ARION BANK HF.

(incorporated with limited liability in Iceland)

€1,000,000,000

Covered Bond Programme

Under this €1,000,000,000 Covered Bond Programme (the **Programme**), Arion Bank hf. (the **Issuer** or the **Bank**) may from time to time issue bonds (the **Covered Bonds**) denominated in any currency agreed between the Issuer and the relevant Dealer (as defined below). Covered Bonds may be issued in bearer form (**Bearer Covered Bonds**), registered form (**Registered Covered Bonds**) or in uncertificated and dematerialised book entry form registered in the Icelandic Securities Depository Ltd. (**ISD Covered Bonds** and the **ISD** respectively). The maximum aggregate nominal amount of all Covered Bonds from time to time outstanding under the Programme will not exceed €1,000,000,000 (or its equivalent in other currencies calculated as described in the Programme Agreement described herein), subject to increase as described herein.

The Covered Bonds may be issued on a continuing basis to one or more of the Dealers specified under "*Overview of the Programme*" and any additional Dealer appointed under the Programme from time to time by the Issuer (each a **Dealer** or **Manager** and together the **Dealers** or **Managers**), which appointment may be for a specific issue or on an ongoing basis. References in this offering circular (the **Offering Circular**) to the relevant Dealer shall, in the case of an issue of Covered Bonds being (or intended to be) subscribed by more than one Dealer, be to all Dealers agreeing to subscribe for such Covered Bonds.

The Covered Bonds may be held in a manner which is intended to allow for Eurosystem eligibility. This simply means that the Covered Bonds may upon issue be deposited with Clearstream Banking, *société anonyme* (**Clearstream**, **Luxembourg**) or Euroclear Bank S.A./N.V. (**Euroclear**) as one of the international central securities depositaries as common safekeeper and does not necessarily mean that the Covered Bonds will be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any or all times during their life. Such recognition will depend upon satisfaction of the Eurosystem eligibility criteria.

See Risk Factors for a discussion of material factors to be considered in connection with an investment in the Covered Bonds.

Application has been made to the Commission de Surveillance du Secteur Financier (the **CSSF**) in its capacity as competent authority under the Luxembourg Act dated 10 July 2005 on prospectuses for securities (the **Prospectus Act 2005**) to approve this document as a base prospectus. By approving this Base Prospectus, the CSSF assumes no responsibility as to the economic and financial soundness of the transactions contemplated by this Offering Circular or the quality or solvency of the Issuer in accordance with Article 7(7) of the Prospectus Act 2005. Application has also been made to the Luxembourg Stock Exchange for Covered Bonds issued under the Programme to be admitted to trading on the Luxembourg Stock Exchange's regulated market and to be listed on the Official List of the Luxembourg Stock Exchange.

References in this Offering Circular to Covered Bonds being listed (and all related references) shall mean that such Covered Bonds have been admitted to trading on the Luxembourg Stock Exchange's regulated market and have been admitted to the official list (the **Official List**) of the Luxembourg Stock Exchange. The Luxembourg Stock Exchange's regulated market is a regulated market for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

Notice of the aggregate nominal amount of Covered Bonds, interest (if any) payable in respect of Covered Bonds, the issue price of Covered Bonds and certain other information which are applicable to each Tranche (as defined under "*Terms and Conditions of the Covered Bonds*") of Covered Bonds will be set out in a final terms document (the **Final Terms**) which will be filed with the CSSF. Copies of Final Terms in relation to Covered Bonds to be listed on the Luxembourg Stock Exchange will also be published on the website of the Luxembourg Stock Exchange (www.bourse.lu).

The Programme provides that Covered Bonds may be listed or admitted to trading, as the case may be, on such other or further stock exchanges or markets as may be agreed between the Issuer and the relevant Dealer. The Issuer may also issue unlisted Covered Bonds and/or Covered Bonds not admitted to trading on any market.

The Covered Bonds have not been and will not be registered under the U.S. Securities Act of 1933, as amended (the **Securities Act**) or any U.S. State securities laws and may not be offered or sold in the United States or to, or for the account or the benefit of, U.S. persons as defined in Regulation S under the Securities Act unless an exemption from the registration requirements of the Securities Act is available and in accordance with all applicable securities laws of any state of the United States and any other jurisdiction. See "*Form of the Covered Bonds*" for a description of the manner in which Covered Bonds will be issued. Registered Covered Bonds are subject to certain restrictions on transfer, see "*Subscription and Sale and Selling Restrictions* ".

The Issuer may agree with any Dealer that Covered Bonds may be issued in a form not contemplated by the Terms and Conditions of the Covered Bonds herein, in which event a supplement to the Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Covered Bonds.

Covered Bonds issued under the Programme may be rated or unrated. Where a Series of Covered Bonds is rated, such rating will be disclosed in the Final Terms and be provided by Moody's Investors Service Limited (**Moody's**), Fitch Ratings Ltd. (**Fitch**) or S&P Global Ratings, a division of S&P Global Inc. (**S&P**). Each rating agency is established in the European Union and is registered under the Regulation (EC) No. 1060/2009 (as amended) (the **CRA Regulation**). As such each of Moody's, Fitch and S&P is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website (at http://www.esma.europa.eu/page/List-registered-and-certified-CRAs) in accordance with the CRA Regulation. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

Arranger

Barclays

Dealers
Barclays
Deutsche Bank
UBS Investment Bank
Arion Bank hf.

The date of this Offering Circular is 23 December 2016.

This Offering Circular comprises a base prospectus (with any relevant Final Terms, the **Prospectus**), for the purposes of Article 5.4 of Directive 2003/71/EC as amended (which includes the amendments made by Directive 2010/73/EU (the **Prospectus Directive**).

The Issuer (the **Responsible Person**) accepts responsibility for the information contained in this Offering Circular and the Final Terms for each Series of Covered Bonds issued under the Programme. To the best of the knowledge of the Issuer (having taken all reasonable care to ensure that such is the case) the information contained in this Offering Circular is in accordance with the facts and does not omit anything likely to affect the import of such information.

Subject as provided in the applicable Final Terms, the only persons authorised to use this Offering Circular in connection with an offer of Covered Bonds are the persons named in the applicable Final Terms as the relevant Dealer or the Managers, as the case may be.

Copies of the Final Terms will be available from the registered office of the Issuer and the specified office set out below of each of the Paying Agents (as defined below) and copies of the Final Terms relating to Covered Bonds which are admitted to trading on the regulated market of the Luxembourg Stock Exchange will be filed with the CSSF and also be published on the website of the Luxembourg Stock Exchange, www.bourse.lu.

Certain information under the heading "*Book-entry Clearance Systems*" has been extracted from information provided by the clearing systems referred to therein. The Issuer confirms that such information has been accurately reproduced and that, so far as it is aware, and is able to ascertain from information published by the relevant clearing systems, no facts have been omitted which would render the reproduced information inaccurate or misleading.

This Offering Circular is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see "*Documents Incorporated by Reference*" below). This Offering Circular shall be read and construed on the basis that such documents are incorporated and form part of this Offering Circular.

The Dealers (other than the Issuer) have not independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Dealers (other than the Issuer) as to the accuracy or completeness of the information contained or incorporated by reference in this Offering Circular or any other information provided by the Issuer in connection with the Programme. No Dealer (other than the Issuer) accepts any liability in relation to the information contained or incorporated by reference in this Offering Circular or any other information provided by the Issuer in connection with the Programme.

No person is or has been authorised by the Issuer to give any information or to make any representation not contained in or not consistent with this Offering Circular or any other information supplied in connection with the Programme or the Covered Bonds and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer or any of the Dealers.

Neither this Offering Circular nor any other information supplied in connection with the Programme or any Covered Bonds (a) is intended to provide the basis of any credit or other evaluation or (b) should be considered as a recommendation by the Issuer or any of the Dealers that any recipient of this Offering Circular or any other information supplied in connection with the Programme or any Covered Bonds should purchase any Covered Bonds. Each investor contemplating purchasing any Covered Bonds should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer. Neither this Offering Circular nor any other information supplied in connection with the Programme or the issue of any Covered Bonds constitutes an offer or invitation by or on behalf of the Issuer or any of the Dealers to any person to subscribe for or to purchase any Covered Bonds.

Investors should review, *inter alia*, the documents deemed incorporated herein by reference when deciding whether or not to purchase any Covered Bonds.

Neither the delivery of this Offering Circular nor the offering, sale or delivery of any Covered Bonds shall in any circumstances imply that the information contained herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same. The Dealers expressly do not undertake to review the financial condition or affairs of the Issuer during the life of the Programme or to advise any investor in the Covered Bonds issued under the Programme of any information coming to their attention.

This Offering Circular may only be used for the purposes for which it has been published.

This Offering Circular does not constitute an offer to sell or the solicitation of an offer to buy any Covered Bonds in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Offering Circular and the offer or sale of Covered Bonds may be restricted by law in certain jurisdictions. The Issuer and the Dealers do not represent that this Offering Circular may be lawfully distributed, or that any Covered Bonds may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular no action has been taken by the Issuer or the Dealers which is intended to permit a public offering of any Covered Bonds or distribution of this document in any jurisdiction where action for that purpose is required. Accordingly, no Covered Bonds may be offered or sold, directly or indirectly, and neither this Offering Circular nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Offering Circular or any Covered Bonds may come must inform themselves about, and observe, any such restrictions on the distribution of this Offering Circular and the offering and sale of Covered Bonds. In particular, there are restrictions on the distribution of this Offering Circular and the offer or sale of Covered Bonds in the United States, the European Economic Area (**EEA**) (including the United Kingdom and Iceland), Japan and Hong Kong, see "*Subscription and Sale and Selling Restrictions*".

This Offering Circular has been prepared on the basis that subject to the existing currency restrictions in place at each time, any offer of Covered Bonds in any Member State of the EEA or contracting party to the Agreement of the EEA (a **Member State**) which has implemented the Prospectus Directive (each, a **Relevant Member State**) must be made pursuant to an exemption under the Prospectus Directive from the requirement to publish a prospectus for offers of Covered Bonds. Accordingly any person making or intending to make an offer in that Relevant Member State of Covered Bonds may only do so in circumstances in which no obligation arises for the Issuer or any Dealer to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive, in each case, in relation to such offer. Neither the Issuer nor any Dealer has authorised, nor do they authorise, the making of any offer of Covered Bonds in circumstances in which an obligation arises for the Issuer or any Dealer to publish or supplement a prospectus for such offer.

In making an investment decision, investors must rely on their own examination of the Issuer and the terms of the Covered Bonds being offered, including the merits and risks involved. The Covered Bonds have not been approved or disapproved by the United States Securities and Exchange Commission or any other securities commission or other regulatory authority in the United States, nor have the foregoing authorities approved this Offering Circular or confirmed the accuracy or determined the adequacy of the information contained in this Offering Circular. Any representation to the contrary is unlawful.

None of the Dealers or the Issuer makes any representation to any investor in the Covered Bonds regarding the legality of its investment under any applicable laws. Any investor in the Covered Bonds should be able to bear the economic risk of an investment in the Covered Bonds for an indefinite period of time.

PRESENTATION OF INFORMATION

Capitalised terms which are used but not defined in any particular section of this Base Prospectus will have the meaning attributed to them in "*Terms and Conditions of the Covered Bonds*" or any section of this Base Prospectus.

In addition, in this Base Prospectus, all references to:

- **2015 Consolidated Financial Statements** means the audited consolidated annual financial statements of the Bank for the financial year ended 31 December 2015;
- **2014 Consolidated Financial Statements** means the audited consolidated annual financial statements of the Bank for the financial year ended 31 December 2014;
- References in this Base Prospectus to the **Group** are to the Bank and its consolidated subsidiaries, taken as a whole;
- **U.S. dollars**, **U.S**.$" and "$ refer to **United States dollars**;
- **ISK**, **krona** or **kronur** refer to **Icelandic Krona**;
- **Sterling** and **£** refer to pounds sterling; and
- **euro** and **€** refer to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty on the functioning of the European Union, as amended.

Certain figures and percentages included in the Base Prospectus have been subject to rounding adjustments; accordingly, figures shown in the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be an arithmetic aggregate of the figures which precede them

STABILISATION

In connection with the issue of any Tranche of Covered Bonds, the Dealer or Dealers (if any) named as the Stabilisation Manager(s) (or persons acting on behalf of any Stabilisation Manager(s)) in the applicable Final Terms may over-allot Covered Bonds or effect transactions with a view to supporting the market price of the Covered Bonds of the Series (as defined below) of which such Tranche forms part at a level higher than that which might otherwise prevail. However, stabilisation may not may not necessarily occur. Any stabilisation action may begin on or after the date on which adequate public disclosure of the terms of the offer of the relevant Tranche of Covered Bonds is made and, if begun, may cease at any time, but it must end no later than the earlier of 30 days after the issue date of the relevant Tranche of Covered Bonds and 60 days after the date of the allotment of the relevant Tranche of Covered Bonds. Any stabilisation action or over-allotment shall be conducted in accordance with all applicable laws and rules.

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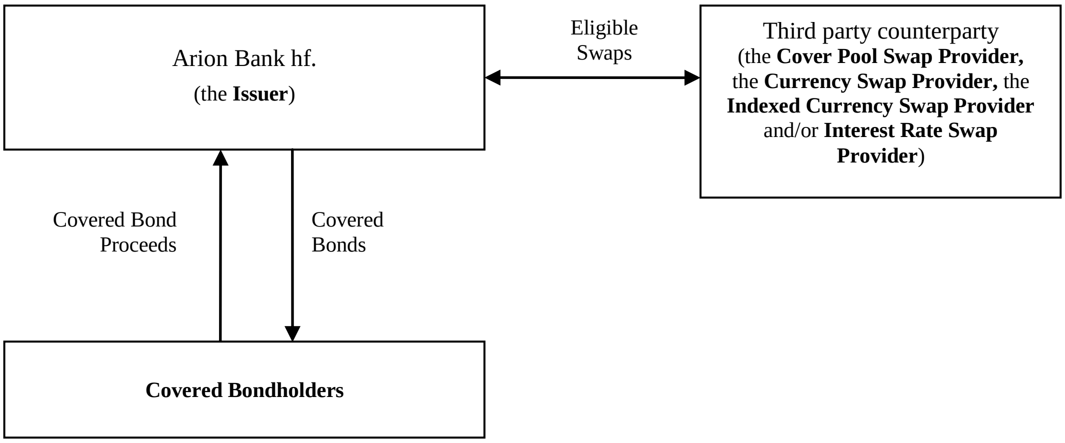
OVERVIEW OF THE PROGRAMME

The following is a brief overview only and should be read in conjunction with the rest of this Offering Circular and, in relation to any Covered Bond, in conjunction with the applicable Final Terms and, to the extent applicable, the Terms and Conditions of the Covered Bonds set out herein. Any decision to invest in the Covered Bonds should be based on a consideration of the Offering Circular as a whole, including the documents incorporated by reference.

This Overview constitutes a general description of the Programme for the purposes of Article 22.5(3) of Commission Regulation (EC) No 809/2004 implementing Directive2003/71/EC (the ***Prospectus Directive****).*



Words and expressions defined in "Form of the Covered Bonds" and "Terms and Conditions of the Covered Bonds" below shall have the same meanings in this overview. A glossary of certain defined terms is contained at the end of this Offering Circular.

Description:	€1,000,000,000 Covered Bond Programme

1. THE PARTIES

Issuer:	Arion Bank hf. (**Arion**), a leading universal Icelandic bank, whose business includes mortgage lending in Iceland, with total assets at 31 December 2015 of €142,840,155 million and net profit of €7,018,649 million for the financial year ended 31 December 2015. The Issuer holds a licence from the Icelandic Financial Supervisory Authority (**FME**) to conduct financing business as a commercial bank and a licence to issue Covered Bonds in accordance with the Icelandic Act on Covered Bonds no. 11/2008 (the **Icelandic Covered Bond Act**).
Arranger:	Barclays Bank PLC, acting through its investment bank (**Barclays**).
Dealers:	Barclays, UBS Limited, Deutsche Bank Aktiengesellschaft (**Deutsche Bank**), Arion and any other Dealers appointed in accordance with the Programme Agreement.
Independent Inspector (*„Sjálfstæður skoðunarmaður“)*:	The Issuer is required to appoint an independent inspector, and this appointment must be approved by the FME. The Independent Inspector will monitor the Register in accordance with the Icelandic Covered Bond Act and the Rules and verify that the valuation of collateral for debt instruments in the cover pool is based on the prescribed methodology. The independent inspector shall report regularly to the FME on his or her observations, and immediately inform the FME of any circumstances he or she becomes aware of, that could affect the FME's assessment of the Issuer. The initial independent inspector has been appointed pursuant to an agreement with KPMG ehf. (**KPMG**).
Cover Pool Swap Provider:	The Issuer may enter into swaps from time to time with third party counterparties to convert ISK interest payments received by the Issuer in respect of assets registered to the Cover Pool (other than derivative agreements with qualified counterparties which are registered to the Cover Pool (the **Eligible Swaps**)) into floating payments linked to the rate of interest under the Covered Bonds (the **Cover Pool Swap**).
Currency Swap Providers:	The Issuer may enter into currency swaps (each a **Currency Swap**) from time to time with third party counterparties (each, a **Currency Swap Provider**), subject to currency restrictions in place at each time, in order to hedge currency risks arising from

(a) Covered Bonds which are issued in currencies other than ISK and (b) assets (other than bonds as defined in Article 2 of the Icelandic Covered Bond Act which are issued by borrowers and as described in Article 5 of the Icelandic Covered Bond Act (**Mortgage Bonds**) and Eligible Swaps) which are registered to the Cover Pool and are denominated in currencies other than ISK.

Indexed Currency Swap Providers: The Issuer may enter into indexed currency swaps (each an **Indexed Currency Swap**) from time to time with third party counterparties (each, an **Indexed Currency Swap Provider**) in order to hedge currency risks arising from (a) Covered Bonds which are issued in currencies other than ISK and (b) assets which are registered to the Cover Pool and are denominated in ISK and inflation linked.

Interest Rate Swap Providers: The Issuer may enter into single currency interest rate swaps (each, an **Interest Rate Swap**) from time to time with third party counterparties (each, an **Interest Rate Swap Provider)** in order to hedge the Issuer's interest rate risks in ISK and/or other currencies to the extent that they have not been hedged by the Cover Pool Swap or a Currency Swap.

The Cover Pool Swap Provider, the Currency Swap Providers and the Interest Rate Swap Providers are together referred to as the **Swap Providers.** The Cover Pool Swap, each Currency Swap and each Interest Rate Swap are together referred to as the **Swaps**.

Fiscal Agent and Transfer Agent: The Bank of New York Mellon, London Branch.

Listing Agent and Registrar: The Bank of New York Mellon Luxembourg S.A..

ISD Agent: Arion Bank hf.

2. KEY FEATURES

FME Licensing: The Issuer is required to hold a licence from the FME to conduct financing business as a commercial bank as well as a licence to issue Covered Bonds in accordance with the Icelandic Covered Bond Act.

Status of the Covered Bonds: The Covered Bonds constitute direct, unconditional and unsubordinated obligations of the Issuer to pay a specified amount and have been issued in accordance with the Icelandic Covered Bond Act. Claims in respect of the Covered Bonds and any other securities issued by the Issuer, subject to any claims due to derivative agreements concluded in accordance with the Icelandic Covered Bond Act which will rank senior, and shall have the benefit of priority of claim to a cover pool of certain registered eligible assets pursuant to the Icelandic Covered Bond Act (the **Cover Pool**).

References to **Covered Bondholders** are to the Covered

Bondholders and the holders of any other securities issued by the Issuer in accordance with the Icelandic Covered Bond Act. The Covered Bonds will be endorsed to show that they have the benefit of priority of claim to the Cover Pool (junior to costs incurred in connection with the operation, management, collection and realisation of the Cover Pool, and claims due to derivative agreements concluded in accordance with the provisions of the Icelandic Covered Bond Act) and have been registered in the Register.

The Register: The rights of priority that covered bondholders and swap providers with respect to the Covered Bonds arise from a registration being made in a register kept by the Issuer, containing details of the Covered Bonds and the assets in the cover pool.

Certain Restrictions: Each issue of Covered Bonds in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time.

Composition of the Cover Pool: The Cover Pool will consist primarily of loans which are secured on interests in residential property, industrial, office or commercial property, and agricultural property, claims which the Issuer holds, or may acquire, against providers of Covered Bond swaps and certain substitute assets. The assets comprising the Cover Pool will comply with requirements set out in the Icelandic Covered Bond Act. See "*Overview of the Icelandic Legislation Regarding Covered Bonds – Eligible Cover Pool Assets*" below.

Programme Size: Up to €1,000,000,000 (or its equivalent in other currencies) outstanding at any time. The Issuer may increase the amount of the Programme in accordance with the terms of the Programme Agreement.

Distribution: Covered Bonds may be distributed by way of private or public placement and in each case on a syndicated or non-syndicated basis.

Currencies: Subject to any applicable legal or regulatory restrictions including the rules on foreign exchange issued by the Central Bank of Iceland (the **Central Bank**), any currency agreed between the Issuer and the relevant Dealer including but not limited to U.S. Dollars, Euro, Sterling, Japanese Yen, Danish Krone, Norwegian Krone and Icelandic Krona.

Form of Covered Bonds: The Covered Bonds will be issued either (i) in bearer form, (ii) in registered form or (iii) in the case of ISD Covered Bonds, in uncertificated and dematerialised book entry form registered in the ISD.

ISD Covered Bonds will not be evidenced by any physical note or document of title. Entitlements to ISD Covered Bonds will be evidenced by registration in the registers between the direct and indirect accountholders at the ISD.

Terms of the Covered Bonds:	The terms of the Covered Bonds will be set out in the Terms and Conditions of the Covered Bonds, as completed by the applicable Final Terms.
Redenomination:	Subject to any applicable legal or regulatory restrictions, the applicable Final Terms may provide that certain Covered Bonds may be redenominated in euro. The relevant provisions applicable to such redenomination are contained in Condition 5 of the Terms and Conditions of the Covered Bonds.
Maturities:	Such maturities as may be agreed between the Issuer and the relevant Dealer, subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Currencies.
Issue Price:	Covered Bonds may be issued on a fully-paid and at an issue price which is at par or at a discount to, or premium over, par.
Interest:	The following types of Covered Bond may be issued: (a) Covered Bonds which bear interest at a fixed rate or a floating rate; (b) Covered Bonds which do not bear interest; and (c) Covered Bonds which bear interest, and/or the redemption amount of which is, calculated by reference to a specified factor such as movements in an index or a currency exchange rate, changes in share or commodity prices or changes in the credit of an underlying entity. In addition, Covered Bonds which have any combination of the foregoing features may also be issued. Interest periods, rates of interest and the terms of and/or amounts payable on redemption may differ depending on the Covered Bonds being issued and such terms will be specified in the applicable Final Terms.
Fixed Rate Covered Bonds:	Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer and on redemption, and will be calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer.
Floating Rate Covered Bonds:	Floating Rate Covered Bonds will bear interest at a rate determined: (a) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the 2006 ISDA Definitions (as published by the International Swaps and Derivatives Association, Inc., and as amended and updated as at the Issue Date of the first Tranche of the Covered Bonds of the relevant

Series); or

(b) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or

(c) on such other basis as may be agreed between the Issuer and the relevant Dealer.

The margin (if any) relating to such floating rate will be agreed between the Issuer and the relevant Dealer for each Series of Floating Rate Covered Bonds.

Inflation Linked Non-Amortising Covered Bonds: Inflation Linked Non-Amortising Covered Bonds will bear interest adjusted for inflation and payable on such date or dates as may be agreed with the Issuer. Inflation Linked Non-Amortising Covered Bonds will be redeemed by payment of one or more amounts adjusted for inflation in accordance with the provisions set out in Condition 8.4, constituting payments of principal in relation to such Inflation Linked Non-Amortising Covered Bonds.

Inflation Linked Covered Bonds: Inflation Linked Covered Bonds will bear interest which will be payable on such date or dates as may be agreed with the Issuer. Inflation Linked Covered Bonds will be redeemed by payment of one or more amounts, adjusted for indexation in accordance with the provisions set out in Conditions 6.3 and 8.3, on such date or dates as may be agreed between the Issuer and the relevant Dealer.

Other provisions in relation to Floating Rate Covered Bonds, Inflation Linked Covered Bonds and Inflation Linked Non-Amortising Covered Bonds: Floating Rate Covered Bonds may also have a maximum interest rate, a minimum interest rate or both or a maximum interest amount. Interest on Floating Rate Covered Bonds in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer, will be payable on the relevant Interest Payment Dates, and will be calculated on the basis of such Day Count Fraction, as may be agreed between the Issuer and the relevant Dealer.

Inflation Linked Covered Bonds and Inflation Linked Non-Amortising Covered Bonds may have variable interest amounts and principal amounts. Interest on Inflation Linked Covered Bonds and Inflation Linked Non-Amortising Covered Bonds in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer, will be payable on the relevant Interest Payment Dates. The interest payable will be calculated in accordance with the formula set out in Condition 6.3 for Inflation Linked Covered Bonds, and Condition 6.4 for Inflation Linked Non-Amortising Covered Bonds.

Zero Coupon Covered Bonds: Zero Coupon Covered Bonds will be offered and sold at a discount to their nominal amount and will not bear interest.

Instalment Covered Bonds: Instalment Covered Bonds may be issued on an instalment basis in which case such Covered Bonds will be redeemed in the

Instalment Amounts and on the Instalment Dates specified in the applicable Final Terms.

Redemption: The applicable Final Terms will indicate either that the relevant Covered Bonds cannot be redeemed prior to their stated maturity (other than in specified instalments, if applicable, or for taxation reasons) or that such Covered Bonds will be redeemable at the option of the Issuer and/or the Covered Bondholders. The terms of any such redemption, including notice periods, any relevant conditions to be satisfied and the relevant redemption dates and prices will be indicated in the applicable Final Terms.

The applicable Final Terms may provide that Covered Bonds are redeemable in two or more instalments of such amounts and on such dates as are indicated in the applicable Final Terms.

Denomination of Covered Bonds: The Covered Bonds will be issued in such denominations as may be agreed between the Issuer and the relevant Dealer save that the minimum denomination of each Covered Bond will be such amount as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the relevant Specified Currency, and save that the minimum denomination of each Covered Bond admitted to trading on a regulated market within the EEA or offered to the public in a Member State of the EEA in circumstances which require the publication of a prospectus under the Prospectus Directive will be €100,000 (or, if the Covered Bonds are denominated in a currency other than euro, the equivalent amount in such currency).

Taxation: All payments in respect of the Covered Bonds will be made without deduction for or on account of withholding taxes imposed by any relevant tax jurisdiction. In the event that any such deduction is made, the Issuer will, save in certain limited circumstances detailed in Condition 9 of the Terms and Conditions of the Covered Bonds, be required to pay additional amounts to cover the amounts so deducted.

Following insolvency of the Issuer: In the event of insolvency of the Issuer, the Covered Bonds of each Series will not become due and payable according to the Icelandic Covered Bond Act. The winding up committee shall continue to fulfil the Issuer's commitments from the cover pool of assets. The Covered Bondholders will have priority recourse to the assets in the Cover Pool (junior to costs incurred in connection with the operation, management, collection and realisation of the Cover Pool, and claims due to derivative agreements concluded in accordance with the provisions of the Icelandic Covered Bond Act), and rights to proceed directly against, amongst others, the Issuer.

Use of Proceeds: The net proceeds from each issue of Covered Bonds will be applied by the Issuer for its general corporate purposes, which include making a profit. If, in respect of any particular issue of Covered Bonds there is a particular identified use of proceeds,

	this will be stated in the applicable Final Terms.
Rating:	The Covered Bonds issued under the Programme may or may not have a rating by any of Moody's Investors Service Limited (**Moody's**), Fitch Ratings Ltd. (**Fitch**) and Standard & Poor's Credit Market Services Europe Limited (**S&P**) and this will be stated in the applicable Final Terms. Whether or not each credit rating applied for in relation to relevant Series of Covered Bonds will be issued by a credit rating agency established in the European Union and registered under Regulation (EC) No. 1060/2009 (as amended) will be disclosed in the Final Terms. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.
Clearing Systems:	The Covered Bonds issued under the Programme will be cleared through Euroclear, Clearstream, Luxembourg or the ISD, and/or any other clearing system as may be specified in the relevant Final Terms.
Listing and Admission to Trading:	Application has been made to the CSSF to approve this document as a base prospectus. Application has also been made to the Luxembourg Stock Exchange for Covered Bonds issued under the Programme to be admitted to trading on the Luxembourg Stock Exchange's regulated market and to be listed on the Official List. Covered Bonds may be listed or admitted to trading, as the case may be, on other or further stock exchanges or markets agreed between the Issuer and the relevant Dealer in relation to the Series. Covered Bonds which are neither listed nor admitted to trading on any market may also be issued. The applicable Final Terms will state whether or not the relevant Covered Bonds are to be listed and/or admitted to trading and, if so, on which stock exchanges and/or markets.
Passporting:	Once this Offering Circular has been approved by the CSSF in Luxembourg, it can be passported into Iceland and thereafter used for the admission to trading of the Covered Bonds in Iceland.
Governing Law:	The Covered Bonds (other than the ISD Covered Bonds) and any non-contractual obligations arising out of or in connection with them, will be governed by, and construed in accordance with, English law, except for provisions relating to the Condition 3 (*Status of the Covered Bonds*). Condition 3 of the Covered Bonds and the ISD Covered Bonds will be governed by Icelandic law.
Selling Restrictions:	There are restrictions on the offer, sale and transfer of the Covered Bonds in the United States, Japan, Hong Kong and the EEA (including the United Kingdom, Norway, Denmark, Sweden, the Netherlands and Iceland) and such other restrictions

as may be required in connection with the offering and sale of a particular Tranche of Covered Bonds. See "*Subscription and Sale and Selling Restrictions*" below.

Risk Factors:	There are certain factors that may affect the Issuer's ability to fulfil its obligations under Covered Bonds issued under the Programme, including the exposure of the Issuer to credit risk, market risk, operational risk and liquidity risk. In addition, there are certain factors which are material for the purpose of assessing the risks associated with Covered Bonds issued under the Programme such as the fact that the Covered Bonds may not be a suitable investment for all investors, certain risks relating to the structure of particular Series of Covered Bonds and certain market risks.

ISSUE OF COVERED BONDS FROM THE PROGRAMME

Under the Programme, and subject to currency restrictions in place at each time, the Issuer may from time to time issue Covered Bonds denominated in any currency, subject as set out herein. An overview of the terms and conditions of the Programme and the Covered Bonds appears above. The applicable terms of any Covered Bonds will be agreed between the Issuer and the relevant Dealer prior to the issue of the Covered Bonds and will be set out in the Terms and Conditions of the Covered Bonds endorsed on, attached to, or incorporated by reference into, the Covered Bonds, as completed by the applicable Final Terms attached to, or endorsed on, such Covered Bonds (except in the case of ISD Covered Bonds), and (in the case of the ISD Covered Bonds) which are deposited with the ISD and the ISD Agent as more fully described under "*Form of the Covered Bonds*" below.

This Offering Circular and any supplement to the Offering Circular will only be valid for the admission to trading of Covered Bonds on the regulated market of the Luxembourg Stock Exchange during the period of 12 months from the date of the approval of this Offering Circular in an aggregate nominal amount which, when added to the aggregate nominal amount then outstanding of all Covered Bonds previously or simultaneously issued under the Programme, does not exceed €1,000,000,000 or its equivalent in other currencies. For the purpose of calculating the euro equivalent of the aggregate nominal amount of Covered Bonds issued under the Programme from time to time:

(a) the euro equivalent Covered Bonds denominated in another Specified Currency (as specified in the applicable Final Terms in relation to the relevant Covered Bonds, described under "*Form of the Covered Bonds*", below) shall be determined, at the discretion of the Issuer, either as of the date on which agreement is reached for the issue of Covered Bonds or on the preceding day on which commercial banks and foreign exchange markets are open for general business in London, in each case on the basis of the spot rate for the sale of the euro against the purchase of such Specified Currency in the London foreign exchange market quoted by any leading international bank selected by the Issuer on the relevant day of calculation;

(b) subject to any existing legal or regulatory restrictions in Iceland, the euro equivalent of Inflation Linked Covered Bonds and Inflation Linked Non-Amortising Covered Bonds (each as specified in the applicable Final Terms in relation to the relevant Covered Bonds, described under "*Form of the Covered Bonds*", below) shall be calculated in the manner specified above by reference to the original nominal amount on issue of such Covered Bonds; and

(c) the euro equivalent of Zero Coupon Covered Bonds (as specified in the applicable Final Terms in relation to the relevant Covered Bonds, described under "*Form of the Covered Bonds*", below) and other Covered Bonds issued at a discount or a premium shall be calculated in the manner specified above by reference to the net proceeds received by the Issuer for the relevant issue.

RISK FACTORS

The following factors may affect the ability of the Bank to fulfil its obligations under Covered Bonds issued under the Programme. Most of these factors are contingencies which may or may not occur and the Bank is not in a position to express a view on the likelihood of any such contingency occurring.

In addition, factors which are material for the purpose of assessing the market risks associated with Covered Bonds issued under the Programme are also described below.

The Issuer believes that the factors described below represent the principal risks inherent in investing in the Covered Bonds issued under the Programme, but the inability of the Bank to pay interest, principal or other amounts on or in connection with any Covered Bonds may occur for other reasons which may not be considered significant risks by the Bank based on information currently available to it or which it may not currently be able to anticipate. Prospective investors should also read the detailed information set out elsewhere in this Offering Circular and reach their own views prior to making any investment decision.

Factors that may affect the Issuer's ability to fulfil its obligations under Covered Bonds issued under the Programme

The Issuer's business is materially affected by Iceland's economy which remains vunerable to a range of domestic and international economic and political factors

The Bank currently conducts substantially all of its business in Iceland. Accordingly, its performance is influenced by the level and cyclical nature of business activity in Iceland, which in turn has been and will continue to be affected by both domestic and international economic and political factors.

Following the collapse of the Icelandic banking system in October 2008 resulting in the winding up proceedings of Glitnir Bank hf. ("**Glitnir**"), Landsbanki Islands hf. (later renamed LBI hf.) ("**Landsbanki**") and Kaupthing Bank hf. ("**Kaupthing**") and a severe recession beginning in the fourth quarter of 2008, Iceland's economy has shown some signs of recovery since 2011, with gross domestic product ("**GDP**") growth of 1.2% in 2012, 4.4% in 2013, 1.9% in 2014, 4.2% in 2015 and 6.2% in the first nine months of 2016 *(source: Statistics Iceland)*. However, no assurance can be given that this recovery will be sustained, particularly in view of the difficulties in resolving the problems arising out of the financial crisis.

The domestic factors that could affect Iceland's recent economic recovery include:

- *Fluctuations in the value of Icelandic Krona:* In the first nine months of 2016, Icelandic Krona appreciated significantly by 15% against U.S. dollar and 16% against euro (source: *Bloomberg*). The continued appreciation in the value of Icelandic Krona could lead to decreased demand for Icelandic exports or services, including tourism (*i.e.*, as a source of foreign income), and could make Iceland less competitive relative to other economies and currencies. Alternatively, a devaluation of Icelandic Krona and an increase in the cost of imports could diminish consumer confidence and lead to contraction in certain sectors, such as real estate.

- *Easing of the Capital Controls:* In response to the financial crisis in 2008, the Parliament of Iceland (*Alþingi*) introduced capital controls in November 2008 with the view of stabilising the foreign exchange rate of Icelandic Krona (the "**Capital Controls**"). The Central Bank of Iceland (*Seðlabanki Íslands*) (the "**Icelandic Central Bank**") has an important role with respect to the Capital Controls, including promulgation of rules and regulations and granting of exemptions. As of the date of this Base Prospectus, limited exemptions from the Capital Controls have been granted by the Icelandic Central Bank, allowing, among other things, certain types of pension funds to engage in foreign currency investments and greater ability for individuals and corporates to undertake foreign investment or purchase property, subject to satisfaction of certain conditions. In October 2016, amendments to Act No. 87/1992 on Foreign Exchange, as amended (the "**Foreign Exchange Act**"), became effective, which were a part of the Icelandic government's liberalisation strategy initially introduced in June 2015. The purpose of such amendments was to ease the Capital Controls for households and businesses by increasing the authorised amounts for foreign exchange transactions and cross-border movement of capital as well as removing specific restrictions that have applied to foreign exchange transactions and cross-border movement of capital. See "*—Existing currency restrictions-Icelandic rules on foreign exchange*". The amendments became effective in October 2016 and January 2017. While the Icelandic government and the Icelandic Central Bank have announced plans to further ease the Capital Controls, the Capital Controls may continue to be in place for some time and there is currently no set date for their complete lifting. See "*—The Capital Controls restrict the manner in which the Bank conducts its business and may result in abnormal pricing and financial bubbles in Iceland*".

- *Lack of foreign direct investment:* The introduction of the Capital Controls has had a material adverse effect on inflows of foreign capital into Iceland. No assurance can be given that sufficient levels of foreign direct investment in Iceland will materialise following the easing or complete lifting of the Capital Controls, which may result in fiscal and balance of payments deficits and a worsening of Iceland's economic and fiscal positions.

- *Inflation:* While inflation currently remains within the Icelandic Central Bank's target rate of 2.5% per annum, the Icelandic Central Bank's current inflation outlook is that the rate of inflation could rise in excess of the target rate in 2017, 2018 and 2019 *(source: Icelandic Central Bank)*. In the view of the International Monetary Fund (the "**IMF**"), inflation was being contained by falling import prices and appreciation of Icelandic Krona. Wage growth is expected to erode competitiveness over time, and an increase in salary costs as a result of inflation could have a direct impact on the Bank's profitability. In addition, the current account surplus is expected to shrink steadily. In the view of the IMF, these processes, if not sufficiently restrained by macroeconomic policies, could overheat the economy *(source: IMF)*.

- *Other factors:* Other domestic factors also pose significant risks to Iceland's economic and fiscal position, including the high level of corporate and household debt, political factors (particularly in light of public sentiment regarding the financial sector), the ongoing restructuring of the financial sector and winding down of Kaupthing, Glitnir and Landsbanki and as well as levels of consumption.

Iceland's economy also remains vulnerable to external factors, including conditions in Europe and other international economic and political developments, many of which are outside the control of the Icelandic government. In particular, instability or deterioration of the international financial markets, whether as a result of the United Kingdom's decision to exit the European Union or other events, could have a material adverse effect on the recovery of the Icelandic economy, especially given the relatively small size of the Icelandic economy and its dependence on trade with external partners, particularly the European Union. Although the financial sector in Iceland is still subject to the Capital Controls and is mostly funded by domestic deposits, a global recession is likely to affect demand for, and the price of, Iceland's most important products and exports (*i.e.*, tourism, seafood and aluminium).

The occurrence of any of the above factors could adversely affect Iceland's economic recovery, which in turn could have a material adverse effect on the Bank's business, prospects, financial position , results of operations and/or cash flows and its ability to make payments in respect of the Covered Bonds.

The Bank's operations are exposed to Iceland's key industry sectors, particularly tourism, seafood, aluminium, energy and real estate

Iceland's economy depends in large measure on a select number of industry sectors. In terms of exports, which accounted for 53% of Iceland's GDP in 2015 (*source: Statistics Iceland)*, the largest are tourism (*i.e.*, as a source of foreign income), seafood, aluminium and other industrial goods and services (including energy), which accounted for 31%, 23%, 20% and 18%, respectively, of total exports in 2015 *(source: IMF, Statistics Iceland)*. In addition, growth in the real estate industry sector has recently helped to fuel the domestic economy and, as of 30 September 2016, loans in the real estate industry sector accounted for 16% of the Bank's customer loan portfolio (the "**customer loan portfolio**").

Key risks in these industry sectors include:

- *Tourism:* In the wake of the financial crisis in 2008, the Icelandic government approved a new public strategy for tourism in Iceland in recognition of tourism's potential as a means to diversify and stimulate national, regional and local economic growth as well as to create jobs, attract foreign direct investment and earn foreign currency income. As a result, the tourism industry sector has emerged in recent years as an important contributor to Iceland's GDP, with the number of tourists increasing 24% in 2014, 30% in 2015 and 34% in the first nine months of 2016 (*source: Statistics Iceland*). In view of its contribution to the Icelandic economy, any decline of the Icelandic tourism industry sector, whether as a result of global economic downturn, natural disasters, significant appreciation of Icelandic Krona or otherwise, could have an adverse impact on the Icelandic economy.

- *Seafood:* Although Iceland's exports of other products have increased, seafood remains a principal export for Iceland. The principal focus of the Icelandic seafood industry sector is the fishing and processing of seafood species. The seafood industry in Iceland therefore depends on the availability of plentiful stocks of various seafood species and the international demand for seafood, and any decline in stocks, a decrease in quotas for a particular seafood species, a decrease in international demand or a significant appreciation of Icelandic Krona can have a material adverse effect on the seafood industry sector.

- *Aluminium:* Iceland's aluminium industry sector has developed as a result of the availability of extensive, relatively inexpensive renewable energy sources to support energy-intensive aluminium smelting operations. Consequently, aluminium (smelted from imported raw materials) has become a principal component of Iceland's exports. Should the price of aluminium decline, to the point where it is no longer economical for aluminium producers to ship raw materials for smelting in Iceland, or if aluminium producers are able to find equivalent or cheaper sources of energy for their smelting operations, Iceland's aluminium exports could decline.

- *Energy:* According to the National Energy Authority of Iceland (*Orkustofnun*), nearly all stationary energy in Iceland is derived from renewable sources, such as hydro, wind and geothermal sources, and Iceland has become a key exporter of know-how regarding renewable energy sources. If Iceland is not able to keep up with the pace of worldwide developments in energy technology, for example, due to a shortage of skilled technicians or a lack of educational programmes specialising in energy, or if foreign investment in Icelandic energy projects and initiatives is not sufficient for its projected growth, Iceland's advantage in the energy industry sector could be impaired.

- *Real estate:* As tourism and the Icelandic population continue to increase, and assuming continued low levels of unemployment in Iceland, there will be a corresponding need for additional real estate development. For example, the Research subdivision of The Bank estimates that between 8,000 and 10,000 extra houses will be needed before 2020. However, any destabilisation of the underlying factors which are driving this increased demand for real estate, such as a decline in tourism or unexpected macroeconomic event increasing unemployment, could have a material adverse effect on the real estate industry sector in Iceland.

As a universal relationship bank with substantially all of its operations in Iceland, a decline in any of these industry sectors as a result of occurrence of any of the above factors could, for example, result in higher levels of problem loans (defined as loans more than 90 days past due but not impaired and other problem (*i.e.*, individually impaired)) loans, and provisions for losses on such problem loans (particularly in the Corporate Banking division), reduced demand for mortgage loans (in the Retail Banking division) and a reduction of transactions executed for customers. In addition, a decline in any of these industry sectors may affect the broader Icelandic economy. Accordingly, a decline in any of the key industry sectors may have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of the Covered Bonds.

Public sentiment and political activity in Iceland could impair the Bank's operations

Due to the financial crisis in 2008 and the subsequent deep recession in Iceland, public sentiment towards the banking sector has at times been negative. Any such negative sentiment could ultimately be reflected in political and legislative decisions having material adverse effects on the Bank. One possibility which has been discussed in Iceland is the potential for a law requiring the separation of commercial banking activities from investment banking activities, which could require the Bank to divest or otherwise restructure some of its operations. Although no such requirement has yet been enacted, no assurance can be given that such a law or similar or related measures will not be proposed and ultimately enacted, which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of the Covered Bonds.

The Bank is exposed to significant liquidity risk

Banking institutions are exposed to liquidity risk, resulting from the fact that the maturity of assets (typically loans) exceeds the maturity of liabilities (the majority of which are demand deposits or otherwise short term) or might not otherwise be adequately matched with the maturity profile of other sources of funding.

The Bank's primary source of funding has historically been deposits from individuals, corporations and financial institutions, although it also accesses international and domestic capital markets for funding through bond issuances under its multicurrency EUR 2,000,000,000 medium term euro note programme (the "**EMTN Programme**") and covered bond facilities. For additional information on the Group's deposits, see "*Risk Management—Liquidity Risk*".

The Bank has recently increased the maturity profile of its liabilities, strengthened its liquidity reserve and converted a large portion of its demand deposits to term deposits (with 66.8% of the Bank's deposits being on demand as of 30 September 2016, as compared to over 90% as of 31 December 2009). However, no assurance can be given that the Bank will continue to be successful in converting its demand deposits to term deposits or will otherwise be able to increase the maturity profile of its funding.

The Bank's non-deposit funding primarily consists of notes issued under the EMTN Programme that are denominated, among others, in euro, Norwegian krone ("**NOK**" or "**Norwegian Krone**") and U.S. dollars and bonds issued under the Bank's covered bond facilities (including covered bonds previously issued by Kaupthing and assured by the Bank in January 2012), other loans and equity funding.

The Bank has recently sought to further diversify its funding profile through increased debt issuances and will continue to do so if its deposit base declines or fails to grow relative to any increases in its lending profile, as there will be a natural limit on the scope for growth in deposits in view of Iceland's relatively small economy and in view of competition for deposits with other banks and with pension funds. See "*Industry Overview—Corporate Banking*". The Bank's loan-to-deposit ratio was 166% as of 30 September 2016 (129% excluding covered bonds), as compared to 145.0% as of 31 December 2015 (116.0% excluding covered bonds) and 142.3% as of 31 December 2014 (113.9% excluding covered bonds) and, as a result, the Bank continues to rely on non-deposit funding to fund its customer loan portfolio. The ability of the Bank to access the domestic and international capital markets depends on a variety of factors, including market conditions, the general availability of credit, the volume of trading activities and rating agencies' and investors' assessment of the Bank's credit strength. These and other factors could limit the Bank's ability to raise funding in the capital markets, which could in turn result in an increase in its cost of funding or could have other material adverse effects on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of the Covered Bonds.

Moreover, as the Capital Controls are eased, the Bank's funding could also be adversely affected by the withdrawal of deposits denominated in Icelandic Krona by customers who are currently restricted to some extent from doing so due to the Capital Controls. The Icelandic government has stated its intention to manage the easing of the Capital Controls with a view to mitigating the risk of capital flight from such customers. However, no assurance can be given that the Icelandic Central Bank will be able to halt capital flight as the Capital Controls are eased.

To the extent that the Bank fails to match more closely the maturity profiles of its assets and liabilities or otherwise ensure that its funding grows in line with any growth in its customer loan portfolio, the Bank will continue to be exposed to a material risk that it may be unable to repay its funding or will only be able to do so at excessive cost, which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of the Covered Bonds.

The Bank is exposed to a range of other typical financial institution market risks, including interest rate risk, equity price risk and inflation risk

As a financial institution, the Bank is exposed to various market risks, including interest rate risk, equity price risk and inflation risk. The Bank's exposure to these market risks arises from imbalances on the Bank's balance sheet as well as in market making activities and position taking in certain securities traded by it. The Bank's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances on the Bank's balance sheet but to accept limited market risk in its trading book. The market risk in the trading book arises from proprietary trading activities, whereas market risk in the banking book arises from mismatches in assets and liabilities, primarily in relation to currencies, maturities and interest rates. The results of operations of the asset management operations of the Bank are also subject to market risk, as fluctuations in the markets in which the asset management operations of the Bank hold assets under management can have a significant impact on their results of operations. The Bank's proprietary trades are largely in Icelandic treasury notes and housing fund bonds and, to a limited extent, listed equity securities. The Bank has implemented a number of position limits and other controls designed to limit its trading book exposure, but no assurance can be given that these controls will be effective in all circumstances. The Bank is exposed to the risk that these controls do not prove to be effective in all circumstances and that the Bank could therefore experience material losses in its trading book. In addition, to the extent that these securities are marked to market, the Bank could experience significant fluctuations in its consolidated income statement as a result of movements in the market value of these securities.

In relation to its balance sheet, the Bank's operations are subject to interest rate risk associated with mismatches between its interest-bearing assets and its interest-bearing liabilities. The principal mismatch arises from the Bank's fixed interest liabilities as against its floating rate assets. The Bank also faces interest rate risk between its interest-bearing assets and interest-bearing liabilities due to different floating rate calculations in different currencies.

The current environment of particularly low interest rates has resulted in interest-earning assets (in particular residential mortgage loans) generating lower yields upon origination or refinancing and other loans and securities held also generating lower levels of interest income when compared to historical levels. In a period of changing interest rates, the Bank's level of interest expense may increase more rapidly than the interest it earns on its loans and other assets. Unfavourable market movements in interest rates (for example, a prolonged period of flatter than usual interest rate curves, a stronger than expected rise in interest rates, in certain circumstances negative interest rates or an inverse yield curve) could materially adversely affect earnings and current and future cash flows. Changes in interest rates may also negatively affect the value of the Bank's assets and its ability to realise gains or avoid losses from the sale of such assets, all of which would ultimately affect the Bank's net results.

The Bank's own account equity price risk principally arises as a result of the fact that, through the loan restructuring process, it acquired significant shareholdings in a number of companies. See "*Issuer Description—History*". The Bank is exposed to inflation risk when there is a mismatch between its CPI-linked assets and liabilities. As of 30 September 2016, the total amount of the Bank's CPI-linked assets was ISK 337,428 million and the total amount of its CPI-linked liabilities was ISK 228,021 million. The Bank also has significant maturity mismatches in its CPI-linked assets and liabilities. Although the Bank has implemented a range of risk management procedures designed to control these risks, no assurance can be given that these controls will be effective in all circumstances, in which case the Bank could experience material losses. Any losses experienced by the Bank as a result of its market risk exposures could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of the Covered Bonds.

The Bank has a high proportion of inflation-linked loans and there is a risk that legislation might be imposed which varies the terms of these loans in a manner that is adverse to the Bank

A high proportion of the Bank's mortgage loans are inflation-linked. Under these loans, the monthly repayment increases if and to the extent that inflation in Iceland increases. Following the financial crisis in 2008, inflation in Iceland increased significantly. This resulted in higher payments falling due under inflation-linked loans at the same time as borrowers faced lower wages and less purchasing power. There was significant debate in Iceland focused on these loans in the period preceding the parliamentary elections in April 2013. The Icelandic government announced at the end of November 2013 an action plan aimed at reducing the country's housing debt. On the basis of the action plan, the Icelandic Parliament passed two new laws. Firstly, the Parliament passed Act no. 35/2014 on the adjustment of Mortgage Loans. The objective of this Act is to write down the principal of indexed residential mortgages. Secondly, the Parliament passed Act no. 40/2014, which amended the Pension Act no. 129/1997 and authorised households with residential mortgages, in the period between 1 July 2014 and 30 June 2017, to use payments which would otherwise go to a private pension fund to reduce the principal amount of their mortgages. This option is open to all residential mortgage holders regardless of the form of their mortgage. This action plan will be financed by an increase in the Bank Levy (as defined below - see "*Changes in tax laws or in their interpretation could harm the Bank's business*") that will increase the Bank's financial burden and decrease its profitability. There is a risk that additional legislation may be adopted or other government action taken to reduce the payment burden under inflation-linked mortgages. Should this occur, it would have a materially negative impact on the Bank's business, prospects, financial position, loan portfolio, financial condition and results of operations and/or cashflow and its ability to make payment in resepct of the Covered Bonds.

The Capital Controls restrict to some extent the manner in which the Bank conducts its business and may result in abnormal pricing and financial bubbles in Iceland

In response to the financial crisis, the Parliament of Iceland approved certain amendments to the Foreign Exchange Act that introduced the Capital Controls in 2008. See "*—Existing currency restrictions-Icelandic rules on foreign exchange*".

Under the Capital Controls, domestic parties, primarily investors, were restricted, and continue to be restricted to some extent, from transferring their funds and investing outside the Icelandic market, subject to certain exemptions. Consequently, domestic investors were confined to and focused their investments on Iceland, which entails various risks, including a risk for abnormal pricing and financial bubbles occurring within several sectors of the Icelandic market. This applies both to investments in shares of listed and unlisted companies, investment funds, various other financial instruments and real estate (primarily commercial). The Capital Controls also limit foreign direct investment into Iceland through restricting the conversion of foreign currency into Icelandic Krona.

The Icelandic Central Bank intends to gradually ease the Capital Controls, subject to satisfaction of three conditions: macroeconomic stability, an adequate level of foreign reserves and a sound financial system. In October 2016, the Parliament of Iceland approved amendments to the Foreign Exchange Act specifically aimed at individuals and investments of legal entities. However, it is uncertain when and if the Capital Controls will be lifted in full. Even if the Capital Controls were to be successfully lifted in full (*i.e.*, with no direct, unintended negative consequences, such as a significant devaluation of Icelandic Krona, a consequential rise in inflation and flight of capital), levels of foreign direct investment may be affected by a market perception that capital restrictions could be reintroduced in the future, which could limit growth prospects for the Icelandic economy and ultimately for the Bank, any of which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages

In addition to the basic corporate income tax rate of 20% in Iceland, the Bank is subject to certain other taxes which increase its effective tax rate and its effective cost of funding, which in turn can inhibit its ability to compete effectively with domestic and foreign lenders who are not subject to such additional taxes.

In particular, in December 2010, the Parliament of Iceland passed Act No. 155/2010 on Special Tax on Financial Institutions, pursuant to which certain types of financial institutions, including the Bank, are required to pay an annual levy (the "**Bank Levy**"), which, since the year ended 31 December 2013, has been calculated at 0.376% on the total debt of the Bank, excluding tax liabilities in excess of ISK 50.0 billion as of the end of the applicable period. Non-financial subsidiaries are exempt from the Bank Levy. Whereas the Bank Levy was originally introduced as a temporary measure, there is currently no fixed date for its removal and no assurance can be given as to whether the Bank Levy will be reduced, eliminated or increased further in the future. In addition, in December 2011, the Parliament of Iceland enacted Act No. 165/2011 on Financial Activities Tax, pursuant to which certain types of financial institutions, including the Bank, are currently required to pay a special additional 5.5% tax levied on all remuneration paid to employees. The Bank Levy and Act No. 165/2011 on Financial Activities Tax place an increased cost burden on the Bank and subject it to a competitive disadvantage relative to other lenders not subject to such taxes, including international banks, domestic pension funds and the Housing Financing Fund.

In addition, the Bank's results of operations could be harmed by changes in tax laws and tax treaties or the interpretation thereof, changes in corporate tax rates and the refusal of tax authorities to issue or extend advanced tax rulings. The unavailability of tax rulings could diminish the range of structured transactions the Bank can enter into with its customers.

Any additional tax could increase the Bank's cost of funding and operating costs generally, impair the ability of the Bank to compete effectively with other lenders and/or decrease the Bank's lending volumes and margins, any of which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

Iceland's banking system has been subject to restructuring and is relatively small given the size of the Icelandic economy, which is expected to result in limited opportunities for growth in the near term

Early in October 2008, the Icelandic banking system faced a serious banking crisis, as a consequence of which Kaupthing, Glitnir and Landsbanki were placed first into restructuring and later into winding up proceedings. As part of the restructuring of the banking sector, the FME transferred certain of their assets and liabilities, including their domestic deposits, into three newly established banks, Íslandsbanki hf. ("**Íslandsbanki**"), Landsbankinn hf. ("**Landsbankinn**") and the Bank, respectively, which hold a combined market share of 56% of loans to households, 77% of loans to corporates and 98% of deposits from customers as of 30 June 2016. The small size of the Icelandic economy and the ongoing restructuring of the Icelandic banking sector have affected and continue to affect the Icelandic banks.

