Arion Bank

ANNUAL REPORT 2009

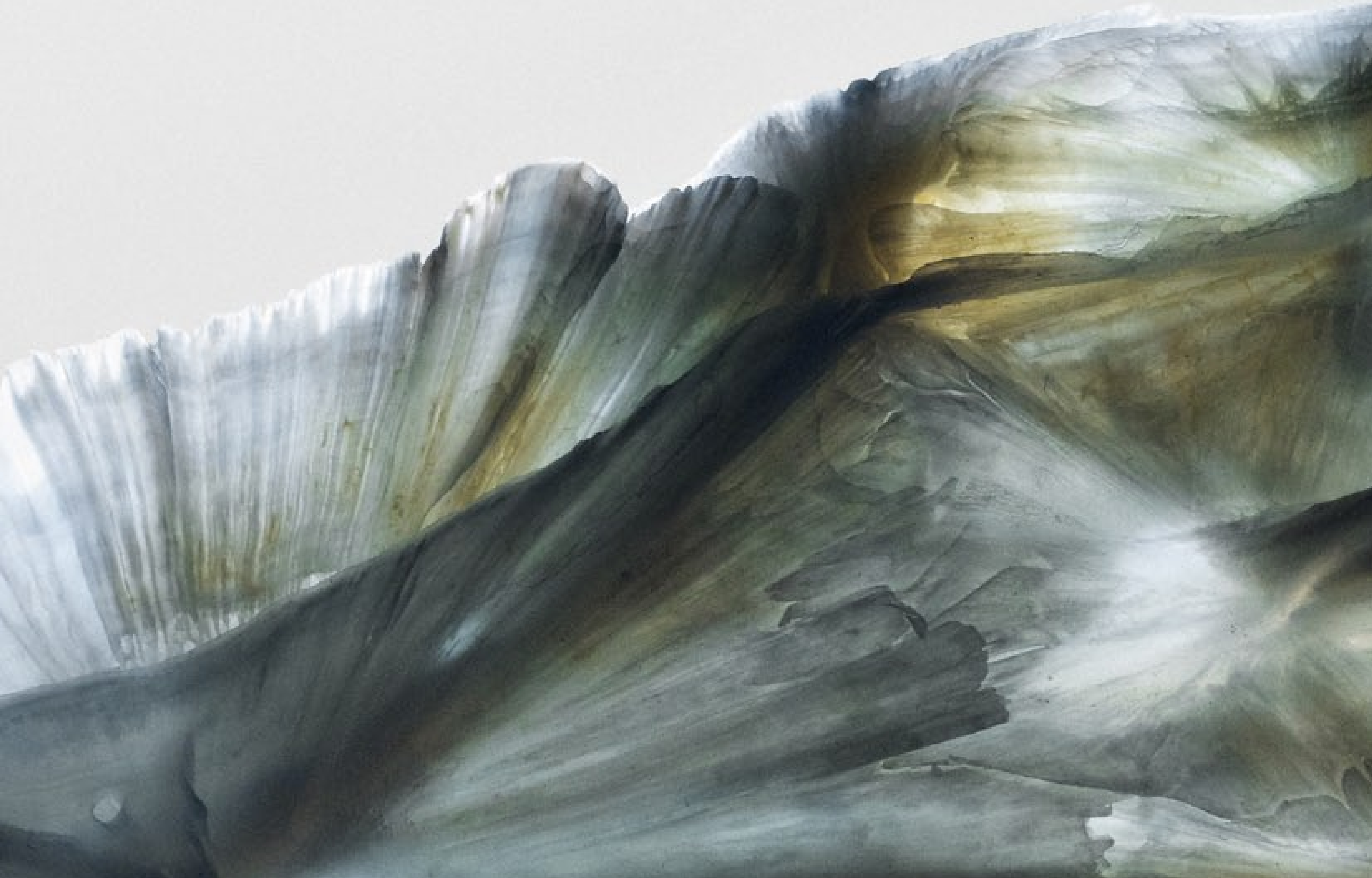


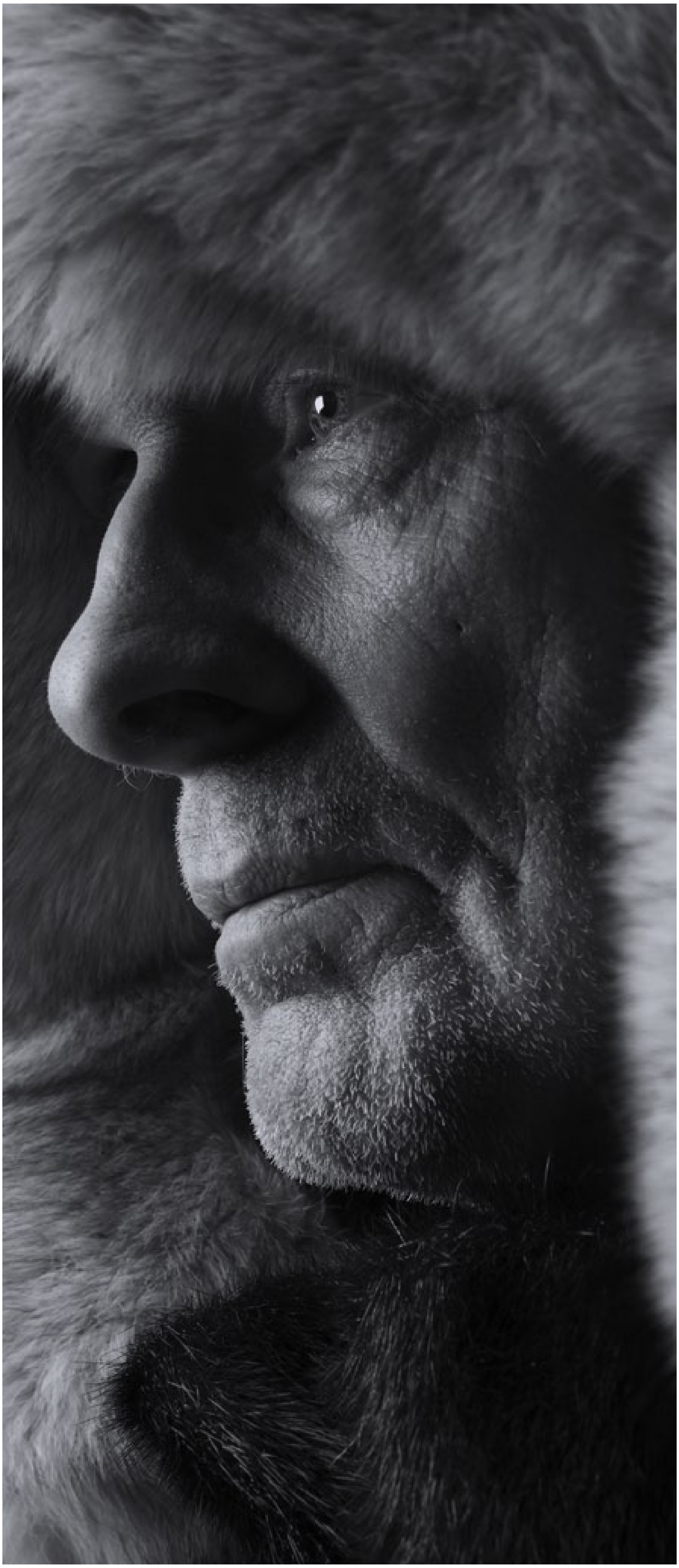
Table of Contents

Icelandic wool

Two materials in particular kept the people of Iceland warm through the ages: turf and wool. Before the advent of television, people gathered on dark winter evenings to work wool. Homespun wool was a valuable export. Icelandic designers have developed unique works of art, turning Icelandic wool into a sought after fashion product and creating lights, lampshades, vases and pictures out of wool.

Bjarni Óskar Pálsson

Bjarni and his wife, Svanfrídur Hagvaag, live in Hvolsvöllur and run the workshop Soap Opera where they make soap wrapped in felted Icelandic wool. The basic ingredient in the soap is locally obtained suet. Olive oil and coconut oil are then added to the mix. They make three types of soap: with seaweed, with birch leaves and with pine needles.



Introduction – A New Beginning

Towards the end of 2008 Iceland suffered a currency and banking crisis. The government was forced to step in and take control of the three major Icelandic banks to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly function of the payment system. The three banks had been very active in the international financial markets. Yet at the very height of the crisis the foundations were laid for a new and exclusively domestic banking system. This has been a lengthy, and at times painful, process but it has ultimately been successful. Now, 20 months after the crisis, Arion Bank is a viable company, performing traditional banking functions.

A new bank is created

After the government took control of Kaupthing Bank certain assets and liabilities were transferred from Kaupthing Bank to a new entity, which was to become Arion Bank. The transition from Kaupthing Bank to Arion Bank was seamless as customers were able to access their savings throughout the whole process and could complete all their domestic transactions without disruption. However, the transfer of ownership of assets from the old to the new bank and the restructuring of assets in a new institution posed numerous challenges, which were the focus of attention during 2009.

An important milestone was reached on 17 July 2009 when the government and the Resolution Committee of Kaupthing Bank reached an agreement on what constituted an equitable valuation of these assets. The assets on Arion Bank's balance sheet are entered at what is considered a fair value. The interests of the creditors of Kaupthing Bank were protected by according them a share in the upside potential in the value of selected and ring-fenced assets of Arion Bank and by granting them an option to buy up to 87% of the Bank's equity.

A financial crisis always leaves waste in its path and the collapse of the Icelandic króna, and the fact that a large part of the corporate loan portfolio of Kaupthing Bank was denominated in foreign currency, have necessitated a revaluation of assets. The balance sheet of Arion Bank is based on this valuation of the assets. Arion Bank now holds a loan portfolio which has been adjusted to the new reality facing Iceland.

On 1 December 2009 the Resolution Committee of Kaupthing Bank announced that it intended to exercise its option to purchase 87% of Arion Bank's equity and a subsequent capital injection took place on 8 January 2010. Kaupthing Bank, through its subsidiary Kaupskil, now holds an 87% stake in Arion Bank and the Ministry of Finance holds the remaining 13%. A new Board of Directors was elected at a shareholders' meeting on 18 March 2010 to represent the new ownership structure. One of the first tasks of the newly elected Board of Directors was to hire a new CEO of Arion Bank. On 23 April the Board of Directors announced that Höskuldur Ólafsson would replace Finnur Sveinbjörnsson, who has been CEO of Arion Bank since its establishment and had announced that he would be stepping down as CEO in early 2010.

Rebuilding trust

Trust has to be earned. One of the greatest challenges faced by the Icelandic banks during 2009 was to rebuild the confidence lost following the crisis of 2008. This goal of rebuilding or earning trust has in fact been Arion Bank's guiding principle in all its actions.

Important changes were made to improve all aspects of corporate governance within Arion Bank. In order to restore trust the following steps were taken by the Board of Directors in 2009:

- A Customers' Ombudsman was appointed. The Ombudsman reports directly to the Board of Directors and has the full authority to monitor individual decisions of the Bank in order to ensure the non-discriminatory treatment of customers needing debt workouts.
- Transparent rules on debt workouts, both for individuals and corporates, were ratified, published and enacted.
- Asset management companies for foreclosed assets were established.

First full year of operations

The collapse of a banking system represents a huge challenge for those to whom the torch has been passed. For Arion Bank's employees, management and Board of Directors the overarching goal for 2009 was to establish the Bank as a fully operational bank. This goal was achieved.

To be successful there were countless challenges, both internal and external, that needed to be addressed and overcome. The aforementioned revaluation of transferred assets from Kaupthing Bank to Arion Bank was one. Additionally the Bank's infrastructure had to be scaled down, and the Bank had to adjust to the new economic reality where many corporations, individuals and households found themselves with a severely diminished ability to service their debt.

The following projects were the main focus of attention during 2009:

Rationalisation of the branch network

When the Financial Supervisory Authority (FME) decided to transfer the deposits of Reykjavík Savings Bank (SPRON) to Arion Bank, all SPRON branches were closed. The Bank also scaled down its own branch network, and the Bank's network is currently the most efficient branch network in Iceland.

Arion Bank now holds a loan portfolio which has been adjusted to the new reality facing Iceland.

Renegotiation of mortgages

One of the most important tasks of 2009 was to find effective solutions for those retail banking customers who found themselves in financial distress. Arion Bank offers its customers seven different solutions, and, by the end of the first quarter of 2010, around 14,000 customers had taken advantage of the available solutions.

Restructuring of corporate loan portfolio

Arion Bank set up a division specialising in corporate restructuring as an unusually high percentage of the Bank's loan book is impaired or needs special attention. Around 2/3 of the Bank's corporate portfolio needs restructuring, and 70% of that had already been restructured or was in the restructuring process at the end of the first quarter of 2010. The Bank expects the portfolio to be performing in 2011.

A new name and strategy

The Bank adopted the name Arion Bank on 20 November 2009 and at the same time introduced a new strategy and a new set of values.

The successful completion of these projects leaves Arion Bank on a sound financial footing and in a strong position in the Icelandic financial market.

The results for the year 2009 were positive and in line with expectations. The net profit for the year was ISK 12.9 billion. The capital ratio of 13.7% at the end of the year exceeds the requirements of the Financial Supervisory Authority (FME) and the Bank is fully funded and has strong liquidity.

A new beginning

Iceland is a land of extremes - the land of fire and ice. Few places in the world demonstrate more clearly the raw and brutal forces of nature at play. The land is constantly changing. But change often leads to new and positive things. Iceland has had to swallow the bitter medicine of a financial collapse; balance sheets are being reorganised and unsustainable leverage is being liquidated and written off. But today, Iceland has a new financial system, the youngest in the world. And while we are mindful of the past, the Bank's focus is on the promises of tomorrow.

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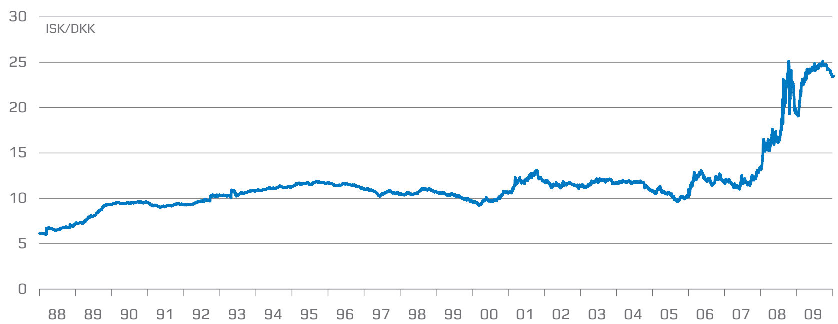
The Economic Landscape

Since Iceland gained sovereignty in 1918, economic growth has averaged 4% annually, which over the span of 90 years has netted a twelve fold increase in GDP in real terms. In the same period, unemployment has averaged around 2% and thus, in terms of factor utilisation and growth, Iceland has been a success as a sovereign economy. However, in terms of economic stability the record is much less flattering, especially when it comes to monetary policy. In 1918, as part of the nation's sovereignty deal, the Icelandic króna became a separate currency from the Danish krone. Just two years later the nation experienced its first currency crisis, and this has been a recurring pattern ever since, creating both price volatility and variations in the purchasing power of the average household.

Therefore, the current situation in Iceland can be viewed as the latest, albeit the most severe, since it was coupled with banking crisis, of the numerous currency crises to befall the country since 1918. The good news is, however, that recovery has always been rather rapid as a weaker currency facilitates a speedy adjustment of the current account and the economy. Nevertheless, prior to the current financial crisis the Icelandic króna had been relatively stable against the major currencies (Deutsche Mark and then the euro) of Europe for almost two decades. This had arguably given rise to a false sense of security against the inherent risk involved in maintaining the smallest currency area in the world.

The value of the Icelandic króna against the Danish krone from 1988 to date



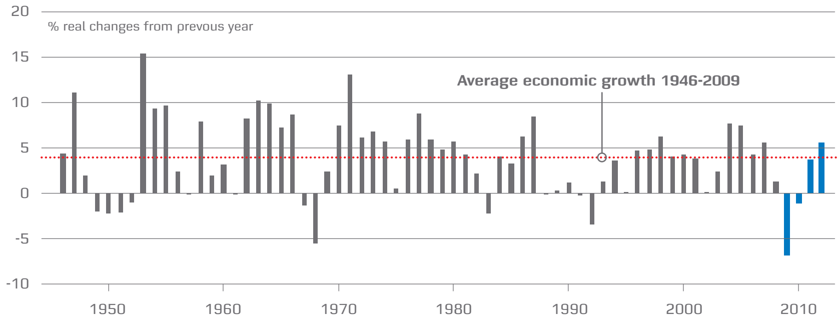
(The Danish krone was pegged to the Deutsche Mark before switching to the euro as an anchor in 1999) *Source: Central Bank of Iceland*

The road to recovery

Now, 20 months after the crisis hit Iceland in October 2008, the rebuilding process has advanced quite far. New banks have been founded with a solid asset base acquired at fair value from the old failed banks. While normality is slowly returning to the banking sector, the currency crisis is still unresolved, since capital controls, enacted in November 2008 at the behest of the IMF, still remain in place. Iceland needs to accumulate foreign reserves to rebuild the credibility of its currency before the controls can be lifted.

On the other hand, the smoothing effect of a lower exchange rate on output can already been seen in the economic numbers. Last year's economic contraction was smaller than previously estimated, as the goods and service deficit was instantly transformed into a surplus. Thus, economic output declined by a "mere" 6.5%, even though consumption and investment have declined at a far greater rate. Growth is also expected to become positive again in the latter half of 2011.

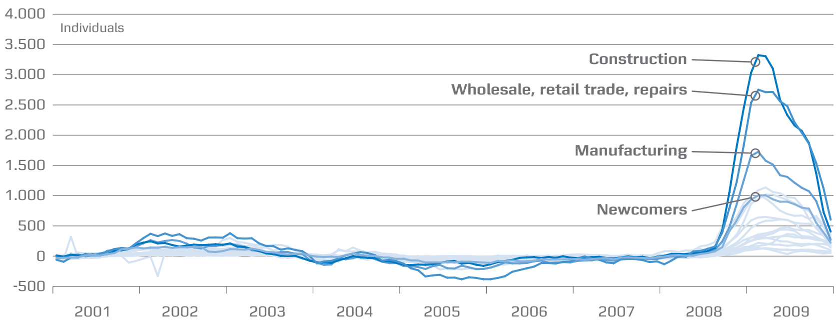
Economic growth



Source: Statistics Iceland

Looking ahead, the way to economic recovery will be led by the export sector boosted by the low real exchange rate, and the main thrust of the adjustment has already taken place. The sectors hardest hit by the crisis, construction and retail, have already shed a considerable proportion of their labour force, and the number of layoffs is now beginning to subside. Unemployment in early 2010 was at its peak at around 8%, and is expected to decline in 2011.

Net increase in registered unemployment in Iceland broken down by sectors

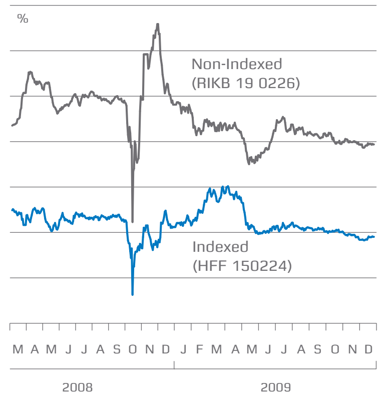


Source: Directorate of Labour

Looking ahead

While countries on both sides of the Atlantic responded to the international financial crisis, beginning in mid 2007, by cutting interest rates to close to zero and increasing the money supply, Iceland was compelled to take the opposite course by tightening monetary policy to shore up its currency and in the end imposing capital controls. The debt had to be structured or written off but could not be floated into the future by the unfettered use of the money printing press. Economic adjustment in Iceland has therefore been painful but rapid. However, the output loss is much smaller than expected, as the adjustment in the labour market has been far more effective than anyone had estimated. One of the advantages enjoyed by small countries is that they are much better suited to switching to foreign demand to make up for the shortfall in the domestic market. Even though the flexible exchange rate has created huge problems for the financial sector, the effect of the depreciating currency on the real economy is nevertheless positive.

Government Bond Yields (%)



Source: Teris

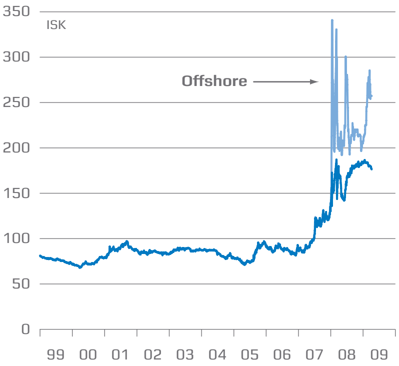
Capital controls and the International Monetary Fund

During the first week of October 2008, the three major banks of Iceland (constituting about 90% of the financial system) collapsed , and were brought under the control of the Icelandic financial regulator, the Financial Supervisory Authority (FME). In the same week the British government invoked anti-terrorist legislation against both Landsbanki and the Central Bank of Iceland (CBI), effectively cutting Iceland off from the international payment and clearing system. It is therefore not surprising that trading in the Icelandic currency market came to a virtual halt in the wake of these events. In the weeks following the collapse the only activity in the market was selected transactions where the CBI would provide currency for key imports such as food and medicine. Outside the country an unofficial market developed for the Icelandic króna where the ISK/EUR cross rate exceeded 300 in the ensuing state of panic.

However, the dust soon began to settle and on 20 November 2008 Iceland signed a joint reconstruction plan with the IMF. Under the plan the CBI brought interest rates to about 18% and it was widely expected in Iceland that the currency market would be floated before the end of the year. Instead, however, the IMF opted to enact capital controls in December 2008 that in effect liberalised the current account (merchandise and service trade as well as interest payments) but stopped all capital account transactions – including capital inflows. The stated rationale for the controls was that the amount of trapped speculative funds, the leftovers from the collapsed currency carry trade, was simply too large for the ISK to float unless the Icelandic republic bolstered its currency reserves.

The capital controls have effectively stabilised the ISK on the official market. First, the CBI had to provide support for the market by intervening but this effectively ceased in the summer of 2009. Furthermore, considerable trading activity continued on the unofficial market, indicating leaks that the CBI responded to by tightening the legal framework surrounding the controls. Nevertheless, on the positive side, the two exchange rates seemed set to converge. In the autumn of 2009 the CBI both tightened the controls and opened for inflows through the capital account so that any new funds entering the country would be issued a permit to bypass the capital controls should they want to leave at any given time. The CBI has announced that the next steps towards capital account liberalisation will be taken as soon as its foreign reserves have been bolstered with loans from both the IMF and the Scandinavian nations.

Exchange rate EUR/ISK



Source: Reuters, Central Bank of Iceland


Birch

The birch tree has been a prominent feature of the Icelandic landscape ever since settlement. Birch woodlands were felled for timber to build houses and for making charcoal, often with little thought for any environmental consequences. Many people like the taste of birch sap, either in its natural state or slightly sweetened. Birch wine is sometimes made and the sap is used in skin cream and shampoo. Birch leaves are strong tasting and can be made into a refreshing broth.

Sóley Elíasdóttir

Potent, wild Icelandic plants such as hand-picked birch leaves and yarrow are at the heart of Sóley Elíasdóttir's skin product line. Sóley was inspired by a recipe which had been in her family for generations. The skin product line from Sóley is unique in that it is 100% natural, environmentally friendly and free of additives.

Year in Review

Results for 2009

- Solid performance in 2009 despite challenging environment.
- Net earnings amounted to ISK 12.9 billion.
- Net interest income of ISK 12.1 billion.
- Net fee and commission income of ISK 5.9 billion.
- Return on equity was 16.7%.
- The Tier 1 capital ratio of 13.7% is above the Financial Supervisory Authority's (FME) requirements of 12%.
- The Bank is liquid and meets the FME/Central Bank guidelines of a minimum secured liquidity ratio of 20%.
- Arion Bank is predominantly funded with domestic deposits. The total deposit base of the Bank was ISK 609.1 billion at the end of the year, compared with ISK 544.1 billion at the beginning of the year.
- Total assets amounted to ISK 757.3 billion at the end of 2009, compared to ISK 641.2 billion at the end of 2008.

Creation of a new bank

- The valuation of assets and liabilities transferred from Kaupthing Bank to Arion Bank was the single most time consuming task of 2009. The valuation provided the basis for the opening balance sheet of Arion Bank.
- A new ownership structure was finalised with capitalisation from the Icelandic government and the Resolution Committee of Kaupthing Bank on behalf of its creditors.
- On 8 January 2010 Kaupthing Bank provided 65% of the capital and now holds 87% of common equity and the government provided 35% of the capital and holds 13% of common equity plus a Tier 2 subordinated bond.
- After this capitalisation the Bank's funding is secure and its liquidity position strong and meets the requirements of the FME's stress tests. The Bank has a 16.4% capital ratio; 12.4% Tier 1 and 4% Tier 2, exceeding the FME's requirements.

A new strategy, name and values

- A new name, Arion Bank, was adopted. The name has its origins in Greek mythology and symbolises new beginnings, teamwork, perseverance and artistry.
- The Bank also introduced a new strategy and a new set of values during the year. Progressive thinking, professionalism, trust and care are the values that the employees of Arion Bank chose themselves.
- The Bank was involved in a variety of charitable projects, including campaigns organised by the Red Cross.

Operations and restructuring

- Great effort was put into aligning the Bank's operations to a new economic reality by scaling down various functions such as IT and the branch network.
- A total of seven branches or outlets were closed or merged with existing branches. The net result is that Arion Bank now has the most efficient branch network in the country.
- With multiple cuts in interest rates on deposits during 2009 the Bank led the necessary interest rate decline in the domestic market.
- The position of Customers' Ombudsman was established.

Mergers and acquisitions

- The Icelandic government chose Arion Bank to take over all of the deposit obligations of Reykjavík Savings Bank (SPRON).
- The Bank acquired the regional Mýrasýsla Savings Bank (SPM), including all its assets and certain liabilities such as deposits.
- The two acquisitions brought 22,000 new customers to the Bank without expanding its existing branch network, giving the Bank the largest market share in retail banking.

Restructuring of the loan book

- The Board of Directors approved a set of rules and processes governing the restructuring of the Bank's loan book; the goals are transparency and objectivity.
- A new corporate recovery unit was established during the year, reflecting the crucial role of recovery at the Bank.
- Asset management companies were established for the management of foreclosed assets.
- The Bank introduced a range of customised solutions designed to help households and individual borrowers tackle their debts. The Bank will continue to offer these solutions until 1 July 2010.

Corporate governance

- Internal Audit was strengthened by recruiting more employees.
- Formal reporting to top management and Board of Directors was increased.
- Structural changes were made to improve all aspects of corporate governance within the Bank.
- Cooperation and coordination between Risk Management, Compliance and Internal Audit have increased.

Key Business Objectives

Arion Bank is a comprehensive financial institution which offers its clients a full range of services in savings, loans, asset management, corporate finance and capital markets.

The Bank's main objective is to deliver clear results to all stakeholders:

- Bring customers decisive advantages through the services we provide.
- Create an environment in which employees can put their skills to use and achieve professional success.
- Deliver unequivocal benefits for the Bank's owners through their stake in the Bank's operations.
- Arion Bank will make an important contribution to the reconstruction of the Icelandic economy and will strive to have a positive influence on Icelandic society.

Arion Bank will act responsibly in creating value while demonstrating corporate social responsibility. The Bank is a source of ideas and solutions, thus creating the model for a responsible and dynamic financial system in Iceland.

The aim is to be the first choice in financial services and to serve as an example of operational efficiency and successful business management.

Corporate Governance

The role of the Board of Directors is to confirm key aspects of the internal organisation and to outline the Bank's business objectives, strategy, risk appetite and business plan, while taking into consideration the interests of stakeholders and the goals of the Bank. The function of the Board of Directors is set out in detail in the Internal Control and Procedural Handbook.

The role of the Board of Directors

The Board of Directors is required to have good knowledge of the relevant rules and it shall regularly evaluate its own activities. Sound corporate governance principles are of paramount importance to the Board of Directors.

The Board of Directors is responsible for formulating the risk appetite and for ensuring transparency and clarity in decision-making processes and ensures that senior management responsibilities and authorisations are delegated clearly in order to prevent conflicts of interest. The Board of Directors follows strict rules on the eligibility of Board Directors, and the Internal Auditor presents an overview of the business affairs of Board Directors and related companies to the Board of Directors on a quarterly basis. The Board of Directors must approve an authorised signature list. The general rule is that two persons should sign agreements jointly. However, the Board of Directors may grant exceptions as deemed necessary. The Board of Directors has an overview of the operations of subsidiaries and ensures integrated corporate governance within the group.

In addition to the Board of Directors, there are three Board committees: the Board Audit and Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The new Board of Directors was elected at the shareholders' meeting of Arion Bank on 18 March 2010. The Board also appoints the Customers' Ombudsman.

Sound corporate governance principles are of paramount importance to the Board of Directors.

Internal Audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter which lays out the responsibilities associated with the position and the scope of the work. The mission of the Internal Audit is to provide independent and objective assurance and consulting services designed to add value and improve the Bank's operations. The scope of the audit is the Bank, its subsidiaries and pension funds serviced by the Bank.

The audit is governed by the audit charter, directive no. 3/2008 issued by the Financial Supervisory Authority (FME) on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by Internal Audit every quarter. Internal Audit had 9 employees at the end of 2009.

Compliance

According to Act no. 108/2007 on Securities Transactions financial undertakings are required to establish a compliance function and must ensure that it is effective and independent of other aspects of operations. Rules no. 995/2007 describe the role of compliance as follows:

- to monitor and regularly assess the adequacy and effectiveness of policies and procedures designed to detect any risk of failure by an undertaking and to put in place procedures to minimise such risk.
- to monitor and assess the actions taken to address any deficiencies in an undertaking's compliance with its obligations.
- to provide the employees of the financial undertaking responsible for carrying out the execution of securities transactions with the necessary training, advice and assistance to enable them to discharge the undertaking's obligations under the Act on Securities Transactions.

The Compliance Officer coordinates the Bank's compliance activities and is assisted by a lawyer from the Legal division and another Compliance employee. The Compliance Officer reports directly to the CEO and the department is part of the CEO's Office. By organising Compliance on these lines, the Bank is meeting the requirements of the FME and Internal Audit that Compliance operates independently. The Compliance Officer has monthly meetings with the CEO at which the Compliance Officer presents a report on activities during the past month and refers certain matters to the CEO. The Compliance Officer also meets the Managing Director of Risk Management and the Internal Auditor on a monthly basis. One of the focuses of the Compliance Officer is to ensure that the Bank's rules meet the most stringent requirements made of financial undertakings at all times.

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Anti-money laundering

The Compliance Officer is responsible for the Bank's measures against money laundering and terrorist financing. Tasks related to anti-money laundering can be broken down as follows:

- Know Your Customer due diligence
- Constant monitoring of clients
- Coordination of the Bank's compliance with laws, regulations and guidelines on measures against money laundering (AML) and terrorist financing.

The Compliance Officer organises and is responsible for the above and carries out these tasks with the assistance of an AML team in Back Office.

The Bank's Internal Control and Procedural Handbook contains the rules on measures against money laundering and terrorist financing. The rules are based on Act no. 64/2006 and subsequent regulations. The rules also take into account 40 recommendations and 9 special recommendations issued by the Financial Action Task Force, an international organisation which combats money laundering and terrorist financing.

Wild mushrooms

Freshly picked mushrooms on a sunny late summer afternoon encapsulate the pure and delicate taste of the Icelandic countryside. Edible wild mushrooms can be found widely in Iceland. Mushrooms thrive close to trees, particularly birch. Some mushrooms, such as the Larch Bolete, were introduced to Iceland with imported timber and have now become established in the Icelandic countryside. Wild mushrooms make tasty soups and sauces.

Ása Margrét Ásgrímsdóttir

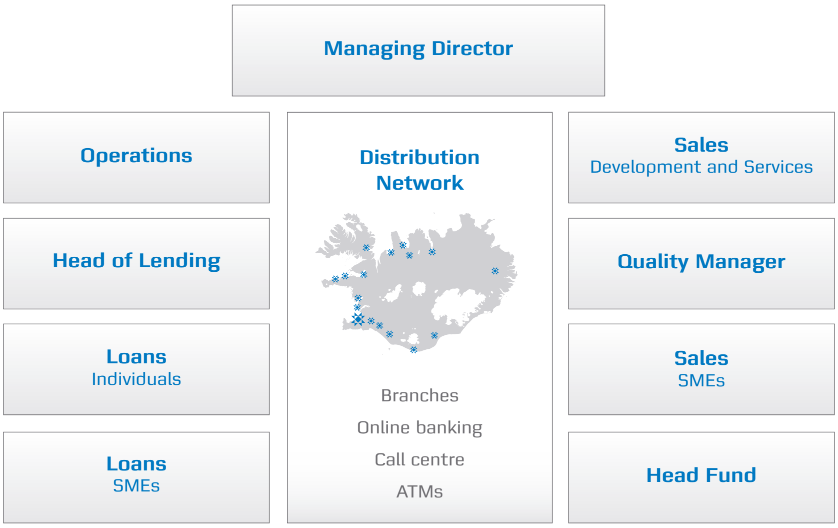
Ása Margrét is a nurse and has been picking mushrooms for almost thirty years. She is particularly busy every August and September, the height of the mushroom picking season. Ása has published two books on edible fungi and has led mushroom picking trips in Iceland.

Retail Banking

The role of Retail Banking is to provide individuals and smaller and medium-sized companies with a full range of financial services and to develop and maintain strong business relationships with its clients. Retail Banking serves its customers through an extensive branch network and other points of contact such as online banking, call centre and ATMs. Retail Banking had 446 employees at the end of 2009.

There are 26 branches and outlets across Iceland. The branches provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more.

Organisational chart



Key projects in 2009 – Consolidating the branch network

One of the key focuses of 2009 was to streamline operations, which was achieved by merging a number of branches. This strategy has helped create larger and stronger units which are better equipped to meet the needs of the customers.

In March 2009, following a ruling from the Financial Supervisory Authority (FME), Arion Bank took over all deposits and card transactions of over 20,000 customers from Reykjavík Savings Bank (SPRON). The operation of the six SPRON branches and the online bank NB.is was discontinued.

Branches

Greater Reykjavík area:
Austurstræti, outlet
Árbær
Gardabær
Grafarvogur
Hafnarfjördur
Hlemmur
Kópavogur
Kringlan
Mosfellsbær
Sudurlandsbraut
Vesturbær

Branches outside Reykjavík area:
Akureyri
Blönduós
Borgarnes
Hólmavík outlet
Búdardalur outlet
Egilsstadir
Hella
Vík í Mýrdal
Kirkjubæjarklaustur outlet
Hveragerdi
Saudárkrókur
Varmahlíd outlet
Selfoss
Stykkishólmur
Grundarfjördur outlet

In April 2009 the Bank acquired Mýrasýsla Savings Bank (SPM) in Borgarnes and merged it with the local Arion Bank branch, increasing the customer base by a further 2,000 clients.

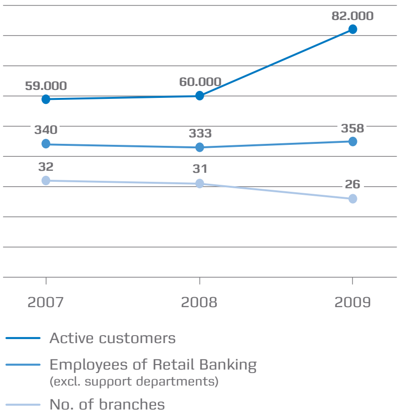
These 22,000 new customers gave Arion Bank the largest retail banking market share in Iceland. Arion Bank was able to meet this sudden growth in business without having to bring in a significant number of new staff. As a result, Arion Bank has played a leading role in the rationalisation of the Icelandic banking system and now has now the most efficient branch network in Iceland.

In December the Bank launched a new initiative to help those customers experiencing payment difficulties restructure their loans.

Key tasks ahead

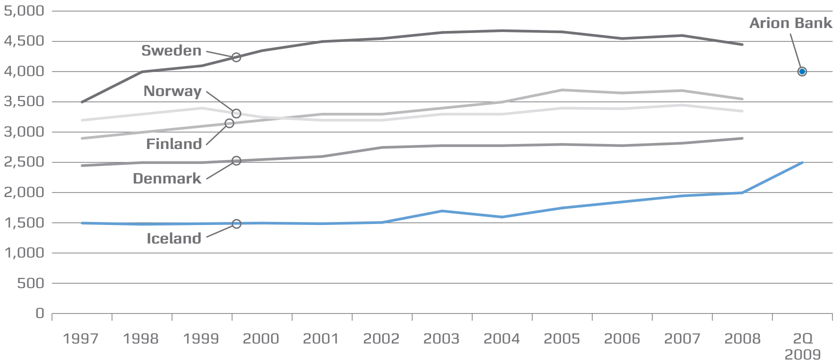
The continued focus of the Retail Banking division will be to work with the customers and to meet their needs and expectations in this new environment; to help customers facing difficulties restructure their finances; to further develop the skills of the employees; to consolidate the Bank´s product range, and to improve customer satisfaction.

Efficient branch network



Source: Icelandic Financial Services Association

Number of inhabitants per retail branch in the Nordic region



** Latest data for the Nordic region December 2008*

Source: Icelandic Financial Services Association

The diagram shows the efficient structure of the branch network.
On average there are 2,500 inhabitants for every retail bank branch in Iceland.
At Arion Bank there are 4,000 customers per branch.

Corporate Banking

Corporate Banking offers a range of financing services and products for its corporate clients, from medium-sized businesses to large corporations. The division is focused on developing long-term relationships with its clients to help them achieve their potential by gaining a thorough understanding of their businesses and the competitive environment in which they operate. Corporate Banking had 26 employees at the end of 2009.

The division can be divided into front line and support functions. The front line staff comprises a team of account managers, most of whom are specialised in certain industries including corporate lending, food & beverage, real estate, project finance, and structured finance. Each account manager also relies on the assistance of a team of specialists in the support functions, which include trade finance & guarantees, legal & documentation, portfolio management, and corporate services.

Products and services

Corporate Banking provides a wide range of banking services and products, including term loans, project finance facilities as well as other kinds of working capital facilities. Services also include cash management, comprehensive deposit products, automatic billing and collection services, online payment slips, internet banking, as well as other specialised add-on products.

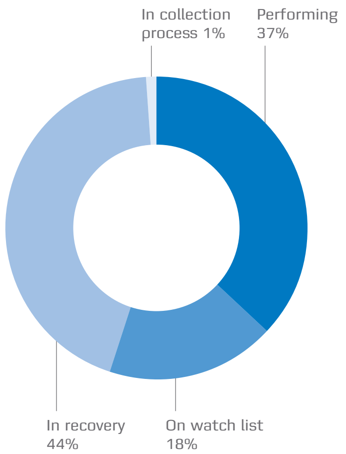
The Bank seeks to provide the best possible solutions for each company, which calls for close co-operation between Corporate Banking and its clients and other business segments of the Bank. The account managers are responsible for a selected group of companies, thus ensuring personal services and a clear overview of each client's financial requirements.

Loan portfolio

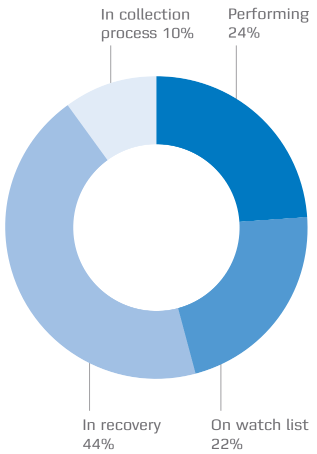
In accordance with a decision by the Financial Supervisory Authority (FME) in October 2008, Kaupthing Bank's domestic loans to customers were transferred to the new bank, Arion Bank. During the first half of 2009 the Corporate Banking team participated in a comprehensive valuation of the corporate loan portfolio. Subsequently, Kaupthing Bank decided to acquire the majority stake in Arion Bank.

As reported at year end 2009, loans to customers were nearly half of the total assets side of the Bank's total assets. The loan portfolio can be grouped into four categories according to the borrower's financial strength. Within Corporate Banking around half of the companies are either grouped as performing (24%) or closely monitored on a watch list (22%), and the other half are either undergoing restructuring of their debt (44%) or have entered legal collection (10%).

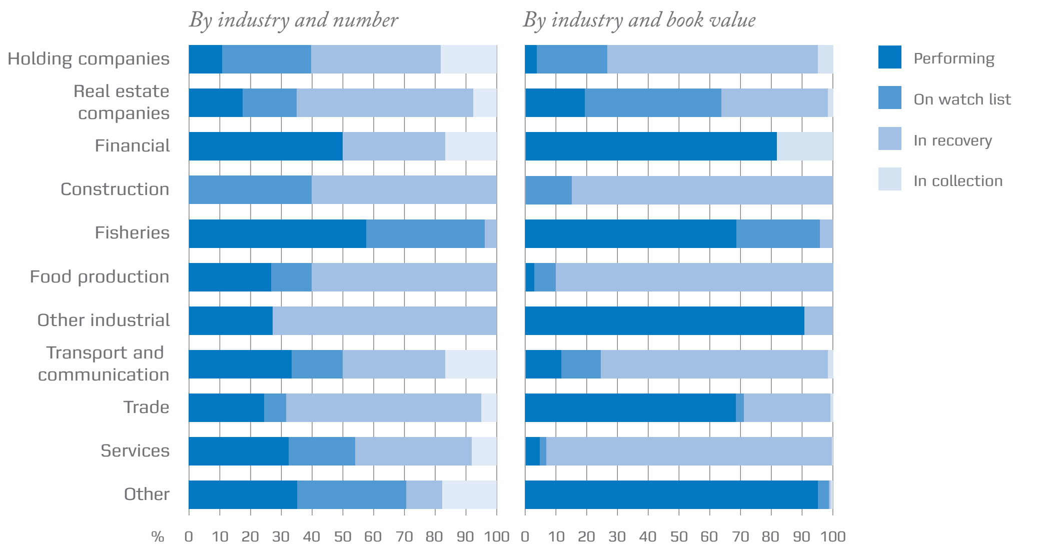
Performance of companies – Book value



Performance of companies – Number of companies



Classification of companies



Adjusting to a new environment

The Icelandic financial sector and companies have had to adjust to dramatic changes in their operating environment following the collapse of the three major domestic banks. The majority of companies had debts denominated in foreign currencies, and as a result, face not only an increased debt leverage due to the substantial weakening of the Icelandic króna, but often a shortfall in demand. Corporate Banking has continued to provide unstinting support for its clients by providing working capital facilities for the ordinary course of business and short-term facilities to enable clients who are undergoing restructuring to continue their day-to-day operations. In order to adapt to these new challenges the Bank has modified its organisational chart. Specialised recovery teams were created under a new division of Corporate Finance. The recovery teams are responsible for the overall restructuring process but join forces with the account managers and form a steering committee on each workout case in line with new processes and Joint Rules on the Financial Restructuring of Companies (agreed upon by the Icelandic Financial Services Association and approved by the FME). The focus is on preserving and maximising value by ensuring that the restructured companies emerge with an optimal capital structure and debt levels that match their future cash flows.

The goal is to maintain professional long-term relationships with customers.

Future prospects

The financial environment, with its currency restrictions, continues to create challenges for the Bank in 2010. This will necessitate giving priority to clients with a relatively balanced capital structure and a viable business model as well as those who need debt restructuring. Corporate Banking will, nevertheless, continue to focus on enabling current clients to operate under the prevailing market conditions with the goal of maintaining professional long-term relationship with its customers.

Corporate Finance - Corporate Advisory

Corporate Advisory, a unit within the Corporate Finance division, provides M&A advisory services and capital markets transaction services to corporate clients and investors. Corporate Advisory also manages the Bank's portfolio of equities. Corporate Advisory had 11 employees at the end of 2009.

Acceptable results in the face of adversity

Corporate Advisory builds on the strong legacy of its predecessor which had a leading market share in share offerings and M&A advisory in the Icelandic market. The collapse of the Icelandic stock market in 2008 had a profoundly negative impact on M&A activities. Corporate Advisory nevertheless took an active role in the market and advised on two successful share offerings for Marel Food Systems and managed the delisting of Alfesca.

Other assignments involved valuation reports, bond offerings and advising clients on various investment opportunities in the market.

During 2009, Corporate Advisory also played an active role within the Bank in relation to the valuation of the opening balance sheet of Arion Bank and negotiations between the Resolution Committee of Kaupthing Bank and the Ministry of Finance.

Overall, the results for 2009 were acceptable as the division was able to generate reasonable fees in the market and support other activities within the Bank that require corporate finance skills.

During 2009, Corporate Advisory also played an active role within the Bank in relation to the negotiations between the Resolution Committee of Kaupthing Bank and the Ministry of Finance.

Positive outlook for 2010

Business activity is expected to increase in 2010. The regeneration of the stock market will continue and several companies are expected to launch an IPO during the year. Corporate Advisory will manage the sales processes of equity that the Bank acquires in debt to equity swaps, whether through direct sales or a stock market listing.

Corporate Advisory will also advise clients on the buy side in sales processes that are expected to take place at other banks during the year. Increased merger activity is likely as many companies have gone through restructuring and need to adapt to the new market conditions.

Corporate Finance - Recovery

Recovery is responsible for restructuring projects within the Bank, i.e. the restructuring of troubled companies. Following the currency and banking crises of 2008 a significant proportion of accounts within the Bank's loan portfolio, in particular those within Corporate Banking, required some kind of restructuring and this necessitated a greater role for the Recovery team. Recovery had 20 employees at the end of 2009.

Key tasks 2009

The team has extensive experience of banking and restructuring activities. The team is divided into three groups:

- Recovery work for smaller corporates (retail clients)
- Recovery work for larger corporates (corporate banking clients)
- Reporting and support

Clients that are unable to serve current debt enter the three-phase recovery process: data gathering, restructuring and execution. In total, some 500 clients are estimated to be in need of financial restructuring, or approximately half of the loan portfolio by value.

Members of the Recovery team lead the restructuring work with support from other units within the Bank e.g. Corporate Banking, Retail Banking and Legal Division. External advisers are also brought in on the more complex projects to conduct independent business reviews, financial and legal due diligence and related services.

The goal of the restructuring process is to return companies with a healthy capital structure, no covenant breaches and satisfactory operating results. The process should also deliver companies with motivated management teams and owners. The interests of all parties should be aligned and the future plans of the client secured. In certain cases, however, the underlying cash flow of the companies is too weak to support ongoing operations and in such cases the companies will go directly into liquidation.

The goal of the restructuring process is to return companies with a healthy capital structure, no covenant breaches and satisfactory operating results.

During this process the Bank may take over certain assets e.g. real estate, land or equity in the restructured companies. These assets are transferred into separate holding companies under the control of the Bank; cash-generating real estate is transferred to Landfestar; development projects and land are transferred to Landey while equity positions are transferred to Eignabjarg. These assets will be managed in the holding companies until the assets have been sold.

Future prospects

Recovery cases are organised in order of priority and the Recovery team's aim is to complete as much of this work as possible during 2010, starting on the most important cases. However, restructuring is unlikely to be finished until 2011.

Asset Management

The Asset Management division consists of Private Banking, Institutional Asset Management Sales & Services. The subsidiary Stefnir Asset Management Company operates the fund management business. Asset Management is a leading participant in the Icelandic market with assets under management in excess of ISK 580 billion at the end 2009. Asset Management had 42 employees at the end of 2009.

Personal and professional services

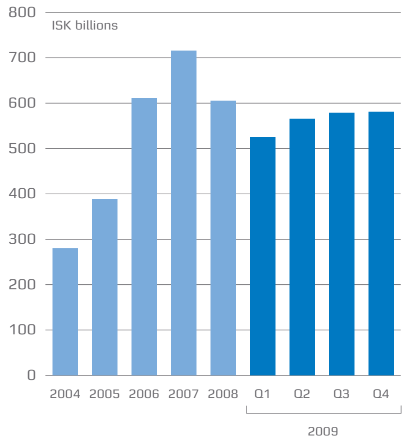
Asset Management is responsible for managing assets on behalf of its clients, who include institutional investors, corporations and retail investors. It serves institutional clients of all sizes with differing investment objectives, offering a wide range of services and a broad product mix. In addition to a variety of mutual funds, alternative investment vehicles and pension plan schemes, the division offers customised asset allocation strategies and managed accounts, designed to meet the diverse needs of corporate, institutional and private clients. Moreover the division offers funds from other global fund managers.

In order to establish a solid foundation for successful business, the Asset Management team devotes consistent effort to formulating investment policy statements based on a long-term strategy, systematically examining obligations, objectives and risk concerns for each client. In addition to servicing institutional clients, the division services private banking customers and mutual fund clients and provides advice on securities.

The Asset Management team's focus is to provide personal and professional service to its customers by identifying their needs and offering customised investment solutions through a combination of expertise, risk management, structuring portfolios and monitoring processes. In its daily work, the Asset Management team follows the principle that teamwork and research create performance and that performance and service create long-standing relationships. A special emphasis is placed on building long-term relationships with customers based on trust, liability, honesty, and transparency.

The Asset Management team employs its market experience and proprietary tools in asset allocation, security selection, portfolio risk management and related services to obtain the best results for clients.

Assets under management



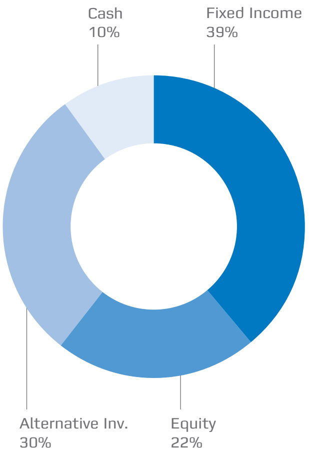
Performance exceeded expectations

Despite the challenges facing the global financial market, the overall strong performance of the asset management business exceeded expectations and helped maintain the loyal client base. The Asset Management team took action to reduce risk in investments and the focus was on restructuring the services and rebuilding the operation in light of the changed economic situation.

The Asset Management team is constantly looking for new opportunities and adapting to changes in the environment. During the year the division introduced several new products and services to customers. Three new government bond funds that address customers' needs at time of a financial turmoil were launched. A new approach to asset allocation, a scheme called Eignaval, was introduced to Private Banking clients and a special pension plan analysis has proven a great success for the clients.

The most challenging task on the pension side was finding solutions to the government programme which allowed holders of secondary pension funds to partially withdraw their balances because of the volatile economic conditions in Iceland.

Split between asset classes



Frjalsi Pension Fund, the best pension fund in Iceland

In November 2009 Frjalsi Pension Fund, which is operated by Arion Bank, was voted "The best pension fund in Iceland" by Investment Pension Europe (IPE) magazine. It was also chosen as the second best pension fund in Europe in the category "funds smaller than €1 billion", and as the second best fund operating in countries with less than 1 million inhabitants. Winning these awards represents a significant achievement for Frjalsi Pension Fund.

Following the collapse of the Icelandic banks, Frjalsi Pension Fund has increased its focus on transparency towards its fund members. A detailed breakdown of the fund's assets is published quarterly on its website, www.frjalsilif.is.

In November Frjalsi Pension Fund was voted the best pension fund in Iceland by Investment Pension Europe (IPE) magazine.

Chosen as the second best pension fund in Europe in the category "funds smaller than €1 billion", and as the second best fund operating in countries with less than 1 million inhabitants.

Asset Management has strong foundations and will continue to focus on helping clients fulfil their investment needs, identifying and seizing opportunities, and play a leading role in asset management in Iceland. Assets under management are expected to grow moderately in 2010.

Treasury & Capital Markets

Treasury & Capital Markets plays an important role in Arion Bank's funding, and asset and liability management. Despite the climate of economic uncertainty and the capital controls that were in force during 2009, Treasury and Capital Markets performed solidly. The division had 32 employees at the end of 2009.

Treasury

Treasury is responsible for the Bank's funding, liquidity management, currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currencies, liaison with other financial institutions, proprietary trading and market making in domestic securities and currencies. In 2009 domestic deposits were the dominant factor in the Bank's funding profile.

An important aspect of managing the currency and interest rate exposure of Arion Bank is the internal pricing of interest rates and currencies. The importance of domestic deposits in the funding profile of Arion Bank will continue to be great but wholesale funding will gradually play an increasingly important role. In 2010 increased effort will be put into broadening the funding base of the Bank, both domestically and internationally. There will also be a strong focus on reducing the currency and interest rate exposure of the Bank.

For further information on Treasury related topics please refer to the chapters Risk Management and Funding and Liquidity.

Capital Markets

Capital Markets brought important diversity to Arion Bank's income and revenue stream in 2009. There are three main functions within Capital Markets: FX and Fixed Income Sales, Equity Sales and Research.

FX and Fixed Income Sales handles the domestic and foreign brokerage of currency, fixed income and derivatives for institutional investors, corporate clients, speculators and smaller domestic financial institutions. Day-to-day activities were heavily influenced by the capital controls and the fixed income market therefore played an important role during 2009. Despite the challenging external environment Fixed Income Sales at Arion Bank was successful in finding and realising new business opportunities.

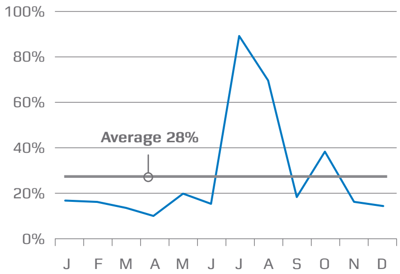
Equity Sales is responsible for the brokerage of domestic and foreign equities for institutional investors, corporate clients and speculators. Despite the capital controls there was a continued focus on the US and Nordic equity markets during the year. Arion Bank was also active on the domestic equity market, maintaining its position as market leader in 2009, with approximately one third of the market share. Arion Bank managed a successful private placement (book-building) to institutional investors for Marel Food Systems in June and participated in a second equity placement for the same company in November.

Capital Markets brought important diversity to Arion Bank's income and revenue stream in 2009.

Arion Bank's Research department delivers research and trading advice. The research function is split into Equity Research, Economy and Fixed Income. The main clients of the Research department are asset management companies, institutional investors and other departments of the Bank.

The main objectives of Capital Markets in the coming months are to continue to be a leading participant in the domestic equity, FX and fixed income markets; to continue to provide the clients with outstanding services and products; and to be an integral component of the Bank's revenue stream.

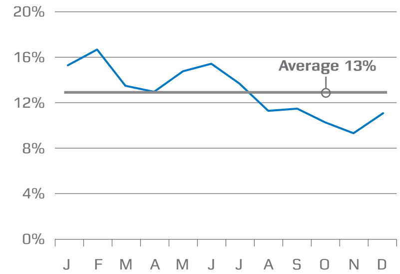
2009 Market share – Equities



The market turnover of the OMX ICE Equities and Related was ISK 100 bn.
Arion Bank's market share was 28%.

Source: Nasdaq OMX

2009 Market share – Fixed income



The market turnover of the OMX ICE Fixed Income was ISK 5,450 bn. in 2009.
Arion Bank's market share was 13%.

Source: Nasdaq OMX

Moss

Moss is common and conspicuous in the wide open spaces of the Icelandic countryside. Moss was frequently used to make scarce food rations stretch even further and was often mixed with blood sausage, porridge and bread. Nowadays we eat moss for health reasons. Moss has healing properties and strengthens the immune system. Try mixing moss with spelt flour or making moss tea. Bring to the boil and then immediately lower the heat to avoid making it taste bitter.

Jakob Kristjánsson

Dr Jakob Kristjánsson is a biochemist and has been involved in a wide range of biotech research projects. In 1993 he was one of the founders of Iceherbs, a company which was set up to make products from Icelandic moss. Jakob has a passionate interest in the sustainable harvesting of Icelandic resources, and the development and production of health products which are suited to modern needs and based on traditional folk wisdom and the results of modern scientific research.

Support Units

Arion Bank has five units which provide support to the Bank's business segments. The support units are IT, Finance, Human Resources, Back Office and Legal. The Support Units had 352 employees at the end of 2009.

Information Technology

The Information Technology (IT) division is responsible for developing, operating and advising on the Bank's information systems and solutions such as the Online Bank and web sites, SAP BCA and CMS, Agresso, Calypso, Vitinn (customer information) and data centres. The IT division had 116 employees at the end of 2009.

The IT division is divided into three main teams: Account Management, Software Development and Technical Services. Account Management is responsible for managing the portfolio of IT projects and assigning project managers to the projects. Software Development is responsible for the implementation and maintenance of both in-house developed solutions such as the Online Bank and Vitinn and standard solutions such as SAP and Calypso. Technical Services is responsible for the operation of all IT systems and solutions at the Bank, including hardware (data centres and PCs), software solutions, telephone systems and ATMs.

The focus of the IT division in 2009 was to evaluate and initiate projects to streamline the system architecture and match it with the Bank's business strategy, and to make changes and adjustments to information systems to conform to new regulations regarding changes in the financial environment. Major projects designed to achieve the above goals were the relocation of SAP, Calypso and Front Arena systems from data centres in Sweden and the United Kingdom to Iceland and the consolidation of the Bank's loan systems. Internal processes have been further developed and streamlined, especially in areas such as software development and project management. Another focus area was to reduce IT costs and to consolidate operations by applying stronger vendor management in the main areas of license management and service agreements in order to meet the needs of the new Bank.

In 2010 the focus areas for the IT division will be to further streamline the system architecture in order to increase business productivity, and to strengthen the employees' skills and flexibility.

Finance

Finance is responsible for the Bank's financial reporting, both internally and to the Financial Supervisory Authority (FME). Finance is divided into four main functions: Reporting, Planning and Analysis, Cost Accounting and Banking Desk/Treasury. Finance had 45 employees at the end of 2009.

One of the chief tasks of Finance is to prepare the accounts for the parent company and some of its subsidiaries. The Bank publishes financial statements every six months which have been prepared by Finance.

Finance reports to the Board of Directors, CEO and managing directors on a monthly basis, with financial performance being the main focus. Finance is also responsible for the preparation of the budget in close cooperation with other divisions of the Bank. The division reports regularly to the appropriate external authorities, such as the Central Bank and the FME.

During 2009 Finance also played a vital role in preparing the opening balance sheet of Arion Bank and its five-year business plan, both of which were vital components in the negotiations between the Resolution Committee of Kaupthing Bank and the Ministry of Finance. With 2009 being the first full operating year of the Bank, the main focus of Finance has been to further strengthen the internal processes in order to be better able to provide accurate and timely financial data to all of its clients.

Human Resources

The Human Resources division has two main functions: a traditional HR function centred on its Personnel and Payroll departments; and an operating division. Their common goal is to provide first-class service to their clients: the approximately 1,000 full-time employees and managers of the different divisions and departments of the Bank and various subsidiaries. Human Resources had 66 employees at the end of 2009.

At the beginning of 2009 the division carried out its annual poll to gauge satisfaction among employees. The results helped lay important groundwork for the development of the new Arion Bank. In May, performance appraisal interviews were conducted with employees throughout the company for the first time. The interviews were short and simple, with the focus on the employee's well-being in the workplace and on providing constructive feedback. In October another work place analysis was carried out. It focused on morale, work-related stress, employee-management interaction and workload. The survey revealed important information which is being processed by the different divisions and departments. The recruitment of new employees has been kept to the minimum in 2009. The general policy has been to fill vacancies with existing Arion Bank employees if at all possible, thus creating more opportunities for career development.

Work also commenced on designing a new personnel system (hiring, education and payroll) which will be more flexible than the current system. In 2010 the Bank will continue to consolidate its facilities and maximise the utilisation of the Bank's properties.

Back Office

Back Office is divided into five departments: Loans, Trade Clearing, Anti Money Laundering (AML), Payment Plans and Services. Back Office had 93 employees at the end of 2009.

Back Office is responsible for settlement and reconciliation. Its main tasks include handling deposits and loans for the branch network and corporates, collateral management, trade finance, FX trade and MM deals, capital markets clearing, clean payments, customer payment plans, including online banking payment plans. Back Office also liaises with international banks over various issues. The Bank's AML team is located in Back Office.

Adjusting to the changed environment has exacted considerable effort and has entailed change within the division. Introducing lean management practices has helped bring about these changes. By implementing this strategy even further the Bank intends to bring greater efficiency to Back Office.

Legal

The Legal division is divided into two departments: Legal Collection and Legal Services. In addition to the aforementioned tasks, the Legal division manages the Bank's foreclosures and handles the collection of debts which have been in default for more than 35 days. Legal division had 32 employees at the end 2009.

The Legal division had an active role in most of the Bank's major projects in 2009. The key area of focus was assisting in negotiations between the Ministry of Finance, the Bank and the Resolution Committee of Kaupthing Bank by taking part in the negotiations, reviewing and in some cases drafting the necessary documents entered into between the parties as well as taking the required measures in order to implement the agreements.

In 2009 there was a 50% increase in legal collection cases compared with 2008, clearly reflecting the challenging economic climate in Iceland. However, when a case enters the legal collection process, the Bank continues to work towards a solution with the customer and cases are therefore frequently brought to a satisfactory conclusion without significant expense to the customer.

Subsidiaries

Arion Bank owns three subsidiaries which play a vital role in the long-term strategy of the Bank. They operate in the fields of asset management, securities custody and life insurance and complement the services that Arion Bank offers its customers. These subsidiaries are Stefnir Asset Management Company, Arion Custody Services and Okkar Life Insurance.

Stefnir Asset Management Company

Stefnir Asset Management Company (formerly Kaupthing Bank Asset Management Company) is a wholly owned subsidiary of Arion Bank. The company manages a broad range of funds, ranging from mutual funds to institutional investors funds. The company is an independent financial institution. Stefnir had 14 employees at the end of 2009.

Stefnir's business is organised along product lines in three divisions: Equities, Fixed Income and Alternative Investments. The client base is broad and consists of retail clients, private banking clients, pension funds and other institutional investors. The investment culture of Stefnir is built around teamwork, organised around each asset class. Team leaders and senior staff make up a Balanced Team which lays down asset allocation guidelines.

Arion Bank is the leading sales agent for funds managed by Stefnir. Furthermore, Arion Bank and its subsidiary Arion Custody Services provide a wide range of services to Stefnir, i.e. legal services, risk management, internal auditing, compliance and fund administration.

Challenging environment in 2009

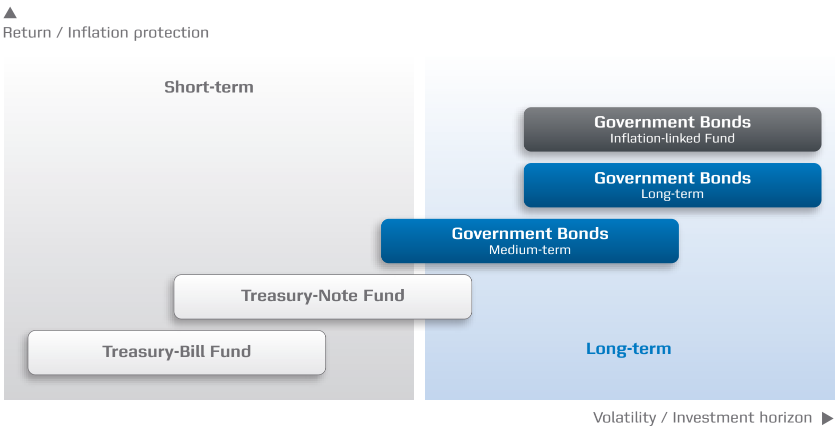
At the end of 2009 Assets under management (AuM) totalled ISK 250 billion, down by 8 percent from the previous year. Icelandic government bonds continued to perform well, both inflation linked and non-inflation linked; the international equity markets rallied remarkably after having sold off heavily in Q1. International equity funds managed by Stefnir benefitted from three positive developments during the year: all major equity indices rose in 2009, the ISK depreciated against other currencies, and finally the funds outperformed their individual benchmarks by a substantial margin.

A number of funds were liquidated and new ones were set up in their place. Client interest moved from Icelandic equities and Icelandic corporate bonds to fixed income funds guaranteed by the Icelandic government. Currency controls put new international investments out of reach of Icelandic investors. New funds included Icelandic 'pure' products: government bills, inflation linked government bonds and non-inflation linked government bonds.

Off to a good start in 2010

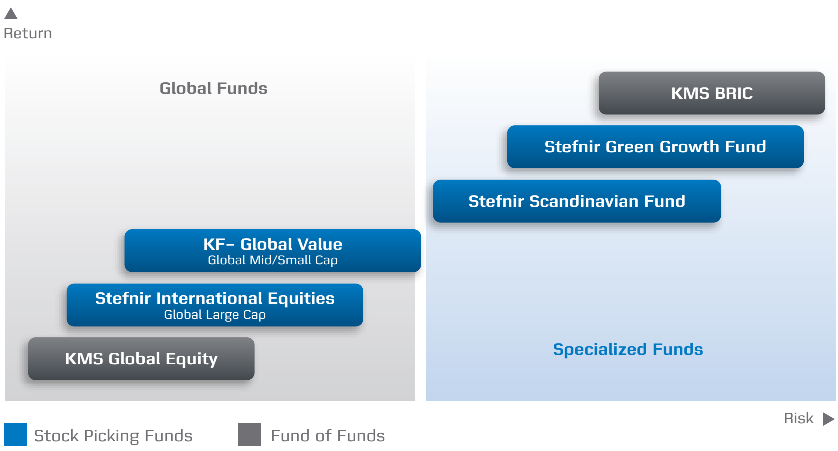
The year 2010 has started well in terms of inflows into funds. Stefnir sees a number of opportunities in 2010. The two main goals are to broaden the client base and to expand the product range. Customised solutions are in great demand as the new Icelandic financial system takes shape. Stefnir is the leading provider of new and innovative institutional investors funds and is intent on building on that foundation. Furthermore, Stefnir has made two distribution agreements with asset management firms outside Arion Bank and plans to make more in 2010. Another area of growth is balanced funds, building on a long and successful track record by the Balanced Team.

Government Bond Funds



Stefnir offers a wide range of funds in most asset classes, tailored to meet the needs of a broad client base.

Global Equity Team – Global and Specialized Products



Arion Custody Services

Arion Custody Services is a service provider for Icelandic and international financial institutions and financial market participants. It offers customised and efficient solutions for the custody of securities. Arion Custody Services had 70 employees at the end of 2009.

The clients of Arion Custody Services include 28 Icelandic financial institutions and institutional investors. It also provides custody and settlement services for Icelandic securities to 23 international banks, including some of the world's leading organisations.

Arion Custody Services attracted some new clients in 2009, including Clearstream, a member of the Deutsche Börse group. Clearstream intends to offer settlement and custody for all classes of securities issued by the Icelandic Securities Depository. This means that it will be easier to sell Icelandic securities internationally to foreign investors as settlement and clearing will be handled by Clearstream and it will not be necessary to enter into custody agreements with Icelandic financial institutions. At the end of 2009, securities under custody totalled ISK 2,731 billion.

Arion Custody Services will continue to concentrate on providing core services in 2010. In the next few years it will focus on improving corporate actions services and reporting at the level of quality which the clients expect. Arion Custody Services will concentrate on improving the existing infrastructure to meet customers' requirements and strengthening risk management. In addition to the continuing project of enhancing automation in the operation, we also seek to provide new service offerings such as investor relation services and compliance services.

Arion Custody Services provides custody and settlement services for Icelandic securities to 23 international banks, including some of the world's leading organisations.

Okkar Life Insurance

The insurance company Althjóda líftryggingarfélagid hf. (Alíf) was founded in 1966 by Icelandic investors and a British insurance company. It is the oldest life insurance company in Iceland. In 2005 the company's entire share capital was acquired by Kaupthing Bank. The company's name was subsequently changed to Kaupthing líftryggingar hf. At the company's annual general meeting held on 20 March 2009 it was decided to change the company's name to Okkar líftryggingar hf. (Okkar Life Insurance). Its main role is to provide modern insurance services and to offer its customers financial security in the event of illness, disability or death. Okkar had 13 employees at the end of 2009.

Okkar has been a pioneer in Iceland in the development of life insurance, health insurance, children's insurance, disability insurance and a range of group insurance policies.

The year 2009 was the most profitable in the company's history, despite the challenges in the Icelandic economy. The company posted a net profit of ISK 444 million, return on equity was 50%, the combined ratio was 70%, the cost ratio was 28%, the capital ratio was 40% and the debt solvency ratio was 2.48.

Okkar's strong results are the product of a well-organised sales operation, customised solutions to suit the needs of each individual customer, precise risk assessment when issuing insurance, skilled asset management in collaboration with Arion Bank and rigorous cost control.

Operations are divided into Insurance, Finance, Sales & Marketing and Technical. Okkar is operated independently of other insurance companies. It has sales and distribution partnerships with Arion Bank and KB rádgjöf, which also sells pension products on behalf of Arion Bank.

Okkar líftryggingar hf. stands on a very firm footing. For many years the company's assets have been almost entirely invested in government bonds and bank deposits.

Okkar has been a pioneer in Iceland in the development of life insurance, health insurance, children's insurance, disability insurance and a range of group insurance policies.

Holding Companies

Arion Bank has founded a number of holding companies to manage the shareholdings of companies and other assets taken over by the Bank through client debt restructuring. The aim is to preserve or increase the value of these assets before they are sold.

Eignabjarg

Eignabjarg is a holding company around equity positions in companies that Arion Bank takes over as a result of financial debt restructuring or other enforcement procedures. Its function is to maximise the value of equity transferred from Arion Bank to the company, develop a strategy for each asset and implement good business practices and good corporate governance in the transferred companies. The company aims to limit its holding period to as short a time as possible, without compromising its goal of maximising recovery through the divestment of assets.

Landsel

Landsel is an independent asset management company which was founded at the end of 2009. Its function is to supervise the management of companies and bankruptcy estates and the disposal of their liquid assets. In some cases Landsel may take over the management of companies and bankruptcy estates and, if they are deemed to be potentially viable, Landsel will oversee their restructuring and management. Companies that are not considered viable are liquidated. The objective of Landsel is to maximise the value of the assets taken over by the company, with the aim of selling the assets at the first opportune moment. Market conditions must be favourable, however, in order to ensure that a satisfactory price can be obtained for the assets.

Landey

Landey is a property development company whose purpose is to deal with properties that currently do not generate revenue, such as building lots and unfinished housing developments. The company's main objective is to maintain and maximise its current assets with a professional approach to real estate and housing development, always working in close collaboration with the planning authorities.

Landfestar

Landfestar is a real estate company founded in 2008 and it is fully owned by Arion Bank.

Its function is to own, manage and lease the commercial property acquired by Arion Bank through debt restructuring agreements with its clients. This applies to properties that have reliable lessees or a competitive edge on the rental market, in terms of their condition and their location.

The objective of the company is to develop a solid, knowledge-based service company on the real estate market which maximises the value of its assets, both in the short and long term, in line with the owners' required rate of return.

The growth of the company is measured against the benchmarks that are normally applied to companies of this kind, including cash flow, the strength of lessees, location value and the return/risk ratio. The company currently manages 75,000 square metres of prime property.

Decisions regarding the sale and rental of property are made with the aim of promoting an active competitive environment in the country. Transparency and non-discrimination are the guiding principles upon which working methods and the provision of information on the acquisition, sale, leasing and maintenance of property are based.

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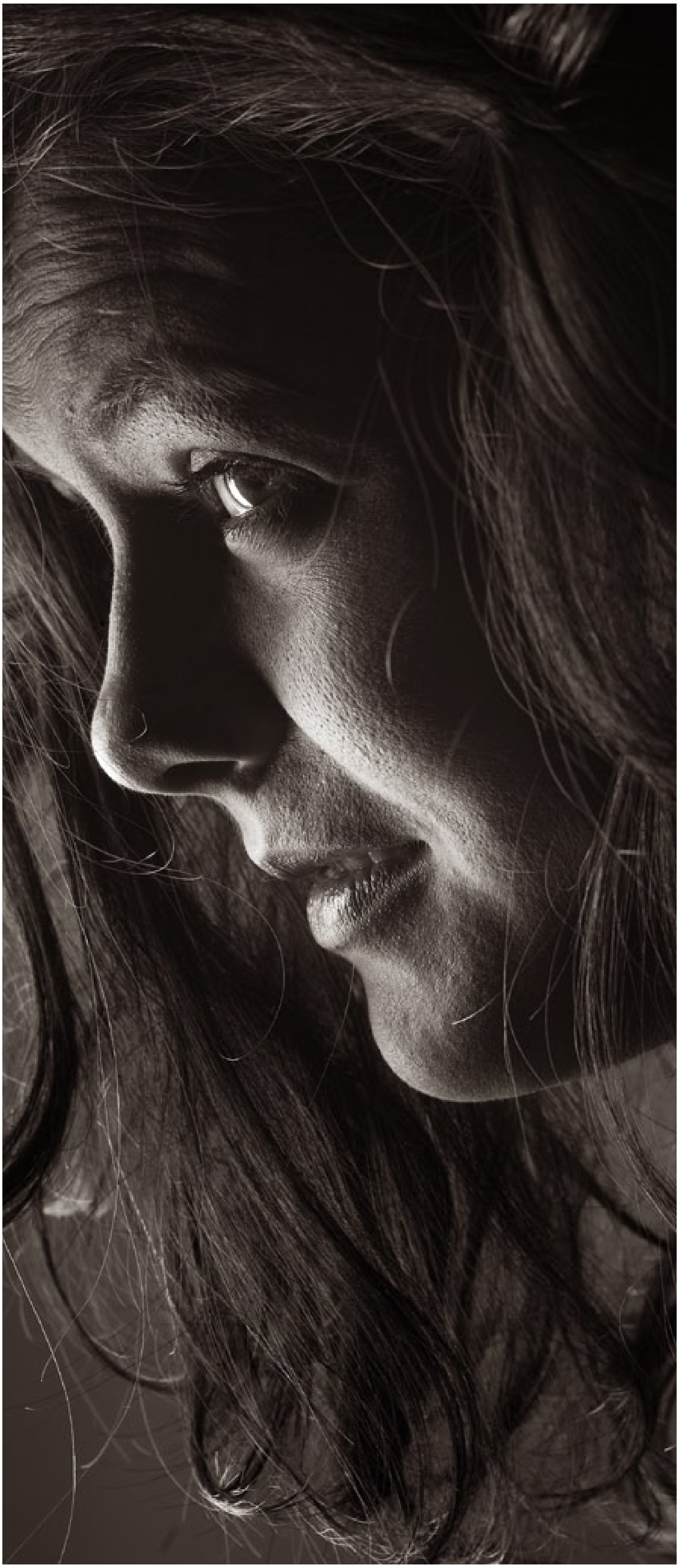
Seaweed

The seashore is a rich source of food. Seaweed is a healthy and nutritious food, a gift to us from the land and sea. Our ancestors often collected seaweed and a beach rich in seaweed was considered a real boon. Seaweed was boiled in fresh milk, used in porridge or added finely chopped to bread and biscuits. Seaweed is an ideal ingredient for soups, pasta and casseroles. It also makes a delicious, healthy snack, fresh and crispy straight out of the pan.

Gudrún Hjörleifsdóttir

Gudrún is a co-owner of the design company “Björg í bú” which collaborates on various food design projects with Icelandic farmers. With her colleagues Edda and Helga she has created a range of healthy Icelandic potato chips and is now preparing a crispy seafood snack with farmer Halla Steinólfssdóttir. Gudrún and her colleagues were recently nominated for the President of Iceland’s Innovation Award.



Risk Management

The Risk Management division comprises four units: Credit Control, which monitors weak and impaired credit exposures on a customer by customer basis; Portfolio Risk, which monitors all risk types on a portfolio level for the Bank's assets and liabilities; Economic Capital, which is responsible for the Bank's Economic Capital model and the Internal Capital Adequacy Assessment Process (ICAAP) and Operational Risk which monitors the risks associated with the daily operation of the Bank. Risk Management had 21 employees at the end of 2009.

The Bank's Risk Management division is independent and centralised and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a risk appetite for the Bank's operations. Risk appetite is translated into exposure limits and targets that are monitored by Risk Management, which reports its findings regularly to the CEO and the Board of Directors.

The Bank faces four major types of risk:

Credit risk

Credit risk is the current or prospective risk to earnings and capital arising from the failure of an obligor to pay an obligation at the stipulated time or otherwise to perform as agreed or as anticipated. The risk comprises concentration risk, residual risk, credit risk in securitisation, cross border (or transfer) risk and more.

The Bank has a two-pronged strategy for credit risk. In the near term, the focus will be on recovering value from the portfolio of impaired assets which was acquired from Kaupthing Bank. To this end, the Bank has expanded its recovery department and defined a complete set of procedures which outline how value will be maximised without compromising transparency.

The long-term objective of the credit strategy is for impairments to represent 1% of loans.

The highest authority with respect to credit is the Board Credit Committee. The next highest credit granting authority is the Bank Credit Committee which operates within limits specified as a fraction of the Bank's capital. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits.

All loans for which no impairment is identified on a counterparty-specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognised as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

Risks in focus:

Currency imbalance between assets and liabilities

Credit concentrations and large exposures

Valuation of transferred assets

Maturity mismatch and on-demand deposits

For full risk disclosures, refer to notes 101-119 to the financial statement

The loan portfolio transferred from Kaupthing Bank contains a category of loans which requires special consideration. These are loans in foreign currency to Icelandic companies and individuals whose income is in ISK. When the ISK depreciates against the foreign currency, the ISK value of the loan increases, whereas the borrower's ability to pay remains fixed. When such a loan has been transferred at a fair-value below face-value, provisions must be made for the unrecoverable increase due to ISK depreciation.

Market risk

Market risk is the current or prospective risk to earnings as a result of changes in financial market prices and rates. The risk arises from market making, dealing, and position taking in bonds, equities, currencies, commodities, derivatives, and any other commitment which depends on market prices and rates. The main types of market risk are interest rate risk, equity price risk and foreign exchange risk.

In the case of proprietary trading the Bank accepts the market risk. The Board of Directors decides how much market risk exposure the proprietary trading units within the Bank are allowed to assume, expressed as a maximum overnight exposure in equities, fixed income and derivatives. The Board entrusts the CEO with the enforcement of this policy and Risk Management with the evaluation and monitoring of positions and limits.

Since its inception, the Bank has been challenged by a large currency imbalance. The Bank's strategy for reducing its currency imbalance is twofold: the systematic ISK-redenomination of defaulting foreign currency loans to customers who have income in ISK; and the hedging of currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers.

Liquidity risk

Liquidity risk is the risk arising from the possible inability of the Bank to meet its liabilities when they come due. It is an unavoidable source of risk in the Bank's operations as the Bank requires funding to support its activities.

The Financial Supervisory Authority (FME) has set a guideline for a minimum secured liquidity ratio of 20%. The high liquidity reserve required by the FME reflects the uncertainty of the stickiness of the deposits of the Icelandic banks and the fact that a large part of the Bank's liabilities are primarily short-term or on demand deposits, while the contractual maturity of the assets is much higher. A pressing task for the Bank will be to monitor its liquidity reserves and to better understand and model the behavior of the deposit base.

Operational risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business segments and in the support units.

The Bank aims to maintain an open, no blame, operational risk culture and aspires to reach a point of no surprises by utilising the Bank's operational tools and processes to the fullest extent possible.

Funding and Liquidity

The funding and liquidity of Arion Bank is managed by the Treasury department. Arion Bank is fully funded and meets all the liquidity requirements of the Financial Supervisory Authority (FME).

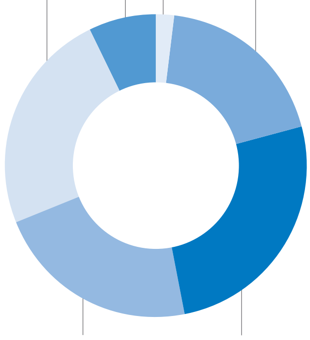
Funding

Arion Bank is predominantly funded with domestic deposits. The total deposit base of the Bank was ISK 609.1 billion at the end of the year, compared with ISK 544.1 billion at the beginning of the year. Long-term debt amounted to ISK 11.0 billion at the end of 2009, total equity was ISK 90.0 billion, and the balance sheet totalled ISK 757.3 billion.

The increase in deposits in 2009 is mainly attributable to the acquisition of Reykjavík Savings Bank (SPRON) deposits, ISK 96.1 billion, in March and the acquisition of Mýrasýsla Savings Bank (SPM) that resulted in a ISK 19.8 billion increase in deposits. The growth of the deposit base is also due to a rise in the level of savings in the Icelandic economy. The increase in long-term debt is related to a bond issuance resulting from the acquisition of SPM.

Deposits are for the most part on demand. Around 28% of deposits are from retail customers, 51% are from corporations and professional investors and 21% are from financial institutions. A proportion of the financial institutions' deposits are from foreign financial institutions that are expected to be withdrawn when the capital controls are lifted.

Funding profile



Liquidity

The Bank is liquid and meets the FME guidelines on a minimum secured liquidity ratio of 20%. At the end of 2009 secured liquid assets were 22.8% of deposits which would enable the Bank to withstand an instantaneous deposit outflow in excess of the FME's requirements. Secured liquidity is in the form of cash and repoable government bonds. In addition to this the Bank has more than a 5% cash ratio as requested by the FME. This means that the Bank has more than 5% of its on demand deposits available in cash at any given time.

The Bank is liquid and meets the FME stress test of 20% instantaneous withdrawal of deposits.

Main tasks in 2010

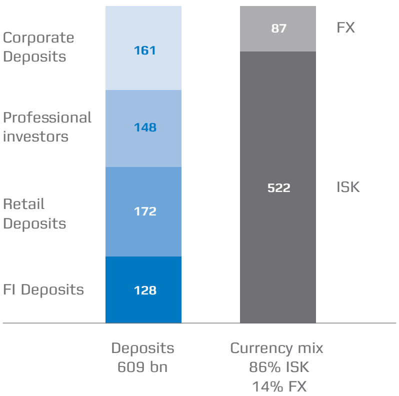
In 2009 a large proportion of the Bank's assets were long term and FX denominated whilst the funding of the Bank was mostly in ISK. In connection with Kaupskil's equity injection on 8 January 2010 the Bank received a senior loan, equivalent to ISK 61.3 billion, from the Central Bank. At the same time the Bank received a subordinated loan from the government of ISK 29.5 billion, as a Tier 2 capital injection.

The senior loan from the Central Bank is partly FX denominated and the currency composition will be adjusted to fully balance the real FX position of Arion Bank. For further information on the currency balance of the Bank can be found in note 109 a) in the annual accounts.

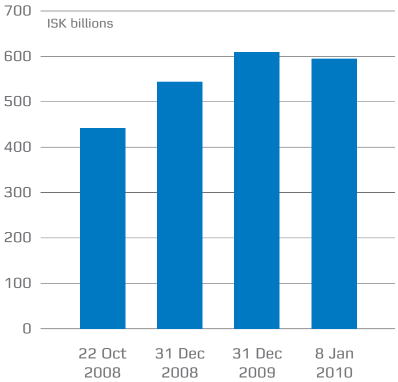
The liquidity risk related to the maturity mismatch of the Balance Sheet will remain a challenge in 2010. Progress has been made in 2009 in lengthening the maturity profile of the existing funding sources but the Bank needs to continue to focus its efforts on diversifying its funding. This can be achieved for example through domestic bond issuance and term deposits. Additionally, the Bank holds strong liquidity reserves to meet the challenge of an asset and liability mismatch. For further information on this subject can be found in note 110 a) in the annual accounts.

Despite efforts to diversify the Bank's funding sources and extend the maturity profile the deposit base will continue to be the Bank's predominant funding source, making it important for the Bank to maintain its current retail market share.

Breakdown of deposits



Total deposits

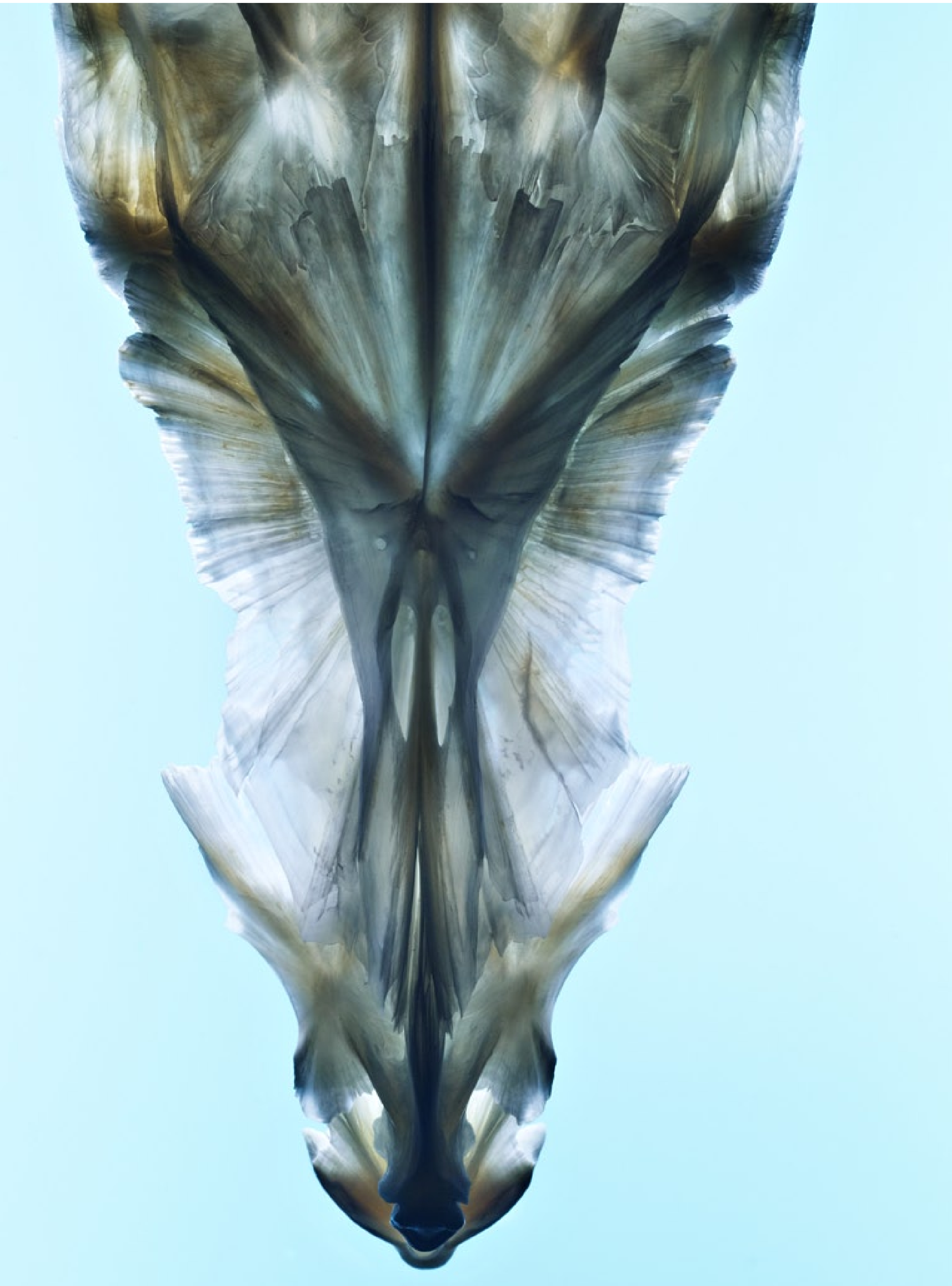


Fish bones

Fish bones have been used by people since the dawn of time. In Iceland fish bones were sometimes used for food; they were boiled in sour whey and water and turned into a thick broth which was eaten with skyr. Pickled bones were also on the menu in some areas. Haddock bones were carved into small objects, animal figures and buttons. Nowadays toys are sometimes made out of fish bones.

Róshildur Jónsdóttir

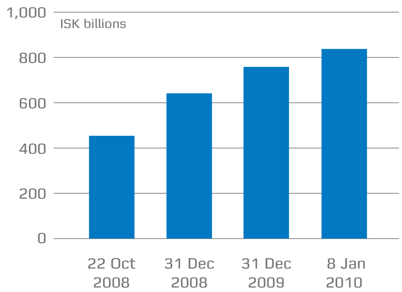
Designer Róshildur Jónsdóttir creates models out of Icelandic fish bones in a project she calls “Something fishy,” an idea she got while studying at the Icelandic Academy of the Arts. The fish bones are packaged with glue and paint, and buyers let their imaginations loose to create their own beasts and figures.



Financial Results

The Bank reported Net earnings of ISK 12.9 billion. Return on equity was 16.7%. The year 2009 was the first full year of operations for Arion Bank. The financial foundations of the new bank were laid during the year. Arion Bank builds on a strong asset base, and is profitable and fully funded. The Bank meets all liquidity and capital requirements set by the Financial Supervisory Authority (FME).

Assets



Income

Operating income in 2009 amounted to ISK 49.6 billion, including Net interest income of ISK 12.1 billion and Net fee and commission income of ISK 5.9 billion

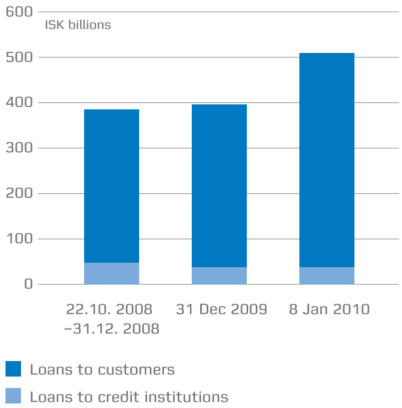
Net financial income and FX gain amounted to ISK 11.9 billion and is mainly due to the 7.6% weakening of the ISK and the Bank's foreign exchange imbalance. Income from subsidiaries acquired with the sole purpose of resale was ISK 17.8 billion.

Arion Bank was established on 22 October 2008 which makes comparisons with previous years impossible.

A revaluation of the Bank's portfolio of loans and receivables resulted in a net ISK 10.3 billion increase. The total increase in value of loans and receivables was ISK 20.2 billion, offset by a decrease in value of ISK 9.9 billion.

Following the transfer of assets, liabilities and contingent liabilities from Kaupthing Bank to Arion Bank in late 2008, Arion Bank held a claim against Kaupthing Bank due to the difference in the fair value of the transferred assets and liabilities. At the time certain assets were ring-fenced and it was agreed by the two parties that an increase in the value of the ring-fenced assets would be shared as a form of payment for the transferred assets. As a result, an expense of ISK 10.6 billion was incurred due to a decrease in Arion Bank's claim against Kaupthing Bank. (See note 73)

Loans

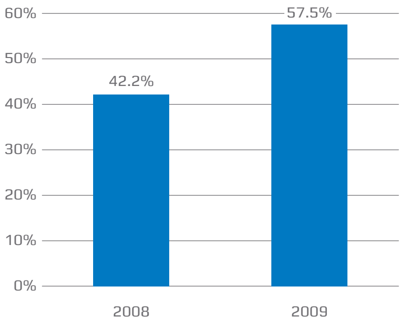


Expenses

Total operating expenses in 2009 amounted to ISK 34.2 billion. At the end of the year the Bank had 1,096 employees. Salaries and related expenses amounted to ISK 10.4 billion. Administration expenses amounted to ISK 5.3 billion. Expenses related to subsidiaries acquired with the sole purpose of resale were ISK 18.0 billion.

The cost-to-income ratio of Arion Bank was 57.5%. During the year there was a strong focus on cost-cutting initiatives to align the Bank´s cost structure to that of a bank with operations solely in Iceland. Several branches were closed or merged and as a result Arion Bank now has the most cost efficient branch network in Iceland in terms of the number of branches and the number of employees per customer.

Cost to income ratio



Asset growth due to acquisitions

Total assets at 31 December amounted to ISK 757.3 billion compared with ISK 641.2 billion at the end of 2008. The growth in assets during the year is largely due to the acquisitions of two savings banks in early 2009: SPRON and SPM.

Loans to credit institutions and customers totalled ISK 396.2 billion at the end of 2009 and deposits amounted to ISK 609.1 billion.

Deposits as a ratio of loans to customers was 170.3%.

Material events after 2009

On 8 January 2010 Kaupskil, the subsidiary of Kaupthing Bank, took ownership of 87% of Arion Bank (see note 120). With the takeover Arion Bank's equity increased from ISK 90.0 billion at year end 2009 to ISK 93.9 billion. The Bank´s assets grew by ISK 80.2 billion to ISK 837.6 billion.

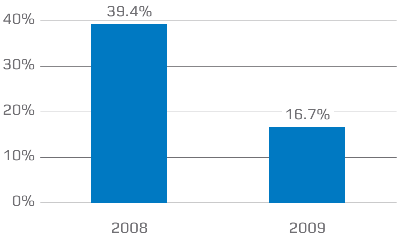
Arion Bank´s loan portfolio increased by ISK 112.8 billion but Bonds and debt instruments decreased by ISK 32.6 billion. The assets that Arion Bank received in return for the bonds bear higher interest than the bonds, which should have a positive effect on the Bank´s Net interest income in 2010.

Capital requirements

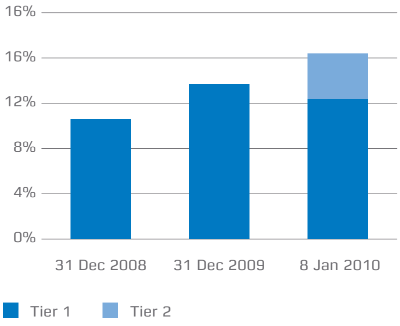
During 2009 Arion Bank operated under state ownership and met the FME's requirements of at least 12% Tier 1 capital. At the end of 2009 Arion Bank's Tier 1 ratio was 13.7%. In addition the Icelandic government held 4% Tier 2 capital in reserve, callable by the FME.

After Kaupskil's acquisition of 87% of Arion Bank the Tier 1 capital ratio of the Bank was 12.4% to which the government added 4% Tier 2 capital making a total of 16.4%, thereby exceeding the FME's requirement for a 16% capital ratio.

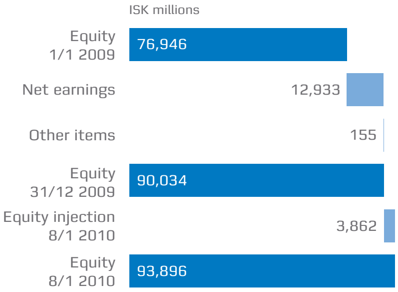
Return on equity



Capital ratio



Breakdown of equity

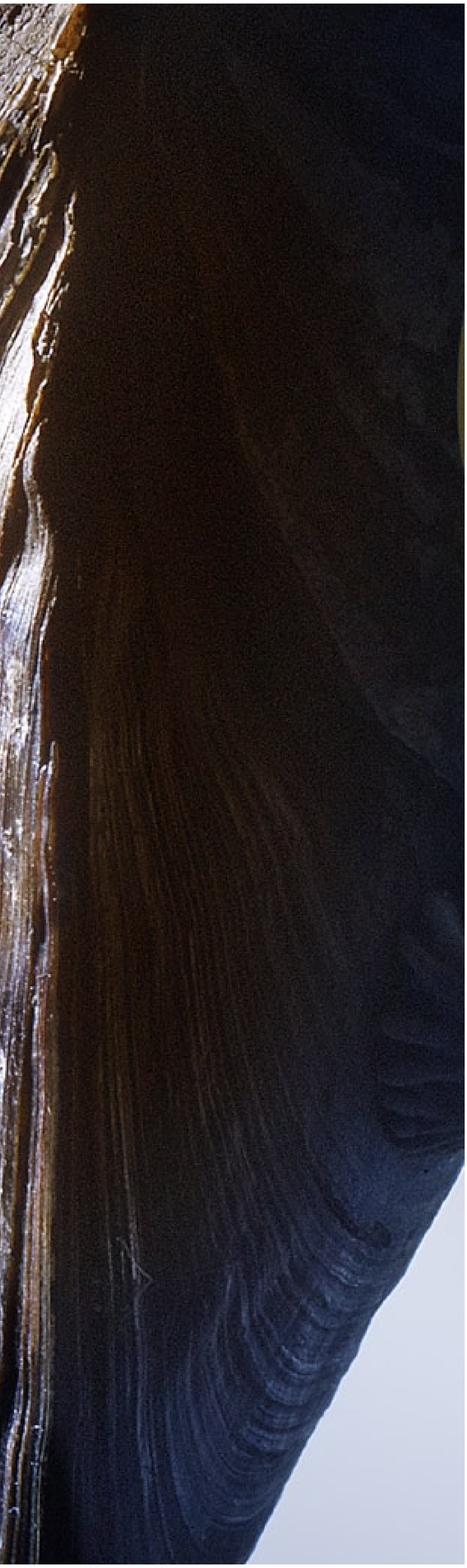


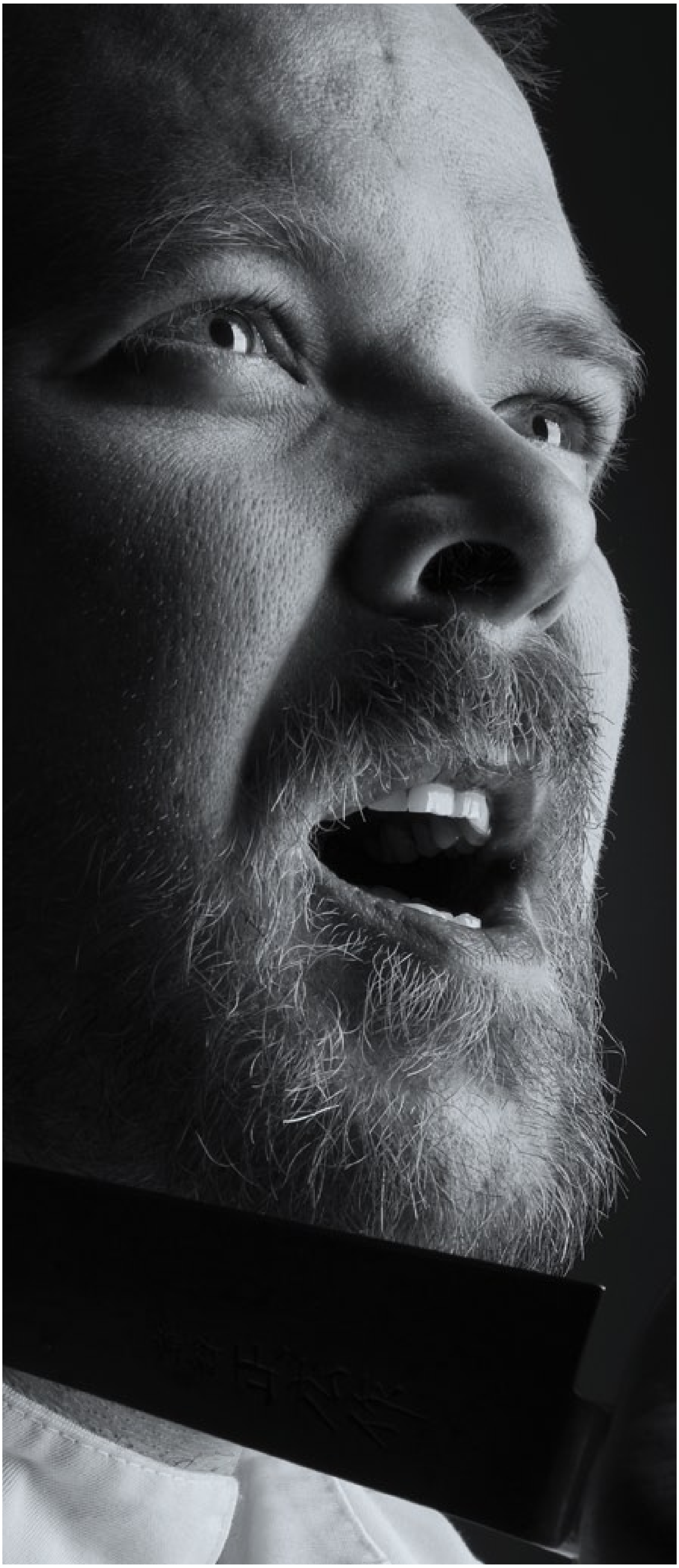
Mussels

Nowadays mussels are considered a delicacy and in Iceland we are fortunate in that mussels are common along every coast except in the south. In the past mussels were not thought fit for human consumption, even in times of hardship, and were virtually only used as bait. Mussels can be harvested from December until the end of April. Only shells which open when boiled are eaten.

Gunnar Karl Gíslason

Gunnar Karl is an innovative master chef and owns the restaurant Dill at Reykjavík's Nordic House. He has often been considered one of the nation's leading chefs. Using Icelandic ingredients is an integral part of his approach to cooking. He collects edible plants around Nordic House and prepares exotic dishes in the Neo-Nordic style, in which mussels are often a key ingredient.





Annual Accounts 2009

Table of Contents

Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion banki hf. for the year ended 31 December 2009 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. The new entity was initially named New Kaupthing banki hf. but on 21 November 2009 the name was changed to Arion banki hf. The year 2009 is 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.

Operations for the year

Consolidated net earnings amounted to ISK 12,871 million for the year ended 31 December 2009. The Board of Directors proposes that no dividend will be paid. Consolidated total equity amounted to ISK 90,034 million at the end of the year, including share capital amounting to ISK 12,646 million. The capital adequacy ratio of the Bank, calculated according to the Act on Financial Undertakings, was 13.7%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Services Authority ("FME") requires it to be no less than 12%.

The transfer of ownership of assets and liabilities from Kaupthing banki hf. to Arion banki hf. and the following restructuring of assets posed several challenges in the operations of Arion banki hf. during the year 2009. The valuation of the transferred assets was a time consuming task. It was finalised with an agreement between the Icelandic State and the Resolution Committee of Kaupthing banki hf. on 20 July 2009.

The restructuring of the transferred assets is an ongoing process which receives great attention within Arion banki hf. Several structural changes were made within the Bank in 2009 that exemplify that, such as the formation of a special division to focus on the reconstruction and recovery of assets. Additionally structural changes were made to improve all aspects of Corporate Governance.

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 depreciated by 7.6% against a trade weighted currency basket during the year, which is the principal reason for the net foreign exchange gain of ISK 10,250 million and increased loan impairment during the year.

With the acquisitions of two savings banks in 2009 the Bank’s customer base grew by close to 25% reaching one hundred thousand. Information on the impact of these acquisitions on the Bank can be found in notes 34-35.

Arion banki hf. made numerous operational changes during 2009 to adjust the cost structure of the Bank to the new economic reality. The branch network was rationalised, IT structure and costs adjusted to the current operational needs of the Bank and the methodology of Lean Management introduced in several divisions, to name only a few. Arion banki hf. today has the most efficient branch network in Iceland.

In 2009 the Bank was entirely owned by the Icelandic State. On 8 January 2010 Kaupskil hf. signed an agreement with the Icelandic State on capitalization and future ownership of 87% shareholding in Arion banki hf. The Icelandic State will remain a 13% shareholder of the Bank. The impacts on the financial position of the Bank are exemplified in notes 111-115 and 120.

Outlook

The Bank faces significant country risk. Its exposures are concentrated within Iceland, a country which at year end 2008 experienced an economic collapse. Even though progress was made in 2009 the economic environment continues to pose a challenge to the operations of Arion banki hf. About 70% of corporate debt was currency linked prior to the crisis. The 2008 collapse of the currency therefore created substantial debt problems which add to economic difficulties created by falling output. The pass from the currency market to the goods market is rapid and Iceland thus has had to deal with both inflation and unemployment from contracting GDP. On the other hand, a lower currency stimulates the economy through exports and has undeniably created a competitive edge for the country in the rebuilding process.

The reconstruction of assets will continue to be one of the most important tasks for the Bank. Both individuals and corporations continue to face financial difficulties and inability to service their debt. Many have negative equity. The importance of this task is great for the Bank, its customers and the Icelandic economy as a whole. 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 to fuel the much needed economic recovery.

Endorsement and Statement by the Board of Directors and the CEO

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. Trust is a key issue here. The Bank needs to regain trust among its customers and the Icelandic nation as a whole. To do that the Bank must 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.

Statement by the Board of Directors and the CEO

The Consolidated Financial Statements for the year ended 31. December 2009 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU.

On 18 March 2010 new Board of Directors was appointed for Arion banki hf. The new Board endorses the information as reported in the Consolidated Financial Statement for 2009.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the consolidated financial performance of the Bank for the year 2009, its consolidated financial position as at 31 December 2009 and its consolidated cash flows in 2009.

Further, in our opinion the Consolidated 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 Consolidated Financial Statements of Arion banki hf. for the year 2009 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion banki hf.

Reykjavík, 5 May 2010

Board of Directors

Monica Caneman

Chairman

Gudrún Johnsen

Steen Hemmingsen

Kristján Jóhannsson

Theodór S. Sigurbergsson

Chief Executive Officer

Finnur Sveinbjörnsson

Independent Auditor's Report

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

We have audited the accompanying Consolidated Financial Statements of Arion banki hf. and its subsidiaries (the "Bank"), which comprise the Consolidated Statement of Financial Position as at 31 December 2009, the Consolidated Statement of Comprehensive Income, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion banki hf. as at 31 December 2009, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Emphasis of matter

Without qualifying our opinion we draw your attention to notes 2 d), 33 and 111 to the Consolidated 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 Consolidated Financial Statements.

Reykjavík, 5 May 2010

Ernst & Young hf.

Margrét Pétursdóttir, Partner

Consolidated Statement of Comprehensive Income
for the year 2009

	Notes	2009	2008 22.10.-31.12.
Interest income		66,905	17,367
Interest expense		(54,759)	(13,169)
Net interest income	39	12,146	4,198
Increase in value of loans and receivables	40	20,199	-
FX gain on loans and receivables from ISK income customers	47	1,535	16,906
Impairment on loans and receivables	41	(11,474)	(19,723)
Changes in compensation instrument	73	(10,556)	-
Net interest income less valuation changes on loans and receivables	39	11,850	1,381
Fee and commission income		8,291	1,658
Fee and commission expense		(2,429)	(371)
Net fee and commission income	42	5,862	1,287
Net financial income (expense)	43-46	1,638	(6,060)
Net foreign exchange gain	47	8,715	14,198
Share of profit or loss of associates	75	369	498
Other operating income	48-49	21,201	418
Operating income		49,635	11,722
Salaries and related expense	51-52	(10,413)	(1,228)
Administration expense		(5,317)	(1,392)
Depositors' and investors' guarantee fund	92	(683)	(2,969)
Depreciation and amortisation	77	(1,161)	(109)
Other operating expense	54-55	(16,279)	(57)
Net loss on non-current assets and disposal groups classified as held for sale	56	(375)	(384)
Earnings before income tax		15,407	5,583
Income tax expense	57	(2,536)	(766)
Net earnings		12,871	4,817
Other comprehensive income			
Exchange difference on translating foreign operations	90	(37)	129
Total comprehensive income for the year		12,834	4,946
Attributable to:			
Shareholder of Arion banki hf.		12,970	4,817
Non-controlling interest		(99)	-
Net earnings		12,871	4,817
Earnings per share			
Basic and diluted earnings per share attributable to the shareholder of Arion banki hf. (ISK)	58	1.02	0.38

The notes on pages 62 to 127 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Consolidated Statement of Financial Position
as at 31 December 2009

Assets	Notes	2009	2008
Cash and balances with Central Bank	59	41,906	87,555
Loans and receivables to credit institutions	60-61	38,470	47,697
Loans and receivables to customers	62-67	357,734	337,014
Unpaid share capital		-	71,225
Bonds and debt instruments	70-71	173,482	10,761
Shares and equity instruments with variable income	70	7,078	6,609
Derivatives	70,87	6	-
Securities used for hedging	70	2,236	-
Compensation instrument	73	34,371	41,156
Investment property	74	22,947	12,079
Investments in associates	75	5,985	2,843
Property and equipment	76-77	10,700	7,656
Intangible assets	78	3,512	2,432
Tax assets	83-86	1,415	551
Non-current assets and disposal groups held for sale	79	41,527	972
Other assets	80-81	15,975	12,653
Total Assets		757,344	641,203
Liabilities			
Due to credit institutions and Central Bank	70	113,647	122,733
Deposits	70	495,465	421,341
Borrowings	82	11,042	-
Financial liabilities at fair value	70	88	2
Tax liabilities	83-86	2,841	1,031
Non-current liabilities and disposal groups held for sale	79	19,230	-
Other liabilities	88	24,997	19,150
Total Liabilities		667,310	564,257
Equity			
Share capital	89	12,646	12,646
Share premium	89	59,354	59,354
Other reserves	90	1,729	129
Retained earnings		16,150	4,817
Total Shareholder's Equity		89,879	76,946
Non-controlling interest		155	-
Total Equity		90,034	76,946
Total Liabilities and Equity		757,344	641,203

The notes on pages 62 to 127 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Consolidated Statement of Changes in Equity
for the year 2009

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holder's equity**	Non-controlling interest	**Total equity**
2009						
Equity 1 January 2009	72,000	129	4,817	76,946	-	76,946
Total comprehensive income for the year attributable to the shareholder 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 year				-	254	254
Equity 31 December 2009	72,000	1,729	16,150	89,879	155	90,034
Changes in equity from 22 October to 31 December 2008:						
Total comprehensive income for the period attributable to the shareholder of Arion banki hf.		129	4,817	4,946	-	4,946
Issued share capital	72,000	-	-	72,000	-	72,000
Equity 31 December 2008	72,000	129	4,817	76,946	-	76,946

The notes on pages 62 to 127 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Consolidated Statement of Cash Flows
for the year 2009

	Notes	2009	2008 22.10.-31.12.
Cash flows (used in) from operating activities:			
Earnings before income tax		15,407	5,583
Adjustments to reconcile earnings before income tax cash flow (used in) from operating activities:			
Non-cash items included in net earnings before income tax and other adjustments	98	(15,879)	(5,708)
Changes in operating assets and liabilities	99	(35,362)	76,051
Income taxes paid		(585)	-
Net cash (used in) from operating activities		(36,419)	75,926
Cash flows (used in) from investing activities:			
Purchase of investment property		(2,865)	-
Investment in associated companies		(612)	-
Proceeds from sale of associated companies		193	-
Purchase of intangible assets		(152)	(3)
Purchase of property and equipment		(208)	(17)
Proceeds from sale of property and equipment		138	128
Net cash (used in) from investing activities		(3,506)	108
Cash flows from financing activities:			
Proceeds from shares issued		-	775
Net cash from financing activities		-	775
Net (decrease) increase in cash and cash equivalents		(39,925)	76,809
Cash and cash equivalents at beginning of the year		92,910	13,581
Cash and cash equivalents acquired through business combinations		804	-
Effect of exchange rate changes on cash and cash equivalents		2,305	2,520
Cash and cash equivalents at the end of the year	100	56,094	92,910

Non-cash investing and financing transactions:

The following non-cash investing and financing transactions that occurred during 2009 have been excluded from the Consolidated Statement of Cash Flows:

1. An equity contribution by the Icelandic state of amount ISK 71,225 million was settled through the receipt of Icelandic government bonds (refer note 89).
2. Deposits and overdrafts were transferred to the Bank from SPRON and Sparisjódabanki Íslands hf. in consideration for a bond claim on Drómi ehf. of amount ISK 91,489 million and Sparisjódabanki Íslands hf. of amount ISK 371 million respectively (refer note 34).
3. The net assets of Sparisjódur Mýrasýslu were acquired by way of the issuance of bonds to creditors of nominal amount ISK 9,714 million (refer note 35).
4. The net assets of subsidiaries acquired with a view to resale, with a fair value of ISK 11,255 million, and disposal groups held for sale, with a fair value of ISK 19,689 mln were acquired through the foreclosure on collateral held against loan balances to these entities (refer notes 36 and 79).

The notes on pages 62 to 127 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions. 61

Notes to the Consolidated Financial Statements
Contents

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

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, Reykjavik. The Consolidated Financial Statements for the year ended 31 December 2009 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 Statement of Comprehensive Income and the Consolidated Statement of Financial Position.

2. Basis of preparation

a) *Statement of compliance*

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as endorsed by the European Union.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion banki hf. on 5 May 2010.

b) *Basis of measurement*

The Consolidated 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 Consolidated Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency.

d) *Use of estimates and judgements*

The preparation of the Consolidated 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 Consolidated 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 Consolidated 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 Consolidated Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in notes 33, 34, 107, 111 and 112.

Notes to the Consolidated Financial Statements

Significant accounting policies

The accounting policies set out below have been applied consistently in these Consolidated Financial Statements.

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 significant 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 from page 52. 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. Of critical importance is the Bank's access to funding to fulfil the maturity of existing short term liabilities and continue to finance the assets of the Bank. The Bank's management has considered the execution of the agreements outlined in note 120 as important to their future business.

The Bank is making progress in adapting to the new economic reality 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 in notes 101-115.

4. Principles underlying the consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for the acquisition of businesses and subsidiaries by the Bank. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed, contingent liabilities assumed and equity instruments issued, plus cost directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Bank's share of the net identifiable assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the business/subsidiary acquired, the difference is recognised directly in the Consolidated Statement of Comprehensive Income.

If an investment in subsidiary is classified as held for sale the investment is accounted for, as non-current asset held for sale from the date of classification.

b) *Non-controlling interest*

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank; such interests are presented separately in the Consolidated Statement of Comprehensive Income and are included in equity in the Consolidated Statement of Financial Position, separately from equity attributable to owners of the Bank. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

c) *Funds management*

The Bank manages and administers assets held in investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Bank controls the entity.

d) *Transactions eliminated on consolidation*

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

5. Associates

Associates are those entities over which the Bank has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The Consolidated Financial Statements include the Bank's share of the total recognised income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Bank's share of losses exceeds its interest in an equity accounted associate, the Bank's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current asset held for sale.

6. Foreign currency

a) *Functional currencies*

Items included in the Financial Statements of each of the Bank's subsidiaries are measured using the functional currency of the respective entity.

b) *Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currencies of Bank entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, and the amortised cost in foreign currency translated at the exchange rate at the end of the year. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

c) *Foreign operations*

The assets and liabilities of foreign operations are translated to Icelandic króna, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic króna at average exchange rates approximating the exchange rates current at the dates of the transactions.

Foreign exchange differences arising on translation are recognised in Consolidated Statement of Comprehensive Income. When a foreign operation is disposed of, in part or in full, the cumulative amount of the exchange differences relating to that foreign operation which is recorded in comprehensive income and accumulated in the separate component of equity, is transferred to the Consolidated Statement of Comprehensive Income when the gain or loss on disposal is recognised.

7. Income and Expense

a) *Interest income and expense*

Interest income and expense are recognised in the Consolidated Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and liability and is not revised subsequently.

The calculation of the effective interest rate includes all fees paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

Interest income and expense presented in the Consolidated Statement of Comprehensive Income include:

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis,
- Interest on trading assets and liabilities on an accrual basis,
- Interest on financial assets and financial liabilities designated at fair value through profit or loss on an accrual basis,
- Interest on derivatives on an accrual basis.

Interest income on non-performing assets are recognised in the Consolidated Statement of Comprehensive Income using the effective interest method. The Bank recognises losses for impaired loans to offset the recognised interest income when appropriate.

Notes to the Consolidated Financial Statements

7. cont.

b) *Fee and commission income and expense*

The Bank provides various services to its clients and earns income there from, such as income from Corporate banking, Retail banking, Treasury and Capital Markets, Corporate Finance and Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

c) *Net financial income*

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value through profit or loss and Net gain on disposal of financial assets and liabilities not at fair value.

i) Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value through profit or loss comprises: Net gain on trading portfolio, Net gain on assets and liabilities designated at fair value through profit or loss.

Net gain on trading portfolio

Net gains on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

Net gain on assets and liabilities designated at fair value through profit or loss

Net gains on financial instruments designated at fair value through profit or loss comprise gains and losses related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

iii) Net foreign exchange gains comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous financial statements.

Net foreign exchange gains also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gains and losses are also recognised in profit or loss.

iv) Net gain on financial assets and liabilities not at fair value through profit or loss relates to derecognition of certain financial assets and liabilities and comprises Net realised gain (loss) on financial liabilities measured at amortised cost and other net realised gain (loss). It does not include either unrealised foreign exchange gains (loss) or interest income and expense which are included in other line items.

d) *Income tax*

Income tax comprises current and deferred tax. Income tax is recognised in the Consolidated Statement of Comprehensive Income except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised in other comprehensive income or equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date.

The deferred income tax asset / liability has been calculated and entered in the Consolidated Statement of Financial Position. The calculation is based on the difference between Consolidated Statement of Financial Position items as presented in the tax return on the one hand, and in the Consolidated Financial Statements on the other. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Consolidated Financial Statements, mostly because revenues and settlement is not expected at the same time. A deferred tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

8. Impairment of financial assets

At each reporting date the Bank assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

a) *Impairment on loans and receivables*

The Bank recognises losses for impaired loans when there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Bank's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

i) Significant financial difficulty of the borrower;

ii) A breach of contract, such as a default on instalments or on interest or principal payments;

iii) The Bank granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;

iv) It becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;

v) Deterioration in collateral to loan ratio; or

vi) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:

- Adverse changes in the payment status of borrowers in the group; or
- General national or local economic conditions connected with the assets in the group.

Individually assessed loans

Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, the following factors are considered:

- The Bank's aggregate exposure to the customer;
- The amount and timing of expected receipts and recoveries;
- The likely distribution available on liquidation or bankruptcy;
- The complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- The realisable value of security (or other credit mitigates) and likelihood of successful repossession; and
- The likely deduction of any costs involved in recovery of amounts outstanding.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Consolidated Statement of Comprehensive Income. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future. The estimated collective impairment loss is recognised through the use of an allowance account.

Notes to the Consolidated Financial Statements

8. cont.

The collective impairment loss is determined after taking into account:

- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the asset
- Historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash; and
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period, for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

Loan write-offs

Loans are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised or acquired impairment loss is reversed. The amount of any reversal is recognised in the Consolidated Statement of Comprehensive Income.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Bank includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Bank revises its estimate of payments or receipts, the Bank adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Bank recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument´s original effective interest rate. The adjustment is recognised as interest income in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

Assets acquired in exchange for loans

Assets acquired in exchange for loans are recorded as non-current assets held for sale in the Consolidated Statement of Financial Position if its sale is highly probable and management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan have been initiated. The non-current asset held for resale is recorded at the lower of its fair value less costs to sell, and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Consolidated Statement of Comprehensive Income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Consolidated Statement of Comprehensive Income.

b) *Calculation of recoverable amount*

The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate, i.e. the effective interest rate computed at initial recognition of these financial assets.

c) *Impairment on investments in associates*

After applying the equity method to account for investments in associates, the Bank determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Bank first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Bank then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Bank. The excess of the carrying amount over the recoverable amount is recognised in the Consolidated Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Consolidated Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

Notes to the Consolidated Financial Statements

9. Impairment of non-financial assets

The carrying amounts of the Bank's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognised in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

10. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognised at fair value. Fair value changes are recognised in the Consolidated Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and other gains and losses. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Derivatives among Financial assets and derivatives with negative fair values are recognised as Financial liabilities at fair value.

The fair value of derivatives is determined in accordance with the accounting policy presented in note 13.

11. Cash and cash equivalents

Cash and cash equivalents in the Consolidated Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition.

12. Loans and receivables

Loans and receivables are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term. Loans include loans provided by the Bank to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognised in the Bank's Financial Statements.

Loans and receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables.

Notes to the Consolidated Financial Statements

13. Financial assets measured at fair value through profit and loss.

a) *Trading assets*
Trading assets are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

b) *Financial assets designated at fair value through profit or loss*
The Bank classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Consolidated Statement of Comprehensive Income as Net financial income if doing so results in more relevant information because:

i) the assets are managed, evaluated and reported internally on a fair value basis;
ii) the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
iii) the assets contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

The assets classified according to the above mentioned conditions consist of equity and debt instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

14. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation models. The Bank uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value on the Consolidated Statement of Financial Position.

15. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all risks and rewards of ownership.

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Bank specified in the contract is discharged or cancelled or expires.

16. Offsetting financial assets and financial liabilities

Financial assets and liabilities are set off and the net amount reported in the Consolidated Statement of Financial Position when, and only when, the Bank has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Bank's trading activity.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

17. Amortised cost measurement of financial assets and financial liabilities

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

18. Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets are not capitalised and expenditure is reflected in the Consolidated Statement of Comprehensive Income in the period in which the expenditure is incurred.

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

a) *Subsequent expenditure*

Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

b) *Amortisation*

Amortisation is recognised in the Consolidated Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of intangible assets. Intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software	5 years

19. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both. Investment property is stated at fair value.

When determining the fair value of the properties, net present value of future cash flow of 30 year is calculated. When determining the cash flow general accepted valuations techniques are applied, such as international valuation standards, IVS no. 1 Market Value Basis of Valuation. The valuation model is based on estimated free cash flow to the shareholders and assumptions applied that reflect the market conditions at accounting date. The cash flow of the properties is based on estimation of rental income less estimated expense.

Rental income are estimated based on valid lease agreements. In the valuation model estimated market lease at end of current lease agreement is taken into consideration. Fundamental assumptions on estimated utilisation of the properties in the future, estimated discounts and loan provisioning are applied when estimating future rental income.

All related expense, e.g. maintenance, real estate tax and other operating and financial expenses, is deducted from the estimated rental income. Real estate tax and insurances are based on historical data and expected future changes. Financial expense is estimated based upon market interest and expected interest yield (interest margin).

Net present value of free cash flow to shareholders, for each property, is found by calculating net present value of the cash flow with a factor representing current market uncertainty on amount and timing of the cash flow, including expected inflation. The CAPM model is used and the required rate of return is based on risk free real interest on accounting date, risk factor of the real estate market and specific risk factor of each lessee.

When estimating the fair value of the investment properties assets like fixtures, equipment and furniture are not accounted for separately as they are considered part of the fair value of the properties. The fair value of the properties does not reflect the possible future increase in the value due to further investments in the property.

The fair value of investment property in progress is mainly based on offers received for the properties.

Notes to the Consolidated Financial Statements

20. Property and equipment

a) *Recognition and measurement*
Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

b) *Subsequent costs*
The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. All other costs are recognised in the Consolidated Statement of Comprehensive Income as an expense as incurred.

c) *Depreciation*
The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Consolidated Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Real estate	33-50 years
Machinery and equipment	3-7 years

The depreciation methods, useful lives and residual values are reassessed annually.

21. Non-current assets and disposal groups held for sale

The Bank classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Consolidated Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement.

22. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

23. Borrowings

Some of the borrowings of the Bank are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised in the Consolidated Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

24. Financial liabilities at fair value

Trading liabilities
Trading liabilities primarily consist of derivatives with negative fair values. Hedging derivatives such as those used for internal risk control but not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain on financial assets and liabilities measured at fair value. Interest expenses on trading liabilities are included in Interest expenses.

25. Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

26. Equity

Dividends on shares
Dividends on shares are recognised in equity in the period in which they are approved by the Bank´s shareholders.

Statutory reserve
According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Bank which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Foreign currency translation reserve
The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations.

27. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to equity holders of the Bank by the weighted average number of ordinary shares outstanding during the year.

28. Financial guarantees

In the ordinary course of business, the Bank gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the financial statements at fair value, being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Consolidated Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Consolidated Statement of Comprehensive Income. The premium received is recognised in the Consolidated Statement of Comprehensive Income in *Net fees and commission income* on a straight line basis over the life of the guarantee.

29. Fiduciary activities

The Bank provides asset custody, asset management, investment management and advisory services to its clients. These services require the Bank to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Bank's custody are not reported in its Consolidated Statement of Financial Position.

30. Employee benefits

All entities within the Bank have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Bank has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Consolidated Statement of Comprehensive income when they become due. The Bank has no defined benefit pension plan.

Notes to the Consolidated Financial Statements

31. New standards and amendments to standards

a) New standards and amendments to standards effective in 2009

Amendments to IFRS 7 financial instruments: Disclosures - Improving disclosures about financial instruments.

The amendments to IFRS 7 were issued in March 2009. The amendments are intended to enhance fair value and liquidity disclosures.

With respect to fair value, the amendments require disclosure of a three level fair value hierarchy, by class, for all financial instruments recognised at fair value and specific disclosures related to the transfers between levels in the hierarchy and detailed disclosures related to level 3 of the fair value hierarchy.

In addition, the amendments modify the required liquidity disclosures with respect to derivative transactions and assets used for liquidity management.

The Bank has disclosed alternative information about financial instruments in the risk management notes which it considers to be more relevant to the users of the financial statements given the unusual risk profile and level of estimates and assumptions in the preparation of the financial statements.

Improvements to IFRS

In May 2008, the IASB issued amendments to IFRS, which resulted from the IASB's annual improvements project. They comprise amendments that result in accounting changes for presentation, recognition or measurement purposes as well as terminology or editorial amendments related to a variety of individual IFRS standards. Most of the amendments are effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. Amendments included in May 2008 "Improvements to IFRS" did not have any impact on the accounting policies, financial position or performance of the Bank.

b) New standards and amendments to standards not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2009, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Bank's reporting are:

IFRS 3 *Business Combinations (revised in 2008)* and amended IAS 27 *Consolidated and Separate Financial Statements* introduce changes to the accounting for business combinations and for non-controlling (minority) interest. The most significant changes from IFRS 3 (2004) and IAS 27 (2003) are the following:

- IFRS 3 (2008) applies also to business combination involving only mutual entities and to business combinations achieved by contract alone;
- The definition of a business combination has been revised to focus on control;
- The definition of a business has been amended;
- Transaction costs incurred by the acquirer in connection with the business combination do not form part of the business combination transaction;
- Acquisitions of additional non-controlling equity interests after the business combination are accounted for as equity transactions;
- Disposals of equity interests while retaining control are accounted for as equity transactions;
- New disclosures are required.

IFRS 3 (revised in 2008) and amended IAS 27 will become mandatory for the Bank's 2010 Financial Statements. The carrying amounts of any assets and liabilities that arose under business combinations prior to the application of IFRS 3 (revised in 2008) are not adjusted while most of the amendments to IAS 27 must be applied retrospectively. The revised standards will affect the accounting for future business combinations.

IFRS 9 *Financial Instruments*. In November 2009, the IASB issued IFRS 9 *Financial instruments*, which includes revised guidance on the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of the first part of a multi-stage project to replace IAS 39 *Financial instruments: recognition and measurement*. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Bank is currently assessing the impact of the new standard on its consolidated financial statements. If endorsed by the EU, the effective date for mandatory adoption is 1 January 2013.

IAS 24 *Related party disclosures (Revised)*. The revised IAS 24, issued in November 2009, simplifies the disclosure requirements for government-related entities and clarifies the definition of a related party. Previously, an entity controlled or significantly influenced by a government was required to disclose information about all transactions with other entities controlled or significantly influenced by the same government. The revised standard requires disclosure about these transactions only if they are individually or collectively significant. If endorsed by the EU, the revised IAS 24 will be effective for annual periods beginning on or after 1 January 2011.

Notes to the Consolidated Financial Statements

32. Segment reporting

The Bank's segmental reporting is based on the management and internal reporting structure. The Bank comprises the following main business segments: Corporate banking, Retail banking, Treasury and Capital Markets, Corporate Finance, Asset Management and Private banking, and other business segments.

33. 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 consolidated 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 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 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.

As set out in note 79, disposal groups being legal entities acquired exclusively with a view to resale had carrying amounts at 31 December 2009 representing their fair values less costs to sell at the date of classification to the held for sale category. For the most part, fair values at the date of classification of these legal entities were 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.

Notes to the Consolidated Financial Statements

Changes within the Bank

34. Acquisition of certain business activities of SPRON and Sparisjóðabanki Íslands hf.

In accordance with a decision of the FME on 21 March 2009 (By the authority of Art. 100a of Act No. 161/2002 on Financial Undertakings, cf. Art. 5 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.), Arion banki hf. took over SPRON and Sparisjóðabanki Íslands hf. obligations due to deposits, overdrafts on current accounts (along with accompanying collateral rights), import and export guarantees and guarantees due to discharge of contract by companies and individuals linked to regular activities, but excluding:

i) Deposits due to savings banks.
ii) Deposit Obligations which were created in a manner whereby a creditor had, by bond and/or other equivalent promissory note, received payment for his claim before the date of maturity, but at the same time created a Deposit with SPRON or Sparisjóðabanki Íslands hf.
iii) Money market deposits from financial undertakings which may own deposits at SPRON or Sparisjóðabanki Íslands hf.
iv) Obligations due to: a) obligations of subsidiaries abroad, b) companies under moratorium, composition or in bankruptcy, c) obligations of those owning a qualifying holding in SPRON or Sparisjóðabanki Íslands hf. and connected parties, d) obligations to Icelandic financial undertakings; e) other specifically identified liabilities.

As consideration, SPRON issued a bond claim on Drómi ehf. in the sum of ISK 96,676 million to Arion banki hf. but value of overdrafts are still to be agreed upon.

The financial impact of this acquisition at fair value is:	22.03.2009
Loans and receivables to customers	5,188
Bonds	91,489
Deposits from customers	(96,055)
Deposits from credit institutions	(621)
Total	-

As consideration, Sparisjóðabanki Íslands hf. issued a bond claim on Sparisjóðabanki Íslands hf. in the sum of ISK 371 million to Arion banki hf.

The financial impact of this acquisition at fair value is:	22.03.2009
Loans and receivables to customers	1,073
Bonds	371
Deposits from customers	(1,444)
Total	-

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

35. Acquisition of Sparisjódur Mýrasýslu

Arion banki hf. bought all assets of Sparisjódur Mýrasýslu (SPM), in accordance with a purchase agreement dated 3 April 2009 including the branch in Borgarnes, Iceland, real estate, fixed assets, cash, loan portfolio, all security interests of Sparisjódur Mýrasýslu, including all pledges, guarantees and other similar rights linked to the claims, securities holdings, trademarks and other intangible asset and rights, listed as well as unlisted, holdings in associate companies and subsidiaries and all other claims, funds and other assets and rights as current at the end of the date of delivery. Arion banki hf. took over non-due obligations according to import and export guarantees, guarantees due to discharge of contract by companies and individuals connected to regular activities, but excluding:

i) Rights conferred by derivatives contracts.
ii) Money market deposits owned by financial undertakings deposits owned by financial undertakings in administration.
iii) Guarantees for
a) the obligations of subsidiaries,
b) companies in administration, subject to composition or undergoing bankruptcy proceedings,
c) obligations to Icelandic financial undertakings,
d) other specific guarantees as decided by the buyer.

The financial impact of the acquisition of SPM is shown in the table below at fair value:

	03.04.2009
Cash and cash balances with Central Bank	805
Loans and receivables to credit institutions	(5,371)
Loans and receivables to customers	33,211
Bonds and debt instruments	595
Shares and equity instruments	289
Investment property	153
Investment in associates	436
Property and equipment	692
Other assets	1,624
Due to credit institutions and Central Bank	(2,844)
Deposits	(19,835)
Borrowings	(7,769)
Other liabilities	(1,945)
Minority interest	(40)
Total	-

Amounts are in ISK millions. 77

Notes to the Consolidated Financial Statements

36. 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 number of legal entities in 2009.

The Bank holds 100% shareholding in Hafrahlíd ehf., Penninn á Íslandi ehf., Penninn Holding 1 Oy, Icecorp Limited, Thyrping ehf. and Drög ehf., as well as 99,34% shareholding in 1998 ehf. These legal entities were acquired exclusively with view to resale. Due to the current market condition the timing of the ultimate disposal of these assets is uncertain and the requirements of IFRS 5 to classify the assets as held for sale can therefore not be met for all of them. These legal entities are classified as subsidiaries and are included in the Consolidated Financial Statements except for 1998 ehf. and Íslenskir adalverktakar ehf., a subsidiary of Drög ehf., which meet the requirements and are classified as non-current assets and disposal groups classified as held for sale.

i) Hafrahlíd ehf.

Hafrahlíd ehf. was acquired 9 February 2009. Hafrahlíd ehf. is the holding company of Hekla ehf. and Hekla fasteignir ehf. Hekla ehf. is a service company specializing in sales and servicing of automobiles and machinery. Hekla ehf. is the Icelandic dealership for brands like Volkswagen, Audi, Skoda, Mitsubishi, Scania and Caterpillar. Hekla fasteignir ehf. holds and operates investment properties.

The financial impact of this acquisition is shown in the table below at fair value:	09.02.2009
Loans and receivables to credit institutions and customers	(2,773)
Property and equipment	2,283
Other assets	4,529
Liabilities	(4,039)
Total	-

ii) Penninn á Íslandi ehf.

Penninn á Íslandi ehf. was acquired 2 April 2009. Penninn á Íslandi ehf. operates book stores and provides enterprises and individuals with office furnitures and supplies. Penninn á Íslandi ehf. operates the stores Eymundsson, Penninn, Griffill and Islandia, all located in Iceland.

The financial impact of this acquisition is shown in the table below at fair value:	02.04.2009
Loans and receivables to credit institutions and customers	(765)
Property and equipment	262
Intangible assets	269
Other assets	1,131
Liabilities	(897)
Total	-

iii) Penninn Holding 1 Oy

Penninn Holding 1 Oy was acquired 2 April 2009. Penninn Holding 1 Oy is the holding company of Officeday Finland Oy. Officeday Finland group is importer and wholesaler of IT and office supplies.

The financial impact of this acquisition is shown in the table below at fair value:	02.04.2009
Loans and receivables to credit institutions and customers	(1,093)
Intangible assets	301
Other assets	1,583
Liabilities	(791)
Total	-

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

36. cont.

iv) Icecorp Limited

Icecorp Ltd. in Ireland was acquired 2 April 2009. The company acts as an investment holding company and holds 50.1% shareholding in Insomnia Ltd. Insomnia group consists of few companies incorporated in the Republic of Ireland with principal activity being retail chain and coffee outlets as well as investment holding.

The financial impact of this acquisition is shown in the table below at fair value:	02.04.2009
Loans and receivables to credit institutions and customers	(118)
Property and equipment	732
Intangible assets	480
Other assets	112
Liabilities	(1,206)
Total	-

v) Thyrping ehf.

On 17 August 2009 the Bank acquired Thyrping ehf. which is the holding company of 101 Skuggahverfi hf., AB 106 ehf., Sjónvarpshúsid Laugavegi ehf. and Akraland ehf. All the companies within Thyrping ehf. mainly hold investment properties in progress. Thyrping ehf. is a subsidiary of Landey ehf.

The financial impact of this acquisition is shown in the table below at fair value:	17.08.2009
Loans and receivables to credit institutions and customers	(1,137)
Investment properties	1,051
Property and equipment	5
Other assets	931
Liabilities	(850)
Total	-

vi) Drög ehf.

Drög ehf. was acquired 4 December 2009. Drög ehf. is the holding company of Íslenskir adalverktakar hf., Ármannsfell ehf., Álftárós ehf., as well as other smaller companies in the construction sector. Íslenskir adalverktakar hf. meets the criteria in IFRS 5 to be classified as non-current asset and disposal groups held for sale and is therefore excluded from the Consolidated Financial Statements of Drög ehf., see note 79. Employees of Íslenskir adalverktakar hf. are not included in the total number of employees of the Bank.

The financial impact of this acquisition is shown in the table below at fair value:	04.12.2009
Loans and receivables to credit institutions and customers	(5,369)
Investment properties	5,416
Other assets	55
Liabilities	(102)
Total	-

vii) 1998 ehf.

In October 2009 the Bank acquired majority of the share capital of 1998 ehf., the holding company of Hagar hf., resulting in a effective shareholding of 99,34% at year end. Hagar hf. is a commercial enterprise operating in Iceland. Under the auspices of Hagar hf. there are numerous stores and few purchasing companies.

1998 ehf. meets the criteria in IFRS 5 to be classified as non-current asset and disposal group held for sale and is reported for as such in these Consolidated Financial Statements, see note 79.

Employees of 1998 ehf. are not included in the total number of employees of the Bank.

Amounts are in ISK millions. 79

Notes to the Consolidated Financial Statements

Operating Segment Reporting

37. 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 year 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.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

38. Summary of the Bank's business segments:

2009	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 ...	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
Operating income	6,294	11,048	8,302	582	3,493	19,916	49,635
Operating expense	(33)	(5,848)	(417)	(255)	(1,017)	(26,658)	(34,228)
Earnings before cost allocation	6,261	5,200	7,885	327	2,476	(6,742)	15,407
Allocated cost	(345)	(511)	(372)	(69)	(110)	1,407	-
Earnings before income tax	5,916	4,689	7,513	258	2,366	(5,335)	15,407
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)	-
Operating income	6,294	11,048	8,302	582	3,493	19,916	49,635
Depreciation and amortisation	1	278	1	1	-	880	1,161
Total assets	233,603	137,364	306,856	5,404	3,963	70,154	757,344
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.

Amounts are in ISK millions. 81

Notes to the Consolidated Financial Statements

38. cont.

2008 22.10. - 31.12.	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	2,981	1,309	(319)	186	401	(360)	4,198
Impairment on loans and receivables	(15,116)	(3,357)	(896)	(10)	-	(344)	(19,723)
Net fee and commission income	75	340	109	121	505	137	1,287
Net financial income	-	33	(5,855)	(134)	(42)	(62)	(6,060)
Net foreign exchange gain	13,203	3,533	14,315	10	50	(7)	31,104
Other income	23	633	-	-	-	260	916
Operating income	1,166	2,491	7,354	173	914	(376)	11,722
Operating expense	(866)	(2,196)	(699)	(22)	(654)	(1,702)	(6,139)
Earnings before cost allocation	300	295	6,655	151	260	(2,078)	5,583
Allocated cost	(40)	(46)	(72)	(14)	(14)	186	-
Earnings before income tax	260	249	6,583	137	246	(1,892)	5,583
Net segment revenue from external customers	5,318	(2,875)	10,160	198	(1,294)	215	11,722
Net segment revenue from other segments	(4,152)	5,366	(2,806)	(25)	2,208	(591)	-
Operating income	1,166	2,491	7,354	173	914	(376)	11,722
Depreciation and amortisation	-	38	-	-	-	71	109
Total assets	265,434	82,437	272,672	1,407	7,197	12,056	641,203
Allocated equity	31,852	10,510	30,027	169	5,048	(660)	76,946

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

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Comprehensive Income

Net interest income

39. Interest income and expense is specified as follows:

2009	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank	2,793	-	2,793
Loans, receivables and deposits	45,408	53,060	(7,652)
Borrowings	-	1,564	(1,564)
Securities	10,934	17	10,917
Compensation instrument	2,411	-	2,411
Other	5,359	118	5,241
Interest income and expense	66,905	54,759	12,146
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
Interest income and expense	66,905	54,759	12,146

2008 22.10. - 31.12.	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank	2,346	-	2,346
Loans, receivables and deposits	11,908	13,168	(1,260)
Securities	344	-	344
Compensation instrument	459	-	459
Other	2,310	1	2,309
Interest income and expense	17,367	13,169	4,198
Interest income and expense from assets and liabilities at fair value	344	-	344
Interest income and expense from assets and liabilities not at fair value through profit or loss	17,023	13,169	3,854
Interest income and expense	17,367	13,169	4,198

Increase in value of loans and receivables

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

Impairment on loans and receivables

41. Impairment on loans and receivables is specified as follows:

	2009	2008 22.10.-31.12.
Impairment on loans and receivables to credit institutions	682	44
Impairment for unrealisable FX gains from FX denominated loans to borrowers with ISK income	1,535	16,906
Impairment on loans and receivables to customers	8,317	1,999
Impairment on receivables and other assets	940	774
Impairment	11,474	19,723

Further information on the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 112 a).

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Net fee and commission income

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

2009	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
Fee and commission income				
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
Fee and commission income	373	622	7,296	8,291
Fee and commission expense				
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
Fee and commission expense	-	-	2,429	2,429
Net fee and commission income	373	622	4,867	5,862

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.

2008 22.10. - 31.12.	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
Fee and commission income				
Securities trading	-	-	29	29
Derivatives	108	-	-	108
Lending and guarantees	-	86	-	86
Asset management fees	-	-	599	599
Other fee and commission income - banking activities	-	-	387	387
Other fee and commission income	-	-	449	449
Fee and commission income	108	86	1,464	1,658
Fee and commission expense				
Securities trading	-	-	37	37
Asset management fees	-	-	95	95
Other fee and commission income - banking activities	-	-	183	183
Other fee and commission expense	-	-	56	56
Fee and commission expense	-	-	371	371
Net fee and commission income	108	86	1,093	1,287

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Net financial income

43. Net financial income is specified as follows:

	2009	2008 22.10.-31.12.
Dividend income	29	3
Net gain (loss) on financial assets and liabilities classified as held for trading	1,240	(5,962)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	369	(101)
Net financial income	1,638	(6,060)

44. Dividend income is specified as follows:

Dividend income on trading assets	20	3
Dividend income on assets designated at fair value through profit or loss	9	-
Dividend income	29	3

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

Net gain (loss) on equity instruments and related derivatives	279	(215)
Net gain (loss) on interest rate instruments and related derivatives	194	(5,773)
Net gain (loss) on other derivatives	767	26
Net gain (loss) on trading portfolio	1,240	(5,962)

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

Net gain (loss) on interest rate instruments designated at fair value	230	(99)
Net gain (loss) on equity instruments designated at fair value	139	(2)
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	369	(101)

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

FX gain on loans and receivables	15,059	11,351
FX gain on bank accounts	2,305	2,510
FX loss from deposits	(9,597)	(2,681)
FX gain on bonds and equity	445	877
FX gain on other assets and liabilities	503	2,141
Net gain (loss) on foreign exchange	8,715	14,198
FX gain on loans and receivables from ISK income customers	1,535	16,906
Total gain (loss) on foreign exchange	10,250	31,104

Other operating income

48. Other operating income is specified as follows:

Rental income from investment properties	1,183	156
Fair value changes on investment property	170	-
Realised gain on investment property	70	-
Earned premiums, net of reinsurance	822	122
Net gain on disposals of assets other than held for sale	44	10
Other income from subsidiaries acquired exclusively with view to resale	17,838	-
Other income	1,074	130
Other operating income	21,201	418

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

49. Earned premiums, net of reinsurance:

	2009	2008 22.10.-31.12.
Premium written	988	164
Outward reinsurance premiums	(96)	-
Change in the gross provision for unearned premiums	(70)	(42)
Earned premiums, net of reinsurance	822	122

Personnel

50. The Bank's total number of employees is as follows:

Average number of full time equivalent positions during the year	1,131	1,036
Full time equivalent positions at the end of the year	1,096	1,012

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 the year no Kaupthing banki hf. employee is included in the number of full time equivalent positions.

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

	2009	2008 22.10.-31.12.
Full time equivalent positions at the end of the year	584	-

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

51. Salaries and related expense are specified as follows:

Salaries	8,438	1,035
Defined contribution pension plans	1,123	139
Salary related expense	852	54
Salaries and related expense	10,413	1,228

Included in the total amount of salaries and related expenses are salaries of Kaupthing banki hf. employees amounting to ISK 309 million in the year 2009 compared to ISK 17 million in the year 2008.

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

	2009	2008 22.10.-31.12.
Salaries	1,949	-
Salary related expense	391	-
Salaries and related expense	2,340	-

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

52. Compensation to the key management personnel:

Salaries and related cost:

	Position	Period	2009
Finnur Sveinbjörnsson	CEO	01.01. - 31.12.2009	21.0
Audur Finnbogadóttir	Director	01.01. - 03.09.2009	1.1
Drífa Sigfúsdóttir	Director	01.01. - 31.12.2009	1.6
Erna Bjarnadóttir, Chairman	Director	01.01. - 31.12.2009	2.1
Helga Jónsdóttir	Director	01.01. - 31.12.2009	2.2
Hulda Dóra Styrmisdóttir, Chairman	Director	10.02. - 03.09.2009	1.7
Jónína A. Sanders	Director	03.09. - 31.12.2009	0.5
Magnús Gunnarsson, Chairman	Director	01.01. - 10.02.2009	0.4
Kaupthing banki hf.*	2 Directors	03.09. - 31.12.2009	1.2
Five managing directors of the Bank's divisions			80.1

The remuneration of the Chairman of the Board and the other directors of the Board was decided by a Shareholder´s meeting on 8 January 2010.

Remuneration to the Chairman of the Board, CEO and other key management personnel consist of salary and other benefits.

* Kaupthing banki hf. assigned two directors to the board of Arion banki hf., Theodór S. Sigurbergsson Vice Chairman and Jóhannes Rúnar Jóhannsson.

Auditor's fee

53. Auditor's fee is specified as follows:

2009	Ernst & Young	KPMG	Total
Audit of the Financial Statements and other related audit service	60	38	98
Other service	18	28	46
Auditor's fee	78	66	144

2008 22.10. - 31.12.	National Audit	Ernst & Young	KPMG	Total
Audit of the Financial Statements and other related audit service	15	104	8	127
Other service	-	-	2	2
Auditor's fee	15	104	10	129

Amounts are in ISK millions. 87

Notes to the Consolidated Financial Statements

Other operating expense

54. Other operating expenses:

	2009	2008 22.10.-31.12.
Direct operating expenses (including repairs and maintenance) arising on rental-earning investment properties	263	11
Claims incurred, net of reinsurance	315	46
Other operating expenses from subsidiaries acquired exclusively with view to resale	15,686	-
Other operating expenses	15	-
Other operating expenses	16,279	57

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

55. Claims incurred, net of reinsurance:

Claims paid	317	66
Change in the provision for claims	(59)	(27)
Claims paid, net of reinsurers share	97	(21)
Change in the provision for claims, reinsurers' share	(39)	29
Claims incurred, net of reinsurance	315	46

Net gain (loss) on non-current assets classified as held for sale

56. Net gain (loss) on non-current assets and disposal groups classified as held for sale are specified as follows:

Net income (expenses) relating to non-current assets held for sale	375	384
Net gain (loss) on non-current and disposal groups assets classified as held for sale	375	384

Income tax expense

57. Income tax recognised in the Consolidated Statement of Comprehensive Income are specified as follows:

Current tax expense		
Current year	1,044	516
Deferred tax expense		
Changes in temporary differences	1,492	250
Total income tax expense	2,536	766

Reconciliation of effective tax rate:	2009		2008 22.10.-31.12.	
Earnings before income tax		15,407		5,583
Income tax using the Icelandic corporation tax rate	15.0%	2,311	15.0%	837
Non-deductible expense	0.1%	9	0.2%	12
Tax exempt revenues	(0.8%)	(126)	(1.3%)	(75)
Effect of increase in the income tax rate from 15% to 18%	1.9%	297	0.0%	-
Other changes	0.0%	3	(0.1%)	(8)
Effective tax rate	16.2%	2,494	13.7%	766

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Earnings per share

58. Earnings per share are specified as follows:

	2009	2008 22.10.-31.12.
Net earnings attributable to the shareholders of Arion banki hf.	12,970	4,817
Weighted average share capital:		
Weighted average number of outstanding shares for the year, million	12,646	12,646
Basic earnings per share	1.02	0.38
Diluted earnings per share	1.02	0.38
Number of outstanding shares at the end of the year, million	12,646	12,646
Number of total shares at the end of the year, million, diluted	12,646	12,646

Notes to the Consolidated Statement of Financial Position

Cash and balances with Central Bank

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

	2009	2008
Cash on hand	3,536	2,102
Cash with Central Bank	28,521	77,985
Mandatory reserve deposits with Central Bank	9,849	7,468
Cash and balances with Central Bank	41,906	87,555

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

Loans and receivables to credit institutions

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

Bank accounts	24,037	12,823
Money market loans	4,733	27,832
Overdrafts	4,074	1,942
Other loans	5,626	5,100
Loans and receivables to credit institutions	38,470	47,697

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

Balance at the beginning of the year	44	-
Provision for losses during the year	683	44
Balance at the end of the year	727	44
Collective	-	-
Specific	727	44
	727	44

Amounts are in ISK millions. 89

Notes to the Consolidated Financial Statements

Loans and receivables to customers

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

	2009	2008
Overdrafts	31,673	17,687
Subordinated loans	17	8,055
Other loans and receivables	354,780	330,177
Provision on loans and receivables	(28,736)	(18,905)
Loans and receivables to customers	357,734	337,014

63. Loans and receivables to customers specified by sectors:

	2009	2008
Individuals	15.5%	11.0%
Holding companies	13.9%	19.7%
Industry	33.2%	32.9%
Real estate	15.2%	13.6%
Service	17.9%	17.6%
Trade	4.0%	5.0%
Transportation	0.3%	0.3%
Loans and receivables to customers	100.0%	100.0%

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

	2009	2008
Balance at the beginning of the year	18,905	-
Provision for losses during the year	8,317	2,002
Provision for unrealisable FX gains from FX denominated loans to borrowers with ISK income	1,535	16,906
Payment of loans previously written off	(21)	(3)
Balance at the end of the year	28,736	18,905
Specific	28,736	18,905
Collective	-	-
	28,736	18,905

Further information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 112 a).

65. Impaired loans and receivables to customers by sector:

	2009		2008	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals	1,201	8,058	1,087	7,461
Holding companies	6,934	20,990	4,439	19,065
Industry	5,247	38,739	3,997	35,962
Real estate	6,303	47,333	3,981	43,549
Service	7,237	53,828	4,516	49,822
Trade	1,809	7,546	882	6,987
Transportation	5	25	3	23
Impairment on loans and receivables to customers	28,736	176,519	18,905	162,869

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

66. Status of monitoring of loans and receivables to customers:

	2009	2008
Performing loans	38%	77%
Stressed loans	10%	9%
Non-performing loans	52%	14%
Total	100%	100%

For a discussion of these results and a detailed definition of the categories "performing loans", "stressed loans" and "non-performing loans" please refer to note 110 b).

Specific provisions of the fair value loan book are ISK 28,736 million (2008: ISK 18,905 million).

67. Loans and receivables to customers that are past due but not impaired

The majority of the loans have been acquired at discount and are in process of being restructured or in a recovery process. Information on past due but not impaired loans to customers are not considered to be informative under these circumstances.

There has been no material changes in the fair value of the loans and receivables to customers during the year.

Additional information on loans and receivables

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

2009	Nominal value	Deep discount	Subsequent impairment	Book value
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
Balance at the end of the year	1,204,409	(778,743)	(29,463)	396,204

2008				
Loans and receivables to credit institutions	77,995	(30,254)	(44)	47,697
Loans and receivables to customers	1,152,290	(796,371)	(18,905)	337,014
Balance at the end of the year	1,230,285	(826,625)	(18,949)	384,711

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 year end.

Renegotiated loans

69. During 2009 Arion banki hf. 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 year 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 year end 2009.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Financial assets and liabilities

70. Financial assets and liabilities are specified as follows:

2009	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
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
Loans and receivables	438,110	-	-	-	438,110
Bonds and debt instruments					
Listed	-	4,221	4,614	-	8,835
Unlisted	-	-	164,647	-	164,647
Bonds and debt instruments	-	4,221	169,261	-	173,482
Shares and equity instruments with variable income					
Listed	-	709	429	-	1,138
Unlisted	-	1,464	3,380	-	4,844
Bond funds with variable income	-	320	776	-	1,096
Shares and equity instruments	-	2,493	4,585	-	7,078
Derivatives					
OTC derivatives	-	6	-	-	6
Derivatives	-	6	-	-	6
Securities used for hedging					
Bonds and debt instruments	-	2,236	-	-	2,236
Securities used for hedging	-	2,236	-	-	2,236
Compensation instrument	-	-	-	34,371	34,371
Other financial assets	-	-	-	9,230	9,230
Financial assets	438,110	8,956	173,846	43,601	664,513
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	113,647	113,647
Deposits	-	-	-	495,465	495,465
Borrowings	-	-	-	11,042	11,042
Liabilities at amortised cost	-	-	-	620,154	620,154
Financial liabilities at fair value					
Derivatives held for trading	-	88	-	-	88
Financial liabilities at fair value	-	88	-	-	88
Other financial liabilities	-	-	-	1,524	1,524
Financial liabilities	-	88	-	621,678	621,766

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

70. cont.

2008	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	87,555	-	-	-	87,555
Loans to credit institutions	47,697	-	-	-	47,697
Loans to customers	337,014	-	-	-	337,014
Loans and receivables	472,266	-	-	-	472,266
Bonds and debt instruments					
Listed	-	8,627	470	-	9,097
Unlisted	-	1,510	154	-	1,664
Bonds and debt instruments	-	10,137	624	-	10,761
Shares and equity instruments with variable income					
Listed	-	808	328	-	1,136
Unlisted	-	2,333	508	-	2,841
Bond funds with variable income	-	783	1,849	-	2,632
Shares and equity instruments	-	3,924	2,685	-	6,609
Compensation instrument	-	-	-	41,156	41,156
Other financial assets	-	-	-	9,577	9,577
Financial assets	472,266	14,061	3,309	50,733	540,369
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	122,733	122,733
Deposits	-	-	-	421,341	421,341
Liabilities at amortised cost	-	-	-	544,074	544,074
Financial liabilities at fair value					
Derivatives held for trading	-	2	-	-	2
Financial liabilities at fair value	-	2	-	-	2
Other financial liabilities	-	-	-	698	698
Financial liabilities	-	2	-	544,772	544,774

71. Bonds and debt instruments designated at fair value specified by issuer:

	2009	2008
Financial institutions	1,760	10
Governments	73,042	440
Corporates	94,454	158
Other	5	16
Bonds and debt instruments designated at fair value	169,261	624

Amounts are in ISK millions. 93

Notes to the Consolidated Financial Statements

72. Fair value hierarchy

The Bank uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;

Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and

Level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data.

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

2009	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	2,215	168,953	2,678	173,846
Financial assets held for trading	4,930	1,790	-	6,720
	7,145	170,743	2,678	180,566
Financial liabilities held for trading	-	88	-	88
2008				
Financial assets designated at FV through PL	788	3,409	3,710	7,907
Financial assets held for trading	6,322	3,141	-	9,463
	7,110	6,550	3,710	17,370

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2008 is in consistency with the classification used in 2009.

Compensation instrument

73. 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:	2009	2008
Balance at the beginning of the year	41,156	-
Issue of compensation instrument	-	38,300
Changes due to the Escrow and contingent value rights agreement	(10,556)	-
Accrued interest	2,398	2,384
Foreign exchange rate differences	1,373	472
Balance at the end of the year	34,371	41,156

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 2009 changes in those defined loans amounted to ISK 11,818 million, 80% of this increased value belonging to Kaupthing banki hf., ISK 9,454 million as presented in the Consolidated Statement of Comprehensive Income, 20% belonging to Arion banki hf. as a part of the Consolidated 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 year end.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Investment property

74. Investment property are specified as follows:

	Investment properties	Investment properties in progress	Subsidiaries acquired with view to resale: Investment properties	Subsidiaries acquired with view to resale: Investment properties in progress	Total 2009	2008
Balance at the beginning of the year	12,079	-	-	-	12,079	-
Acquisition through business combination	239	2,177	2,715	2,701	7,832	11,598
Additions during the year	3,289	-	-	-	3,289	-
Other disposals during the year	(423)	-	-	-	(423)	-
Transferred from property and equipment	-	-	-	-	-	481
Fair value adjustments	170	-	-	-	170	-
Investment property	15,354	2,177	2,715	2,701	22,947	12,079

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

Investments in associates

75. The Bank´s interest in its principal associates are as follows:

	Ownership at year end
Audkenni hf. Engjateigur 3, 105 Reykjavík, Iceland	25.0%
KB rádgjöf ehf. Hlídarsmári 17, 201 Kópavogur, Iceland	43.1%
Reiknistofa Bankanna Kalkofnsvegur 1, 150 Reykjavík, Iceland	18.0%
Valitor hf. Laugarvegur 77, 101 Reykjavík, Iceland	38.0%
Reitir fasteignafélag hf. Kringlan 4-12, 103 Reykjavík, Iceland	42.7%

Investment in associates are specified as follows:	2009	2008
Carrying amount at the beginning of the year	2,843	-
Acquisition through business combination	2	2,345
Additions during the year	2,941	-
Sold during the year	(153)	-
Transferred from financial assets at fair value due to step acquisition	(17)	-
Share of profit (loss)	369	498
Carrying amount at the end of the year	5,985	2,843

Summarised financial information in respect of the Bank´s associates is set out below:	2009	2008
Total assets	71,238	36,276
Total liabilities	(58,953)	(30,204)
Net assets	12,285	6,072

Share of profit and associates:	2009	2008 22.10.-31.12.
Total revenue	4,178	1,960
Total profit in associates at the end of the year	763	442
Bank's share of profit of associates	369	498

Amounts are in ISK millions. 95

Notes to the Consolidated Financial Statements

Property and equipment

			Subsidiaries acquired with view to resale			
		Machinery		Machinery		
	Real	and	Real	and	Total	Total
76. Property and equipment are specified as follows:	estate	equipm.	estate	equipm.	2009	2008
Balance at the beginning of the year	5,640	2,112	-	-	7,752	-
Acquisitions through business combination	193	88	1,944	1,761	3,986	8,346
Additions during the year	14	194	-	-	208	16
Disposals during the year	(17)	(121)	-	-	(138)	(129)
Transfers to investment properties	-	-	-	-	-	(481)
Gross carrying amount at the end of the year	5,830	2,273	1,944	1,761	11,808	7,752
Previously depreciated	28	67	-	-	95	-
Depreciation during the year	152	466	-	401	1,019	97
Disposals during the year	-	(6)	-	-	(6)	(1)
Total depreciation at the end of the year	180	527	-	401	1,108	96
Property and equipment	5,650	1,746	1,944	1,360	10,700	7,656

The official real estate value amounts to ISK 8,687 million at year end. The insurance value of fixed assets amounts to ISK 12,215 million at year end. The official real estate value and the insurance value of the real estates in subsidiaries acquired with view to resale amounts to ISK 2,030 million and ISK 2,435 million at year end and is excluded from the values above.

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

77. Depreciation and amortisation in the Consolidated Statement of Comprehensive Income is specified as follows:

	2009	2008
Depreciation of property and equipment	1,019	97
Amortisation of intangible assets	142	12
Depreciation and amortisation	1,161	109

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Intangible assets

78. The intangible assets are related to different business segments in the Bank's operation. They comprise insurance contract agreements, Assets under Management and custody contracts.

Intangible assets are specified as follows:

			Subsidiaries acquired with view to resale		
2009	Indefinite life intangible assets	Software	Indefinite life intangible assets	Software	Total
Balance at the beginning of the year	2,075	357	-	-	2,432
Acquisition through business combination	-	-	282	813	1,095
Additions during the year	24	128	-	-	152
Impairment	-	-	(25)	-	(25)
Amortisation	-	(142)	-	-	(142)
Intangible assets	2,099	343	257	813	3,512
2008 22.10. - 31.12.					
Acquisition through business combination	2,075	366	-	-	2,441
Additions during the period	-	3	-	-	3
Amortisation	-	(12)	-	-	(12)
Intangible assets	2,075	357	-	-	2,432

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

Non-current assets and disposal groups held for sale

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

	2009	2008
Legal entities	38,922	3
Real estates	2,570	709
Other assets	35	260
Non-current assets and disposal groups held for sale	41,527	972

The legal entities were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5, see note 36.

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:

	2009	2008
Legal entities	19,230	-
Liabilities associated with the legal entities held for sale	19,230	-

Amounts are in ISK millions. 97

Notes to the Consolidated Financial Statements

Other assets

80. Other assets are specified as follows:

	2009	2008
Unsettled securities trading	1,583	117
Accounts receivables	7,647	9,460
Accrued income	376	2,787
Prepaid expense	341	289
Sundry assets	236	-
Other assets from subsidiaries acquired exclusively with view to resale	5,792	-
Other assets	15,975	12,653

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

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

81. Provision for other assets

During the year impairment on accounts receivables and accrued income was made, amounting to ISK 940 million compared to ISK 774 million in 2008.

Borrowings

82. Borrowings are specified as follows:

	2009	2008
Other loans	11,042	-
Borrowings	11,042	-

Tax assets and tax liabilities

83. Tax assets and liabilities are specified as follows:

	2009		2008	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	1,051	-	585
Deferred tax	1,415	1,790	551	446
Tax assets and liabilities	1,415	2,841	551	1,031

84. Deferred tax assets and liabilities are specified as follows:

2009

	Assets	Liabilities	Net
Balance at the beginning of the year	551	(446)	105
Acquisition through business combination	1,005	-	1,005
Income tax recognised in profit or loss	39	(1,524)	(1,485)
Other changes	(180)	180	-
Net tax assets and (liabilities)	1,415	(1,790)	(375)

2008
22.10. - 31.12.

Acquisition through business combination	578	(227)	351
Income tax recognised in profit or loss	(42)	(208)	(250)
Other changes	15	(11)	4
Net tax assets and (liabilities)	551	(446)	105

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

85. Changes in deferred tax assets and liabilities are specified as follows:

2009	At Jan. 1	Addition/ disposal during the year	Recognised in profit or loss	At Dec. 31
Foreign currency denominated assets and liabilities	(136)	-	(64)	(200)
Investment property and property and equipment	18	-	(34)	(16)
Other assets and liabilities	(3)	-	3	-
Deferred foreign exchange differences	-	-	(1,430)	(1,430)
Tax loss carry forward	226	1,005	40	1,271
Change in deferred tax	105	1,005	(1,485)	(375)

2008	At Oct. 22	Exchange rate and other adjustment	Recognised in profit or loss	At Dec. 31
Foreign currency denominated assets and liabilities	-	-	(136)	(136)
Investment property and property and equipment	115	(6)	(91)	18
Other assets and liabilities	(23)	10	10	(3)
Tax loss carry forward	259	-	(33)	226
Change in deferred tax	351	4	(250)	105

86. Deferred tax assets and liabilities are attributable to the following:

	31.12.2009		31.12.2008	
	Assets	Liabilities	Assets	Liabilities
Deferred tax related to foreign exchange gain	-	(1,430)	-	-
Foreign currency denominated assets and liabilities	-	(201)	-	(136)
Investment property and property and equipment	144	(160)	325	(307)
Other assets and liabilities	-	-	-	(3)
Tax loss carry forward	1,271	-	226	-
Deferred tax assets and liabilities	1,415	(1,791)	551	(446)

Amounts are in ISK millions. 99

Notes to the Consolidated Financial Statements

Derivatives

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

2009	Nominal				Book value	
	Up to 3 months	Over 3 months and up to a year	Over 1 year	Total	Assets	Liabilities
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
Derivatives	5,107	-	2,147	7,254	6	88

2008						
Currency and interest rate derivatives, agreements unlisted:						
Forward exchange rate agreements	254	-	-	254	-	2
Derivatives	254	-	-	254	-	2

Other liabilities

88. Other liabilities are specified as follows:

	2009	2008
Unsettled securities trading	1,134	2,401
Accounts payable	1,524	698
Withholding tax	2,743	2,641
Deposit and investor guarantee fund	3,041	2,969
Insurance claim	1,847	1,713
Sundry liabilities	8,151	8,728
Other liabilities from subsidiaries acquired exclusively with view to resale	6,557	-
Other liabilities	24,997	19,150

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

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Equity

Share capital

89. According to the Parent Company's Articles of Association, total share capital amounts to ISK 12,646 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.

The Icelandic state committed to fund Arion banki hf. in 2008. The finalization of the equity contribution of ISK 72,000 million was agreed in the Government Capitalisation Agreement as outlined in note 120.

On 8 January 2010 the Annual Shareholders Meeting approved a transfer of 87% shareholding from the Icelandic State to Kaupskil hf. The impacts due to this agreement are described in note 120.

Other reserves

90. Other reserves are specified as follows:

	2009	2008
Statutory reserve	1,637	-
Foreign currency translation reserve	92	129
Other reserves	1,729	129

Off Balance Sheet information

Obligations

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

	2009	2008
Guarantees	15,318	18,644
Unused overdrafts	45,132	40,273
Loan commitments	12,879	4,210

The Bank estimates possible loss of ISK 2,363 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 118.

92. Depositors' and investors' guarantee fund

According to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Scheme the total assets of the Depositors' and Investors' Guarantee Fund shall amount to a minimum of 1% of the average amount of guaranteed deposits in the commercial bank concerned during the preceding year. In the event that total assets do not amount to the 1% minimum, all commercial banks shall contribute to the Fund an amount equivalent to 0.15% of the average of guaranteed deposits in the Bank during the preceding year. The Bank expensed 1% of the Bank's guaranteed deposits balance based on estimated future payments to the Fund, amounting to a net present value of ISK 683 million at year end 2009. The Bank has granted the Fund a guarantee for the total obligation amounting to ISK 3,934 million.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Operating lease commitments

93. Bank as a lessee

The Bank has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 25 years. Majority of the contracts include renewal options for various period of time. Certain contracts include priority right to purchase the real estate at the end of the lease period.

	2009	2008
Less than one year	166	150
Over 1 year and up to 5 years	393	299
Over 5 years	408	224
Minimum lease payments under non-cancellable leases	967	673

94. Bank as a lessor

The Bank has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 29 years, with majority being non-cancellable agreements. The future minimum lease payments under non-cancellable leases are as follows:

	2009	2008
Less than one year	1,505	1,119
Over 1 year and up to 5 years	4,405	3,668
Over 5 years	2,949	1,733
Minimum lease payments under non-cancellable leases	8,859	6,520

Assets under management and under custody

95. Assets under management and assets under custody are specified as follows:

Assets under management	580,523	604,566
Assets under custody	2,129,518	2,144,585

Contingent liabilities

96. 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.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Notes to the Cash Flow Statement

97. Operational cash flows from interest and dividends:

	2009	2008
Interest paid	53,337	13,169
Interest received	54,436	6,077
Dividend received	27	3

Interest paid includes interest credited to deposit accounts at 31 December 2009.

98. Non-cash items included in net earnings before income tax and other adjustments:

	2009	2008
Increase in value of loans and receivables	(20,199)	-
Impairment on loans and other credit risk provisions	11,448	19,723
Compensation instrument, revaluation and accrued interest	8,158	-
Depreciation and amortisation	1,162	109
Impairment on other assets	25	-
Share of profit of associates	(369)	(498)
Investment property, fair value change	(170)	-
Indexation and foreign exchange difference	(10,205)	(31,104)
Net (gain) loss on financial assets and liabilities at fair value through profit or loss	(5,307)	6,063
Net gain on disposal of property and equipment	(8)	(1)
Net gain on sale of associates	(39)	-
Net gain on non-current assets classified as held for sale	(375)	-
	(15,879)	(5,708)

99. Changes in operating assets and liabilities:

	2009	2008
Mandatory reserve with Central Bank	(2,381)	(7,468)
Loans and receivables to credit institutions	21,215	(4,455)
Loans and receivables to customers	4,923	(2,935)
Financial assets measured at fair value	138	(6,309)
Shares and equity instruments with variable income	679	-
Derivatives	(6)	-
Other assets	6,037	(12,152)
Due to credit institutions and Central Bank	(11,638)	70,554
Deposits	(52,622)	28,904
Borrowings	3,087	-
Financial liabilities at fair value	86	749
Other liabilities	(4,880)	9,163
	(35,362)	76,051

100. Cash and cash equivalents at the end of the year:

	2009	2008
Cash in hand and demand deposits	41,906	87,555
Due from credit institutions	24,037	12,823
Mandatory reserve with Central Bank	(9,849)	(7,468)
Cash and cash equivalents at year end	56,094	92,910

Amounts are in ISK millions. 103

Notes to the Consolidated Financial Statements

Risk Management Disclosures

Introduction

Arion banki hf. is an Icelandic bank offering comprehensive retail, corporate and investment banking services to individuals, companies and institutional investors. The Bank has five core business areas: Corporate Banking, Retail Banking, Treasury and Capital Markets, Corporate Finance and Asset Management and Private Banking. These business areas are supported by six ancillary divisions: Finance, Back Office, Legal Services, Information Technology and Human Resources, in addition to Risk Management.

101. Risk Management's role and position in the Bank

The Bank's Risk Management department is independent and centralized and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a Risk Appetite for the Bank's operations. The Risk Appetite is translated into exposure limits and targets that are monitored by the Risk Management department, which reports its findings regularly to the CEO and the Board of Directors. Risk is measured and monitored according to internal policies, principles and processes that are reviewed and approved by the Board of Directors at least annually. The CEO of Arion banki hf. and all members of the Arion banki hf. Board of Directors are subject to a fit and proper examination by the FME.

102. Organization of the Risk Management division

The Risk Management Department is divided into four units: Credit Control, which monitors credit exposures on a customer by customer basis; Portfolio Risk, which monitors risks in the Bank's Assets and Liabilities at the portfolio level; Economic Capital, which is responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and Operational Risk which monitors risks associated with the daily operation of the Bank.

103. High level discussion of the consequences of the crash

The Bank faces numerous challenging risks related to the circumstances leading to the Bank's foundation on 22 October 2008, following the failure of the North European bank, Kaupthing banki hf. The Bank acquired assets, liabilities and contingent liabilities in accordance with the decision of the FME which resulted in significant mismatching of FX, interest rate and liquidity in the Consolidated Statement of Financial Position. An asset shortfall of ISK 38.300 million resulted in a priority claim on Kaupthing banki hf.

104. Overview of the most material risks

The Consolidated Statement of Financial Position of Arion banki hf. presents significant asset-liability management challenges. A considerable portion of the transferred assets are denominated in low interest rate foreign currencies. The assets are predominantly 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 the interest rate base are discussed below.

The asset portfolio transferred from Kaupthing banki hf. presents additional challenges. Assets were transferred at fair value, where the distressed nature of the Icelandic economy and the funding cost were taken into account. A conservative approach was taken to the asset valuation, which has reduced the Bank's downside risk. Nevertheless, much risk is related to the accuracy of the asset valuation and assumptions about the performance of the assets. These risks and very considerable credit concentration risks are discussed below.

The Bank faces very significant country risk as its exposures are concentrated to Iceland, a country which at year end 2008 experienced a nearly total economic collapse and subsequent political turmoil. The year 2009 was marked by continued uncertainty about the economy, the economic assistance of the International Monetary Fund (IMF) and progress toward a negotiated settlement of the Icesave debt between the governments of Iceland, the UK and the Netherlands. At year end 2009 there were positive signs that the Icelandic economy had bottomed out, that the Icesave conflict would be amicably resolved and that IMF's aid would be forthcoming.

In addition to the aforementioned, the Bank faces the traditional types of risks related to its business as a financial institution arising from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below.

As part of its preparation for granting the Bank an operating license, the FME has conducted a rigorous assessment of the Bank's risk management and governance infrastructure. The assessment identified areas for improvement and the Bank is working closely with the FME to address these.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Risk Management Strategy

105. Definition of Material Risks

a) Credit risk
Credit risk is the current or prospective risk to earnings and capital arising from the failure of an obligor to pay an obligation at the stipulated time or otherwise to perform as agreed or as anticipated. This risk is enhanced if the assigned collateral only partly covers the claims made on the borrower or if its value is variable or uncertain. Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. The risk comprises concentration risk, residual risk, credit risk in securitisation, cross border (or transfer) risk and more.

b) Market risk
Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments. The risk arises from market making, dealing, and position taking in bonds, equities, currencies, commodities, derivatives, and any other commitment depending on market prices and rates.

c) Liquidity risk
Liquidity risk is the risk arising from the possible inability of the Bank to meet its liabilities when they come due. It is an unavoidable source of risk in the Bank's operations as the Bank requires funding to support its activities.

d) Operational risk
Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business areas and in the ancillary divisions.

106. Credit Risk Strategy

The Bank has a two pronged strategy for credit risk. In the near term, emphasis will be placed on recovering value from the portfolio of impaired assets which was acquired from Kaupthing banki hf. To this end, the Bank has expanded its Recovery department and defined a complete set of procedures which outline how value will be maximized without compromising transparency. The FME carefully monitors the Recovery process.

Longer term, the Bank recognizes that carefully monitored credit risk is a base for stable profits. Undertaking credit risk is a cornerstone in the Bank's strategy for maintaining the future profitability of the Bank. The main asset of the Bank is its loan portfolio, and therefore managing and analyzing the loan portfolio is of utmost importance. The emphasis is on keeping a high quality credit portfolio, by seeking business with strong parties, maintaining a strict credit process, critically inspecting loan applications, identifying and reacting to possible problem loans at an early stage and other measures.

a) Credit Granting Process
A fundamental requirement is to have a comprehensive structure for credits which is coherent across the Bank. This structure applies both for the granting of new credits and for the restructuring of impaired credits. The highest authority in credits is the Board Credit Committee. The next highest credit granting authority is the Bank Credit Committee which operates within limits specified as a fraction of the Bank's capital. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The principle of central management of risk is maintained by having the Bank's CEO or his deputy as a member of the Board Credit Committee and the Bank Credit Committee, and by the having the Managing Director of Risk Management attend the meetings of the Bank Credit Committee. The CEO is responsible for maintaining the Bank's exposures within legal and policy limits.

The pricing of each new credit granted and the credits arising from the impaired loan restructuring process should reflect the risk taken. The client's interests must be protected at all times and there must be a high likelihood that the client will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

It is the aim of the credit strategy that, in the long run, write-offs should be less than 5% of interest income. Aspects of the credit process have been designed and implemented with this long term goal in mind.

Provisions for losses reflect the expected loss, both for loans for which specific provisions exist as well as for portfolios of performing loans. The collective assessment of such portfolios is based on default predictions and loss–given-default parameters.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures.

Notes to the Consolidated Financial Statements

106. cont.

b) Quantification and Rating model description

The basic elements for the quantification of credit risk are the probability of default, the loss given default, and exposure at default. These quantities need to be measured with an effective and accurate credit rating system. Information, both quantitative and qualitative, must be gathered, both specifically in regard to the counterparty and to its general economic situation in order to estimate its creditworthiness. Furthermore, a facility rating should be performed to determine the loss parameters in case of a default.

The policy of the Bank is to apply sophisticated credit models to monitor credit risk. These credit models do not come into play in the application of the Basel II standardized approach to capital requirements calculations but they are the basis for a future application of an internal rating based approach. Therefore, the development, implementation and application of these models must be in accordance with Basel II requirements. The credit models are an integral component in the Bank's Internal Capital Adequacy Assessment Process (ICAAP) strategy.

c) Sources of Credit Risk

Loan portfolio

The main assets of the Bank are its loans. To maintain and further improve the quality of the loan portfolio it is imperative to constantly monitor loans, both individually and at the portfolio level. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

Commitments and guarantees

The Bank often commits itself to and ensures that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on checking accounts, credit cards and credit lines. Potential loss on these accounts is equal to the amount of the limits although they may only be partly used at any one time. In practice, the potential loss is less severe since many of these commitments can be recalled immediately by the Bank in case the clients do not meet credit standards.

Guarantees carry the credit risk to the full amount similar as loans, since they represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties.

Derivatives trading

The Bank uses or may use, on a very limited basis, derivative financial instruments, including, but not limited to, swaps, futures, forwards, options and other similar types of contracts whose value changes in response to changes in interest rates, foreign exchange rates, security prices, commodity prices or price indices. Limits on the net open derivative positions on these types of contracts are strictly controlled by the Bank. These limits are generally client specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Acceptable collateral for margin accounts is cash or very liquid assets e.g. Treasury bills. In case the net negative position of the contract falls below a certain level a call for added collateral is made. If extra collateral is not supplied the contract is closed.

Master netting agreements

Frequently, exposure to credit losses is reduced by entering into master netting agreements with clients that counterparties have significant and/or diverse credit related business with the Bank. Master netting agreements do not generally result in an offset of Consolidated Statement of Financial Position assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by these types of agreements since in the case of default all amounts of the counterparty are terminated and settled on a net basis.

d) Loan provisioning

The Bank's loan book consists of loans which were acquired from Kaupthing banki hf. at fair value. However, the maximization of the value of the loan book requires that the Bank continue to service it on a face value basis.

In a face value treatment of the loan book an allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the Consolidated Statement of Financial Position, whereas for an off balance sheet item such as a commitment a provision for credit loss is reported in other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans.

When considering loans at face value, allowances and provisions for credit losses are evaluated at a counterparty specific level and a collective basis, based on the principles described below.

Meanwhile, the fair value pricing of the loan takes into account impairment for credit loss and counterparty specific provision is not considered unless the impairment of the loan is believed to exceed the difference between the face value and the fair value. Loans which were priced as a homogeneous pool (retail loans to individuals and SMEs) are excluded from counterparty specific provisioning. This is because the homogeneous pool pricing methodology fully accounts for loan impairment. Therefore, special consideration of loans which have impairment beyond the pool average would be inappropriate, without corresponding consideration of loans which have objective evidence of recovery above the pool average. Efforts are underway to refine the Bank's processes to identify loans which are substantially above or below the pool average and separating them from the homogeneous pool.

Notes to the Consolidated Financial Statements

106. cont.

Counterparty specific provisions

A claim is considered impaired when there is objective evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual credit exposures are evaluated based upon the borrower's character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, where applicable, the realizable value of any collateral.

The estimated recoverable amount is the present value, using the loan's original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount.

Upon impairment, the accrual of interest income based on the original terms of the claim is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

All impaired claims are reviewed and analyzed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of timely collection of principal and interest in accordance with the original contractual terms of the claim agreement.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim. Recoveries in part or in full of amounts previously written off are credited to credit loss expense.

Collective Provisions

All loans for which no impairment is identified on a counterparty specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognized as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

Special provisioning for currency exchange rate impairment

The loan book transferred from Kaupthing banki hf. contains a category of loans which requires special consideration. These are loans in foreign currency to Icelandic companies and individuals whose income is in ISK. When the ISK depreciates against the foreign currency, the ISK value of the loan increases, whereas the borrower's ability to pay remains fixed. When such a loan has been transferred at a fair value below face value, provisions must be made for the unrecoverable increase due to ISK depreciation.

107. Market Risk Strategy

The Bank's strategy is to invest its own capital on a limited and carefully selected basis in transactions, underwritings and other activities that involve market risk.

The main types of market risk are interest rate risk, equity price risk and foreign exchange risk.

The Bank is exposed to market risk from its proprietary trading activities and its asset and liability management.

In the case of proprietary trading the Bank accepts the market risk. The Board of Directors decides how much market risk exposure the proprietary trading units within the Bank are allowed to assume, expressed as a maximum overnight exposure in equities, fixed income and derivatives. The Board entrusts the CEO with the enforcement of this policy and the Risk Management with the evaluation and monitoring of positions and limits.

In the case of asset and liability management the Bank aims to reduce or eliminate this risk going forward.

The Bank keeps firm track of the market risk embedded in market investments and makes sure that the total measured market risk does not exceed the market risk limits set by the Bank's Board of Directors.

Notes to the Consolidated Financial Statements

107. cont.

a) Currency risk
Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities.

The Bank's strategy for reducing its currency imbalance is twofold: The systematic ISK redenomination of defaulting foreign currency loans to customers which have ISK income, and hedging of currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers.

Net exposures per currency are monitored centrally in the Bank.

b) Interest rate risk

The Bank faces interest rate risk in the banking and trading books. The interest rate risk faced in trading book is primarily due to listed Icelandic Treasury notes, Housing Fund bonds and OTC interest rate swaps. The interest rate risk in the banking book is mainly related to floating rate indices and, to a very limited extent, fixed interest rate.

The Bank is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities.

The Bank's strategy for managing its interest rate risk and its inflation risk is to strive for an interest rate balance between assets and liabilities and a balance between inflation linked assets and liabilities by offering deposit incentives and by targeted lending practices.

c) Derivatives
The Bank's use of derivatives is through derivative sales and trading portfolios. The types of derivative currently used by the Bank are asset swaps, forwards and interest rate and cross currency swaps.

d) Market price risk
Market price risk is the risk of loss due to changes in market prices. The Bank's main exposures are through listed Icelandic Treasury notes and Housing Fund bonds and to a very limited extent listed equities. Management of currency risk is handled separately.

Market price risk is measured by notional amount for equities and basis point value approach for fixed income products.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Bank to measure financial assets and financial liabilities. If quoted prices for a financial instrument fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

i. Fair value established from quoted market prices
The best evidence of the fair value of a financial instrument at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of the financial instrument in note 70 is used as an approximation for the fair value of the instrument. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that carry interests close to or equal to market rates and expose the Bank to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed in following balance sheet items; Trading assets and Trading liabilities.

Notes to the Consolidated Financial Statements

107. cont.

ii. Fair value established using valuation techniques with observable market information

For financial instruments, for which the market is not active, the Bank applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuations techniques used by market participants to price the instrument.

For financial instruments for which quoted prices on active markets are not available, the fair values are derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation is based on theoretical financial models, such as the Black Scholes models or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities was calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Consolidated Statement of Financial Position.

iii. Fair value established using valuation techniques with significant unobservable market information

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of financial instruments with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

Although the Bank follows market standards and relies on well accepted methods there is still wide room for choice, both in the models themselves and the assumptions that must be supplied and cannot be derived from market data. Consequently, different assumptions and choices could lead to different estimates.

108. Liquidity Risk Strategy

Liquidity risk is an unavoidable source of risk in the Bank’s operations. Liquidity risk is the current or prospective risk that the Bank either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources. The funding liquidity risk limit is quantified by secured liquidity ratio as well as applying stress tests to identify scenarios of possible liquidity strain.

The Bank calculates its secured liquidity ratio from cash on hand and cash balance with the Central Bank of Iceland, Treasury notes and Housing Fund bonds which are held specifically as liquidity reserves and other eligible assets for repo transactions with the Central Bank and compare it with the total interest bearing liabilities.

FME has set a guideline for minimum secured liquidity ratio of 20% and a minimum cash ratio of 5%. The high liquidity reserve required by the FME reflects the uncertainty of the deposit’s stickiness of the Icelandic banks and the fact that a large part of the Bank’s liabilities are primarily short term or on demand deposits while the contractual maturity of the assets is much higher. The Bank actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base.

The Bank’s stress tests are primarily focused on the effect of lifting the capital controls in Iceland on the deposit base.

The Bank’s strategy is to lengthen the maturity profile on the liability side, making it comparable to other Nordic banks and strengthening the Bank’s liquidity reserve.

Notes to the Consolidated Financial Statements

109. Operational Risk Strategy

Operational Risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank can reduce its exposure to operational risk with selection of internal control and quality management, well educated and qualified staff. The Bank can choose to transfer operational risk through outsourcing the activity or to transfer the financial consequences through insurance programs.

The Bank keeps a firm track of the operational risk that the Bank is exposed to. Identification and measurements are made by the means of Control and Risk Self Assessment, registration of loss events, near misses and quality deficiencies and by monitoring potential risk indicators and other early warning signals. Operational risk is reduced through staff training, process redesign and enhancement of the control environment.

The Bank aims to maintain an open, no blame, operational risk culture and to seek to get to the point of no surprises by utilizing the Bank's operational tools and processes to the fullest extent possible. The Bank operates no tolerance policy for internal fraud.

a) ICAAP considerations

The Bank has elected to use the Basel II basic indicator approach to the calculation of Risk Capital requirements for Operational Risk.

Risk Capital for Operational Risk is measured 15% of the average over three years of the sum of net interest income and net non interest income, outlined in the Capital Requirements Directive (CRD). As Arion banki hf. does not have three years of operation, the 15% is of the sum of net interest income and net non interest income.

110. Capital Adequacy and ICAAP Strategy

The Bank's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long term capital planning at the Bank currently is based on a benchmark minimum Core Tier 1 capital ratio of 12%, using Pillar 2 calculations. Additional capital can be injected by the Ministry of Finance as Tier 2 capital in the form of a subordinated loan, at the discretion of the FME. The capital reserve is equivalent to a 4% capital ratio.

Under government ownership, all Tier 1 capital and the reserve Tier 2 capital is in the form of Treasury notes. The book value of intangible assets is deducted in arriving at the Tier 1 capital ratio.

It is the policy of the Bank to refrain from paying dividends, divesting shares and conducting share buy-backs for 3 years after its initial capitalisation. This policy will only be altered in cooperation with the FME and only if the Bank and the FME jointly determine that a sustainable turnaround of the Icelandic Economy has been achieved.

a) Capital adequacy and the Basel I and II capital adequacy standards

The FME supervises the Bank, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole.

Bank supervision is currently transitioning from the Basel I capital adequacy standard to the Basel II capital requirements directive (CRD). As such the Bank calculates the capital adequacy both in terms of Basel I and Basel II but with focus on Basel II and compliance to the CRD. The Basel II CRD consists of three Pillars:

- Pillar 1 that contains the set of rules for calculation of the capital requirement based on risk weights for credit risk, market risk and operational risk.

- Pillar 2 that describes the supervisory review and evaluation process (SREP). Pillar 2 also contains a framework for internal capital adequacy assessment process (ICAAP). The ICAAP is an ongoing process that aims at describing the Bank's risk appetite, current risk profile and how the Bank intends to mitigate those risks, as well as how much current and future capital is needed having considered the risk profile and risk mitigates in place.

- Pillar 3 that describes market discipline and disclosure requirements for risk profile, methods and processes and capital management.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

110. cont.

Capital Requirements according to Pillar 1 are based on the sum of risk weighted assets ("RWA") for credit risk, market risk and operational risk, computed using formulas from the EU's Capital Requirements Directive (CRD). The CRD offers different approaches for calculating RWA for these risk types:

Credit Risk

Standard approach, Foundation IRB approach, and Advanced IRB approach.

Market Risk

Standardised approach and Internal value at risk model.

Operational Risk

Basic indicator approach, Standardised approach, and AM approach.

Banking operations are categorised as either trading book or banking book and the calculation of risk weighted assets is conducted differently for the assets in different books. Banking book risk weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Banking book off balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned risk weights appropriate to the category of the counterparty, again accounting for eligible collateral or guarantees. Trading book risk weighted assets are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

b) Approaches used for capital requirement calculations:
Arion banki hf. will use the Basel II standardized method to calculate the capital requirements for credit risk under Pillar 1.

The Bank uses credit rating models for its corporate and retail portfolio but will be focusing on recalibrating those models for the post-crisis business environment and deploying them in its internal risk capital management and ICAAP. When the consistent fidelity of the credit rating models can be demonstrated they will be submitted to the FME as part of an application to use the Foundation Internal Ratings Based (FIRB) approach to calculating the capital requirements for credit risk.

The Bank will use the standardized method for market risk.

The Bank will use the basic indicator approach for operational risk.

The Bank has implemented methods and tools for operational risk management based on the minimal requirements for the standardised approach. The Bank will continue refining these tools and methods as part of its internal management of operational risk and will be using them within its ICAAP.

c) Internal Capital Assessment Process:

The internal capital adequacy assessment process (ICAAP) is an ongoing process that ensures that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed to identify and measure the Bank's risk across all risk types and ensure that the Bank has sufficient capital in accordance to its risk profile.

To measure the Pillar 2 capital requirement the Bank uses an internal capital model (economic capital model). This model is based on Pillar 1 calculations, using internal models for credit risk calculations, and takes into consideration risks that are not covered under Pillar 1, e.g. concentration risk, residual risk, country risk, settlement risk, fx risk, liquidity risk, interest rate risk in the banking book, reputation risk, legal and compliance risk, business risk and strategic risk.

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

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macro economic changes, downswings in the Bank's core business or other major events. The Bank is currently running, under the ICAAP, stress testing scenarios on its business plan and planned capital needs. The Bank is currently reviewing and enhancing its stress testing framework which will be deployed in the Bank's ICAAP, once it is ready.

Notes to the Consolidated Financial Statements

110. cont.

d) Capital allocation

The allocation of capital between specific operations and activities is, to a large extent, driven by the optimisation of the return achieved on the capital allocated. The amount of capital allocated to each operation or activity is based primarily upon expected regulatory capital usage, calculated within the business plan, but in some cases the regulatory requirements do not reflect fully the varying degree of risk associated with different activities. In such cases the internal capital requirements may be inflated to reflect different risk profiles.

Although maximization of the risk adjusted return on capital is the principal basis used in determining how capital is allocated within the Bank to particular operations or activities, it is not the sole basis used for decision making. Account also is taken of synergies with other operations and activities, the availability of management and other resources, and the fit of the activity with the Bank's longer term strategic objectives and risk appetite. The Bank's policies with respect to capital management and allocation are reviewed regularly by the Board of Directors.

Economic capital usage of each operation will then be continuously compared with allocated capital to ensure that the Bank's risk profile remains within its risk appetite. Performance calculations are linked to this process in terms of calculation of return on allocated capital.

Risk Disclosures

111. 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 counterparty 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 a few customer names and to business sectors.

a) Asset valuation

Asset valuation risk is the risk that assets transferred to the Consolidated Statement of Financial Position of the Bank were overvalued. 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. In some instances, in light of new information, a loan valued by one method at year end 2008 is more appropriately valued with another method at year end 2009. In 2009 the Bank changed valuation method for some loans that resulted in material change in 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.

Category: Description (D) / Valuation method (V):	2009 Value	2008 Value
Higher discount factor: D: Loans where Arion banki hf. a expects full recovery and the contractual cash flow is used. V: Present value of discounted contractual cash flows at market interest rates.	35%	38%
Collateral value: D: Loans where the underlying collateral value is greater than the value of future expected cash flow. V: Assessment of underlying collateral.	17%	24%
Real estate companies: D: Real estate companies. V: The Iceland Property Registry rate with a discount of approximately 8%.	16%	15%
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.	25%	15%
Currently in recovery: D: Borrowers that are currently in a recovery and restructuring process. V: Individual assessment using discounted cash flows, collateral value, multiples and other methods available.	8%	8%
	100%	100%

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

111. cont.

75% 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 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 19% of the total fair-value loan-book (25% of 75%). 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 7% 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 1.4% 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 12% 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 2.4% 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% 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% loss in value of the loan book would correspond to approximately 0.5% point reduction in the Bank's Tier 1 capital ratio.

b) Non-performing loans

The sharp depreciation of the ISK in the autumn of 2008 and the following inflation left many borrowers with foreign currency and Icelandic indexed linked loans unable to service their loans. Payment holidays were offered to all customers, regardless of their ability to pay, as a temporary solution. In December 2009 the Bank announced a set of programs to assist individuals who have run into financial difficulties. The programs will be offered until the summer of 2010. A substantial portion of the Bank's loan book was restructured during 2009 and this work will continue during the year 2010.

The Bank is highly focused on the performance of the loan book and uses the following classification to monitor the development of the performance.

This classification is somewhat ambiguous at year end, since it does not distinguish between the customers in need of a payment holiday and those who were able to service their debts.

Non-performing are loans that are:

- more than 90 days in default.
- the borrower is currently in restructuring.
- have received specific provisions.
- the borrower has taken advantage of payment holidays of both principal and interest payments.

Stress loans are those that are:

- between 30 and 90 days in default.
- the borrower has taken advantage of payment holidays, paying only interests.

All other loans are classified as performing.

Notes to the Consolidated Financial Statements

111. cont.

The following table shows a breakdown of the fair value loan book based on these categories :

	2008	2009	8 Jan 2010
Performing	77%	38%	46%
Stressed	9%	10%	10%
Non-performing	14%	52%	44%
Total	100%	100%	100%

The aforementioned categories were poor predictors of loan-book quality at year end 2008 for the following reasons: Loans were were not yet in 90-day default as a consequence of the economic crash, because the crash had occurred only two months earlier. Furthermore borrowers were not yet actively taking advantage of payment holidays. Lastly the Bank's loan restructuring program was not yet active.

In early 2009 payment holidays became widely used, reaching peak levels during the year and starting to expire before year end 2009. The 90-day default measure became broadly active and the Bank became fully engaged in loan restructuring.

A large number of performing loans was injected as part of the 8 January 2010 capitalization.

For further information on the agreements made 8 January 2010, see note 120.

c) Credit Concentration Disclosures

The Bank seeks proper diversification in the granting of all new credits. Nevertheless, the loan portfolio which was transferred to Arion banki hf. from Kaupthing banki hf. suffers from material credit concentrations because only Icelandic assets were transferred to the Bank and assets were transferred at fair value resulting in a very different loan portfolio make-up.

Maximum exposure to credit risk by sector

Maximum exposure to credit risk related to on balance sheet assets:

2009	Individuals	Holding companies	Industry	Real estate	Service[1]	Other	Total
Cash and balances with Central Bank	-	-	-	-	41,906	-	41,906
Loans and receivables to credit institutions	-	-	-	-	38,470	-	38,470
Loans and receivables to customers	55,366	49,814	118,821	54,525	63,700	15,508	357,734
Overdrafts	*9,989*	*605*	*3,446*	*1,324*	*13,846*	*2,463*	*31,673*
Subordinated loans	-	-	-	-	*17*	-	*17*
Other loans	*45,377*	*49,209*	*115,375*	*53,201*	*49,837*	*13,045*	*326,044*
Bonds and debt instruments	-	92,439	370	20	80,611	42	173,482
Listed	-	*16*	*370*	-	*8,407*	*42*	*8,835*
Unlisted	-	*92,423*	-	*20*	*72,204*	-	*164,647*
Derivatives	-	-	-	-	6	-	6
Bonds and debt instruments used for hedging	-	-	-	-	2,236	-	2,236
Listed	-	-	-	-	*2,236*	-	*2,236*
Compensation instrument	-	-	-	-	34,371	-	34,371
Other assets with credit risk	69	6	8	340	4,925	18	5,366
Total on balance sheet maximum exposure to credit risk	55,435	142,259	119,199	54,885	266,225	15,568	653,571

Maximum exposure to credit risk related to off balance sheet items:

	Individuals	Holding companies	Industry	Real estate	Service[1]	Other	Total
Financial guarantees	334	600	4,887	2,903	5,224	1,370	15,318
Unused overdrafts	26,743	1,728	7,677	345	4,643	3,997	45,133
Loan Commitments	-	1,043	2,981	-	15,757	76	19,857
Total off balance sheet maximum exposure to credit risk	27,077	3,371	15,545	3,248	25,624	5,443	80,308

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

111. cont.

2008	Individuals	Holding companies	Industry	Real estate	Service[1]	Other	Total
Cash and balances with Central Bank	-	-	-	-	87,555	-	87,555
Loans and receivables to credit institutions	-	-	-	-	47,697	-	47,697
Loans and receivables to customers	37,179	66,362	110,874	45,701	59,253	17,645	337,014
Overdrafts	*6,537*	*198*	*3,168*	*473*	*6,037*	*1,274*	*17,687*
Subordinated loans	-	*7,896*	-	-	*159*	-	*8,055*
Other loans	*30,642*	*58,268*	*107,706*	*45,228*	*53,057*	*16,371*	*311,272*
Bonds and debt instruments	-	-	471	256	9,670	364	10,761
Listed	-	-	*471*	*250*	*8,364*	*12*	*9,097*
Unlisted	-	-	-	*6*	*1,306*	*352*	*1,664*
Compensation instrument	-	-	-	-	41,156	-	41,156
Other assets with credit risk	18	39	320	9	9,385	15	9,786
Total on balance sheet maximum exposure to credit risk	37,197	66,401	111,665	45,966	254,716	18,024	533,969

Maximum exposure to credit risk related to off balance sheet items:

Financial guarantees	471	1,115	8,008	424	6,938	1,687	18,643
Unused overdrafts	18,625	5,356	7,825	228	4,711	3,527	40,272
Loan Commitments	-	4,210	-	-	-	-	4,210
Total off balance sheet maximum exposure to credit risk	19,096	10,681	15,833	652	11,649	5,214	63,125

1. Included is financial service.

The majority of the revenues from external customers were attributable to Iceland.

The Bank has used methods based on the Herfindahl-Hirshman index to analyze credit concentration to individual borrowers and industry sectors and found that concentrations warrant granularity increases to capital requirements for credit risk in order to compensate. Refer to note 115 b) for results.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

111. cont.

d) Large Exposure Disclosures

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Bank's risk capital. The exposure is presented net of the credit risk mitigating effects of collateral which is eligible under Basel II rules.

The legal maximum for individual large exposures under the rules of the FME rule is 25% of risk capital and the sum of all large exposures cannot exceed 800% of risk capital.

The loan book which was transferred from Kaupthing banki hf. to Arion banki hf. contained loans which, while appropriately sized in Kaupthing banki hf.'s large Consolidated Statement of Financial Position, have a much larger impact on Arion banki hf.'s more modest Consolidated Statement of Financial Position. The Bank has 10 large exposures if eligible collateral is not accounted for. If exposures are taken net of eligible collateral the number drops to 6.

	2008		2009		8 Jan 2010	
no.	Gross	Net	Gross	Net	Gross	Net
1	0%	0%	115%	0%	77%	0%
2	53%	53%	40%	40%	29%	29%
3	76%	51%	42%	30%	33%	24%
4	37%	37%	31%	31%	22%	22%
5	0%	0%	22%	21%	16%	15%
6	21%	21%	17%	17%	17%	17%
7	17%	13%	17%	14%	12%	10%
8	17%	7%	15%	5%	10%	4%
9	18%	11%	15%	8%	10%	6%
10	15%	8%	13%	7%	9%	5%
11	0%	0%	12%	11%	9%	8%
12	16%	16%	12%	11%	8%	8%
13	11%	8%	9%	7%	6%	5%
14	0%	0%	0%	0%	14%	14%
Sum of exposure > 10%	282%	202%	351%	175%	239%	120%

At year end 2008 the Bank reported only large exposures among loans to customers. Two exposures (listed number 3 and 4 in the table) exceeded the legal limit of 25% of capital base and the Bank sought and obtained dispensation from the FME while it looked for an opportunity to divest, syndicate or share the risk from these loans with a willing party. During 2009 the Bank made progress in reducing these two large exposures and increasing eligible collateral and after the 8 January 2010 capitalization and the associated injection of Tier 2 capital, neither of the two exceeds the 25% maximum on a net basis.

In 2009 the Bank reports large exposures among all assets. Thus the Kaupthing banki hf. compensation instrument (see notes 70 and 73) is also listed as a large exposure, number 2 in the table. The year 2009 saw the introduction of a new large exposure, the bond claim on Drómi ehf. (see note 34), listed number 1 the table.

With regard to Drómi ehf. the Ministry of Finance has pledged that Arion banki hf. will be held harmless from this exposure. The FME has ruled that the Bank can use a 0% risk weight for the Drómi ehf. claim. Consequently, the Bank finds that the net exposure is zero.

The compensation instrument was issued by Kaupthing banki hf. in recognition of the valuation gap between the liabilities and assets which were transferred to Arion banki hf. from Kaupthing banki hf. The compensation instrument is a priority claim secured by selected Kaupthing banki hf. assets which have been approved by Arion banki hf. and were placed in Escrow. The value of the compensation instrument is tied to the value of a set of ring fenced Arion banki hf. assets and 80% of the increase in the value of the ring fenced assets is subtracted off its value.

The compensation instrument exceeds the 25% legal limit and the Bank will be seeking dispensation from the FME.

At year end 2009 the sum of all large exposures is 342% but 176% after accounting for eligible collateral, which is well below the 800% legal maximum and the Bank's internal 300% limit.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

112. 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:

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	29,000	836	1,901	620	916	255	8,378	41,906
Loans to credit institutions	9,209	7,333	8,165	1,090	2,897	410	9,366	38,470
Loans and receivables to customers	133,740	60,683	39,279	53,750	11,928	34,222	24,131	357,734
Bonds and debt instruments	172,296	1,154	32	-	-	-	-	173,482
Shares and equity instruments	4,599	1,548	53	-	176	-	702	7,078
Derivatives	6	-	-	-	-	-	-	6
Securities used for hedging	2,236	-	-	-	-	-	-	2,236
Compensation instruments	15,893	18,478	-	-	-	-	-	34,371
Investment property	22,947	-	-	-	-	-	-	22,947
Investments in associates	5,577	408	-	-	-	-	-	5,985
Property and equipment	9,970	730	-	-	-	-	-	10,700
Intangible assets	2,605	844	-	-	63	-	-	3,512
Tax assets	1,415	-	-	-	-	-	-	1,415
Non-current assets held for sale	41,516	9	1	-	-	-	-	41,527
Other assets	12,758	2,385	536	(0)	30	-	266	15,975
Total assets 31.12.2009	463,765	94,409	49,968	55,460	16,010	34,887	42,843	757,343
Liabilities								
Due to credit inst. and Central Bank	79,971	3,115	5,006	1,338	6,713	908	16,596	113,647
Deposits	441,755	34,774	10,674	611	3,669	336	3,646	495,465
Borrowings	4,874	6,168	-	-	-	-	-	11,042
Financial liabilities at fair value	-	88	-	-	-	-	-	88
Tax liabilities	2,836	-	-	-	-	-	5	2,841
Non-current liabilities held for sale	19,230	-	-	-	-	-	-	19,230
Other liabilities	17,996	4,506	1,600	15	123	71	686	24,997
Equity	90,034	-	-	-	-	-	-	90,034
Total liabilities 31.12.2009	656,696	48,651	17,280	1,963	10,505	1,314	20,933	757,343
Net on balance sheet position	(192,931)	45,758	32,687	53,497	5,505	33,573	21,910	
Net off balance sheet position	2,265	(2,265)	-	-	-	-	-	
Net position 2009	(190,666)	43,493	32,687	53,497	5,505	33,573	21,910	
Net position 2008	(231,342)	76,304	38,265	53,540	(18,414)	36,979	44,667	
Net position 8 Jan 2010	(179,120)	(10,405)	30,461	70,398	11,060	54,253	23,353	
Loans to custom. with ISK income	141,043	(29,980)	(15,429)	(42,440)	(4,939)	(32,500)	(15,755)	
Net real position 2009	(49,623)	13,513	17,258	11,057	566	1,074	6,155	
Net real position 2008	(90,848)	44,273	20,691	16,756	(23,899)	9,933	23,092	
Net real position 8 Jan 2010	8,963	(46,960)	11,604	11,033	5,409	2,969	6,982	

Amounts are in ISK millions. 117

Notes to the Consolidated Financial Statements

112. cont.

The 8 January 2010 acquisition of the Bank by Kaupthing banki hf. was the source of the injection of assets and liabilities which significantly alters the breakdown of assets and liabilities by currency, as shown below:

	2009
FX loans to customers with FX income	32,221
FX loans to corporates with ISK income	47,039
ISK loans to customers	33,565
ISK deposits	14,428
FX loan from Central Bank (70% EUR, 20% USD, 10% CHF)	(61,253)
Total	66,000

The currency composition of the loan from the Central Bank will be adjusted to fully balance the real FX position.

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. These loans were transferred from Kaupthing banki hf. at 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. The year end 2009 values of the foreign currency imbalance are shown in the following table with year end 2008 values by comparison. Also shown is an unaudited approximation of the impact of the 8 January 2010 capital injection. The book value refers to the value of the imbalance without accounting for the natural hedge whereas the effective value takes into consideration the mitigating effect of the natural hedge, as modelled by the bank. This strength of the natural hedge is different at different times. In 2008 the natural hedge is such that the effective FX imbalance due to customers with ISK income is 38%. Through 2009 the natural hedge is strengthened, due to the accumulation of FX provisions and the effective FX imbalance due to customers with ISK income is only 24%. The injection of additional FX loans to customers with ISK income on 8 January 2010 weakens the natural hedge effect because the loans have disproportionally high rates of expected recovery and do not have any accumulation of FX provisions. The effective FX imbalance of the book of FX loans to customers with ISK income after the capital injection is 35%.

	2008		2009		8 Jan 2010	
	Book value	Effective value	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income	90,848	90,848	49,623	49,623	(8,902)	(8,902)
FX imbalance due to customers with ISK income	140,494	53,388	141,043	33,850	188,083	65,829
Total	231,342	144,236	190,666	83,473	179,181	56,927

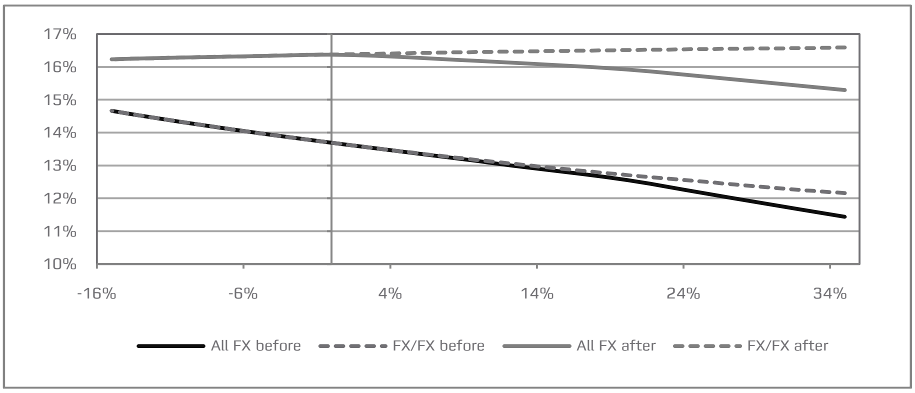
The effective FX imbalance due to customers with ISK income during 2009, 2008 and after the 8 January 2010 acquisition is 24%, 38% and 35% respectively, whereas the effective FX imbalance due to customers with FX income is always 100%.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

112. cont.

Sensitivity to currency exchange rates



The graph reveals the Bank's FX risk exposure at year end 2009 (solid black curve) and after the 8 January 2010 capital injection (solid gray curve). Here, the FX risk exposure is defined as the sensitivity of the Bank's CAD ratio to the appreciation of the ISK relative to the weighted index of currencies. The higher CAD ratio values after the capital injection is the result of the injection of 4% Tier 2 capital. According to the analysis, a 35% appreciation of the ISK (the ability to buy an additional 35% of the foreign currency for each ISK) would, at year end 2009, have resulted in the Bank's CAD ratio to dropping from 13.7% to 11.4%. After the capital injection a 35% appreciation of the ISK would have resulted in a CAD ratio drop from 16.4% to 15.3%. Also shown on the graph (as dashed curves) is the FX risk contribution of loans to customers with FX income the source of true FX risk. The deviation of the solid curves from their dashed counterparts is the contribution of naturally hedged loans. The strength of the natural hedge prior to the injection is evident the loans are almost fully hedged up to a 15% appreciation of the ISK.

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.

2009

		0-1Y	1-5Y	5-10Y	10-20Y	>20
CPI Indexed linked	ISK	152	178	(80)	(418)	(363)
Non Indexed linked	ISK	(50)	(24)	(26)	(81)	(19)
	EUR	2	(18)	-	-	-
	Other	(4)	-	-	-	-

2008

		0-1Y	1-5Y	5-10Y	10-20Y	>20
CPI Indexed linked	ISK	(3)	84	47	35	50
Non Indexed linked	ISK	(9)	(190)	(53)	129	(33)
	EUR	3	(15)	-	-	-
	Other	(7)	-	-	-	-

Notes to the Consolidated Financial Statements

112. cont.

2009 after taking into account changes in capitalization according to agreement made 8 January 2010

		0-1Y	1-5Y	5-10Y	10-20Y	>20
CPI Indexed linked	ISK	150	96	(433)	(3,198)	(1,113)
Non Indexed linked	ISK	(23)	(27)	(26)	(81)	(19)
	EUR	75	(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 70.7 billion (2008: ISK 42.1 billion) and the total amount of indexed liabilities amounted to ISK 85.4 billion (2008: ISK 63.7 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.

c) Market Price Risk Disclosures

The Bank is not materially exposed to market price risk for financial assets at year end 2009.

At year end 2008 the Bank had in place market risk limits for its proprietary trading desk in listed Icelandic Treasury notes, Housing Fund bonds and, to a limited extent, equities.

d) Derivatives Risk Disclosures

The Bank is not materially exposed to derivative risk at year end 2009.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

113. 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:

Assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total
Cash with Central Bank	41,906	-	-	-	-	-	41,906
Loans to credit institutions	24,024	3,244	5,463	5,124	615	-	38,470
Loans and receivables to customers	-	13,534	48,013	193,376	102,811	-	357,734
Bonds and debt instruments	5,969	474	1,127	93,562	72,350	-	173,482
Shares and equity instruments	-	-	-	-	-	7,078	7,078
Derivatives	-	6	-	-	-	-	6
Securities used for hedging	2,236	-	-	-	-	-	2,236
Compensation instrument	-	-	-	34,371	-	-	34,371
Investment property	-	-	-	-	-	22,947	22,947
Investments in associates	-	-	-	-	-	5,985	5,985
Property and equipment	-	-	-	-	-	10,700	10,700
Intangible assets	-	-	-	-	-	3,512	3,512
Tax assets	-	-	-	-	-	1,415	1,415
Non-current assets held for sale	-	-	-	-	-	41,527	41,527
Other assets	1,583	1,486	5,999	1,114	-	5,793	15,975
Total assets 31.12.2009	75,718	18,744	60,602	327,547	175,776	98,957	757,344
Total assets 31.12.2008	110,640	30,371	126,760	223,607	116,582	33,243	641,203
Total assets 8 Jan 2010	81,842	23,041	62,562	358,364	212,806	98,957	837,572
Liabilities							
Due to credit inst. and Central Bank	104,571	3,431	5,645	-	-	-	113,647
Deposits	448,307	16,461	14,127	14,842	1,728	-	495,465
Borrowings	348	-	-	-	10,694	-	11,042
Financial liabilities at fair value	45	17	-	26	-	-	88
Tax liabilities	-	-	-	-	-	2,841	2,841
Non-current liabilities held for sale	-	-	-	-	-	19,230	19,230
Other liabilities	1,134	13,457	333	1,696	675	7,702	24,997
Total liabilities 31.12.2009	554,405	33,366	20,105	16,564	13,097	29,773	667,310
Total liabilities 31.12.2008	283,578	188,138	42,919	28,861	18,017	2,744	564,257
Total liabilities 8 Jan 2010	539,977	33,366	20,105	16,564	74,349	59,316	743,677
Assets - liabilities 31.12.2009	(478,687)	(14,622)	40,497	310,983	162,679	69,184	90,034
Assets - liabilities 31.12.2008	(172,938)	(157,767)	83,841	194,746	98,565	30,499	76,946
Assets - liabilities 8 Jan 2010	(458,135)	(10,325)	42,457	341,800	138,457	39,641	93,895

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 the year end 2009 the secured liquid assets were 22.8% of deposits which would enable the Bank to withstand an instantaneous deposit outflow in excess of the FME requirement of 20%. This number was down from a ratio of 27.4% at year end 2008.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

113. cont.

c) Deposit Stickiness

The Bank's deposit base has been split into six different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described being sticky if has shown to be a stable funding for the Bank in the past and is expected to remain stable in the future. The Bank uses six different levels of stickiness to describe its deposit base.

Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Bank and the maturity of the deposit. These criteria are based both on qualitative and quantitative methods.

The table below shows the split between different levels of the Bank's deposit stickiness, according to the Bank's classification. The rating 6 means the stickiest deposits (e.g., deposits from retail individuals) and the rating 1 the least sticky (e.g., deposits from customers believed to be waiting for the lifting of capital controls).

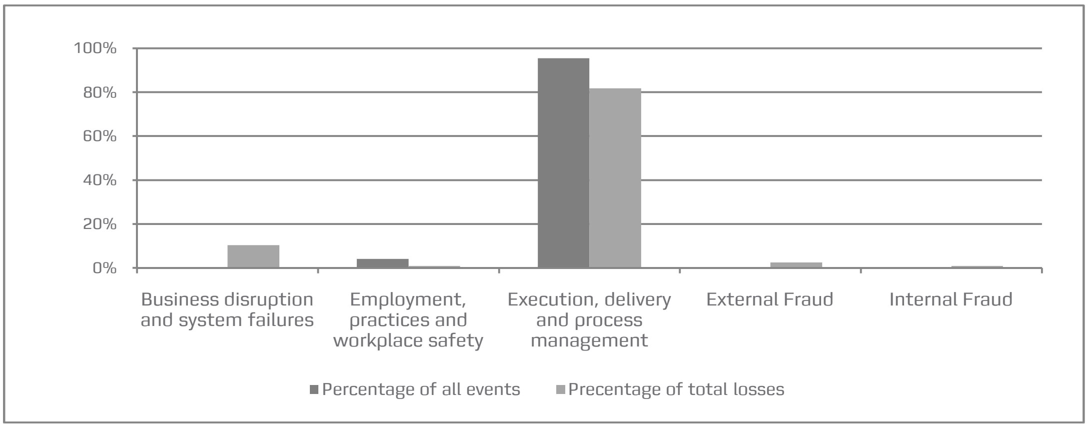
% of deposit base:

Stickiness rating	2009	2008
1	11%	4%
2	7%	22%
3	2%	1%
4	24%	23%
5	26%	26%
6	28%	24%

114. Operational Risk Disclosures

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analyzed to understand the cause of the event, control failure and amendments made where applicable to reduce the risk of the event happening again.

Losses of ISK 171 million were registered in the loss database for the 2009. The majority of the loss events were due to mistakes in processing. The largest single loss accounted for 10% of the total loss amount.



50% of total losses during 2009 were due to the collapse of the banking system.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

115. Capital Adequacy Disclosures

Equity base at 31 December 2009 amounts to ISK 86,984 million. The core Tier 1 capital ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 13.7%, exceeding the minimum legal requirement of 8%.

On 12 August 2009 , the 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 Core Tier 1 ratio of 12% from that date and this which must be maintained for at least 3 years after the initial capitalization unless revised by the FME. The Bank complies with the 12% ratio from 13 August 2009.

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 24% 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 has increased to 35% as explained in note 112.

The table shows the Bank's RWA calculations for 31 December of 2008 and 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 (see note 120) with an attendant increase in credit risk weighted assets. The capital injection is accompanied by 4% Tier 2 capital and aim to exceed a 16% target set by the FME.

RWA	2008	2009	8 Jan 2010
Credit risk	490,403	480,374	574,943
Market risk	154,915	104,082	109,210
Operational risk	58,831	51,055	51,055
Risk weighted assets	704,149	635,511	735,208
Capital Requirement (Pillar 1)	56,332	50,841	58,817
Tier 1 Capital	74,871	86,984	90,846
Tier 2 Capital	-	-	29,543
Total own funds	74,871	86,984	120,389
Tier 1 ratio	10.6%	13.7%	12.4%
Capital adequacy ratio	10.6%	13.7%	16.4%

b) Pillar 2

The Bank is developing methods to calculate concentration risk for single name concentration and sector concentration. Methods for evaluating other Pillar 2 risks will be developed in line with further development 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.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Other information

Mortgage loans

116. The Bank has a service level agreement providing back office services.

	2009	2008
Fee income	179	45

Related parties

117. The Bank is 100% owned by the Icelandic state. The Bank's products and services are offered to the state, state authorities and state companies (including other State Owned Banks) in competition with other vendors under generally accepted commercial terms. In a similar manner, the Bank purchases products and services from state authorities and companies at market prices and otherwise under generally accepted commercial terms. No significant share of the Bank's net interest, expenditure or earnings is attributable to the Icelandic state or any of its authorities or companies. Those transactions are related party transactions as defined in IAS 24 Related Party Disclosures but are not disclosed owing to the volume of transactions conducted.

The Bank has a related party relationship with its 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 insubstantial and are reported in the Consolidated Statement of Financial Position.

For compensation to the key management personnel see note 52. All compensation to key personnel were short term employee benefits.

No unusual transactions took place with related parties in the year of 2009. Transaction with related parties have been conducted on arm's length basis.

With Kaupskil hf. becoming a major shareholder in Arion banki hf. as of 8 January 2010 the Bank will have a related party relationship with Kaupskil hf. and its shareholder, Kaupthing banki hf. thereafter, see note 120.

Information on related party balance at year end is shown below:

	2009
Total assets	42,715
Total liabilities	64,525
Net liabilities against Kaupskil hf. and related parties	21,810

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

118. 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

119. On 8 January 2010 there was a change in the capitalization and the ownership of Arion banki hf. The estimated impacts on the Consolidated Statement of Financial Position as at 31 December 2009 are discussed in note 120.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Agreements

120. On 3 September 2009, the Resolution Committee of Kaupthing banki hf., on behalf of Kaupskil hf., 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 hf., 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 hf.

With the final approval made on 8 January 2010 these Consolidated Financial Statements do not reflect changes in capitalization following the changes in ownership of Arion banki hf. These changes would have major impacts on the financial position of Arion banki hf. if recorded in 2009.

The estimated impacts on the Consolidated Statement of Financial Position of Arion banki hf. as at 31 December 2009, when taking into account the changes in capitalization following the agreement signed 8 January 2010, are shown in the table below:

Assets	According to Financial Statement 2009	Changes following agreement signed 8 Jan 2010	Proforma after change of control 8 Jan 2010
Cash and balances with Central Bank	41,906		41,906
Loans and receivables to credit institutions	38,470		38,470
Loans and receivables to customers	357,734	112,824	470,558
Bonds and debt instruments	173,482	(32,595)	140,887
Shares and equity instruments with variable income	7,078		7,078
Derivatives	6		6
Securities used for hedging	2,236		2,236
Compensation instrument	34,371		34,371
Investment property	22,947		22,947
Investments in associates	5,985		5,985
Property and equipment	10,700		10,700
Intangible assets	3,512		3,512
Tax assets	1,415		1,415
Non-current assets and disposal groups held for sale	41,527		41,527
Other assets	15,975		15,975
Total Assets	757,344	80,229	837,573

Liabilities			
Due to credit institutions and Central Bank	113,647	(14,428)	99,219
Deposits	495,465		495,465
Borrowings	11,042	61,252	72,294
Subordinated loans	-	29,543	29,543
Financial liabilities at fair value	88		88
Tax liabilities	2,841		2,841
Non-current liabilities and disposal groups held for sale	19,230		19,230
Other liabilities	24,997		24,997
Liabilities	667,310	76,367	743,677

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

120. cont.

Equity	According to Financial Statement 2009	Changes following agreement signed 8 Jan 2010	Proforma after change of control 8 Jan 2010
Share capital	12,646	(10,646)	2,000
Share premium	59,354	14,508	73,862
Other reserves	1,729		1,729
Retained earnings	16,150		16,150
Total Shareholder's Equity	89,879	3,862	93,741
Non-controlling interest	155	-	155
Total Equity	90,034	3,862	93,896
Total Liabilities and Equity	757,344	80,229	837,573

Following the agreement made on 8 January 2010 the Icelandic State received a capital return of 87% of its shareholding in Arion banki hf. equity, amounting to ISK 62,138 million. The Icelandic State provided Arion banki hf. with a ISK 29,543 million subordinated loan, as calculated 4% Tier 2 capital. Net payment of government bonds to the Icelandic State was ISK 32,595 million. After this transaction Kaupskil hf. will own approximately 65% of total capital (equity and subordinated loans) and the Icelandic State approximately 35%.

With new shareholder and changes in capitalization the share capital was increased by ISK 66,000 million. The capital increase consists of the following transactions:

Capitalization	8 Jan 2010
ISK mortgage loans	6,584
Due to credit institutions and Central Bank	14,428
Corporate loans	28,770
Other loans	16,218
	66,000

Related funding agreement with Central Bank	
FX mortgage loans	38,094
ISK mortgage loans	23,158
Borrowings	(61,252)
	-

Arion banki hf. shall pay the Icelandic State ISK 6,500 million which shall be deducted from the retained earnings, by a way of single one time payment if the following conditions are met:

i. The Core Tier 1 ratio of Arion banki hf. has to be at least 12%.

ii The Core Tier 1 ratio shall be calculated according to the audited annual accounts results of Arion banki hf. (year end), the first accounts for this purposes being for operating year of 2010, and annually thereafter.

iii For the purpose of this calculation ISK 6,5 billion of retained earnings are disregarded.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Subsidiaries

121. Shares in subsidiaries are specified as follows:

Company:	Country	Currency	Activity[1]	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	CF	100.0
AFL - sparisjódur, Adalgata 34, 580 Siglufjördur	Iceland	ISK	RB	94.5
Arion Verdbréfavarsla 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
Sparisjódur Mýrasýslu, Digranesgata 2, 310 Borgarnes	Iceland	ISK	RB	100.0
Sparisjódur Ólafsfjardar, Adalgata 14, 625 Ólafsfjördur	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:				
Drög ehf., Pósthólf 878, 121 Reykjavík	Iceland	ISK	OD	82.1
Hafrahlíd ehf., Laugavegur 174, 105 Reykjavík	Iceland	ISK	OD	100.0
Icecorp Ltd., 4 St. Stephen's Green, Dublin	Ireland	EUR	OD	100.0
Penninn Holding 1 Oy, Vainö Tannerin tie 3, Vantaa	Finland	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.

Amounts are in ISK millions. 127

Sand

Before sand was used in the manufacture of cement, Icelanders looked on the vast expanses of sand in the country as a wasteland, unfit for use. It ruined farmland and despite the constant battle to restore pastureland, sand erosion remains a huge problem. Yet sand does have its beautiful side. A young Icelandic designer has captured this beauty in vases which he has cast from sand and calls “Flower Eruption.”

Jón Björnsson

Designer Jón Björnsson hails from Höfn and has attracted considerable attention for the works he creates from black Icelandic sand. Jón studied industrial design in the Netherlands and has exhibited his work in many places. “Flower Eruption” is a range of vases made from sand and cast in paper or wooden moulds. Jón mixes the sand with a setting agent and then fills the mould from the bottom.

Board of Directors

On 18 October 2008 the establishment meeting of Arion Bank was held at which an interim Board of Directors was elected.

The following people were elected on to the interim Board of Directors:

Ólafur Hjálmarsson, Chairman
Einar Gunnarsson,
Helga Óskarsdóttir,
Jónína B. Bjarnadóttir,
Sigurdur Thórdarson.
Finnur Sveinbjörnsson was appointed as Chief Executive Officer.

The interim Board of Directors remained in place until 10 November 2008 when it was replaced by a new Board comprising the following members:

Magnús Gunnarsson, Chairman
Audur Finnbogadóttir,
Erna Bjarnadóttir
Helga Jónsdóttir, Vice-Chairwoman
Drífa Sigfúsdóttir
Magnús Gunnarsson resigned on 10 February.
Hulda Dóra Styrmisdóttir took over as Chairwoman at a shareholders' meeting on 26 February 2009.

A new board of Directors was elected on 3 September 2009, comprising the following members:

Erna Bjarnadóttir, Chairwoman
Drífa Sigfúsdóttir
Helga Jónsdóttir
Jóhannes Rúnar Jóhannesson
Jónína A. Sanders
Theodór S. Sigurbergsson, Vice-Chairman

A new Board of Directors was elected on 18 March 2010, comprising the following members:

Monica Caneman, Chairwoman.
Gudrún Johnsen, Vice-Chairwoman.
Kristján Jóhannsson
Steen Hemmingsen
Theodór S. Sigurbergsson

The Board of Directors was elected on 18 March 2010: Theodór S. Sigurbergsson, Gudrún Johnsen, Vice-Chairwoman, Steen Hemmingsen, Monica Caneman, Chairwoman, Kristján Jóhannesson.

Monica Caneman, Chairwoman
Monica is Swedish and lives in Sweden. She graduated as an economist from the Stockholm School of Economics in 1976. She worked at Skandinaviska Enskilda Banken (now SEB) from 1977 to 2001. Monica held various positions at SEB in retail banking. She became a member of the group executive committee and group management in 1995 and became deputy CEO in 1997. She became a deputy member of the board of directors at the same time. Monica left SEB in 2001. Since then she has built a career around board assignments. Currently she sits on the board of a number of companies and non-profit organizations and is the chairwoman of several of them, including Arion Bank.

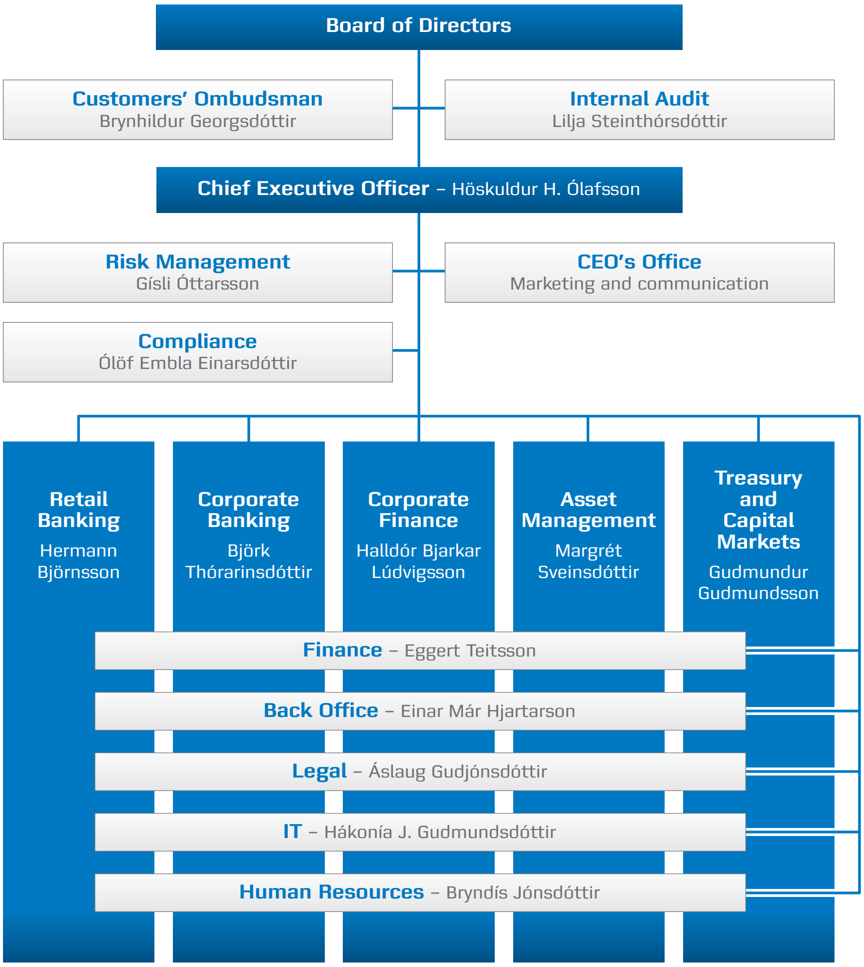
Gudrún Johnsen, Vice-Chairwoman
Gudrún completed her BA in economics at the University of Iceland in 1999. In 2002 she graduated with an MA in applied economics at the University of Michigan, Ann Arbor in the United States and with an MA in statistics from the same university the following year. Gudrún worked as a securities broker at the Icelandic Investment Bank (FBA) between 1999 and 2001, as a teaching and research assistant at the University of Michigan, Ann Arbor in 2002-2003 and as a specialist at the RAND Corporation in the United States in 2004. Between 2004 and 2006 she worked as a specialist in the Monetary and Financial Systems Department of the International Monetary Fund (IMF) in Washington, DC. Gudrún has been an assistant professor at Reykjavík University School of Business since 2006. She has served on the board of a fund management company of MP Bank, is the current chairwoman of a research and analysis company formed by a group of academics and sits on the advisory council of the Consumer Spokesman.

Kristján Jóhannsson, Director
Kristján studied business administration and economics at the Copenhagen Business School, graduating with an MSc in 1981. His specialist fields were finance, investment analysis and corporate strategy. Kristján was the chief economist of the Federation of Icelandic Industries between 1981 and 1983 and the CEO of a publishing company from 1983 to 1990. From 1990 to 1992 he worked as an independent consultant and has been an assistant professor at the School of Business at the University of Iceland since 1992. Kristján has served on the boards of various companies and non-profit organisations and was chairman of the Association of Business and Economics Graduates from 1986 to 1990 and the head of the Institute of Business Research at the University of Iceland.

Steen Hemmingsen, Director
Steen is Danish and lives in Denmark. He graduated from the Copenhagen Business School with an MSc in 1969 and a Ph.D. in 1973. His doctoral thesis was on the investment behaviour of Danish companies. Steen worked as an adviser at the commercial bank Privatbanken between 1972 and 1975, as the CFO of the steel producer Det Danske Staalvalseværk from 1975 to 1983, the CEO of the savings bank Sparekassen Sydjylland between 1983 and 1986, the CEO of the insurer Baltica Forsikring from 1986 to 1993, and was CFO of the East Asiatic Company from 1993 to 1997. He has been the CEO of the Lundbeck Foundation and its investment company LFI since 1999. The Foundation is the largest shareholder in the pharmaceutical companies H. Lundbeck and Alk-Abello and is a major provider of financial support for research in biomedical and natural sciences. Steen serves on the boards of various companies and non-profit organisations and is also an external examiner at the Copenhagen Business School.

Theodór S. Sigurbergsson, Director
Theodór graduated with an MSc from the Business School of the University of Iceland in 1982, majoring in auditing. He became a state authorised public accountant in 1989 and became a partner at Grant Thornton in Iceland later that year. He has been active member of the Institute of State Authorised Public Accountants in Iceland and has served on various committees within the institute. Theodór has wide-ranging experience in auditing and accounting. He has served on the Kaupthing Bank Resolution Committee since October 2008.

Senior Management



Höskuldur H. Ólafsson
Incoming CEO
Höskuldur H. Ólafsson will take over the position of Chief Executive Officer on 1 June 2010. Höskuldur graduated with an MSc in business studies from the University of Iceland in 1987. He joins Arion Bank from Valitor hf – VISA Iceland, where he was CEO from 2006. Prior to that he worked at the Icelandic transportation company Eimskip for almost 20 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organisations in Iceland and abroad.

Business segments

Björk Thórarinsdóttir
Managing Director of Corporate Banking and Deputy CEO
Björk graduated with an MSc in business administration from the University of Iceland in 1990. She joined the corporate banking division of Búnadarbanki Íslands (later Kaupthing Bank) in 2001. In 2009 she was appointed managing director of Corporate Banking at Arion Bank and currently holds the position of deputy CEO. Björk was previously a specialist and financial director at Baxter International in the United States and later in Germany from 1991-1996. In 1997-1998 she was financial director of Philips Consumer Communications in France, before moving to Silfurtún in Iceland and Silverton in Norway in 1998-2000 as financial director. She was elected as chairwoman of the board of directors of Valitor hf. in January 2010.

Gudmundur Thórdur Gudmundsson
Managing Director of Treasury and Capital Markets
Gudmundur graduated in mechanical engineering from the University of Iceland in 1990 and gained a Master's in engineering from DTU in Denmark in 1993. Gudmundur became a CFA charterholder in 2006. Between 1996 and 1998 he worked in securities trading, proprietary trading and asset management at Íslandsbanki, before moving on to the capital markets division of FBA from 1998 to 2000. When Íslandsbanki and FBA merged in 2000 he became head of derivatives. In 2004 he joined Kaupthing Bank as head of derivatives and was appointed managing director of treasury the following year. Gudmundur became managing director of Treasury & Capital Markets at Arion Bank in 2008.

Halldór Bjarkar Lúdvígsson
Managing Director of Corporate Finance
Halldór graduated with a degree in mechanical engineering from the University of Iceland in 1991 and a BSc in computer studies in 1992 from the same university. Between 1992 and 2005 Halldór held a number of management positions, including the position of CEO at Maritech A/S, an international company which sells technical solutions for the fishing industry. In 2005 Halldór joined the Corporate Banking division of Kaupthing Bank where he supervised lending activities in Scandinavia. Halldór joined Kaupthing's Resolution Committee in 2008 as managing director of the bank's Nordic asset portfolio and in December 2009 he was appointed managing director of Corporate Finance at Arion Bank. Halldór has served on the boards of a number of companies, particularly startup companies.

Hermann Björnsson
Managing Director of Retail Banking
Hermann graduated with an MA in law from the University of Iceland in 1990 and qualified as a district court attorney in 1993. He joined the Retail Banking division in January 2006, first as head of operations, then as assistant managing director. He became managing director on 1 April 2009. Prior to this, Hermann spent more than 15 years at Íslandsbanki, initially in the legal services department, then as head of operations and finally as assistant managing director of the branches division. Hermann has held a number of management positions and other positions of responsibility during this period. He is currently chairman of the board of Fjölgreidslumidlun and serves on the boards of Okkar life insurance and the Bank Employees' Pension Fund.

Margrét Sveinsdóttir
Managing Director of Asset Management
Margrét was awarded an MBA from Babson College in Massachusetts in 1990. She also has an MSc in business administration from the University of Iceland and is a qualified securities dealer. Margrét has been managing director of Asset Management at Arion Bank since February 2009. She has more than 20 years' experience in the financial sector, having worked in credit analysis, customer relationship management and asset management. She started her career in the corporate banking division of the Industrial Bank of Iceland in 1985. Margrét then moved on to Íslandsbanki Securities Ltd, later the asset management division Glitnir, where she was head of securities brokerage and advisory. In 2007 she became head of financial institutions client relations at Glitnir. Margrét has served on a number of boards of directors, including: The Depositors' and Investors' Guarantee Fund on behalf of SFF, Okkar líf hf. and several funds in Luxembourg. She has also contributed to several books and magazines on asset management services, investments and financial planning.

Support Units

Áslaug Gudjónsdóttir
Acting Managing Director of Legal
Áslaug graduated from the faculty of law at the University of Iceland in 1987. She gained an LL.M. from the University of Pennsylvania Law School in 1989 and completed postgraduate studies in management and business at the University of Iceland Continuing Education Institute in 1998. She qualified as a district court attorney in 1992 and joined Kaupthing Bank as a lawyer in 2002. She became head of Legal Services and was deputy managing director of the Legal Division from 1 November 2009, before becoming acting managing director. Before entering the banking sector Áslaug worked for the Icelandic Ministry of Finance. She was responsible for pension fund affairs and worked on preparing and implementing the EEA agreement. From 1999 to 2001 Áslaug was a financial counsellor at the Icelandic embassy in Brussels. She has also been a lecturer and examiner at the faculty of law at the University of Iceland.

Bryndís Jónsdóttir
Managing Director of Human Resources
Bryndís graduated with a BA in psychology from the University of Iceland in 1997 and an MA in human resource management from the same university in 2007. Bryndís joined the Bank in 2006 when she was appointed as a specialist in human resources. She was also head of human resources and operations at Arion Custody Services and was head of the Bank's customer service centre. Bryndís has been managing director of Human Resources at Arion Bank since January 2009. Between 1996 and 2005 Bryndís held various positions in the travel industry. She worked at the offices of the Icelandic travel agent Samvinnuferdir Landsýn, firstly as head of destinations and then as head of human resources and operations. Between 2002 and 2005 Bryndís was head of revenue at Iceland Express.

Hákonía J. Gudmundssdóttir
Managing Director of Information Technology
Hákonía graduated with a BSc in computer studies from the University of Iceland in 1986 and gained an MBA from the University of Edinburgh in 1993. Hákonía became managing director of IT in 2009. After completing her graduate and postgraduate studies, she taught at Verzlunarskóli Íslands, worked as a specialist at the Icelandic Banks' Data Centre and at Kristján Ó. Skagfjörd, was project manager at Ölgerdin and spent more than 11 years as head of software at Íslandsbanki (later Glitnir). Hákonía joined Kaupthing Bank's IT division in 2006 and is currently on the board of the Icelandic Banks' Data Centre.

Eggert Teitsson
Managing Director of Finance
Eggert graduated with an MSc in business administration from the University of Iceland in 1995. He qualified as a chartered accountant in 2002. Between 1994 and 1996 Eggert was a farmer in northern Iceland, before moving into accountancy in 1996 at Löggiltir endurskodendur (later Deloitte) where he stayed until 2004. He joined Kaupthing Bank in 2004 as departmental head in the finance division. He became managing director of Finance in 2005. Eggert is a member of the Institute of State Authorized Public Accountants in Iceland and has sat on a number of committees on behalf of the association.

Einar Már Hjartarson
Managing Director of Back Office
Einar Már graduated with an MSc in business administration from the University of Iceland in 1999. He worked for Deloitte & Touche from 1998 to 2001, before joining Búnadarbanki Íslands as head of back office. In 2003 Einar Már became head of Back Office at Kaupthing Bank. In 2004 he was appointed managing director of Back Office at Kaupthing Bank (later Arion Bank).

Internal Control

Gísli Óttarsson
Chief Risk Officer
Gísli received a PhD in mechanical engineering from the University of Michigan in 1994. Gísli worked as a software designer and adviser for various engineering software companies in the United States before he joined Kaupthing Bank's risk management division as head of research and development in January 2006. In April 2009 Gísli became the Chief Risk Officer of Arion Bank.

Ólöf Embla Einarsdóttir
Compliance Officer
Ólöf Embla graduated from the faculty of law at the University of Iceland in 2000. From 2000-2004 she worked as a lawyer for the Consumers' Association of Iceland. In 2005-2007 she worked at the Ministry of Commerce on matters relating to banking and securities, e.g. the introduction of the EU's Anti Money Laundering Directive and the EU's Transparency Directive into Icelandic legislation. In 2007 Ólöf Embla was hired by Kaupthing Bank as Compliance Officer. Ólöf Embla qualified as a district court attorney in 2002 and as a licensed securities broker in 2008. Jófrídur Ósk Hilmarsdóttir is acting Compliance Officer while Ólöf Embla is on maternity leave.

Lilja Steinthórsdóttir
Chief Audit Executive
Lilja gained an MBA degree from the University of Edinburgh in 1998. She qualified as a chartered accountant in 1984 and graduated with an MSc in business administration in 1980. Before she joined the Bank in late 2006 as chief audit executive she was the chief auditor at the Central Bank of Iceland for eight years. She established an accounting firm in Akureyri in 1986 and headed it for 13 years when it was sold to Deloitte. She is a member of the Institute of State Authorized Public Accountants in Iceland and has served on the audit committee on behalf of the organisation. She also served on the audit committee of Icelandic Bank's Data Centre from 1998 to 2010, first on behalf of the Central Bank and then Arion Bank.

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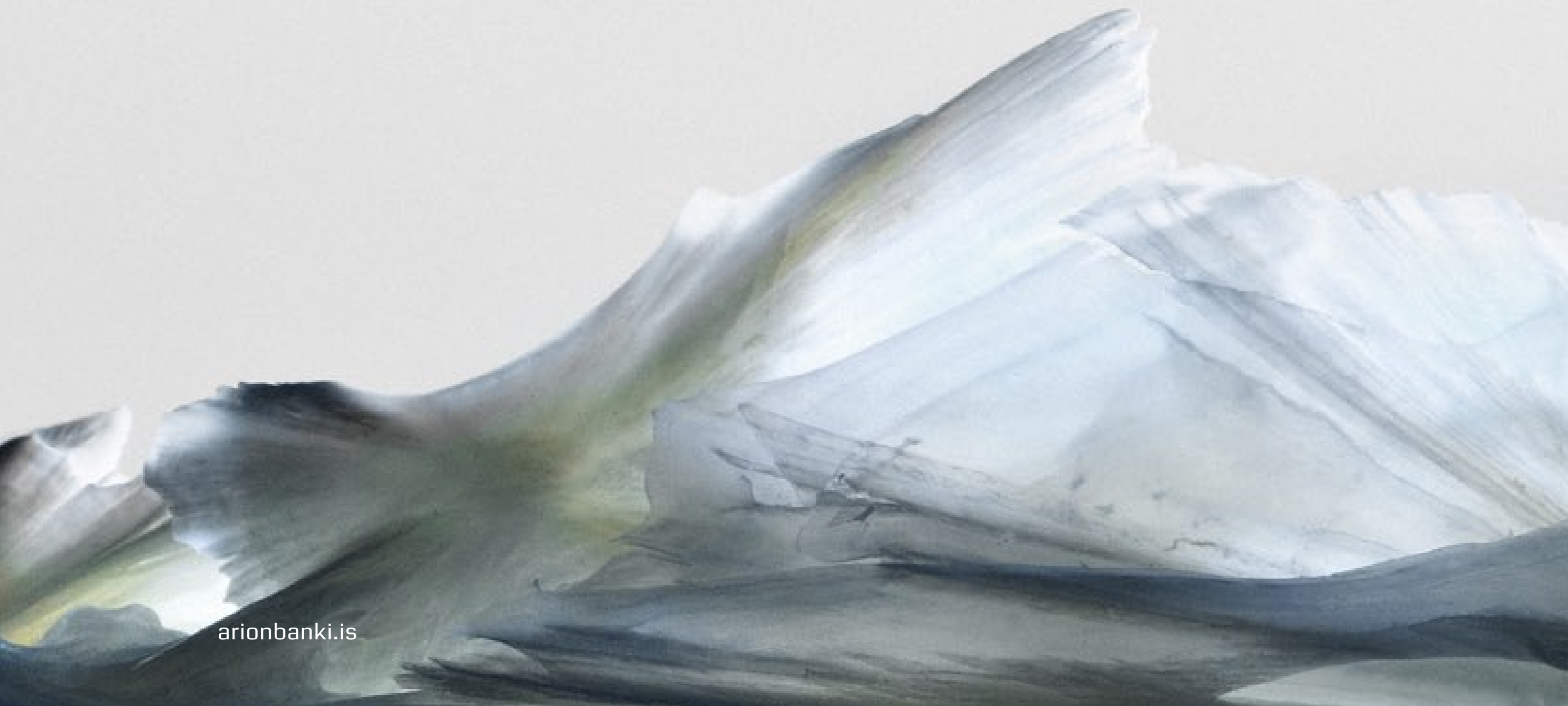
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