

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** and together the **Dealers**), which appointment may be for a specific issue or on an ongoing basis. References in this 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 will allow 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 depositories 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 certain 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 to approve this document as a 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.

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 any other terms and conditions not contained herein 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 (the **Final Terms**) which, with respect to Covered Bonds to be listed on the official list of the Luxembourg Stock Exchange, will be filed with the CSSF. 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 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.

The rating of certain Series of Covered Bonds to be issued under the Programme may be specified 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) (the **CRA Regulation**) will be disclosed in the Final Terms.

Arranger

Barclays Capital

Dealers

Barclays Capital

Deutsche Bank

UBS Investment Bank

Arion Bank hf.

The date of this Offering Circular is 9 February 2012

This Offering Circular comprises a base prospectus for the purposes of Article 5.4 of Directive 2003/71/EC (the **Prospectus Directive**) as amended (which includes the amendments made by Directive 2010/73/EU (the **2010 PD Amending Directive**) to the extent such amendments have been implemented in a relevant Member State of the European Economic Area or contracting party to the Agreement on the European Economic Area (a **Member State**).

The Issuer (the **Responsible Person**) accepts responsibility for the information contained in this Offering Circular. 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 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 as to the accuracy or completeness of the information contained or incorporated in this Offering Circular or any other information provided by the Issuer in connection with the Programme. No Dealer 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 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 (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 European Economic Area or contracting party to the Agreement of the European Economic Area which has implemented the Prospectus Directive (each, a **Relevant Member State**) will be made pursuant to an exemption under the Prospectus Directive, as implemented in that Relevant Member State, 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 which are the subject of an offering contemplated in this Offering Circular as completed by final terms in relation to the offer of those 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.

All references in this document to "U.S. dollars", "U.S.\$" and "\$" refer to United States dollars and references to "ISK", "krona" or "kronur" refer to Icelandic Krona. In addition, all references to "Sterling" and "£" refer to pounds sterling and references to "EUR", "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.

In connection with the issue of any Tranche of Covered Bonds, the Dealer or Dealers (if any) named as the Stabilising Manager(s) (or persons acting on behalf of any Stabilising 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, there is no assurance that the Stabilising Manager(s) (or persons acting on behalf of a Stabilising Manager) will undertake stabilisation action. 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 be ended 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.

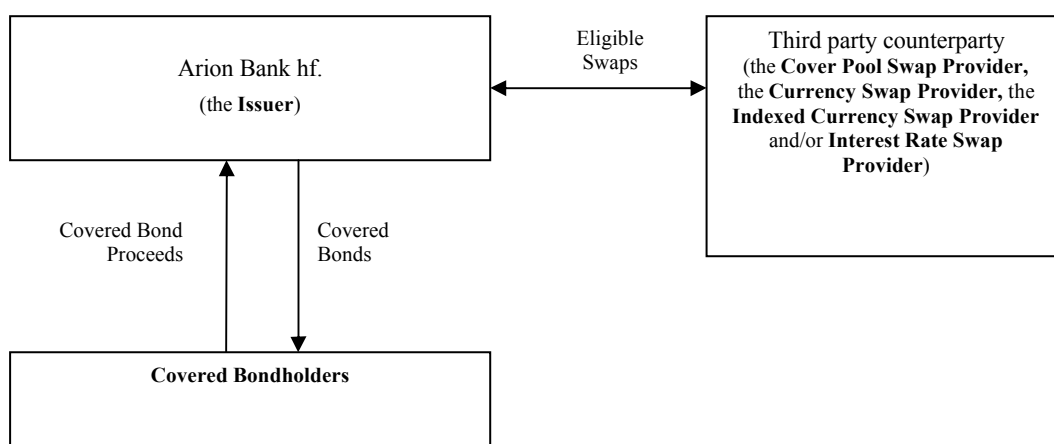
Table of Contents

	Page
Overview of the Programme	7
General Description of the Programme	15
Risk Factors.....	16
Documents Incorporated by Reference.....	46
Form of the Covered Bonds	48
Applicable Final Terms	52
Terms and Conditions of the Covered Bonds	70
1. Form, Denomination and Title	72
2. Transfers of Registered Covered Bonds.....	73
3. Status of the Covered Bonds	74
4. Compliance with the Icelandic Covered Bond Act.....	75
5. Redenomination.....	75
6. Interest.....	77
7. Payments	86
8. Redemption and Purchase	90
9. Taxation.....	94
10. Prescription.....	96
11. Replacement of Covered Bonds, Receipts, Coupons and Talons	96
12. Agents	96
13. Exchange of Talons.....	97
14. Notices	97
15. Meetings of Covered Bondholders, Modification and Waiver	98
16. Further Issues.....	100
17. The Contracts (Rights of Third Parties) Act 1999	100
18. Governing Law and Submission to Jurisdiction	100
19. Definitions	101
Use of Proceeds.....	103
Summary of the Icelandic Legislation Regarding Covered Bonds.....	104
Description of the Issuer	109
Financial Markets in Iceland.....	149
Summary of Transaction Documents	151
Book-Entry Clearance Systems.....	159
Taxation	161
Subscription and Sale and Selling Restrictions	164
General Information	168
Glossary	170

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 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 2010 of €5.3 billion and net profit of €76.2 million for the financial year ended 31 December 2010.

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 Capital, the investment banking division of Barclays Bank PLC (**Barclays**).

Dealers: Barclays, UBS Limited, Deutsche Bank Aktiengesellschaft (**Deutsche Bank**), Arion and any other Dealers appointed in accordance with the Programme Agreement.

Independent Inspector The Issuer is required to appoint an independent inspector, and

(„Sjálfstæður skoðunarmaður“):

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 be made up of those assets which comply with requirements set out in the Icelandic Covered Bond Act.

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, 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:	<p>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.</p> <p>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.</p>
Terms of the Covered Bonds:	The terms of the Covered Bonds will be specified in 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.
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 or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par.
Interest:	<p>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.</p> <p>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.</p>

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.

Index Linked Covered Bonds: Subject to any existing legal or regulatory restrictions in Iceland being lifted, payments of principal in respect of Index Linked Redemption Covered Bonds or of interest in respect of Index Linked Interest Covered Bonds will be calculated by reference to such index and/or formula or to changes in the prices of securities or commodities or to such other factors as the Issuer and the relevant Dealer may agree.

Other provisions in relation to Floating Rate Covered Bonds and Index Linked Interest Covered Bonds: Floating Rate Covered Bonds and Index Linked Interest 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 and Index Linked Interest Covered Bonds in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer, will be payable on such 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.

Dual Currency Covered Bonds: Subject to currency restrictions in place at each time, payments (whether in respect of principal or interest and whether at maturity or otherwise) in respect of Dual Currency Covered Bonds will be made in such currencies, and based on such rates of exchange, as the Issuer and the relevant Dealer may agree.

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.

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 European Economic Area or offered to the public in a Member State of the European Economic Area 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.

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, 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.

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 a prospectus has been approved by the CSSF in Luxembourg, it can be passported into Iceland and thereafter used to offer securities to the public and/or for an admission to trading 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 European Economic Area (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.

GENERAL DESCRIPTION OF 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 modified and supplemented 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 listing Covered Bonds on the Luxembourg Stock Exchange during the period of 12 months from the date 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 Dual Currency Covered Bonds, Index Linked Covered Bonds and Partly Paid 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 (in the case of Partly Paid Covered Bonds regardless of the amount of the subscription price paid); 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 Base Prospectus 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 Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and remains vulnerable to external shocks and a range of internal risks

Over the course of 2008, the difficulties in Iceland's financial system and overall economy escalated, due to internal and external developments. Early in October 2008, Iceland's economy experienced a serious banking crisis when nearly nine-tenths of Iceland's banking system collapsed. The three large commercial banks, Glitnir Bank hf. (**Glitnir**), Landsbanki Íslands hf. (**Landsbanki**) and Kaupthing Bank hf. (**Kaupthing**), were taken into special resolution regimes on the basis of emergency legislation passed by Parliament. This collapse accelerated the prevailing recessionary forces, as did the international contraction in world trade and economic activity in the last months of 2008 and the first half of 2009. According to Statistics Iceland, Iceland's economy contracted by 6.9 per cent. in 2009 and by 3.5 per cent. in 2010, in each case relative to the year before. Iceland's gross domestic product (**GDP**) declined in the first three quarters of 2010 but was unchanged in the last quarter. Private consumption declined by 16 per cent. in 2009 but remained stable between 2009 and 2010, and domestic demand fell by close to 23 per cent. over the same period in real terms. The economic slowdown was also reflected in an increase in unemployment, with the jobless rate rising from approximately one per cent. in the first half of 2008 to 9.1 per cent. in April 2009. Government finances came under strain with the balance of State revenues and expenditures declining from a surplus of 6.8 per cent. of GDP in 2007 to a deficit of 14.6 per cent. of GDP in 2008, as the central government borrowed in order to recapitalise the banking system and the Icelandic Central Bank (the **Central Bank**).

To restore confidence and stabilise the economy, a joint economic programme was developed in November 2008 (the **Joint Economic Programme**) by the Icelandic government, the Central Bank and the International Monetary Fund (the **IMF**) under a two year Stand-By Arrangement that was subsequently extended until 31 August 2011. The Stand-By Arrangement included a loan of approximately U.S.\$2.1 billion and was accompanied by bilateral loan commitments from European neighbours and other loan commitments and standing facilities aggregating approximately U.S.\$3 billion. The Joint Economic Programme was a condition of the Stand-By Arrangement and its objectives are threefold: (1) to establish exchange rate stability, (2) to achieve fiscal consolidation from 2010 onwards and (3) to restructure the banking system.

Exchange rate stability was a key objective of the Joint Economic Programme. Tighter monetary policy and temporary capital account restrictions were applied to support the Icelandic currency and prevent disorderly capital outflows which could undermine the króna. The Icelandic authorities intend to lift the capital account restrictions in stages. The first step towards lifting capital controls was taken in October 2009, with the

abolition of restrictions on capital inflows. On 25 March 2011, the Central Bank announced a new strategy for the gradual removal of remaining capital controls in phases, each of which is subject to conditions. While the new strategy does not set a timetable for removing of capital controls, the Central Bank stated that conditions are favourable for starting to relax some parts of the controls, but that it would seek authority to extend capital controls, if necessary, until 2015.

The financial crisis and the ensuing economic downturn significantly altered the government's financial position. It was therefore necessary to undertake broad-based fiscal consolidation measures to ensure the long-term sustainability of general government finances. The government forecasts substantial fiscal deficits and a sharp rise in general government debt in the next several years due to plans to inject new capital into Icelandic financial institutions at a time when revenue sources are contracting as a result of the recession. As part of the Joint Economic Programme, the government has announced a long-term consolidation plan aimed at curtailing the growth of fiscal debt and gradually reducing it over time. The plan envisages that the fiscal deficits will be turned into surplus over several years primarily through large expenditure cuts and increases in direct and indirect taxes. The Ministry of Finance has issued a report confirming a surplus on the primary balance in 2011. In October 2011 the Ministry of Finance introduced the government's fiscal plan for the years 2012 to 2015 according to which a surplus in the overall balance is envisaged by 2014, with the gross general government debt ratio gradually declining to an estimated 90 per cent of GDP in 2014 and continuing to fall thereafter. The last objective of the Joint Economic Programme centred on rebuilding and restructuring the domestic financial system. The restructuring aims to improve corporate governance within Iceland's financial institutions, capitalise the new commercial banks, protect the banks' asset portfolios, strengthen financial supervision, create transparency for depositors and other creditors so as to facilitate normal international relations and access to global financial markets and to curtail the impact of private sector losses on the government. The restructuring of Iceland's three largest commercial banks, Kaupthing, Landsbanki and Glitnir, was concluded in December 2009. The three new banks, Arion, Landsbankinn and Islandsbanki (the **New Banks**), that were established in October 2008 became fully financed and operational at this time. Agreements were reached between the Icelandic authorities and the New Banks on the one hand and the resolution committees of Kaupthing, Landsbanki and Glitnir on behalf of their creditors on the other hand. These agreements involved settlements of assets which were transferred from the three largest commercial banks to the New Banks. The Icelandic State has holdings in the New Banks as follows: 81 per cent. in Landsbanki, 13 per cent. in Arion and 5 per cent. in Islandsbanki. The State's total equity capital contribution to the New Banks amounts to ISK 135 billion. The State also provided subordinated loans to Arion in the amount of ISK 24 billion and to Islandsbanki in the amount of ISK 25 billion. The total financing contributed by the State to the New Banks' reconstruction at 31 December 2010 was ISK 184 billion.

As of 26 August 2011, the Executive Board of the IMF completed the sixth and final review of Iceland's economic performance under the Joint Economic Programme, and the programme has been successfully completed. Nevertheless, Iceland remains vulnerable to developments, many of which are outside the control of the central government, that could arrest its economic progress or prolong or deepen recessionary conditions. In particular, any deterioration of the international financial markets could have a material adverse effect on the recovery of Iceland's economy.

Iceland's economy is also vulnerable to a range of risks affecting the banking system (see "*Iceland's banking sector is in the process of being restructured and remains subject to considerable risks. Should any of these risks materialise the Bank could be materially and adversely affected, either directly or by association should the risks primarily materialise in relation to other Icelandic banks*") as well as risks relating to high levels of public debt resulting from the banking system and economic collapse. At 31 December 2011, the Icelandic State's total indebtedness was estimated at ISK 1,353 billion, equal to around 100 per cent. of estimated 2011 GDP, compared to 20 per cent. of GDP in 2007. In addition, the Icelandic State has provided significant guarantees of third party debt, in an amount equivalent to ISK 1,292 billion. A significant proportion of this debt falls due in 2011 and 2012 and there is no assurance that the State will have sufficient funds to pay any guarantee claims that may be made in respect of such debt.

In addition, if the króna does not strengthen over the long term and confidence in Iceland's currency does not increase, it may be less likely that Iceland's economy will emerge fully from recession. Essential elements to such recovery include significant debt reduction by Icelandic households and businesses, in particular in respect of their foreign-currency and indexed borrowings, which will be challenging in light of the currently lower exchange rate for the króna than at the time most of the loans were incurred and a scarcity of foreign currency; revived investment and revived but contained growth in consumer demand, which may be constrained by the continued high indebtedness of Icelandic consumers and businesses; controlled inflation that remains within targets set by the Central Bank; continued demand for Iceland's exports; appreciation of the króna to levels that sustain a favourable balance of trade and current account; renewed access to foreign financial markets; and sufficient, stable foreign currency reserves.

Further, the governments of the United Kingdom and The Netherlands have asserted claims against Iceland for reimbursement of amounts, up to €20,000 per account holder, each of them paid to their respective residents as compensation for residents' deposits at foreign branches of Landsbanki, which to date has not been repaid by Landsbanki. Although Iceland reached agreements with the governments of both the United Kingdom and The Netherlands in relation to these claims, the agreements required ratification by referendum in Iceland and, in the most recent referendum in April 2011, the agreements were rejected. Following the referendum, the government stated that it believes that the IMF Stand-By Arrangement will not be affected by the outcome of the referendum but also indicated that removal of remaining capital controls may be delayed. However, the European Free Trade Association (EFTA) Surveillance Authority has issued a reasoned opinion finding that Iceland is in breach of the deposit guarantee directive and has referred the matter to the EFTA Court. A ruling by the Court may be expected at the end of 2012. In addition, the governments of the United Kingdom and of The Netherlands could commence legal proceedings against the government or the State. Any amounts claimed in any such legal proceedings could be substantial, equal to at least the amount of guaranteed deposits held by Landsbanki in the United Kingdom and The Netherlands plus interest. In a worst-case scenario in which a very substantial judgment is rendered against the State, it could have a material adverse effect on Iceland's economy.

Finally, Iceland's economy is highly dependent on international trade, with imports and exports representing 46 per cent. and 56 per cent. of GDP, respectively, in 2010. This means that Iceland's economy may be vulnerable to external events that disrupt trade flows to and from Iceland. Such events include, but are not limited to: natural events, including volcanic activity; changes in the exchange rate of the króna against other currencies; economic conditions of major trading partners; Iceland's relationship with trading partners; tariffs and other trade barriers; and international hostilities. If Iceland experiences a significant and prolonged disruption in its international trade as a result of any one or more of the factors mentioned above or for any other reason, Iceland's economy could be materially adversely affected.

Should Iceland's economy continue to be adversely affected by external shocks or otherwise fail to recover, whether as a result of any of the above factors or for other reasons, this could adversely affect the ability of the Bank's customers to repay their loans (many of which have already been restructured) which in turn could have a material adverse affect on the Bank's business and its ability to make payments in respect of Covered Bonds.

Iceland's banking sector is in the process of being restructured and remains subject to considerable risks. Should any of these risks materialise the Bank could be materially and adversely affected, either directly or by association should the risks primarily materialise in relation to other Icelandic banks

Following the collapse of Glitnir, Landsbanki and Kaupthing, the FME transferred certain of their assets and liabilities (including the domestic deposits) into the New Banks. The Icelandic banking sector is dominated by the New Banks but also includes other commercial banks and savings banks. The New Banks currently have limited access to the international financial markets and have so far engaged in only limited lending, primarily domestic lending in króna. The vast majority of the New Banks' funding comes from deposits by customers. Since October 2008, the government has maintained a policy that deposits in banks domiciled in Iceland are guaranteed by the State. The government's guarantee of domestic deposits has never been enacted

into law by Parliament, and the government may withdraw the guarantee at any time, which may adversely affect the business and assets of Icelandic banks. Moreover, should current capital controls be lifted, funding of Icelandic banks could be adversely affected by the removal of deposits by customers who are currently unable to do so due to such capital controls. The government has stated its intention to manage the exchange controls with a view to mitigating the risk of capital flight from such customers, although no assurance is given that this will prove to be the case.

Iceland's new banking system is small and the New Banks have limited opportunities for growth in the near term. Given the existing leverage of Icelandic households and businesses and continuing lack of economic growth, the New Banks are not expected to grow significantly through domestic lending in the near term. It is also not likely that the New Banks will grow through international operations in the near future. Further, the growth of foreign currency transactions by Icelandic banks is expected to be limited by continued capital controls, which may continue to be in place until 2015. Even though a large amount of Icelandic banks' assets are denominated in foreign currencies, the banks do not have access to foreign funding or exchange rate hedging to the same degree as before.

Uncertainty about the quality of the loan assets held by the New Banks is a major risk to the success of Icelandic banks. Iceland's New Banks are capitalised with pre-crisis domestic loans extended by the failed banks, many of which are being restructured and many of which may be unrecoverable. During the period from 2003 through 2007, the old banks maintained liberal lending policies, and Icelandic households and businesses took on a large amount of debt, of which a large proportion was denominated in, or indexed to the value of, a foreign currency. Prior to October 2008, Iceland's banks lent extensively in foreign currency. As a result, a large portion of the assets of the New Banks consist of foreign currency loans to businesses and individuals in Iceland that were made before the financial crisis. As a result of the pre-crisis lending practices of the banks, these borrowers were highly indebted before the crisis, and the subsequent collapse of the króna raised their foreign loan balances sharply. In most cases, these borrowers lack sources of foreign currency income or assets to service their borrowings. The depreciation of the króna and the resulting changes in operating conditions have caused the New Banks financial and operating difficulties. Many borrowers have negotiated deferred payments or have had their loans frozen temporarily, many others are in need of balance sheet restructuring and defaults have escalated. Uncertainty about the quality of the loan book also reflects legal risk regarding loans linked to foreign currencies, especially with respect to commercial loans indexed to a foreign currency. As a result, loan recovery is unusually uncertain, in terms of both the amount recoverable and whether loans will be repaid on time. Determination of loan values and write-off needs will depend on general economic developments and on the operating and financial condition of the particular borrowers.

Should an unexpectedly large number of borrowers default on loans transferred to the New Banks by the old banks or need to restructure or reschedule these loans, the balance sheets of the New Banks could be materially adversely affected. In the event that the quality of assets held by one or more of the New Banks is so poor that it is not able to meet applicable capital standards, then additional State assistance may be necessary to rescue it. Any such rescue could be costly for the State and would represent a major setback for the growth and international acceptance of the new Icelandic banking system.

Iceland's savings banks, which represent a smaller share of the banking system than the commercial banks, have also experienced distress. The total assets of the savings bank system amounted to ISK 137 billion as of 31 December 2010 compared to ISK 627 billion as of 31 December 2007. The biggest factor in this decline was the collapse of Reykjavik Savings Bank (**SPRON**), the largest of the savings banks, which was taken over by the Icelandic Financial Supervisory Authority (the **FME**) in March 2009. **SPRON**'s deposits were subsequently transferred to the Bank, and a bond was issued to the Bank to back up those deposits, secured by the estate of **SPRON** and by a State indemnity. Overall, the savings banks have taken substantial write-offs due to falling securities prices and anticipated loan losses.

If Iceland's banking system does not increase in size and in the strength of its assets and business, or if some or all of the new banks should collapse, Iceland's economy could be vulnerable to renewed disruptions,

cessation or reversal of growth and a deepening recession. The New Banks could also be adversely affected if other developments in the Icelandic economy or in world affairs result in further slowing the growth of Iceland's economy or trigger a deepening recession.

In addition the Icelandic Government has since autumn 2008 backed deposits in domestic commercial and savings banks, on the basis of an announcement from the Prime Minister's Office of 6 October 2008 stating that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered. This announcement has since been repeated by subsequent Governments and the EFTA Surveillance Authority has not objected to the guarantee under the EEA State Aid rules to date. It is assumed that the blanket guarantee will be gradually lifted when the banking market both domestic and foreign has stabilised. However, a sudden lifting of the guarantee, with or without regulatory intervention, could have an impact on deposit holders and the outflow of deposits held by Arion.

The occurrence of any the factors described above could seriously undermine Iceland's economy and confidence in the banking system in Iceland and could have a material adverse effect on the Bank's business and its ability to make payments in respect of the Covered Bonds.

The Bank has a number of significant exposures and its loan portfolio contains a high level of impaired loans and would be materially adversely affected should a customer to which it has a large exposure default or if the level of impairment in its loan portfolio were to increase

The Bank was established as the successor to Kaupthing following its take over by the FME at the end of 2008. Following the establishment of the Bank, a portfolio of assets and liabilities was transferred to the Bank. These assets and liabilities resulted in significant foreign exchange, interest rate and liquidity mismatches. In addition, the serious recession in Iceland in 2009 and 2010 resulted in a significant increase in non-performing loans and poor 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 loan portfolio. However, the Bank is still exposed to credit-type risks through the loan portfolio relating to the accuracy of the transfer valuation, the performance of the loans and the success of the Bank in restructuring non-performing loans. The Bank also has credit concentrations to a few significant customers and to certain business sectors.

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 a bank's capital base net of eligible collateral. The legal maximum for individual large exposures is 25 per cent. of a bank's risk capital and the sum of all large exposures cannot exceed 800 per cent. of a bank's risk capital. The loans which were transferred from Kaupthing to the Bank include loans which have led to high counterparty concentration for the Bank. In particular, as at 30 June 2011, the Bank had six large exposures (as defined by Icelandic regulation) and one further loan with a gross exposure in excess of 10 per cent. of its capital base. Should any of the customers to which the Bank has a large exposure default, this would have a material adverse effect on the Bank's business and its ability to make payments in respect of the Covered Bonds.

At 30 June 2011, only 42 per cent. of the Bank's customer loans and receivables (the **customer loan portfolio**) was classified as performing with the remaining loans being classified as watch (11 per cent.), sub-performing (17 per cent.) or non-performing (30 per cent.). As at the same date, the Bank's provisions on its customer loan portfolio amounted to 8.3 per cent. of the total amount of the portfolio and 41 per cent. in aggregate amount outstanding of its customer loans and receivables had been wholly or partially impaired. At 30 June 2011, the value of collateral that the Bank holds relating to loans individually determined to be impaired amounted to ISK 78.5 billion, or 47.51 per cent., of the aggregate amount of such loans.

As at 30 June 2011, the aggregate amount of the Bank's 10 largest customer loans and receivables equalled 29 per cent. of its total gross customer loans and receivables at that date. The Bank's loan portfolio is also highly concentrated on Icelandic borrowers.

The Bank has developed a number of solutions to assist customers that are experiencing payment difficulties. The recovery strategy is based on identifying clusters of similar customers, such as small to medium sized enterprises (SMEs) and individuals, and implementing standardised solutions for those customers. In the case of larger companies, the solutions are tailored to the circumstances of each company. Although significant progress has been made restructuring the debts of the Bank's largest corporate customers, considerable work remains in relation to restructuring the debts of SMEs and individuals. The goal of the corporate restructuring process is to create companies with a healthy capital structure, no covenant breaches, satisfactory operating results and motivated management teams and owners although no assurance can be given as to the extent to which this can be achieved or that the Bank will not be forced to put a significant number of corporate customers into liquidation, thereby experiencing material losses.

Should a customer to which the Bank has a large exposure default or if the outcome of the restructuring process is that a greater number of loans prove to be non-recoverable in whole or in part than originally anticipated, the Bank's business and its ability to make payments in respect of the Covered Bonds would be materially adversely affected.

The Bank has acquired the mortgage portfolio related to Kaupthing's covered bond programme and could be adversely affected if these assets generate less revenue than anticipated at the time of acquisition

In January 2012, the Bank acquired the mortgage portfolio, managed by a special fund owned by the bankruptcy estate of Kaupthing, related to Kaupthing's covered bond programme. In connection with the acquisition, the Bank was also substituted as issuer under six series of covered bonds issued by Kaupthing and relating to the mortgage portfolio. See "*Description of the Issuer - Recent developments - Acquisition of the mortgage portfolio related to Kaupthing's covered bond programme*". This acquisition increased the Bank's loan portfolio and is a significant addition to the Bank's balance sheet.

The acquisition does, however, expose the Bank to risks if the acquired mortgage portfolio does not generate profits as anticipated. In such a case, the Bank may achieve lower than expected cost savings or otherwise incur losses in relation to the mortgage portfolio. In addition, the Bank's results of operations and financial position could be materially adversely affected if the mortgages acquired do not generate sufficient revenue to service the associated covered bonds.

The Bank is exposed to significant liquidity risk. In particular, the Bank's funding is dominated by deposits and a significant majority of these are on demand. The Bank is also limited in its ability to seek alternative sources of funding

The Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of its loans exceeds the maturity of its deposits, the majority of which are on demand deposits.

The Bank's total deposit base was ISK 449 billion at 30 June 2011. The Bank's other funding at 30 June 2011 was in the form of long-term debt (ISK 100 billion at 30 June 2011) and equity (ISK 110 billion at 30 June 2011). Around 72.69 per cent. of the Bank's deposits were on demand, 7.57 per cent. had a maturity of up to three months, 7.79 per cent. had a maturity of between three and 12 months. 10.42 per cent. had a maturity of between one and five years and 1.54 per cent. had a maturity of more than five years.

The Bank has classified its deposit base according to its stickiness. The stickiness of the deposit base is determined by the stability of the deposits in the past and their expected stability in the future. Deposits that are determined to have the highest stickiness are the ones that have proven to be the most stable funding source for the Bank in the past and are expected to remain so. The least sticky deposits are the deposits that

are expected to be withdrawn under particular circumstances, such as the lifting of capital controls. The Bank's deposits are classified into seven categories, the first category being the least sticky and the seventh being the most sticky.

As at 30 June 2011, 46 per cent. of the Bank's on demand deposits were classified as falling within the three least sticky categories, being (i) deposits from customers (including foreign financial institutions) that are believed to be waiting to withdraw their deposits when the capital controls are lifted, (ii) deposits from entities that are in the resolution process, including in many cases entities that are insolvent and whose deposits are held as security against other liabilities and (iii) deposits from investors (such as Icelandic pension funds) who may reduce their deposits when other investment opportunities become available or if a competitor bank raises its interest rates on deposits. As at the same date, the Bank's 10 largest customer deposits accounted for 29 per cent. of its total customer deposits.

The Bank's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Bank's liquidity reserve. The Bank has made significant process in converting its on demand deposits to term deposits. At 31 December 2009, over 90 per cent. of the Bank's deposits were on demand compared to 73 per cent. at 30 June 2011. However, no assurance can be given that the Bank will continue to be successful in converting its deposits or will otherwise be able to increase the maturity profile of its funding.

The Bank's non-deposit funding principally comprises a limited number of loans (including two subordinated loans from the Icelandic state and a loan from the Central Bank) and equity funding. Reflecting the poor economic situation in Iceland, it is difficult for the Bank to obtain longer-term funding in the domestic market and the Bank is also limited in its ability to seek such funding from international sources as it does not have a rating and it lacks a significant trading history.

For so long as the Bank is unable to match more closely the maturity profiles of its assets and liabilities, 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. The Bank is also exposed to the risk that it experiences a material loss of its least sticky deposits in the future. In either of these cases the Bank's business and its ability to make payments in respect of the Covered Bonds would be materially adversely affected.

The Bank is exposed to significant foreign exchange risk through a currency mismatch between its assets and liabilities and through legal uncertainties relating to certain foreign currency loans

The Bank is primarily exposed to currency risk through a currency mismatch between its assets and liabilities. The Bank's liabilities are predominantly denominated in ISK whereas its assets principally comprise foreign currency denominated loans to customers. The Bank's foreign currency imbalances exceeded applicable regulatory limits until the second quarter of 2011 although the Bank was granted a dispensation from complying by the Central Bank.

The Bank's strategy for reducing its currency imbalance is first to seek to convert into ISK foreign currency denominated loans to customers who have ISK income and second to hedge its other currency imbalances, principally through agreements with the Central Bank and other counterparties. Until the end of 2010, the Bank was limited in its ability to pursue the first part of its strategy as a result of legal uncertainty relating to the status of foreign currency loans. However, following a series of cases in the Icelandic courts, on 18 December 2010, a new Icelandic law was passed relating to the calculation of interest on certain loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal amount of those loans is required to be recalculated from the loan commencement date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. In addition, the law requires that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. In all cases, either the loan principal is adjusted or, if the borrower has overpaid, the amount overpaid must be reimbursed. This law has enabled banks to better assess their risks and has expedited the financial restructuring of companies and households.

Notwithstanding the foregoing, for so long as the Bank is unable to match more closely the currencies of its assets and liabilities, the Bank will continue to be exposed to a material risk that it may experience significant losses as a result of changes in currency exchange rates.

Currently, the legitimacy of loans to corporates and individuals not addressed by the December law remains somewhat unclear. By a series of judgments in 2011, the Icelandic Supreme Court has held that certain types of foreign currency loans and lease agreements with SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. As a result, these loans were held to be in breach of applicable Icelandic legislation relating to interest and price indexation.

Even though no foreign currency indexed ISK loans made by the Bank have been considered by the Icelandic Supreme Court, the Bank has decided and announced that these rulings provide a precedent for the Bank to follow, and that all of the Bank's loans which fall within the conditions established by the Supreme Court in its rulings will be recalculated into ISK denominated loans. The Bank estimates that around 2,000 retail and corporate loans will have to be recalculated.

The recently announced recalculation follows the recalculation of foreign currency indexed ISK mortgage loans which was implemented earlier in 2011. As a result, almost all of the Bank's foreign currency indexed ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of corporate loans, the Bank was advised in mid 2010 that certain of its foreign currency corporate loans were fully compliant with applicable regulations whilst others were more vulnerable, as the recent rulings of the Supreme Court have confirmed. The Bank remains party to a number of court cases relating to such loans, see "*Description of the Issuer—Litigation*".

The recalculation of foreign currency loans will adversely affect the Bank's results of operations and financial position in 2011. However, the Bank's capital ratio is expected to remain well above the 16 per cent. requirement set by the FME.

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

The Bank's exposure to market risk arises from imbalances in 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 in 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 principally in relation to currencies, maturities and interest rates. The Bank principally trades 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 on 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 is the large maturity gap resulting from the fact that the Bank has significant on demand liabilities. 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 Bank's own account equity price risk principally arises as a result of the fact that, through the loan restructuring process, it has acquired significant shareholdings in troubled companies. The Bank is exposed to inflation risk when there is a mismatch between its inflation-linked assets and liabilities. As at 30 June 2011, the total amount of the Bank's inflation-linked assets was ISK 114 billion and the total amount of its inflation-linked liabilities was ISK 97 billion. The Bank also has

significant maturity mismatches in its inflation-linked assets and liabilities. Whilst 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. 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.

Any losses experienced by the Bank as a result of its market risk exposures could materially adversely affect the Bank's business and its ability to make payments in respect of the Covered Bonds.

While the Bank seeks to manage its operational risks, these risks remain an inherent part of its business

The operational risks that the Bank faces include the possibility of inadequate or failed internal or external processes or systems, human error, regulatory breaches, employee misconduct or external events such as fraud. The Bank's business inherently generates operational risks. The business is dependent on processing numerous complex transactions. The recording and processing of these transactions are potentially exposed to the risk of human and technological errors 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 there can be no assurance that risk assessments made in advance will adequately estimate the costs of these errors.

The Bank has implemented controls designed to mitigate operational risks but these controls cannot eliminate such risks and failures in internal control could subject the Bank to regulatory scrutiny. These events could potentially result in financial loss as well as harm to the Bank's reputation.

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. The Bank's more qualitative approach to managing risks takes into account a broader set of risks, but is less precise than quantified modelling and could prove insufficient. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Bank's business and its ability to make payments in respect of the Covered Bonds.

The Bank is exposed to competition, principally from other large Icelandic banks, and expects that this competition will increase as Iceland's economy recovers

The Bank currently faces competition from the two other large commercial banks in Iceland. While the banks were focusing on restructuring their loan portfolios and improving their asset and liability matching, the competition is currently limited. 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. If the Bank is unable to compete effectively in the future in any market in which it has a significant presence, this could adversely affect its business.

The Bank is exposed to the risk of failure of its information technology (IT) systems and breaches of its security systems

The Bank relies on the proper functioning and continuity of its IT systems. Any significant interruption, degradation, failure or lack of capacity of its IT systems or any other systems in its clearing operations or elsewhere could cause it to fail to complete transactions on a timely basis or at all. 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.

The secure transmission of confidential information is a critical element of the Bank's operations. The Bank cannot guarantee that its existing security measures will prevent security breaches, including break-ins, viruses and disruptions. Persons that circumvent the security measures could use the Bank's or its clients' confidential information wrongfully, which could expose it to a risk of loss, adverse regulatory consequences or litigation.

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

The Bank's operations entail considerable regulatory and legal risk, including litigation and liability risk. The Bank and certain of its subsidiaries are subject to government regulation and supervision as financial companies in Iceland, and regulations may be extensive and may change rapidly, as they have done since the global financial crisis. In addition, certain of the Bank's and its subsidiaries' operations are contingent upon licences issued by financial authorities.

Violations of rules and regulations, whether intentional or unintentional, may lead to the withdrawal of some of these licences or to liability claims. Any breach of these or other regulations may adversely affect the Bank's reputation or financial condition. 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, which could adversely affect the way the Bank operates its business and its market reputation.

The Bank is also exposed to legal risks in its role as a financial intermediary and consultant to third party businesses. 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 trading transactions will claim that the Bank failed to properly inform them of the associated risks or that they were not authorised or permitted to enter into these transactions with the Bank and that their obligations are therefore not enforceable. The Bank is also exposed to customer claims.

The Bank may also be subject to claims arising from disputes with employees for, among other things, alleged illegal dismissal, discrimination or harassment. 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 business and its ability to make payments in respect of the Covered Bonds.

The Bank is involved as defendant in ongoing litigation which, if determined adversely to the Bank, could result in significant losses. In addition, the Bank is a plaintiff in a case which, if not successful, could have a material adverse effect on the Bank's results of operations

A number of clients have alleged that assets under management were improperly managed before the collapse of Kaupthing resulting in the clients suffering financial loss. There is currently uncertainty relating to finality of the court's decision which was that the claims should be dismissed.

There are also a number of cases concerning the legality of FX loans owed to the Bank which, if resolved adversely by the courts, could have a significant impact on the Bank's loan portfolio and results of operations.

In June 2011, Stefnir (formerly Rekstrarfélag Kaupþings banka hf.) received two demands for the rescission of contracts from the winding up committee of Landsbanki. The aggregate amounts involved are approximately ISK 3 billion plus interest. Stefnir intends to defend the claims as it believes they are unfounded see "*Description of the Issue – Litigation*".

In addition, the Bank has challenged a ruling by the FME that has reduced the rate of interest payable to the Bank on a bond issued to it in connection with an acquisition made by it. This bond is the Bank's largest single asset and the interest rate reduction has both reduced the fair value of the bond in the Bank's accounts and materially decreased its interest income. The outcome of the challenge is still uncertain. However, the Bank's results of operations will be materially adversely affected if its challenge is not successful in reversing the FME's ruling.

The EFTA Surveillance Authority has opened the formal investigation procedures in relation to the Bank on certain matters which, if determined adversely to the Bank, could result in losses

Two formal investigations involving the Bank were launched by the EFTA Surveillance Authority (the **ESA**) in 2010.

The first investigation, commenced in September 2010 relates to whether or not the purchases by the New Banks, including the Issuer, of assets of money market funds in the autumn of 2008 should be considered to be state aid under the Agreement on the European Economic Area (the **EEA Agreement**). The Bank, which was state-owned at the time, acquired assets worth ISK 7,700,000,000 from the funds of Rekstrarfélag Kaupþings banka hf. (now Stefnir hf.) on 30 October 2008. According to a preliminary opinion of the ESA, the actions of the New Banks enabled certain management companies of money market funds to sell assets to an extent not available to other management companies at the time. The Bank has objected to this opinion of the ESA, stating that the acquisition of the assets in question from the funds of Rekstrarfélag Kaupþings banka hf. was made for commercial reasons and does not constitute state aid under the EEA Agreement. The ESA last invited the parties involved to make any objections before 29 November 2010. The outcome of the investigations are difficult to predict.

The second investigation was launched in December 2010 and relates to the state aid granted in the restoration of certain operation of Kaupthing and the establishment and capitalisation of the Issuer. Similar investigations have been launched in relation to the restoration and capitalisation of Íslandsbanki and Landsbanki. The ESA will consider the appropriateness of the capitalisation measures taken by Icelandic authorities which were not notified to the ESA in advance of their implementation. While the ESA has accepted that if it had been notified in advance of the measures undertaken in accordance with the terms of the EEA Agreement, the measures would most likely have been approved temporarily as aid compatible with the EEA Agreement, subject to the assessment of a restructuring plan for the Issuer by the ESA. A restructuring plan for the Issuer has been submitted to the ESA and is currently under assessment. The ESA will therefore determine, following the investigation, whether the measures constitute state aid, and if so whether they are compatible with the provisions of the EEA Agreement. A negative decision may be accompanied by a decision on recovery of the illegal state aid.

If the ESA concludes that that illegal state aid is present, the recipient of such illegal state aid may be required to reimburse the state funding.

Investigation by the Icelandic Competition Authority

The Icelandic Competition Authority (**ICA**) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three major banks in Iceland, including Arion. The investigation was initiated by separate complaints from BYR bank and MP bank. The ICA received a similar complaint from an insurance company regarding the banks' abuse of an alleged collective dominant position. The complaints from BYR bank and MP bank concern the terms of the banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The insurance company's complaint concerns the banks' alleged tying of banking services and insurances. The ICA has also opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including Arion, following a complaint by Kortathjonustan, a credit card payment acquirer, in 2009. The Bank has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Bank.

Changes in tax laws or in their interpretation could harm the Bank's business

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 clients.

In December 2010, the Icelandic Parliament passed a new law (Act no. 155/2010) under which certain types of financial institution, including the Bank, are required to pay an annual tax calculated at 0.041 per cent. of the carrying amount of their liabilities as determined for tax purposes, with effect from the year ending 31 December 2010 and in the assessment of year 2011 based on figures of calendar year 2010. The law is permanent but will be reviewed after one year. In December 2011, a transitional provision was introduced under which financial institutions, including the Bank, must pay an additional 0.0875 per cent. of their tax base in the assessment of the years 2012 and 2013. The additional tax is due on November 2012 and 2013.

In June 2009, the Icelandic Parliament adopted an amendment to the law (Act no. 70/2009) on income tax and withholding liability on interest payments to parties with limited tax liability. Following this, payments of Icelandic sourced interest by an Icelandic debtor (such as the Bank) to a foreign creditor (including holders of Covered Bonds who are not Icelandic) is taxable in Iceland and can be subject to withholding tax at the rate of 10 per cent., unless the foreign creditor can demonstrate and get approval from the Icelandic Inland Revenue to the effect that a relevant double taxation treaty applies, in which case the provisions of the double tax treaty will apply.

In May 2011, a proposed amendment to exempt interest payable under loan agreements between unconnected parties was not adopted by the Icelandic parliament although the parliament has agreed to reconsider the amendment in 2012.

In December 2011, the Icelandic Parliament passed a new law (Act no. 165/2011) under which certain types of financial institution, including the Bank, are required to pay a special additional 5.45% tax levied on all remuneration, salary, wages etc., paid to employees, with effect from 1 January 2012. The law is permanent.

Changes to the Icelandic Fisheries Management Act could harm the Bank's business

A bill concerning changes to the Fisheries Management Act is currently in discussion before the Icelandic parliament, which, if passed, could adversely effect the Bank. As at 30 June 2011, 13.2 per cent. of the Bank's loans and receivables to customers were to customers in the agriculture, forestry and fishing sectors.

Further, as at 30 June 2011, it is estimated that approximately 4 per cent. of the Bank's loans to customers were directly sensitive to the price of fishing quotas.

The proposed changes being considered concern the restriction of fishing rights, a ban on the transfer and pledging of fishing quotas, increased authority to the minister of fisheries for granting quotas and the raising of fishing fees. The bill is being discussed by the Icelandic parliament, and it is currently unclear whether it will be passed and, if so, in what form.

Catastrophic events, terrorist attacks and other acts of war could have a negative impact on the Bank's business

Catastrophic events, terrorist attacks, other acts of war or hostility, and responses to those acts may create economic and political uncertainties, which could have a negative impact on economic conditions in Iceland and, more specifically, on the Bank's business in ways that cannot be predicted.

The Bank may be unable to recruit or retain experienced and qualified personnel and is dependent on key members of management

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 may also make it less attractive to a large portion of potential applicants.

The loss of the services of key members of the Bank's senior management or staff with institutional and client knowledge may significantly delay the Bank's achievement of its business objectives and could have a material adverse effect on its business.

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, there can be no assurance that the coverage that the Bank maintains is adequate to cover the losses for which it believes it is insured.

The Bank's audit and review reports emphasise the importance of certain estimates and judgments

The Bank's audit reports at 31 December 2010 and 2009 and its review report at 30 June 2011 emphasise the sensitivity of the carrying amounts of the Bank's assets and liabilities involving accounting estimates and judgments to changes in reasonably possible alternative assumptions and judgments and note that actual amounts realised in the future from these assets could differ from current estimates and significant uncertainty exists over whether the differences may be material to the Bank's financial statements.

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 two 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. If 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.

U.S. Foreign Account Tax Compliance Withholding

The Issuer and other non-U.S. financial institutions through which payments on the Covered Bonds are made may be required to withhold U.S. tax at a rate of 30 per cent. on all, or a portion of, payments made after 31 December 2014 in respect of (i) any Covered Bonds issued after 18 March 2012 and (ii) any Covered Bonds which are treated as equity for U.S. federal tax purposes, whenever issued, pursuant to the U.S. Foreign Account Tax Compliance Act (**FATCA**). This withholding tax may be triggered if (i) the Issuer is a foreign financial institution (**FFI**) (as defined in FATCA) which enters into and complies with an agreement with the U.S. Internal Revenue Service (**IRS**) to provide certain information on its account holders (a term which includes the holders of its debt or equity interests that are not regularly traded on an established securities market) (making the Issuer a **Participating FFI**), (ii) the Issuer has a positive "passthru percentage" (as defined in FATCA), and (iii)(a) an investor does not provide information sufficient for the Participating FFI to determine whether the investor is a U.S. person or should otherwise be treated as holding a "United States Account" of the Issuer, or (b) any FFI through which payment on such Covered Bonds is made is not a Participating FFI.

The application of FATCA to interest, principal or other amounts paid with respect to the Covered Bonds is not clear. If an amount in respect of U.S. withholding tax were to be deducted or withheld from interest, principal or other payments on the Covered Bonds as a result of a holder's failure to comply with these rules or as a result of the presence in the payment chain of a non-Participating FFI, neither the Issuer nor any paying agent nor any other person would, pursuant to the Conditions of the Covered Bonds be required to pay additional amounts as a result of the deduction or withholding of such tax other than in respect of payments as to which the withholding would not have been required had the Issuer's Agent receiving the payment been a Participating FFI. As a result, investors may, if FATCA is implemented as currently proposed by the IRS, receive less interest or principal than expected. