94	-	-	94
Lending and guarantees .....	-	315	-	315
Asset management fees .....	-	-	1,387	1,387
Other fee and commission income - banking activities .....	-	-	1,693	1,693
Other fee and commission income .....	-	-	288	288
<b>Fee and commission income</b> .....	<u>94</u>	<u>315</u>	<u>3,437</u>	<u>3,846</u>
<b>Fee and commission expense</b>				
Purchased guarantees .....	11	-	-	11
Securities trading .....	-	-	96	96
Asset management fees .....	-	-	147	147
Other fee and commission income - banking activities .....	-	-	584	584
Other fee and commission expense .....	-	-	156	156
<b>Fee and commission expense</b> .....	<u>11</u>	<u>-</u>	<u>983</u>	<u>994</u>
<b>Net fee and commission income</b> .....	<u>83</u>	<u>315</u>	<u>2,454</u>	<u>2,852</u>

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.

# Notes to the Condensed Consolidated Interim Financial Statements

13. cont.

1.1.-31.12.2009	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 .....	-	-	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

14. Net financial income is specified as follows:	2010 1.1.-30.6.	2009 1.1.-31.12.
Dividend income .....	26	29
Net (loss) gain on financial assets and liabilities classified as held for trading .....	(481)	1,240
Net gain on financial assets and liabilities designated at fair value through profit or loss .....	193	369
<b>Net financial income</b> .....	<b>(262)</b>	<b>1,638</b>
15. 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 .....	24	9
<b>Dividend income</b> .....	<b>26</b>	<b>29</b>
16. Net gain (loss) on trading portfolio are specified as follows:		
Net gain on equity instruments and related derivatives .....	182	279
Net (loss) gain on interest rate instruments and related derivatives .....	(598)	194
Net (loss) gain on other derivatives .....	(65)	767
<b>Net (loss) gain on trading portfolio</b> .....	<b>(481)</b>	<b>1,240</b>

# Notes to the Condensed Consolidated Interim Financial Statements

17. Net gain (loss) on assets/liabilities designated at fair value through profit or loss are specified as follows:	2010	2009
	1.1.-30.6.	1.1.-31.12.
Net gain on interest rate instruments designated at fair value .....	160	230
Net gain on equity instruments designated at fair value .....	33	139
<b>Net gain on assets/liabilities designated at fair value through profit and loss .....</b>	<b>193</b>	<b>369</b>

18. Net gain (loss) on foreign exchange are specified as follows:		
FX (loss) gain on loans and receivables .....	(6,215)	15,059
FX (loss) gain on bank accounts .....	(1,894)	2,305
FX gain (loss) from deposits and borrowings .....	12,616	(9,597)
FX gain on bonds, equity and derivatives .....	145	445
FX (loss) gain on other assets and liabilities .....	(2,983)	503
<b>Net gain on foreign exchange .....</b>	<b>1,669</b>	<b>8,715</b>
FX gain (loss) on loans and receivables from ISK income customers .....	(686)	1,535
<b>Total gain (loss) on foreign exchange .....</b>	<b>983</b>	<b>10,250</b>

## Other operating income

19. Other operating income is specified as follows:		
Rental income from investment properties .....	1,039	1,183
Fair value changes on investment property .....	36	170
Realised gain on investment property .....	163	70
Earned premiums, net of reinsurance .....	408	822
Net gain on disposals of assets other than held for sale .....	37	44
Other income from subsidiaries acquired exclusively with view to resale .....	10,616	17,838
Other income .....	411	1,074
<b>Other operating income .....</b>	<b>12,710</b>	<b>21,201</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Personnel

20. The Bank's total number of employees is as follows:	30.6.2010	31.12.2009
Average number of full time equivalent positions during the period .....	1,146	1,177
Full time equivalent positions at the end of the period .....	1,142	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:

	30.6.2010	31.12.2009
Full time equivalent positions at the end of the period .....	600	584

21. Salaries and related expense are specified as follows:	2010	2009
	1.1.-30.6.	1.1.-31.12.
Salaries .....	4,909	8,438
Defined contribution pension plans .....	577	1,123
Salary related expense .....	722	852
<b>Salaries and related expense</b> .....	<b>6,208</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	2009
	1.1.-30.6.	1.1.-31.12.
Salaries .....	1,417	1,949
Salary related expense .....	350	391
<b>Salaries and related expense</b> .....	<b>1,767</b>	<b>2,340</b>

## Other operating expense

22. Other operating expenses:

Direct operating expenses (including repairs and maintenance) arising on rental-earning investment properties .....	214	263
Claims incurred, net of reinsurance .....	132	315
Other operating expenses from subsidiaries acquired exclusively with view to resale .....	8,186	15,686
Other operating expenses .....	9	15
<b>Other operating expenses</b> .....	<b>8,541</b>	<b>16,279</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Income tax expense

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

	2010	2009
	1.1.-30.6.	1.1.-31.12.
<i>Current tax expense</i>		
Current period .....	1,601	1,044
<i>Deferred tax expense</i>		
Changes in temporary differences .....	(99)	1,492
<b>Total income tax expense</b> .....	<b>1,501</b>	<b>2,536</b>

Reconciliation of effective tax rate:	1.1.-30.6.2010	1.1.-31.12.2009
Earnings before income tax .....	9,438	15,407
Income tax using the Icelandic corporation tax rate .....	18.0% 1,699	15.0% 2,311
Non-deductible expense .....	0.1% 9	0.1% 9
Tax exempt revenues .....	(0.8%) (71)	(0.8%) (126)
Effect of increase in the income tax rate from 15% to 18% .....	0.0% -	1.9% 297
Other changes .....	(1.4%) (136)	0.3% 45
<b>Effective tax rate</b> .....	<b>15.9% 1,501</b>	<b>16.5% 2,536</b>

## Earnings per share

24. Earnings per share are specified as follows:

	2010	2009
	1.1.-30.6.	1.1.-31.12.
Net earnings attributable to the shareholders of Arion banki hf. ....	7,859	12,970
Weighted average share capital:		
Weighted average number of outstanding shares for the period, million .....	2,414	12,646
Basic earnings per share .....	3.26	1.02
Diluted earnings per share .....	3.26	1.02
Number of outstanding shares at the end of the period, million .....	2,000	12,646
Number of total shares at the end of the period, million, diluted .....	2,000	12,646

## Notes to the Consolidated Interim Statement of Financial Position

### Cash and balances with Central Bank

25. Cash and balances with Central Bank are specified as follows:

	30.6.2010	31.12.2009
Cash on hand .....	3,954	3,536
Cash with Central Bank .....	21,088	28,521
Mandatory reserve deposits with Central Bank .....	8,217	9,849
<b>Cash and balances with Central Bank</b> .....	<b>33,259</b>	<b>41,906</b>

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

# Notes to the Condensed Consolidated Interim Financial Statements

## Loans and receivables to credit institutions

26. Loans and receivables to credit institutions specified by types of loans:	30.6.2010	31.12.2009
Bank accounts .....	29,553	24,037
Money market loans .....	5,007	4,733
Overdrafts .....	4,268	4,074
Other loans .....	3,975	5,626
<b>Loans and receivables to credit institutions .....</b>	<b>42,803</b>	<b>38,470</b>
27. 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>
Collective .....	-	-
Specific .....	727	727
	727	727

## Loans and receivables to customers

28. Loans and receivables to customers specified by types of loans:		
Overdrafts .....	38,006	31,673
Subordinated loans .....	12	17
Other loans and receivables .....	460,811	354,780
Provision on loans and receivables .....	(32,808)	(28,736)
<b>Loans and receivables to customers .....</b>	<b>466,021</b>	<b>357,734</b>
29. Loans and receivables to customers specified by sectors:		
Individuals .....	23.5%	15.5%
Holding companies .....	10.0%	13.9%
Industry .....	25.1%	33.2%
Real estate .....	14.3%	15.2%
Service .....	23.7%	17.9%
Trade .....	3.1%	4.0%
Transportation .....	0.3%	0.3%
<b>Loans and receivables to customers .....</b>	<b>100.0%</b>	<b>100.0%</b>



# Notes to the Condensed Consolidated Interim Financial Statements

30. Changes in the provision for losses on loans and receivables to customers are specified as follows:	2010	2009
	1.1.-30.6.	1.1.-31.12.
Balance at the beginning of the period .....	28,736	18,905
Provision for losses during the period .....	4,817	8,317
Provision for unrealisable FX gains from FX denominated loans to borrowers with ISK income .....	(686)	1,535
Payment of loans previously written off .....	(59)	(21)
<b>Balance at the end of the period .....</b>	<b>32,808</b>	<b>28,736</b>
Specific .....	32,808	28,736
Collective .....	-	-
	<b>32,808</b>	<b>28,736</b>

## Additional information on loans and receivables

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

1.1.-30.6.2010	Nominal value	Deep discount	Subsequent impairment	Book value
Loans and receivables to credit institutions .....	64,734	(21,204)	(727)	42,803
Loans and receivables to customers .....	1,237,263	(738,434)	(32,808)	466,021
<b>Balance at 30 June 2010 .....</b>	<b>1,301,997</b>	<b>(759,638)</b>	<b>(33,535)</b>	<b>508,824</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

32. 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 transferred 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. An insignificant number of corporate restructurings had been finalized by the end of June 2010.

# Notes to the Condensed Consolidated Interim Financial Statements

## Financial assets and liabilities

33. Financial assets and liabilities are specified as follows:

30.6.2010	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 .....	33,259	-	-	-	33,259
Loans to credit institutions .....	42,803	-	-	-	42,803
Loans to customers .....	466,021	-	-	-	466,021
<b>Loans and receivables .....</b>	<b>542,083</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>542,083</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	7,746	42,294	-	50,040
Unlisted .....	-	-	100,463	-	100,463
<b>Bonds and debt instruments .....</b>	<b>-</b>	<b>7,746</b>	<b>142,757</b>	<b>-</b>	<b>150,503</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	585	557	-	1,142
Unlisted .....	-	678	4,459	-	5,137
Bond funds with variable income .....	-	363	1,687	-	2,050
<b>Shares and equity instruments .....</b>	<b>-</b>	<b>1,626</b>	<b>6,703</b>	<b>-</b>	<b>8,329</b>
<i>Derivatives</i>					
OTC derivatives .....	-	1,347	-	-	1,347
<b>Derivatives .....</b>	<b>-</b>	<b>1,347</b>	<b>-</b>	<b>-</b>	<b>1,347</b>
<i>Securities used for hedging</i>					
Bonds and debt instruments .....	-	2,369	-	-	2,369
<b>Securities used for hedging .....</b>	<b>-</b>	<b>2,369</b>	<b>-</b>	<b>-</b>	<b>2,369</b>
Compensation instrument .....	-	-	-	29,917	29,917
Other financial assets .....	-	-	-	14,454	14,454
<b>Financial assets .....</b>	<b>542,083</b>	<b>13,088</b>	<b>149,460</b>	<b>44,371</b>	<b>749,002</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	-	-	-	107,508	107,508
Deposits .....	-	-	-	493,438	493,438
Borrowings .....	-	-	-	67,480	67,480
Subordinated loans .....	-	-	-	26,084	26,084
<b>Liabilities at amortised cost .....</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>694,510</b>	<b>694,510</b>
<i>Financial liabilities at fair value</i>					
Short position in equity held for trading .....	-	5,382	-	-	5,382
Derivatives held for trading .....	-	140	-	-	140
<b>Financial liabilities at fair value .....</b>	<b>-</b>	<b>5,522</b>	<b>-</b>	<b>-</b>	<b>5,522</b>
Other financial liabilities .....	-	-	-	592	592
<b>Financial liabilities .....</b>	<b>-</b>	<b>5,522</b>	<b>-</b>	<b>695,102</b>	<b>700,624</b>

# Notes to the Condensed Consolidated Interim Financial Statements

33. 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>-</b>	<b>-</b>	<b>-</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>-</b>	<b>4,221</b>	<b>169,261</b>	<b>-</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>-</b>	<b>2,493</b>	<b>4,585</b>	<b>-</b>	<b>7,078</b>
<i>Derivatives</i>					
OTC derivatives .....	-	6	-	-	6
<b>Derivatives .....</b>	<b>-</b>	<b>6</b>	<b>-</b>	<b>-</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>-</b>	<b>2,236</b>	<b>-</b>	<b>-</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>-</b>	<b>-</b>	<b>-</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>-</b>	<b>88</b>	<b>-</b>	<b>-</b>	<b>88</b>
Other financial liabilities .....	-	-	-	1,524	1,524
<b>Financial liabilities .....</b>	<b>-</b>	<b>88</b>	<b>-</b>	<b>621,678</b>	<b>621,766</b>

34. Bonds and debt instruments designated at fair value specified by issuer:	30.6.2010	31.12.2009
Financial institutions .....	1,588	1,760
Governments .....	53,965	73,042
Corporates .....	87,198	94,454
Other .....	6	5
<b>Bonds and debt instruments designated at fair value .....</b>	<b>142,757</b>	<b>169,261</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Compensation instrument

35. 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. The maturity of this instrument is 30 June 2012 and is a priority claim against Kaupthing banki hf.

Compensation instrument is specified as follows:	30.6.2010	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 .....	665	2,398
Foreign exchange rate differences .....	(1,697)	1,373
<b>Balance at the end of the period .....</b>	<b>29,917</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	31.12.2009
			Investment properties	Investment properties in progress		
36. Investment property is specified as follows:					30.6.2010	
Balance at the beginning of the period .....	15,354	2,177	2,715	2,701	22,947	12,079
Acquisition through business combination .....	630	-	984	-	1,614	7,832
Additions during the period .....	-	412	172	675	1,259	3,289
Other disposals during the period .....	-	(262)	-	-	(262)	(423)
Fair value adjustments .....	36	-	(186)	(99)	(249)	170
<b>Investment property .....</b>	<b>16,020</b>	<b>2,327</b>	<b>3,685</b>	<b>3,277</b>	<b>25,309</b>	<b>22,947</b>

# Notes to the Condensed Consolidated Interim Financial Statements

## Investments in associates

37. 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 hf., Laugarvegur 77, 101 Reykjavík, Iceland .....	46.0%
Borgarland ehf., Egilsholti 1, 310 Borgarnesi, Iceland .....	42.0%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland .....	42.7%

Investments in associates are specified as follows:

	30.6.2010	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 (loss) .....	142	369
<b>Carrying amount at the end of the period .....</b>	<b>6,127</b>	<b>5,985</b>

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

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

Legal entities, total assets .....	36,083	38,922
Real estates .....	2,335	2,570
Other assets .....	38	35
<b>Non-current assets and disposal groups held for sale .....</b>	<b>38,456</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:

	30.6.2010	31.12.2009
Legal entities, total liabilities .....	15,841	19,230

# Notes to the Condensed Consolidated Interim Financial Statements

38. cont.

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.

Penninn Holding 1 Oy which is a holding company of Officeday Finland Oy. Officeday Finland group is importer and wholesaler of IT and office supplier.

## Other assets

39. Other assets are specified as follows:	30.6.2010	31.12.2009
Unsettled securities trading .....	366	1,583
Accounts receivables .....	14,088	7,647
Accrued income .....	405	376
Prepaid expense .....	565	341
Sundry assets .....	1,887	236
Other assets from subsidiaries acquired exclusively with view to resale .....	4,792	5,792
<b>Other assets</b> .....	<b>22,103</b>	<b>15,975</b>

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

40. 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

41. Borrowings are specified as follows:	30.6.2010	31.12.2009
Bonds issued .....	6,986	-
Other loans .....	60,494	11,042
<b>Borrowings</b> .....	<b>67,480</b>	<b>11,042</b>

## Subordinated loans

42. Subordinated loans are specified as follows:

Tier II capital .....	26,084	-
<b>Subordinated loans</b> .....	<b>26,084</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

43. Tax assets and liabilities are specified as follows:	30.6.2010		31.12.2009	
	Assets	Liabilities	Assets	Liabilities
Current tax .....	-	2,848	-	1,051
Deferred tax .....	1,620	1,618	1,415	1,790
<b>Tax assets and liabilities</b> .....	<b>1,620</b>	<b>4,466</b>	<b>1,415</b>	<b>2,841</b>

## Derivatives

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

30.6.2010	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 .....	2,606	-	-	2,606	2	32
Interest rate and exchange rate agreements .....	-	21	3,476	3,497	1,316	-
	2,606	21	3,476	6,103	1,318	32
Bond derivatives:						
Bond swaps, agreements unlisted .....	14,863	-	-	14,863	29	108
	14,863	-	-	14,863	29	108
<b>Derivatives</b> .....	<b>17,469</b>	<b>21</b>	<b>3,476</b>	<b>20,966</b>	<b>1,347</b>	<b>140</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
	180	-	2,147	2,327	-	71
Bond derivatives:						
Bond swaps, agreements unlisted .....	4,927	-	-	4,927	6	17
	4,927	-	-	4,927	6	17
<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

45. Other liabilities are specified as follows:	30.6.2010	31.12.2009
Unsettled securities trading .....	240	1,134
Accounts payable .....	592	1,524
Withholding tax .....	618	2,743
Deposit and investor guarantee fund .....	2,352	3,041
Insurance claim .....	1,989	1,847
Other liabilities from subsidiaries acquired exclusively with view to resale .....	4,929	6,557
Sundry liabilities .....	9,552	8,151
<b>Other liabilities</b> .....	<b>20,272</b>	<b>24,997</b>

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

## Equity

### Share capital

46. 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

47. Other reserves are specified as follows:	30.6.2010	31.12.2009
Statutory reserve .....	2,423	1,637
Foreign currency translation reserve .....	(82)	92
<b>Other reserves</b> .....	<b>2,341</b>	<b>1,729</b>

## Off Balance Sheet information

### Obligations

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

	30.6.2010	31.12.2009
Guarantees .....	11,690	15,318
Unused overdrafts .....	41,948	45,132
Loan commitments .....	20,464	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

49. Assets under management and assets under custody are specified as follows:	30.6.2010	31.12.2009
Assets under management .....	602,212	580,523
Assets under custody .....	2,014,190	2,129,518

## Contingent liabilities

50. 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

#### 51. 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.

Category: Description (D) / Valuation method (V):	30.6.2010 Value	31.12.2009* Value
Higher discount factor:		
D: Loans where Arion banki hf. expects full recovery and the contractual cash flow is used.		
V: Present value of discounted contractual cash flows at market interest rates.	44%	40%
Collateral value:		
D: Loans where the underlying collateral value is greater than the value of future expected cash flow.		
V: Assessment of underlying collateral.	18%	21%
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.		
V: EV/EBITDA multiples.	20%	21%
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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51. 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

## 52. 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 .....	20,932	3,903	2,886	435	1,443	389	3,271	33,259
Loans to credit institutions .....	3,584	8,333	10,697	1,974	5,366	3,683	9,166	42,803
Loans and receivables to customers ..	186,832	69,751	46,450	68,924	16,466	54,146	23,451	466,021
Bonds and debt instruments .....	149,464	1,007	33	-	-	-	-	150,503
Shares and equity instruments .....	5,731	1,765	83	-	167	-	584	8,329
Derivatives .....	1,347	-	-	-	-	-	-	1,347
Securities used for hedging .....	2,369	-	-	-	-	-	-	2,369
Compensation instruments .....	21,710	8,206	-	-	-	-	-	29,917
Investment property .....	25,308	-	-	-	-	-	-	25,308
Investments in associates .....	5,662	465	-	-	-	-	-	6,127
Property and equipment .....	10,646	473	-	-	-	-	-	11,119
Intangible assets .....	2,499	470	-	-	-	-	-	2,970
Tax assets .....	1,620	-	-	-	-	-	-	1,620
Non-current assets held for sale .....	36,826	1,630	1	-	-	-	-	38,456
Other assets .....	19,708	824	1,394	65	98	14	-	22,103
<b>Total assets 30.6.2010 .....</b>	<b>494,238</b>	<b>96,830</b>	<b>61,544</b>	<b>71,398</b>	<b>23,539</b>	<b>58,232</b>	<b>36,472</b>	<b>842,251</b>
<b>Liabilities</b>								
Due to credit inst. and Central Bank ..	77,624	3,329	3,817	1,373	4,513	476	16,376	107,508
Deposits .....	449,259	28,683	7,899	372	3,771	517	2,938	493,438
Borrowings .....	4,043	42,727	12,659	7,120	-	874	57	67,480
Subordinated loans .....	-	26,084	-	-	-	-	-	26,084
Financial liabilities at fair value .....	5,522	-	-	-	-	-	-	5,522
Tax liabilities .....	4,466	-	-	-	-	-	-	4,466
Non-current liabilities held for sale ....	15,330	511	-	-	-	-	-	15,841
Other liabilities .....	16,371	2,534	959	1	65	68	274	20,272
Equity .....	101,640	-	-	-	-	-	-	101,640
<b>Total liabilities 30.6.2010 .....</b>	<b>674,254</b>	<b>103,868</b>	<b>25,334</b>	<b>8,866</b>	<b>8,349</b>	<b>1,934</b>	<b>19,645</b>	<b>842,251</b>
Net on balance sheet position .....	(180,016)	(7,040)	36,210	62,531	15,190	56,298	16,826	
Net off balance sheet position .....	(1,228)	374	847	-	-	-	6	
Net position 30.6.2010 .....	(181,244)	(6,665)	37,057	62,531	15,190	56,298	16,832	
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 .....	155,551	(33,319)	(16,858)	(47,925)	(6,157)	(40,354)	(10,937)	
Net real position 30.6.2010 .....	(25,693)	(39,984)	20,199	14,606	9,033	15,944	5,895	
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

52. 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 transferred 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 effect 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.

30.6.2010

		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked .....	ISK	565	331	38	(5,384)	9
Non Indexed linked .....	ISK	(44)	(173)	(37)	(138)	(227)
	EUR	(33)	(17)	-	-	-
	Other	(371)	(36)	-	-	-

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 102.9 billion (2009: ISK 70.7 billion) and the total amount of indexed liabilities amounted to ISK 86.7 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

## 53. 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 year 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 .....	25,042	-	8,217	-	-	-	33,259
Loans to credit institutions .....	21,404	12,717	5,130	3,053	499	-	42,803
Loans and receivables to customers .....	-	8,833	45,935	244,889	166,364	-	466,021
Bonds and debt instruments .....	22,278	400	648	87,438	39,739	-	150,503
Shares and equity instruments .....	-	-	-	-	-	8,329	8,329
Derivatives .....	-	32	17	1,298	-	-	1,347
Securities used for hedging .....	2,369	-	-	-	-	-	2,369
Compensation instrument .....	-	-	-	29,917	-	-	29,917
Investment property .....	-	-	-	-	-	25,308	25,308
Investments in associates .....	-	-	-	-	-	6,127	6,127
Property and equipment .....	-	-	-	-	-	11,119	11,119
Intangible assets .....	-	-	-	-	-	2,970	2,970
Tax assets .....	-	-	-	-	-	1,620	1,620
Non-current assets held for sale .....	-	-	-	-	-	38,456	38,456
Other assets .....	366	5,103	10,506	1,114	-	5,014	22,103
<b>Total assets 30.6.2010 .....</b>	<b>71,459</b>	<b>27,085</b>	<b>70,453</b>	<b>367,709</b>	<b>206,602</b>	<b>98,943</b>	<b>842,251</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 .....	96,351	11,129	28	-	-	-	107,508
Deposits .....	425,676	27,723	16,660	18,994	4,385	-	493,438
Borrowings .....	382	-	91	81	66,926	-	67,480
Subordinated loans .....	-	-	-	-	26,084	-	26,084
Financial liabilities at fair value .....	5,382	140	-	-	-	-	5,522
Tax liabilities .....	-	-	-	-	-	4,466	4,466
Non-current liabilities held for sale .....	-	-	-	-	-	15,841	15,841
Other liabilities .....	240	10,961	873	994	675	6,529	20,272
<b>Total liabilities 30.6.2010 .....</b>	<b>528,031</b>	<b>49,953</b>	<b>17,652</b>	<b>20,069</b>	<b>98,070</b>	<b>26,836</b>	<b>740,611</b>
Total liabilities 31.12.2009 .....	554,405	33,366	20,105	16,564	13,097	29,773	667,310
<b>Assets - liabilities 30.6.2010 .....</b>	<b>(456,572)</b>	<b>(22,868)</b>	<b>52,801</b>	<b>347,640</b>	<b>108,532</b>	<b>72,107</b>	<b>101,640</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.

At mid year 2010 the secured liquid assets were 27.4% (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

## 54. Capital Adequacy Disclosures

Equity base at June 30 2010 amounts to ISK 119,687 million. The core Tier 1 capital ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 13.1%, 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 June 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	30.6.2010	8.1.2010	31.12.2009
Credit risk .....	561,186	574,943	480,374
Market risk .....	125,311	109,210	104,082
Operational risk .....	43,279	51,055	51,055
<b>Risk weighted assets</b> .....	<b>729,776</b>	<b>735,208</b>	<b>635,511</b>
<b>Capital Requirement (Pillar 1)</b> .....	<b>58,382</b>	<b>58,817</b>	<b>50,841</b>
Tier 1 Capital .....	95,349	90,846	86,984
Tier 2 Capital .....	24,338	29,543	-
<b>Total own funds</b> .....	<b>119,687</b>	<b>120,389</b>	<b>86,984</b>
Tier 1 ratio .....	13.1%	12.4%	13.7%
Capital adequacy ratio .....	16.4%	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 2.3% and 2.9% respectively, on top of the capital requirement for credit risk.

No Pillar 2 adjustments are made for FX risk, because we feel 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

55. On 16 June 2010, the Icelandic Supreme Court ruled that foreign currency denominated auto-loans made by another Icelandic financial institution were in fact Icelandic Krona loans indexed to the exchange rate of foreign-currencies. Such loans are prohibited according to Icelandic laws on interest and indexing (38/2001). The Bank discloses that although it has no auto-loans in its books, some of its foreign currency denominated loans could be vulnerable to similar interpretation.

The Court's ruling did not specify which alternative terms should apply to these loans. Two scenarios are considered plausible:

**Scenario 1:** The removal of currency indexing and applying the low foreign currency interest rate on the Icelandic Krona loan.

**Scenario 2:** The removal of currency indexing and substituting the lowest market interest rate for the Icelandic Krona, with or without the inflation indexing which is common in the Icelandic marketplace.

A subsequent ruling by a lower court has stipulated Icelandic interest without inflation indexing, but the ruling has been appealed.

It is currently uncertain which categories of foreign currency denominated loans, if any, may receive an adverse court ruling and the alternative loan terms that will apply. This will be determined by future court rulings, for which it is not currently possible to predict an outcome. Significant uncertainty exists over the impact of these future court rulings on the carrying value of the Bank's portfolio of foreign currency denominated loans, as well as on the shareholders' equity and capital adequacy ratios of the Bank.

The Bank has participated in a study of the associated risk which was supervised by the FME. All the Bank's loan documents were classified by degrees of vulnerability to numerous risk parameters in a classification schema set out by the FME and the loan book was subjected to four variations of the two basic scenarios for alternative loan terms which are outlined above.

The study attempted to take into account all of the factors that aggravate the basic risk, such as the potential requirement to reimburse, with interest at the market rate, any overpayments made on a loan during its lifetime, instead of netting overpayments against the Bank's claim.

A number of mitigating factors were taken into consideration. One of these is the reversal of the reduction in the Bank's claim on Kaupthing Bank hf. due to previous value increases in ring-fenced assets (See note 35). Another mitigating factor is a considerable reduction in the Bank's currency imbalance when loans are redenominated into Icelandic krona. Numerous other risk mitigations were not accounted for, such as the improved loan-to-value ratio of many of the affected loans, and the Bank's ability to further adjust its currency imbalance.

Although a very significant portion of the Bank's foreign currency lending is, by all standards, fully legitimate, other foreign currency loans have various degrees of vulnerability to the FME's risk parameters. The Bank has defined three risk categories for loans, R1, R2, and R3 depending on the perceived risk of a negative Supreme Court ruling. The Bank regards very limited risk of a ruling against category R3, somewhat more risk of a ruling against R2 and the most risk of a ruling against R1. The following table aggregates the effect on the Bank's capital ratios should the different levels of risk events occur, showing the capital ratio resulting from the two possible Court decisions on alternative interest rate for the affected loans.

Interest rate ruling	Risk categories of loans		
	R1	R1+R2	R1+R2+R3
Scenario 1 .....	13.3%	12.4%	8.0%
Scenario 2 (assuming unindexed interest rates) .....	14.9%	14.8%	14.3%

According to this analysis, the Bank would satisfy the 8% legal minimum capital ratio, even in the event of the worst possible scenario contemplated by the FME, after converting some Tier-2 capital to Tier-1 capital. It would, however fall considerably short of the current capital requirements of 16% set by the FME. Reimbursing over-payments would not cause the bank to breach the minimum secured liquidity requirement set by the FME and the Central Bank, currently 20% of all deposits.



# Notes to the Condensed Consolidated Interim Financial Statements

## Related parties

56. 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:

	30.6.2010	31.12.2009
Total assets .....	54,669	56,680
Total liabilities .....	54,723	66,280
<b>Net liabilities against related parties .....</b>	<b>53</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.

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

57. 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

58. In August 2010, the transaction for the disposal of the Bank's 100% shareholding in Penninn Holding 1 Oy was completed. As described in note 7, this entity was classified as held for sale at 30 June 2010. The Bank has recognised the resulting gain from this transaction in August 2010.

# Notes to the Condensed Consolidated Interim Financial Statements

## Subsidiaries

59. 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., Sudurlandsbraut 22, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landfestar ehf., Sudurlandsbraut 22, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landsel ehf., Sudurlandsbraut 22, 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 Mýrasýslu, Digranesgata 2, 310 Borgarnes .....	Iceland	ISK	RB	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., Pósthólf 878, 121 Reykjavík .....	Iceland	ISK	OD	82.1
Hafrahlíd 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.