Uncertainty about the quality of the loan assets held by the Bank, Íslandsbanki and Landsbankinn and the relatively high levels of problem loans on their balance sheets have been a risk to the business, prospects, financial position and results of operations of the Icelandic banks. Although the levels of problem loans on the balance sheets of the Bank, Íslandsbanki and Landsbankinn have declined from 42% as of 31 December 2009 to 2% as of 30 September 2016 *(source: Icelandic Central Bank)*, no assurance can be given that the rate of problem loans will not increase. Levels of problem loans, determination of loan values and the levels of write-offs will depend, in the medium term, on general economic developments and on the operating and financial condition of the particular borrowers as well as decisions by the Supreme Court of Iceland affecting the value of loans linked to foreign currencies. Worldwide financial and economic developments, in particular financial and economic developments in the United Kingdom and the other European countries that constitute Iceland's main trading partners, may also have an effect.

Given the relatively small size of the Icelandic economy and the short period of time since the financial crisis in 2008, Icelandic households and businesses are reluctant to engage in new lending activities and, as a result, the Icelandic banks are not expected to grow significantly through domestic lending in the near term. It is also unlikely that the Bank, Íslandsbanki or Landsbankinn will grow significantly through international operations in the near future. Each of the Bank, Íslandsbanki and Landsbankinn have begun to re-establish credit lines with foreign institutions which are beginning to give them access to foreign currency transactions, but only on a limited scale until the Capital Controls are completely lifted, which may not happen for a considerable time. Iceland's economy could be vulnerable to renewed disruptions, cessation or reversal of growth and a return to recession. Moreover, the Icelandic banks could also be adversely affected if other developments in the Icelandic economy or internationally result in slowing of growth in Iceland's economy or trigger a recession, any of which could in turn have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank may be unable to successfully implement its strategy or its strategy may not yield the anticipated benefits

The Bank's strategy is based on assumptions and expectations, including in respect of macroeconomic developments, interest rates, revenue, expenses and cost of risk and future demand for Bank's services, that may not prove valid. Also, the benefits and impact of the Bank's strategy could fall short of what the Bank anticipates. For example, the Bank might not be able to realise the full benefits of its lean banking or digitalisation initiatives, which could result in less than expected customer satisfaction improvements and cost reductions and, consequently, an impact on revenues and operating results, respectively. In addition, the expansion of Valitor Holding hf.'s ("**Valitor**") (a subsidiary of the Bank) operations and the integration of Vörður Tryggingar hf. ("**Vörður**") might take longer or cost more than expected and not realise the currently expected benefits. For additional information on the Bank's strategy, see "*Business Overview—Strategy*".

Since the global financial crisis in 2008, macroeconomic volatility has made it more difficult to predict GDP development in many economies, resulting in frequent modifications to growth expectations published by economic research institutions as well as in adjustments by market research specialists, sometimes giving rise to significant revisions to growth expectations for specific markets. As a result, many financial institutions, including the Bank, may find it difficult to accurately model and predict the prospects for their businesses and set viable financial targets, and it may be difficult for investors to use historical financial results as an indicator for future results. Any failure by the Bank to accurately predict the macroeconomic developments, interest rates, revenue, expenses and cost of risk and/or future demand for Bank's services could lead to misjudgements with respect to its strategy and increase the risk of failed implementation. If the Bank's strategy is not implemented successfully or if the Bank's strategy does not yield the anticipated benefits, this could have a material adverse effect on the Group's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank is exposed to competition, and expects that this competition will increase as Iceland's economy recovers

The Icelandic banking sector is dominated by the Bank, Íslandsbanki and Landsbankinn, the latter two being wholly owned by the Icelandic government, but also includes other commercial banks and savings banks, the Housing Financing Fund, a provider of financing for residential housing in Iceland, and pension funds, which have increased their mortgage lending to individuals at aggressive interest rates, partially as a result of the fact that they are not subject to the Bank Levy. Pension funds in Iceland also provide competition for deposits, as a vast proportion of individuals' savings are held in pensions rather than in bank deposits, and a significant portion of payments to pension funds, representing a proportion of salary and a contribution by employers, are required by law. Pension funds also represent a significant source of the Bank's funding in Icelandic Krona as purchasers of the Bank's covered bonds. In addition, in respect of Valitor's operations, the market for card and electronic payments is highly competitive and has many players, including dedicated payment processing companies, financial institutions and non-traditional payment processors, such as PayPal. Valitor's main competitor in the Icelandic card and electronic payments market is Borgun, a card issuing and acquiring subsidiary of Íslandsbanki. As Valitor expands outside of Iceland, it also faces increasing competition from global card issuing and acquiring companies, such as Worldpay and Barclaycard (a division of Barclays Bank) which have an established presence in many markets where Valitor seeks to expand, including the United Kingdom.

As Iceland's economy continues to recover and demand for new lending and other banking products increases, the Bank expects to face increased competition from the other large Icelandic banks, pension funds and smaller specialised institutions. In addition, as the Capital Controls continue to be eased and there is sufficient credit demand, the Bank may potentially face competition from foreign banks seeking to establish operations in Iceland, in particular with respect to the Corporate Banking division. The Bank may have to comply with regulatory requirements that may not apply to such foreign competitors, creating an unequal playing field and resulting in higher costs of regulatory compliance for the Bank. Foreign competitors may also have substantially more resources and financial means available to them than the Bank does (particularly given the Bank's relatively smaller size and lack of scale advantage in light of its regulatory obligations as a systemically important financial institution in Iceland), permitting them to invest more in business development and expansion or being able to increase lending volumes or endure a greater reduction in margins.

The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its local know-how, its ability to innovate, reputation and price. If the Bank is unable to compete effectively in the future in any market in which it has a significant presence, this could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

There are regulatory and legal risks inherent in the Bank's businesses

The Bank's operations entail considerable regulatory and legal risks, including litigation and liability risk. The Bank and certain of its subsidiaries are subject to government regulation and supervision as financial institutions in Iceland, and regulations may be extensive and may change rapidly, at times unexpectedly and with only a very short period of notice and consultation, as they have done since the global financial crisis in 2008. In addition, certain of the Bank's and its subsidiaries' operations are contingent upon licences issued by financial authorities. The implementation of new European directives and regulations into Icelandic legislation will be subject to the ability of the Icelandic legislature and regulators to apply additional, more stringent requirements where they are permitted to do so, for example with respect to capital requirements.

Violations of rules and regulations, whether intentional or unintentional, or failure to comply with licensing or other requirements, may lead to administrative fines being applied or withdrawal of some of these licences. Any breach of these or other regulations or licensing requirements may adversely affect the Bank's reputation or financial condition, results of operations and prospects. In addition, existing laws and regulations could be amended, the manner in which laws and regulations are enforced or interpreted could change and new laws or regulations could be adopted in ways unfavourable to the Bank's operations in certain of its business operations, which could adversely affect the way the Bank operates its business and its market reputation. See "*—Public sentiment and political activity in Iceland could impair the Bank's operations*" and "*Description of the Issuer—Litigation*".

The Bank is also exposed to risks of lawsuits or other claims inherent in its role as a financial intermediary and consultant to third party businesses through its Investment Banking division. These risks include potential liability for the Bank's role in determining the price of a company and for advice the Bank provides to participants in corporate transactions and in disputes over the terms and conditions of trading arrangements. The Bank also faces the possibility that counterparties in the above mentioned activities as well as trading transactions will claim that the Bank failed to properly inform them of the associated risks. The Bank is also exposed to customer claims in the Retail Banking and Corporate Banking divisions, including significant claims in relation to loans advanced by its predecessor, Kaupthing. See "*—The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities*".

The Bank may also be subject to claims arising from disputes with employees for, among other things, alleged illegal dismissal, discrimination or harassment, and it may also be subject to losses or reputational damage as a result of illegal behaviour by its employees or third party service providers. These risks may often be difficult to assess or quantify and their existence and magnitude often remain unknown for substantial periods of time. Liability resulting from any of the foregoing or other claims could have a material adverse effect on the Bank's reputation, business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities

The Bank is involved in, or could be affected by, a number of ongoing legal proceedings and is subject to investigations by governmental authorities, including, but not limited to:

- *legal proceedings concerning the legality of foreign currency loans to individuals and companies and the recalculation of those loans which are currency-linked loans denominated in Icelandic Krona*: Since the financial crisis of 2008, there has been considerable uncertainty with respect to the legality of foreign currency loans to individuals and companies and the recalculation of those loans which are deemed to be currency-linked loans denominated in Icelandic Krona, particularly with respect to which loans are considered legal foreign currency loans and which loans are considered currency-linked loans denominated in Icelandic Krona and how loans in the latter category should be recalculated.

  The Bank has been required to recalculate numerous loans which are considered currency-linked loans in Icelandic Krona on the basis of Act No. 38/2001 on Interest and Price Indexation, as amended (the "**Interest Act**") and after review of relevant judgements passed by the Supreme Court of Iceland. The uncertainty surrounding the legality of foreign currency loans has continued, and the Bank constantly monitors judgements involving itself and others to refine its provisions on foreign currency loans. Although there is more clarity with respect to the foreign currency loans, there still remains uncertainty in certain respects, especially how currency-linked loans should be recalculated. Although the Bank considers that its portfolio of foreign currency loans is fully provisioned for the most likely outcome, no assurance can be given that subsequent adverse developments will not lead to a need for further material impairment provisions in respect of such loans;

- *legal proceedings concerning the legitimacy and the presentation of loans linked to the Consumer Price Index ("**CPI**")*: Recently, three cases were heard by the Icelandic courts for the purpose of verifying the legitimacy and the presentation of CPI-linked loans. The Supreme Court of Iceland upheld the arguments of the lenders in two of such cases (case No. 160/2015 and case No. 243/2015). In the third case, the District Court of Reykjavík acquitted the lender of the borrower's claim on similar grounds to the two previous cases (case No. E-338/2013), and the case has been appealed to the Supreme Court of Iceland. Although the Bank is not party to any of these proceedings, and it expects that the decision of the District Court of Reykjavík will also be upheld by the Supreme Court of Iceland in the third case, an adverse decision could have a material adverse effect on the Bank's net interest income, as the Bank could be required to recalculate the CPI-linked portion of the relevant loans in its customer loan portfolio, which could lead to a need for further material impairment provisions in respect of its CPI-linked loans;

- *legal proceedings on legacy mortgage collateral*: The Bank is involved in several court cases in the District Court of Reykjavík regarding whether it has the right to 100% of the value of a property pledged as collateral in a mortgage loan, where only one of the two owners has signed the document granting the property as collateral. The result of this case could affect other similar mortgage loan contracts of the Bank. The Bank has not recorded any provision in respect of the matter. Any finding in favour of the borrowers in this case or any similar cases could have a material adverse effect on the Bank in terms of the value of its collateral and loan-to-value ratio;

- legal proceedings regarding damages in the amount of ISK 1.2 billion plus interest claimed by Kortathjonustan hf. ("**Kortathjonustan**") from the Bank, Íslandsbanki, Landsbanki, Borgun hf. and Valitor as a result of losses Kortathjonustan contends the five parties caused Kortathjonustan due to violations of the Competition Act No. 44/2005, as amended (the "**Competition Act**"); and

- an investigation by the Icelandic Competition Authority (*Samkeppniseftirlitið*) (the "**ICA**") into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank, concerning the terms of such retail banks' mortgage loan arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition.

For additional information on legal proceedings, see "*Business Overview—Legal Proceedings*".

The Bank has made objections to, and is defending, the complaint regarding damages by Kortathjonustan and the investigation by the ICA into the purported abuse of an alleged dominant position. The extent and outcome of the legal proceedings or investigations, as the case may be, as well as any effect on the Bank remain uncertain. However, if such legal proceedings or investigations are determined adversely to the Bank, the Bank could be required to pay damages and/or fines and be subject to future restrictions on its business activities, either of which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank's customer loan portfolio contains certain problem and impaired loans

Following the establishment of the Bank, a portfolio of assets and liabilities originated by Kaupthing was transferred to the Bank in 2008. These assets and liabilities initially resulted in significant foreign exchange, interest rate and liquidity mismatches within the Bank's asset portfolio, although these mismatches have now largely been addressed. In addition, the serious recession in Iceland in 2009 and 2010 resulted in a significant increase in problem loans and deteriorating asset quality. The valuation of assets that were transferred to the Bank from Kaupthing attempted to account for all realised and foreseen losses, and this has significantly reduced the credit risk that would otherwise have been present in the Bank's customer loan portfolio. However, the Bank is still exposed to credit risk in its customer loan portfolio as a result of these transfers relating to the accuracy of the transfer valuation performance of the loans and the extent to which the Bank is successful in restructuring problem loans. In addition, no assurance can be given that any currently performing loans will not become problem loans in the future, whether as a result of a general impairment of conditions in a particular customer or class of customers, a deterioration of the Icelandic economy or otherwise.

In particular:

- as of 30 September 2016, 2.0% of the Bank's customer loan portfolio was classified as problem loans, which are defined as loans more than 90 days past due but not impaired and other problem (*i.e.*, individually impaired) loans. As of 30 September 2016, the Bank's provisions on its customer loan portfolio amounted to 3.4% of the total gross amount of the customer loan portfolio and 3.6% of the aggregate amount of loans to customers outstanding had been wholly or partially impaired. As of 30 September 2016, the value of collateral that the Bank holds relating to loans to customers determined to be individually impaired amounted to ISK 5.7 billion, or 21.87% of the aggregate carrying amount of such loans to customers;

- the Bank has significant exposure to the commercial real estate and seafood industry sectors, with exposure amounting to 15.8% and 11.1%, respectively, of the Bank's capital base as of 30 September 2016;

- as of 30 September 2016, the aggregate amount of the Bank's 10 largest loans to customers equalled 12.3% of the total gross amount of the customer loan portfolio as of such date; and

- the Bank's customer loan portfolio is also highly concentrated in Icelandic borrowers.

Should any customers or an industry sector to which the Bank is exposed default or experience a significant deterioration in their business or prospects, as the case may be, this could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank is exposed to the risk of failure and breaches of its information technology systems

The availability, integrity, reliability and operational performance of the Bank's information technology ("**IT**") systems, including Valitor's global payments platform, are critical to the Bank's operations. The Bank's business relies on the efficient and uninterrupted operation of numerous systems, including computer hardware and software systems, data centres, third party telecommunications networks and the systems of third parties. Although the Bank's IT systems and Valitor's global payments platform have demonstrated a high level of reliability and performance to date, no assurance can be given that the Bank will be able to continue to maintain past levels of performance. In particular, the Bank currently uses a system provided by Reiknistofa Bankanna ("**RB**"), which is a centralised cash settlement system in Iceland, as its core system for deposits and payments, with all payment instructions settled through the RB system. RB intends to replace its current deposit and payment system with the Sopra Banking system, which is expected to become effective in early 2017. This would in turn require the Bank to replace its core deposit and payment systems, and the Bank is currently exploring its options with respect to future partners for its core deposit and payment systems. The implementation of a new cash settlement system or any other IT operations, outsourced or otherwise, will be subject to unexpected implementation costs and delays, and no assurance can be given that such implementations could be delivered on time or within budget.

The Bank's ability to provide products and services to its customers on a timely basis or at all would be impaired by damage, interruption, failure or lack of capacity of its IT systems, core deposit and payment systems, global payments platform, any other systems in its clearing operations or the systems of third parties on which it relies due to malicious increases in usage or attacks by hackers (including as a result of denial of service or similar attacks which exceed network or gateway capacity), hardware or software defects, human error, unauthorised access, natural hazards, disasters or similarly disruptive events as well as due to planned upgrades and improvements which may be subject to developmental delay or fail to be effective. Although the Bank maintains customary insurance policies for its operations, such insurance policies may not be adequate to compensate the Bank for all losses that may occur as a result of any such damage, interruption, failure or lack of capacity. A sustained failure of the Bank's IT systems centrally or across its branches would have a significant impact on its operations and the confidence of its customers in the reliability and safety of its banking systems and Valitor's global payments platform.

Unauthorised disclosure of confidential information, whether through cyber security breaches, computer viruses or otherwise, could expose the Bank to liability and protracted and costly litigation and damage its reputation

The secure transmission of confidential information is a critical element of the Bank's operations, with the Bank processing sensitive personal customer data (including, in certain instances, consumer names, addresses, credit and debit card numbers and bank account details) and merchant data (including merchant names, addresses, sales data and bank account details) as part of its business. Therefore, the Bank is responsible for safeguarding such confidential information and must comply with strict data protection and privacy laws in the jurisdictions in which it operates, including through the Bank's subsidiary Valitor. The Bank seeks to ensure that procedures are in place for compliance with the relevant data protection regulations by its employees and any third party service providers and also implements security measures to help prevent cyber-theft. In addition, the data protection requirements in the jurisdictions in which the Group operates are evolving, including necessary compliance with the new European General Data Protection Regulation which is expected to become effective in May 2018, which will bring a number of changes to current data protection legislation in the European Union. Notwithstanding such efforts at compliance, the Bank is exposed to the risk and could be liable in the event of loss of control of such confidential information or as a result of unauthorised third party access. Unauthorised disclosure of confidential information could occur through cyber security breaches as a result of malware infection and malicious or accidental user activity, internal security breaches or as a result of human error as well as physical security breaches due to unauthorised personnel gaining physical access.

The loss, destruction or unauthorised modification of confidential information by the Bank or third parties could result in significant reputational damage, additional costs relating to customer and/or merchant compensation or other charges, fines, loss of relationships with financial institutions, sanctions and legal proceedings or adverse regulatory actions against the Bank by the governmental authorities, customers, merchants or other third parties. Although the Bank generally requires that its agreements with third party partners or service providers who may have access to sensitive information include confidentiality obligations that restrict such third parties from using or disclosing any such confidential information, these contractual measures may fail to prevent the unauthorised use, modification, destruction or disclosure of confidential information or allow the Bank to seek reimbursement from such third party in case of a breach of confidentiality obligations. In addition, certain of the Bank's small- to medium-sized enterprise customers, defined as corporates with loans up to ISK 2.0 billion ("**SME**"), may have limited data security capability and experience loss of sensitive data when using the Bank's business-to-business services. Any unauthorised use, modification, destruction or disclosure of confidential information could also result in protracted and costly litigation. Any of these or other factors could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank may be unable to recruit or retain experienced and qualified personnel and depends on key members of the Executive Committee

The Bank's future success depends, in part, on its ability to attract, retain and motivate qualified and experienced banking and management personnel. Competition for personnel with relevant expertise is significant, due to the relatively small number of available qualified individuals. The geographical location of employment in Iceland may also make employment by the Bank less attractive to a large pool of potential applicants.

In addition, the loss of the services of key members of the Executive Committee or staff with institutional and customer knowledge may significantly delay the Bank's achievement of its business objectives and could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank could experience credit rating downgrades

Rating agencies assess the creditworthiness of the Bank and its operating environment and they assign a rating to it and certain of the financial instruments it has issued for funding and capital management purposes. The Bank has been rated BBB by Standard & Poor's Credit Market Services Europe Limited ("**Standard & Poor's**").

A rating agency assessment is based on various factors. While most of the factors are specific to the Bank and the relevant financial instruments it issues, some relate to general economic conditions and other circumstances outside the Bank's control, such as changes in the macroeconomic environment, sovereign credit rating of Iceland and prospective level of systemic support a government can provide. No assurance can be given that a rating agency will not revise downward a credit rating or change the outlook on any such credit rating. In addition, rating agencies have and may in the future change their methodology from time to time, which may also result in a downgrade or a change in the outlook on any credit rating of the Bank or the relevant financial instruments it issues, for example by reducing or removing the effect of systemic support.

Any downgrade or potential downgrade in the ratings of the Bank or of the relevant financial instruments it issues may limit the Bank's access to the capital markets and certain types of instruments (for example, in terms of seniority and maturity), reduce its prospective investor base, increase borrowing costs, require the Bank to replace funding lost due to the downgrade or potential downgrade (for example, customer deposits), limit the Bank's access to capital, funding and money markets and trigger requirements to post additional collateral in derivatives contracts and other secured funding arrangements. In addition, a rating downgrade or potential downgrade of the Bank could, among other things, limit its opportunities to operate in certain business lines and materially adversely affect certain other business activities, which in turn could have a material adverse effect on the Bank's business, prospects, financial position results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank is exposed to operational risks

The operational risks that the Bank faces include the possibility of inadequate or failed internal or external processes or systems failures, human error, regulatory breaches, employee misconduct or external events, such as fraud. The Bank's business inherently generates operational risks. The business depends on processing numerous complex transactions. The recording and processing of these transactions are potentially exposed to the risk of human and technological errors, including miscalculations, or a breakdown in internal controls relating to the due authorisation of transactions. Given the volume of transactions processed by the Bank, errors may be repeated or compounded before they are discovered and rectified, and no assurance can be given that risk assessments made in advance will adequately estimate the costs of these errors. Errors or misconduct can have a particularly significant impact with respect to funds and portfolios managed by the Bank or its wholly owned independent subsidiary Stefnir hf. ("**Stefnir**") given the volume of assets under management in any particular fund or portfolio and the consequent magnitude of any errors or misconduct.

The Bank has implemented controls designed to mitigate operational risks, but these controls cannot eliminate such risks and failures in internal controls could subject the Bank to regulatory scrutiny. Such events could harm the Bank's reputation and have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank relies on its reputation and brands and those of its subsidiaries

The success of the Bank's business depends significantly on the Bank's reputation with customers as well as the strength and appeal of the brand of the Bank. The Bank's reputation is one of its most important assets and its ability to attract and retain customers and staff and conduct business with its counterparties could be materially adversely affected to the extent that its reputation or the reputation of its brand is damaged. Failure to address, or perception that the Bank has failed to address, various issues that could give rise to reputational risk could cause harm to the Bank and its business prospects. Reputational issues could include:

- poor customer service or IT failures or interruptions that impact customer services and accounts (see "*—The Bank is exposed to the risk of failure and breaches of its information technology systems*");
- failure, or allegations of having failed, to maintain appropriate standards of customer privacy, customer service and record keeping and disclosure of confidential information (see "*—Unauthorised disclosure of confidential information, whether through cyber security breaches, computer viruses or otherwise, could expose the Bank to liability, protracted and costly litigation and damage its reputation*");
- failure to appropriately address potential conflicts of interest and acting, or allegations of having acted, unethically in the conduct of its business;
- breaching, or allegations of having breached, legal and regulatory requirements, including anti-money laundering and anti-terrorism financing requirements (see "*—There are regulatory and legal risks inherent in the Bank's businesses*", "*—The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities*" and "*—The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences*");
- failure to properly identify legal, reputational, credit, liquidity and market risks inherent in the Bank's products and services (see "*—The Bank is exposed to a range of other typical financial institution market risks, including interest rate risk, equity price risk and inflation risk*" and "*—The Bank is exposed to operational risks*");
- third parties on whom the Bank relies for products and services failing to provide the necessary products and services;
- the fact that the Bank is majority privately owned, while its principal competitors Íslandsbanki and Landsbankinn are government owned; and
- generally poor business performance.

Failure to address these or any other relevant issues appropriately could damage the Bank's reputation and make customers, depositors and investors less willing to do business with the Bank, which may have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

In addition, the Bank believes that its brand and the brands of its subsidiaries, in particular Valitor, Okkar líftryggingar hf. ("**Okkar Life Insurance**") and Vörður, are one of the key differentiators from competitors and provide a key competitive advantage. However, no assurance can be given that the Bank and its subsidiaries will be successful in further developing their respective brands and leveraging them into market share growth over competitors. Any circumstance that causes real or perceived damage to the Bank's brand or the brands of its subsidiaries, including the occurrence of any of the risks or events described in these "*Risk Factors*", could have a material adverse effect on the Bank's ability to retain existing customers and attract new customers. An inability by the Bank or its subsidiaries to manage the risks to their brands could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank's risk management methods may leave it exposed to unidentified, unanticipated or incorrectly quantified risks, which could lead to material losses or material increases in liabilities

The Bank's risk management strategies may fail under certain circumstances, particularly when confronted with risks that have not been identified or anticipated. Risk methodologies and techniques that the Bank adopts to assess credit risk, market risk, liquidity risk and operational risk may be flawed or may not take all risks into account, and it is possible that the methods for assessing these risks are not sound or are based on faulty information or that they will be misunderstood, not implemented correctly or misapplied by the Bank's personnel. In addition, the Bank's risk management policies are constantly being re-evaluated and there may be a lag in implementation. Furthermore, some of the Bank's qualitative tools and metrics for managing risk are based upon the use of observed historical market behaviour. The Bank may apply statistical and other tools to these observations to arrive at quantifications of risk exposures. These tools and metrics may fail to predict future risk exposures.

The Bank's losses thus could be significantly greater than its risk management measures would indicate. In addition, the Bank's quantified modelling does not take all risks into account. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank relies on third party service providers

The Bank relies on the services, products and knowledge of third party service providers in the operation of its business. For example, the Bank relies on RB for deposit account and payment infrastructure. The Bank also relies on third party service providers in connection with its IT systems, and it is considering other opportunities for IT outsourcing and the outsourcing of its cash centre operations in order to benefit from scale synergies with the other Icelandic banks. In addition, the Bank's subsidiary Valitor is subject to chargeback risk if Valitor or its bank sponsors are unable to collect the chargeback from its merchant's account or if the merchant refuses or is financially unable due to bankruptcy or other reasons to reimburse the merchant's bank for the chargeback. Accordingly, the Bank faces the risk that such third party service providers become insolvent, enter into default or fail to perform their contractual obligations in a timely manner or at all or fail to perform at an adequate and acceptable level. Any such failure could lead to interruptions in the Bank's operations or result in vulnerability of its IT systems, exposing the Bank to operational failures, additional costs or cyber-attacks. The Bank may need to replace a third party service provider on short notice to resolve any potential problems, and the search for and payment to a new third party service provider on short notice or any other measures to remedy such potential problems could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

In addition, no assurance can be given that the third party service providers selected by the Bank will be able to provide the products and services for which they have been contracted, for example, as a result of failing to have the relevant capabilities, products or services or due to changed regulatory requirements. Any failure of third party service providers to deliver the contracted products and services in a timely manner or at all or to deliver products and services in compliance with applicable laws and regulations and at an adequate and acceptable level could result in reputational damage, claims, losses and damages and have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences

The Bank is subject to laws regarding money laundering and the financing of terrorism as well as laws that prohibit the Bank or its employees or intermediaries from making improper payments or offers of payment to foreign governments and their officials and political parties for the purpose of obtaining or retaining business. Compliance with anti-money laundering and anti-bribery regulations can place a significant financial burden on banks and other financial institutions and requires significant technical capabilities. The Bank cannot predict the nature, scope or effect of future regulatory requirements to which it might be subject or the manner in which existing laws might be administered or interpreted. Although the Bank believes that its current policies and procedures are sufficient to comply with applicable anti-money laundering, anti-bribery and sanctions rules and regulations, it cannot guarantee that such policies completely prevent situations of money laundering or bribery, including actions by the Bank's employees, for which the Bank might be held responsible. Any such events may have severe consequences, including sanctions, fines and reputational consequences, which could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

Changes to the Capital Requirements Directives could adversely affect the Bank's results

In 2013, the European Parliament and the European Council adopted a legislative package ("**CRD IV**") for the implementation of the Basel III framework in the European Union. Approximately two thirds of the CRV IV legislative package have been implemented and passed into Icelandic laws. The implementation of CRD IV in Iceland could limit the Bank's ability to manage effectively its capital requirements and affect the Bank's ability to pay dividends. Any failure by the Bank to maintain increased regulatory capital requirements or to comply with any other requirements introduced by regulators could result in intervention by regulators or the imposition of sanctions, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds and could also have other effects on the Bank's financial performance, both with or without the intervention by regulators or the imposition of sanctions.

The Bank could incur unforeseen liabilities from prior and future acquisitions and disposals

During the last few years, the Bank has made various acquisitions (in particular, the acquisition of the insurance subsidiary Vörður and Valitor's acquisition of AltaPay A/S for its e-commerce platform) and it has divested a number of assets, primarily non-core assets, which consist of legacy equity holdings of non-core subsidiaries and other assets, such as investment property, which it had acquired through restructuring processes following the financial crisis in 2008. See "*Issuer Description—History*". In the future, the Bank may make additional acquisitions and may decide to divest certain parts of its current businesses. The Bank may encounter difficulties integrating entities it has acquired into its operations or the combination of the businesses may not perform as well as anticipated. Failure to complete announced business combinations or failure to successfully integrate acquired businesses could lead to departures of key employees and have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

Acquisitions expose the Bank to the risk of unforeseen expenses, losses, tax liabilities or obligations with respect to employees, clients and business partners of acquired businesses, governmental authorities and other parties. Before making an investment in a company or business, the Bank assesses the value or potential value of such company or business and the potential return on such an investment. In making the assessment and otherwise conducting due diligence, the Bank relies on the resources available and, in some cases, an investigation by third parties. However, no assurance can be given that due diligence examinations carried out by the Bank or by third parties in connection with equity interests in companies or businesses that the Group has acquired or will acquire are sufficient or will reveal all of the risks associated with such companies and businesses or the full extent of such risks. In addition, acquired companies or businesses may have hidden liabilities that are not apparent at the time of acquisition. Although the Bank normally obtains certain warranties and indemnities from the seller, these warranties and indemnities may not cover all of the liabilities that may arise following the acquisition, and any indemnification may not fully compensate the Bank for any diminution in the value of its interest in such companies or businesses. The Bank may also encounter difficulties enforcing warranties or indemnities against a seller for various reasons, including the insolvency of the seller, legal technicalities, such as the relevant jurisdiction or evidence requirements, or expiry of claim periods for such warranties or indemnities.

When divesting businesses or assets, the Bank may not always be able to pass on the entire risk relating to the divested business or assets to the purchaser, which may lead to additional risks, such as liability related to legacy obligations.

The Bank's insurance coverage may not adequately cover all losses

The Bank maintains customary insurance policies for its operations, including insurance for its liquid assets, money transport and directors' and officers' liability, as well as insurance against computer crimes and for employee dishonesty and mistakes. Due to the nature of the Bank's operations and the nature of the risks that it faces, no assurance can be given that the coverage that the Bank maintains is adequate to cover the losses for which it believes it is insured and, in the event the Bank's insurance is not adequate, this could have a material adverse effect on the Bank's business, prospects, financial position, results of operations and/or cashflows and its ability to make payments in respect of Covered Bonds.

The Council of the European Union has published revised proposals for a bank recovery and resolution directive which is intended to enable a range of actions to be taken in relation to credit institutions and investment firms considered to be at risk of failing. The full scope of the directive and its impact on the Bank is currently unclear

On 2 July 2014, Directive 2014/59/EU providing for the establishment of an EU-wide framework for the recovery and resolution of credit institutions and investment firms (the **Bank Recovery and Resolution Directive** or **BRRD**) entered into force. Iceland, Liechtenstein, Norway and Switzerland are members of the EFTA and Iceland, together with Liechtenstein and Norway (the **EEA EFTA States**) is also a party to the EEA Agreement by which the EEA EFTA States participate in the internal market of the European Union (the **EU**). On 27 November 2013, the EFTA Working Group on Financial Services stated that "it would appear that the proposal represented by the June 2012 draft of the BRRD may be deemed EEA relevant and thus likely to be incorporated into the EEA Agreement once adopted by the EU side." A committee has been established, charged with the task of preparing new legislation implementing the BRRD in Iceland. However, as at the date of this Base Prospectus, the proposed new legislation has not been put before the legislator. The BRRD is designed to provide authorities with a credible set of tools to intervene sufficiently early and quickly in an unsound or failing institution so as to ensure the continuity of the institution's critical financial and economic functions, while minimising the impact of an institution's failure on the economy and financial system.

The BRRD provides that it will be applied by Member States from 1 January 2015, except for the general bail-in tool (see below) which has applied from 1 January 2016.

The BRRD contains four resolution tools and powers which may be used alone or in combination where the relevant resolution authority considers that (a) an institution is failing or likely to fail, (b) there is no reasonable prospect that any alternative private sector measures would prevent the failure of such institution within a reasonable timeframe, and (c) a resolution action is in the public interest: (i) sale of business - which enables resolution authorities to direct the sale of the firm or the whole or part of its business on commercial terms; (ii) bridge institution - which enables resolution authorities to transfer all or part of the business of the firm to a "bridge institution" (an entity created for this purpose that is wholly or partially in public control); (iii) asset separation - which enables resolution authorities to transfer impaired or problem assets to one or more publicly owned asset management vehicles to allow them to be managed with a view to maximising their value through eventual sale or orderly wind-down (this can be used together with another resolution tool only); and (iv) bail-in - which gives resolution authorities the power to write down certain claims of unsecured creditors of a failing institution and to convert certain unsecured debt claims (including Notes) to equity (the **general bail-in tool**), which equity could also be subject to any future cancellation, transfer or dilution.

The BRRD also provides for a Member State as a last resort, after having assessed and exploited the above resolution tools to the maximum extent possible whilst maintaining financial stability, to be able to provide extraordinary public financial support through additional financial stabilisation tools. These consist of the public equity support and temporary public ownership tools. Any such extraordinary financial support must be provided in accordance with the EU state aid framework.

An institution will be considered as failing or likely to fail when: it is, or is likely in the near future to be, in breach of its requirements for continuing authorisation; its assets are, or are likely in the near future to be, less than its liabilities; it is, or is likely in the near future to be, unable to pay its debts as they fall due; or it requires extraordinary public financial support (except in limited circumstances).

Although the "bail-in" powers are not intended to apply to secured debt (such as the rights of Covered Bondholders in respect of the Cover Pool), there remains significant uncertainty regarding the ultimate nature and scope of these powers and how they would affect the Bank and the Covered Bondholders. Accordingly, it is not yet possible to assess the full impact of the BRRD on the Bank and on Covered Bondholders, and there can be no assurance that, once it is implemented, the manner in which it is implemented or the taking of any actions by the relevant resolution authority currently contemplated in the BRRD would not adversely affect the rights of Covered Bondholders, the price or value of an investment in the Covered Bonds and/or the Issuer's ability to satisfy its obligations under the Covered Bonds. The exercise of any bail-in power or any suggestion of such exercise could, therefore, adversely affect the value of the Covered Bonds. Relevant claims for the purposes of the bail-in tool would include the claims of holders in respect of any Covered Bonds issued under the Programme if and only to the extent that the Covered Bond liability exceeded the value of the Cover Pool against which it is secured.

Iceland's national implementation of the EEA rules may not be comprehensive in all circumstances

As a member state of the EEA, Iceland is obligated to implement certain European Union legislation with EEA relevance, including legislation relating to financial markets. Where Iceland has failed to adapt national law to conform to EEA rules, citizens may be unable to rely on them and the Icelandic courts barred from applying them, unless Icelandic legislation may be interpreted to conform with the relevant EEA rules. As a result Covered Bondholders may not, in all circumstances, enjoy the same legal protection they would expect as holders of securities issued by issuers in member states of the European Union where European Union instruments are directly applicable or have been comprehensively implemented into national legislation.

The Bank's accounting policies and methods are critical to how it reports its financial condition and results of operations. They require management to make estimates about matters that are uncertain.

Accounting policies and methods are fundamental to how the Bank records and reports its financial condition and results of operations. Management must exercise judgment in selecting and applying many of these accounting policies and methods so they comply with IFRS.

Management has identified certain accounting policies in the notes to its financial statements as being critical because they require management's judgment to ascertain the valuations of assets, liabilities, commitments and contingencies. See note 32 to the 2015 Consolidated Financial Statements.

A variety of factors could affect the ultimate value that is obtained either when earning income, recognising an expense, recovering an asset or reducing a liability. The Bank has established detailed policies and control procedures that are intended to ensure that these critical accounting estimates and judgments are well controlled and applied consistently. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. Because of the uncertainty surrounding the Bank's judgments and the estimates pertaining to these matters, the Bank cannot guarantee that it will not be required to make changes in accounting estimates or restate prior period financial statements in the future.

Legal and regulatory risks relating to the Covered Bonds

Set out below is a brief description of certain legal and regulatory risks relating to Covered Bonds.

Legal risks

The Issuer's business operations are governed by law and regulations and are subject to authority supervision. Any changes to the current legislation might affect the Issuer's business operations and its operating results. Furthermore, competition and other factors might also affect the Issuer's business. The Icelandic Covered Bond Act No. 11/2008 provides that the FME may issue rules providing for the types of assets in a Cover Pool, methods for appraisal of collateral of bonds, terms and conditions for derivative agreements and conditions for the calculation of risk and interest payments. FME has issued such rules, i.e. Rules No. 528/2008 on Covered Bonds that concern, among other things, the conditions for being granted a licence to issue Covered Bonds, appraisal and revaluation of the assets in the cover pool, matching rules, derivative agreements, the covered bond register and the eligibility and reporting of the independent inspector (the **Rules**). Any changes to the Icelandic Covered Bond Act and/or the Rules as well as other current legislation might affect the legal and regulatory risks relating to the Covered Bonds.

The Icelandic Covered Bond Act entered into force on 4 March 2008; only three licences to issue covered bonds have to date been granted under the Act, and there are limited precedents on how its provisions will be interpreted or applied by Icelandic courts or administrative authorities. The preparatory works to the Act are limited and the system of Covered Bonds secured by the Cover Pool lacks any clear analogues in Icelandic law that would allow for robust arguments in respect of the Icelandic Covered Bond Act, the Covered Bonds or the Cover Pool based on analogy from such analogues.

Credit risks relating to the Issuer's collateral

Given that the Issuer's loans are granted with mortgages on residential real estate as collateral, the credit risk is driven in part by performance of the real estate and housing market in Iceland. There can be no assurance regarding the future development of the value of this collateral. Should the prices of real property and the housing market substantially decline, this could adversely affect the Issuer's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

There are many circumstances that affect the level of credit loss, including early repayments, withdrawals and final payments of interest and principal amounts, such as changes in the economic climate, both nationally and internationally, changes regarding taxation, interest rate developments, inflation and political changes. Borrowers may default as a result of interest rate increases or as a result in changes in their own personal circumstances (e.g. following redundancy or divorce).

Default in respect of the Issuer's assets that comprise the Cover Pool could jeopardise the Issuer's ability to make payments in full or on a timely basis on the Covered Bonds. lf a material amount of assets in the Cover

Pool were to default, there is no guarantee that the required level of assets within the Cover Pool could be maintained or that the Issuer would be able to substitute non-defaulting assets for the defaulting assets. Any such failure could adversely affect the Issuer's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

Basel Capital Requirements Directive

Following the issue of proposals from the Basel Committee on Banking Supervision for reform of the 1988 Capital Accord, a framework has been developed by the Basel Committee on Banking Supervision which places enhanced emphasis on market discipline and sensitivity to risk. A comprehensive version of the text of the framework was published in June 2006 under the title "International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version)" (the **Framework**). The Framework is not self-implementing and, accordingly, the implementation measures and dates in participating countries are dependent on the relevant national implementation process in those countries.

In July 2009, the Basel Committee finalised certain revisions to the Framework, including changes intended to enhance certain securitisation requirements (e.g. increased risk weights for "resecuritisation" exposures). In addition, the European Parliament has approved certain amendments to the Capital Requirements Directive 2006/49/EC (the **CRD**) (including investment restrictions and put forward further securitisation related amendments to the European Parliament and the Council of Ministers for consideration (including increased capital charges for relevant trading book exposures and for resecuritisation exposures)). As and when implemented, the Framework (and any relevant changes to it or to any relevant implementing measures) may affect the risk-weighting of the Covered Bonds for investors who are subject to capital adequacy requirements that follow the Framework. Consequently, prospective investors of the Covered Bonds should consult their own advisers as to the implications for them of the application of the Framework and any relevant implementing measures.

Foreign Account Tax Compliance Act withholding may affect payments on the Covered Bonds

Whilst the Covered Bonds are held within Euroclear, Clearstream, Luxembourg or the ISD (the **ICSDs**), in all but the most remote circumstances, it is not expected that FATCA will affect the amount of any payment received by the ICSDs. However, FATCA may affect payments made to custodians or intermediaries in the subsequent payment chain leading to the ultimate investor if any such custodian or intermediary generally is unable to receive payments free of FATCA withholding. It also may affect payment to any ultimate investor that is a financial institution that is not entitled to receive payments free of withholding under FATCA, or an ultimate investor that fails to provide its broker (or other custodian or intermediary from which it receives payment) with any information, forms, other documentation or consents that may be necessary for the payments to be made free of FATCA withholding. Investors should choose their custodians or intermediaries with care (to ensure each is compliant with FATCA or other laws or agreements related to FATCA) and provide each custodian or intermediary with any information, forms, other documentation or consents that may be necessary for such custodian or intermediary to make a payment free of FATCA withholding. The Issuer’s obligations under the Covered Bonds are discharged once it has made payment to, as to the order of, the common depository or the common safekeeper for the ICSDs, and the Issuer has therefore no responsibility for any amount thereafter transmitted through the ICSDs and custodians or intermediaries. Further, foreign financial institutions is a jurisdiction which has entered into an intra governmental agreement with the United States (an **IGA**) are generally not expected to be required to withhold under FATCA or an IGA (or any law implementing an IGA) from payments they make. Prospective investors should refer to the section "*Taxation – Foreign Account Tax Compliance Act*."

Change of law and establishment of case law

The Terms and Conditions of the Covered Bonds (the **Conditions**) are governed by English law and, in respect of Condition 3, Icelandic law, in each case as in effect as at the date of this Offering Circular. No assurance can be given as to the impact of any possible judicial decision or change to English law, Icelandic law and/or administrative practice after the date of this Offering Circular.

In particular, the Icelandic Covered Bond Act is new legislation in Iceland, having been adopted by the Icelandic Parliament on 4 March 2008, and relatively there is no available case law on it. It is uncertain how the Icelandic Covered Bond Act will be interpreted or whether changes or amendments will be made to it which will affect Covered Bonds issued under the Programme. This same risk applies to the Rules.

No gross-up

Under the Terms and Conditions of the Covered Bonds, all payments in respect of the Covered Bonds will be made without deduction for or on account of withholding taxes imposed by the Republic of Iceland (**Iceland**) or any political subdivision or any authority thereof or therein having power to tax unless such withholding or deduction is required by law, in which case such deduction will be made by the Issuer.

In the event that any such withholding or deduction is required by law, the Terms and Conditions require the Issuer to pay additional amounts in respect of such withholding or deduction subject to customary exceptions (see Condition 9 (*Taxation*)). lf the withholding or deduction arises as a result of one of the circumstances described in paragraphs (a) to (f) of Condition 9, the Issuer will not be required to pay such additional amounts and affected investors will receive interest payments net of such withholding. If however the Issuer is required to pay additional amounts, it will have the option under Condition 8.2 (*Redemption for Tax Reasons*) to redeem the relevant Covered Bonds early.

Paragraph (f) of Condition 9 deals with the Article 3(8) of the Income Tax Act no. 90/2003 (**ITA**) (as amended by Act no. 70/2009) and Act no. 107/2015, which imposes withholding tax on payments of Icelandic sourced interest to a foreign bondholders at a rate of 10%, unless the issue is exempt on the grounds that the bonds are registered with a securities depository within the EEA or OECD and has been registered as such or bonds issued by the estates of previously operating financial institutions as part of a composition agreement. Further exemptions are available to the relevant bondholders in their home countries or under a double taxation treaty with Iceland.

In April 2013 the Icelandic Parliament adopted an amendment to Article 3(8) of the ITA exempting from taxation the interest earned on income by non-domestic entities, from certain debt instruments issued by financial institutions. This exemption includes bonds registered with a securities depository within the EEA or OECD such as those issued under this programme. Furthermore, the Parliament adopted an amendment in November 2015 exempting from taxation interest on bonds that are issued in connection to the obligations under composition agreements and in the own name of a legal entity previously operating as a financial institution but are under a winding up proceeding or have completed such proceedings. The exception is subject to general registration of the programme with the Director of Revenue (*Ríkisskattstjóri*).

Existing currency restrictions – Icelandic rules on foreign exchange

On 28 November 2008, the Icelandic Parliament passed Act No. 134/2008 (the **Amending Act**), on Amendments to the Foreign Exchange No. 87/1992, as amended, (the **Foreign Exchange Act**) granting the Icelandic Central Bank powers to intervene in the currency-market with the view of stabilizing the foreign exchange rate of the Icelandic krona. For this purpose, the Central Bank issued new Rules on Foreign Exchange, no 1082, of 28 November 2008 (the **Foreign Exchange Rules**) which were subject to review every six months. The Foreign Exchange Rules were codified with the adoption of Act no 127/2011 in 2011. The Foreign Exchange Act has since been amended several times, first in March 2012, March 2013, May 2014 June 2015, July 2015, July 2016 and in October 2016. The general regime on currency restrictions is set out in Article 13 of the Act.

The Foreign Exchange Act as codified with certain minor amendments effectively prohibited the outflow of foreign currency from Iceland unless it was a payment for goods or services. Therefore all financial transactions leading to currency outflow were prohibited unless explicitly allowed for in the future. More specifically the Foreign Exchange Act included provisions prohibiting certain transactions including lending and borrowing between resident and non-resident parties as well as currency-derivatives of any kind and the acquisition by domestic parties of financial instruments nominated in foreign currency. Furthermore, the Foreign Exchange Act makes it compulsory for Icelanders and Icelandic companies to "repatriate" all their foreign currency back into the country.

The Foreign Exchange Act provides for several general exceptions. Commercial banks are provided with a general exemption from certain provisions of the Foreign Exchange Act and consequently the capital controls. Accordingly commercial banks, savings banks and credit institutions operating under a FME licence, are exempt from restrictions on borrowing and lending between national and foreign parties, the restriction on assuming liability for payments between national and foreign parties, and the requirement to repatriate all foreign currency. Payments by the Bank of interest on interest payment dates and of principal on the maturity dates are, therefore, exempt from the restrictions of the Foreign Exchange Act under the general exemption. However, only limited exemption is provided for prepayments and, therefore, payments of an early redemption or an optional redemption under the Covered Bonds.

In addition to the general exemptions, the Foreign Exchange Act provides for specific exemptions from the restrictions of the legislation, subject to the Central Bank's approval. Such exemptions have to be applied for to the Central Bank where the process can take an estimated 8 to 12 weeks.

However, in the case of the winding-up, bankruptcy or insolvency of the Bank the exemptions from the Foreign Exchange Act may not apply and, therefore, restrictions will be effected in respect of payments of foreign currency due under the Covered Bonds, whether by reason of the Foreign Exchange Act, the Act on Bankruptcy no. 21/1991 or applicable provisions under the Act on Financial Undertakings, which may effectively prohibit the outflow of foreign currency from Iceland. Payments under winding-up, bankruptcy or insolvency could consequently be due in Icelandic krona.

The amendments in March 2012, with act no 17/2012, imposed further restrictions on the outflow of foreign currency. This entailed two amendments to the capital controls regime, inter alia, in response to a perceived increase in circumvention of the capital controls. Before these amendments, an investor could change principal payment, amortization and the indexation share of a CPI indexed annuity bond into foreign currency and transfer out of the economy. The legislation removed the previous exemption provided for the principal payment, amortization and indexation share of bond payments which are now subject to the general capital controls regime. Furthermore, the wide exemptions for payments of the winding-up committees of the failed Icelandic banks to their creditors were removed and are now subject to the Central Bank's approval.

Two additional amendments were made to the Foreign Exchange Act in March 2013. Firstly on 9 March, act no 16/2013 was adopted, implementing changes to the capital control regime, including the removal of the expiration date from the Act, making them continuous. Moreover the amendments imposed limits on the exemptions which the Central Bank can apply and may now be subject to prior consultation with the relevant ministry. This primarily relates to financial institutions or legal entities under the control of the FME through winding up proceedings or legal entities with a balance sheet exceeding ISK 400 billion and where the transaction has substantial effect on the debt position of the economy and regards ownership of a commercial bank. Secondly on 26 March 2013 further amendments were adopted with act no. 35/2013, primarily relating to general exemptions and enhanced authorizations for the Central Bank. The amendments enhanced the Central Bank's surveillance on foreign exchange, including in relation to payments of interest, indexation, dividends and contractual maturities. This includes authorization to collect information, which may extend to any relevant third party and to impose fines.

Further changes were made to the Foreign Exchange in May 2014 with the adoption of Act no 67/2014. The exemption on cross-border payment of dividend was further clarified, just applying to dividend on the basis of profit from operations of companies, excluding e.g. profit from sale of assets and any payments of deriving from decrease in share capital or liquidation of companies.

Amendments were made to the Act in June and July 2015. The amendments mainly aimed at the winding-up proceedings of the estates of Glitnir, Landsbanki, Kaupthing and other smaller bankrupt banks. With the adoption of Act No. 27/2015 several amendments were made restricting the operations of the estates and withdrawing of the general exemption that previously applied to the estates. After the amendments, the estates are prohibited from (i) purchasing foreign currency other than from domestic banks, (ii) intra group lending and borrowing and (iii) granting security unless with regards to the purchase of goods and services or loans that are generally exempt. Also, restrictions were adopted on repayments of loans, the granting of security as well as certain payments of the estates no longer qualify as allowed repayments under the Act no. 27/2015. Investments in derivatives or claims on the estates no longer qualify as new investments under the Central Bank's new investment regime. Several amendments applied to other legal entities, for example with respect to intra group loans, where limits were adopted on repayments of intra group loans and the purchase of currency for such repayment. Furthermore, restrictions were adopted on borrowing by domestic parties from non-domestic parties and purchase of foreign currency for repayment of loans advanced by domestic lenders.

Furthermore amendments were adopted with Act no. 60/2015 granting the estates exemption from some of the restrictions of the Foreign Exchange Act provided that payment of stability contribution or a 39% stability tax according to Act no. 60/2015 has been made.

On 25 March 2011, the Central Bank announced a new strategy for the gradual removal of remaining capital controls in phases. Further steps for such removal have been awaited since, with little development, until June 2015 when the Icelandic government and the Central Bank announced its action plan to that effect. The estates of Glitnir, Landsbanki, Kaupthing and other smaller bankrupt banks where given a timeframe to finalize a composition agreement and payment of stability contribution. This part of the strategy has now been completed.

The Icelandic government and the Central Bank have been active in taking further steps in 2016 towards the easing of the Capital Controls, aimed at individuals and the investments of legal entities.

A new act no 37/2016 on the Treatment of Króna-Denominated Assets Subject to Special Restrictions (the Króna Asset Act), was enacted on 23 May 2016. The act was a step in the liberalisation of the Capital Controls and implemented reserve requirements and prohibition on hypothecation of offshore króna assets.

The Foreign Exchange Act was amended further in July and October 2016, with the same aim. The amendments from July provide permission for reinvesting following investments through the new investment regime permitted under the Foreign Exchange Act, as well as a temporary provision in relation to the Króna Asset Act. The October 2016 amendments provided further relaxation of provisions relating to individuals and investors, the most significant amendment being new exemptions from the general prohibition on cross-border capital movements and foreign exchange transactions, including unlimited direct foreign investments by domestic parties. Furthermore other foreign investments by domestic parties, repayments and retirement of loans and investments of securities are subject to limitations on amounts.

The capital controls constitute protective measures under Article 44 of the EEA Agreement and have as such been notified to the EFTA Standing Committee under the procedures provided for in Protocol 18 of that agreement in conjunction with Protocol 2 to the Surveillance and Court Agreement. Following a referral by the District Court of Reykjavík, the EFTA Court issued a reasoned opinion on 14 December 2011, whereby the Court ruled that it had competence under the EEA Agreement and the Surveillance and Court Agreement to review the rules on currency restrictions inter alia in light of the general principle of proportionality. The Court further declared that at the time in question the rules in question where proportionate. However, this ruling of the EFTA Court does not preclude further scrutiny of the above capital controls by the relevant EEA institutions at any time.

In light of this, prospective investors must consider the risk of further changes to the above capital controls and the impact this may have on an investment in the Listed Covered Bonds.

Abnormal pricing as a consequence of capital control

The capital controls set out above have now become continuous. Domestic parties, primarily investors, are therefore restricted from transferring their funds and investing outside of the Icelandic market, unless such funds are considered re-investible funds pursuant to Article 13e and 13f of the Foreign Exchange Act. Consequently they are confined to and must focus their investments on Iceland, which entails various risks, including a risk for abnormal pricing and financial bubbles occurring within several sectors of the Icelandic market. This applies both to investments in shares of listed and un-listed companies, investment funds, various other financial instruments, real-estate (primarily commercial) and may have a negative impact on the Bank.

No events of default

The Terms and Conditions of the Covered Bonds do not include any events of default relating to the Issuer, the occurrence of which would entitle Covered Bondholders to accelerate the Covered Bonds, and Covered Bondholders will only be paid the scheduled interest payments under the Covered Bonds as and when they fall due under the Terms and Conditions of the Covered Bonds.

Maintenance of the Register

The Issuer must also maintain a Register in respect of the Covered Bonds, the Cover Pool and any derivative agreements. If the Register or the value of the Cover Pool are not maintained in accordance with the Act, the FME may revoke the Issuer's license to issue Covered Bonds. Mortgage Bonds in a Cover Pool must be endorsed showing they are part of a Cover Pool and have been entered in a Register as provided for in the Icelandic Covered Bond Act. The endorsement must also indicate that the debt instrument is to secure priority rights of a specific class of Covered Bonds. The Icelandic Covered Bond Act does not stipulate to what extent it is necessary to register a security in respect of the other assets in the Cover Pool.

If the Issuer fails to enter the assets in the Cover Pool and payments received therefrom (**Cover Pool Revenue**) in the Register, the Covered Bondholders and Swap Providers will not have priority claims to the Cover Pool and Cover Pool Revenue and will rank with the Issuer's unsecured creditors in the event the Issuer is subject to winding up proceedings.

Conflicting interests of other creditors

The rights of the Covered Bondholders rank junior to counterparties to derivatives agreements included in the Cover Pool, though they have preferential right with respect to other creditors against the Cover Pool. Further, in the event of the winding up of the Issuer, they will rank junior to costs incurred in connection with the operation, management, collection and realisation of the Cover Pool, as well as the claims due to derivative agreements concluded in accordance with the provisions of the Icelandic Covered Bond Act (as mentioned above), which will be covered before the claims of the Covered Bondholders.

To the extent that Covered Bondholders are not fully paid from the proceeds of the liquidation of the assets comprising the Cover Pool, they will be able to apply for the balance of their claims as unsecured creditors of the Issuer and will be entitled to receive payment from the proceeds of the liquidation of the other assets of the Issuer not comprising the Cover Pool. The Covered Bondholders would in such case rank *pari passu* with the other unsecured, unsubordinated creditors of the Issuer and, as a result, may not receive all amounts owed by the Issuer to such Covered Bondholders. Please note that as a result of the enactment of Act No. 125/2008 on the Authority for Treasury Disbursements Due to Special Financial Market Circumstances etc. (the **Emergency Act**), should the Issuer enter into winding-up proceedings, such claims of Covered Bondholders would be subordinated to claims of the Issuer’s depositors.

Liquidity

If the Issuer is wound up neither the Issuer nor its estate would be allowed to issue further Covered Bonds. It would therefore not be possible for a winding up committee to raise finance in the market by the issuance of further Covered Bonds following the winding up of the Issuer. Further, neither the Icelandic Covered Bond Act nor the Rules stipulate that the winding up committee or the Issuer's estate may contract debt obligations of any kind in order to service the timely payment under the terms of the Covered Bonds. There is no legislation in place that states that the winding up committee managing the Issuer's estate can raise loans or enter into any such agreements in order to service the timely payment of interest and principal on the Covered Bonds. Article 17(1) of the Icelandic Covered Bond Act states that the winding up committee shall fulfil an issuer's commitments under the covered bonds and derivative agreements using the mortgage bonds and other assets in the cover pool and payments received on such assets, provided that the assets are listed in the register. However, neither the Icelandic Covered Bond Act nor the Rules on Covered Bonds include guidelines as to whether liquidity could be raised by selling the Mortgage Bonds and other assets registered to the Cover Pool in the market.

The Issuer is also subject to liquidity requirements in its capacity as a commercial bank supervised by the FME, including a statutory requirement to maintain sufficient liquidity to enable it to discharge its obligations as they fall due. The FME has issued guidelines on liquidity, which are not binding on the Issuer. However, any serious or systematic deviations from such guidelines may lead to the FME determining that the Issuer's business does not satisfy the statutory soundness requirement for commercial banks and result in the FME imposing sanctions against the Issuer.

Risks related to the Cover Pool

Non-compliance with matching rules

The Icelandic Covered Bond Act contains matching rules which, *inter alia*, require that the total current value of the assets registered to the Cover Pool as collateral for a specific class of Covered Bonds must always exceed the total current value of the principal of the Covered Bonds of that same class. The Icelandic Covered Bond Act also requires that the instalments and other payment flows accruing on assets in the Cover Pool and from derivative agreements are in such a manner that all commitments towards the Covered Bondholders and derivative agreements can be met. See "*Overview of the Icelandic Legislation Regarding Covered Bonds – Matching Rules*" below for further details.

A breach of the matching requirements prior to the winding up of the Issuer in the circumstances where no additional assets are available to the Issuer or the Issuer lacks the ability to acquire additional assets could cause the FME to revoke the Issuer's license to issue Covered Bonds. The same applies in the event that the Issuer does not comply with other requirements prescribed in the Icelandic Covered Bond Act.

If the matching requirements are breached following the winding up of the Issuer, the winding up committee would not be permitted to add more assets to the Cover Pool. The Icelandic Covered Bond Act does not provide any further guidance as to the consequences of a breach of the matching rules following the winding up of the Issuer.

The explanatory memorandum for the Act on Covered Bonds states that assets can be removed from the cover pool and replaced with same kind of assets without limitations. If assets are replaced with substitute collateral there are limitations in the law on how much can be replaced with such collateral. This can, however, be subject to contract.

No Specified Overcollateralisation

The Icelandic Covered Bond Act requires the value of the assets in the cover pool to at all times exceed the value of the claims on the cover pool. However, the Icelandic Covered Bond Act does not require that the value of such assets exceeds the value of such claims by any specific amount. Failure to maintain sufficient assets in the cover pool could result in the Bank being unable to issue further Covered Bonds or refinance existing Covered Bonds.

The Bank intends to overcollateralise the Cover Pool at all times by at least 5 per cent. of the aggregate value of the principal amount outstanding of the Covered Bonds.

The Cover Pool consists of limited assets

The Cover Pool consists of loans which are secured on interests in residential property, industrial, office or commercial property, and agricultural property, claims which the Issuer holds, or may acquire, against providers of Covered Bond swaps and certain substitute assets. All assets in the Cover Pool must comply with the terms of the Icelandic Covered Bond Act and Rules. See "Overview *of the Icelandic Legislation Regarding Covered Bonds – Eligible Cover Pool Assets"* below for a description of the assets that can constitute the Cover Pool. At the date of this Offering Circular, all of the properties over which mortgages are created are in Iceland. The value of the Cover Pool may therefore decline in the event of a general downturn in the value of property in Iceland, which could adversely affect the Issuer's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

Limited Description of the Cover Pool

Save as contemplated by each Final Terms, holders of the Covered Bonds will not receive detailed statistics or information in relation to the assets contained or to be contained in the Bank's cover pool, as it is expected that the constitution of the cover pool may change from time to time due to, for example, the purchase or origination of further residential mortgages by the Bank from time to time. Although an independent inspector appointed under the Icelandic Covered Bond Act will monitor the Bank's compliance with some of the requirements of the Icelandic Covered Bond Act, the report of such inspector is not publicly available.

Geographic Concentration Risks

Certain geographic regions of Iceland from time to time will experience weaker regional economic conditions and housing markets or be directly or indirectly affected by natural disasters or civil disturbances. Mortgage loans in such areas will experience higher rates of loss and delinquency than mortgage loans generally.

The ability of borrowers to make payments on the mortgage loans may also be affected by factors which do not necessarily affect property values, such as adverse economic conditions generally in particular geographic areas or industries, or affecting particular segments of the borrowing community (such as borrowers relying on commission income and self-employed borrowers). Such occurrences may accordingly affect the actual rates of delinquencies and losses with respect to the mortgage loans in the cover pool.

The mortgage loans underlying certain series of Covered Bonds may be concentrated in certain regions. Such concentration may present the risk considerations described above in addition to those generally present for similar securities without such concentration.

Appraisals

In accordance with the Icelandic Covered Bond Act, appraisals or valuation of the properties securing the mortgage loans may be undertaken by the Issuer, and takes account of the following: (a) The selling price of a property on the day the transaction is made; or (b) an independent appraisal conducted by a licensed estate agent; or (c) an acquisition offer, signed on behalf of both the seller and the buyer; or (d) the rateable value of the property, made by the Icelandic Property Registry. Appraisals based on the selling price of a property shall be valid for a period of 12 months from the day the transaction was made.

Such appraisal undertaken by the Issuer will be verified by the independent inspector as being based on an accepted methodology.

No assurance can be given that values of the properties underlying the mortgage loans have remained or will remain at the levels which existed on the dates of appraisal (or, where applicable, on the dates of appraisal updates) of the related mortgage loans.

The appraisal relates both to the land and to the structure; in fact, a significant portion of the appraised value of a property may be attributable to the value of the land rather than to the residence. Because of the unique locations and special features of certain properties, identifying comparable properties in nearby locations may be difficult. The appraised values of such properties will be based to a greater extent on adjustments made by the appraisers to the appraised values of reasonably similar properties rather than on objectively verifiable sales data. As a result, such appraisals could be more likely to overvalue certain properties and therefore overstate the value of the collateral underlying the cover pool.

Audit of the Cover Pool

Other than any interim financial statements or annual audited financial statements incorporated by reference in this Offering Circular, the Bank does not publish any separate reviews or audits of the cover pool. However, in accordance with the requirements of the Icelandic Covered Bond Act and the FME the Bank is monitored by an independent inspector appointed licensed by the FME who monitors that the register is maintained in a correct manner. Furthermore, none of the Arranger and any Dealer have conducted any audit of the Cover Pool.

Factors that may affect the realisable value of the Cover Pool

The Cover Pool Revenue or the realisable value of Cover Pool, in the event of the winding up of the Issuer, may be reduced, which may affect the ability of the Issuer (or the winding up committee in the event of the winding up of the Issuer) to make payments on the Covered Bond as a result of:

- default by Borrowers in payment of amounts due on their Mortgage Bonds;
- changes to the lending criteria of the Issuer (the **Lending Criteria**);
- no representations or warranties being given by the Issuer;
- set-off risks in relation to some types of Mortgage Bonds in the Cover Pool; and
- possible regulatory changes by regulatory authorities in Iceland.

Each of these factors is considered in more detail below. However, it should be noted that the matching rules under the Icelandic Covered Bond Act are intended to ensure that the value of the Cover Pool will be sufficient to enable the Issuer to meet its obligations under the Covered Bonds and the derivative agreements.

The Parliamentary Ombudsman's investigation into the calculation of the price indexation of loans by the Central Bank

The parliamentary ombudsman has launched an investigation into whether the current rules of the Central Bank no. 492/2001 on the Price Indexation of Savings and Loans, which were established on the basis of the Interest and Indexation Act no. 38/2001, were lacking a legal basis which may have resulted in the Central Bank's having calculated the price indexation of loans incorrectly compared to what it is provided for in Act no. 38/2001. The Central Bank, however, believes that the main principles provided for in Act no. 38/2001 have been employed correctly. The Parliamentary Ombudsman's investigation is at the preliminary stages, and therefore it is impossible to say what conclusion will be reached and what the effect may be, should it transpire that the rules of the Central Bank had no legal basis. This may affect price-indexed loans in the Cover Pool.

Default by Borrowers in paying amounts due on their Mortgage Bonds

Borrowers may default on their obligations under the Mortgage Bonds in the Cover Pool. Defaults may occur for a variety of reasons. The Mortgage Bonds are affected by credit, liquidity and interest rate risks. Various factors influence mortgage delinquency rates, prepayment rates, repossession frequency and the ultimate payment of interest and principal, such as changes in the national or international economic climate, regional economic or housing conditions, changes in tax laws, interest rates, inflation, the availability of financing, yields on alternative investments, political developments and government policies. Other factors in Borrowers' individual, personal or financial circumstances may affect the ability of Borrowers to repay the Mortgage Bonds. Loss of earnings, illness, divorce and other similar factors may lead to an increase in delinquencies by and bankruptcies of Borrowers, and could ultimately have an adverse impact on the ability of Borrowers to repay the Mortgage Bonds. In addition, the ability of a Borrower to sell a property given as security for a Mortgage Bond at a price sufficient to repay the amounts outstanding under that Mortgage Bond will depend upon a number of factors, including the availability of buyers for that property, the value of that property and property values in general at the time.

The Icelandic Covered Bond Act provides that no Mortgage Bond may be registered in the Cover Pool if payment on it is in arrears of 90 days or more.

Changes to the Lending Criteria of the Issuer

Each of the Mortgage Bonds originated by the Issuer will have been originated in accordance with its Lending Criteria at the time of origination. It is expected that the Issuer's Lending Criteria will generally consider type of property, term of loan, age of applicant, the loan-to-value ratio, status of applicants and credit history. The Issuer retains the right to revise its Lending Criteria from time to time but would do so only to the extent that such a change would be acceptable to a Reasonable, Prudent Mortgage Lender. If the Lending Criteria change in a manner that affects the creditworthiness of the Mortgage Bonds, that may lead to increased defaults by Borrowers and may affect the Cover Pool Revenue or the realisable value of the Cover Pool.

In accordance with the Icelandic Covered Bond Act the Issuer may only include in the Cover Pool Mortgage Bonds issued against Mortgages secured by real property if the loan-to-value (**LTV**) ratio does not exceed 80% for residential property, 60% for industrial, office or commercial property, and 70% for agricultural property. Moreover, as noted above, Mortgage Bonds in arrears for 90 days or more may not be registered in the Cover Pool.

Set-off risks in relation to some types of Mortgage Bonds may adversely affect the value of the Cover Pool or any part thereof

The registration of assets in the Cover Pool will not affect rights of Borrowers. Therefore, the Borrowers will continue to have independent set-off rights against the Issuer (such as, for example, set-off rights associated with Borrowers holding deposits with the Issuer).

The exercise of set-off rights by Borrowers may adversely affect the realisable value of the Cover Pool and/or the ability of the winding up committee to meet in full the Issuer's obligation under the Covered Bond. In order to mitigate this risk the Issuer currently intends that it shall include additional assets in the Cover Pool up to a value that is equal to the set-off risk as calculated periodically as may be required or agreed from time to time with the Rating Agencies.

No representations or warranties to be given by the Issuer if Cover Pool to be sold

In the event of the winding up of the Issuer, the winding up committee shall fulfil the Issuers' obligations under the Covered Bonds and Swap Agreements using the assets in the Cover Pool and the Cover Pool Revenue. In respect of any sale of assets in the Cover Pool to third parties, the Issuer may not be permitted to give representations and warranties or indemnities in respect of the assets in the Cover Pool. Accordingly, there is a risk that the realisable value of the Cover Pool could be adversely affected by the lack of representations and warranties or indemnities which in turn could adversely affect the ability of the administrator to meet in full all the Issuer's obligations under the Covered Bonds.

Reliance on Swap Providers

A brief description of certain risks relating to the Swaps is set out below. As of the date of this Offering Circular, the Issuer has not entered into any Swaps in connection with this programme and any issuances thereunder.

Reliance on Currency Swaps

Subject to currency restrictions in place at each time, the Issuer may rely on the Currency Swap Providers under the Currency Swaps to provide payments on Covered Bonds denominated in currencies other than ISK. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under a Currency Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Currency Swap. If the Issuer defaults under a Currency Swap due to non-payment or otherwise, the relevant Currency Swap Provider will not be obliged to make further payments under that Currency Swap and may terminate that Currency Swap. If a Currency Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Currency Swap Agreement, or if it defaults in its obligations to make payments under a Currency Swap, the Issuer will be exposed to changes in currency exchange rates and in the associated interest rates on the currencies. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

Reliance on Interest Rate Swaps

Subject to currency restrictions in place at each time, in order to hedge the Issuer's interest rate risks in ISK and/or other currencies to the extent that these have not already been hedged by the Cover Pool Swap or a Currency Swap, the Issuer may enter into Interest Rate Swaps. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under an Interest Rate Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Interest Rate Swap. If the substitute assets available to the Issuer on a payment date are insufficient to make the payment ordinarily required in full, the payment obligations of both the Issuer and the swap counterparty on that payment date may be reduced accordingly and may be deferred should the Issuer introduce deferral of payment mechanics into the interest rate swaps. If the Issuer defaults under an Interest Rate Swap due to non-payment or otherwise, the relevant Interest Rate Swap Provider will not be obliged to make further payments under that Interest Rate Swap and may terminate that Interest Rate Swap. If an Interest Rate Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Interest Rate Swap Agreement, or if it defaults in its obligations to make payments under an Interest Rate Swap, the Issuer will be exposed to changes in interest rates. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

Reliance on Indexed Currency Swaps

Subject to currency restrictions in place at each time, the Issuer may rely on the Indexed Currency Swap Providers under the Currency Swaps to provide payments on Covered Bonds denominated in currencies other than ISK and not indexed linked. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under an Indexed Currency Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Currency Swap. If the Issuer defaults under an Index Currency Swap due to non-payment or otherwise, the relevant Indexed Currency Swap Provider will not be obliged to make further payments under that Indexed Currency Swap and may terminate that Indexed Currency Swap. If an Indexed Currency Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Indexed Currency Swap Agreement, or if it defaults in its obligations to make payments under an Indexed Currency Swap, the Issuer will be exposed to changes in currency exchange rates, the associated interest rates on the currencies and inflation. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

Reliance on Cover Pool Swap

In order to hedge the possible variance between the rates of interest payable on the Covered Bonds and the various rates of interest payable in respect of certain assets registered to the Cover Pool, the Issuer will enter into the Cover Pool Swap. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under the Cover Pool Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Cover Pool Swap. If the Issuer defaults under the Cover Pool Swap due to non-payment or otherwise, the Cover Swap Provider will not be obliged to make further payments under the Cover Pool Swap and may terminate the Cover Pool Swap. If the Cover Pool Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the Cover Pool Swap Agreement, or if it defaults in its obligations to make payments under the Cover Pool Swap, the Issuer will be exposed to changes in interest rates. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

Termination payments for Swaps

If any of the Interest Rate Swaps, Currency Swaps or Cover Pool Swap are terminated, the Issuer may as a result be obliged to make a termination payment to the relevant Swap Provider. The amount of the termination payment will be based on the cost of entering into a replacement Interest Rate Swap, Currency Swap or Cover Pool Swap, as the case may be. Any termination payment to be made by the Issuer to a Swap Provider will rank *pari passu* with payments due to the Covered Bondholders.

Potential amendments to the swap agreements

lf and when the Issuer enters into a swap agreement in the context of an issue of Covered Bonds, the terms of the swap agreement will be negotiated with the relevant swap provider. As a result of such negotiations, the terms of a swap agreement may contain terms that adversely affect the Issuer's results of operations, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

Risks related to the structure of a particular issue of Covered Bonds

A wide range of Covered Bonds may be issued under the Programme. A number of these Covered Bonds may have features which contain particular risks for potential investors. Set out below is a description of the most common such features:

If the Issuer has the right to redeem any Covered Bonds at its option, this may limit the market value of the Covered Bonds concerned and an investor may not be able to reinvest the redemption proceeds in a manner which achieves a similar effective return

An optional redemption feature of Covered Bonds is likely to limit their market value. During any period when the Issuer may elect to redeem Covered Bonds, the market value of those Covered Bonds generally will not rise substantially above the price at which they can be redeemed. This also may be true prior to any redemption period.

The Issuer may be expected to redeem Covered Bonds when its cost of borrowing is lower than the interest rate on the Covered Bonds. At those times, an investor generally would not be able to reinvest the redemption proceeds at an effective interest rate as high as the interest rate on the Covered Bonds being redeemed and may only be able to do so at a significantly lower rate. Potential investors should consider reinvestment risk in light of other investments available at that time.

There are particular risks associated with an investment in Inflation Linked Covered Bonds and Inflation Linked Non-Amortising Covered Bonds. In particular, an investor might receive less interest than expected or no interest in respect of such Covered Bonds and may lose some or all of the principal amount invested by it

Subject to any applicable legal or regulatory restrictions being lifted, the Issuer may issue Covered Bonds with principal or interest determined by reference to an index or formula, to changes in the prices of securities or commodities, to movements in currency exchange rates or other factors (each, a **Relevant Factor**). In addition, the Issuer may issue Covered Bonds with principal or interest payable in one or more currencies which may be different from the currency in which the Covered Bonds are denominated. Potential investors should be aware that:

(a) the market price of such Covered Bonds may be volatile;

(b) they may receive no interest;

(c) payment of principal or interest may occur at a different time or in a different currency than expected;

(d) they may lose all or a substantial portion of their principal;

(e) a Relevant Factor may be subject to significant fluctuations that may not correlate with changes in interest rates, currencies or other indices;

(f) if a Relevant Factor is applied to Covered Bonds in conjunction with a multiplier greater than one or contains some other leverage factor, the effect of changes in the Relevant Factor on principal or interest payable likely will be magnified; and

(g) the timing of changes in a Relevant Factor may affect the actual yield to investors, even if the average level is consistent with their expectations. In general, the earlier the change in the Relevant Factor, the greater the effect on yield.

The historical experience of an index or other Relevant Factor should not be viewed as an indication of the future performance of such Relevant Factor during the term of any Covered Bonds. Accordingly, each potential investor should consult its own financial and legal advisers about the risk entailed by an investment in any Covered Bonds linked to a Relevant Factor and the suitability of such Covered Bonds in light of its particular circumstances.

Covered Bonds which are issued with variable interest rates or which are structured to include with a multiplier or other leverage factor are likely to have more volatile market values than more standard securities

Covered Bonds with variable interest rates can be volatile investments. If they are structured to include multipliers or other leverage factors, or caps or floors, or any combination of those features or other similar related features, their market values may be even more volatile than those for securities that do not include those features and, as a consequence, could drop further in value.

Inverse Floating Rate Covered Bonds will have more volatile market values than conventional Floating Rate Covered Bonds

Inverse Floating Rate Covered Bonds have an interest rate equal to a fixed rate minus a rate based upon a reference rate such as LIBOR. The market values of those Covered Bonds typically are more volatile than market values of other conventional floating rate debt securities based on the same reference rate (and with otherwise comparable terms). Inverse Floating Rate Covered Bonds are more volatile because an increase in the reference rate not only decreases the interest rate of the Covered Bonds, but may also reflect an increase in prevailing interest rates, which further adversely affects the market value of these Covered Bonds.

If the Issuer has the right to convert the interest rate on any Covered Bonds from a fixed rate to a floating rate, or vice versa, this may affect the secondary market and the market value of the Covered Bonds concerned

Fixed/Floating Rate Covered Bonds may bear interest at a rate that converts from a fixed rate to a floating rate, or from a floating rate to a fixed rate. Where the Issuer has the right to effect such a conversion, this will affect the secondary market and the market value of the Covered Bonds since the Issuer may be expected to convert the rate when it is likely to produce a lower overall cost of borrowing. If the Issuer converts from a fixed rate to a floating rate in such circumstances, the spread on the Fixed/Floating Rate Covered Bonds may be less favourable than then prevailing spreads on comparable Floating Rate Covered Bonds tied to the same reference rate. In addition, the new floating rate at any time may be lower than the rates on other Covered Bonds. If the Issuer converts from a floating rate to a fixed rate in such circumstances, the fixed rate may be lower than then prevailing market rates on its Covered Bonds.

Covered Bonds which are issued at a substantial discount or premium may experience price volatility in response to changes in market interest rates

The market values of securities issued at a substantial discount or premium from their principal amount tend to fluctuate more in relation to general changes in interest rates than do prices for conventional interest-bearing securities. Generally, the longer the remaining term of such securities, the greater the price volatility as compared to more conventional interest-bearing securities with comparable maturities.

Extendable obligations under the Covered Bonds

Following the failure by the Issuer to pay the Final Redemption Amount of a Series of Covered Bonds on their Maturity Date, payment of such amounts shall be automatically deferred. This will occur if the Final Terms for a relevant Series of Covered Bonds (the **Relevant Series of Covered Bonds**) provides that such Covered Bonds are subject to an extended final maturity date on which the payment of all or (as applicable) part of the Final Redemption Amount payable on the Maturity Date will be deferred in the event that the Final Redemption Amount is not paid in full on the Maturity Date (the **Extended Final Maturity Date**).

To the extent that the Issuer has sufficient moneys available to pay in part the relevant Final Redemption Amount in respect of the relevant Series of Covered Bonds, the Issuer shall make partial payment of the relevant Final Redemption Amount as described in Condition 7.10. Payment of all unpaid amounts shall be deferred automatically until the applicable Extended Final Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date thereafter up to (and including) the relevant Extended Final Maturity Date.

The Issuer is not required to notify the Covered Bondholders of such automatic deferral. The Extended Final Maturity Date will be specified in the relevant Final Terms. Interest will continue to accrue on any unpaid amount and be payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Final Maturity Date. In these circumstances, failure by the Issuer to make payment in respect of the Final Redemption Amount on the Maturity Date shall not constitute a default in payment by the Issuer.

However, failure by the Issuer to pay the Final Redemption Amount or the balance thereof on the Extended Final Maturity Date and/or interest on such amount on any Interest Payment Date falling after the Maturity Date up to (and including) the Extended Final Maturity Date shall constitute a default in payment by the Issuer.

Furthermore, in relation to all amounts constituting accrued interest due and payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Final Maturity Date, as provided in the applicable Final Terms, the Issuer may pay such interest pursuant to the Floating Rate set out in the applicable Final Terms notwithstanding that the relevant Covered Bond was a Fixed Rate Covered Bond as at its relevant Issue Date.

In addition, following deferral of the Maturity Date, the Interest Payment Dates and Interest Periods may change as set out in the applicable Final Terms.

Risks related to Covered Bonds generally

Set out below is a description of material risks relating to the Covered Bonds generally:

The Covered Bonds may not be a suitable investment for all investors

Each potential investor in the Covered Bonds must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

(a) have sufficient knowledge and experience to make a meaningful evaluation of the Covered Bonds, the merits and risks of investing in the Covered Bonds and the information contained or incorporated by reference in this Offering Circular or any applicable supplement;

(b) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Covered Bonds and the impact the Covered Bonds will have on its overall investment portfolio;

(c) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Covered Bonds, including Covered Bonds with principal or interest payable in one or more currencies, or where the currency for principal or interest payments is different from the potential investor's currency;

(d) understand thoroughly the terms of the Covered Bonds and be familiar with the behaviour of any relevant indices and financial markets; and

(e) be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for legislative, economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

Some Covered Bonds are complex financial instruments. Sophisticated institutional investors generally do not purchase complex financial instruments as stand-alone investments. They purchase complex financial instruments as a way to reduce risk or enhance yield with an understood, measured, appropriate addition of risk to their overall portfolios. A potential investor should not invest in Covered Bonds which are complex financial instruments unless it has the expertise (either alone or with a financial adviser) to evaluate how the Covered Bonds will perform under changing conditions, the resulting effects on the value of the Covered Bonds and the impact this investment will have on the potential investor's overall investment portfolio.

Covered Bonds are obligations of the Issuer only

The Covered Bonds will constitute obligations of the Issuer only which have the benefit of a statutory preference under the Icelandic Covered Bond Act on the Cover Pool maintained by the Issuer. An investment in the Covered Bonds involves a reliance on the creditworthiness of the Issuer. The Covered Bonds are not guaranteed by any other person. In addition, an investment in the Covered Bonds involves the risk that subsequent changes in the actual or perceived creditworthiness of the Issuer may adversely affect the market value of the relevant Covered Bonds. There can be no assurance that the Cover Pool will be sufficient to pay in full the amounts payable under the Covered Bonds.

Covered Bonds issued under the Programme

Covered Bonds issued under the Programme (save in respect of the first issue of Covered Bonds) will either be fungible with an existing Series of Covered Bonds or have different terms to an existing Series of Covered Bonds (in which case they will constitute a new Series). All Covered Bonds issued from time to time will rank *pari passu* with each other in all respects and will rank *pari passu* with any other Covered Bonds which may be issued by the Issuer in accordance with the Icelandic Covered Bond Act.

Covered Bondholder Meetings

The conditions of the Covered Bonds contain provisions for calling meetings of Covered Bondholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Covered Bondholders including Covered Bondholders who did not attend and vote at the relevant meeting and Covered Bondholders who voted in a manner contrary to the majority. As a result, Covered Bondholders can be bound by the result of a vote they voted against. Certain significant modifications may be made following approval of a quorum of one or more persons holding or representing not less than two-thirds in aggregate nominal amount of the Covered Bonds for the time being outstanding, including modifying the date of maturity of the Covered Bonds or any date for payment of interest thereof, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Covered Bonds or altering the currency of payment of the Covered Bonds.

The value of the Covered Bonds could be adversely affected by a change in law or administrative practice

The conditions of the Covered Bonds are governed by English law (or, in respect of Condition 3, Icelandic law) in effect as at the date of this Offering Circular. No assurance can be given as to the impact of any possible judicial decision or change to English law or Icelandic law or administrative practice after the date of this Offering Circular and any such change could materially adversely impact the value of any Covered Bonds affected by it.

Investors who purchase Covered Bonds in denominations that are not an integral multiple of the Specified Denomination may be adversely affected if definitive Covered Bonds are subsequently required to be issued

In relation to any issue of Covered Bonds which have denominations consisting of a minimum Specified Denomination plus one or more higher integral multiples of another smaller amount, it is possible that such Covered Bonds may be traded in amounts in excess of the minimum Specified Denomination that are not integral multiples of such minimum Specified Denomination. In such a case a holder who, as a result of trading such amounts, holds an amount which is less than the minimum Specified Denomination in his account with the relevant clearing system would not be able to sell the remainder of such holding without first purchasing a principal amount of Covered Bonds at or in excess of the minimum Specified Denomination such that its holding amounts to a Specified Denomination. Further, a holder who, as a result of trading such amounts, holds an amount which is less than the minimum Specified Denomination in his account with the relevant clearing system at the relevant time may not receive a definitive Covered Bond in respect of such holding (should definitive Covered Bonds be printed) and, in order to receive a definitive Covered Bond, would need to purchase a principal amount of Covered Bonds at or in excess of the minimum Specified Denomination such that its holding amounts to a Specified Denomination.

If such Covered Bonds in definitive form are issued, holders should be aware that definitive Covered Bonds which have a denomination that is not an integral multiple of the minimum Specified Denomination may be illiquid and difficult to trade.

Reliance on Euroclear and Clearstream, Luxembourg procedures

Covered Bonds (other than the ISD Covered Bonds) issued under the Programme will be represented on issue by one or more Global Covered Bonds that may be deposited with a common depositary (in the case of Bearer Global Covered Bonds) or common safekeeper (in the case of Registered Global Covered Bonds) for Euroclear and Clearstream, Luxembourg (each as defined under "*Form of the Covered Bonds*"). Except in the circumstances described in each Global Covered Bond, investors will not be entitled to receive Covered Bonds in definitive form. Each of Euroclear and Clearstream, Luxembourg and their respective direct and indirect participants will maintain records of the beneficial interests in each Global Covered Bond held through it. While the Covered Bonds (other than the ISD Covered Bonds) are represented by Global Covered Bonds, investors will be able to trade their beneficial interests only through the relevant clearing systems and their respective participants.

While the Covered Bonds (other than the ISD Covered Bonds) are represented by Global Covered Bonds, the Issuer will discharge its payment obligation under the Covered Bonds by making payments through the relevant clearing systems. A holder of a beneficial interest in a Global Covered Bonds must rely on the procedures of the relevant clearing system and its participants to receive payments under the Covered Bonds. The Issuer has no responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in any Global Covered Bond.

Holders of beneficial interests in a Global Covered Bonds will not have a direct right to vote in respect of the Covered Bonds so represented. Instead, such holders will be permitted to act only to the extent that they are enabled by the relevant clearing system and its participants to appoint appropriate proxies.

Risks related to the market generally

Set out below is a description of material market risks, including liquidity risk, exchange rate risk, interest rate risk and credit risk:

An active secondary market in respect of the Covered Bonds may never be established or may be illiquid and this would adversely affect the value at which an investor could sell his Covered Bonds

Covered Bonds may have no established trading market when issued, and one may never develop. If a market does develop, it may not be very liquid. Additionally, the market places concerned may be closed, or temporary restrictions may be imposed. Therefore, investors may not be able to sell their Covered Bonds easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. This is particularly the case for Covered Bonds that are especially sensitive to interest rate, currency or market risks, are designed for specific investment objectives or strategies or have been structured to meet the investment requirements of limited categories of investors. These types of Covered Bonds generally would have a more limited secondary market and more price volatility than conventional debt securities. Illiquidity may have a severely adverse effect on the market value of Covered Bonds.

The Covered Bonds have not been, and will not be, registered under the Securities Act or any other applicable securities laws and they are subject to certain restrictions on the resale and other transfer thereof as set forth under "*Subscription and Sale and Selling Restrictions*".

Lack of liquidity in the secondary market may adversely affect the market value of the Covered Bonds

Generally weak global credit market conditions could contribute to a lack of liquidity in the secondary market for instruments similar to the Covered Bond. In addition, the difficult market conditions which have prevailed since mid-September 2008 have limited the primary market for a number of financial products including instruments similar to the Covered Bonds. While some measures have been taken by governments, there can be no assurance that the market for securities similar to the Covered Bonds will recover at the same time or to the same degree as such other recovering global credit market sectors.

If an investor holds Covered Bonds which are not denominated in the investor's home currency, he will be exposed to movements in exchange rates adversely affecting the value of his holding. In addition, the imposition of exchange controls in relation to any Covered Bonds could result in an investor not receiving payments on those Covered Bonds

The Issuer will pay principal and interest on the Covered Bonds in the Specified Currency. Subject to currency restrictions in place at each time, if Covered Bonds are issued in currencies other than ISK, this presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the **Investor's Currency**) other than the Specified Currency. These include the risk that exchange rates may significantly change (including changes due to devaluation of the Specified Currency or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to the Specified Currency would decrease (1) the Investor's Currency-equivalent yield on the Covered Bonds, (2) the Investor's Currency-equivalent value of the principal payable on the Covered Bonds and (3) the Investor's Currency-equivalent market value of the Covered Bonds.

Icelandic government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate or the ability of the Issuer to make payments in respect of the Covered Bonds. As a result, investors may receive less interest or principal than expected, or no interest or principal.

Exchange rate risk will be mitigated by the use of the Currency Swaps and by matching interest rate flow with the maturity of loan and other assets of the Issuer.

The value of Fixed Rate Covered Bonds may be adversely affected by movements in market interest rates

Interest rate risks occur when fixed interest periods or interest basis for assets and liabilities do not coincide. Investment in Fixed Rate Covered Bonds involves the risk that if market interest rates subsequently increase above the rate paid on the Fixed Rate Covered Bonds, this will adversely affect the value of the Fixed Rate Covered Bonds. Investments in Floating Rate Covered Bonds will involve a risk of interest rate changes.

The Issuer will enter into the Cover Pool Swap and Interest Rate Swaps to ensure that the risks do not exceed the limit values approved by its board of directors and to ensure that matching is maintained in accordance with the Icelandic Covered Bond Act.

Judicial considerations may restrict certain investments

The investment activities of certain investors are subject to rules and regulations and/or review or regulation by certain authorities. Each potential investor should consult its legal advisers or responsible supervisory authority in order to determine whether and to what extent the investor has the opportunity to invest in Covered Bonds.

Credit ratings assigned to the Covered Bonds may not reflect all the risks associated with an investment in those Covered Bonds

One or more independent credit rating agencies may assign credit ratings to the Covered Bonds. The ratings may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Covered Bonds. A credit rating is not a recommendation to buy, sell or hold securities and may be revised, suspended or withdrawn by its assigning rating agency at any time. A credit rating may not reflect all risks associated with an investment in the Covered Bonds.

In general, European regulated investors are restricted under Regulation (EC) No. 1060/2009 (as amended) (the **CRA Regulation**) from using credit ratings for regulatory purposes, unless such ratings are issued by a credit rating agency established in the EU and registered under the CRA Regulation (and such registration has not been withdrawn or suspended), subject to transitional provisions that apply in certain circumstances whilst the registration application is pending. Such general restriction will also apply in the case of credit ratings issued by non-EU credit rating agencies, unless the relevant credit ratings are endorsed by an EU-registered credit rating agency or the relevant non-EU rating agency is certified in accordance with the CRA Regulation (and such endorsement action or certification, as the case may be, has not been withdrawn or suspended). The list of registered and certified rating agencies published by the European Securities and Markets Authority (**ESMA**) on its website in accordance with the CRA Regulation is not conclusive evidence of the status of the relevant rating agency included in such list, as there may be delays between certain supervisory measures being taken against a relevant rating agency and the publication of the updated ESMA list. Certain information with respect to the credit rating agencies and ratings will be disclosed in the Final Terms, and is set out on the cover of this Offering Circular.

Legal investment considerations may restrict certain investments

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) Covered Bonds are legal investments for it, (2) Covered Bonds can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any Covered Bonds. Financial institutions should consult their legal advisors or the appropriate regulators to determine the appropriate treatment of Covered Bonds under any applicable risk-based capital or similar rules.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents which have previously been published or are published simultaneously with this Offering Circular and have been filed with the CSSF shall be incorporated by reference in, and form part of, this Offering Circular:

(a) the auditors' reports and audited consolidated annual financial statements of the Issuer for the financial years ended 31 December 2014 and 31 December 2015 including the information set out at the following pages in particular:

	Annual Report for the financial year ended 31 December 2014	Annual Financial Statement for the financial year ended 31 December 2015
Consolidated Statement of Financial Position	Page 8	Page 9
Significant Accounting Policies	Pages 66 to 76	Pages 69 to 78
Consolidated Statement of Cash Flows	Page 11	Page 11 to 12
Consolidated Statement of Comprehensive Income	Page 8	Page 8
Consolidated Statement of Changes in Equity………………………………….	Page 10	Page 10
Notes ………………………………….	Pages 13 to 76	Pages 13 to 78
Independent Auditor's Report ………...	Page 7	Page 7

The information incorporated by reference that is not included in the cross-reference list, is considered as additional information and is not required by the relevant schedules of Commission Regulation (EC) No 809/2004;

(b) the interim unaudited consolidated financial statements of the Issuer for the nine month period ended 30 September 2016 including the information set out at the following pages in particular:

Interim Consolidated Statement of Comprehensive Income……………………………………………..	Page 6
Interim Consolidated Statement of Financial Position……………………………………………	Page 7
Interim Consolidated Statement of Changes in Equity………………………………………………	Page 8
Interim Consolidated Statement of Cash Flows………………………………………………………	Pages 9 to 10
Significant Accounting Policies……………...………	Pages 57
Notes to the Interim Consolidated Financial Statements………………………………………………	Pages 11 to 57

The information incorporated by reference that is not included in the cross-reference list, is considered as additional information and is not required by the relevant schedules of Commission Regulation (EC) No 809/2004;

(c) On 16 November 2016 the Bank published the "Arion Bank Factbook – 30.9.2016" (the **Q3 2016 Factbook**).

the following information contained in the Q3 2016 Factbook, and set out at the pages below, is incorporated by reference in, and forms part of, this Base Prospectus:

KFI – 5 years………………………………………….. Page 2

The information incorporated by reference that is not included in the cross-reference list, is considered as additional information and is not required by the relevant schedules of Commission Regulation (EC) No 809/2004;

A copy of each of the Q3 2016 Interim Financial Statements and the Q3 2016 Factbook has been filed with the Commission de Surveillance du Secteur Financier.

(d) the terms and conditions of the Covered Bonds set out on pages 70 to 102 (inclusive) of the Prospectus dated 9 February 2012 and prepared by the Issuer in connection with the Programme;

(e) the terms and conditions of the Covered Bonds set out on pages 64 to 100 (inclusive) of the Prospectus dated 23 August 2013 and prepared by the Issuer in connection with the Programme;

(f) the terms and conditions of the Covered Bonds set out on pages 65 to 101 (inclusive) of the Prospectus dated 5 December 2014 and prepared by the Issuer in connection with the Programme; and

(g) the terms and conditions of the Covered Bonds set out on pages 66 to 101 (inclusive) of the Prospectus dated 18 December 2015 and prepared by the Issuer in connection with the Programme.

Following the publication of this Offering Circular, a supplement to the Offering Circular may be prepared by the Issuer and approved by the CSSF in accordance with Article 16 of the Prospectus Directive. Statements contained in any such supplement (or contained in any document incorporated by reference therein) shall, to the extent applicable, be deemed to modify or supersede statements contained in this Offering Circular or in a document which is incorporated by reference in this Offering Circular. Any statement so modified or superseded shall not, except as so modified or superseded, constitute a part of this Offering Circular.

Copies of documents incorporated by reference in this Offering Circular can be obtained from the Luxembourg Stock Exchange's website at www.bourse.lu and from the registered office of the Issuer and from the specified offices of the Agents for the time being in Luxembourg.

Any documents themselves incorporated by reference in the documents incorporated by reference in this Offering Circular shall not form part of this Offering Circular. In each case, where only certain sections of a document referred to (in item (c) above) are incorporated by reference in this Offering Circular, the parts of the document which are not incorporated by reference are either not relevant to prospective investors in the Covered Bonds or covered elsewhere in this Offering Circular.

The Issuer will, in the event of any significant new factor, material mistake or inaccuracy relating to information included in this Offering Circular which is capable of affecting the assessment of any Covered

Bonds, prepare a supplement to this Offering Circular or publish a new Offering Circular for use in connection with any subsequent issue of Covered Bonds.

FORM OF THE COVERED BONDS

The Covered Bonds of each Series will be either (i) in bearer form, with or without interest coupons attached, or (ii) in registered form, without interest coupons attached, or (iii) in uncertificated book entry form cleared through the ISD. Bearer Covered Bonds and ISD Covered Bonds will be issued outside the United States in reliance on Regulation S under the Securities Act (**Regulation S**) and Registered Covered Bonds will be issued both outside the United States in reliance on the exemption from registration provided by Regulation S.

Bearer Covered Bonds

Each Tranche of Bearer Covered Bonds will be in bearer form and will be initially issued in the form of a temporary global bond (a **Temporary Global Covered Bond**) or, if so specified in the applicable Final Terms, a permanent global bond (a **Permanent Global Covered Bond** and, together with a Temporary Bearer Global Covered Bond, each a **Bearer Global Covered Bond**) which, in either case, will:

(a) if the Global Covered Bonds are intended to be issued in new global note (**NGCB**) form, as stated in the applicable Final Terms, be delivered on or prior to the original issue date of the Tranche to a common safekeeper (the **Common Safekeeper**) for Euroclear Bank SA/NV (**Euroclear**) and Clearstream Banking, société anonyme (**Clearstream, Luxembourg**); and

(b) if the Global Covered Bonds are not intended to be issued in NGCB form, be delivered on or prior to the original issue date of the Tranche to a common depositary (the **Common Depositary**) for Euroclear and Clearstream, Luxembourg.

Bearer Covered Bonds will be issued outside the United States in reliance on Regulation S under the Securities Act (**Regulation S**).

Covered Bonds shall not be physically delivered in Belgium, except to a clearing system, a depository or other institution for the purpose of their immobilisation in accordance with article 4 of the Belgian Law of 14 December 2005.

Where the Global Covered Bonds issued in respect of any Tranche are in NGCB form, the applicable Final Terms will also indicate whether or not such Global Covered Bonds are intended to be held in a manner which would allow Eurosystem eligibility. Any indication that the Global Covered Bonds are to be so held does not necessarily mean that the Covered Bonds of the relevant Tranche will be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any times during their life as such recognition depends upon satisfaction of the Eurosystem eligibility criteria. The Common Safekeeper for NGCBs will either be Euroclear or Clearstream, Luxembourg or another entity approved by Euroclear and Clearstream, Luxembourg, as indicated in the applicable Final Terms.

Whilst any Covered Bond is represented by a Temporary Global Covered Bond, payments of principal, interest (if any) and any other amount payable in respect of the Covered Bonds due prior to the Exchange Date (as defined below) will be made (against presentation of the Temporary Global Covered Bond if the Temporary Global Covered Bond is not intended to be issued in NGCB form) only to the extent that certification (in a form to be provided) to the effect that the beneficial owners of interests in such Covered Bond are not U.S. persons or persons who have purchased for resale to any U.S. person, as required by U.S. Treasury regulations, has been received by Euroclear and/or Clearstream, Luxembourg and Euroclear and/or Clearstream, Luxembourg, as applicable, has given a like certification (based on the certifications it has received) to the Fiscal Agent.

On and after the date (the **Exchange Date**) which is 40 days after the Temporary Global Covered Bond is issued, interests in such Temporary Global Covered Bond will be exchangeable (free of charge) upon a request as described therein either for (a) interests in a Permanent Global Covered Bond of the same Series or (b) for definitive Covered Bonds of the same Series with, where applicable, receipts, interest coupons and talons attached (as indicated in the applicable Final Terms and subject, in the case of definitive Covered Bonds, to such notice period as is specified in the applicable Final Terms), in each case against certification of beneficial ownership as described above unless such certification has already been given. The holder of a Temporary Global Covered Bond will not be entitled to collect any payment of interest, principal or other amount due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Global Covered Bond for an interest in a Permanent Global Covered Bond or for definitive Covered Bonds is improperly withheld or refused.

Payments of principal, interest (if any) or any other amounts on a Permanent Global Covered Bond will be made through Euroclear and/or Clearstream, Luxembourg (against presentation or surrender (as the case may be) of the Permanent Global Covered Bond if the Permanent Global Covered Bond is not intended to be issued in NGCB form) without any requirement for certification.

The applicable Final Terms will specify that a Permanent Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for definitive Covered Bonds with, where applicable, receipts, interest coupons and talons attached upon either (a) not less than 60 days' written notice given at any time from Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Bearer Global Covered Bond) to the Fiscal Agent as described therein or (b) only upon the occurrence of an Exchange Event or (c) at any time at the request of the Issuer.

For these purposes, **Exchange Event** means that (a) the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and no successor clearing system is available or (b) the Issuer has or will become subject to adverse tax consequences which would not be suffered were the Covered Bonds represented by the Permanent Global Covered Bond in definitive form. The Issuer will promptly give notice to Covered Bondholders in accordance with Condition 14 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg or the common depositary or the common safekeeper for Euroclear and Clearstream, Luxembourg, as the case may be, on their behalf (acting on the instructions of any holder of an interest in such Permanent Global Covered Bond) may give notice to the Fiscal Agent requesting exchange and, in the event of the occurrence of an Exchange Event as described in (b) above, the Issuer may also give notice to the Fiscal Agent requesting exchange. Any such exchange shall occur not later than 45 days after the date of receipt of the first relevant notice by the Fiscal Agent.

The following legend will appear on all Bearer Covered Bonds (other than Temporary Global Covered Bonds) and on all receipts and interest coupons relating to such Covered Bonds where TEFRA D is specified in the applicable Final Terms, as the case may be:

"ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS, INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287(a) OF THE INTERNAL REVENUE CODE."

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on Bearer Covered Bonds, receipts or interest coupons and will not be entitled to capital gains treatment in respect of any gain on any sale, disposition, redemption or payment of principal in respect of such Bearer Covered Bonds, receipts or interest coupons.

Covered Bonds which are represented by a Bearer Global Covered Bonds will only be transferable in accordance with the rules and procedures for the time being of Euroclear or Clearstream, Luxembourg, as the case may be.

Registered Covered Bonds

The Registered Covered Bonds of each Tranche offered and sold in reliance on Regulation S, which will be sold to non-U.S. persons outside the United States, will initially be represented by a global note in registered form (a Regulation S Global Covered Bonds or Registered Global Covered Bonds). Prior to expiry of the distribution compliance period (as defined in Regulation S) applicable to each Tranche of Covered Bonds, beneficial interests in a Regulation S Global Covered Bonds may not be offered or sold to, or for the account or benefit of, a U.S. person save as otherwise provided in Condition 2 (*Transfers of Registered Covered Bonds*) and may not be held otherwise than through Euroclear or Clearstream, Luxembourg and such Regulation S Global Covered Bonds will bear a legend regarding such restrictions on transfer.

Registered Global Covered Bonds will either (i) be deposited with a common depositary or common safekeeper, as the case may be for Euroclear and Clearstream, Luxembourg, and registered in the name of a common nominee of, Euroclear and Clearstream, Luxembourg or in the name of a nominee of the common safekeeper, as specified in the applicable Final Terms. Persons holding beneficial interests in Registered Global Covered Bonds will be entitled or required, as the case may be, under the circumstances described below, to receive physical delivery of definitive Covered Bonds in fully registered form.

Payments of principal, interest and any other amount in respect of the Registered Global Covered Bonds will, in the absence of provision to the contrary, be made to the person shown on the Registered Covered Bond Register (as defined in Condition 7.5 (*Payments - Payments in respect of Registered Covered Bonds*) as the registered holder of the Registered Global Covered Bonds. None of the Issuer, any Paying Agent or the Registrar will have any responsibility or liability for any aspect of the records relating to or payments or deliveries made on account of beneficial ownership interests in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

Payments of principal, interest or any other amount in respect of the Registered Covered Bonds in definitive form will, in the absence of provision to the contrary, be made to the persons shown on the Registered Covered Bond Register on the relevant Record Date (as defined in Condition 7.5 (*Payments - Payments in respect of Registered Covered Bonds*) immediately preceding the due date for payment in the manner provided in that Condition.

Interests in a Registered Global Covered Bonds will be exchangeable (free of charge), in whole but not in part, for definitive Registered Covered Bonds without receipts, interest coupons or talons attached only upon the occurrence of an Exchange Event. For these purposes, **Exchange Event** means that (i) in the case of Covered Bonds registered in the name of a nominee for a common depositary for Euroclear and Clearstream, Luxembourg, the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and, in any such case, no successor clearing system is available or (ii) the Issuer has or will become subject to adverse tax consequences which would not be suffered were the Covered Bonds represented by the Registered Global Covered Bond in definitive form. The Issuer will promptly give notice to Covered Bondholders in accordance with Condition 14 (*Notices*) if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg or any person acting on their behalf (acting on the instructions of any holder of an interest in such Registered Global Covered Bond) may give notice to the Registrar requesting exchange and, in the event of the occurrence of an Exchange Event as described in (ii) above, the Issuer may also give notice to the Registrar requesting exchange. Any such exchange shall occur not later than 10 days after the date of receipt of the first relevant notice by the Registrar.

Transfer of Interests

Interests in a Registered Global Covered Bonds may, subject to compliance with all applicable restrictions, be transferred to a person who wishes to hold such interest in another Registered Global Covered Bonds. No beneficial owner of an interest in a Registered Global Covered Bond will be able to transfer such interest, except in accordance with the applicable procedures of Euroclear and Clearstream, Luxembourg, in each case to the extent applicable. Registered Covered Bonds are also subject to the restrictions on transfer set forth therein and will bear a legend regarding such restrictions, see "*Subscription and Sale and Selling Restrictions*".

ISD Covered Bonds

Each Tranche of ISD Covered Bonds will be issued in uncertificated book entry form cleared through the ISD. On the issue of such ISD Covered Bonds, the Issuer (if it is not the ISD Agent) will send a copy of the applicable Final Terms to the ISD Agent. On delivery of the applicable Final Terms by the ISD Agent to the ISD and notification to the ISD of the subscribers and their ISD account details by the relevant Dealer, the ISD Agent acting on behalf of the Issuer will credit each subscribing account holder with the ISD with a nominal amount of ISD Covered Bonds equal to the nominal amount thereof for which it has subscribed and paid.

Settlement of sale and purchase transactions in respect of ISD Covered Bonds in the ISD will take place in accordance with the market practice at the time of the transaction.

Title to the ISD Covered Bonds will pass by registration in the registers between the direct accountholders at the ISD in accordance with the rules and procedures of the ISD. The holder of an ISD Covered Bond will be the person evidenced as such by a book entry in the records of the ISD. The person evidenced (including any nominee) as a holder of the ISD Covered Bonds shall be treated as the holder of such ISD Covered Bonds for the purposes of payment of principal and interest on such ISD Covered Bonds. The expressions **Covered Bondholders** and **holder of Covered Bonds** and related expressions shall be construed accordingly.

General

Pursuant to the Agency Agreement (as defined under "*Terms and Conditions of the Covered Bonds*"), the Agent shall arrange that, where a further Tranche of Covered Bonds (not being ISD Covered Bonds) is issued which is intended to form a single Series with an existing Tranche of Covered Bonds at a point after the Issue Date of the Further Tranche, the Covered Bonds of such further Tranche shall be assigned a common code and ISIN which are different from the common code and ISIN assigned to Covered Bonds of any other Tranche of the same Series until such time as the Tranches are consolidated and form a single Series, which shall not be prior to the expiry of the distribution compliance period (as defined in Regulation S under the Securities Act) applicable to the Covered Bonds of such Tranche.

For so long as any of the Covered Bonds (other than a ISD Covered Bonds) is represented by a Global Covered Bond held on behalf of Euroclear and/or Clearstream, Luxembourg each person (other than Euroclear or Clearstream, Luxembourg) who is for the time being shown in the records of Euroclear or of Clearstream, Luxembourg as the holder of a particular nominal amount of such Covered Bonds (in which regard any certificate or other document issued by Euroclear or Clearstream, Luxembourg as to the nominal amount of such Covered Bonds standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer and its agents as the holder of such nominal amount of such Covered Bonds for all purposes other than with respect to the payment of principal or interest on such nominal amount of such Covered Bonds, for which purpose the bearer of the relevant Global Covered Bond shall be treated by the Issuer and its agents as the holder of such nominal amount of such Covered Bonds in accordance with and subject to the terms of the relevant Global Covered Bond and the expressions **Covered Bondholders** and **holder of Covered Bonds** and related expressions shall be construed accordingly.

Any reference herein to Euroclear and/or Clearstream, Luxembourg and/or the ISD shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system specified in the applicable Final Terms.

The Issuer may agree with any Dealer that Covered Bonds may be issued in a form not contemplated by the Terms and Conditions of the Covered Bonds herein, in which event a new Offering Circular or a supplement to the Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Covered Bond.

FORM OF FINAL TERMS

[Date]

ARION BANK HF

**Issue of [Aggregate Nominal Amount of Tranche] [Title of Covered Bonds]
under the €1,000,000,000
Covered Bond Programme**

PART A – CONTRACTUAL TERMS

Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated 23 December 2016 [and the supplement[s] to it dated [*date*] [and [*date*]] which [together] constitute[s] a base prospectus for the purposes of the Prospectus Directive (Directive 2003/71/EC) (the **Prospectus Directive**). This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5.4 of the Prospectus Directive and must be read in conjunction with the Offering Circular. Full information on the Issuer and the offer of the Covered Bonds is only available on the basis of the combination of these Final Terms and the Offering Circular. The Offering Circular and the Final Terms are available for viewing at Borgartún 19, 105 Reykjavík, Iceland and on the Luxembourg Stock Exchange's website at www.bourse.lu and from the registered office of the Issuer and from the specified office of the Agent in London.

[The following alternative language applies if the first tranche of an issue which is being increased was issued under an Offering Circular with an earlier date.]

[Terms used herein shall be deemed to be defined as such for the purposes of the Conditions (the **Conditions**) set forth in the Offering Circular dated [●] which are incorporated by reference in the Offering Circular dated]23 December 2016.] This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5.4 of the Prospectus Directive (Directive 2003/71/EC) (the **Prospectus Directive**) and must be read in conjunction with the Offering Circular dated 23 December 2016 [and the supplement[s] to it dated [*date*] [and [*date*]] which [together] constitute[s] a base prospectus for the purposes of the Prospectus Directive, including the Conditions incorporated by reference in the Offering Circular. Full information on the Issuer and the offer of the Covered Bonds is only available on the basis of the combination of these Final Terms and the Offering Circular dated 23 December 2016. Copies of such Offering Circulars and Final Terms are available for viewing at Borgartúni 19, 105 Reykjavík, Iceland and on the Luxembourg Stock Exchange's website at www.bourse.lu and copies may be obtained from the registered office of the Issuer and from the specified office of the Agent in London.]

1.	(a)	Series Number:	[ ]
	(b)	Tranche Number:	[ ]
	(c)	Series which Covered Bonds will be consolidated and form a single Series with:	[●]/[Not Applicable]
	(d)	Date on which the Covered Bonds will be consolidated and form a single Series with the Series specified above:	[●]/[Issue Date]/[Not Applicable]

2.	Specified Currency or Currencies:		[ ]
3.	Aggregate Nominal Amount:		
		Tranche:	[ ]
		Series:	[ ]
4.	Issue Price:		[ ]% of the Aggregate Nominal Amount [plus accrued interest from [●]
5.	(a)	Specified Denominations:	[ ]/€[100,000] and integral multiples of [€1,000] in excess thereof up to and including €199,000. No Covered Bonds in definitive form will be issued with a denomination above €[199,000].)
	(b)	Calculation Amount	[ ]
6.	(a)	Issue Date:	[ ]
	(b)	Interest Rate:	[Fixed Rate/ Floating Rate/ Zero Coupon/ Inflation Linked]
	(c)	Interest Commencement Date:	[ ]/[Issue Date]/[Not Applicable]
7.	Maturity Date:		[●]/[Interest Payment Date falling in or nearest to [●]
8.	Extended Final Maturity Date:		[●]/[Interest Payment Date falling in or nearest to [●]/[Not Applicable] *(If an Extended Final Maturity Date is specified and the Final Redemption Amount is not paid in full on the Maturity Date, payment of the unpaid amount will be automatically deferred until the Extended Final Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date occurring thereafter up to (and including) the relevant Extended Final Maturity Date. See Condition 8.1)*
9.	Interest Basis:		[[ ]% Fixed Rate] [[LIBOR/EURIBOR] +/- [ ]% Floating Rate] [Zero Coupon] [See paragraphs [16/17/18/19/20] below]
10.	Redemption/Payment Basis:		

		[Subject to any purchase or cancellation or early redemption, the Covered Bonds will be redeemed on the Maturity Date at [100] per cent. of their nominal amount.]/[Inflation linked redemption in accordance with item 16 below, and Conditions 6.3 and 8.3]/ [Inflation linked redemption in accordance with Condition 8.4]
11.	Change of Interest Basis:	[In accordance with paragraph [17]/[18] below]/[Not applicable]
12.	Put/Call Options:	[Investor Put] [Issuer Call] [Not Applicable]
13.	[Date of [Board] approval for issuance of Covered Bonds obtained:]	[●] [and [●], respectively]
14.	Method of distribution:	[Syndicated/Non-syndicated]
15.	Name and address of the Calculation Agent	[ ]

PROVISIONS RELATING TO INFLATION LINKED COVERED BONDS

16.	[Inflation Linked Covered Bond Provisions		[Applicable /Not Applicable]
	(a)	Rate(s) of Interest:	[ ] per cent. per annum [payable [annually/semi-annually/quarterly/other (specify)] in arrear]
	(b)	Interest Payment Date(s):	[The [ ] day in each month]/[[ ] in each year] up to and including the Final Maturity Date
	(c)	Number of Interest payments in a year:	[ ]
	(d)	Total number of annuity payments on the relevant Covered Bonds:	[ ]
	(e)	Base Index:	[●], being the value of the CPI on [●]
	(f)	Day Count Fraction:	[30/360 or Actual/360 or Actual/Actual (ICMA)]

PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE

17.	**Fixed Rate Covered Bond Provisions**		[Applicable/Not Applicable]
	(a)	Rate(s) of Interest:	[ ]% per annum payable [in arrear on each Interest Payment Date]
	(b)	Interest Payment Date(s):	[[ ] in each year up to and including the Maturity Date or the Extended Final Maturity Date, as applicable]

	(c)	Fixed Coupon Amount[(s)]: (*Applicable to Covered Bonds in definitive form.*)	[ ] per Calculation Amount
	(d)	Broken Amount(s): (*Applicable to Covered Bonds in definitive form.*)	[[ ] per Calculation Amount, payable on the Interest Payment Date falling [in/on] [ ]]/[Not Applicable]
	(e)	Day Count Fraction:	[30/360 or Actual/Actual (ICMA)]
	(f)	Determination Date(s):	[ ] in each year / [Not Applicable]
18.	**Floating Rate Covered Bond Provisions**		[Applicable/Not Applicable]
	(a)	Specified Period(s)/Specified Interest Payment Dates:	[ ]
	(b)	Business Day Convention:	[Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention]
	(c)	Additional Business Centre(s):	[[ ]/Not Applicable]
	(d)	Manner in which the Rate of Interest and Interest Amount is to be determined:	[Screen Rate Determination/ISDA Determination]
	(e)	Party responsible for calculating the Rate of Interest and Interest Amount (if not the Fiscal Agent):	[ ]
	(f)	Screen Rate Determination:	[Applicable/ Not Applicable]
		– Reference Rate:	[ ] Reference Rate: [●] month [LIBOR/EURIBOR]
		– Interest Determination Date(s):	[ ]
		– Relevant Screen Page:	[ ]
	(g)	ISDA Determination:	[Applicable/ Not Applicable]
		– Floating Rate Option:	[ ]
		– Designated Maturity:	[ ]
		– Reset Date:	[ ]
	(h)	Margin(s):	[+/-] [ ]% per annum
	(i)	Minimum Rate of Interest:	[ ]% per annum

	(j)	Maximum Rate of Interest:	[ ]% per annum
	(k)	Day Count Fraction:	[Actual/Actual (ISDA) Actual/365 (Fixed) Actual/365 (Sterling) Actual/360 30/360 30E/360 30E/360 (ISDA)]
19.	**Zero Coupon Covered Bond Provisions**[1]		[Applicable/Not Applicable]
	(a)	Accrual Yield:	[ ]% per annum
	(b)	Reference Price:	[ ]
	(c)	Day Count Fraction in relation to Early Redemption Amounts and late payment:	[Condition 8.7 applies/30/360 or Actual/Actual (ICMA) *r*] (*Consider applicable day count fraction if not U.S. dollar denominated*)
20.	**Inflation Linked Non-Amortising Covered Bond Provisions**		[Applicable /Not Applicable]
	(a)	Rate(s) of Interest:	[ ] per cent. per annum [payable [annually/semi-annually/quarterly/other (specify)] in arrear]
	(b)	Interest Payment Date(s):	[The [ ] day in each month]/[[ ] in each year] up to and including the Final Maturity Date
	(c)	Base Index:	[●], being the value of the CPI on [●]
	(d)	Day Count Fraction:	[30/360 or Actual/Actual (ICMA)]

PROVISIONS RELATING TO REDEMPTION

21.	**Issuer Call**		[Applicable/Not Applicable]
	(a)	Optional Redemption Date(s):	[ ]
	(b)	Optional Redemption Amount of each Covered Bond:	[ ] per Covered Bond of [ ] Specified Denomination
	(c)	If redeemable in part:	
		(i) Minimum Redemption Amount:	[ ]
		(ii) Maximum Redemption Amount:	[ ]

1 Zero Coupon Covered Bonds not to be issued with an Extended Final Maturity Date unless otherwise agreed with the Dealers.

	(d)	Notice period (if other than as set out in the Conditions):	[ ]
22.	Investor Put:		[Applicable/Not Applicable]
	(a)	Optional Redemption Date(s):	[●]
	(b)	Optional Redemption Amount:	[●] per Calculation Amount
	(c)	Notice period (if other than as set out in the Conditions):	[●]
23.	Final Redemption Amount of each Covered Bond		[[ ] per Covered Bond of [ ] Specified Denomination]/[[●] for the Inflation Linked Covered Bonds]/[In accordance with Condition 8.4 per Covered Bond of [ ] Specified Denomination]/[Not Applicable]
24.	Early Redemption Amount of each Covered Bond payable on redemption for taxation reasons:		[ ]/[As set out in Condition 8.7(b)]
25.	Relevant Percentage:		As at the Issue Date, [ ] per cent.

GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS

26.	Form of Covered Bonds:	[Bearer Covered Bonds [Temporary Global Covered Bond exchangeable for a Permanent Global Covered Bond which is exchangeable for definitive Covered Bonds [on 60 days' notice given at any time/only upon an Exchange Event.]] [Temporary Global Covered Bond exchangeable for definitive Covered Bonds on and after the Exchange Date.] [Permanent Global Covered Bond which is exchangeable for definitive Covered Bonds [on 60 days' notice given at any time/ only upon an Exchange Event/at any time at the request of the Issuer].] *(Ensure that this is consistent with the wording in the "Form of Covered Bonds" section of the Offering Circular and the Covered Bonds themselves.* *N.B. The exchange upon notice/at any time at the request of the Issuer options should not be expressed to be applicable if the Specified Denomination of the Covered Bonds in paragraph 6 includes language substantially to the following effect: " [€100,000 and*

		integral multiples of [€1,000] in excess thereof up to and including €199,000." Furthermore, such Specified Denomination construction is not permitted in relation to any issue of Covered Bonds which is to be represented on issue by a Temporary Global Covered Bond exchangeable for Definitive Covered Bonds.) [Registered Covered Bonds [Regulation S Global Covered Bond (U.S.$[ ] nominal amount) registered in the name of a common depositary for Euroclear and Clearstream, Luxembourg/a common safekeeper for Euroclear and Clearstream, Luxembourg]] [ISD Covered Bonds ISD Covered Bonds issued in uncertificated and dematerialised book entry form. See further item [7] of Part B below.]
27.	New Global Covered Bond:	[Yes] [No] *(If ISD Covered Bonds, insert "No")*
28.	Additional Financial Centre(s):	[●]/[Not Applicable]
29.	Talons for future Coupons or Receipts to be attached to definitive Covered Bonds in bearer form (and dates on which such Talons mature):	[Yes, as the Covered Bonds have more than 27 coupon payments, Talons may be required if, on exchange into definitive form, more than 27 coupons payments are still to be made /No.]
30.	Details relating to Instalment Covered Bonds; amount of each instalment, date on which each payment is to be made:	[Applicable/Not Applicable] [*[For Instalment Covered Bonds:]* Instalment Amount = [●] Instalment Date(s) = [●]]
31.	Redenomination:	[Redenomination not applicable/ The provisions of Condition 5 apply]

DISTRIBUTION

32.	(a)	If syndicated, names of Managers:	[Not Applicable/*give names*] *(If the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies, include names of entities agreeing to underwrite the issue on a firm commitment basis and names of the entities agreeing to place the issue without a firm commitment or on a "best efforts" basis if such entities are not the same as the Managers.)*
	(b)	Date of [Subscription] Agreement:	[ ]/ [Not Applicable] *(The above is only relevant if the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies.)*
	(c)	Stabilisation Manager(s) (if any):	[Not Applicable/*give name*]
33.	If non-syndicated, name of Dealer:		[*Name*]
34.	U.S. Selling Restrictions:		[Reg. S Category 1/2/3; TEFRA D/TEFRA C/TEFRA not applicable]

PART B – OTHER INFORMATION

1.	**ADMISSION TO TRADING**	[Application has been made by the Issuer (or on its behalf) for the Covered Bonds to be admitted to trading on [*specify relevant regulated market (for example the Bourse de Luxembourg, the London Stock Exchange's regulated market or the Regulated Market of the Luxembourg Stock Exchange)*] with effect from [ ].] [Application is expected to be made by the Issuer (or on its behalf) for the Covered Bonds to be admitted to trading on [*specify relevant regulated market (for example the Bourse de Luxembourg, the London Stock Exchange's regulated market or the Regulated Market of the Irish Stock Exchange)*] with effect from [ ].] [Not Applicable.]
	Estimate of total expenses related to admission to trading:	[●]
2.	**RATINGS**	
	Ratings:	The Covered Bonds to be issued have [not] been rated: [S & P: [ ]] [Moody's: [ ]] [Fitch: [ ]] [[Other]: [ ]] [The Covered Bonds to be issued [[have been]/[are expected to be]] rated *[insert details]* by *[insert credit rating agency name(s)]*.] Each of [defined terms] is established in the European Union and is registered under Regulation (EC) No. 1060/2009 (as amended) (the **CRA Regulation**). *(The above disclosure should reflect the rating allocated to Covered Bonds of the type being issued under the Programme generally or, where the issue has been specifically rated, that rating.)*

3. INTERESTS OF NATURAL AND LEGAL PERSONS INVOLVED IN THE ISSUE

[Save for any fees payable to the [Manager[s]/Dealer[s]], so far as the Issuer is aware, no person involved in the issue of the Covered Bonds has an interest material to the offer. The [Manager[s]/Dealer[s]] and [their/its] affiliates have engaged, and may in the future engage, in investment banking and/or commercial banking transactions with, and may perform other services for, the Issuer and its affiliates in the ordinary course of business]

4. REASONS FOR THE OFFER, ESTIMATED NET PROCEEDS AND TOTAL EXPENSES

(i)	Reasons for the offer	[ ]
(ii)	Estimated net proceeds:	[ ]
(iii)	Estimated total expenses:	[ ]
		(N.B.: Delete unless the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies, in which case (i) above is required where the reasons for the offer are different from making profit and/or hedging certain risks and, where such reasons are inserted in (i), disclosure of net proceeds and total expenses at (ii) and (iii) above are also required.)

5. YIELD (FIXED RATE COVERED BONDS ONLY)

Indication of yield:	[ ]

6. PERFORMANCE OF FORMULA/CPI, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING (*INFLATION LINKED COVERED BONDS AND INFLATION LINKED NON AMORTISING COVERED BONDS ONLY*)

[Need to include details of where past and future performance and volatility of the formula/CPI can be obtained.]

The Covered Bonds are linked to the performance of the Icelandic Consumer Price Index (CPI) produced based on data from Statistics Iceland

Information about the CPI can be obtained from the website of Statistics of Iceland being [http://www.statice.is/Statistics/Prices-and-consumption/Indices-overview]

The Issuer [intends to provide post-issuance information [*specify what information will be reported and where it can be obtained*]] [does not intend to provide post-issuance information]

(N.B. This paragraph only applies if the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies.)

7. OPERATIONAL INFORMATION

(i)	ISIN Code:	[ ]
(ii)	Common Code:	[ ]
(iii)	Any clearing system(s) other than Euroclear Bank S.A./N.V. and Clearstream Banking, société anonyme (together with the address of each such clearing system) and the relevant identification number(s):	[Not Applicable]/[Icelandic Securities Depository Ltd., Iceland]

(iv)	Delivery:	Delivery [against/free of] payment
(v)	Names and addresses of additional Paying Agent(s) (if any) or, in the case of ISD Covered Bonds, the ISD Agent:	[ ]
(vi)	Deemed delivery of clearing system notices for the purposes of Condition 14 (*Notices)*:	Any notice delivered to Covered Bondholders through the clearing systems will be deemed to have been given on the [second] [business] day after the day on which it was given to Euroclear, and Clearstream, Luxembourg and ISD.
(vii)	Intended to be held in a manner which would allow Eurosystem eligibility:	[Yes. Note that the designation "yes" simply means that the Covered Bonds are intended upon issue to be deposited with one of the ICSDs as common safekeeper [, and registered in the name of a nominee of one of the ICSDs acting as common safekeeper, that is, held under the NSS,] [*include this text for Registered Covered Bonds which are to be held under the NSS*] and does not necessarily mean that the Covered Bonds will be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any or all times during their life. Such recognition will depend upon the ECB being satisfied that Eurosystem eligibility criteria have been met.] [No. Whilst designation is specified as "no" at the date of these Final Terms, should the Eurosystem eligibility criteria be amended in the future such that the Covered Bonds are capable of meeting them the Covered Bonds may then be deposited with one of the ICSDs as common safekeeper (and registered in the name of a nominee of one of the ICSDs acting as common Safekeeper). Note that this does not necessarily mean that the Covered Bonds will then be recognised as eligible collateral for Eurosystem monetary policy and intra day credit operations by the Eurosystem at any time during their life. Such recognition will depend upon the ECB being satisfied that Eurosystem eligibility criteria have been met.]]

Signed on behalf of the Issuer:

By: ....

Duly authorised signatory

TERMS AND CONDITIONS OF THE COVERED BONDS

The following are the Terms and Conditions of the Covered Bonds. Where applicable, the Terms and Conditions will be incorporated by reference into each Global Covered Bond (as defined below) and each Definitive Covered Bond, in the latter case only if permitted by the rules of the relevant stock exchange or other relevant authority (if any) and agreed by the Issuer and the relevant Dealer at the time of issue but, if not so permitted and agreed, such definitive Covered Bond will have endorsed thereon or attached thereto such Terms and Conditions. The applicable Final Terms (or the relevant provisions thereof) will, where applicable, be endorsed upon, or attached to, each Global Covered Bond and definitive Covered Bond. Reference should be made to "Form of the Covered Bonds" for a description of the content of Final Terms which will specify which of such terms are to apply in relation to the relevant Covered Bonds.

The Covered Bonds are bonds issued by Arion Bank hf. (the **Issuer**) in accordance with the Icelandic Act on Covered Bonds no. 11/2008 (the **Icelandic Covered Bond Act**) and the Rules No. 528/2008 on covered bonds (the **Rules**). The Covered Bonds will be issued in compliance with any applicable legal or regulatory restrictions including the rules on foreign exchange issued by the Central Bank, and any reference to currencies other than ISK, and to Inflation Linked Covered Bonds and related expressions shall be construed as taking effect subject to such restrictions being lifted.

This Covered Bond is one of a Series (as defined below) of Covered Bonds issued by the Issuer.

References herein to the **Covered Bonds** shall be references to the Covered Bonds of this Series and shall mean:

(a) in relation to any Covered Bonds represented by a global Covered Bond (a **Global Covered Bond**), units of the lowest denomination specified in the relevant Final Terms (**Specified Denomination**) in the currency specified in the relevant Final Terms (**Specified Currency**);

(b) any Global Covered Bond; and

(c) any definitive Covered Bonds in bearer form (**Bearer Covered Bonds**) issued in exchange for a Global Covered Bond in bearer form; and

(d) any definitive Covered Bonds in registered form (**Registered Covered Bonds**) (whether or not issued in exchange for a Global Covered Bond in registered form); and

(e) any Covered Bonds issued in uncertificated book entry form cleared through the Icelandic Securities Depository (the **ISD Covered Bonds** and the **ISD**, respectively). ISD Covered Bonds are in dematerialised form. Any references in these Terms and Conditions (the **Conditions**) to Receipts, Coupons and Talons shall not apply to ISD Covered Bonds and no global or definitive Covered Bonds will be issued in respect of ISD Covered Bonds.

The Covered Bonds (other than the ISD Covered Bonds), the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an Agency Agreement dated 10 February 2012, as amended and restated on 23 December 2016 (such Agency Agreement as amended and/or supplemented and/or restated from time to time, the **Agency Agreement**), and made between the Issuer and The Bank of New York Mellon, London Branch as fiscal agent (the **Fiscal Agent**) and transfer agent (the **Transfer Agent**, which expression shall include any additional or successor transfer agents), and The Bank of New York Mellon Luxembourg S.A. as paying agent (the **Paying Agent**, which expression shall include any successor paying agent) and as registrar (the **Registrar**, which expression shall include any successor registrar). In relation to the ISD Covered Bonds, Arion Bank hf. will act as the ISD system account manager (the **ISD Agent**, which expression shall include any additional agent appointed by the Issuer from time to time in relation to the ISD

Covered Bonds). The Fiscal Agent, the Registrar the, other Paying Agents, the ISD Agent and the other Transfer Agents are together referred to as the **Agents**.

Interest bearing definitive Covered Bonds have interest coupons (**Coupons**) and, if indicated in the applicable Final Terms, talons for further Coupons (**Talons**) attached on issue. Any reference herein to Coupons or coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons or talons. Definitive Covered Bonds repayable in instalments have receipts (**Receipts**) for the payment of the instalments of principal (other than the final instalment) attached on issue. Global Covered Bonds do not have Receipts, Coupons or Talons attached on issue.

The Final Terms for this Covered Bond (or the relevant provisions thereof), as set out in Part A of the Final Terms which are (except in the case of ISD Covered Bonds) attached to or endorsed on this Covered Bond, complete the Conditions for the purposes of this Covered Bond. References to the **applicable Final Terms** are to Part A of the Final Terms (or the relevant provisions thereof) which are (except in the case of ISD Covered Bonds) attached to or endorsed on this Covered Bond and (in the case of the ISD Covered Bonds) which are deposited with the ISD and the ISD Agent. The expression Prospectus Directive means Directive 2003/71/EC (and amendments thereto, including the **2010 PD Amending Directive**) to the extent implemented in the relevant Member State of the European Economic Area and includes any relevant implementing measure in the relevant Member State and the expression 2010 PD Amending Directive means Directive 2010/73/EU.

Any reference to **Covered Bondholders** or **holders** in relation to any Covered Bonds shall mean (in the case of Bearer Covered Bonds) the holders of the Covered Bonds, (in the case of Registered Covered Bonds) the persons in whose name the Covered Bonds are registered and (in the case of ISD Covered Bonds) the persons who are for the time being shown in the records of the ISD as the holders of the Covered Bonds, and shall, in relation to any Covered Bonds represented by a Global Covered Bond and any ISD Covered Bonds, be construed as provided below. Any reference herein to **Receiptholders** shall mean the holders of the Receipts and any reference herein to **Couponholders** shall mean the holders of the Coupons and shall, unless the context otherwise requires, include the holders of the Talons.

As used herein, **Tranche** means Covered Bonds which are identical in all respects (including as to listing and admission to trading) and **Series** means a Tranche of Covered Bonds together with any further Tranche or Tranches of Covered Bonds which (a) are expressed to be consolidated and form a single series and (b) have the same terms and conditions or terms and conditions which are the same in all respects save for the amount and date of the first payment of interest thereon and the date from which interest starts to accrue.

The Covered Bondholders (except in the case of ISD Covered Bonds), the Receiptholders and the Couponholders are entitled to the benefit of the Deed of Covenant (the **Deed of Covenant**) dated 5 December 2014 and made by the Issuer. The original of the Deed of Covenant is held by the common depositary for Euroclear and Clearstream, Luxembourg (each as defined below).

Copies of the Agency Agreement and the Deed of Covenant are available for inspection during normal business hours at the specified office of each of the Fiscal Agent and the Registrar. Copies of the applicable Final Terms are available for viewing at the registered office of the Issuer and of the Fiscal Agent and on the Luxembourg Stock Exchange's website (www.bourse.lu) and copies may be obtained from those offices save that, if this Covered Bond is neither admitted to trading on a regulated market in the European Economic Area nor offered in the European Economic Area in circumstances where a prospectus is required to be published under the Prospectus Directive (Directive 2003/71/EC), the applicable Final Terms will only be obtainable by a Covered Bondholder holding one or more unlisted Covered Bonds of that Series and such Covered Bondholder must produce evidence satisfactory to the Issuer and (except in the case of ISD Covered Bonds) the relevant Paying Agent as to its holding of such Covered Bonds and identity. The Covered Bondholders, the Receiptholders and the Couponholders are deemed to have notice of, and are entitled to the benefit of, all the provisions of the Agency Agreement, the Deed of Covenant and the applicable Final Terms which are applicable to them. The statements in the Conditions include summaries of, and are subject to, the detailed provisions of the Agency Agreement.

Words and expressions defined in the Agency Agreement or used in the applicable Final Terms shall have the same meanings where used in the Conditions unless the context otherwise requires or unless otherwise stated and provided that, in the event of inconsistency between the Agency Agreement and the applicable Final Terms, the applicable Final Terms will prevail.

1. FORM, DENOMINATION AND TITLE

The Covered Bonds are in bearer form (**Bearer Covered Bonds**) or registered form (**Registered Covered Bonds**) or, in the case of ISD Covered Bonds, uncertificated book entry form, as specified in the applicable Final Terms, and, in the case of definitive Covered Bonds, in the Specified Currency and the Specified Denomination(s) and (other than ISD Covered Bonds) serially numbered. Covered Bonds of one Specified Denomination may not be exchanged for Covered Bonds of another Specified Denomination and Bearer Covered Bonds may not be exchanged for Registered Covered Bonds and *vice versa*. Neither Bearer Covered Bonds nor Registered Covered Bonds may be exchanged for ISD Covered Bonds and *vice versa*.

This Covered Bond may be a Fixed Rate Covered Bond, a Floating Rate Covered Bond, a Zero Coupon Covered Bond, an Inflation Linked Covered Bond, an Inflation Linked Non-Amortising Covered Bonds or a combination of any of the foregoing, depending upon the Interest Basis shown in the applicable Final Terms and may be an Instalment Covered Bond.

This Covered Bond may be an Inflation Linked Covered Bond or an Inflation Linked Non-Amortising Covered Bonds depending on the Redemption/Payment Basis shown in the applicable Final Terms.

Definitive Covered Bonds are issued with Coupons attached, unless they are Zero Coupon Covered Bonds in which case references to Coupons and Couponholders in the Conditions are not applicable.

Subject as set out below, title to the Bearer Covered Bonds, Receipts and Coupons will pass by delivery, title to the Registered Covered Bonds will pass upon registration of transfers in accordance with the provisions of the Agency Agreement and title to ISD Covered Bonds will pass by registration in the registers between the direct or indirect accountholders at the ISD in accordance with the rules and procedures of the ISD. The Issuer and any Agent will (except as otherwise required by law) deem and treat the bearer of any Bearer Covered Bond, Receipt or Coupon and the registered holder of any Registered Covered Bond or ISD Covered Bond as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any Global Covered Bond, without prejudice to the provisions set out in the next succeeding paragraph, and the expressions **Covered Bondholders** or **holders of Covered Bonds** and related expressions shall be construed accordingly.

For so long as any of the Covered Bonds is represented by a Global Covered Bond held on behalf of Euroclear Bank SA/NV (**Euroclear**) and/or Clearstream Banking, société anonyme (**Clearstream, Luxembourg**) or so long as any of the Covered Bonds is an ISD Covered Bond each person (other than Euroclear, Clearstream, Luxembourg or the ISD) who is for the time being shown in the records of Euroclear or of Clearstream, Luxembourg or the ISD, as the case may be, as the holder of a particular nominal amount of such Covered Bonds (in which regard any certificate or other document issued by Euroclear, Clearstream, Luxembourg or the ISD, as the case may be, as to the nominal amount of such Covered Bonds standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer and the relevant Agents as the holder of such nominal amount of such Covered Bonds for all purposes other than (in the case only of Covered Bonds not being ISD Covered Bonds) with respect to the payment of principal or interest on such nominal amount of such Covered Bonds, for which purpose, in the case of Covered Bonds represented by a bearer Global Covered Bond, the bearer of the relevant Global Covered Bond, or, in the case of Covered Bonds represented by Registered Global Covered Bonds, the registered holder shall be treated by the Issuer and any Agent as the holder of such nominal amount of such Covered Bonds in accordance with and subject to the terms of the relevant Global Covered Bond and the expressions **Covered Bondholder** and **holder of Covered Bonds** and related expressions shall be construed accordingly. Covered Bonds which are represented by a Global Covered Bond will be transferable only in accordance with the rules and procedures for the time being of Euroclear and Clearstream, Luxembourg, as the case may be.

The Issuer shall be entitled to obtain certain information from the register maintained by the ISD for the purpose of performing its obligations under the issue of ISD Covered Bonds. The ISD Agent shall be entitled to obtain such information as is required to perform its duties under the Terms and Conditions of the Covered Bonds and rules and regulations of, and applicable to, the ISD.

References to the ISD, Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system specified in the applicable Final Terms or as may otherwise be approved by the Issuer.

2. TRANSFERS OF REGISTERED COVERED BONDS

2.1 Transfers of interests in Registered Global Covered Bonds

Transfers of beneficial interests in Registered Global Covered Bonds will be effected by Euroclear or Clearstream, Luxembourg, as the case may be, and, in turn, by other participants and, if appropriate, indirect participants in such clearing systems acting on behalf of transferors and transferees of such interests. A beneficial interest in a Registered Global Covered Bond will, subject to compliance with all applicable legal and regulatory restrictions, be transferable for Covered Bonds in definitive form or for a beneficial interest in another Registered Global Covered Bond only in the authorised denominations set out in the applicable Final Terms and only in accordance with the rules and operating procedures for the time being of Euroclear or Clearstream, Luxembourg, as the case may be, and in accordance with the terms and conditions specified in the Agency Agreement.

2.2 Transfers of Registered Covered Bonds in definitive form

Subject as provided in paragraphs 2.5 and 2.6 below, upon the terms and subject to the conditions set forth in the Agency Agreement, a Registered Covered Bond in definitive form may be transferred in whole or in part (in the authorised denominations set out in the applicable Final Terms). In order to effect any such transfer (a) the holder or holders must (i) surrender the Registered Covered Bond for registration of the transfer of the Registered Covered Bond (or the relevant part of the Registered Covered Bond) at the specified office of any Transfer Agent, with the form of transfer thereon duly executed by the holder or holders thereof or his or their attorney or attorneys duly authorised in writing and (ii) complete and deposit such other certifications as may be required by the relevant Transfer Agent and (b) the relevant Transfer Agent must, after due and careful enquiry, be satisfied with the documents of title and the identity of the person making the request. Any such transfer will be subject to such reasonable regulations as the Issuer and the Registrar may from time to time prescribe (the initial such regulations being set out in Schedule 8 to the Agency Agreement). Subject as provided above, the relevant Transfer Agent will, within three business days (being for this purpose a day on which banks are open for business in the city where the specified office of the relevant Transfer Agent is located) of the request (or such longer period as may be required to comply with any applicable fiscal or other laws or regulations), authenticate and deliver, or procure the authentication and delivery of, at its specified office to the transferee or (at the risk of the transferee) send by uninsured mail, to such address as the transferee may request, a new Registered

Covered Bond in definitive form of a like aggregate nominal amount to the Registered Covered Bond (or the relevant part of the Registered Covered Bond) transferred. In the case of the transfer of part only of a Registered Covered Bond in definitive form, a new Registered Covered Bond in definitive form in respect of the balance of the Registered Covered Bond not transferred will be so authenticated and delivered or (at the risk of the transferor) sent to the transferor.

2.3 Registration of transfer upon partial redemption

In the event of a partial redemption of Covered Bonds under Condition 8, the Issuer shall not be required to register the transfer of any Registered Covered Bond, or part of a Registered Covered Bond, called for partial redemption.

2.4 Costs of registration

Covered Bondholders will not be required to bear the costs and expenses of effecting any registration of transfer as provided above, except for any costs or expenses of delivery other than by regular uninsured mail and except that the Issuer may require the payment of a sum sufficient to cover any stamp duty, tax or other governmental charge that may be imposed in relation to the registration.

2.5 Transfers of interests in Regulation S Global Covered Bonds

Prior to expiry of the applicable Distribution Compliance Period, transfers by the holder of, or of a beneficial interest in, a Regulation S Global Covered Bond to a transferee in the United States or who is a U.S. person will only be made upon receipt by the Registrar of a written certification substantially in the form set out in the Agency Agreement, amended as appropriate (a **Transfer Certificate**), copies of which are available from the specified office of any Transfer Agent, from the transferor of the Covered Bond or beneficial interest therein to the effect that such transfer is being made pursuant to the Securities Act or an exemption therefrom, subject to receipt by the Issuer of such satisfactory evidence as the Issuer may reasonably require, which may include an opinion of U.S. counsel, that such transfer is in compliance with any applicable securities laws of any State of the United States, and, in each case, in accordance with any applicable securities laws of any State of the United States or any other jurisdiction.

2.6 Exchanges and transfers of Registered Covered Bonds generally

Holders of Registered Covered Bonds in definitive form may exchange such Covered Bonds for interests in a Registered Global Covered Bond of the same type at any time.

2.7 Definitions

In this Condition, the following expressions shall have the following meanings:

Distribution Compliance Period means the period that ends 40 days after the completion of the distribution of each Tranche of Covered Bonds, as certified by the relevant Dealer (in the case of a non-syndicated issue) or the relevant Lead Manager (in the case of a syndicated issue);

Reference Banks means, in the case of a determination of LIBOR, the principal London office of four major banks in the London inter-bank market and, in the case of a determination of EURIBOR, the principal Euro-zone office of four major banks in the Euro-zone inter-bank market, in each case selected by the Agent;

Regulation S means Regulation S under the Securities Act;

Regulation S Global Covered Bond means a Registered Global Covered Bond representing Covered Bonds sold outside the United States in reliance on Regulation S;

Securities Act means the United States Securities Act of 1933, as amended.

3. STATUS OF THE COVERED BONDS

The Covered Bonds and any related Receipts and Coupons constitute direct, unilateral, unconditional and unsubordinated obligations of the Issuer to pay the Final Redemption Amount and rank *pari passu* among themselves and with all other outstanding unsubordinated obligations of the Issuer that have been provided equivalent priority of claim to Covered Bonds issued in accordance with the terms of the Icelandic Covered Bond Act.

On the winding up or voluntary or involuntary liquidation of the Issuer, the Covered Bondholders will, by virtue of the Icelandic Covered Bond Act, have certain rights of priority over and be senior to other creditors of the Issuer to the Cover Pool and the payments received with respect to the Cover Pool, but junior to claims due to derivative agreements concluded or issued in accordance with the terms of the Icelandic Covered Bond Act.

4. COMPLIANCE WITH THE ICELANDIC COVERED BOND ACT

So long as any of the Covered Bonds, Receipts or Coupons remains outstanding the Issuer undertakes that with respect to the Covered Bonds and the related Cover Pool, it will comply with all provisions of the Icelandic Covered Bond Act, and the related Rules, as amended from time to time.

5. REDENOMINATION

5.1 Redenomination

Where redenomination is specified in the applicable Final Terms as being applicable, the Issuer may, without the consent of the Covered Bondholders, the Receiptholders and the Couponholders, on giving prior notice to the Fiscal Agent, Euroclear and Clearstream, Luxembourg (in the case of Covered Bonds other than ISD Covered Bonds) or to the ISD Agent and the ISD (in the case of ISD Covered Bonds) and at least 30 days' prior notice to the Covered Bondholders in accordance with Condition 14, elect that, with effect from the Redenomination Date specified in the notice, the Covered Bonds with a Specified Currency other than euro shall be redenominated in euro.

The election will have effect as follows:

(a) the Covered Bonds and the Receipts shall be deemed to be redenominated in euro in the denomination of euro 0.01 with a nominal amount for each Covered Bond and Receipt equal to the nominal amount of that Covered Bond or Receipt in the Specified Currency, converted into euro at the Established Rate, provided that, if the Issuer determines, with the agreement of the Fiscal Agent in the case of Covered Bonds other than ISD Covered Bonds, that the then market practice in respect of the redenomination in euro of internationally offered securities is different from the provisions specified above, such provisions shall be deemed to be amended so as to comply with such market practice and the Issuer shall promptly notify the Covered Bondholders, the stock exchange (if any) on which the Covered Bonds may be listed and the Agents of such deemed amendments;

(b) save to the extent that an Exchange Notice has been given in accordance with paragraph (d) below, the amount of interest due in respect of the Covered Bonds will be calculated by reference to the aggregate nominal amount of Covered Bonds presented (or, as the case may be, in respect of which Coupons are presented) for payment by the relevant holder and the amount of such payment shall be rounded down to the nearest €0.01;

(c) if definitive Covered Bonds are required to be issued after the Redenomination Date, they shall be issued at the expense of the Issuer (i) in the case of Relevant Covered Bonds in the denomination of euro 100,000 and/or such higher amounts as the Fiscal Agent (in the case of Covered Bonds other than ISD Covered Bonds) or the Issuer (in the case of ISD Covered Bonds) may determine and notify to the Covered Bondholders and any remaining amounts less than euro 100,000 shall be redeemed by the Issuer and paid to the Covered Bondholders in euro in accordance with Condition 7 (*Payments*); and (ii) in the case of Covered Bonds which are not Relevant Covered Bonds, in the denominations of €1,000, €10,000, €100,000 and (but only to the extent of any remaining amounts less than €1,000 or such smaller denominations as the Agent may approve) €0.01 and such other denominations as the Fiscal Agent (in the case of Covered Bonds other than ISD Covered Bonds) or the Issuer (in the case of ISD Covered Bonds) shall determine and notify to the Covered Bondholders;

(d) if issued prior to the Redenomination Date, all unmatured Coupons denominated in the Specified Currency (whether or not attached to the Covered Bonds) will become void with effect from the date on which the Issuer gives notice (the **Exchange Notice**) that replacement euro-denominated Covered Bonds, Receipts and Coupons are available for exchange (provided that such securities are so available) and no payments will be made in respect of them. The payment obligations contained in any Covered Bonds and Receipts so issued will also become void on that date although those Covered Bonds and Receipts will continue to constitute valid exchange obligations of the Issuer. New euro-denominated Covered Bonds, Receipts and Coupons will be issued in exchange for Covered Bonds, Receipts and Coupons denominated in the Specified Currency in such manner as the Fiscal Agent (in the case of Covered Bonds other than ISD Covered Bonds) or the Issuer (in the case of ISD Covered Bonds) may specify and as shall be notified to the Covered Bondholders in the Exchange Notice. No Exchange Notice may be given less than 15 days prior to any date for payment of principal or interest on the Covered Bonds;

(e) after the Redenomination Date, all payments in respect of the Covered Bonds, the Receipts and the Coupons, other than payments of interest in respect of periods commencing before the Redenomination Date, will be made solely in euro as though references in the Covered Bonds to the Specified Currency were to euro. Payments will be made in euro by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque;

(f) if the Covered Bonds are Fixed Rate Covered Bonds and interest for any period ending on or after the Redenomination Date is required to be calculated for a period ending other than on an Interest Payment Date, it will be calculated:

    (i) in the case of the Covered Bonds represented by a Global Covered Bond or ISD Covered Bonds, by applying the Rate of Interest to the aggregate outstanding nominal amount of the Covered Bonds; and

    (ii) in the case of definitive Covered Bonds, by applying the Rate of Interest to the Calculation Amount,

    and, in each case, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention. Where the Specified Denomination of a Fixed Rate Covered Bond in definitive form is a multiple of the Calculation Amount, the amount of interest payable in respect of such Fixed Rate Covered Bond shall be the product of the amount (determined in the manner provided above) for each the Calculation Amount and the amount which the Calculation Amount is multiplied to reach the Specified Denomination without any further rounding;

(g) if the Covered Bonds are Floating Rate Covered Bonds, the applicable Final Terms will specify any relevant changes to the provisions relating to interest; and

(h) such other changes shall be made to this Condition as the Issuer may decide, after consultation with the Fiscal Agent in the case of Covered Bonds other than ISD Covered Bonds), and as may be specified in the notice, to conform it to conventions then applicable to instruments denominated in euro.

5.2 Definitions

In the Conditions, the following expressions have the following meanings:

Established Rate means the rate for the conversion of the Specified Currency (including compliance with rules relating to roundings in accordance with applicable European Union regulations) into euro established by the Council of the European Union pursuant to Article 140 of the Treaty;

euro means the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty;

Redenomination Date means (in the case of interest bearing Covered Bonds) any date for payment of interest under the Covered Bonds or (in the case of Zero Coupon Covered Bonds) any date, in each case specified by the Issuer in the notice given to the Covered Bondholders pursuant to paragraph 5.1 above and which falls on or after the date on which the country of the Specified Currency first participates in the third stage of European economic and monetary union;

Relevant Covered Bonds means all Covered Bonds where the applicable Final Terms provide for a minimum Specified Denomination in the Specified Currency which is equivalent to at least euro 100,000 and which are admitted to trading on a regulated market in the European Economic Area; and

Treaty means the Treaty on the Functioning of the European Union, as amended.

6. INTEREST

6.1 Interest on Fixed Rate Covered Bonds

Each Fixed Rate Covered Bond bears interest from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Maturity Date or, if the applicable Final Terms specifies that an Extended Final Maturity Date applies, the Extended Final Maturity Date or any earlier Interest Payment Date on which the Covered Bonds are redeemed in full, provided that any amounts representing interest payable after the Maturity Date shall be paid at such rate and on such dates specified in the applicable Final Terms.

If the Covered Bonds are in definitive form, except as provided in the applicable Final Terms, the amount of interest payable on each Interest Payment Date in respect of the Fixed Interest Period ending on (but excluding) such date will amount to the Fixed Coupon Amount. Payments of interest on any Interest Payment Date will, if so specified in the applicable Final Terms, amount to the Broken Amount so specified.

As used in the Conditions, **Fixed Interest Period** means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

Except in the case of Covered Bonds in definitive form where an applicable Fixed Coupon Amount or Broken Amount is specified in the applicable Final Terms, interest shall be calculated in respect of any period by applying the Rate of Interest to:

(a) in the case of Fixed Rate Covered Bonds which are represented by a Global Covered Bond or Fixed Rate Covered Bonds which are ISD Covered Bonds, the aggregate outstanding nominal amount of the Fixed Rate Covered Bonds; or

(b) in the case of Fixed Rate Covered Bonds in definitive form, the Calculation Amount,

and, in each case, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention. Where the Specified Denomination of a Fixed Rate Covered Bond in definitive form is a multiple of the Calculation Amount, the amount of interest payable in respect of such Fixed Rate Covered Bond shall be the product of the amount (determined in the manner provided above) for the Calculation Amount and the amount by which the Calculation Amount is multiplied to reach the Specified Denomination, without any further rounding.

Day Count Fraction means, in respect of the calculation of an amount of interest in accordance with this Condition 6.1:

(i) if "**Actual/Actual (ICMA)**" is specified in the applicable Final Terms:

(A) in the case of Covered Bonds where the number of days in the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (the **Accrual Period**) is equal to or shorter than the Determination Period during which the Accrual Period ends, the number of days in such Accrual Period divided by the product of (1) the number of days in such Determination Period and (2) the number of Determination Dates (as specified in the applicable Final Terms) that would occur in one calendar year; or

(B) in the case of Covered Bonds where the Accrual Period is longer than the Determination Period during which the Accrual Period ends, the sum of:

(1) the number of days in such Accrual Period falling in the Determination Period in which the Accrual Period begins divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and

(2) the number of days in such Accrual Period falling in the next Determination Period divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and

(ii) if "**30/360**" is specified in the applicable Final Terms, the number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (such number of days being calculated on the basis of a year of 360 days with 12 30-day months) divided by 360.

In these Conditions:

Determination Period means each period from (and including) a Determination Date to but excluding the next Determination Date (including, where either the Interest Commencement Date or the final Interest Payment Date is not a Determination Date, the period commencing on the first Determination Date prior to, and ending on the first Determination Date falling after, such date); and

sub-unit means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, one cent.

6.2 Interest on Floating Rate Covered Bonds

(a) Interest Payment Dates

Each Floating Rate Covered Bond bears interest from (and including) the Interest Commencement Date and such interest will be payable in arrear on either:

(i) the Specified Interest Payment Date(s) in each year specified in the applicable Final Terms; or

(ii) if no Specified Interest Payment Date(s) is/are specified in the applicable Final Terms, each date (each such date, together with each Specified Interest Payment Date, an **Interest Payment Date**) which falls the number of months or other period specified as the Specified Period in the applicable Final Terms after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period (which expression shall, in the Conditions, mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date).

If a Business Day Convention is specified in the applicable Final Terms and (x) if there is no numerically corresponding day on the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:

(A) in any case where Specified Periods are specified in accordance with Condition 6.2(a)(ii) above, the Floating Rate Convention, such Interest Payment Date (i) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (b) below shall apply *mutatis mutandis* or (ii) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (1) such Interest Payment Date shall be brought forward to the immediately preceding Business Day and (2) each subsequent Interest Payment Date shall be the last Business Day in the month which falls the Specified Period after the preceding applicable Interest Payment Date occurred; or

(B) the Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day; or

(C) the Modified Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or

(D) the Preceding Business Day Convention, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

In the Conditions, **Business Day** means a day which is both:

I. a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London and any Additional Business Centre specified in the applicable Final Terms; and

II. either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney and Auckland, respectively) or (2) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET2) System (the **TARGET2 System**) is open.

(b) Rate of Interest

The Rate of Interest payable from time to time in respect of Floating Rate Covered Bonds will be determined in the manner specified in the applicable Final Terms.

(i) ISDA Determination for Floating Rate Covered Bonds

Where ISDA Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Final Terms) the Margin (if any). For the purposes of this subparagraph (i), **ISDA Rate** for an Interest Period means a rate equal to the Floating Rate that would be determined by the Fiscal Agent or the ISD Agent, as the case may be, under an interest rate swap transaction if that Agent were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 2006 ISDA Definitions as published by the International Swaps and Derivatives Association, Inc. and as amended and updated as at the Issue Date of the first Tranche of the Covered Bonds (the **ISDA Definitions**) and under which:

(A) the Floating Rate Option is as specified in the applicable Final Terms;

(B) the Designated Maturity is a period specified in the applicable Final Terms; and

(C) the relevant Reset Date is either (I) if the applicable Floating Rate Option is based on the London inter- bank offered rate (**LIBOR**) or on the Euro-zone inter-bank offered rate (**EURIBOR**), the first day of that Interest Period or (II) in any other case, as specified in the applicable Final Terms.

For the purposes of this subparagraph (i), **Floating Rate**, **Calculation Agent**, **Floating Rate Option**, **Designated Maturity** and **Reset Date** have the meanings given to those terms in the ISDA Definitions.

Unless otherwise stated in the applicable Final Terms the Minimum Rate of Interest shall be deemed to be zero.

(ii) Screen Rate Determination for Floating Rate Covered Bonds

Where Screen Rate Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:

(A) the offered quotation; or

(B) the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) of the offered quotations,

(expressed as a percentage rate per annum) for the Reference Rate which appears or appear, as the case may be, on the Relevant Screen Page (or such replacement page on that service which displays the information) as at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question plus or minus (as indicated in the applicable Final Terms) the Margin (if any), all as determined by the Fiscal Agent or the Calculation Agent. If five or more of such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) and the lowest (or, if there is more than one such lowest quotation, one only of such quotations) shall be disregarded by the Fiscal Agent for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

If the Relevant Screen Page is not available or if, in the case of (A) above, no offered quotation appears or, in the case of (B) above, fewer than three offered quotations appear, in each case as at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR), the Fiscal Agent shall request each of the Reference Banks to provide the Fiscal Agent with its offered quotation (expressed as a percentage rate per annum) for the Reference Rate at approximately at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question. If two or more of the Reference Banks provide the Fiscal Agent with offered quotations, the Rate of Interest for the Interest Period shall be the arithmetic mean (rounded if necessary to the fifth decimal place with 0.000005 being rounded upwards) of the offered quotations plus or minus (as appropriate) the Margin (if any), all as determined by the Fiscal Agent.

If on any Interest Determination Date one only or none of the Reference Banks provides the Fiscal Agent with an offered quotation as provided in the preceding paragraph, the Rate of Interest for the relevant Interest Period shall be the rate per annum which the Fiscal Agent determines as being the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) of the rates, as communicated to (and at the request of) the Fiscal Agent by the Reference Banks or any two or more of them, at which such banks were offered, at approximately 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the relevant Interest Determination Date, deposits in the Specified Currency for a period equal to that which would have been used for the Reference Rate by leading banks in the London inter-bank market (if the Reference Rate is LIBOR) or the Euro-zone inter-bank market (if the Reference Rate is EURIBOR) plus or minus (as appropriate) the Margin (if any) or, if fewer than two of the Reference Banks provide the Fiscal Agent with offered rates, the offered rate for deposits in the Specified Currency for a period equal to that which would have been used for the Reference Rate, or the arithmetic mean (rounded as provided above) of the offered rates for deposits in the Specified Currency for a period equal to that which would have been used for the Reference

Rate, at which, at approximately 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the relevant Interest Determination Date, any one or more banks (which bank or banks is or are in the opinion of the Issuer suitable for the purpose) informs the Fiscal Agent it is quoting to leading banks in the London inter-bank market (if the Reference Rate is LIBOR) or the Euro-zone inter-bank market (if the Reference Rate is EURIBOR) plus or minus (as appropriate) the Margin (if any), provided that, if the Rate of Interest cannot be determined in accordance with the foregoing provisions of this paragraph, the Rate of Interest shall be determined as at the last preceding Interest Determination Date (though substituting, where a different Margin is to be applied to the relevant Interest Period from that which applied to the last preceding Interest Period, the Margin relating to the relevant Interest Period in place of the Margin relating to that last preceding Interest Period).

In the case of Floating Rate Covered Bonds which are ISD Covered Bonds:

I. If the Relevant Screen Page is not available or if, in the case of (A) above, no offered quotation appears or, in the case of (B) above, fewer than three offered quotations appear, in each case as at the Specified Time, the Calculation Agent shall request each of the Reference Banks to provide the Calculation Agent with its offered quotation (expressed as a percentage rate per annum) for the Reference Rate at approximately the Specified Time on the Interest Determination Date in question. If two or more of the Reference Banks provide the Calculation Agent with offered quotations, the Rate of Interest for the Interest Period shall be the arithmetic mean (rounded if necessary to the fifth decimal place with 0.000005 being rounded upwards) of the offered quotations plus or minus (as appropriate) the Margin (if any), all as determined by the Calculation Agent.

II. If on any Interest Determination Date one only or none of the Reference Banks provides the Calculation Agent with an offered quotation as provided in the preceding paragraph, the Rate of Interest for the relevant Interest Period shall be the rate per annum which the Calculation Agent determines as being the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) of the rates, as communicated to (and at the request of) the Calculation Agent by the Reference Banks or any two or more of them, at which such banks were offered, at approximately the Specified Time on the relevant Interest Determination Date, deposits in the Specified Currency for a period equal to that which would have been used for the Reference Rate by leading banks in the London inter-bank market (if the Reference Rate is LIBOR) or the Euro-zone inter-bank market (if the Reference Rate is EURIBOR) plus or minus (as appropriate) the Margin (if any) or, if fewer than two of the Reference Banks provide the Calculation Agent with offered rates, the offered rate for deposits in the Specified Currency for a period equal to that which would have been used for the Reference Rate, or the arithmetic mean (rounded as provided above) of the offered rates for deposits in the Specified Currency for a period equal to that which would have been used for the Reference Rate, at which, at approximately the Specified Time on the relevant Interest Determination Date, any one or more banks (which bank or banks is or are in the opinion of the Issuer suitable for the purpose) informs the Calculation Agent it is quoting to leading banks in the London inter-bank market (if the Reference Rate is LIBOR) or the Euro-zone inter-bank market (if the Reference Rate is EURIBOR) plus or minus (as appropriate) the Margin (if any), provided that, if the Rate of Interest cannot be determined in accordance with the foregoing provisions of this paragraph, the Rate of Interest shall be determined as at the last preceding Interest Determination Date (though substituting, where a different Margin is to be applied to the relevant Interest Period from that which applied to the last preceding Interest

Period, the Margin relating to the relevant Interest Period in place of the Margin relating to that last preceding Interest Period).

If the Reference Rate from time to time in respect of Floating Rate Covered Bonds is specified in the applicable Final Terms as being other than LIBOR or EURIBOR, the Rate of Interest in respect of such Covered Bonds will be determined as provided in the applicable Final Terms.

(c) Minimum Rate of Interest and/or Maximum Rate of Interest

If the applicable Final Terms specifies a Minimum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (b) above is less than such Minimum Rate of Interest, the Rate of Interest for such Interest Period shall be such Minimum Rate of Interest.

If the applicable Final Terms specifies a Maximum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (b) above is greater than such Maximum Rate of Interest, the Rate of Interest for such Interest Period shall be such Maximum Rate of Interest.

(d) Determination of Rate of Interest and calculation of Interest Amounts

The Fiscal Agent, in the case of Floating Rate Covered Bonds other than ISD Covered Bonds, and the Calculation Agent, in the case of Floating Rate Covered Bonds which are ISD Covered Bonds, will at or as soon as practicable after each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period.

The Fiscal Agent (in the case of Covered Bonds other than ISD Covered Bonds) and the Calculation Agent (in the case of ISD Covered Bonds) will calculate the amount of interest (the **Interest Amount**) payable on the Floating Rate Covered Bonds for the relevant Interest Period by applying the Rate of Interest to:

(i) in the case of Floating Rate Covered Bonds which are represented by a Global Covered Bond or a ISD Covered Bond, the aggregate outstanding nominal amount of the Covered Bonds; or

(ii) in the case of Floating Rate Covered Bonds in definitive form, the Calculation Amount,

and, in each case, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention. Where the Specified Denomination of a Floating Rate Covered Bond in definitive form is a multiple of the Calculation Amount, the Interest Amount payable in respect of such Covered Bond shall be the product of the amount (determined in the manner provided above) for the Calculation Amount and the amount by which the Calculation Amount is multiplied to reach the Specified Denomination without any further rounding.

Day Count Fraction means, in respect of the calculation of an amount of interest in accordance with this Condition 6.2:

(i) if "Actual/Actual (ISDA)" or "Actual/Actual" is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 (or, if any portion of that Interest Period falls in a leap year, the sum of (I) the actual number of days in that portion of the

Interest Period falling in a leap year divided by 366 and (II) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);

(ii) if "Actual/365 (Fixed)" is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365;

(iii) if "Actual/365 (Sterling)" is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366;

(iv) if "Actual/360" is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 360;

(v) if "30/360", "360/360" or "Bond Basis" is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360, calculated on a formula basis as follows:

$$\text{Day Count Fraction} = \frac{[360 \times (Y_2 - Y_1)] + [30 \times (M_2 - M_1)] + (D_2 - D_1)}{360}$$

where:

Y_1 is the year, expressed as a number, in which the first day of the Interest Period falls;

Y_2 is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M_1 is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M_2 is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D_1 is the first calendar day, expressed as a number, of the Interest Period, unless such number is 31, in which case D_1 will be 30; and

D_2 is the calendar day, expressed as a number, immediately following the last day included in the Interest Period, unless such number would be 31 and D_1 is greater than 29, in which case D_2 will be 30;

(vi) if "30E/360" or "Eurobond Basis" is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360, calculated on a formula basis as follows:

$$\text{Day Count Fraction} = \frac{[360 \times (Y_2 - Y_1)] + [30 \times (M_2 - M_1)] + (D_2 - D_1)}{360}$$

where:

Y_1 is the year, expressed as a number, in which the first day of the Interest Period falls;

Y_2 is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M_1 is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M_2 is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D_1 is the first calendar day, expressed as a number, of the Interest Period, unless such number would be 31, in which case D_1 will be 30; and

D_2 is the calendar day, expressed as a number, immediately following the last day included in the Interest Period, unless such number would be 31, in which case D_2 will be 30;

(vii) if "30E/360 (ISDA)" is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360, calculated on a formula basis as follows:

$$\text{Day Count Fraction} = \frac{[360 \text{ x } (Y_2 - Y_1)] + [30 \text{ x } (M_2 - M_1)] + (D_2 - D_1)}{360}$$

where:

Y_1 is the year, expressed as a number, in which the first day of the Interest Period falls;

Y_2 is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M_1 is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M_2 is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D_1 is the first calendar day, expressed as a number, of the Interest Period, unless (i) that day is the last day of February or (ii) such number would be 31, in which case D_1 will be 30; and

D_2 is the calendar day, expressed as a number, immediately following the last day included in the Interest Period, unless (i) that day is the last day of February but not the Maturity Date or (ii) such number would be 31, in which case D_2 will be 30.

(e) Maximum Interest Amounts

If the applicable Final Terms specifies a Maximum Interest Amount for any Interest Period, then, in the event that the Interest Amount in respect of such Interest Period determined in accordance with the provisions of paragraph (d) above is greater than such Maximum Interest Amount, the Interest Amount for such Interest Period shall be such Maximum Interest Amount.

(f) Notification of Rate of Interest and Interest Amounts

The Fiscal Agent or, where the relevant Floating Rate Covered Bonds are ISD Covered Bonds, the Calculation Agent will cause the Rate of Interest and each Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Issuer and any stock exchange on which the relevant Floating Rate Covered Bonds are for the time being listed (by no later than the first day of each Interest Period (or, where the relevant Floating Rate Covered Bonds are not ISD Covered Bonds and the Calculation Agent is other than the Fiscal Agent, as soon as reasonably practicable after the Calculation Agent has notified the Fiscal Agent of such)) and notice thereof to be published in accordance with Condition 14 as soon as possible after their determination but in no event later than the fourth London Business Day thereafter. Each Interest Amount and Interest Payment Date so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without prior notice in the event of an extension or shortening of the Interest Period. Any such amendment will be promptly notified to each stock exchange on which the relevant Floating Rate Covered Bonds are for the time being listed and to the Covered Bondholders in accordance with Condition 14. For the purposes of this paragraph, the expression **London Business Day** means a day (other than a Saturday or a Sunday) on which banks and foreign exchange markets are open for general business in London.

(g) Certificates to be final

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition 6.2, whether by the Fiscal Agent or, if applicable, the Calculation Agent shall (in the absence of wilful default, bad faith or manifest error) be binding on the Issuer, the Agent, the Calculation Agent (if applicable), the other Paying Agents, the ISD Agent (in the case of ISD Covered Bonds) and all Covered Bondholders, Receiptholders and Couponholders and (in the absence of wilful default or bad faith) no liability to the Issuer, the Covered Bondholders, the Receiptholders or the Couponholders shall attach to the Fiscal Agent or, if applicable, the Calculation Agent in connection with the exercise or non-exercise by it of its powers, duties and discretions pursuant to such provisions.

6.3 Interest on Inflation Linked Covered Bonds

Each Inflation Linked Covered Bond bears interest from (and including) the Interest Commencement Date at the rate per annum equal to the Rate of Interest payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Final Maturity Date.

If interest is required to be calculated for a period other than an Interest Period such interest shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction (as defined in Condition 6.2 (d) (*Determination of Rate of Interest and calculation of Interest Amounts*)), and rounding the resultant figure to the nearest sub-unit (as defined in Condition 6.2 (d) (*Determination of Rate of Interest and calculation of Interest Amounts*)) of the relevant Specified Currency, half of any such sub unit being rounded upwards or otherwise in accordance with applicable market convention.

6.4 Interest on Inflation Linked Non-Amortising Covered Bonds

Each Inflation Linked Non-Amortising Covered Bond bears interest from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest multiplied by the Index Ratio (as defined in Condition 7.1(b) (*Payments in respect of Inflation Linked Covered Bonds)* below. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Final Maturity Date or, if the applicable Final Terms specifies that an Extended Final Maturity Date applies, the Extended Final Maturity Date or any earlier Interest Payment Date on which the Covered Bonds are redeemed in full, provided that any amounts representing interest payable after the Final Maturity Date shall be paid at such rate and on such dates specified in the applicable Final Terms.

If interest is required to be calculated for a period other than an Interest Period, such interest shall be calculated in respect of any period by applying the Rate of Interest multiplied by the Index Ratio (as defined in Condition 7.1(b) (*Payments in respect of Inflation Linked Covered Bonds*) to:

(a) in the case of Inflation Linked Non-Amortising Covered Bonds which are represented by a Global Covered Bond or Inflation Linked Non-Amortising Covered Bonds which are ISD

Covered Bonds, the aggregate outstanding nominal amount of the Inflation Linked Non-Amortising Covered Bonds; or

(b) in the case of Inflation Linked Non-Amortising Covered Bonds in definitive form, the Calculation Amount,

and, in each case, multiplying such sum by the applicable Day Count Fraction (as defined in Condition 6.1), and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention. Where the Specified Denomination of an Inflation Linked Non-Amortising Covered Bond in definitive form is a multiple of the Calculation Amount, the amount of interest payable in respect of such Inflation Linked Non-Amortising Covered Bond shall be the product of the amount (determined in the manner provided above) for the Calculation Amount and the amount by which the Calculation Amount is multiplied to reach the Specified Denomination, without any further rounding.

As used in these Conditions, **Interest Period** means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

6.5 Accrual of interest

Each Covered Bond (or in the case of the redemption of part only of a Covered Bond, that part only of such Covered Bond) will cease to bear interest (if any) from the date for its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue until whichever is the earlier of:

(a) the date on which all amounts due in respect of such Covered Bond have been paid; and

(b) five days after the date on which the full amount of the moneys payable in respect of such Covered Bond has been received by the Fiscal Agent or the ISD Agent or the Registrar, as the case may be, and notice to that effect has been given to the Covered Bondholders in accordance with Condition 14.

7. PAYMENTS

7.1 Payments in respect of Inflation Linked Covered Bonds

If this is an Inflation Linked Covered Bond, the Issuer shall, on each relevant Interest Payment Date, make a combined payment of principal due under Condition 8.3, interest due under Condition 6.3 and any indexation amount (together, the **Annuity Amount**) as calculated by the Calculation Agent in accordance with the following formula.

$$P = \frac{r}{1 - (1 + r)^{-n}} \times IR \times d$$

where:

P = The combined payment of principal, interest and indexation amount of the relevant Covered Bonds;

$$r = \frac{c}{[\textit{insert number of interest payments per year}];}$$

c = The Rate of Interest applicable to the relevant Covered Bonds;

d = The Specified Denomination of the relevant Covered Bonds;

n = [*Insert total number of annuity payments on the relevant Covered Bonds*]; and

IR = The Index Ratio as determined in accordance with subparagraph (b) below

(b) The value of the Index Ratio (**Index Ratio** or **IR**) on the relevant Interest Payment Date shall be the value of the Reference Index (**RI**) applicable to the relevant Interest Payment Date divided by the value of the Base Index (**BI**) as calculated by the Calculation Agent

$$\text{being IR} = \frac{\text{RI}}{\text{BI}}$$

where:

Reference Index or **RI** means:

(i) for the first day of the relevant calendar month, the value of the Consumer Price Index (the **CPI**) for the relevant month as calculated by Statistics Iceland pursuant to the Consumer Price Index Act of 1995 (*lög um vísitölu neysluverðs nr.* 12/1995) and published monthly in the Legal Gazette (*Lögbirtingarblaðið*);

(ii) for each day in the relevant calendar month other than the first day:

(A) if the CPI for the calendar month immediately succeeding the month in which the relevant Interest Payment Date falls (the **Succeeding Month CPI**) has been published as at the relevant Interest Payment Date:

$$RI = CPI_t + (CPI_{t+1} - CPI_t)\frac{d}{30}$$

(B) if the Succeeding Month CPI has not been published as at the relevant Interest Payment Date:

$$\text{RI} = CPI_t \times (1+i)^{\frac{d}{360}}$$

where:

RI = Reference Index;

CPI_t = CPI value for the first day of the relevant calendar month;

CPI_{t+1} = Succeeding Month CPI;

d = number of days since the first day of the month; and

i = annualised inflation forecast of the Central Bank of Iceland

and

Base Index means the value specified in the Final Terms of the relevant Tranche of Covered Bonds, being the value of the CPI on the relevant date specified in such Final Terms.

If at any time a new index is substituted for the CPI, as of the calendar month from and including that in which such substitution takes effect:

(i) the Reference Index shall be deemed to refer to the new index; and

(ii) the new Base Index shall be the product of the old Base Index prior to the change and the new Reference Index immediately following such substitution, divided by the old Reference Index immediately prior to such substitution.

7.2 Method of payment

Subject as provided below:

(a) payments in a Specified Currency other than euro will be made by credit or transfer to an account in the relevant Specified Currency (which, in the case of a payment in Japanese yen to a non-resident of Japan, shall be a non-resident account) maintained by the payee with, or, at the option of the payee, by a cheque in such Specified Currency drawn on, a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney and Auckland respectively); and

(b) payments in euro will be made by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque.

Payments will be subject in all cases to (i) any fiscal or other laws and regulations applicable thereto in the place of payment, but without prejudice to the provisions of Condition 9 and (ii) any withholding or deduction required pursuant to an agreement described in Section 1471(b) of the U.S. Internal Revenue Code of 1986 (the Code) or otherwise imposed pursuant to Sections 1471 through 1474 of the Code, any regulations or agreements thereunder, any official interpretations thereof, or (without prejudice to the provisions of Condition 9 (Taxation)) any law implementing an intergovernmental approach thereto (**FATCA**).

7.3 Presentation of definitive Covered Bonds, Receipts and Coupons

Payments of principal in respect of definitive Bearer Covered Bonds will (subject as provided below) be made in the manner provided in paragraph 7.1 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of definitive Covered Bonds, and payments of interest in respect of definitive Covered Bonds will (subject as provided below) be made as aforesaid only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia and its possessions)).

Payments of instalments of principal (if any) in respect of definitive Bearer Covered Bonds, other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph 7.1 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in paragraph 7.1 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Covered Bond in accordance with the preceding paragraph. Each Receipt must be presented for payment of the relevant instalment together with the definitive Bearer Covered Bond to which it appertains. Receipts presented without the definitive Bearer Covered Bond to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any definitive Bearer Covered Bond becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Covered Bonds and Inflation Linked Covered Bonds in definitive bearer form (other than Long Maturity Covered Bonds (as defined below)) should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 9) in respect of such principal (whether or not such Coupon would otherwise have become void under Condition 10) or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Covered Bond or Inflation Linked Covered Bonds in definitive bearer form becoming due and repayable prior to its Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Covered Bond, or Long Maturity Covered Bond in definitive form becomes due and repayable, unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof. A **Long Maturity Covered Bond** is a Fixed Rate Covered Bond (other than a Fixed Rate Covered Bond which on issue had a Talon attached) or an Inflation Linked Non-Amortising Covered Bond whose nominal amount on issue is less than the aggregate interest payable thereon provided that such Covered Bond shall cease to be a Long Maturity Covered Bond on the Interest Payment Date on which the aggregate amount of interest remaining to be paid after that date is less than the nominal amount of such Covered Bond.

If the due date for redemption of any definitive Bearer Covered Bond is not an Interest Payment Date, interest (if any) accrued in respect of such Bearer Covered Bond from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Bearer Covered Bond.

7.4 Payments in respect of Bearer Global Covered Bonds

Payments of principal and interest (if any) in respect of Covered Bonds represented by any Bearer Global Covered Bond will (subject as provided below) be made in the manner specified above in relation to definitive Bearer Covered Bonds and otherwise in the manner specified in the relevant Bearer Global Covered Bond, where applicable, against presentation or surrender, as the case may be, of such Bearer Global Covered Bond at the specified office of any Paying Agent outside the United States. A record of each payment, distinguishing between any payment of principal and any payment of interest, will be made on such Bearer Global Covered Bond either by the Paying Agent to which it was presented or in the records of Euroclear and Clearstream, Luxembourg, as applicable.

7.5 Payments in respect of Registered Covered Bonds

Payments of principal (other than instalments of principal prior to the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the Registered Covered Bond at the specified office of the Registrar or any of the Paying Agents. Such payments will be made by transfer to the Designated Account (as defined below) of the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the register of holders of the Registered Covered Bonds maintained by the Registrar (the **Registered Covered Bond Register**) (i) where in global form, at the close of the business day (being for this purpose a day on which Euroclear and

Clearstream, Luxembourg are open for business) before the relevant due date, and (ii) where in definitive form at the close of business on the third business day (being for this purpose a day on which banks are open for business in the city where the specified office of the Registrar is located) before the relevant due date. Notwithstanding the previous sentence, if (a) a holder does not have a Designated Account or (b) the principal amount of the Covered Bonds held by a holder is less than U.S.$250,000 (or its approximate equivalent in any other Specified Currency), payment will instead be made by a cheque in the Specified Currency drawn on a Designated Bank (as defined below). For these purposes, **Designated Account** means the account (which, in the case of a payment in Japanese yen to a non-resident of Japan, shall be a non-resident account) maintained by a holder with a Designated Bank and identified as such in the Registered Covered Bond Register and Designated Bank means (in the case of payment in a Specified Currency other than euro) a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney and Auckland, respectively) and (in the case of a payment in euro) any bank which processes payments in euro.

Payments of interest and payments of instalments of principal (other than the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made by a cheque in the Specified Currency drawn on a Designated Bank and mailed by uninsured mail on the business day in the city where the specified office of the Registrar is located immediately preceding the relevant due date to the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the Registered Covered Bond Register (i) where in global form, at the close of the business day (being for this purpose a day on which Euroclear and Clearstream, Luxembourg are open for business) before the relevant due date, and (ii) where in definitive form, at the close of business on the fifteenth day (whether or not such fifteenth day is a business day) before the relevant due date (the Record Date) at his address shown in the Registered Covered Bond Register on the Record Date and at his risk. Upon application of the holder to the specified office of the Registrar not less than three business days in the city where the specified office of the Registrar is located before the due date for any payment of interest in respect of a Registered Covered Bond, the payment may be made by transfer on the due date in the manner provided in the preceding paragraph. Any such application for transfer shall be deemed to relate to all future payments of interest (other than interest due on redemption) and instalments of principal (other than the final instalment) in respect of the Registered Covered Bonds which become payable to the holder who has made the initial application until such time as the Registrar is notified in writing to the contrary by such holder. Payment of the interest due in respect of each Registered Covered Bond on redemption and the final instalment of principal will be made in the same manner as payment of the principal amount of such Registered Covered Bond.

Holders of Registered Covered Bonds will not be entitled to any interest or other payment for any delay in receiving any amount due in respect of any Registered Covered Bond as a result of a cheque posted in accordance with this Condition arriving after the due date for payment or being lost in the post. No commissions or expenses shall be charged to such holders by the Registrar in respect of any payments of principal or interest in respect of the Registered Covered Bonds.

None of the Issuer or the Agents will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

7.6 General provisions applicable to payments

The holder of a Global Covered Bond shall be the only person entitled to receive payments in respect of Covered Bonds represented by such Global Covered Bond and the Issuer will be discharged by payment to, or to the order of, the holder of such Global Covered Bond in respect of each amount so paid. Each of the persons shown in the records of Euroclear or Clearstream, Luxembourg as the beneficial holder of a particular nominal amount of Covered Bonds represented by such Global Covered Bond must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for his share of each payment so made by the Issuer to, or to the order of, the holder of such Global Covered Bond.

Notwithstanding the foregoing provisions of this Condition, if any amount of principal and/or interest in respect of Covered Bonds is payable in U.S. dollars, such U.S. dollar payments of principal and/or interest in respect of such Covered Bonds will be made at the specified office of a Paying Agent in the United States if:

(a) the Issuer has appointed Paying Agents with specified offices outside the United States with the reasonable expectation that such Paying Agents would be able to make payment in U.S. dollars at such specified offices outside the United States of the full amount of principal and interest on the Covered Bonds in the manner provided above when due;

(b) payment of the full amount of such principal and interest at all such specified offices outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions on the full payment or receipt of principal and interest in U.S. dollars; and

(c) such payment is then permitted under United States law without involving, in the opinion of the Issuer, adverse tax consequences to the Issuer.

7.7 Payments in respect of ISD Covered Bonds

Payments of principal and interest in respect of ISD Covered Bonds will be made to the Covered Bondholders shown in the relevant records of the ISD in accordance with and subject to the rules and regulations from time to time governing the ISD.

7.8 Payment Day

If the date for payment of any amount in respect of any Covered Bond, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment until the next following Payment Day in the relevant place and shall not be entitled to further interest or other payment in respect of such delay. For these purposes, **Payment Day** means any day which (subject to Condition 10) is:

(a) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:

  (i) in the case of Covered Bonds in definitive form only, the relevant place of presentation; and

  (ii) each Additional Financial Centre specified in the applicable Final Terms; and

(b) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney and Auckland, respectively) or (2) in relation to any sum payable in euro, a day on which the TARGET2 System is open.

7.9 Interpretation of principal and interest

Any reference in the Conditions to principal in respect of the Covered Bonds shall be deemed to include, as applicable:

(a) any additional amounts which may be payable with respect to principal under Condition 9;

(b) the Final Redemption Amount of the Covered Bonds;

(c) the Early Redemption Amount of the Covered Bonds;

(d) the Optional Redemption Amount(s) (if any) of the Covered Bonds;

(e) in relation to Covered Bonds redeemable in instalments, the Instalment Amounts;

(f) in relation to Zero Coupon Covered Bonds, the Amortised Face Amount (as defined in Condition 8.7); and

(g) any premium and any other amounts (other than interest) which may be payable by the Issuer under or in respect of the Covered Bonds.

Any reference in the Conditions to interest in respect of the Covered Bonds shall be deemed to include, as applicable, any additional amounts which may be payable with respect to interest under Condition 9.

7.10 Partial Payment

If on the Maturity Date of a Series of Covered Bonds where an Extended Final Maturity Date is specified in the applicable Final Terms the Issuer has insufficient moneys to pay the Final Redemption Amount on that Series of Covered Bonds and any other amounts due and payable by the Issuer in respect of Covered Bonds on such date, then the Issuer shall apply available moneys, after having made payment of all other amounts due and payable by the Issuer in respect of Covered Bonds on such date, to redeem the relevant Series of Covered Bonds in part at par together with accrued interest *pro rata* and *pari passu* with any other Series of Covered Bonds for which an Extended Final Maturity Date is specified in the Final Terms.

8. REDEMPTION AND PURCHASE

8.1 Redemption at maturity

Unless previously redeemed or purchased and cancelled as specified below, each Covered Bond will be redeemed by the Issuer at the Final Redemption Amount specified in, or determined in the manner specified in, the applicable Final Terms in the relevant Specified Currency on the Maturity Date.

If an Extended Final Maturity Date is specified as applicable in the Final Terms for a Series of Covered Bonds and the Issuer has failed to pay the Final Redemption Amount on the Maturity Date specified in the Final Terms, then (subject as provided below) payment of the unpaid amount by the Issuer shall be deferred until the Extended Final Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date occurring thereafter to the extent that funds are available in the Cover Pool up to (and including) the relevant Extended Final Maturity Date.

The Issuer shall confirm to the Rating Agencies (if applicable), any relevant Swap Provider and the Fiscal Agent as soon as reasonably practicable and in any event at least 4 business days in London prior to the Maturity Date of any inability of the Issuer to pay in full the Final Redemption Amount in respect of a Series of Covered Bonds on that Maturity Date.

Where the applicable Final Terms for a relevant Series of Covered Bonds provides that such Covered Bonds are subject to an Extended Final Maturity Date, such failure to pay by the Issuer on the Maturity Date shall not constitute a default in payment.

8.2 Redemption for tax reasons

(a) The Covered Bonds may, subject to Condition 8.2(b) below, be redeemed at the option of the Issuer in whole, but not in part, at any time (if this Covered Bond is neither a Floating Rate Covered Bond, an Inflation Linked Covered Bond nor an Inflation Linked Non-Amortising Covered Bond) or on any Interest Payment Date (if this Covered Bond is either a Floating Rate Covered Bond, an Inflation Linked Covered Bond or an Inflation Linked Non-Amortising Covered Bond), on giving not less than 30 nor more than 60 days' notice to the Agent and, in accordance with Condition 14, the Covered Bondholders (which notice shall be irrevocable), if:

(i) on the occasion of the next payment due under the Covered Bonds, the Issuer has or will become obliged to pay additional amounts as provided or referred to in Condition 9 as a result of any change in, or amendment to, the laws or regulations of the Republic of Iceland (**Iceland**) or any political subdivision of, or any authority in, or of, Iceland having power to tax, or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after the date on which agreement is reached to issue the first Tranche of the Covered Bonds; and

(ii) such obligation cannot be avoided by the Issuer taking reasonable measures available to it,

provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer would be obliged to pay such additional amounts were a payment in respect of the Covered Bonds then due.

(b) Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Fiscal Agent a certificate signed by two Directors of the Issuer stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred, and an opinion of independent legal advisers of recognised standing to the effect that the Issuer has or will become obliged to pay such additional amounts as a result of such change or amendment.

(c) Each Covered Bond redeemed pursuant to this Condition 8.2 will be redeemed at the Early Redemption Amount.

8.3 Calculation of principal payments in respect of Inflation Linked Covered Bonds

Unless previously redeemed or purchased and cancelled, each Inflation Linked Covered Bond will, subject to Condition 7.1 (*Payments in respect of Inflation Linked Covered Bonds*), be redeemed in one or more amounts constituting payments of principal in relation to such Inflation Linked Covered Bond, in the relevant Specified Currency on the relevant Interest Payment Dates, calculated in accordance with the following formula:

$$A = \frac{r\,(1+r)^{k-1}}{(1+r)^{n}-1} \times d$$

where:

A = The amount of each instalment of the relevant Covered Bonds;

$$r = \frac{c}{[\textit{insert number of interest payments per year}];}$$

c = The Rate of Interest applicable to the relevant Covered Bonds;

d = The Specified Denomination of the relevant Covered Bonds;

n = [*Insert total number of [annuity] payments on the relevant Covered Bonds*]; and

k = The number of payments that have already taken place + 1 (*k = 1 for the first payment, k = 2 for the second payment, etc*)

For the avoidance of doubt, this formula does not link the principal amount calculated to inflation.

8.4 Calculation of principal payments in respect of Inflation Linked Non-Amortising Covered Bonds

Unless previously redeemed or purchased and cancelled, each Inflation Linked Non-Amortising Covered Bond will be redeemed in one or more amounts constituting payments of principal in relation to such Inflation Linked Non-Amortising Covered Bond, in the relevant Specified Currency on the relevant Interest Payment Dates, calculated in accordance with the following formula:

$$\underline{P} = N \times IR$$

where:

P = the Final Redemption Amount per Specified Denomination of each Inflation Linked Non-Amortising Covered Bond;

N = the Specified Denomination (as specified in the relevant Final Terms) for each Inflation Linked Non-Amortising Covered Bond; and

IR = the Index Ratio as set out in Condition 7.1(b), above.

8.5 Redemption at the option of the Issuer (Issuer Call)

If Issuer Call is specified in the applicable Final Terms, the Issuer may, having given:

(a) not less than 15 nor more than 30 days' notice to the Covered Bondholders in accordance with Condition 14; and

(b) not less than 15 days before the giving of the notice referred to in notice to the Fiscal Agent and, (in the case of a redemption of Registered Covered Bonds) the Registrar;

(which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Covered Bonds then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in the applicable Final Terms together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount not less than the Minimum Redemption Amount or not more than the Maximum Redemption Amount, in each case as may be specified in the applicable Final Terms. In the case of a partial redemption of Covered Bonds, the Covered Bonds to be redeemed (**Redeemed Covered Bonds**) will be selected individually by lot, in the case of Redeemed Covered Bonds represented by definitive Covered Bonds, and in accordance with the rules of Euroclear and/or Clearstream, Luxembourg, (to be reflected in the records of Euroclear and Clearstream, Luxembourg as either a pool factor or a reduction in nominal amount, at their discretion) in the case of Redeemed Covered Bonds represented by a Global Covered Bond, and in accordance with the rules of the ISD in the case of the ISD Covered Bonds, in each case not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the **Selection Date**). In the case of Redeemed Covered Bonds represented by definitive Covered Bonds, a list of the serial numbers of such Redeemed Covered Bonds will be published in accordance with Condition 14 not less than 15 days prior to the date fixed for redemption. No exchange of the relevant Global Covered Bond will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this paragraph 8.3 and notice to that effect shall be given by the Issuer to the Covered Bondholders in accordance with Condition 14 at least five days prior to the Selection Date.

8.6 Redemption at the option of the Covered Bondholders (Investor Put)

If Investor Put is specified in the applicable Final Terms, upon the holder of any Covered Bond giving to the Issuer in accordance with Condition 14 not less than 15 nor more than 30 days' notice the Issuer will, upon the expiry of such notice, redeem, subject to, and in accordance with, the terms specified in the applicable Final Terms, such Covered Bond on the Optional Redemption Date and at the Optional Redemption Amount together, if appropriate, with interest accrued to (but excluding) the Optional Redemption Date. Registered Covered Bonds may be redeemed under this Condition in any multiple of their lowest Specified Denomination. It may be that before an Investor Put can be exercised, certain conditions and/or circumstances will need to be satisfied. Where relevant, the provisions will be set out in the applicable Final Terms.

To exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, if this Covered Bond is in definitive form and held outside Euroclear and Clearstream, Luxembourg, deliver, at the specified office of any Paying Agent (in the case of Bearer Covered Bonds) or the Registrar (in the case of Registered Covered Bonds) at any time during normal business hours of such Paying Agent or, as the case may be, the Registrar falling within the notice period, a duly completed and signed notice of exercise in the form (for the time being current) obtainable from any specified office of any Paying Agent or, as the case may be, the Registrar (a **Put Notice**) and in which the holder must specify a bank account (or, if payment is required to be made by cheque, an address) to which payment is to be made under this Condition and, in the case of Registered Covered Bonds, the nominal amount thereof to be redeemed and, if less than the full nominal amount of the Registered Covered Bonds so surrendered is to be redeemed, an address to which a new Registered Covered Bond in respect of the balance of such Registered Covered Bonds is to be sent subject to and in accordance with the provisions of Condition 2. If this Covered Bond is in definitive bearer form, the Put Notice must be accompanied by this Covered Bond or evidence satisfactory to the Paying Agent concerned that this Covered Bond will, following delivery of the Put Notice, be held to its order or under its control.

If the Covered Bond is represented by a Global Covered Bond or is in definitive form and held through Euroclear or Clearstream, Luxembourg, to exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, within the notice period, give notice to the

Fiscal Agent of such exercise in accordance with the standard procedures of Euroclear and Clearstream, Luxembourg (which may include notice being given on his instruction by Euroclear or Clearstream, Luxembourg or any common depositary for them to the Fiscal Agent by electronic means) in a form acceptable to Euroclear and Clearstream, Luxembourg from time to time and, if this Covered Bond is represented by a Global Covered Bond, at the same time present or procure the presentation of the relevant Global Covered Bond to the Agent for notation accordingly.

If the Covered Bond is an ISD Covered Bond, to exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, within the notice period, give notice to the ISD Agent of such exercise in accordance with the standard procedures of the ISD from time to time.

Any Put Notice or other notice given in accordance with the standard procedures of Euroclear and Clearstream, Luxembourg or, in the case of ISD Covered Bonds, the ISD given by a holder of any Covered Bond pursuant to this paragraph shall be irrevocable.

8.7 Early Redemption Amounts

For the purpose of sub-clause 8.2 above (*Redemption for Tax Reasons*):

(a) each Covered Bond (other than a Zero Coupon Covered Bond) will be redeemed at its Early Redemption Amount; and

(b) each Zero Coupon Covered Bond, will be redeemed at an amount (the **Amortised Face Amount**) calculated in accordance with the following formula:

$$\text{Early Redemption Amount} = \text{RP}\ (1 + \text{AY})^{x}$$

where:

RP means the Reference Price;

AY means the Accrual Yield expressed as a decimal; and

x is a fraction the numerator of which is equal to the number of days (calculated on the basis of a 360-day year consisting of 12 months of 30 days each) from (and including) the Issue Date of the first Tranche of the Covered Bonds to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Covered Bond becomes due and repayable and the denominator of which is 360,

or on such other calculation basis as may be specified in the applicable Final Terms.

8.8 Instalments

Instalment Covered Bonds will be redeemed at the lesser of the Instalment Amounts and the Maximum Instalment Amounts and on the Instalment Dates. In the case of early redemption, each Instalment Covered Bond will be redeemed at the Early Redemption Amount.

8.9 Purchases

The Issuer or any subsidiary of the Issuer may at any time purchase Covered Bonds (provided that, in the case of definitive Covered Bonds, all unmatured Receipts, Coupons and Talons appertaining thereto are purchased therewith) at any price in the open market or otherwise. Such Covered Bonds may be held, reissued, resold or, at the option of the Issuer, surrendered to any Paying Agent and/or the Registrar for cancellation.

8.10 Cancellation

All Covered Bonds which are redeemed or surrendered for cancellation pursuant to paragraph 8.9 above will forthwith be cancelled (together with all unmatured Receipts, Coupons and Talons attached thereto or surrendered therewith at the time of redemption). All Covered Bonds so cancelled (together with all unmatured Receipts, Coupons and Talons cancelled therewith) shall be forwarded to the Fiscal Agent and cannot be reissued or resold.

8.11 Late payment on Zero Coupon Covered Bonds

If the amount payable in respect of any Zero Coupon Covered Bond upon redemption of such Zero Coupon Covered Bond pursuant to paragraph 8.1, 8.2, 8.3 or 8.6 above is improperly withheld or refused, the amount due and repayable in respect of such Zero Coupon Covered Bond shall be the amount calculated as provided in paragraph 8.7(b) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Covered Bond becomes due and payable were replaced by references to the date which is the earlier of:

(a) the date on which all amounts due in respect of such Zero Coupon Covered Bond have been paid; and

(b) five days after the date on which the full amount of the moneys payable in respect of such Zero Coupon Covered Bonds has been received by the Fiscal Agent or the Registrar and notice to that effect has been given to the Covered Bondholders in accordance with Condition 14.

9. TAXATION

All payments of principal and interest in respect of the Covered Bonds, Receipts and Coupons by or on behalf of the Issuer will be made without withholding or deduction for or on account of any present or future taxes or duties, assessments or government charges of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction, unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amounts as shall be necessary in order that the net amounts received by the holders of the Covered Bonds, Receipts or Coupons after such withholding or deduction shall equal the respective amounts of principal and interest which would otherwise have been receivable in respect of the Covered Bonds, Receipts or Coupons, as the case may be, in the absence of such withholding or deduction; except that no such additional amounts shall be payable with respect to any Covered Bond, Receipt or Coupon:

(a) presented for payment in Iceland;

(b) the holder of which is liable for such taxes or duties in respect of such Covered Bond, Receipt or Coupon by reason of his having some connection with a Tax Jurisdiction other than the mere holding of such Covered Bond, Receipt or Coupon; or

(c) presented for payment more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on such thirtieth day assuming that day to have been a Payment Day (as defined in Condition 7.8); or

(d) [RESERVED]

(e) [RESERVED]

(f) where such withholding or deduction is required to be made based on provisions of the Act on Withholding of Public Levies at Source No 45/1987, as amended, the Act on Withholding of Tax on Financial Income No 94/1996, as amended, and Article 3 of the Income Tax Act no. 90/2003 (**ITA**), and any other legislation, laws or regulations, replacing or supplementing the same.

As used herein:

Tax Jurisdiction means Iceland or any political subdivision or any authority thereof or therein having power to tax; and

Relevant Date means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Fiscal Agent or the Registrar or, in the case of ISD Covered Bonds, the ISD Agent, as the case may be, on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Covered Bondholders in accordance with Condition 14.

10. PRESCRIPTION

The Covered Bonds (whether in bearer, registered or dematerialised form), Receipts and Coupons will become void unless claims in respect of principal and/or interest are made within a period of 10 years (in the case of principal) and five years (in the case of interest) after the Relevant Date (as defined in Condition 9) therefor.

There shall not be included in any Coupon sheet issued on exchange of a Talon any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 7.3) or any Talon which would be void pursuant to Condition 7.3.

11. REPLACEMENT OF COVERED BONDS, RECEIPTS, COUPONS AND TALONS

Should any Covered Bond, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Fiscal Agent (in the case of Bearer Covered Bonds, Receipts or Coupons) or the Registrar (in the case of Registered Covered Bonds) upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Covered Bonds, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

12. AGENTS

The names of the initial Agents and their initial specified offices are set out below.

The Issuer is entitled to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/or approve any change in the specified office through which any Paying Agent acts, provided that:

(a) there will at all times be a Fiscal Agent and a Registrar;

(b) so long as the Covered Bonds are listed on any stock exchange or admitted to trading by any other relevant authority, there will at all times be a Paying Agent (in the case of Bearer Covered Bonds) which may be the Fiscal Agent and a Transfer Agent (in the case of Registered Covered Bonds) with a specified office in such place as may be required by the rules and regulations of the relevant stock exchange (or any other relevant authority);

(c) [RESERVED]; and

(d) there will at all times be a Paying Agent in a jurisdiction within Europe, other than the jurisdiction in which the Issuer is incorporated; and

(e) in the case of ISD Covered Bonds, there will at all times be an ISD Agent authorised to act as an account holding institution with the ISD and one or more calculation agent(s) where the Terms and Conditions of the relevant ISD Covered Bonds so require.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in Condition 7.6. Any variation, termination, appointment or change shall only take effect (other than in the case of winding up or, from the effective date of withholding on "passthru payments," where the Paying Agent is an FFI and does not become, or ceases to be, exempt from withholding under FATCA, when it shall be of immediate effect) after not less than 30 nor more than 45 days' prior notice thereof shall have been given to the Covered Bondholders in accordance with Condition 14.

In acting under the Agency Agreement, the Agents act solely as agents of the Issuer and do not assume any obligation to, or relationship of agency or trust with, any Covered Bondholders, Receiptholders or Couponholders. The Agency Agreement contains provisions permitting any entity into which any Paying Agent is merged or converted or with which it is consolidated or to which it transfers all or substantially all of its assets to become the successor paying agent.

13. EXCHANGE OF TALONS

On and after the Interest Payment Date on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Covered Bond to which it appertains) a further Talon, subject to the provisions of Condition 10.

14. NOTICES

(a) Covered Bonds other than ISD Covered Bonds

All notices regarding the Bearer Covered Bonds will be deemed to be validly given if published (a) in a leading English language daily newspaper of general circulation in London and (b) if and for so long as the Bearer Covered Bonds are admitted to trading on the regulated market of the Luxembourg Stock Exchange and listed on the Official List of the Luxembourg Stock Exchange, a daily newspaper of general circulation in Luxembourg and/or the Luxembourg Stock Exchange's website (www.bourse.lu). It is expected that any such publication in a newspaper will be made in the Financial Times in London and in the Luxemberger Wort or the Tageblatt in Luxembourg. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any stock exchange or any other relevant authority on which the Bearer Covered Bonds are for the time being listed or by which they have been admitted to trading. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers.

All notices regarding the Registered Covered Bonds will be deemed to be validly given if sent by first class mail or (if posted to an address overseas) by airmail to the holders (or the first named of joint holders) at their respective addresses recorded in the Registered Covered Bond Register and will be deemed to have been given on the fourth day after mailing and, in addition, (a) for so long as any Registered Covered Bonds are admitted to trading on the regulated market of the Luxembourg

Stock Exchange and listed on the Official List of the Luxembourg Stock Exchange, a daily newspaper of general circulation in Luxembourg and/or the Luxembourg Stock Exchange's website (www.bourse.lu), and(b) a stock exchange or are admitted to trading by another relevant authority and the rules of that stock exchange or relevant authority so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules.

Until such time as any definitive Covered Bonds are issued, there may, so long as any Global Covered Bonds representing the Covered Bonds are held in their entirety on behalf of Euroclear and/or Clearstream, Luxembourg, be substituted for such publication in such newspaper(s) or such mailing the delivery of the relevant notice to Euroclear and/or Clearstream, Luxembourg for communication by them to the holders of the Covered Bonds and, in addition, for so long as any Covered Bonds are listed on a stock exchange or are admitted to trading by another relevant authority and the rules of that stock exchange or relevant authority so require, such notice will be published in a daily newspaper of general circulation in the place or places required by the rules of that stock exchange the Luxembourg Stock Exchange's website (www.bourse.lu). Any such notice shall be deemed to have been given to the holders of the Covered Bonds on the third day after the day on which the said notice was given to Euroclear and/or Clearstream, Luxembourg.

(b) *ISD Covered Bonds*

All notices regarding the ISD Covered Bonds will be valid if published in a manner which complies with the rules and regulations of the relevant act which apply to publicly listed securities and/or any stock exchange and/or any other relevant authority on which the ISD Covered Bonds are for the time being listed or by which they have been admitted to trading. Any such notice will be deemed to have been given on the date of the first publication. Where the Covered Bonds are ISD Covered Bonds, the Issuer can additionally at its own discretion obtain information from the ISD on the Covered Bondholders in order to send notices to each Covered Bondholder directly.

(c) *Notices given by Covered Bondholders*

Notices to be given by any Covered Bondholder shall be in writing and given by lodging the same, together (in the case of any Covered Bond in definitive form) with the relative Covered Bond or Covered Bonds, with the Fiscal Agent (in the case of Bearer Covered Bonds) or the Registrar (in the case of Registered Covered Bonds). Whilst any of the Covered Bonds are represented by a Global Covered Bond, such notice may be given by any holder of a Covered Bond to the Fiscal Agent or the Registrar through Euroclear and/or Clearstream, Luxembourg, as the case may be, in such manner as the Fiscal Agent, the Registrar and Euroclear and/or Clearstream, Luxembourg, as the case may be, may approve for this purpose.

15. MEETINGS OF COVERED BONDHOLDERS, MODIFICATION AND WAIVER

(a) *Covered Bonds other than ISD Covered Bonds*

The Agency Agreement contains provisions for convening meetings of the Covered Bondholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of the Covered Bonds, the Receipts, the Coupons or any of the provisions of the Agency Agreement. Such a meeting may be convened by the Issuer and shall be convened by the Issuer if required in writing by Covered Bondholders holding not less than 5% in nominal amount of the Covered Bonds for the time being remaining outstanding. The quorum at any such meeting for passing an Extraordinary Resolution is one or more persons holding or representing not less than 50% in nominal amount of the Covered Bonds for the time being outstanding, or at any adjourned meeting one or more persons being or representing Covered Bondholders whatever the nominal amount of the Covered Bonds so held or represented, except that at any meeting the business of which includes the modification of certain provisions of the Covered Bonds, the Receipts or the

Coupons (including modifying the date of maturity of the Covered Bonds or any date for payment of interest thereon, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Covered Bonds or altering the currency of payment of the Covered Bonds, the Receipts or the Coupons or amending the Deed of Covenant in certain respects)), the quorum shall be one or more persons holding or representing not less than two-thirds in nominal amount of the Covered Bonds for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third in nominal amount of the Covered Bonds for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Covered Bondholders shall be binding on all the Covered Bondholders, whether or not they are present at the meeting, and on all Receiptholders and Couponholders.

The Issuer may agree, without the consent of the Covered Bondholders, Receiptholders or Couponholders, to:

(a) any modification (except as mentioned above) of the Covered Bonds, the Receipts, the Coupons or Agency Agreement which is not prejudicial to the interests of the Covered Bondholders; or

(b) any modification of the Covered Bonds, the Receipts, the Coupons or the Agency Agreement which is of a formal, minor or technical nature or is made to correct a manifest or proven error or to comply with mandatory provisions of the law.

Any such modification shall be binding on the Covered Bondholders, the Receiptholders and the Couponholders and any such modification shall be notified to the Covered Bondholders in accordance with Condition 14 as soon as practicable thereafter.

In relation to modifications made pursuant Condition 15(a) and (b) above, the Issuer shall consider the interest of the Covered Bondholders and in the event that the Issuer proposes any modification to the Agency Agreement, the Agents are (i) not obliged to consider the interests of the Covered Bondholder and (ii) entitled to assume without further enquiry that the conditions set out in this Condition have been satisfied.

(b) ISD Covered Bonds

The Issuer may, in its capacity as ISD Agent, convene meetings of the holders of ISD Covered Bonds to consider any matter affecting their interests, including sanctioning by a majority of votes a modification of the ISD Covered Bonds. Such a meeting may be convened by the Issuer or by the holders of not less than 10 per cent. of the Voting ISD Covered Bonds. For the purpose of this Condition, **Voting ISD Covered Bonds** means the aggregate nominal amount of the total number of ISD Covered Bonds not redeemed or otherwise deregistered in the ISD, less the ISD Covered Bonds owned by the Issuer, any party who has decisive influence over the Issuer or any party over whom the Issuer has decisive influence.

The quorum at a meeting for passing a resolution is one or more persons holding at least one half of the Voting ISD Covered Bonds or at any adjourned meeting one or more persons being or representing holders of Voting ISD Covered Bonds whatever the nominal amount of the ISD Covered Bonds so held or represented, except that at any meeting the business of which includes the modification of certain provisions of the ISD Covered Bonds (including modifying the date of maturity of the ISD Covered Bonds or any date for payment of interest thereof, reducing or cancelling the amount of principal or the rate of interest payable in respect of the ISD Covered Bonds or altering the currency of payment of the ISD Covered Bonds), the quorum shall be one or more persons holding or representing not less than two-thirds in aggregate nominal amount of the Voting ISD Covered Bonds for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third in aggregate nominal amount of the

Voting ISD Covered Bonds. A resolution passed at any meeting of the holders of ISD Covered Bonds shall be binding on all the holders, whether or not they are present at such meeting. If and whenever the Issuer has issued and has outstanding ISD Covered Bonds of more than one Series, (i) a resolution which affects the ISD Covered Bonds of only one Series shall be deemed to have been duly passed if passed at a separate meeting of the holders of the ISD Covered Bonds of that Series; (ii) a resolution which affects the ISD Covered Bonds of more than one Series but does not give rise to a conflict of interest between the holders of ISD Covered Bonds of any of the Series so affected shall be deemed to have been duly passed if passed at a single meeting of the holders of the ISD Covered Bonds of all the Series so affected; and (iii) a resolution which affects the ISD Covered Bonds of more than one Series and gives or may give rise to a conflict of interest between the holders of the ISD Covered Bonds of one Series or group of Series so affected and the holders of the ISD Covered Bonds of another Series or group of Series so affected shall be deemed to have been duly passed only if it is duly passed at separate meetings of the holders of the ISD Covered Bonds of each Series or group of Series so affected.

The Issuer, in its capacity as ISD Agent, may in certain circumstances, without the consent of the holders of the ISD Covered Bonds, make decisions binding on all holders relating to the Conditions which are not in its opinion, materially prejudicial to the interests of the holders of the ISD Covered Bonds. The Issuer shall consider the interest of the holders of ISD Covered Bonds while making such decisions.

16. FURTHER ISSUES

The Issuer shall be at liberty from time to time without the consent of the Covered Bondholders, the Receiptholders or the Couponholders to create and issue further covered bonds having terms and conditions the same as the Covered Bonds or the same in all respects save for the amount and date of the first payment of interest thereon and the date from which interest starts to accrue and so that the same shall be consolidated and form a single Series with the outstanding Covered Bonds.

17. THE CONTRACTS (RIGHTS OF THIRD PARTIES) ACT 1999

No person shall have any right to enforce any term or condition of this Covered Bond under the Contracts (Rights of Third Parties) Act 1999, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

18. GOVERNING LAW AND SUBMISSION TO JURISDICTION

18.1 Governing law

The Agency Agreement, the Deed of Covenant, the Covered Bonds (except for Condition 3 and for ISD Covered Bonds, respectively), the Receipts and the Coupons and any non-contractual obligations arising out of or in connection with the aforementioned, are governed by, and shall be construed in accordance with, English law. Condition 3 of the Covered Bonds and the ISD Covered Bonds are governed by, and shall be construed in accordance with, Icelandic law.

18.2 Submission to jurisdiction

The Issuer irrevocably agrees, for the benefit of the Covered Bondholders, the Receiptholders and the Couponholders, that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Covered Bonds (other than the ISD Covered Bonds), the Receipts and/or the Coupons (including a dispute relating to any non-contractual obligations arising out of or in connection with the Covered Bonds, the Receipts and/or the Coupons) and accordingly submits to the exclusive jurisdiction of the English courts. The Issuer irrevocably agrees that any dispute arising out of the ISD Covered Bonds shall be subject to the exclusive jurisdiction of the

District Court of Reykjavik. Legal action taken in respect of the ISD Covered Bonds under this Condition 18 may be proceeded with in accordance with the Act on Civil Procedure No. 91/1991, chapter 17.

The Issuer waives any objection to the courts of England on the grounds that they are an inconvenient or inappropriate forum. The Covered Bondholders, the Receiptholders and the Couponholders, may take any suit, action or proceedings (together referred to as **Proceedings**) arising out of or in connection with the Covered Bonds, the Receipts and the Coupons (including any Proceeding relating to any non-contractual obligations arising out of or in connection with the Covered Bonds, the Receipts and/or the Coupons) against the Issuer in any other court of competent jurisdiction and concurrent Proceedings in any number of jurisdictions.

18.3 Appointment of Process Agent

The Issuer appoints Law Debenture Corporate Services Limited at its registered office at Fifth Floor, 100 Wood Street, London EC2V 7EX as its agent for service of process in England, and undertakes that, in the event of Law Debenture Corporate Services Limited ceasing so to act or ceasing to be registered in England, it will appoint another person as its agent for service of process in England in respect of any Proceedings. Nothing herein shall affect the right to serve proceedings in any other manner permitted by law.

18.4 Waiver of immunity

The Issuer hereby irrevocably and unconditionally waives with respect to the Covered Bonds, the Receipts and the Coupons any right to claim sovereign or other immunity from jurisdiction or execution and any similar defence and irrevocably and unconditionally consents to the giving of any relief or the issue of any process, including without limitation, the making, enforcement or execution against any property whatsoever (irrespective of its use or intended use) of any order or judgment made or given in connection with any Proceedings.

18.5 Other documents

The Issuer has in the Agency Agreement and the Deed of Covenant submitted to the jurisdiction of the English courts, appointed an agent for service of process and waived immunity in terms substantially similar to those set out above.

19. DEFINITIONS

In these Conditions the following words shall have the following meanings:

Cover Pool Swap Agreement means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Cover Pool Swap entered into from time to time between the Issuer and the Cover Pool Swap Provider;

Cover Pool Swap Provider means the third party counterparties in their respective capacities as cover pool swap provider under a Cover Pool Swap Agreement;

Cover Pool Swap means the Cover Pool swap which enables the Issuer to convert ISK interest payments (less a client margin) received by the Issuer in respect of assets (other than Swaps) registered to the Cover Pool into floating or fixed payments (as the case may be) payments linked to the interest rate payable on the Covered Bonds;

Cover Pool means the pool of eligible assets recorded in the Register maintained by the Issuer in accordance with the Icelandic Covered Bond Act;

Currency Swap Agreement means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Currency Swap(s) entered into from time to time between the Issuer and each Currency Swap Provider;

Currency Swap Provider means the third party counterparties in their respective capacities as currency swap provider under a Currency Swap Agreement;

Currency Swap means each currency swap which enables the Issuer to hedge currency risks arising from (a) Covered Bonds which are issued in currencies other than ISK and (b) assets (other than Mortgage Bonds) which are registered to the Cover Pool and are denominated in currencies other than ISK;

Indexed Currency Swap Agreement means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Indexed Currency Swap(s) entered into from time to time between the Issuer and each Indexed Currency Swap Provider;

Indexed Currency Swap Provider means the third party counterparties in their respective capacities as indexed currency swap provider under an Indexed Currency Swap Agreement;

Indexed Currency Swap means each currency swap which enables the Issuer to hedge currency and inflation risks arising from (a) Covered Bonds which are issued in currencies other than ISK and not indexed linked and (b) assets which are registered to the Cover Pool and are denominated in ISK and indexed linked;

Interest Rate Swap Agreement means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Interest Rate Swap(s) entered into from time to time between the Issuer and each Interest Rate Swap Provider;

Interest Rate Swap Provider means the third party counterparties in their respective capacities as interest rate swap provider under an Interest Rate Swap Agreement;

Interest Rate Swap means each single currency interest rate swap which enables the Issuer to hedge the Issuer's interest rate risks in ISK and/or other currencies to the extent that they have not been hedged by the Cover Pool Swap or a Currency Swap;

records of Euroclear, Clearstream, Luxembourg and the ISD means the records that each of Euroclear, Clearstream, Luxembourg and the ISD holds for its customers which reflect the amount of such customer's interest in the Covered Bonds;

Relevant Percentage means, from time to time, the proportion which the outstanding principal amount of the relevant Series of Covered Bonds bears to the aggregate of the outstanding principal amounts of all series of Covered Bonds outstanding;

Register has the meaning given to it in the Icelandic Covered Bond Act; and

Swap Providers means the Cover Pool Swap Provider, each Currency Swap Provider, each Interest Rate Swap Provider and each Indexed Currency Swap Provider.

USE OF PROCEEDS

The net proceeds from each issue of Covered Bonds will be applied by the Issuer for general funding purposes, which include making a profit and/or hedging certain risks. If, in respect of any particular issue there is a particular identified use of proceeds, this will be stated in the applicable Final Terms.

OVERVIEW OF THE ICELANDIC LEGISLATION REGARDING COVERED BONDS

Introduction

The Icelandic Act on Covered Bonds No. 11/2008 (as amended with Act No. 35/2008) (the **Icelandic Covered Bond Act**) was adopted by the Icelandic Parliament on 4 March 2008. This legislation enables Icelandic commercial banks, savings banks and credit undertakings which have been licensed to issue covered bonds as defined therein.

The following summary contains a general summary of the Icelandic Covered Bond Act, and does not entirely apply to the Covered Bonds issued pursuant to the proposed Programme, and should not be construed as being an exhaustive presentation or description of all aspects regarding the Icelandic Covered Bond Act.

Covered Bonds

The Icelandic Covered Bond Act defines "covered bonds" as bonds and other unilateral, unconditional, written debt obligations which enjoy a right of priority over the cover pool of the issuer and which are issued in compliance with the Icelandic Covered Bond Act.

Cover Pool

The Icelandic Covered Bond Act defines a "cover pool" as the collection of bonds, substitute collateral and other assets that have been registered on a register in accordance with Chapter VI of the Icelandic Covered Bond Act and covered bondholders and counterparties of the Issuer under derivative agreements have a priority claim to seek enforcement in respect of such assets in accordance with the Icelandic Covered Bond Act.

A cover pool will consist primarily of mortgage bonds secured against residential property; industrial, office or commercial property; agricultural property; debt instruments including those issued by the Icelandic government or other member state, municipality in Iceland or in another member state, or guaranteed by such member state within the EEA and certain substitute collateral (**Substitute Collateral**) up to a specific limit of the value of the relevant cover pool. These assets are to be kept separate from the other business operations of the issuer, as further described under "*The Register*" below. The Icelandic Covered Bond Act defines a bond as a written debt instrument whereby an issuer recognises unilaterally and unconditionally its obligations to make specific monetary payments.

The Icelandic Covered Bond Act requires that the total current value (in Icelandic "*uppreiknuð heildarfjárhæð höfuðstóls*") of the mortgage bonds and other assets in the cover pool that is to serve as collateral for a specific class of covered bonds shall always exceed the total current value (in Icelandic "*uppreiknuð heildarfjárhæð höfuðstóls*") of the principal of the same class of covered bonds (see further "*Matching rules*" below).

The Financial Supervisory Authority

The issue of covered bonds requires a licence from the Icelandic Financial Supervisory Authority (**FME**), which is also the supervisory authority for the business operations of the Issuer conducted in connection with the issue of covered bonds. A licence from the FME requires, *inter alia*, that the issuance complies with the Icelandic Covered Bond Act and that a certified public accountant certifies that the Issuer's budget and accounts demonstrate that its financial situation is stable enough not to jeopardise the interests of other creditors. Furthermore, the FME may grant the licence subject to specified conditions.

Subject to FME's authorisation, previously issued bonds and other comparable debt instruments which were issued for the purpose of financing the assets in a cover pool may be converted to covered bonds under the Icelandic Covered Bond Act.

The FME has issued Rules No. 528/2008 on covered bonds that concern among other things the conditions for being granted a licence to issue covered bonds, appraisal and revaluation of the assets in the cover pool, matching rules, derivative agreements, the cover bond register and the eligibility and reporting of the independent inspector (the **Rules**). The Rules are issued with reference to the Icelandic Cover Bond Act and elaborate on the provisions of the Act.

The Register

The rights of priority that covered bondholders have over the cover pool, which rank junior to swap providers in respect of the derivative agreements related to the covered bonds or the cover pool, arise from a registration being made in a register kept by the issuer (referred to herein as the **Register**). The Register shall always show, among other things, (1) the nominal value, interest terms, and final maturity dates of the covered bonds (2) the types of assets in the cover pool, and (3) in respect of each mortgage bond in the cover pool, the name of the underlying borrowers, their ID no., the nominal value of the loan, date of issue, maturity, terms of instalments and interest. Furthermore, the Register shall show the appraisal of the collateral security in the cover pool, when the appraisal was made and the premises used. Mortgage bonds in a cover pool must be endorsed showing they are part of a cover pool and have been entered in the Register as provided in Chapter VI of the Icelandic Covered Bond Act. The endorsement shall also indicate that the mortgage bond is to secure priority rights of a specific class of covered bonds.

Independent Inspector ("Sjálfstæður skoðunarmaður")

The FME shall supervise the Issuer to ensure that the Issuer acts in accordance with the Icelandic Covered Bond Act and other applicable legislation and regulations that govern the Issuer's operations. The Issuer must appoint an independent inspector, and this appointment must be approved by the FME. The independent inspector is assigned the task of monitoring that the Register is maintained in accordance with the provisions of the Icelandic Covered Bond Act and verifying that the valuation of collateral for debt instruments in the cover pool is based on the prescribed methodology. The independent inspector shall report regularly to the FME on his observations, and immediately inform the FME of any circumstances he becomes aware of, that could affect the FME's assessment of the Issuer.

Eligible Cover Pool Assets

The cover pool consists primarily of mortgage bonds issued by borrowers against collateral in the form of real property or public credit (i.e. loans to creditors with high credit worthiness, such as the State of Iceland, Icelandic municipalities and foreign central banks). Collateral for mortgage bonds shall consist of (a) pledged real property designated for residential purposes; (b) pledged real property designated for industrial, office or business purposes, and (c) pledged real property designated for agricultural purposes. The collateral may form part of the cover pool only to the extent that the ratio of the principal balance of the mortgage bond compared to the Market Value (the **LTV**) in relation to the collateral does not exceed (a) 80% of the Market Value for real property designated for residential purposes, (b) 70% of the Market Value for real property designated for agricultural purposes and (c) 60% of the Market Value for real property designated for industrial office or commercial purposes. Furthermore, the mortgage bonds issued against mortgages in residential, industrial, office, commercial or agricultural purposes may not be registered in the cover pool if payment is in arrears for 90 days or more.

The cover pool may also include a limited proportion of Substitute Collateral. The Substitute Collateral may constitute no more than 20% of the cover pool. The FME may, however, approve that the Substitute Collateral constitutes as much as 30% of its value.

The **Market Value** of real properties is assessed by an appraisal which must be based on the selling price in recent transactions with comparable properties. The Issuer shall regularly monitor the development of such selling prices. If the Market Value of collateral in the cover pool (i.e. the underlying mortgaged real estate) substantially decreases, the amount of the value of the assets in the cover pool shall be decreased to ensure that the LTV lies within the limits described above.

Matching Rules

The Issuer must ensure that the total current value of the cover pool which is to serve as collateral for a specific class of covered bonds always exceeds the aggregate total current value of that class of covered bonds. Moreover, instalments and other cash flows accruing on the assets in the cover pool and from derivative agreements shall be in such a manner that at any given time the issuer can meet all its financial obligations to covered bondholders and counterparties to derivative agreements.

In order to maintain a suitable balance between the cover pool and the corresponding class of covered bonds, the issuer (a) must ensure that the assets in the cover pool (including Substitute Collateral) are valued having proper regard to currency exchange rates, interest rates, maturity dates, and other relevant factors; and (b) may enter into derivative agreements for the purpose of achieving this balance.

Rights of Priority

In the event of winding up of the issuer, covered bondholders and derivative agreement counterparties are entitled to rights of priority to the assets in the cover pool that are registered in the Register, as well as over the funds that originate from those assets.

Handling of assets in the event of winding up of the Issuer

If an Issuer enters into winding up proceedings, any issued covered bonds do not fall due unless it was specifically agreed otherwise. Furthermore, any derivative agreements entered into by the Issuer in relation thereto shall not accelerate upon the winding of the Issuer and such agreements may not include provisions on automatic closing of contracts under such circumstances. In case of the winding up of the issuer, the winding up committee shall keep the covered bonds, Substitute Collateral and other assets in the cover pool segregated from other assets of the Issuer's estate. The same shall apply to funds and other assets substituted for the covered bonds, Substitute Collateral and other assets in the cover pool, or paid in respect of such assets. Such separation shall be maintained until claims arising from the covered bonds have been paid in full.

The winding up committee shall also keep derivative agreements, and funds returned by such assets or which must be paid from the cover pool to the counterparties to those derivative agreements, separate from other assets of the Issuer's estate.

Payments received by the Issuer after the date of a winding up order in respect of funds and other assets substituted for the covered bonds, Substitute Collateral and other assets in the cover pool intended for payment of claims, including fulfilment of derivative agreements, shall be entered in the Register by the winding up committee.

However, Article 17(1) of the Icelandic Covered Bond Act states that the winding up committee shall fulfil the Issuer's commitments under the covered bonds and derivative agreements using mortgage bonds and other assets in the cover pool and payments received on such assets provided these assets are listed in the register.

The separation of the cover pool shall be maintained until claims arising from the covered bonds have been paid in full. The general rule is that to the extent that a cover pool is not sufficient to cover the covered bonds and derivative agreements, the covered bondholders may continue to file claims as non-preferential creditors of the Issuer and to receive dividends from the other assets of the Issuer and be ranked *pari passu* with other, general and non-prioritised non-preferential creditors of the Issuer.

Under the act on Bankruptcy etc. no. 21/1991 (the **Bankruptcy Act**), the covered bondholders' priority rights to the cover pool rank third after(1) third party's assets held by the Issuer, provided that the third party can prove his entitlement to the asset (no such third party's assets should be a part of the cover pool); (2) (i) certain bankruptcy costs, (ii) third party claims incurred after the date of the winding up order due to agreements made on behalf of the bankruptcy estate by the winding up committee or to liability for losses incurred by third parties as a result of any negligent act of the bankruptcy estate; and (iii) lawful third party claims, including claims due to derivative agreements concluded in accordance with the provisions of the Icelandic Covered Bond Act, incurred by the estate after the date of a moratorium order or a composition proceedings order, if applicable.

Where the Issuer seeks composition with creditors, the composition arrangement will not affect claims which benefit from security (such as the claims of Covered Bondholders), to the extent the security is sufficient to pay the claim and the security interest will not cease to exist as a result of the composition arrangements. However, according to article 60(4) of the Bankruptcy Act, if the creditor values the collateral as being insufficient to meet his claim, he may (in order to increase the chances of recovery) partly waive his right to a secured claim and thereby partly obtain a contractual claim on the debtor, to the extent of such waiver.

The part of the winding up costs that concerns the covered bonds, the cover pool, and payments with respect to the covered bonds, cover pool or derivative agreements shall be paid from the cover pool. Payments received by the issuer after the date of the winding up order in accordance with the terms and conditions governing the cover pool should be entered in the Register.

Notwithstanding the provisions of Chapter XX of the Bankruptcy Act actions taken by the Issuer in accordance with the Icelandic Covered Bond Act, including the delivery of funds or Substitute Collateral to the cover pool, payments on the cover pool, or disposal of funds from the cover pool to fulfil obligations under a covered bond or a derivative agreement concluded in accordance with the Icelandic Covered Bond Act and in connection with the cover pool, shall not be subject to annulment or claw-back.

In relation to specific risk factors of the Icelandic Covered Bond Act that have been identified, please see the section on *Risk Factors* above.

The Rules

The Rules provide further detail on a few issues described in the Icelandic Covered Bond Act. Below is a short summary of the main sections of the Rules:

The Rules list the documents to be submitted to the FME by the issuer when the issuer seeks FME's license to issue covered bonds. Such documents include, i.e., approvals, descriptions of the proposed programme, the issuer's budget, information on data systems, etc.

The Rules describe the assets which are eligible to be registered to the cover pool and how such asset's eligibility shall be evaluated.

The Rules provide further clarifications with respect to the matching requirements described above and provide a method of calculating the present value of assets/liabilities in relation thereto. The Rules prescribe that the Issuer shall complete such calculations as often as deemed necessary and at least on a weekly basis.

The Rules provide for certain restrictions to the provisions and counterparties of derivative agreements. Such agreements may not include provisions on automatic closing of contracts upon the winding up of the issuer. Furthermore, the counterparties to derivative agreements must have a financial strength rating from a fully accredited rating agency and such a rating may not fall below the limits listed in the table below. If another rating agency has given the respective counterparty a lower rating, it has to receive ratings from at least two accredited rating agencies giving it equal or higher rating than listed in the following table:

Rating agency	Minimum rating	
	Long term	Short term
Moody's	A3	P2
Standard & Poor's	A-	A2
Fitch	A-	F2

The Rules provide further detail on the Register. The Register shall be kept in a secure manner and updated on a daily basis. The FME shall have access to the Register.

Furthermore, the Rules provide further detail on the obligations of the independent inspector to be appointed by the issuer. The independent inspector shall ensure that the Register is properly maintained and updated and shall therefore verify that bonds and derivative agreements are correctly registered, only eligible assets and Substitute Collateral are included in the cover pool, the value of the assets registered in the cover pool and the valuation thereof is in accordance with the Icelandic Covered Bond Act and the Rules, that LTV calculations are correctly updated upon significant decrease in the Market Value of mortgaged assets, and that the matching rules are complied with.

The independent inspector shall once a year provide the FME with a written report regarding his/her surveillance. Furthermore, the independent inspector shall as soon as possible notify the FME should he/she become aware of any matters which could affect the FME's assessment of the Issuer's position in general.

DESCRIPTION OF THE ISSUER

OVERVIEW

Arion Bank hf. is the entity to which certain assets and liabilities of Kaupthing Bank hf. (**Kaupthing**) were transferred following the assumption of control of Kaupthing by the Icelandic government towards the end of 2008. The Bank was established on 18 October 2008 and is incorporated in Reykjavik and domiciled in Iceland. It is a public limited company established under Act No 2/1995 regarding Public Limited Companies, under the laws of the Republic of Iceland with ID number 581008-0150 in the Icelandic Register of Enterprises. The Bank was initially named New Kaupthing banki hf. and, on 21 November 2009, its name was changed to Arion banki hf.

The Bank faced a number of challenges following its establishment. In particular, the assets and liabilities acquired by the Bank resulted in significant foreign exchange, interest rate and liquidity mismatches. In addition, an asset shortfall of ISK 38.3 billion resulted in a priority claim on Kaupthing, see "—*Related Party Transactions*". Further, a serious recession in Iceland in 2009 and 2010 resulted in significant non-performing loans and poor asset quality.

To address these risks, the Bank has focused on restructuring its loan portfolio and expanding its sources of funding as well as reducing other mismatches and maintaining high levels of liquidity and capital. In addition, a strategic plan was adopted in October 2010 which seeks to position the Bank as a universal bank providing a range of quality services and focuses on improving the Bank's competitiveness.

Since 2011, the Bank made significant progress in loan restructuring and has completed the majority of this work, although it expects that some personal and corporate borrowers will continue to require assistance for some time.

As a result of debt restructurings and other enforcement procedures, the Bank has in recent years acquired a significant amount of assets (largely in the form of shareholdings in companies). Since 2012, the Bank has made steady progress in the sale of companies acquired as a result of these collateral enforcement procedures and has now sold most of these companies (see "- *Asset Holding Companies*" and "- *Asset Portfolio Disposals*").

In the year ended 31 December 2015, the Bank's net interest income was ISK 26.9 billion (compared to ISK 24.2 billion in 2014), its operating income was ISK 86.6 billion (compared to ISK 54.0 billion in 2014) and its net earnings were ISK 49.7 billion (compared to ISK 28.6 billion in 2014). As at 31 December 2015, the Bank's total assets were ISK 1,011.1 billion.

In the nine month period ended 30 September 2016, the Bank's net interest income was ISK 22.1 billion (compared to ISK 20.3 billion in the nine month period ended 30 September 2015), its operating income was ISK 40.0 billion (compared to ISK 50.4 billion in the nine month period ended 30 September 2015) and its net earnings were ISK 17.3 billion (compared to ISK 25.4 billion in the nine month period ended 30 September 2015). As at 30 September 2016, the Bank's total assets were ISK 1,083 billion.

The Bank's registered address is Borgartún 19, 105 Reykjavík and its telephone number is +354 444 7000.

HISTORY

The Bank was established at the end of 2008 as the vehicle to receive the transfer of certain assets and liabilities of Kaupthing following the Icelandic government assuming control over it towards the end of 2008. Kaupthing was the product of a merger in May 2003 of two of Iceland's then leading banks, Kaupthing Bank hf. and Bunadarbanki Islands hf. (**Bunadarbanki**). Bunadarbanki was established in 1929 by a law passed by the Icelandic parliament, the Althingi. At the beginning of 1998, Bunadarbanki became a limited liability company and was privatised in stages up to the beginning of 2003. Kaupthing hf. was established in Reykjavik in 1982, coinciding with the launch of the free capital market in Iceland. Kaupthing hf. later became an investment bank before its merger with Bunadarbanki in 2003.

In July 2009, the Icelandic government and the resolution committee of Kaupthing (the **Kaupthing Resolution Committee**) reached agreement on the valuation of the assets transferred to the Bank through the issue of a compensation instrument by the Bank to Kaupthing. In addition, the agreement identified certain ring-fenced assets in respect of which the creditors were accorded a share in certain future increases of value through an escrow and contingent rights agreement (the **ECVRA**) and the creditors (through the Kaupthing Resolution Committee) were also granted an option to purchase up to 87 per cent. of the Bank's equity, see "—*Related Party Transactions*".

In March 2009, following a ruling from the FME, the Bank acquired all the deposits and card transactions of over 20,000 customers from SPRON. The operations of the six SPRON branches and its online bank were discontinued following the acquisition. In April 2009, the Bank acquired Mýrasýsla Savings Bank (**SPM**) in Borgarnes and merged it with its branch in Borgarnes, increasing its customer base by a further 2,000 clients.

In December 2009, the Kaupthing Resolution Committee acting through Kaupskil exercised its option to acquire shares in the Bank and, following a capital injection in January 2010, Kaupthing is currently the owner of 87 per cent. of the Bank with the Icelandic government owning the remaining 13 per cent.

In March 2010 a new board of directors (the **Board**) was appointed at the Bank's annual general meeting and, on 1 June 2010, the Board appointed a new chief executive officer (**CEO**).

On 30 June 2011, the Bank and Kaupthing executed a settlement agreement under which the compensation instrument and the ECVRA were both discharged.

In January 2012, the Bank acquired the mortgage portfolio managed in a special fund (the Fund) owned by the estate of Kaupthing. The Fund had guaranteed the covered bonds issued from 2006 to 2008 by Kaupthing to finance its mortgage loans (the Kaupthing Covered Bonds) under the structured covered bond programme established by Kaupthing on 30 March 2006 (the Kaupthing Covered Bond Programme). As a part of this acquisition, the Bank was substituted for, and has assumed all liabilities and obligations (past, present and future, other than Kaupthing's liabilities and obligations relating to withholding tax payments) of, Kaupthing in respect of each of the six series of outstanding Kaupthing Covered Bonds. The Kaupthing Covered Bonds are inflation linked with final maturities between 2033 and 2048, and have an aggregate face value of approximately ISK 92.5 billion.

The Bank paid an agreed cash consideration to the Kaupthing Resolution Committee in connection with the acquisition. The mortgage portfolio which the Bank now holds following the acquisition of all of the units in the Fund was valued at ISK 110 billion when it was acquired.

KAUPTHING

In October 2008, Kaupthing was taken into a special resolution regime (see "*Risk Factors - The Issuer's business is materially affected by Iceland's economy which remains vunerable to a range of domestic and international economic and political factors*"), and the Kaupthing Resolution Committee was appointed by the FME.

Under this regime, Kaupthing entered into moratorium on 24 November 2008, which ended following a ruling of the Reykjavik District Court, on 22 November 2010, after which it entered into a winding-up process.

Prior to its dissolution, the Kaupthing Resolution Committee represented Kaupthing in all matters and safeguarded its interest. The Kaupthing Resolution Committee had a legal obligation to maximise the value of Kaupthing's assets and preserve the interests of its creditors as a whole. In addition, the Kaupthing Resolution Committee was responsible for managing Kaupthing's daily operations.

In May 2009, the Reykjavik District court approved a request from the Kaupthing Resolution Committee and appointed a Winding-up Committee (the **Winding-up Committee**) for Kaupthing, to administer the processing of claims against Kaupthing. Prior to the dissolution of the Kaupthing Resolution Committee, the Winding-up Committee worked alongside the Kaupthing Resolution Committee and administered the formal process of filing and handling all claims against Kaupthing.

Under the winding-up proceedings, agreements and obligations of the financial undertaking continue to exist and Kaupthing was protected against petitions for insolvent liquidation. Its assets could not become subject to an attachment, execution or forced sale. No law suit could be filed against Kaupthing in Iceland while it was in winding-up proceedings, unless in accordance with a provision of law (primarily concerning disputes as to the processing of claims against Kaupthing) or through criminal proceedings.

The Kaupthing Resolution Committee was dissolved on 1 January 2012 and the Winding-up Committee has assumed all responsibility for managing the Kaupthing estate. On 16 March 2016, a new board of directors was appointed to replace the Winding-up Committee.

On 24 November 2015, the requisite majority of Kaupthing's unsecured creditors voted at a creditors' meeting held to approve a composition proposal (at which point it became a composition agreement, the **Composition Agreement**), through which Kaupthing would exit the winding-up proceedings. The Composition Agreement was approved by the District Court on 15 December 2015 and became final and binding on 23 December 2015. In order to allow Kaupthing to implement the Composition Agreement, the Central Bank has granted Kaupthing certain exemptions from Icelandic foreign capital controls on the basis that Kaupthing, among other things, has made a "stability contribution" to the Central Bank.

As part of a refinancing of the Bank's debt position undertaken in connection with the "stability contribution", on 11 January 2016 the Bank issued USD747,481,000 Resettable Notes due 2023 (the **Resettable Notes**) under the Programme to Kaupthing. The Bank and Kaupthing agreed to set off Kaupthing’s obligation to pay the purchase price in respect of the Resettable Notes against the Bank’s obligation to make payment of all amounts outstanding under a foreign currency loan provided to the Bank by the Central Bank on 22 January 2010 (such loan having been purchased by Kaupthing from the Central Bank) and to return certain foreign currency deposits held by the Bank for Kaupthing. More information about Kaupthing, its current status and completion of the winding-up proceedings can be found on www.kaupthing.com.

SHAREHOLDER OF THE ISSUER

Kaupthing's share in the Issuer is held through its wholly owned subsidiary Kaupskil ehf. (**Kaupskil**), a private limited liability company, ID no. 580609-0150, Borgartún 26, Reykjavik. The Kaupthing Winding-up Committee appoints one member of Kaupskil's board but the other two must be independent. Further, under a special representation agreement between Kaupskil and Kaupthing dated 20 April 2010, Kaupthing has agreed to respect the independence of the board of directors of Kaupskil and Kaupthing's duty to promote sound and solid financial operations of the Issuer free of external intervention. The board of directors of Kaupskil is required to report to the FME on the implementation of this policy on a quarterly basis. In order to facilitate supervision, Kaupskil is required to transfer the ownership of all financial and insurance subsidiaries to a single parent company if the FME considers such a transfer necessary.

Various restrictions have been placed on Kaupthing by the FME, including with regard to the sale of shares of the Issuer until September 2012. Kaupthing is required to notify the FME in advance of a proposed transfer of ownership of shares in the Issuer or Kaupskil. Upon receipt of such a notification, the FME will carry out a new eligibility assessment of the prospective owners if the change of ownership affects the board of directors of the Issuer. Further conditions relate to the financial strength of Kaupskil is required to, the ownership of the Issuer, supervisory interest and the owners' objectives. The FME set out the details of its approval and conditions in a press release dated 18 January 2010 (http://www.fme.is/utgefid-efni/frettir-og-tilkynningar/frettir/nr/602).

Following the completion of the Composition Agreement, Kaupthing holds 87 per cent. of the Bank's shares through Kaupskil (with the remaining 13 per cent. held by the Icelandic government). In addition, a profit-sharing agreement is in place whereby the proceeds from any future sale of the Bank will be divided between Kaupthing and the Icelandic government in proportions which will vary depending on the proceeds of any such sale, and will form part of Kaupthing's stability contribution.

STRATEGY

Following the appointment of a new Board and CEO in mid- 2010, a new strategic plan for the Bank was adopted in October 2010. The key elements of the strategy are:

- positioning the Bank as a universal bank in Iceland, providing a wide range of services and focusing on tailored and personalised solutions for its customers, with special emphasis being placed on the Bank's ability to meet the financial needs of those customers, both retail and corporate, which require comprehensive and diverse financial services; and

- improving the Bank's competitiveness by focusing on its product offering, quality of service, efficiency and profitability in its operations. In particular, the Bank reduced its branch network from 39 branches at the end of 2008 to 24 branches at 30 September 2016 and has also sought to reduce back office costs and streamline its organisational structure.

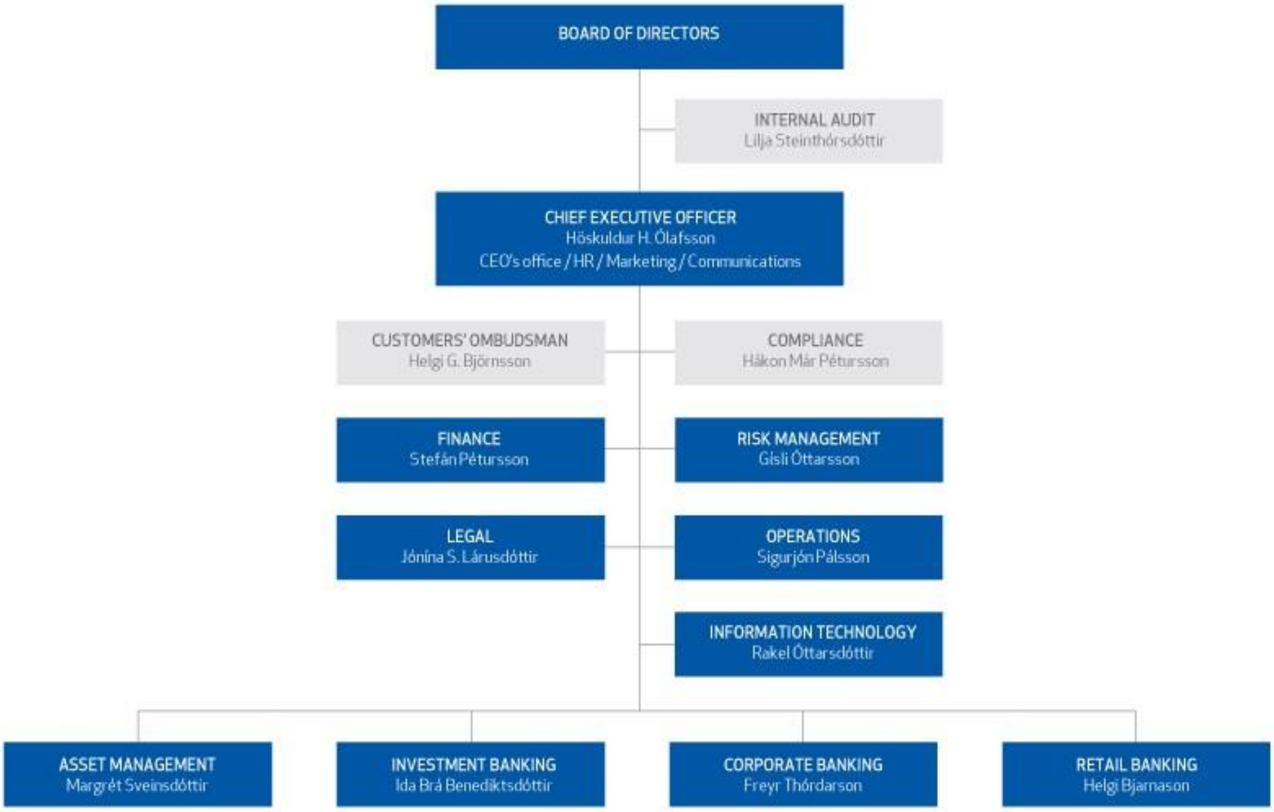
- in relation to business customers, emphasising the Bank's focus on developing long-term business relationships through continuous dialogue with customers so as to fully understand their needs and continuous product development which the Bank believes is fundamental to successful business relationships. The Bank aims to innovate and develop products and services which respond to the changing needs of its customers and to put its customers' interests first in all transactions.

The Bank's core values (or Cornerstones) were introduced in 2012 and are "We make a difference, we say what we mean, and we get things done". The Cornerstones guide the Bank in everything it says and does, particularly in its interaction with its main stakeholders, that is its customers, employees, society and shareholders.

From its creation at the end of 2008, the immediate and ongoing areas of focus for the Bank have been the restructuring of its loan portfolio, expansion of its sources of funding and the need to rebuild trust with its customers, Icelandic society as a whole and international financial institutions and investors. In addition, the Bank inherited certain significant risks in terms of loan and funding concentrations and currency mismatches which it has sought to reduce whilst focusing on maintaining high levels of liquidity and capital.

BUSINESS

The chart below illustrates the Bank's principal operating and support functions as at 30 September 2016.



Effective from 1 July 2016

The Group has six main reporting segments:

Corporate Banking provides comprehensive financial services and customized solutions to larger corporate clients in Iceland. Corporate Banking provides a full range of conventional lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund and AFL - sparisjóður (**AFL**), provide a comprehensive range of services. This includes among other advice on deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. As at 30 September 2016, the Bank had 24 branches throughout Iceland and over 100,000 retail customers.

Asset Management, comprises Institutional Asset Management, Private Banking and Investment Services. Asset Management manages financial assets on behalf of its clients according to a pre-determined investment strategy. Asset Management also administers pension funds. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Investment Banking is divided into Corporate Advisory, Capital Markets and Research. Corporate Advisory advises clients on securities offerings and the admission of securities for trading on regulated securities markets and also provides M&A advisory services. Capital Markets handles securities brokerage and foreign exchange trading for the Bank's customers. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking's clients are private individuals, companies and institutions.

Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management for the Bank. Treasury is also responsible for the internal pricing of interest rates and currency and for liaising with other financial institutions.

Other divisions and Subsidiaries, include the market making in domestic securities and currencies. The subsidiaries are Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor Holding hf. and other smaller entities.

The tables below show operating income and earnings before tax for each segment as at 30 September 2016, 31 December 2015 and 2014 and the total assets of each reporting segment.

	Nine month period ended as at 30 September 2016							
	Corporate Banking	**Retail Banki ng**	**Asset Manage-ment**	**Investment Banking**	**Treasury**	**Other Divisions and Sub-sidiaries**	**Head-Quarters and Elimination**	**Total**
	(*ISK million*)							
Operating income	5,841	14,075	3,205	2,934	3,467	10,619	(179)	39,962
Earnings before tax....	5,450	14,748	2,165	3,788	3,319	5,414	(12,930)	21,954
Total assets	253,507	472,439	5,106	18,705	194,455	64,603	29,665	1,038,480

	Year ended/as at 31 December 2015							
	Corporate Banking	**Retail Banking**	**Asset Manage-ment**	**Investment Banking**	**Treasury**	**Other Divisions and Sub-sidiaries**	**Head-Quarters and Elimination**	**Total**
	(*ISK million*)							
Operating income	7,012	16,346	4,882	36,434	6,758	7,646	7,477	**86,555**
Earnings before tax....	3,391	8,077	3,431	38,312	6,513	777	(8,047)	**52,454**
Total assets	236,621	448,547	5,884	62,904	179,375	50,166	27,546	**1,011,043**

	Year ended/as at 31 December 2014							
	Corporate Banking	**Retail Banking**	**Asset Manage-ment**	**Investment Banking**	**Treasury**	**Other Divisions and Sub-sidiaries**	**Head-Quarters and Elimination**	**Total**
	(*ISK million*)							
Operating income	9,481	15,277	4,144	7,640	4,454	12,086	908	**53,990**
Earnings before tax....	12,303	8,193	2,735	6,421	4,481	6,815	(11,865)	**29,083**
Total assets…………	231,575	416,912	5,230	33,730	160,210	65,459	20,620	**933,736**

Corporate Banking Division

The Bank's Corporate Banking division provides a range of financial services and products to its corporate clients. The prime focus of the division is to maintain long-term relationships with its clients and to deliver tailored solutions and personalised services. The division had 26 full time equivalent employees (**FTEs**) at 30 September 2016.

The Corporate Banking division provides services to corporate clients, from medium-sized businesses to large corporations. Corporate Banking comprises a team of account managers specialising in industries, such as services, manufacturing and real estate, and/or lending, such as project finance and structured finance. The account managers are each responsible for specific clients, thus ensuring personal services and a clear overview of each client's financial requirements. Each account manager also relies on the assistance of staff in a range of support functions, including trade finance and guarantees, legal and documentation, portfolio management and corporate services.

Although a significant proportion of the Corporate Banking division's business is the provision of credit, the Bank offers a wide range of products and financial solutions to meet the needs of each customer. Examples of these services include cash management solutions, a range of deposit products, automatic billing and collection services, online payment slips, internet banking and factoring.

The Corporate Banking loan portfolio principally comprises large corporate customers many of which had become over-leveraged following the 2008 financial crisis and the sharp depreciation of the Icelandic krona. The loans of a majority of the Corporate Banking customers in this position have either been restructured, refinanced or are still undergoing a restructuring process.

In 2011, the Bank started to offer factoring, or asset-based lending, which is used by SMEs, both importers and exporters. In particular, the Bank uses factoring in connection with trade finance, where inventory financing is linked with the financing of receivables which suits the needs of exporters, such as fishing companies.

At the beginning of 2012, the Bank entered into a partnership with European insurer, Euler Hermes, which enables its corporate clients to insure themselves against counterparty default. This type of credit insurance is increasingly important to companies engaged in the export and import business.

The Corporate Banking division is organised into six units; corporate lending, specialised lending, factoring, legal and documentation, portfolio management and corporate services. A seventh unit, recovery, existed until the end of 2013. The recovery unit was responsible for the Bank's debt recovery and was particularly involved in restructuring companies which were experiencing payment difficulties. During the restructuring process, the Bank acquired assets previously owned by the restructured companies. These assets have been transferred into separate holding companies under the control of the Bank. The restructuring process is now overseen by the Bank's legal department.

Retail Banking Division

The Retail Banking division provides a range of banking services to individual as well as SMEs. Retail Banking serves its customers through its branch network and other points of contact such as online banking, a call centre and automatic telling machines (**ATMs**). As at 30 September 2016, the Bank had 24 branches throughout Iceland and over 100,000 retail customers. The branches provide a comprehensive range of financial services, including advice on deposits and loans, payment cards, pension savings, insurance, securities and funds, with a focus on tailored solutions and personalised services to meet customer needs. Retail Banking had 366 FTEs at 30 September 2016.

Following its establishment in late 2008, the Bank has sought to streamline its retail banking operations by merging a number of its branches. This strategy has resulted in a reduction of the branch network and has created larger and stronger branches which the Bank believes are better able to meet the needs of its customers.

Retail Banking seeks to build long-lasting and profitable relationships with its customers. To maximise operational efficiency the branch network is divided into six clusters, and each cluster has its own business manager. Smaller branches capitalise on the strength of larger units within each cluster. As a result, more executive authority and responsibility is transferred to the branches and therefore closer to the customers. Three of the business managers work in the greater Reykjavík area and three in other large urban areas.

Retail Banking is in the process of establishing financial consultants within its branches with a view to improving the level of service to its customers. The financial consultants are expected to be knowledgeable in a wide range of fields including banking services, pensions and insurance and other financial instruments.

In the period up to 2012, the Bank's key focus was to work with its customers to restructure their debts. However, during 2012 the Bank noted clear signs that demand for traditional financial services was increasing and accordingly switched its focus to providing such services. In August 2012, the Bank launched a new application which enables its customers to keep track of their finances with a single click and without having to log in. Use of the application has steadily increased and, during 2014, 50 per cent. of online access to Arion Online Bank was through this application.

In October 2011, the Bank was the first bank in Iceland to offer non-inflation indexed mortgages with interest fixed for five years. The Bank also offers mixed mortgages which are partly indexed and partly noninflation indexed, which allows customers to find the type of loan that best suits their risk appetite and ability to repay. The Bank's latest product is designed to temporarily lower the borrower's debt repayments during parental leave.

In the autumn of 2012, Retail Banking launched a new unit which specialises in financing vehicles and various other types of equipment for personal and commercial use. In late 2012, the savings bank, Sparisjodur Olafsfjardar, merged with the Bank. This increased the number of the Bank's branches by one and allows the Bank to improve the services it offers in northern Iceland and to consolidate its position in that region.

Asset Management Division

The Asset Management division is responsible for managing assets on behalf of the Bank's clients, including institutional investors, corporations, high net worth clients and retail investors. It offers a wide range of services and a broad product mix. In addition to 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 investors. The division also offers funds from other leading global fund management companies.

Private Banking, a unit within the Asset Management division, seeks to provide first-class financial services tailored to the needs of individual clients with over ISK 10 million in assets under management. Each private banking client has his own account manager who provides personal service and financial advice suited to the client's needs.

Institutional Asset Management, another unit within the Asset Management division, services pension fund clients, trade unions, insurance companies, government institutions and other institutional investors. The services offered to these clients include portfolio management and advice on devising investment strategies.

The Bank's subsidiary, Stefnir Asset Management Company (**Stefnir**), is also part of the Asset management division. Stefnir is Iceland's largest fund management company with assets of around ISK 402,303 billion under active management as at 30 September 2016. Stefnir caters for both retail and professional clients with the aim of managing its clients' assets as best serves their interests. The company was founded in 1996 and its employees possess on average over 10 years' experience in the financial market. Stefnir has 16 specialists in four teams managing a diverse collection of mutual, investment and institutional investment funds. The company also manages assets of several limited partnerships that have been established around private equity investments in well-known Icelandic companies. Stefnir is wholly-owned by the Bank and had 22 FTEs at 30 September 2016.

As at 30 September 2016, the Bank had consolidated assets under management of ISK 606,240 billion. Asset Management had 32 FTEs at 30 September 2016.

During 2012, the Bank's subsidiary, Verdis, was merged into the Bank. Verdis provided custody and fund administration services which are now provided under the Arion brand.

The Asset Management division aims to continue satisfying its clients' needs by offering first-class services and a broad product range with competitive returns on investments as well as safeguarding its clients' interests.

Investment Banking Division

The Investment Banking division is divided into three units, Corporate Finance, Capital Markets and Research. The Investment Banking division had 32 FTEs at 30 September 2016.

Corporate Finance

Corporate Finance provides advisory services to corporate clients and investors in relation to merger and acquisition (**M&A**) and capital markets transactions, together with advice on funding and capital controls. The Bank’s principal investments are also managed within Corporate Finance.

The collapse of the Icelandic stock market in 2008 and the over-leveraging of a significant proportion of Icelandic companies had a significantly negative impact on M&A activities in Iceland. During 2009 and 2010, Corporate Finance was involved in a limited number of share listings and delistings as well as the sale of shares in companies which had been acquired by the Bank in settlement of debts owed. Corporate Finance has also provided valuation reports, managed bond offerings and advised clients on investment opportunities.

In 2011, Corporate Finance managed the listing of Hagar hf. (**Hagar**), which the Bank had acquired through a debt enforcement process, in Iceland's first public equity offering since 2008.

During 2012, Corporate Finance managed the sale of the Group's shares in Hagar, BM Vallá hf., Penninn a Islandi ehf., Boyfood Oy in Finland and Fram Foods AB in Sweden. Corporate Finance also advised the Bakkavor Group on its financial restructuring and arranged the listing of asset-backed bonds issued by institutional investor funds run by Stefnir on NASDAQ OMX Iceland.

In 2013, Corporate Finance managed the listing of each of VÍS hf. and N1 hf., the sale of a stake in Sena ehf., the sale of Klakki ehf.'s stake in VÍS hf., the sale of Fram Foods Ísland hf. (which was owned by Arion Bank's subsidiary Eignabjarg ehf.) and the acquisition of both Skeljungur hf. and Magn P/F by SF IV slhf. (which is managed by Arion Bank's subsidiary Stefnir). Corporate Finance has also been involved in the merger between the Bank's subsidiary Landfestar ehf. and Eik Fasteignafélag hf. (**Eik**). In addition, Corporate Finance arranged the listing on NASDAQ OMX Iceland of covered bonds issued by institutional investor funds managed by Stefnir.

In the first half of 2014 the Bank sold majority of its shareholding in HB Grandi hf and the company's listed the shares on the Main List of NASDAQ OMX Iceland.

In 2014, Corporate Finance arranged the refinancing of Reitir fasteignafélag hf. (**Reitir**), the largest commercial real estate company in Iceland and the sale and listing of HB Grandi hf., a fishing company, on

NASDAQ OMX Iceland. In 2015 it arranged the listing of real estate companies Reitir, Eik and Síminn hf. (**Síminn**), the largest telecommunication company in Iceland on NASDAQ OMX Iceland.

Capital Markets Unit

The Capital Markets unit provides securities brokerage and FX sales for institutional investors and corporate clients. It is divided into FX and Fixed Income Sales and Equity Sales.

FX and Fixed Income Sales offers domestic and foreign brokerage of currency, fixed income and derivatives for institutional investors, corporate clients and smaller domestic financial institutions. Equity Sales is responsible for the brokerage of domestic and foreign equities for institutional investors and corporate clients. Trading on the FX market is significantly restricted in Iceland by the capital controls established in 2008. In the fixed income market, the principal instruments traded are government bonds.

On the equities side, the Bank focuses on the United States and Nordic equity markets. The Bank also remains active in the domestic equity market although the market is currently limited. However, a number of companies have been listed on NASDAQ OMX Iceland since 2011.

In the fixed income market, while the Icelandic government bond market has reached saturation levels, additional investment options, such as asset-backed bonds and corporate bonds, have been introduced.

Trading on the foreign exchange market remains minimal, although the Central Bank held a number of currency auctions in 2014 as part of the process of lifting capital controls. The main aim of Capital Markets is to provide its growing client base with a comprehensive range of capital markets services and access to expert knowledge. The focus in the medium term is expected to shift towards product development as investors seek more opportunities to invest and distribute risk.

Research

Arion Research publishes macro research on the Icelandic economy and its developments, as well as research on individual companies and sectors. It publishes regular forecasts and updates on key economic issues. Arion Research holds regular conferences at which new research and reports produced by the unit are presented, such as economic forecasts, analysis of the real estate market, analysis of the finances of various municipalities as well as other different sectors. As more domestic initial public offerings take place, Arion Research is also focusing on providing clients of Investment Banking and Asset Management with research on listed companies and companies planning to go public in the near future. Arion Research is independent of the other divisions of the Bank.

Other Divisions and Subsidiaries

Other divisions

The Bank has five support divisions:

- ***Information Technology***: Supports the Bank by providing flexible and secure IT solutions, and offering expert advice and services designed to enhance the users' experience. A powerful information system and focused application of IT are integral to the Bank's strategy of being a relation bank. Finally, the division is responsible for developing the Bank's internet banking solutions, websites, online communication and electronic distribution channels. This division had 110 FTEs at 30 September 2016.

- ***Finance***: The Finance division includes funding and treasury (which together form the Treasury reporting segment) as well as accounting and planning and analysis. The accounting unit is responsible for the Bank's financial reporting, both internally and to external stakeholders, including the FME and the Central Bank. The Planning and analysis unit is responsible for short-term and long-term budgeting and for benchmarking the Bank with comparable financial institutions, both local and international. The funding unit is responsible for the Bank's long-term funding in both the domestic and international markets and the treasury unit is responsible for the Bank's liquidity, currency and interest rate management, the internal pricing of interest rates and currency, liaison with other financial institutions, proprietary trading and market making in domestic securities and currencies. The Finance division had 53 FTEs at 30 September 2016.

- ***Risk Management***: For a description of the activities of the Risk Management division, see "—*Risk Management*". The Risk Management division had 31 FTEs at 30 September 2016.

- ***Legal***: The Legal division handles collection, appropriated assets and legal representation on behalf of the Bank as well as a range of other legal services for the Bank's other divisions. The legal division had 43 FTEs at 30 September 2016.

- ***Operations***: The Operations division comprises back office and property management units. The Operations division had 143 FTEs at 30 September 2016.

Subsidiaries

The Bank is the parent company of a number of wholly-owned and majority-owned subsidiaries, of which the most significant are:

*Okkar líftryggingar hf. (**Okkar Life Insurance**)*

Okkar Life Insurance was founded in 1966 and acquired by Kaupthing in 2005. Okkar Life Insurance provides a range of insurance policies against illness, disability and death. Okkar Life Insurance has sales and distribution partnerships with the Bank and KB rádgjöf, which also sells pension products on behalf of the Bank. Okkar is wholly-owned by the Bank and had 18 FTEs at 30 September 2016.

*Valitor Holding hf. (**Valitor**)*

Valitor is a leading payment services company in Iceland. It is a group member of Visa Europe and a licensee of MasterCard and provides card acquiring services to merchants and card issuing services to Icelandic and international banks, savings banks and cardholders. Valitor had 240 FTEs at 31 December 2015. Valitor is 100.0 per cent. owned by the Bank and had 253 FTEs at 30 September 2016.

*AFL - sparisjóður (**AFL**)*

AFL. The Bank also increased its shareholding in the savings bank AFL to 100 per cent. in September 2015. On 15 October 2015, the Bank's merger with AFL was approved by the Icelandic Financial Supervisory Authority.

Vörður Tryggingar hf. (**Vörður**).

In October 2015, the Bank concluded a conditional purchase agreement with BankNordik P/F (**BankNordik**) to acquire a 51 per cent. shareholding in the Icelandic insurer Vörður. The Bank and BankNordik also entered into another agreement at the same time in relation to the purchase of the remaining shareholding in Vörður, which will come into effect when restrictions on the sale of the remaining minority shareholding have been lifted and no later than in 2017. The purchase price agreed for 100 per cent. of the shares of Vörður was €37.3 million.

Bakkavor

The Group, through the subsidiary BG12 slhf., revalued its 46.0% shareholding in Bakkavor Group Limited ("**Bakkavor**"), resulting in a change from a valuation according to the equity method (less impairment) to the sales value (less cost of sale) in anticipation of the disposal thereof. This revaluation had a positive impact on share of profit of associates in the Group's statement of comprehensive income, resulting in the recognition of a one-off gain in the amount of ISK 20,845 million for the year ended 31 December 2015, which in turn had a corresponding positive impact on the Group's operating income for the year ended 31 December 2015. BG12 sold its shareholding in Bakkavor at the beginning of 2016. BG12 is now in winding down process.

Asset Holding Companies

Eignarhaldsfélagið Landey ehf. (**Landey**)

Landey is a property development company which manages properties that currently do not generate any revenue but which may do so in the future. Such assets include unfinished housing developments, building lots and the rights attached to them. The company's objective is to maintain and increase the value of its properties through professional development, design and construction in collaboration with the planning authorities until a satisfactory price can be obtained.

*Eignabjarg ehf. (**Eignabjarg**)*

Eignabjarg was a wholly-owned subsidiary of the Bank and was liquidated as of 31 December 2015. Eignabjarg has been responsible for managing and selling shareholdings in companies which the Bank has acquired through debt restructurings or other enforcement procedures. Its function was to maximise the value of the shareholdings held, to develop a strategy for each asset and to implement good business practices and good corporate governance in the transferred companies.

During 2012 and 2013, Eignabjarg completed a significant number of disposals from its asset portfolio:

- Hagar was listed on the main market of NASDAQ OMX Iceland in December 2011. In February 2012, Eignabjarg sold a 13.3 per cent. share in Hagar in a private placement. By the end of 2012, Eignabjarg had sold its entire stake in Hagar.

- All share capital in Sigurplast ehf. was sold in April 2012 to the company Hilmar D. Ólafsson ehf.

- B.M. Vallá ehf., which specialises in the production of cement, prefabricated housing units, walls and pumice, was sold to BMV Holding ehf. in October 2011. The sale was completed in June 2012, following approval from the ICA.

- The entire share capital of Penninn á Íslandi ehf., which owns and operates a range of stores in Iceland, was offered for sale at the beginning of 2012. In June 2012, the company was sold to a consortium of investors led by Ingimar Jónsson, Ólafur Stefán Sveinsson and Stefán D. Franklín.

- In March 2012, the Bank offered Fram Foods ehf. for sale. In April 2012, the Bank decided to sell each business unit separately as no satisfactory offer had been received. In July 2012, the subsidiary, Boyfood Oy in Finland, was sold to the Finnish company, Felix Abba Oy. In November 2012, the subsidiary, Fram Foods AB in Sweden, was sold to the Swedish company, Domstein Sverige AB. The sale of the subsidiary, Fram Foods ehf. in Iceland, is currently being prepared.

Asset Portfolio Disposals

In addition to the disposals made by Eignabjarg (see "- *Asset Holding Companies*"), the disposals made by the Bank in respect of its asset portfolio have also included the following:

- In July 2016, the Bank sold a majority of its shareholding in the subsidiary Kolufell ehf. ("**Kolufell**"). Kolufell's main asset was investment property. Prior to the sale the Bank held 68.89% share in Kolufell, the Bank owns approximately 19.89 per cent. of Kolufell as at the date of this Base Prospectus

- In June 2016, Valitor completed the sale of its shareholding in Visa Europe to Visa Inc..

- In December 2013, Eik and the Bank signed an agreement relating to the acquisition by Eik of all of the share capital in Landfestar ehf. Eik financed the acquisition through the issuance of new share capital to the Bank, resulting in the Bank becoming the largest shareholder of Eik, owning 44% share in Eik. The Bank sold part of its shareholdings in Eik during 2014 and in April 2015 the Bank sold its remaining shares in Eik when the company was listed on the main list of NASDAQ OMX Iceland. The Bank currently holds no stake in Eik.

- In May 2014, HB Grandi hf. was listed on the main list of NASDAQ OMX Iceland. Following the sale of 18.8 per cent. of the Bank's shareholding in HB Grandi hf. in April 2014. Prior to the sale the Bank held 31% share in HB Grandi., the Bank owns approximately 5.18 per cent. of HB Grandi hf. as at the date of this Base Prospectus.

- In April 2015, Reitir was listed on the main market of NASDAQ OMX Iceland. Following Reitir's listing, the Bank sold approximately 17 per cent. of its shareholding in the company and owns approximately 6.25 per cent. of Reitir as at the date of this Base Prospectus.

- In October 2015, Siminn was listed on the main market of NASDAQ OMX Iceland. Following Siminn´s listing, the Banks sold approximately 22 per cent. of it is shareholding in the company and owns approximately 4.64 per cent. of Siminn as at the date of this Base Prospectus.

LOAN PORTFOLIO

The tables below sets out details of the Bank's loans to customers as at 30 September 2016, 31 December 2015 and 2014 classified by type of loan.

	As at 30 September 2016		
	Individuals	Corporates	Total
		(*ISK million*)	
Overdrafts	15,603	22,015	37,618
Credit cards	10,852	1,243	12,095
Mortgage loans	283,423	14,729	298,152
Other loans	35,314	358,004	393,318
Provision on loans	(10,545)	(14,731)	(25,276)
Loans to customers	334,647	381,260	715,907

	As at 31 December 2015		
	Individuals	Corporates	Total
		(*ISK million*)	
Overdrafts	16,840	24,248	41,088
Credit cards	10,842	1,054	11,896
Mortgage loans	271,895	12,889	284,784
Other loans	38,058	334,849	372,907
Provision on loans	(13,016)	(17,309)	(30,325)
Loans to customers	**324,619**	**355,731**	**680,350**

	As at 31 December 2014		
	Individuals	Corporates	Total
		(*ISK million*)	
Overdrafts	17,955	24,420	42,375
Credit cards	11,065	943	12,008
Mortgage loans	271,639	10,406	282,045
Capital lease	2,469	3,607	6,076
Other loans	31,294	300,391	331,685
Provision on loans	(13,111)	(13,570)	(26,681)
Loans to customers	**321,311**	**326,197**	**647,508**

The table below sets out details of the book value of the Bank's loans to customers as at 30 September 2016, 31 December 2015 and 2014 classified by customer sector.

	30.09.2016	2015	2014
Individuals	46.7%	47.7%	49.6%
Real estate activities and construction	15.8%	15.1%	12.5%
Fishing industry	11.1%	11.1%	11.8%
Information and communication technology	4.1%	4.7%	3.6%
Wholesale and retail trade	8.0%	7.6%	8.5%
Financial and insurance activities	4.9%	4.9%	4.3%
Industry, energy and manufacturing	4.0%	3.1%	3.9%
Transportation	0.8%	0.9%	0.9%
Services	2.5%	2.9%	2.8%
Public administration, human health and social activities	1.3%	1.2%	1.2%
Agriculture and forestry	0.8%	0.8%	0.9%
Total	**100.0%**	**100%**	**100.0%**

As at 30 September 2016, the aggregate amount of the Bank's 10 largest customer loans equalled 12.29 per cent. of its total gross customer loans at that date.

In addition to its customer loans, the Bank has a portfolio of loans to credit institutions. The table below sets out details of the Bank's loans to credit institutions as at 30 September 2016, 31 December 2015 and 2014 classified by type of loan.

	30.09.2016	2015	2014
		(*ISK million*)	
Bank accounts	48,429	74,533	79,587
Money market loans	10,700	7,976	23,007
Other loans	9,128	4,982	6,198
Loans to credit institutions	68,257	**87,491**	**108,792**

The tables below shows the credit quality of the Bank's financial assets, including its net loans, as at 30 September 2016, 31 December 2015 and 2014.

	As at 30 September 2016			
	Neither past due nor impaired	Past due but not impaired	Individually impaired(1)	Total
		(*ISK million*)		
Cash and balances with Central Bank	85,645	-	-	85,645
Loans to credit institutions	68,257	-	-	68,257
Loans to customers				
Loans to corporates	362,102	17,475	1,683	381,260
Loans to individuals	305,461	25,092	4,094	334,647
Financial instruments	86,198	-	-	86,198
Other assets with credit risk	10,091	-	-	10,091
Total	**918,754**	**42,567**	**5,777**	**966,098**

	As at 31December 2015			
	Neither past due nor impaired	Past due but not impaired	Individually impaired[1]	Total
		(*ISK million*)		
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Other assets with credit risk	4,581	-	-	4,581
Total	**851,318**	**43,834**	**8,086**	**903,238**

	As at 31 December 2014			
	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
		(*ISK million*)		
Cash and balances with Central Bank	21,063	-	-	21,063
Loans to credit institutions	108,792	-	-	108,792
Loans to customers				
Loans to corporates	308,588	15,114	2,495	326,197
Loans to individuals	277,859	32,847	10,605	321,311
Financial instruments	70,704	-	-	70,704
Other assets with credit risk	3,514	-	-	3,514
Total	**790,520**	**47,961**	**13,100**	**851,581**

The tables below shows the ageing of the Bank's past due but not impaired loans by class as at 30 September 2016, 31 December 2015 and 2014.

As at 30 September 2016	**Up to 3 days**	**4 to 30 days**	**31 to 60 days**	**61 to 90 days**	**More than 90 days**	**Total**
				(*ISK million*)		
Loans to corporates	4,428	7,549	2,169	839	2,490	17,475
Loans to individuals	3,193	9,845	5,767	591	5,696	25,092
Past due but not impaired loans	**7,621**	**17,394**	**7,936**	**1,430**	**8,186**	**42,567**

As at 31 December 2015	**Up to 3 days**	**4 to 30 days**	**31 to 60 days**	**61 to 90 days**	**More than 90 days**	**Total**
				(*ISK million*)		
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Past due but not impaired loans	**13,344**	**13,216**	**6,918**	**1,216**	**9,140**	**43,834**

As at 31 December 2014	**Up to 3 days**	**4 to 30 days**	**31 to 60 days**	**61 to 90 days**	**More than 90 days**	**Total**
				(*ISK million*)		
Loans to corporates	6,553	2,434	2,267	565	3,295	15,114

As at 31 December 2015	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to individuals	3,436	10,589	5,974	847	12,001	32,847
Past due but not impaired loans	**9,989**	**13,023**	**8,241**	**1,412**	**15,296**	**47,961**

The tables below sets out details of the Bank's impaired loans and receivables to customers as at 30 September 2016 and 31 December 2015 and 2014 classified by customer sector.

	As at 30 September 2016	
	Impairment amount	**Gross carrying amount**
Individuals	8,195	12,289
Real estate activities and construction	1,521	1,964
Fishing industry	515	614
Information and communication technology	377	392
Wholesale and retail trade	619	932
Financial and insurance activities	176	212
Industry, energy and manufacturing	1,267	1,384
Transportation	4,567	4,575
Services	3,167	3,710
Public administration., human health and social activities	64	64
Agriculture and forestry	175	284
Total	**20,643**	**26,420**

	As at 31 December			
	2015		**2014**	
	Impair-ment amount	**Loan carrying amount**	**Impair-ment amount**	**Loan carrying amount**
		(*ISK million*)		
Individuals	10,593	17,403	11,016	21,621
Real estate activities and construction	1,515	1,867	1,396	1,981
Fishing industry	257	373	1,115	2,366
Information and communication technology	308	332	251	251
Wholesale and retail trade	681	893	751	831
Financial and insurance activities	5,953	6,011	6,739	6,756
Industry, energy and manufacturing	828	1,025	296	474
Transportation	4,433	4,440	18	18
Services	504	682	375	641
Public sector	143	215	27	35
Agriculture and forestry	126	186	230	340
Total	**25,341**	**33,427**	**22,214**	**35,314**

FUNDING AND LIQUIDITY

Funding

The Bank is predominantly funded with domestic deposits. Its total deposit base at 30 September 2016 was ISK 440,667 billion, or 53 per cent. of its total liabilities. The Bank's other funding at 30 September 2016 comprised bonds, other debt and equity.

The Bank's funding profile changed significantly in 2012. In January 2012, the Bank acquired a mortgage portfolio from Kaupthing and was substituted as issuer under six series of Kaupthing Covered Bonds. In February 2012, the Bank issued its first series of covered bonds. The bonds, which mature in 2034, are denominated in Icelandic krona and the total issue amounted to ISK 2.5 billion. The Bank issued a total of ISK 5 billion in covered bonds in 2012. In May 2012 the Bank became the first Icelandic bank to issue covered bonds that were not inflation-linked and further issuances of such covered bonds took place in January 2013.

In February 2013, the Bank completed a senior unsecured bond offering denominated in Norwegian krone. This is the first time the Bank has raised funding in the international markets and it is also the first international bond offering by an Icelandic financial institution since 2007. The bonds, with a value of NOK 500 million (ISK 11.2 billion), were placed with more than 60 investors in Norway, Sweden, Finland, the United Kingdom, continental Europe and Asia.

In March 2015 the Bank issued a senior unsecured bond for €300 million to a broad group of investors. The bonds were 3 year instrument with a fixed 3.125% coupon and were sold at a rate corresponding to a 3.10% premium over interbank rates.

In June 2015 the Bank completed a bond issue in Norwegian kroner, issuing 500 million of 5-year instruments. The bonds bear floating NIBOR plus 2.95%

On 11 January 2016, the Bank issued the Resettable Notes (see " - *Kaupthing*" above).

As at 30 September 2016, the aggregate amount of the Bank's 10 largest deposits equalled 15 per cent. of the aggregate amount of the Bank's total deposits at that date. At the beginning of 2010, the Bank received a senior unsecured loan from the Central Bank amounting to ISK 61.3 billion and an ISK 29.5 billion subordinated loan from the Icelandic State that qualifies as Tier II capital. In June 2011, the Bank received a foreign currency subordinated loan from the Icelandic State in an amount equivalent to ISK 6.1 billion that qualifies as Tier II capital, see "—*Related Party Transactions*".

The Bank is focused on maintaining a large and stable deposit base originated from its clients. Deposits are expected to continue to form the core of the Bank's funding in the future. However, there are external factors that might affect the Bank's deposit base in the short to medium term, such as the lifting of capital controls and the increased availability of other investment opportunities for investors who currently hold deposits with the Bank. The Bank intends to continue diversifying its funding profile by issuing bonds in the domestic and international bond market when conditions permit.

Liquidity

On 1 December 2013 new liquidity rules issued by the Central Bank took effect, overriding the rules on liquidity and cash ratios that have previously been reported by the Group. The new rules are based on the liquidity standards introduced in the Basel III Accord which began to be implemented in 2015 on a global level. The standard defines the LCR, which is the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

The criteria for liquid assets used to meet unexpected outflow is stricter under these new liquidity measures. The assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank and not issued by the Group or its related entities.

The Central Bank has set a guideline for the minimum LCR which requires that, as at 1 January 2014, the LCR is 100 per cent. in foreign currency and 70 per cent. in total (ISK and foreign currency). The latter benchmark increases by 10 per cent. every year until a 100 per cent. requirement is implemented in 2017.

The LCR as at 30 September 2016 and 31 December 2015 (which is the end of the first complete year in which the LCR rules have been in effect) is shown below:

	As at	
	30 September 2016	**31 December 2015**
Liquidity coverage ratio		
FX	372%	212%
Total	194%	134%

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorisation is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Bank and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions.

The tables below shows the breakdown of the Bank's deposit base according to the LCR categorisation, with the associated expected stressed outflow weights as at 30 September 2016 and 31 December 2015. Some similar categories are grouped together.

	As at 30 September 2016				
	Deposits maturing within 30 days				
	Less stable	**Weight (%)**	**Stable**	**Weight (%)**	**Term deposits***
			(*ISK million*)		
Retail	95,232	10%	39,617	5%	58,594
SME	41,557	10%	4,255	5%	4,501
Corporations	52,991	40%	931	20%	5,369
Sovereigns, central-banks and PSE	18,729	40%		-	1,612
Financial entities being wound up		100%		-	
Pension funds	31,857	100%		-	22,200
Domestic financial entities	27,041	100%		-	21,847
Foreign financial entities	2,312	100%		-	-
Other foreign parties	6,999	100%	3,309	25%	2,346
Total	**276,718**		**48,082**		**116,469**

	As at 31 December 2015				
	Deposits maturing within 30 days				
	Less stable	**Weight (%)**	**Stable**	**Weight (%)**	**Term deposits***
			(*ISK million*)		
Retail	86,095	10%	39,598	5%	53,599
SME	37,884	10%	3,928	5%	4,327

	As at 31 December 2015				
	Deposits maturing within 30 days				
	Less stable	**Weight (%)**	**Stable**	**Weight (%)**	**Term deposits***
Operational relationship	-	25%	-	5%	
Corporations	36,300	40%	823	20%	4,945
Sovereigns, central-banks and PSE	11,900	40%	-	-	1,304
Financial entities being wound up	16,948	100%	-	-	47,062
Pension funds	41,609	100%	-	-	35,104
Domestic financial entities	32,727	100%	-	-	11,016
Foreign financial entities	5,193	100%	-	-	
Other foreign parties	3,707	100%	3,260	25%	1,923
Total	**272,363**		**47,609**		**159,280**

	As at 31 December 2014				
	Deposits maturing within 30 days				
	Less stable	**Weight (%)**	**Stable**	**Weight (%)**	**Term deposits***
			(*ISK million*)		
Retail	78,659	10%	36,076	5%	53,803
SME	36,060	10%	3,895	5%	6,011
Operational relationship	-	25%	-	5%	1,190
Corporations	36,961	40%	830	20%	5,873
Sovereigns, central-banks and PSE	12,196	40%	-	-	2,870
Financial entities being wound up	19,796	100%	-	-	67,105
Pension funds	36,824	100%	-	-	19,765
Domestic financial entities	22,634	100%	-	-	16,752
Foreign financial entities	4,532	100%	-	-	522
Other foreign parties	3,425	100%	3,026	25%	2,082
Total	**251,087**		**43,827**		**175,973**

* No outflow assumed from term deposits

** Changes in LCR rules in 2014 resulted in certain deposit pension funds being re-classified as retail deposits. Here, 2014 figures have been revised accordingly to show comparable data. The officical LCR figures for 31.12.2014 of 274% (FX) and 123% (Total) have not been adjusted accordingly.

RISK MANAGEMENT

Overview

The Bank seeks to manage its risks through a process of on-going risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and price the risk encountered is critical to the Bank's continuing profitability and its ability to ensure that the Bank's exposure to risk remains within acceptable levels.

The Board is ultimately responsible for the Bank's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Bank's risk exposure are in place. The Board defines the overall risk appetite of the Bank which is translated into exposure limits and targets that are monitored by the Bank's Risk Management division, which reports its findings regularly to the Bank's CEO and the Board. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board at least annually. The Board is also responsible for the Bank's internal capital adequacy assessment process (**ICAAP**). The Board has determined that management of risks encountered within subsidiaries should principally be carried out within each subsidiary.

The CEO is responsible for sustaining an effective risk management framework, policies and control as well as maintaining a high level of risk awareness among the Bank's employees.

The Bank operates the following committees to manage risk:

- Board Audit and Risk Committee (the **BARC**). This committee is responsible for supervising the Bank's risk management framework, risk appetite and ICAAP. The BARC regularly reviews reports on the Bank's risk exposures.

- Asset and Liability Committee (the **ALCO**). This committee is chaired by the CEO and is responsible for managing any asset-liability mismatches, liquidity risk, market risk, interest rate risk and capital management.

- Underwriting and Investment Committee (the **UIC**). This committee decides on underwriting and principal investments.

- Credit Committees. The Bank operates four credit committees: The Board Credit Committee (**BCC**) which decides on all major credit risk exposures, the Arion Credit Committee (**ACC**) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (**CCC**) and Retail Branch Committees (**RBC**) which operate within tighter credit granting limits.

In addition the Bank operates five Collateral Valuation Committees, which set guidelines on collateral assessment and valuation, and a Debt Cancellation Committee which deals with applications to reach composition with debtors.

The Bank's internal audit division conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal audits examine both the adequacy and completeness of the Bank's control environment and processes as well as the Bank's compliance with its procedures, internal rules and external regulations. Internal audit results are discussed with the Bank's management and reported to the BARC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into four units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is responsible for the Bank's ICAAP and Operational Risk which monitors risks associated with the daily operation of the Bank

The Bank is exposed to four major areas of risk: credit risk, market risk, liquidity risk and operational risk.

Credit Risk

Credit risk is managed and controlled by setting limits on the amount of risk the Bank is willing to accept for individual counterparties and groups of connected clients, and by monitoring exposures in relation to such limits.

The Bank´s main asset is its loan portfolio. Therefore managing and analysing the loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to groups of connected clients. Note 37 to the Q3 2016 Interim Financial Statements shows the Bank's maximum exposure to credit risk by type of instrument. As at 30 September 2016 and 31 December 2015, the Bank's total on and off balance sheet maximum exposure to credit risk totalled ISK 1,113,576 million and ISK 1,094,624 million respectively. The major industry exposures at 30 September 2016 were (i) individuals (46.7 per cent. of the total exposure), (ii) real estate and construction (15.8 per cent. of the total exposure), and (iii) fishing industry (11.1 per cent. of the total exposure).

Credit Approval Process

As discussed above, the Bank has a tiered structure of credit approval committees.

The BCC, which acts on the behalf of the Board, is the Bank's top credit, investment and underwriting authority. The ACC, which sits below the BCC's granting limits, has the right to delegate authority within its own credit limits and sets credit granting rules and guidelines for the business units. The Risk Management department is represented at credit committee meetings in an advisory role with a view to ensuring that all credit decisions are taken in line with the Bank's credit policy. Risk Management has the power to escalate a controversial credit committee decision to a higher authority.

For each credit application, the Bank gathers information and evaluates certain elements that serve as a basis for the decision, for example the borrower's profile, a financial analysis of the borrower, any proposed collateral, the borrower's credit rating and related parties and their total exposure.

Credit Analysis is Risk Management's primary interface with the Bank's credit committees. Credit Analysis prepares an opinion for all credit applications that go before the BCC, the ACC and the CCC. The Chief Risk Officer or his designated representative from Credit Analysis participates in all meetings of the CCC, the ACC and the BCC as a non-voting advisor. Credit Analysis also monitors the activities of the RBC. Credit Analysis ensures that credit decisions are within a committee's credit granting authority and is authorised to escalate controversial credit decisions from one committee to a committee with a higher authority.

Credit Analysis is also responsible for the approval of the corporate credit rating performed by account managers by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings.

The Bank generally requires collateral, but a central element in its assessment of a proposed borrower's creditworthiness is the borrower's ability to service debt. The main types of collateral obtained by the Bank are:

- Retail loans to individuals: Mortgages on residential properties;

- Corporate loans, real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities; and

- Derivative exposures, cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

In addition to collateral, other important credit risk mitigating techniques are pledges, guarantees and master netting agreements.

To ensure consistent collateral value assessment, the Bank has five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value, valuation parameters and haircuts on the applied collateral value. The committees are divided by area of expertise as follows:

- Agriculture;

- Fishing vessels and fishing quotas;
- Real estate;
- Securities; and
- Inventory and trade receivables.

The value of any collateral given is monitored by Risk Management and additional collateral may be requested in accordance with the underlying agreement. The value of any collateral given is taken into account when determining the adequacy of the allowance for impairment losses made in relation to each loan.

Credit Monitoring

The Bank has credit concentrations to a few significant customers and to certain business sectors, such as the real estate activities and construction sector, the fishing industry and wholesale and retail trade.

The Bank uses an internal rating system to rate its loans to companies and individuals. The rating model for larger companies bases its rating both on qualitative factors (such as sector stability and outlook) and quantitative factors (such as their equity and liquidity ratios). The rating model for SMEs and individuals are purely quantitative models.

To monitor the performance of its loan portfolio, the Bank relies on an Early Warning System (**EWS**), which is a forward–looking classification system for loans and borrowers. The monthly EWS classification is a prelude to the credit review by the Credit Control department. The need for impairment and/or financial restructuring is identified and evaluated during the review. The loan portfolio is grouped into four categories according to the borrower's financial strength and behaviour: Green, Yellow, Orange and Red.

In this system, borrowers in the Green category are financially the strongest, whereas a possible loss has been identified in the case of borrowers in the Red category. The EWS attempts to anticipate a deterioration in a customer's credit quality.

The classification is based on borrowers' contractual arrangements with the Bank, i.e. the timeliness of payments and compliance with other loan terms, financial ratio and the borrowers' credit ratings. The table below shows certain underlying criteria for the EWS.

Category	Provision	Default	(Debt/EBITDA)/LTV	Equity ratio	Credit rating	Covenant breach
Green	No	<30	<4.0–5.0 / <75-80%	>15-25%	≥B-	None
Yellow	No	30-90	4.0–6.0 / <75-90%	10-25%	CCC+	Minor
Orange	No	>90	>5.0–6.0 / 90-100%	<10-20%	<CCC+	Serious
Red	Yes	>90	>5.0–6.0 / >100%	<10-20%	<CCC+	Serious

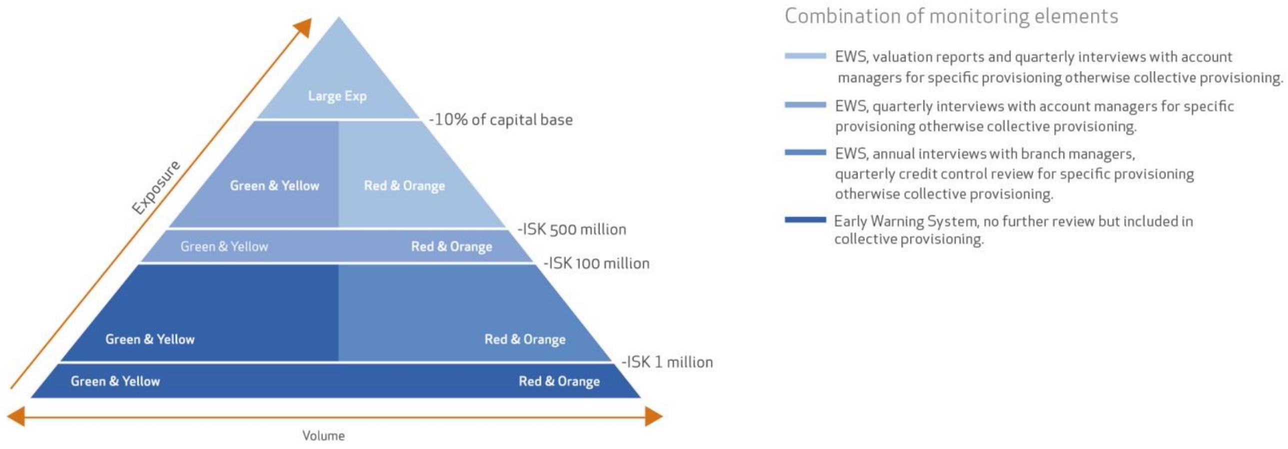
The classification is made on a customer basis; all conditions must be met for all loans of each borrower for that borrower to be classified as Green.

The classification is intentionally strict since its main purpose is to draw attention to plausible evidence of impairment e.g. payment difficulties of borrowers with resulting credit loss by the Bank. Risk Management has the authority to reassess the classification if an account manager has solid arguments for the change.

Risk Management's Credit Control department monitors individual credits based on selected samples. The samples are determined by the size of the exposure and its risk. The risk measurements are based on the

EWS. The level-of-detail in credit monitoring depends on credit size and loan volume. Credit monitoring consists of a quarterly review by Credit Control which usually involves communication with the borrower's account manager. A semi-annual valuation report is prepared for borrowers with a credit above 10 per cent. of the capital base and for borrowers in the orange and red category with credit above ISK 500 million.

The following chart describes how four different depth-levels of monitoring are applied to loans, depending on the size of the exposure and the EWS classification.



As a result of the Credit Control´s analysis a specific provision for impairment is determined based on the customer's aggregate exposure, the realisable value of collateral in accordance with the valuation committees' guidance. Special provisioning is based on the FME's rule No. 834/2003 on the Annual Accounts of Credit Institutions and reflects the estimated loss on loans.

Collective provisioning is applied to credits other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default but which have been determined not to require specific impairment. Collective provisions are estimates of expected loss based on the borrower's probability of default, standardised loss given default values and exposure at default.

Loan Provisioning

The Group analyses whether loans are impaired at both a borrower-specific level and a collective level. Analysing whether loans are impaired at a borrower-specific level involves an assessment of a combination of factors, including the borrowers' exposure, the number of days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers at this level, 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 collateral (or other credit mitigates) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment two deciding quantitative components are addressed in order to perform the calculation: (i) the probability of default and (ii) the loss given default. The Group uses internally developed models to calculate the probability of default, and these models are regularly benchmarked against actual outcomes to ensure their accuracy. When calculating loss given default, the Group also uses internally developed models.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurs after an impairment loss has been recognised which causes the amount of impairment loss to decrease, the decrease in the impairment loss is reversed through profit or loss.

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

Loans are 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 collateral have been received.

Counterparty Credit Risk

The Bank offers financial derivative instruments to professional investors. The table below shows derivative trading activities that are currently permitted. The derivative instruments are classified according to the primary risk factor and type of derivative instrument.

Primary risk factor	**Swaps**	**Forwards**	**Options**
Interest rate	x		
Securities	x	x	x
Commodities		x	x

Valuation changes are made in response to changes in interest rates, exchange rates, security prices and commodity prices.

The Bank sets limits to the total exposure and on the customer’s negative value, net of collateral, to control the Bank's risk towards these instruments. These limits are generally client-specific and may refer specifically to different categories of contract. Generally, collateral is required to cover potential losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. The margin-call process is monitored by Risk Management.

Large Exposures

In accordance with applicable Icelandic regulations, a large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10 per cent. of the Bank's capital base. The legal maximum for individual large exposures is 25 per cent. of the Bank's capital base, net of eligible collateral, and the sum of all large exposures cannot exceed 400 per cent. of the Bank's capital base. The Bank had no large exposures in excess of the legal limit of 25 per cent. at 30 September 2016. The sum of all large exposures at 30 September 2016 was 25 per cent. of the Bank's capital base before collateral mitigation or 25 per cent. net of eligible collateral, which is well below the 400 per cent. legal maximum.

The table below shows all gross exposures exceeding 10 per cent. of the Bank's capital base as at 30 September 2016 and 31 December 2015, together with the net amount of each of those exposures after taking account of collateral.

	As at			
	30 September		31 December	
	2016		2015	
	Gross	Net	Gross	Net
1	<10%	<10%	11%	11%
Sum of exposure gross and net >10%	0%	0%	**11%**	**11%**

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 imbalances in the Bank's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives and other commitments which are marked to market.

The Bank keeps firm track of market risk and separates its exposures for its trading book and banking book. Market risk in the trading book arises from proprietary trading activities. Market risk in the banking book arises from various mismatches in assets and liabilities e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately by Treasury.

Market risk allowance is set by the Board in the Bank´s risk appetite and the CEO decides on the limit framework for each trading desk and sets individual limits. ALCO is responsible for managing the Bank's overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances in the Group's balance sheet but accept limited risk in its trading book.

Interest Rate Risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The Bank's operations are subject to interest rate risk associated with mismatches between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a large gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are generally fixed for a long period resulting in a yield curve risk for the Bank. Note 38 to the Bank's Interim Financial Statements as at 30 September 2016 provides further information on the Bank's interest rate risk. 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, of which the largest is EUR.

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

Indexation Risk

The Bank is exposed to inflation risk when there is a mismatch between its index-linked assets and liabilities. As at 30 September 2016, the total amount of the Bank's indexed-linked assets was ISK 337,428 billion and the total amount of its inflation-linked liabilities was ISK 228,021 billion. See note 38 to the Interim Financial Statements as at 30 September 2016.

Currency Risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are the primary source of funding for the Bank whereas a substantial part of the Bank's assets consist of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

There have been a number of court cases in which the legality of different types of foreign currency loan has been considered by the Icelandic courts in recent years. See "—*Litigation*". Although these cases have clarified the law relating to these loans, there remains uncertainty regarding certain foreign currency linked loans. Nevertheless, the Bank considers that its portfolio of foreign currency linked loans is fully provisioned for the most likely outcome.

The table below indicates the currencies to which the Bank had significant exposure at 31 December 2015. The analysis calculates the effect of a 10 per cent. movement of the currency rate against the ISK (with +10% in the table denoting a depreciation of the ISK) on the Bank's income statement as a result of the change in fair value of currency sensitive non-trading monetary assets and liabilities. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact.

The table assumes that all other variables remain constant.

	As at 31 December 2015	
	-10%	**+10%**
	(*ISK million*)	
EUR	(1,105)	1,105
USD	(209)	209
GBP	(2,425)	2,425
DKK	221	(221)
NOK	304	(304)
Other	3	(3)

Equity Price Risk

Equity price risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Bank's assets i.e. restructuring of troubled companies which the Bank has taken over. For information on assets seized and held for sale and equity exposures, see Notes 21 and 27 respectively to the Interim Financial Statements 30 September 2016.

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Bank are FX swaps and forwards, interest rate swaps, cross-currency swaps, as well as options and forwards on equities, Treasury notes and bonds with a Icelandic government guarantee. Limits on exposures and collateral are determined in accordance with the Bank's risk appetite. The Bank also uses derivatives to reduce market risk on its balance sheet. The Bank's exposure to derivative instruments is not considered a material risk.

Prepayment Risk

Prepayment risk is the risk that the Bank will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Bank was not materially exposed to prepayment risk at 30 September 2016.

Liquidity Risk

Liquidity risk is defined as the risk that the Bank, though solvent, 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 Bank's primary source of funding is deposits from individuals, businesses and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 66.2 per cent is on-demand or with less than 30 day term.

The Bank's strategy is to diversify the funding profile of the Bank by establishing access to domestic and international debt markets and prudently manage the maturity profile of liabilities. Additionally the Bank's strategy is to always maintain sufficient liquidity by maintaining a high level of liquid assets and available funding to near term liabilities and expected payment outflows. The Bank has made significant process in converting its on demand deposits to term deposits. As at 31 December 2009, over 90 per cent. of the Bank's deposits were on demand compared to 59.7 per cent. at 31 December 2012, 52.8 per cent. as at 31 December 2013, 58.1 per cent as at 31 December 2014, 58.4 per cent. as at 30 September 2015, 57.3 per cent. as at 31 December 2015and 66.8 per cent. as at 30 September 2016.

Operational Risk

Operational risk is the risk of direct or indirect loss, or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Bank's image and operational earnings.

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.

Each business unit within the Bank is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk.

The Bank uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk. The Bank's capital base for operational risk is measured as 15 per cent. of the average over three years of the sum of net interest income and net non-interest income, as required by applicable legislation.

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analysed to understand the cause of the event and any control failure and amendments to controls are made where applicable to reduce the risk of the event recurring. Losses are categorised according to the Basel II event categories for operational risk. In the first nine months of 2016, the categories "execution delivery & process management" and "clients, products & business practices" accounted for 70 per cent., respectively, of total reported loss events. Measured by amount, "clients, products & business practices" accounted for 89 per cent of the total losses in the nine months of 2016.

CAPITAL ADEQUACY

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.

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 Directives (the **CRD**), which have now been replaced by CRD IV.

The CRD offers different approaches for calculating RWA for these risk types.

The Bank uses the following approaches for its capital requirement calculations:

- The standardised approach is used to calculate the capital requirements for credit risk;
- The standardised method is used to calculate the capital requirements for market risk; and
- The basic indicator approach is used for operational risk.

The Ministry of Industries and Innovation has formed a committee to implement CRD IV and the CRR in Iceland. The transposition of the CRD IV into Icelandic law is set to take place in three separate amendments. The first amendment was introduced on 9 July 2015 by Act No. 57/2015, which amended the Act on Financial Undertakings No. 161/2002. This amendment includes the CRD IV's provisions on capital buffers and adopts for the Minister of Industries and Innovation a regulation implementing the provisions of the CRR and related technical standards. The second amendment was introduced on 21 September 2016 by Act No. 96/2016, which includes the CRV IV's provisions on capital requirements, supervisory review and evaluation process (SREP) and leverage ratios. The timeframe for further implementation in Iceland has not yet been published (see "*Risk Factors – Changes to the Capital Requirements Directive could adversely affect the Bank's results*"). On 22 January 2016, the Financial Stability Council of Iceland published its recommendation to the FME to introduce a 2 per cent. capital buffer for systemically important financial institutions (including the Bank), a systemic risk buffer (of 3 per cent. in the case of the Bank) and a 1 per cent. countercyclical capital buffer. On 1 March 2016, the FME decided to uphold these recommendations. As regards the systemic risk buffer, a phase-in period is foreseen in the case of less significant credit institutions but it has applied, along with the capital buffer for systemically important financial institutions, to systemically important credit institutions (including the Bank) since 1 April 2016. The countercyclical capital buffer shall apply as of 1 March 2017.

Banking operations are categorised as either trading book or banking book and the calculation of RWA is conducted differently for the assets in different books. Banking book RWA are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account 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, taking into account eligible collateral or guarantees. Trading book RWA are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

The Bank carries out an ongoing process, the ICAAP, with the aim of ensuring 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 at identifying and measuring the Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance to its risk profile. The FME supervises the Bank, reviews the Bank's ICAAP and sets capital requirements for the Bank as a whole.

To measure the Pillar 2 capital requirement the Bank uses an internal economic capital model. Pillar 2 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, including concentration risk, residual risk, country risk, settlement risk, liquidity risk, interest rate risk in the banking book, reputational risk, legal and compliance risk, business risk and political risk.

Although the Bank uses credit rating models for credit risk monitoring, these models are not used for capital adequacy calculations. The Bank intends to recalibrate those models for use in its ICAAP. The Bank has implemented methods and tools for operational risk management based on the minimum requirements for the standardised approach. The Bank expects to continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macro-economic changes, downturns in the Bank's core business or other major events.

The Group is subject to capital requirements which are specified by the FME following a supervisory review and evaluation process (**SREP**). The Bank's capital base exceeded the FME's SREP requirements in each of 2015, 2014, 2013, 2012 and 2011.

The Group's capital base at 30 September 2016 amounted to ISK 198,622 million. The Group's official capital adequacy ratio, calculated in accordance with Icelandic requirements, was 26.1 per cent., exceeding the minimum legal requirement of 8 per cent.

The table shows the Group's RWA calculations as at 30 September 2016, 31 December 2015 and 31 December 2014.

	30 September 2016	**31 December 2015**
Capital Base	*(ISK million, except percentage)*	
Total equity	207,006	**201,894**
Non-controlling interest not eligible for inclusion in CET1 capital*	(66)	(9,108)
Intangible assets	(11,077)	(9,285)
Tax assets	(241)	(205)
Common equity Tier 1 capital*	193,923	**180,145**
Non-controlling interest not eligible for inclusion in CET1 capital*	66	9,108
Total Tier 1 capital	193,989	**189,253**
Subordinated Liabilities	-	10,365
Regulatory adjustments to Tier 2 capital**	-	(771)
Equity holding in financial sector entities*	-	(3,118)
General credit risk adjustments	4,633	-
Tier 2 capital	4,633	6,476
Total Capital base	198,622	195,729

*CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here

**Straight-line amortisation for maturities within five years.

Risk weighted assets		
Credit risk	663,903	681,034
Market risk FX	2,578	38,401
Market risk other	10,926	7,035

Credit valuation adjustment	815	-
Operational risk	81,441	81,441
Total risk weighted assets	759,663	**807,911**
Capital ratios		
CET1 ratio using current RWA*	25.5%	22.3%
Tier 1 ratio	25.5%	23.4%
Capital adequacy ratio	26.1%	24.2%

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

COMPLIANCE

According to Icelandic law, financial institutions are required to establish a compliance function and must ensure that it is effective and independent of other aspects of the institution's operations. The compliance function is required to:

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

The Bank's compliance officer coordinates the Bank's compliance activities. The Bank's compliance department had 7 FTEs at 30 September 2016.

The compliance officer works independently and reports directly to the CEO in accordance with both FME and internal audit requirements. 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 chief risk officer and the internal auditor on a monthly basis.

The compliance officer is also responsible for the Bank's anti-money laundering (**AML**) and terrorist financing procedures. The compliance officer organises and is responsible for:

- know your customer (**KYC**) due diligence;
- constant monitoring of the Bank's clients; and
- coordinating the Bank's compliance with applicable AML and terrorist financing laws, regulations and guidelines.

INVESTMENTS

The Bank has a small portfolio of debt and equity investments. These instruments are classified either as trading assets (being assets which are held by the Bank with a view to generating profit from short-term changes in price) or as assets held at fair value through profit and loss. The Bank's shares and equity instruments include those shareholdings that the Bank has acquired in recent years through debt restructurings and other enforcement procedures. Since 2012, the Bank has made steady progress in the sale of companies acquired as a result of these collateral enforcement procedures (see "– *Asset Holding Companies*").

The table below shows the classification of the Bank's investment portfolio as at 30 September 2016 and 31 December 2015.

	As at 30 September 2016			
	Trading	Designated at fair value	Available to sale	Total
			(*ISK million*)	
Listed bonds and debt instruments	4,880	66,132		71,012
Unlisted bonds and debt instruments	105	3,876		3,981
Total bonds and debt instruments	4,985	70,008		74,993
Listed shares and equity instruments	3,480	11,246		14,726
Unlisted shares and equity instruments	1,336	12,799		14,135
Bond funds with variable income	655	2,681		3,336
Total shares and equity instruments	5,491	26,726		32,197

	As at 31 December 2015			
	Trading	Designated at fair value	Available to sale	Total
			(*ISK million*)	
Listed bonds and debt instruments	2,526	74,757		77,283
Unlisted bonds and debt instruments	99	1,412		1,511
Total bonds and debt instruments	**2,625**	**76,169**		**78,794**
Listed shares and equity instruments	2,138	13,869		16,007
Unlisted shares and equity instruments	1,668	10,665	5,852	18,185
Bond funds with variable income	1,090	222		1,312
Total shares and equity instruments	**4,896**	**24,756**	**5,852**	**35,504**

COMPETITION

The Bank currently faces competition from the two other large commercial banks in Iceland, Landsbankinn and Islandsbanki, although this competition is currently limited as all three banks are focused on restructuring their loan portfolios and improving their asset and liability matching. The Bank also faces competition domestically from the Housing Financing Fund (see "*Financial Markets in Iceland – Other relevant institutions*").

As Iceland's economy recovers and demand for new lending and other banking products increases, the Bank expects to face increased competition from both the other large Icelandic banks and smaller specialised institutions as well as, potentially, foreign banks seeking to establish operations in Iceland. The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation and price.

The Bank also believes that it has a leading investment banking franchise in Iceland although there is currently little activity in this area in Iceland.

INFORMATION TECHNOLOGY

The Bank's IT division is responsible for developing, operating and advising on the Bank's information systems and solutions, including the Internet Bank, websites, its internally developed and third party software, its hardware such as data centres, telephone systems, ATMs and personal computers. The IT division had 110 FTEs at 30 September 2016. The Bank's focus in the IT area in the next few years will be on upgrading its systems and thereby improving its operational efficiency.

The Bank engages in a wide range of activities involving finance and financial services. The reliability of information and communications systems is a key factor in the Bank's activities as a financial enterprise.

Control of information security is an essential tool to achieve this objective. The Bank's Information Security Policy forms the basis of the measures used by the Bank to ensure the security of data, data systems and communication systems. Through the implementation of this policy, the Bank aims to prevent the inappropriate use of information, to safeguard the secure and uninterrupted transfer of electronic data and communications, and to integrate a risk management process into the work processes and daily tasks of all employees.

Legal security and the secrecy of information on customers are required to be observed at all times when IT is used. The Bank operates two data centres in an active mode to ensure continuous system uptime and to minimise downtime in disaster scenarios.

LITIGATION

Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland, the chances of litigation against the Bank have increased. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of any possible loss has been reasonably estimated, the Bank takes appropriate steps to mitigate any adverse effects which the claims may have on its financial standing.

ICA Investigation into Mortgage Loans Arrangements

The ICA has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated on the basis of separate complaints from BYR hf. and MP banki hf. made in 2010, which related to the terms of certain mortgage loans arrangements. According to the complaint, the terms of the mortgage loans have the effect of deterring individuals from moving their business to other banks and thereby restricting competition. The ICA has sent the Bank a proposed settlement agreement. The Bank is considering the conditions of the proposed settlement agreement and, as of 30 September 2016, has recorded a provision of ISK 300 million.

Claim for Alleged Violations of the Competition Act

With a writ issued in June 2013, Kortathjonustan claimed damages in the amount of up to ISK 1.2 billion plus interest from the Bank, Íslandsbanki, Landsbankinn, Borgun hf. and Valitor as a result of losses that Kortathjonustan contends the five parties caused it due to violations of the Competition Act. The Bank has put forward its arguments in the case and has requested the rejection of Kortathjonustan’s claims. Kortathjonustan’s court-appointed evaluator has submitted its report relating to the market shares in the card payments services market and Kortathjonustan’s alleged loss in June 2016. The Bank has contested the findings of the court-appointed evaluator set forth in the report and has requested the court in September 2016 to appoint new evaluators to re-evaluate. The preparation of such report by the new court-appointed evaluators is expected to take approximately 12 months after the appointment of such evaluators. Before the appointment of evaluators, procedural issues are being addressed by the court which might lead to the case being dismissed. The court decision regarding dismissal is expected in January / February 2017. As of 30 September 2016, the Bank has recorded a provision of ISK 300 million.

Claims for Damages due to Forced Bankruptcies

On the 12 June 2014, the former chairman of the board of directors of BM Valla hf., together with Lindarflot ehf., has filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Valla hf. and Fasteignafelagid Artun ehf., which had been customers of the Bank, damages by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy, resulting in the sale of assets of the companies at values which the plaintiffs contend are lower than they would have been had the Bank permitted the companies to be financially restructured. The Bank believes it is likely that it will prevail in both cases and has not therefore made any provision.

Valitor Damages Assessment

In its judgement in case No. 612/2012 from 24 April 2013, the Supreme Court of Iceland ruled that Valitor had not been authorised to rescind an agreement between the company and Datacell ehf. In January 2015, Datacell ehf. and Sunshine Press Productions ehf. brought legal action against Valitor for the payment of compensation relating to damage, which the companies considered they had sustained as a result of Valitor rescinding the agreement. Court-appointed evaluators were subsequently asked to assess the damage in question at the request of the plaintiffs. The court-appointed evaluators announced their conclusions in March 2016. Valitor disagrees with the court-appointed evaluators' conclusions and has requested other court-appointed evaluators to provide a second opinion in light of further information which Valitor has provided.

EFTA Surveillance Authority Investigation

In May 2015, ESA began an investigation into potentially unlawful state aid granted to Íslandsbanki and the Bank through allegedly preferential terms provided by the Icelandic Central Bank to Íslandsbanki and the Bank on two separate loan conversion agreements for the rescheduling of short-term collateral and securities loans from the Icelandic Central Bank to long-term loans.

ESA is investigating whether these loan conversion agreements, which were concluded between the Icelandic Central Bank and Íslandsbanki and the Icelandic Central Bank and the Bank in September 2009 and November 2009, respectively, could be regarded as unlawful state aid within the meaning of the EEA rules.

The Authority concluded that the loan agreements were on market terms and did not constitute state aid.

Dispute on Legacy Mortgage Loans Collateral

The Bank is involved in several court cases in the District Court of Reykjavík regarding whether it has the right to 100% of the value of a property pledged as collateral in a mortgage loan, where only one of the two owners has signed the document granting the property as collateral. The result of this case could affect other similar mortgage loan contracts of the Bank. The Bank has not recorded any provision in respect of the matter.

The district Court of Reykjavík has recently ruled in a similar court case, involving another Icelandic bank and its customer, and found in favour of the mortgagee holding that the Bank was entitled to enforce with respect to only 50% of the value of the property. This case has been appealed.

Legal matters concluded

FME Sanctions

In January 2016, the FME published an announcement in relation to the Bank's sale of the shares in Síminn in October 2015, in which the FME concluded that the Bank had not taken reputational risk properly into account when selling the shares in Síminn to certain customers of the Bank. As a consequence, the FME concluded that the Bank was in breach of the good business practices requirements of the Financial Undertakings Act. The Bank was not subject to any administrative fines in respect of these findings on the basis that the Bank had suffered reputational loss as a consequence of the transaction.

In November 2015, the FME concluded that the Bank had breached the insider trading provisions of the Securities Transactions Act when the Bank sold its interest in Hagar hf. The FME found that the Bank had been in possession of insider information at the time of the transaction and that the Bank had not proved that its counterparties had been in possession of the same information, as the Bank had claimed. As a consequence, the Bank received an administrative fine in the amount of ISK 30.0 million.

In September 2015, following an inspection of certain loans made by the Bank, the FME published an announcement in which the FME concluded that the Bank had not respected its own internal rules, decision of a credit committee or provisions of the loan agreements when it annulled and deregistered certain collateral, in breach of the good business practices requirements of the Financial Undertakings Act. The Bank was not subject to any administrative fines in respect of these findings.

European Surveillance Authority Investigation

In May 2015, the European Free Trade Association ("**EFTA**") Surveillance Authority ("**ESA**") began an investigation into potentially unlawful state aid granted to Íslandsbanki and the Bank through allegedly preferential terms provided by the Icelandic Central Bank to Íslandsbanki and the Bank on two separate loan conversion agreements for the rescheduling of short-term collateral and securities loans from the Icelandic Central Bank to long-term loans.

ESA is investigating whether these loan conversion agreements, which were concluded between the Icelandic Central Bank and Íslandsbanki and the Icelandic Central Bank and the Bank in September 2009 and November 2009, respectively, could be regarded as unlawful state aid within the meaning of the EEA rules.

In November 2016, ESA concluded that the terms agreed by the Icelandic Central Bank were in line with commercial conditions at the time the agreements were entered into and the Icelandic Central Bank acted in line with the conduct of a private creditor and, consequently, the loan agreements did not constitute state aid within the meaning of the EEA rules.

RELATED PARTY TRANSACTIONS

The Bank has a related party relationship with Kaupskil, Kaupthing, the Bank's associates, the Board of the Bank, the key management personnel of the Bank and close family members of the directors and key management personnel.

Icelandic State Financial Investments (**ISFI**, a separate state institution under the Ministry of Finance and Economic Affairs) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties and balances and transactions with these entities are included in the table in Note 36 to the Interim Financial Statements for the first nine months of the year 2016 under Shareholders with control over the Group.

The Board of Directors of Arion Bank, key management personnel of the Bank and the Group´s associates are defined as related parties, as well as close family members of individuals referred to above and legal entities controlled by them.

No unusual transactions took place with related parties during the period commencing on 1 January 2014 and ending on 30 September 2016. Transactions with related parties have been conducted on an arm's length basis. There have been no guarantees provided or received for related party receivables or payables during the aforementioned period.

See note 36 to the Interim Financial Statements for the first nine months of the year 2016, note 40 to the Financial Statements 2015 and note 39 to the Financial Statements 2014 for further information in relation to the Bank's related party transactions.

Key Financial Indicators

The following table includes certain of the Bank’s key financial indicators for the nine month period ended 30 September 2016 and for the years ended 31 December 2015 and 31 December 2014. This information should not be considered in isolation from, or as a substitute for, financial information presented in the Q3 2016 Interim Financial Statements or the 2015 Year End Financial Statements (each of which is incorporated by reference into the Base Prospectus) and should be read in conjunction with the Q3 2016 Interim Financial Statements or the 2015 Year End Financial Statements.

	As of and for the nine month period ended	**As of and for the twelve month period ended**	
	30 September 2016	**31 December 2015**	**31 December 2014**
	%	%	%
Profitability			
Return on equity[2]………………………....	11.2	28.1	18.6
Return on assets[3]…………………………	2.2	5.0	3.0
Return on risk weighted assets[4]…………	3.0	6.7	4.0
Net interest margin			
Net interest margin on interest bearing assets[5]…………………………………….	3.1	3.0	2.8

2 Return on equity is net earnings for the period as a percentage of average total equity (calculated as the average of the opening, quarter-end and closing balances for the applicable period). Return on equity is used as an alternative measure of performance of the Bank based on returns generated relative to equity and is a measure of the profits generated by the Bank from the equity of its shareholders. The higher this figure, the greater the profits of shareholders relative to their equity for the relevant period.

3 Return on assets is net earnings for the period as a percentage of average total assets (calculated as the average of the opening, quarter-end and closing balances for the applicable period). Return on assets is used as an alternative measure of performance of the Bank based on returns generated relative to total assets and is a measure of the profits generated by the Bank from its assets. The higher this figure, the greater the profits from the Bank’s assets for the relevant period.

4 Return on risk weighted assets is net earnings for the period as a percentage of average risk weighted assets (calculated as the average of the opening, quarter-end and closing balances for the applicable period). For the calculation of risk weighted assets see Note 40 of the Q3 2016 Interim Financial Statements and Note 45 of the 2015 Year End Financial Statements. Return on risk weighted assets is used as an alternative measure of performance of the Bank based on returns generated relative to risk weighted assets and is a measure of the profits generated by the Bank from its risk weighted assets (which is a prudential measure by which the assets of the Bank are adjusted to give different weight to certain risk based considerations as a means to assess those assets relative to such risks). The higher this figure, the greater the profits from the Bank’s risk weighted assets for the relevant period, which can then be compared to return on assets above to assess the risk based return of the Bank relative to the total asset return.

5 Net interest margin on interest bearing assets is interest income on interest bearing assets less interest expense as a percentage of average interest bearing assets (calculated as the average of the opening, quarter-end and closing balances for the applicable period). Interest income on interest bearing assets was ISK 956,006 million for the nine month period ended 30 September 2016, ISK 898,657 million and ISK 848,067 million for the twelve month periods ended 31 December 2015 and 2014, respectively. “Interest bearing assets” means the sum of

Net interest margin on total assets[6]………	2.9	2.7	2.6
Efficiency			
Cost-to-income ratio[7]……………………	56.7	32.6	50.1
Cost-to-total assets ratio[8]……………….	2.9	2.9	2.9

cash and balances with Central Bank, loans to credit institutions, loans to customers and interest bearing financial instruments (which is made up of bonds and debt instruments (ISK74,993 million as at 30 September 2016, ISK78,794 million as at 31 December 2015 and ISK66,466 million as at 31 December 2014), derivatives (ISK4,953 million as at 30 September 2016, ISK2,401 million as at 31 December 2015 and ISK1,026 million as at 31 December 2014) and listed bonds and debt instruments (ISK6,252 million as at 30 September 2016, ISK1,519 million as at 31 December 2015 and ISK3,212 million as at 31 December 2014). See Note 21 of the Q3 2016 Interim Financial Statements and Note 21 of the 2015 Year End Financial Statements). Net interest margin on interest bearing assets is used as an alternative measure of performance of the Bank based on the Bank's net interest margin relative to its interest bearing assets and is a measure of the difference in the interest income generated by the Bank's interest bearing assets and its interest expense by reference to the average interest bearing assets for the relevant period. The higher this figure, the greater the returns from the Bank's interest bearing assets for that period.

6 Net interest margin on total assets is net interest income as a percentage of average total assets (calculated as the average of the opening, quarter-end and closing balances for the applicable period). Net interest margin on total assets is used as an alternative measure of performance of the Bank based on the Bank's net interest margin relative to its total assets and is a measure of the difference in the interest income generated by the Bank's total assets and its interest expense by reference to the average total assets for the relevant period. The higher this figure, the greater the returns from the Bank's total assets for that period.

7 With respect to cost-to-income ratio, "cost" means salaries and related expense and other operating expense. "Income" means operating income. Cost-to-income ratio is used as an alternative measure of performance of the Bank based on the costs of the Bank relative to income generated and is a measure of the Bank's costs as compared with its income. The lower this figure, the lower the Bank's costs relative to its income.

8 With respect to cost-to-total assets ratio, "cost" means salaries and related expense and other operating expense. "Total assets" means total assets of the Bank as set out in the financial statements of the Bank (calculated as the average of the opening, quarter-end and closing balances for the applicable period). Cost-to-total assets ratio is used as an alternative measure of performance of the Bank based on the costs of the Bank relative to its total assets and is a measure of the Bank's costs as compared with its total assets. The lower this figure, the lower the Bank's costs relative to its total assets.

MANAGEMENT AND EMPLOYEES

MANAGEMENT

Shareholders´ meetings

The Bank's shareholders in general meetings are the supreme authority in the affairs of the Bank, within the limits established by the articles of association and statutory law. The Bank's annual general meeting is required to be held before the end of April each year.

Board of Directors

The Board is the supreme authority between shareholders' meetings, as further stipulated by law, regulations, and the Articles of Association.

The Board appoints the CEO. The Board also manages the Bank's affairs and ensures that its organisation and activities are at all times maintained in good order. The Board and the CEO undertake the administration of the Bank.

The Board is responsible for ensuring that the Bank's book-keeping and the handling of its funds is sufficiently supervised. The Board represents the Bank and may grant directors, the CEO or others authority to sign for the Bank.

The Board bears the principal responsibility for the Bank's daily operations and is required to regularly discuss the manner in which it discharges its duties, its substantive areas of focus and the main goals of its work.

The Board also bears the principal responsibility for the development and long-term success of the Bank. To that effect, individual directors must exercise their duties with due diligence and care, and with good faith in the best interests of the Bank and its shareholders. The Board confirms and bears the principal responsibility for the Bank's strategy.

The Board and the CEO are required to inform the FME without delay of any issues they become aware of that could affect the ongoing operation of the Bank.

The Board, which must be of a size and composition that makes it possible for the Board to discharge its duties efficiently and with integrity, currently comprises seven members. All the members are nominated by Kaupskil except one, Thóra Hallgrímsdóttir who was nominated by the ISFI.

The Bank's Board comprises the following members:

Monica Caneman, Chairman

Born in 1954, Monica Caneman was first elected to the Board of Directors at the Annual General Meeting held on 18 March 2010. Monica is Swedish and currently resides in Sweden. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Monica is also the chairman of the Board Credit Committee.

Monica worked at Skandinaviska Enskilda Banken (now SEB) from 1977 to 2001, holding various positions in marketing and commercial banking. She became a member of the SEB's Group Executive Committee and Group Management in 1995 and became the deputy chief executive officer and the deputy member of the SEB's board of directors in 1997. Since 2001, Monica has built a career around assignments on boards of directors, currently serving on the boards of directors of numerous companies and non-profit organisations. She is also the chairman of several boards of directors. Monica graduated with a Bachelor of Science degree in business and economics from the Stockholm School of Economics in 1976.

Gudrún Johnsen, Vice-Chairman

Born in 1973, Gudrún Johnsen was first elected to the Board of Directors at the Annual General Meeting held on 18 March 2010. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Gudrún is also chairman of the Board Remuneration Committee and is a member of the Board Risk Committee.

Gudrún was employed as the securities broker at the Icelandic Investment Bank between 1999 and 2001 and interned with the Financial Stability Division of the Icelandic Central Bank in 2002. Between 2004 and 2006, she was employed as the research assistant at the IMF in Washington, D.C. Gudrún was an assistant professor at the Reykjavík University from 2006 to 2013 and has worked as an assistant professor at the University of Iceland since 2013, teaching courses on corporate finance. In 2009 and 2010, she worked as the senior researcher for the Special Investigation Committee of the Parliament of Iceland, researching the causes and events leading up to the collapse of the Icelandic banking sector in 2008. She is currently the chairman of the board of directors of ÞOR-þróun og rannsóknir ehf., a research company providing independent advice, analysis and research to businesses, governments and policy makers. Gudrún graduated with a Bachelor of Arts degree in financial economics from the University of Iceland in 1999 and received a Master of Arts degree in applied economics and a Master of Arts degree in statistics from the University of Michigan in the United States in 2003.

Kirstín Th. Flygenring, Director

Born in 1955, Kirstín was first elected as an Alternate Director at the Annual General Meeting held on 22 March 2012 and was elected to the Board of Directors as a member at the Annual General Meeting held on 20 March 2014. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Kirstín is also a member of the Board Remuneration Committee and the Board Audit Committee.

Kirstín was marketing manager at the Icelandic Freezing Plants Corporation (now Icelandic Group hf.) from 1986 to 1989. Between 1995 and 1998, she was an economist and deputy managing director at the Fisheries Association of Iceland. From 1989 to 2000, she was also editor of the economics glossary at the Icelandic Language Institute at the University of Iceland. From 2002 to 2007, she was an economist in the Department of Economics at the Icelandic Central Bank. She was a part time lecturer and adjunct professor at the University of Iceland between 2007 and 2012 and was a specialist at the Institute for Research in Finance and Economics at Reykjavík University from 2007 to 2009. From 2011 to 2013, she was a member of a three-person committee of the Parliament of Iceland's investigative committee on the Housing Financing Fund. Kirstín graduated with a cand. oecon. degree from the University of Iceland in 1980. In 1983, she received a Master of Arts degree in economics from Northwestern University, Illinois in the United States. She completed practical media studies at the University of Iceland from 1993 to 1994.

Benedikt Olgeirsson, Director

Born in 1961, Benedikt was first elected to the Board of Directors at a meeting of shareholders held on 18 December 2013. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Benedikt is also a member of the Board Credit Committee and the Board Risk Committee.

Benedikt was employed as the project manager in civil engineering between 1988 and 1992 at SH Verktakar and Álftarós ehf. He was a manager at Eimskip hf. ("**Eimskip**"), Icelandic transportation company, between 1993 and 2004, most recently as the general manager of Eimskip's operations in Hamburg. He was the chief executive officer of Parlogis from 2004 to 2005 and the managing director of Atorka Group ehf. between 2005 and 2009. Benedikt served as the deputy chief executive officer of Landspítali University Hospital from 2010 to 2015 and has been the executive director of development at Landspítali University Hospital since 2015. Benedikt graduated with a Bachelor of Science degree in civil engineering from the University of Iceland in 1986 and received a Master of Science degree in construction engineering and project management and integrative program in business administration from the University of Washington in Seattle, United States in 1987. He has also completed courses at the Wharton Business School, the Harvard Business School and the Massachusetts Institute of Technology.

Brynjólfur Bjarnason, Director

Born in 1946, Brynjólfur was first elected to the Board of Directors at a meeting of shareholders held on 20 November 2014. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Brynjólfur is also a member of the Board Credit Committee and the chairman of the Board Audit Committee.

Brynjólfur was the head of the economics department of Vinnuveitendasamtök Íslands, an association of employers, between 1973 and 1976 and the chief executive officer of AB bókaútgáfa, a book publishing company between 1976 and 1983. He was employed as the chief executive officer of HB Grandi, one of Iceland's largest seafood companies, between 1984 and 2002 and as the chief executive officer of Síminn between 2002 and 2007. Brynjólfur was the chief executive officer of Skipti hf., a telecommunications and information technology company, between 2007 and 2010, the chief executive officer of the Icelandic Group, a seafood processing company, in 2011 and the chief executive officer of the Enterprise Investment Fund, an investment fund owned by a group of Icelandic pension funds, between 2012 and 2014. Brynjólfur has served on the boards of directors of numerous companies and organisations, including in the telecommunications and information technology, seafood and financial services industry sectors. Brynjólfur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1971 and received a Master of Business Administration degree from the University of Minnesota in Minnesota, United States in 1973.

Måns Höglund, Director

Born in 1951, Måns was first elected to the Board of Directors at the Annual General Meeting held on 24 March 2011. Måns is Swedish and currently resides in Portugal. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Måns is also a chairman of the Board Risk Committee and a member of the Board Credit Committee.

Måns was employed in various positions at Hambros Bank in London between 1977 and 1984, including serving as the regional director for Denmark and Iceland for two years. In 1984, he began working for Götabanken in London and was transferred to Götabanken's Stockholm operations in 1989, where he was the head of international finance until 1991. Between 1991 and 1999, Måns worked for Swedbank AB, including serving as the head of Swedbank AB's large corporate business. Between 1999 and 2002, he worked for both UniBank AS as the head of Swedish operations and Nordea Bank AB as the head of private banking. From 2002 to 2011, Måns worked for Swedish Export Credit Corporation as the executive director and the head of corporate and structured finance. He was also a member of the Swedish Export Credit Corporation's executive committee. Måns graduated with a Bachelor of Science degree in business and economics from the Stockholm School of Economics in 1975.

Thóra Hallgrímsdóttir, Director

Born in 1974, Thóra was first elected as an Alternate Director at the Annual General Meeting held on 24 March 2011 and was elected to the Board of Directors as a member at the Annual General Meeting held on 21 March 2013. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Thóra is also a member of the Board Risk Committee and the Board Remuneration Committee.

Thóra worked in the insurance business for over ten years, from 2000 for Tryggingamidstödin hf. and from 2005 for Sjóvá-Almennar tryggingar hf., as a legal advisor in claims. She was general counsel for Sjóvá-Almennar tryggingar hf. from 2005 to 2011 and director of claims from 2006 to 2007. From 2007 to 2011, Thóra served on behalf of Sjóvá-Almennar tryggingar hf. on the board of directors of International Motor Insurance in Iceland sf. and was an alternate member of the board of directors of the Icelandic Financial Services Association. Since 2011, Thóra has worked as a specialist for the School of Law in Reykjavík University, specialising in insurance law, contract law and tort law. Thóra is a member of the board of directors of VIRK (the Icelandic Rehabilitation Fund) nominated by SA-Confederation of Icelandic Employers and she is also on the board of the Association of Icelandic Lawyers and is chief editor of the journal Tímarit lögfræðinga issued by the Association of Icelandic Lawyers. Thóra serves as chairman of the insurance complaints committee and chairman of the seamen and fishermen's arbitration committee, appointed by the government. Thóra graduated with a degree in law from the University of Iceland in 2000 and qualified as a district court attorney in 2002.

John P. Madden, Director

Born in 1973, John was first elected to the Board of Directors at a meeting of shareholders held on 15 September 2016. John holds a dual citizenship from the United States and the United Kingdom and currently resides in the United Kingdom. John is not an independent member of the Board of Directors and is not a shareholder of the Bank.

John is a managing director at Kaupthing, which is the majority shareholder of Arion Bank through its subsidiary Kaupskil. He has also worked at BC Partners, Arle, ICG since 2014. Between 1998 and 2013, John worked at Arcapita, first in the United States, then in the United Kingdom. Prior to 1998, he was at Lehman Brothers, New York. John serves on the board of directors at Fairhold Securitisation Limited and Noreco. John graduated with a Bachelor of Arts degree in political economy from Williams College in Massachusetts, United States in 1996.

Board of Directors Alternates

In the event that a Director resigns or is unable to attend a meeting of the Board, an alternate director attends such meeting. The Board's alternate directors are as follows:

- Björg Arnardóttir (who is a non-indpendent Board member, as an employee of Kaupthing) B.Sc. Business Administration and Account Manager in Asset Management at Kaupthing hf;
- Ólafur Örn Svansson Attorney at Law and owner at Forum lögmenn ehf; and
- Sigurbjörg Ásta Jónsdóttir.

Board's sub-committee members (other than Directors)

Lúðvík Karl Tómasson, CPA, Vice President Global Corporate Controller and Treasurer, Lúðvík is a member of the Board Audit and Risk Committee.

Senior Management

The Bank's senior management team comprises the following members:

Höskuldur H. Ólafsson, CEO

Born in 1959, Höskuldur was appointed as the CEO of Arion Bank in June 2010. Höskuldur was employed at Eimskip between 1989 and 2005, holding a range of management positions, including deputy chief executive officer and managing director. From 2006 until his appointment as the CEO of Arion Bank, Höskuldur served as the chief executive officer of Valitor. He has also served on the boards of directors of various companies and organisations in Iceland and abroad, including the Chamber of Commerce of Iceland, and is currently a member of the board of directors of the Icelandic Financial Services Association. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987 and holds a diploma in shipping and business studies from the London School of Foreign Trade.

Freyr Thórdarson, Managing Director of Corporate Banking

Born in 1973, Freyr was appointed as the managing director of the Corporate Banking division in May 2013. Freyr has worked in banking and finance since 2001, both in Iceland and abroad. Prior to starting his career in banking and finance, Freyr was employed at Iceland Spring, a start-up bottling company, as the project manager and deputy plant manager from 1999 to 2001. Between 2001 and 2007, he worked at Straumur-Burdaras Investment Bank, serving most recently as the executive director and the head of debt finance at the London branch. In 2007, Freyr became the head of private equity at Gnupur Investment Company, a family wealth investment company, and the senior credit manager at Glitnir in 2008. Between 2009 and 2013, he managed as the senior director the restructuring and asset recovery projects in Kaupthing's Scandinavian portfolio. Freyr has served on the boards of directors of various companies and organisations, including Norvestia Oyj, an investment company listed on NASDAQ OMX Helsinki, and two unlisted industrial companies in Scandinavia on behalf of Kaupthing. He was previously a member of the Board of Directors from 22 March 2012 until 13 May 2013. Freyr graduated with a Bachelor of Science degree in business and finance from the Reykjavík University in 2003 and received an executive Master of Business Administration degree from the Reykjavík University in 2010. Freyr also completed a Vordiplom degree in communication science at the Universität Salzburg in Austria in 1999.

Helgi Bjarnason, Managing Director of Retail Banking

Born in 1969, Helgi was appointed as the managing director of the Retail Banking division in October 2011. Helgi was employed as the actuary at Okkar Life Insurance from 1997 to 2006. In 2006, he began working at Sjóvá Almennar Insurance, serving as the managing director of the life insurance company and the deputy managing director of the non-life insurance company. In October 2010, Helgi joined Arion Bank as the managing director of operations. He has also served on the boards of directors of various companies and organisations and is currently a member of the boards of directors of Okkar Life Insurance, Vörður and the Actuarial Association of Iceland. Helgi is a member of the Actuarial Association of Iceland (Félag íslenskra tryggingastærðfræðinga) and the Actuarial Association of Denmark (Den Danske Aktuarforening). Helgi graduated with a Bachelor of Science degree in mathematics from the University of Iceland in 1992 and received a cand. act. degree in actuarial mathematics from the University of Copenhagen in 1997.

Gísli S. Óttarsson, Chief Risk Officer and Managing Director

Born in 1963, Gísli was appointed as the Chief Risk Officer in April 2009. From 1994 to 2001, Gísli was employed as a software architect and development manager for the multibody dynamics and motion analysis software ADAMS at Mechanical Dynamics Inc. in the United States. From 2001 to 2006, Gísli was employed as a software designer and advisor for the engineering software company MSC. Software in the United States. From 2006 to 2009, he was head of research and development in Kaupthing's risk management division. Gísli graduated with a Bachelor of Science degree in civil engineering from the University of Iceland in 1986. Gísli received a Master of Science degree in applied mechanics in 1989 and a Ph.D. in mechanical engineering in 1994 from the University of Michigan. He is also a certified stockbroker.

Iða Brá Benediktsdóttir, Managing Director of Investment Banking

Born in 1976, Ida was appointed as the managing director of the Investment Banking division in February 2016. Ida started her career at Kaupthing in 1999, when she joined the research division of Kaupthing, during which time she held various positions, including the head of financial institutions. Upon establishment of Arion Bank in 2008, Ida continued working as the head of financial institutions until

September 2010, when she became the head of communications, investor relations and public relations. In 2013, Ida became the head of the Private Banking subdivision. Ida has served on the boards of directors of numerous companies, including Sparisjóður Ólafsfjardar, AFL, Landfestar and HB Grandi. Ida graduated with a cand. oecon. degree in business administration from the University of Iceland in 1999 and received a Master of Science degree in financial management from the Rotterdam School of Management in 2004. Ida is a certified securities broker in Iceland.

Jónína S. Lárusdóttir, Managing Director of Legal Division

Born in 1970, Jónína was appointed as the managing director of the Legal division in November 2010. Jónína started her career at the law firm A&P Árnason in 1996. She moved to the Ministry of Industry and Commerce (currently, the Ministry of Economic Affairs) in 2000, where she was a specialist in the financial markets department. Jónína was appointed director of the general office of the Ministry of Industry and Commerce in 2004. In 2007, she became permanent secretary of the Ministry of Industry and Commerce, where she was employed until 2010. Jónína has served on and chaired the boards of directors of various committees and organisations, including serving as a chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004. She is currently a chairman of the Association of Icelandic Lawyers (Lögfræðingafélag Íslands—Islands Juristforbund) and a member of the Icelandic Bar Association (Lögmannafélag Íslands). Jónína has also worked as a lecturer in several institutions, including the faculty of law of the University of Iceland. Jónína graduated with a cand. jur. degree from the University of Iceland in 1996 and received a Master of Laws degree, including in European competition law, from the London School of Economics in 2000. Jónína qualified as a district court attorney in Iceland in 1997.

Margrét Sveinsdóttir, Managing Director of Asset Management

Born in 1960, Margrét was appointed as the managing director of the Asset Management division in February 2009. Margrét has more than 30 years of experience in the financial sector, having worked in credit analysis, customer relationship management and asset management. She started her career in the credit department of the Industrial Bank of Iceland in 1985. Margrét then moved to Íslandsbanki Securities Ltd VÍB, later the asset management division of Glitnir, where she was the executive director of securities advisory unit and a member of the management team of the asset management division. Between 2007 and 2009, Margrét worked as the executive director of the financial institutions team within the Treasury division of Glitnir, with emphasis on relationship management with over 300 international banks. Margrét has served on the boards of directors of various companies and organisations, including the Depositors' and Investors' Guarantee Fund on behalf of the Icelandic Financial Services Association, Okkar Life Insurance and several funds in Luxembourg. She is also a member of the Advisory Board of the Faculty of Business Administration at the University of Iceland and served as a liaison for a course on cooperation and achievement at the University of Iceland during the spring semester of 2016. Margrét has co-edited several books and contributed articles to magazines on investments and financial planning and has taught courses on securities advisory and securities taxation. Margrét graduated with a cand. oecon. degree in business administration from the University of Iceland in 1986 and received a Master of Business Administration degree from the Babson College in Massachusetts, United States in 1990. Margrét is a certified securities dealer in Iceland.

Rakel Óttarsdóttir, Managing Director of Corporate Development & Marketing

Born in 1973, Rakel was appointed as the Chief Information Officer in 2016. Rakel joined the information technology division of Kaupthing in 2005, where she was an account manager. In 2010, she became head of project management in the Corporate Development and Marketing division of Arion Bank and was appointed as the managing director of the Corporate Development and Marketing division in December 2011. Before joining Arion Bank, Rakel was head of development at TM Software. Rakel graduated with a Bachelor of Science degree in computer science from the University of Iceland in 1997. She also received a Master of Business Administration degree from Duke University in North Carolina, United States in 2002.

Stefán Pétursson, Chief Financial Officer and Managing Director

Born in 1963, Stefán was appointed as the Chief Financial Officer in August 2010. From 1986 to 1989, Stefán was employed as head of administration at the Icelandic Fisheries Laboratories Institute. After completing his studies in the United States, Stefán joined Landsvirkjun in 1991, first as head of funding and then as treasurer from 1995. He became chief financial officer of Landsvirkjun in 2002 and was a member of Landsvirkjun's negotiation committee with energy-intensive industries. Stefán was on leave from Landsvirkjun in 2008, while serving as the chief executive officer of the investment company HydroKraftInvest hf. Stefán has served on a number of boards of directors and held other positions of responsibility in recent years. He is currently a member of the boards of directors of Landey hf. and the Depositors' and Investors' Guarantee Fund on behalf of SFF. Stefán graduated with a cand. oecon. degree from the faculty of business of the University of Iceland in 1986. He also received a Master of Business Administration degree from Babson College in Massachusetts, United States in 1991.

Sigurjón Pálsson, Managing Director of Operations

Born in 1972, Sigurjón was appointed as the Chief Operating Officer in October 2011. Prior to 2004, Sigurjón held various management positions with Ístak hf., Icelandic contracting firm, including the management of infrastructure projects and the construction of industrial buildings. In addition to managing these projects, he was also in charge of the information technology division. From 2005 to 2009, Sigurjón was employed at the corporate finance division of Kaupthing, where he held various positions, including as head of corporate recovery. He has served on the boards of directors of various companies in Iceland and abroad. Sigurjón graduated with a Bachelor of Science degree in civil engineering from the University of Iceland in 1996. He has also received a Master of Science degree in construction management from the KTH Royal Institute of Technology in Stockholm, Sweden in 1999 and a Master of Engineering degree in logistics and supply chain management from the Massachusetts Institute of Technology in Massachusetts, United States in 2005. Sigurjón is a certified stockbroker in Iceland.

Hákon Már Pétursson, Compliance Officer

Hákon studied law at the University of Iceland and University of Copenhagen, and is also a certified stockbroker. From 2006 to 2009 he worked as a specialist in the Securities Market division at the FME. During this time he was, among other things, the FME's representative in the Takeover Directive expert group and the Markets in Financial Instruments Directive (**MiFID**) expert group at the Committee of European Securities Regulators. He was also a guest lecturer at the University of Iceland and University of Reykjavík. From 2009 to 2011 he worked for KVASIR Legal on various matters relating to banking and financial restructuring. Hákon joined the Bank's Compliance Division in 2011.

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 a degree 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 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 Authorised Public Accountants and has served on the audit committee on behalf of the organisation. She also served on the audit committee of Icelandic Banks' Data Centre from 1998 to 2010, first on behalf of the Central Bank and then the Bank.

Helgi G. Björnsson, Customers' Ombudsman

In 1993, Helgi was appointed deputy branch manager at Búnadarbanki (a predecessor of the Bank) in Akureyri and became branch manager at Höfdi, Reykjavík, in 1999. He was then branch manager in Grafarvogur, Reykjavík, until spring 2010 when he joined the Customers' Ombudsman department as a specialist. Helgi was appointed Customers' Ombudsman of the Bank in April 2012. Between 1989 and 1993

Helgi worked for the Director of Tax Investigations and also advised on accounting for companies in north eastern Iceland. From 1987 to 1989 Helgi worked at Bifröst University in Iceland, teaching accounting, production management and human resource management. Helgi graduated with a diploma in industrial technology from the Technical College of Iceland (now Reykjavík University) in 1987.

Conflicts of Interest

John P. Madden, who is a member of the Board of Directors, and Björg Arnardóttir, who is an Alternate Director, are employees of Kaupthing. Arion Bank and Kaupthing, as owner of Kaupskil, may have different interests with respect to the financial reorganisations of customers who have obligations with both parties. Accordingly, under the Rules of Procedure, a member of the Board of Directors may not be involved in the handling of a case if it concerns dealings of companies, where they are members of the board of directors, hold positions of responsibility or have substantial interests at stake in other respects. The same applies to the handling of cases that concern parties who are considered connected to them in another way, whether personally or financially. In these cases, such members of the Board of Directors are required to leave the meeting. In addition, Arion Bank has implemented a procedure, whereby Björg Arnardóttir is not permitted to act as an Alternate Director where such conflict of interest arises.

There are no other conflicts of interest between the duties of the members of the Board of Directors, the Alternate Directors or members of the Executive Committee to Arion Bank and their private interests or other duties.

Corporate Governance

The Bank's Corporate Governance framework is based on law, the Bank's Articles of Association and the Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland hf. and the Confederation of Icelandic Employers in accordance with the Bank's Corporate Governance Statement. The Bank is directed and controlled by this framework. By establishing rules on corporate governance, the Bank sets forth criteria of conduct in key areas, which complement statutory rules. The Bank believes that a strong governance culture enhances trust, reduces risk and increases economic benefit for the Bank and its shareholders in the long term. The Bank continually seeks to update its corporate governance framework in response to new events, changes in statutory law and developments in domestic and international standards.

Management

The CEO is appointed by the Board. He is in charge of the day-to-day operations of the Bank and represents it in all matters concerning normal operations. The CEO is assisted by an executive management committee, in which all nine managing directors hold a seat.

Customers' Ombudsman

The Customers' Ombudsman is appointed by the Board in accordance with a government recommendation made at the end of 2008.

The role of the Ombudsman is to ensure fairness and objectivity when dealing with recovery cases, prevent discrimination between customers and to ensure that the process for handling cases is transparent and documented. In the case of companies, the Ombudsman must also ensure that competition perspectives are taken into account, viable companies are entered into the restructuring process and rules on financial restructuring are adhered to.

In order to achieve these objectives, the Ombudsman takes part in the formation of procedures and solutions for customers as appropriate. In addition, the Ombudsman reviews specific cases upon request from customers, the Bank's employees or at his own initiative. Such a review can take place both while cases are being processed and after they are closed. The Ombudsman has access to information and data on specific issues. The Ombudsman submits information about the outcome of cases to clients, employees and the Board as appropriate.

Internal Audit

The internal auditor is appointed by the Board 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 work. Internal Audit is required 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 internal audit is governed by the audit charter, an FME directive on the internal audit function in financial institutions and international standards on internal auditing. All internal 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 8 employees at 30 September 2016.

Employees

During the first nine months of 2016, the average number of FTEs at the Group was 1,185 (compared to 1,139 during 2015). At 30 September 2016, the number of FTEs at the Group was 1,189.

The Bank had 893 average number of full time equivalent employees during the first nine months of 2016 and 887 full time equivalent employees at 30 September 2016.

FINANCIAL MARKETS IN ICELAND

General

Towards the end of 2008, Iceland suffered a currency and banking crisis. The Icelandic government was forced to step in and take control of the three major Icelandic banks Kaupthing, Landsbanki and Glitnir all of which had been very active in the international financial markets, to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly functioning of the payment system. Following this, certain assets and liabilities were transferred from the banks into three new entities, including the Bank, which have operated as commercial banks from that time.

The establishment of the new banks

After the Icelandic government took control of Kaupthing, Glitnir and Landsbanki in October 2008, certain assets and liabilities were transferred from the banks into new entities, which have now become the Bank, Íslandsbanki and Landsbankinn. Following an agreement between the Icelandic government and the Kaupthing Resolution Committee in July 2009, the Kaupthing Resolution Committee announced that it intended to exercise its option to purchase 87 per cent. of the Bank's equity, and a subsequent capital injection took place on 8 January 2010. Kaupthing, through its subsidiary Kaupskilehf., now holds an 87 per cent. stake in the Bank and the Ministry of Finance holds the remaining 13 per cent. A similar agreement was reached between the Icelandic government and Íslandsbanki hf., and Glitnir's Resolution Committee, through ISB Holding, held 95 per cent. of the shares in Íslandsbanki and the Ministry of Finance and Economic Affairs hold the remaining 5 per cent. However, as part of the Glitnir composition agreement, Íslandsbanki is now fully state-owned. Landsbankinn is 98.2 per cent. state-owned (with the shares held by Icelandic State Financial Investments on behalf of the National Treasury of Iceland), while the Bank holds 0.91 per cent. and employees and other investors hold the remaining 0.89 per cent.

The Icelandic financial sector before 2008

Prior to the collapse of the banking system in Iceland, the financial sector and the legislative environment in Iceland had undergone much transition. For example, in connection with the EEA Agreement, Icelandic legislation and regulations regarding commercial banks and other financial undertakings and the financial market had been adopted to implement various regulations and directives of the European Union.

Before 2000 the Icelandic banking system mostly consisted of three investment banks, four commercial banks and 26 savings banks. By 2008, however, the financial market mainly consisted of three major international banks (Kaupthing, Glitnir and Landsbanki), while the number of savings banks had been reduced to 21. The total assets of the Icelandic banking system amounted to around ISK 9,739 billion at the end of December 2007.[9]

Other relevant institutions

Housing Financing Fund (http://www.ils.is) was established at the beginning of 1999. The fund is based on legislation approved by the Icelandic Parliament in June 1998, which was aimed at rationalising the existing state financing system for housing. The Housing Financing Fund used to be by far the largest provider of financing for residential housing in Iceland but with the competition from the three major banks over the years leading up to 2008 its market share shrunk significantly. After the collapse of the banking system, the importance of the Housing Financing Fund grew. However, the three major banks have been strengthening their position in the market for the financing of residential housing over the past four years, partly due to Icelandic banks starting to offer non-inflation linked mortgage loans from 2011 onwards. Plans for changing the structure and purpose of the Housing Financing Fund have been introduced which anticipate the Housing

[9] http://sedlabanki.is/lisalib/getfile.aspx?itemid=848

Financing Fund's reduced role in the financing of residential housing, with more focus on financing housing within the social system, lowering the cap on loans and introducing social requirements for rental companies. This would also result in the Housing Financing Fund's decreased role as a competitor of the Icelandic banks.

Several domestic securities houses are currently operating in Iceland. However, the operations of these securities houses have been greatly limited since the banking collapse, but before 2008, many of them operated mutual funds of various kinds.

In addition, there are several insurance companies licensed to operate in Iceland. Insurance companies have been active in the financial market through their investment activities especially before 2008.

Furthermore, pension funds receive payments from employers and employees and are an important source of long term finance in the country. Membership in a pension fund is obligatory for wage earners and self-employed people, in accordance with Act No. 129/1997, on Mandatory Pension Insurance and on the Activities of Pension Funds. The pension funds are independent non-government entities. They invest mainly in domestic bond issues, equity capital and foreign securities and are a source of financing for residential and commercial property. Since July 2015, pension funds have been granted limited exemptions from Iceland's capital controls allowing, as expanded in January, May, July and October 2016, such funds to engage in foreign currency investments within a capped amount

The Financial Supervisory Authority, the Central Bank and the Icelandic Stock Exchange

At the beginning of 1999, the Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority were merged into a new independent entity, the Financial Supervisory Authority (the **FME**) (www.fme.is). The field of supervision covered by the new entity is the whole range of financial institutions as well as insurance companies and pension funds. The activities of FME are primarily governed by Act No. 87/1998, on the Official Supervision of Financial Operations, and Act No. 98/1999, on the Payment of Cost Due to the Official Supervision of Financial Activities.

The Central Bank (www.sedlabanki.is) is responsible for implementing monetary policy consistent with the goal of maintaining price stability. The activities of the Central Bank are primarily governed by Act No. 36/2001, on The Central Bank of Iceland. The Central Bank imposes a reserve requirement on all commercial banks and savings banks. The purpose of this requirement is to ensure these credit institutions are able to meet fluctuations in their liquidity positions. The Central Bank also oversees surveillance of the Rules on foreign exchange. See "*Risk Factors - Existing currency restrictions – Icelandic rules on foreign exchange*" and "*Risk Factors - The Issuer's business is materially affected by Iceland's economy which remains vunerable to a range of domestic and international economic and political factors*").

The Iceland Stock Exchange (NASDAQ OMX Iceland) (http://www.nasdaqomxnordic.com/nordic/Nordic.aspx) operates under Act No. 110/2007, on Stock Exchanges. In the autumn of 2000, the Iceland Stock Exchange joined NOREX, a joint project of the Nordic stock exchanges. One of the main benefits from the NOREX Alliance is the SAXESS trading system, which is used by all NOREX participants. In September 2006, the Iceland Stock Exchange joined the OMX Nordic Exchange.

OVERVIEW OF TRANSACTION DOCUMENTS

Cover Pool Swap Agreement

The Issuer may enter into an interest rate swap transaction governed by an ISDA Master Agreement (including a schedule, a credit support annex and confirmation(s)) in respect of the assets registered to the Cover Pool (respectively, the **Cover Pool Swap** and the **Cover Pool Swap Agreement**) with a Cover Pool Swap Provider.

On each monthly payment date under the Cover Pool Swap, the Issuer may pay to the Cover Pool Swap Provider all revenue payments (i.e. excluding principal payments) received in respect of the assets (other than Eligible Swaps) registered to the Cover Pool (but excluding amounts corresponding to the client margin) and the Cover Pool Swap Provider may pay to the Issuer an amount calculated on the nominal amount of the assets (other than Eligible Swaps) which are registered to the Cover Pool, based on the applicable floating rate or fixed rate payable under the Covered Bonds plus a margin.

The matching requirements referred to in "*Overview of the Icelandic Legislation Regarding Covered Bonds-Matching Rules*" above will apply in respect of the Cover Pool Swap.

Ratings downgrade

Under the Cover Pool Swap Agreement, in the event that the relevant rating(s) of the Cover Pool Swap Provider are downgraded by a rating agency below the rating(s) specified in the Cover Swap Agreement (in accordance with the requirements of the rating agencies) for the Cover Pool Swap Provider, the Cover Pool Swap Provider will, in accordance with the Cover Pool Swap Agreement, be required to take certain remedial measures which may include providing additional collateral for its obligations under the Cover Pool Swap, arranging for its obligations under the Cover Pool Swap to be transferred to an entity with rating(s) required by the relevant rating agency as specified in the Cover Pool Swap Agreement (in accordance with the requirements of the relevant rating agency), procuring another entity with rating(s) required by the relevant rating agency as specified in the Cover Pool Swap Agreement (in accordance with the requirements of the relevant rating agency) to become a co-obligor or guarantor, as applicable, in respect of its obligations under the Cover Pool Swap or taking some other action as it may agree with the relevant rating agency.

Termination events

The Cover Pool Swap Agreement will or may be terminated under certain circumstances, including the following:

- at the option of the Cover Pool Swap Provider, if the Issuer is in breach of representations contained in the Cover Pool Swap Agreement to register the Cover Pool Swap Agreement and the Cover Pool Swap thereunder in the Cover Pool register;

- at the option of one party to the Cover Pool Swap Agreement, if there is a failure by the other party to pay any amounts due under the Cover Pool Swap Agreement and any applicable grace period has expired;

- at the option of the Issuer, upon the occurrence of an insolvency of the Cover Pool Swap Provider or its guarantor, or the merger of the Cover Pool Swap Provider without an assumption of its obligations under the Cover Pool Swap Agreement, or if a material misrepresentation is made by the Cover Pool Swap Provider under the Cover Pool Swap Agreement, or if the Cover Pool Swap Provider defaults under an over-the-counter derivatives transaction under another agreement between the Issuer and the Cover Pool Swap Provider or if a breach of a provision of the Cover Pool

Swap Agreement by the Cover Pool Swap Provider is not remedied within the applicable grace period;

- if a change in law results in the obligations of one party becoming illegal or if a *force majeure* event occurs;
- at the option of the Cover Pool Swap Provider, if withholding taxes are imposed on payments made by the Issuer or by the Cover Pool Swap Provider under the Cover Pool Swap due to a change in law;
- if the Cover Pool Swap Provider or its guarantor, as applicable, is downgraded and fails to comply with the requirements of the ratings downgrade provisions contained in the Cover Pool Swap Agreement and described above under *Ratings downgrade*; and
- at the option of the Cover Pool Swap Provider, upon the redemption, prepayment or purchase of the Covered Bonds in whole or in part.

Upon the occurrence of a swap early termination event, the Issuer or the Cover Pool Swap Provider may be liable to make a termination payment to the other. The amount of any termination payment will be based on a good faith determination of total losses and costs (or gains) as to entering into a swap with terms and conditions that would have the effect of preserving the economic equivalent of the respective full payment obligations of the parties (which may be determined following consideration of quotations sought from leading dealers, relevant market data and information from internal sources) and will include any unpaid amounts that became due and payable prior to termination. Any such termination payment could be substantial and may affect the funds available to pay amounts due to the Covered Bondholders.

Covered Bondholders will not receive extra amounts (over and above interest and principal payable on the Covered Bonds) as a result of the Issuer receiving a termination payment from the Cover Pool Swap Provider.

Transfer

The Cover Pool Swap Provider may, subject to certain conditions specified in the Cover Pool Swap Agreement, including the satisfaction of certain requirements of the rating agencies, transfer its obligations under the Cover Pool Swap to another entity.

Taxation

Either party may be obliged to gross up payments made by it to the other party if withholding taxes are imposed on payments made under a Swap. However, if due to a change in law, either the Issuer or the Swap Provider is required to gross up a payment under a Swap or to receive a payment under a Swap from which an amount has been deducted or withheld, either the Issuer or the relevant Swap Provider, as the case may be, may terminate the relevant Swap.

The Cover Pool Swap Provider will rank senior to the Covered Bondholders in respect of its claims against the Issuer in respect of assets registered to the Cover Pool.

The margins over the applicable floating rate or fixed rate applicable to the Cover Pool Swap will be determined on the effective date of such swap and may be varied from time to time by the Issuer and the Cover Pool Swap Provider, subject to written confirmation from the rating agencies that the proposed amendment will not adversely affect the then current ratings of the Covered Bonds.

The Cover Pool Swap Agreement will be governed by English law.

Interest Rate Swap Agreements

The Issuer may also, from time to time, enter into additional interest rate swaps with Interest Rate Swap Providers by executing an ISDA Master Agreement (including schedules, a credit support annex and confirmations) (each such agreement, an **Interest Rate Swap Agreement** and each of the transactions thereunder, an **Interest Rate Swap**), in order to hedge the Issuer's interest rate risks in ISK and/or other currencies to the extent that these have not already been hedged by the Cover Pool Swap, Currency Swap or an Indexed Currency Swap, subject always to the matching requirements as referred to in "*Overview of the Icelandic Legislation Regarding Covered Bonds- Matching Rules*" above.

Ratings downgrade

Under each of the Interest Rate Swap Agreements, in the event that the relevant rating(s) of an Interest Rate Swap Provider are downgraded by a rating agency below the rating(s) specified in the relevant Interest Rate Swap Agreement (in accordance with the requirements of the rating agencies) for such Interest Rate Swap Provider, the relevant Interest Rate Swap Provider will, in accordance with the relevant Interest Rate Swap Agreement, be required to take certain remedial measures which may include providing additional collateral for its obligations under the relevant Interest Rate Swap, arranging for its obligations under the relevant Interest Rate Swap to be transferred to an entity with rating(s) required by the relevant rating agency as specified in the relevant Interest Rate Swap Agreement (in accordance with the requirements of the relevant rating agency), procuring another entity with rating(s) required by the relevant rating agency as specified in the relevant Interest Rate Swap Agreement (in accordance with the requirements of the relevant rating agency) to become a co-obligor or guarantor, as applicable, in respect of its obligations under the relevant Interest Rate Swap or taking some other action as it may agree with the relevant rating agency.

Termination events

The Interest Rate Swap Agreements will or may be terminated under certain circumstances, including the following:

- at the option of each Interest Rate Swap Provider, if the Issuer is in breach of representations contained in the relevant Interest Rate Swap Agreement to register the relevant Interest Rate Swap Agreement and each Interest Rate Swap thereunder in the Cover Pool register;
- at the option of one party to the relevant Interest Rate Swap Agreement, if there is a failure by the other party to pay any amounts due under that Interest Rate Swap Agreement and any applicable grace period has expired;
- at the option of the Issuer, upon the occurrence of an insolvency of the relevant Interest Rate Swap Provider or its guarantor, or the merger of the relevant Interest Rate Swap Provider without an assumption of its obligations under the relevant Interest Rate Swap Agreement, or if a material misrepresentation is made by the relevant Interest Rate Swap Provider under the relevant Interest Rate Swap Agreement, or if the relevant Interest Rate Swap Provider defaults under an over-the-counter derivatives transaction under another agreement between the Issuer and such Interest Rate Swap Provider or if a breach of a provision of the relevant Interest Rate Swap Agreement by the Interest Rate Swap Provider is not remedied within the applicable grace period;
- if a change in law results in the obligations of one party becoming illegal or if a *force majeure* event occurs;
- at the option of the relevant Interest Rate Swap Provider, if withholding taxes are imposed on payments made by the Issuer or by the relevant Interest Rate Swap Provider under the relevant Interest Rate Swap due to a change in law;

- if the relevant Interest Rate Swap Provider, or its guarantor, as applicable, is downgraded and fails to comply with the requirements of the ratings downgrade provisions contained in the relevant Interest Rate Swap Agreement and described above under "*Ratings downgrade*"; and

- at the option of the relevant Interest Rate Swap Provider, upon the redemption, prepayment or purchase of the Covered Bonds in whole or in part.

Upon the occurrence of a swap early termination event, the Issuer or the relevant Interest Rate Swap Provider may be liable to make a termination payment to the other. The amount of any termination payment will be based on a good faith determination of total losses and costs (or gains) as to entering into a swap with terms and conditions that would have the effect of preserving the economic equivalent of the respective full payment obligations of the parties (which may be determined following consideration of quotations sought from leading dealers, relevant market data and information from internal sources), and will include any unpaid amounts that became due and payable prior to termination. Any such termination payment could be substantial and may affect the funds available to pay amounts due to the Covered Bondholders.

Covered Bondholders will not receive extra amounts (over and above interest and principal payable on the Covered Bonds) as a result of the Issuer receiving a termination payment from an Interest Rate Swap Provider.

Transfer

Each Interest Rate Swap Provider may, subject to certain conditions specified in the relevant Interest Rate Swap Agreement, including the satisfaction of certain requirements of the rating agencies, transfer its obligations under any Interest Rate Swap to another entity.

Taxation

Either party may be obliged to gross up payments made by it to the other party if withholding taxes are imposed on payments made under a Swap. However, if due to a change in law, either the Issuer or the Swap Provider is required to gross up a payment under a Swap or to receive a payment under a Swap from which an amount has been deducted or withheld, either the Issuer or the relevant Swap Provider, as the case may be, may terminate the relevant Swap.

The Interest Rate Swap Agreements will be governed by English law.

The Interest Rate Swap Providers will rank senior to the Covered Bondholders in respect of their claims against the Issuer in respect of assets registered to the Cover Pool.

Currency Swap Agreements

Subject to currency restrictions in place at each time, if Covered Bonds are issued in currencies other than ISK, the Issuer may enter into Currency Swaps from time to time with Currency Swap Providers by executing ISDA Master Agreements (including schedules, a credit support annex and confirmations) (each such agreement, a **Currency Swap Agreement** and each of the transactions thereunder, a **Currency Swap**), in order to hedge currency risks arising between (a) Covered Bonds issued in currencies other than ISK and (b) assets (other than Mortgage Bonds and Eligible Swaps) forming part of the Cover Pool but denominated in currencies other than ISK, subject always to the matching requirements as referred to in "*Overview of the Icelandic Legislation Regarding Covered Bonds- Matching Rules*" above.

Ratings downgrade

Under each of the Currency Swap Agreements, in the event that the relevant rating(s) of a Currency Swap Provider are downgraded by a rating agency below the rating(s) specified in the relevant Currency Swap

Agreement (in accordance with the requirements of the rating agencies) for such Currency Swap Provider, the relevant Currency Swap Provider will, in accordance with the relevant Currency Swap Agreement, be required to take certain remedial measures which may include providing additional collateral for its obligations under the relevant Currency Swap, arranging for its obligations under the relevant Currency Swap to be transferred to an entity with rating(s) required by the relevant rating agency as specified in the relevant Currency Swap Agreement (in accordance with the requirements of the relevant rating agency), procuring another entity with rating(s) required by the relevant rating agency as specified in the relevant Currency Swap Agreement (in accordance with the requirements of the relevant rating agency) to become a co-obligor or guarantor, as applicable, in respect of its obligations under the relevant Currency Swap or taking some other action as it may agree with the relevant rating agency.

Termination events

The Currency Swap Agreements will or may be terminated under certain circumstances, including the following:

- at the option of each Currency Swap Provider, if the Issuer is in breach of representations contained in the relevant Currency Swap Agreement to register the relevant Currency Swap Agreement and each Currency Swap thereunder in the Cover Pool register;

- at the option of one party to the relevant Currency Swap Agreement, if there is a failure by the other party to pay any amounts due under that Currency Swap Agreement and any applicable grace period has expired;

- at the option of the Issuer, upon the occurrence of an insolvency of the relevant Currency Swap Provider or its guarantor, or the merger of the relevant Currency Swap Provider without an assumption of its obligations under the relevant Currency Swap Agreement, or if a material misrepresentation is made by the relevant Currency Swap Provider under the relevant Currency Swap Agreement, or if the relevant Currency Swap Provider defaults under an over-the-counter derivatives transaction under another agreement between the Issuer and such Currency Swap Provider or if a breach of a provision of the relevant Currency Swap Agreement by the Currency Swap Provider is not remedied within the applicable grace period;

- if a change in law results in the obligations of one party becoming illegal;

- at the option of the relevant Currency Swap Provider, if withholding taxes are imposed on payments made by the Issuer or by the relevant Currency Swap Provider under the relevant Currency Swap due to a change in law;

- if the relevant Currency Swap Provider or its guarantor, as applicable, is downgraded and fails to comply with the requirements of the ratings downgrade provisions contained in the relevant Currency Swap Agreement and described above under "*Ratings downgrade*"; and

- at the option of the relevant Currency Swap Provider, upon the redemption, prepayment or purchase of the Covered Bonds in whole or in part.

Upon the occurrence of a swap early termination event, the Issuer or the relevant Currency Swap Provider may be liable to make a termination payment to the other. The amount of any termination payment will be based on a good faith determination of total losses and costs (or gains) as to entering into a swap with terms and conditions that would have the effect of preserving the economic equivalent of the respective full payment obligations of the parties (which may be determined following consideration of quotations sought from leading dealers, relevant market data and information from internal sources), and will include any unpaid amounts that became due and payable prior to termination. Any such termination payment could be substantial and may affect the funds available to pay amounts due to the Covered Bondholders.

Covered Bondholders will not receive extra amounts (over and above interest and principal payable on the Covered Bonds) as a result of the Issuer receiving a termination payment from a Currency Swap Provider.

Transfer

Each Currency Swap Provider may, subject to certain conditions specified in the relevant Currency Swap Agreement, including the satisfaction of certain requirements of the rating agencies, transfer its obligations under any Currency Swap to another entity.

Taxation

Either party may be obliged to gross up payments made by it to the other party if withholding taxes are imposed on payments made under a Swap. However, if due to a change in law, either the Issuer or the Swap Provider is required to gross up a payment under a Swap or to receive a payment under a Swap from which an amount has been deducted or withheld, either the Issuer or the relevant Swap Provider, as the case may be, may terminate the relevant Swap.

The Currency Swap Agreements will be governed by English law.

The Currency Swap Provider will rank senior to the Covered Bondholders in respect of their claims against the Issuer in respect of assets registered to the Cover Pool.

Where the Issuer enters into both interest rate swap transactions and currency swap transactions with the same counterparty these may be entered into under the same ISDA Master Agreement.

Indexed Currency Swap Agreements

The Issuer will enter into Indexed Currency Swaps from time to time with Indexed Currency Swap Providers by executing ISDA Master Agreements (including schedules, a credit support annex and confirmations) (each such agreement, an **Indexed Currency Swap Agreement** and each of the transactions thereunder, an **Indexed Currency Swap** in order to hedge currency and inflation risks arising between (a) Covered Bonds issued in currencies other than ISK and (b) assets forming part of the Cover Pool but denominated in ISK and indexed linked, subject always to the matching requirements as referred to in "*Overview of the Icelandic Legislation Regarding Covered Bonds- Matching Rules*" above.

Ratings downgrade

Under each of the Indexed Currency Swap Agreements, in the event that the relevant rating(s) of an Indexed Currency Swap Provider are downgraded by a rating agency below the rating(s) specified in the relevant Indexed Currency Swap Agreement (in accordance with the requirements of the rating agencies) for such Indexed Currency Swap Provider, the relevant Indexed Currency Swap Provider will, in accordance with the relevant Indexed Currency Swap Agreement, be required to take certain remedial measures which may include providing additional collateral for its obligations under the relevant Indexed Currency Swap, arranging for its obligations under the relevant Indexed Currency Swap to be transferred to an entity with rating(s) required by the relevant rating agency as specified in the relevant Indexed Currency Swap Agreement (in accordance with the requirements of the relevant rating agency), procuring another entity with rating(s) required by the relevant rating agency as specified in the relevant Indexed Currency Swap Agreement (in accordance with the requirements of the relevant rating agency) to become a co-obligor or guarantor, as applicable, in respect of its obligations under the relevant Indexed Currency Swap or taking some other action as it may agree with the relevant rating agency.

Termination events

The Indexed Currency Swap Agreements will or may be terminated under certain circumstances, including the following:

- at the option of each Indexed Currency Swap Provider, if the Issuer is in breach of representations contained in the relevant Indexed Currency Swap Agreement to register the relevant Indexed Currency Swap Agreement and each Indexed Currency Swap thereunder in the Cover Pool register;

- at the option of one party to the relevant Indexed Currency Swap Agreement, if there is a failure by the other party to pay any amounts due under that Indexed Currency Swap Agreement and any applicable grace period has expired;

- at the option of the Issuer, upon the occurrence of an insolvency of the relevant Indexed Currency Swap Provider or its guarantor, or the merger of the relevant Indexed Currency Swap Provider without an assumption of its obligations under the relevant Indexed Currency Swap Agreement, or if a material misrepresentation is made by the relevant Currency Swap Provider under the relevant Indexed Currency Swap Agreement, or if the relevant Indexed Currency Swap Provider defaults under an over-the-counter derivatives transaction under another agreement between the Issuer and such Indexed Currency Swap Provider or if a breach of a provision of the relevant Indexed Currency Swap Agreement by the Indexed Currency Swap Provider is not remedied within the applicable grace period;

- if a change in law results in the obligations of one party becoming illegal or if a *force majeure* event occurs;

- at the option of the relevant Indexed Currency Swap Provider, if withholding taxes are imposed on payments made by the Issuer or by the relevant Indexed Currency Swap Provider under the relevant Indexed Currency Swap due to a change in law;

- if the relevant Indexed Currency Swap Provider or its guarantor, as applicable, is downgraded and fails to comply with the requirements of the ratings downgrade provisions contained in the relevant Indexed Currency Swap Agreement and described above under "*Ratings downgrade*";

- at the option of the relevant Indexed Currency Swap Provider, upon the redemption, prepayment or purchase of the Covered Bonds in whole or in part.

Upon the occurrence of a swap early termination event, the Issuer or the relevant Indexed Currency Swap Provider may be liable to make a termination payment to the other. The amount of any termination payment will be based on a good faith determination of total losses and costs (or gains) as to entering into a swap with terms and conditions that would have the effect of preserving the economic equivalent of the respective full payment obligations of the parties (which may be determined following consideration of quotations sought from leading dealers, relevant market data and information from internal sources), and will include any unpaid amounts that became due and payable prior to termination. Any such termination payment could be substantial and may affect the funds available to pay amounts due to the Covered Bondholders.

Covered Bondholders will not receive extra amounts (over and above interest and principal payable on the Covered Bonds) as a result of the Issuer receiving a termination payment from a Indexed Currency Swap Provider.

Transfer

Each Indexed Currency Swap Provider may, subject to certain conditions specified in the relevant Indexed Currency Swap Agreement, including the satisfaction of certain requirements of the rating agencies, transfer its obligations under any Indexed Currency Swap to another entity.

Taxation

Either party may be obliged to gross up payments made by it to the other party if withholding taxes are imposed on payments made under a Swap. However, if due to a change in law, either the Issuer or the Swap Provider is required to gross up a payment under a Swap or to receive a payment under a Swap from which an amount has been deducted or withheld, either the Issuer or the relevant Swap Provider, as the case may be, may terminate the relevant Swap.

The Indexed Currency Swap Agreements will be governed by English law.

Eligibility Criteria for Swap Providers

The Issuer will only enter into Swaps with entities which are "qualified counterparties" for the purposes of the Icelandic Covered Bond Act (such Swaps, the **Eligible Swaps**).

BOOK-ENTRY CLEARANCE SYSTEMS

The information set out below is subject to any change in or reinterpretation of the rules, regulations and procedures of Euroclear or Clearstream, Luxembourg or the ISD (together, the **Clearing Systems***) currently in effect. Investors wishing to use the facilities of any of the Clearing Systems are advised to confirm the continued applicability of the rules, regulations and procedures of the relevant Clearing System. None of the Issuer nor any other party to the Agency Agreement will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in the Covered Bonds held through the facilities of any Clearing System or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.*

In light of the existing withholding tax regime in Iceland, the clearing of the Covered Bonds through Euroclear or Clearstream, Luxembourg will be subject to confirmation that the relevant registration requirements with the Icelandic authorities have been completed.

Book-entry Systems

Euroclear and Clearstream, Luxembourg

Euroclear and Clearstream, Luxembourg each holds securities for its customers and facilitates the clearance and settlement of securities transactions by electronic book-entry transfer between their respective account holders. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depository and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective participants may settle trades with each other.

Euroclear and Clearstream, Luxembourg customers are world-wide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions that clear through or maintain a custodial relationship with an account holder of either system.

Transfers of Covered Bonds Represented by Registered Global Covered Bonds

Transfers of any interests in Covered Bonds represented by a Registered Covered Bond within Euroclear and Clearstream, Luxembourg will be effected in accordance with the customary rules and operating procedures of the relevant clearing system.

Subject to compliance with the transfer restrictions applicable to the Registered Covered Bonds described under "*Subscription and Sale and Selling Restrictions*", and directly or indirectly through Clearstream, Luxembourg or Euroclear accountholders, will be effected by the relevant clearing system in accordance with its rules and through action taken by the Registrar, the Fiscal Agent and any custodian (**Custodian**) with whom the relevant Registered Global Covered Bonds have been deposited.

On or after the Issue Date for any Series, transfers of Covered Bonds of such Series between accountholders in Clearstream, Luxembourg and Euroclear will generally have a settlement date three business days after the trade date (T+3). The customary arrangements for delivery versus payment will apply to such transfers.

Clearstream, Luxembourg and Euroclear have each published rules and operating procedures designed to facilitate transfers of beneficial interests in Registered Global Covered Bonds among participants and accountholders of Clearstream, Luxembourg and Euroclear. However, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued or changed at any time. None of the Issuer, the Agents or any Dealer will be responsible for any performance by Clearstream, Luxembourg or Euroclear or their respective direct or indirect participants or accountholders of their respective obligations under the rules and procedures governing their operations and none of them will have any liability for any aspect of the records relating to or payments made on account of beneficial interests in the Covered Bonds represented by Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial interests.

TAXATION

General

Prospective purchasers of Covered Bonds are advised to consult their tax advisers as to the consequences, under the tax laws of the countries of their respective citizenship, residence or domicile, of a purchase of Covered Bonds, including, but not limited to, the consequences of receipt of payments under the Covered Bonds and their disposal or redemption.

Iceland

The comments below are of general nature based on the understanding of the Issuer of current law and practice in Iceland. They should not be construed as providing specific advice as to Icelandic taxation and are subject to changes as to the applicable rules in the future. They relate only to the position of persons who are the absolute beneficial owners of the Covered Bonds. They may not apply to certain classes of persons, such as dealers. Prospective holders of the Covered Bonds who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers.

In light of the existing withholding tax regime in Iceland, the clearing of the Covered Bonds through Euroclear or Clearstream, Luxembourg will be subject to confirmation that the relevant registration requirements with the Icelandic authorities have been completed.

(a) Non-Icelandic Tax Residents

As a general rule, Article 3(8) of the Income Tax Act no. 90/2003 (the **ITA**) provides that any interest received from Iceland (outbound payments), such as the interest payable under the Covered Bonds, by any person or entity residing outside of Iceland is taxable income in Iceland. According to Article 70 (8) of the ITA, the current tax rate on taxable income under Article 3(8) is (a) 10 per cent. for individuals (only applicable to interest income exceeding the annual amount of ISK 125,000.00); and (b) 10 per cent. for legal entities.

From the general rule of Article 3(8) of the ITA, there are certain exemptions listed in the provision, e.g. if an applicable double taxation treaty states otherwise. Also, according to Article 3(8), cf. Article 3(3) of Regulation no. 630/2013, the Bank is not required by Icelandic law to deduct or withhold tax from interest payments on notes or bonds that are issued by a financial institution, in its own name, registered with a securities depository in 1) a member state of the OECD, 2) a member state of the European Economic Area (**EEA**), 3) a member state of The European Free Trade Association (**EFTA**), or 4) the Faroe Islands, and do not constitute business covered by Articles 13. b – 13. n of Act No. 87/1992 on Foreign Exchange, as amended (which contain some restrictions on cross-border capital movements since Iceland is under foreign exchange restrictions subject to Icelandic law). In 2015, the ITA was amended by Amendment Act No. 107/2015 to provide for an exemption from the general rule for payments of interest on notes or bonds issued in connection with a composition agreement or by financial institutions which are subject to winding-up proceedings or a composition process.

The Bank has obtained confirmation from the Directorate of Internal Revenue in Iceland (the **RSK**) that the Programme is within the scope of the exemption contained in paragraph 3 of Article 3(8) of the ITA, although an exemption will need to be applied for in respect of each Tranche. Accordingly, the Bank will, based on this confirmation, register any Bonds issued under the Programme with the RSK and request that the RSK provide a certificate confirming that the relevant Bonds are exempt from such taxation.

In the absence of an applicable exemption, the Bank will be making the relevant withholding at source in accordance with the provisions of Regulation no. 630/2013, on the taxation and withholding of interest to non-Icelandic tax residents subject to limited tax liability (as based on Article 3(8) of the ITA and Article 41 of the Act no. 45/1987 on Withholding of Public Levies at Source).

There are no estate or inheritance taxes, succession duties, gift taxes or capital gains taxes imposed on the holder of the Covered Bonds by Iceland or any authority of, or in, Iceland in respect of the Covered Bonds if, at the time of the death of the holder or the transfer of the Covered Bonds, such holder or transferor and transferee are not tax residents of Iceland.

Capital gains on the sale of the Bonds are classified as interest under Icelandic tax law. Accordingly, based on the wording of Article 3 (8) of the ITA, cf. Article 3 (3) of Regulation no. 630/2013, capital gains on the sale of Bonds should not be subject to Income tax in Iceland, provided a tax exemption is in place.

In instances other than those specifically stated herein as being applicable, the provisions of Condition 9 will apply and the Issuer will be required to pay additional amounts as provided in Condition 9, but may be entitled to redeem the relevant Covered Bonds pursuant to Condition 8.2.

(b) Icelandic Tax Residents

Beneficial owners of the Covered Bonds that are resident in Iceland for tax purposes are subject to income tax in Iceland on their interest income in accordance with Icelandic tax law. The rate depends on their tax status. Any capital gains upon sale of Covered Bonds are subject to the same tax as interest income of Icelandic residents.

Subject to certain exemptions (which apply, inter alia, to most banks and pension funds), the Bank is required to withhold a 20 per cent. tax on the interest paid to the owners of Covered Bonds who are Icelandic residents, cf. Act no. 94/1996 on Withholding of Tax on Financial Income. Such withholding is considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder. However, the Bank should generally not be held responsible for withholding tax on income related to bonds that have been registered as exempted with the Director of Revenue, unless the Bank has knowledge that the bonds have been acquired by an Icelandic tax resident, cf. inter alia explanatory notes accompanying Act no. 39/2013, amending the ITA. This exemption of the withholding obligation does not affect the tax obligations of the relevant bondholder.

Luxembourg Taxation

The following information is of a general nature only and is based on the laws presently in force in Luxembourg, though it is not intended to be, nor should it be construed to be, legal or tax advice. The information contained within this section is limited to Luxembourg withholding tax issues and prospective investors in the Covered Bonds should therefore consult their own professional advisers as to the effects of state, local or foreign laws, including Luxembourg tax law, to which they may be subject.

Please be aware that the residence concept used under the respective headings below applies for Luxembourg income tax assessment purposes only. Any reference in the present section to a withholding tax or a tax of a similar nature, or to any other concepts, refers to Luxembourg tax law and/or concepts only.

Withholding Tax

(i) Non-resident holders of Covered Bonds

Under Luxembourg general tax laws currently in force, there is no withholding tax on payments of principal, premium or interest made to non-resident holders of Covered Bonds, nor on accrued but unpaid interest in respect of the Covered Bonds, nor is any Luxembourg withholding tax payable upon redemption or repurchase of the Covered Bonds held by non-resident holders of Covered Bonds.

(ii) Resident holders of Covered Bonds

Under Luxembourg general tax laws currently in force and subject to the law of 23 December 2005 as amended (the **Relibi Law**) mentioned below, there is no withholding tax on payments of principal, premium or interest made to Luxembourg resident holders of Covered Bonds, nor on accrued but unpaid interest in respect of Covered Bonds, nor is any Luxembourg withholding tax payable upon redemption or repurchase of Covered Bonds held by Luxembourg resident holders of Covered Bonds.

Under the Relibi Law payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to an individual beneficial owner who is a resident of Luxembourg or to a residual entity (within the meaning of the laws of 21 June 2005 implementing Council Directive 2003/48/EC of 3 June 2003 on the taxation of savings income and ratifying the treaties entered into by Luxembourg and certain dependent and associated territories of EU Member States (the **Territories)**) established in an EU Member State (other than Luxembourg) or one of the Territories and securing such payments for the benefit of such individual beneficial owner will be subject to a withholding tax of 10 per cent. Such withholding tax will be in full discharge of income tax if the beneficial owner is an individual acting in the course of the management of his/her private wealth. Responsibility for the withholding of the tax will be assumed by the Luxembourg paying agent. Payments of interest under the Covered Bonds coming within the scope of the Law will be subject to a withholding tax at a rate of 10 per cent.

U.S. Foreign Account Tax Compliance Act

FATCA imposes a new reporting regime and potentially a 30% withholding tax with respect to certain payments to (i) any non-U.S. financial institution (a "foreign financial institution", or **FFI** (as defined by FATCA)) that does not become a **Participating FFI** by entering into an agreement with the U.S. Internal Revenue Service (**IRS**) to provide the IRS with certain information in respect of its account holders and investors or is not otherwise exempt from or in deemed compliance with FATCA and (ii) any investor (unless otherwise exempt from FATCA) that does not provide information sufficient to determine whether the investor is a U.S. person or should otherwise be treated as holding a "United States account" of the Issuer (a "Recalcitrant Holder"). The Issuer is classified as an FFI.

The new withholding regime is currently in effect for payments from sources within the United States and will apply to **foreign passthru payments** (a term not yet defined) no earlier than 1 January 2017. This withholding would potentially apply to payments in respect of (i) any Covered Bonds characterized as debt (or which are not otherwise characterized as equity and have a fixed term) for U.S. federal tax purposes that are issued after the **grandfathering date**, which is the date that is six months after the date on which final U.S. Treasury regulations defining the term foreign passthru payment are filed with the Federal Register, or which are materially modified after the grandfathering date and (ii) any Covered Bonds characterized as equity or which do not have a fixed term for U.S. federal tax purposes, whenever issued. If Covered Bonds are issued on or before the grandfathering date, and additional Covered Bonds of the same series are issued on or after that date, the additional Covered Bonds may not be treated as grandfathered, which may have negative consequences for the existing Covered Bonds, including a negative impact on market price.

The United States and a number of other jurisdictions have announced their intention to negotiate intergovernmental agreements to facilitate the implementation of FATCA (each, an **IGA**). Pursuant to FATCA and the "Model 1" and "Model 2" IGAs released by the United States, an FFI in an IGA signatory country could be treated as a **Reporting FI** not subject to withholding under FATCA on any payments it receives. Further, an FFI in an IGA jurisdiction would generally not be required to withhold under FATCA or an IGA (or any law implementing an IGA) (any such withholding being **FATCA Withholding**) from payments it makes. Under each Model IGA, a Reporting FI would still be required to report certain information in respect of its account holders and investors to its home government or to the IRS. The United States and Iceland have entered into an agreement (the **US-Iceland IGA**) based largely on the Model 1 IGA.

If the Issuer is treated as a Reporting FI pursuant to the US-Iceland IGA it does not anticipate that it will be obliged to deduct any FATCA Withholding on payments it makes. There can be no assurance, however, that the Issuer will be treated as a Reporting FI, or that it would in the future not be required to deduct FATCA Withholding from payments it makes. The Issuer and financial institutions through which payments on the Covered Bonds are made may be required to withhold FATCA Withholding if (i) any FFI through or to which payment on such Covered Bonds is made is not a Participating FFI, a Reporting FI, or otherwise exempt from or in deemed compliance with FATCA or (ii) an investor is a Recalcitrant Holder.

Whilst the Covered Bonds are in global form and held within the ICSD, it is expected that FATCA will not affect the amount of any payments made under, or in respect of, the Covered Bonds by the Issuer, any paying agent and the Common Depositary or the Common Safekeeper, given that each of the entities in the payment chain between the Issuer and the clearing systems is a major financial institution whose business is dependent on compliance with FATCA and that any alternative approach introduced under an IGA will be unlikely to affect the Covered Bonds. The documentation expressly contemplates the possibility that the Covered Bonds may go into definitive form and therefore that they may be taken out of the clearing systems. If this were to happen, then a non-FATCA compliant holder could be subject to FATCA Withholding. However, definitive covered bonds will only be printed in remote circumstances.

FATCA is particularly complex and its application is uncertain at this time. The above description is based in part on regulations, official guidance and model IGAs, all of which are subject to change or may be implemented in a materially different form. Prospective investors should consult their tax advisers on how these rules may apply to the Issuer and to payments they may receive in connection with the Covered Bonds.

SUBSCRIPTION AND SALE AND SELLING RESTRICTIONS

The Dealers have, in a programme agreement dated 10 February 2012, as amended and restated on 5 December 2014 (the **Programme Agreement**), agreed with the Issuer a basis upon which they or any of them may from time to time agree to purchase Covered Bonds. Any such agreement will extend to those matters stated under "*Form of the Covered Bonds*" and "*Terms and Conditions of the Covered Bonds*". In the Programme Agreement, the Issuer has agreed to reimburse the Dealers for certain of their expenses in connection with the establishment and any future update of the Programme and the issue of Covered Bonds under the Programme and to indemnify the Dealers against certain liabilities incurred by them in connection therewith.

In order to facilitate the offering of any Tranche of the Covered Bonds, certain persons participating in the offering of the Tranche may engage in transactions that stabilise, maintain or otherwise affect the market price of the relevant Covered Bonds during and after the offering of the Tranche. Specifically such persons may over-allot or create a short position in the Covered Bonds for their own account by selling more Covered Bonds than have been sold to them by the Issuer. Such persons may also elect to cover any such short position by purchasing Covered Bonds in the open market. In addition, such persons may stabilise or maintain the price of the Covered Bonds by bidding for or purchasing Covered Bonds in the open market and may impose penalty bids, under which selling concessions allowed to syndicate members or other broker-dealers participating in the offering of the Covered Bonds are reclaimed if Covered Bonds previously distributed in the offering are repurchased in connection with stabilisation transactions or otherwise. The effect of these transactions may be to stabilise or maintain the market price of the Covered Bonds at a level above that which might otherwise prevail in the open market. The imposition of a penalty bid may also affect the price of the Covered Bonds to the extent that it discourages resales thereof. No representation is made as to the magnitude or effect of any such stabilising or other transactions. Such transactions, if commenced, may be discontinued at any time. Under U.K. laws and regulations stabilising activities may only be carried on by the Stabilisation Manager(s) named in the applicable Final Terms (or persons acting on behalf of any Stabilisation Manager(s)) and only for a limited period following the Issue Date of the relevant Tranche of Covered Bonds.

Selling Restrictions

United States

The Covered Bonds have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

The Covered Bonds in bearer form are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. Treasury regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986 and Treasury regulations promulgated thereunder. The applicable Final Terms will identify whether TEFRA C rules or TEFRA D rules apply or whether TEFRA is not applicable.

In connection with any Covered Bonds which are offered or sold outside the United States in reliance on an exemption from the registration requirements of the Securities Act provided under Regulation S (**Regulation S Covered Bonds**), each, Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that it will not offer, sell or deliver such Regulation S Covered Bonds (a) as part of their distribution at any time or (b) otherwise until 40 days after the completion of the distribution, as determined and certified by the relevant Dealer or, in the case of an issue of Covered Bonds on a syndicated basis, the relevant lead manager, of all Covered Bonds of the Tranche of which such

Regulation S Covered Bonds are a part, within the United States or to, or for the account or benefit of, U.S. persons. Each Dealer has further agreed, and each further Dealer appointed under the Programme will be required to agree, that it will send to each dealer to which it sells any Regulation S Covered Bonds during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Regulation S Covered Bonds within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

Until 40 days after the commencement of the offering of any Series of Covered Bonds, an offer or sale of such Covered Bonds within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with an available exemption from registration under the Securities Act.

Public Offer Selling Restriction under the Prospectus Directive

In relation to each Member State of the EEA which has implemented the Prospectus Directive (each, a **Relevant Member State**), each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the **Relevant Implementation Date**) it has not made and will not make an offer of Covered Bonds which are the subject of the offering contemplated by this Offering Circular as completed by the final terms in relation thereto to the public in that Relevant Member State, except that it may, with effect from and including the Relevant Implementation Date, make an offer of such Covered Bonds to the public in that Relevant Member State:

(a) at any time to any legal entity which is a qualified investor as defined in the Prospectus Directive and, where relevant, is registered with the Financial Supervisory Authority of Norway as a professional investor;

(b) at any time to fewer than 150 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the relevant Dealer or Dealers nominated by the Issuer for any such offer; or

(c) at any time in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of Covered Bonds referred to in (a) to (c) above shall require the Issuer or any Dealer to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this provision, the expression **an offer of Covered Bonds to the public** in relation to any Covered Bonds in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Covered Bonds to be offered so as to enable an investor to decide to purchase or subscribe the Covered Bonds, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression **Prospectus Directive** means Directive 2003/71/EC (as amended, including by Directive 2010/73/EU), and includes any relevant implementing measure in the Relevant Member State.

United Kingdom

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that:

(a) in relation to any Covered Bonds which have a maturity of less than one year, (i) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (ii) it has not offered or sold and will not offer or sell any Covered Bonds other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses where the issue of the Covered Bonds would otherwise constitute a contravention of Section 19 of the Financial Services and Markets Act 2000 (**FSMA**) by the Issuer;

(b) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Covered Bonds in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and

(c) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to such Covered Bonds in, from or otherwise involving the United Kingdom.

Iceland

Each Dealer has represented and agreed and each further Dealer appointed under the Programme will be required to represent and agree that it will not offer Covered Bonds to the public in Iceland, except in compliance with the Icelandic Act on Securities Transactions (No.108/2007), as amended, and any applicable laws or regulations of Iceland.

Japan

The Covered Bonds have not been and will not be registered under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the **FIEA**) and each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that it will not offer or sell any Covered Bonds, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (as defined under Item 5, Paragraph 1, Article 6 of the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949, as amended)), or to others for re-offering or resale, directly or indirectly, in Japan or to, or for the benefit of, a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the FIEA and any other applicable laws, regulations and ministerial guidelines of Japan.

Hong Kong

Each Dealer has represented and agreed that:

(a) it has not offered or sold and will not offer or sell in Hong Kong, by means of any document, any of the Covered Bonds (except for Covered Bonds which are a "structured product" as defined in the Securities and Futures Ordinance (Cap. 571) of Hong Kong) other than (i) to persons whose ordinary business is to buy or sell shares or debentures (whether as principal or agent); or (ii) to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance; or (iii) in other circumstances which do not result in the document being a "prospectus" as defined in the Companies Ordinance (Cap. 32) of Hong Kong or which do not constitute an offer to the public within the meaning of that Ordinance; and

(b) it has not issued or had in its possession for the purposes of issue, and will not issue or have in its possession for the purposes of issue, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the Covered Bonds, which is directed at, or the contents of which are likely to be accessed or read by, the public of Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Covered Bonds which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance.

General

Each Dealer has represented and agreed and each further Dealer appointed under the Programme will be required to represent and agree that it will (to the best of its knowledge and belief) comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Covered Bonds or possesses or distributes this Offering Circular and will obtain any consent, approval or permission, required by it for the purchase, offer, sale or delivery by it of Covered Bonds under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and neither the Issuer nor any of the other Dealers shall have any responsibility therefor.

None of the Issuer and the Dealers represents that Covered Bonds may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating any such sale.

With regard to each Tranche, the relevant Dealer will be required to comply with such other restrictions as the Issuer and the relevant Dealer shall agree and as shall be set out in the applicable Final Terms.

GENERAL INFORMATION

Authorisation

The establishment of the Programme and the issue of Covered Bonds were duly authorised by a resolution of the Board of Directors of the Issuer dated 2 March 2011, 11 October 2011 and 27 July 2013. Board approval for continued update and issuances of Covered Bonds under the Programme was obtained on 16 November 2016.

Listing, Approval and Admission to Trading

Application has been made to the CSSF to approve this document as a base prospectus. Application has also been made to the Luxembourg Stock Exchange for Covered Bonds issued under the Programme to be admitted to trading on the regulated market of the Luxembourg Stock Exchange and to be listed on the Official List of the Luxembourg Stock Exchange. The regulated market of the Luxembourg Stock Exchange is a regulated market for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

Documents available

For the period of 12 months following the date of this Offering Circular, copies of the following documents will, when published, be available for inspection from the registered office of the Issuer and from the specified office of the Paying Agent for the time being in Luxembourg:

(a) the articles of association (with an English translation thereof) of the Issuer;

(b) the 2015 Consolidated Financial Statements and the 2014 Consolidated Financial Statements (with an English translation thereof) in each case together with the audit reports prepared in connection therewith. The Issuer currently prepares audited consolidated accounts on an annual basis. The Issuer does not currently prepare non-consolidated accounts;

(c) the most recently published audited annual financial statements of the Issuer and the most recently published unaudited interim financial statements of the Issuer (with an English translation thereof) in each case together with any audit or review reports prepared in connection therewith. The Issuer currently prepares unaudited consolidated interim accounts on a quarterly basis;

(d) the Agency Agreement, the Deed of Covenant and the forms of the Global Covered Bonds, the Covered Bonds in definitive form, the Receipts, the Coupons and the Talons;

(e) relevant Cover Pool Swap Agreements, Currency Swap Agreements, Indexed Currency Swap Agreements and Interest Rate Swap Agreements, if any;

(f) a copy of this Offering Circular;

(g) the terms and conditions of the Covered Bonds set out on pages 70 to 102 (inclusive) of the Prospectus dated 9 February 2012 and prepared by the Issuer in connection with the Programme;

(h) the terms and conditions of the Covered Bonds set out on pages 64 to 100 (inclusive) of the Prospectus dated 23 August 2013 and prepared by the Issuer in connection with the Programme;

(i) the terms and conditions of the Covered Bonds set out on pages 65 to 101 (inclusive) of the Prospectus dated 5 December 2014 and prepared by the Issuer in connection with the Programme;

(j) the terms and conditions of the Covered Bonds set out on pages 68 to 104 (inclusive) of the Prospectus dated 18 December 2015 and prepared by the Issuer in connection with the Programme;

(k) any future offering circulars, prospectuses, information memoranda and supplements, and any Final Terms (save that a Final Terms relating to a Covered Bond which is neither admitted to trading on a regulated market in the EEA nor offered in the EEA in circumstances where a prospectus is required to be published under the Prospectus Directive will only be available for inspection by a holder of such Covered Bond and such holder must produce evidence satisfactory to the Issuer and the Paying Agent as to its holding of Covered Bonds and identity) to this Offering Circular and any other documents incorporated herein or therein by reference; and

(l) in the case of each issue of Covered Bonds admitted to trading on the regulated market of the Luxembourg Stock Exchange subscribed pursuant to a subscription agreement, the subscription agreement (or equivalent document).

In addition, copies of this Offering Circular, each Final Terms relating to Covered Bonds which are admitted to trading on the regulated market of the Luxembourg Stock Exchange and each document incorporated by reference are available on the Luxembourg Stock Exchange's website at www.bourse.lu.

Investors should consult the Issuer should they require a copy of the 2006 ISDA Definitions.

Clearing systems

The Covered Bonds have been accepted for clearance through Euroclear, Clearstream, Luxembourg and the ISD (which are the entities in charge of keeping the records). The appropriate Common Code and ISIN for each Tranche of Covered Bonds allocated by Euroclear and Clearstream, Luxembourg or the ISD will be specified in the applicable Final Terms. If the Covered Bonds are to clear through an additional or alternative clearing system the appropriate information will be specified in the applicable Final Terms.

The address of Euroclear is Euroclear Bank SA/NV, 1 Boulevard du Roi Albert II, B-1210 Brussels. The address of Clearstream, Luxembourg is Clearstream Banking, 42 Avenue JF Kennedy, L-1855 Luxembourg. The address of ISD is Icelandic Securities Depository, Laugavegur 182, 105 Reykjavik.

Conditions for determining price

The price and amount of Covered Bonds to be issued under the Programme will be determined by the Issuer and the relevant Dealer at the time of issue in accordance with prevailing market conditions.

Significant change or material adverse change

There has been no significant change in the financial or trading position of the Issuer since 30 September 2016 and there has been no material adverse change in the financial position or prospects of the Issuer since 31 December 2015.

Litigation

Neither the Issuer nor any of its subsidiaries is or has been involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer is aware) in the 12 months preceding the date of this document which may have or have in such period had a significant effect on the financial position or profitability of the Issuer or the Issuer and its subsidiaries, taken as a whole.

Auditors

The 2014 Consolidated Financial Statements were audited, without qualification and in accordance with International Standards on Auditing by Ernst & Young ehf., members of The Institute of State Authorised Public Accountants in Iceland whose address is Borgartúni 30, Reykjavík105, Iceland.

On 19 March 2015 Deloitte ehf., members of The Institute of State Authorised Public Accountants in Iceland, were appointed auditors of the Issuer. Deloitte ehf. have audited the 2015 Consolidated Financial Statements, without qualification, in accordance with International Standards on Auditing. The comparative figures in the 2015 Consolidated Financial Statements have been audited by Ernst & Young ehf.

Neither Ernst & Young ehf. nor Deloitte ehf. have a material interest in the Bank.

Post-issuance information

The Issuer does not intend to provide any post-issuance information in relation to any assets underlying any Covered Bonds constituting derivative securities.

Dealers transacting with the Issuer

Certain of the Dealers and their affiliates have engaged, and may in the future engage, in investment banking and/or commercial banking transactions with, and may perform services to, the Issuer and its affiliates in the ordinary course of business.

GLOSSARY

THE ISSUER AND ISD AGENT

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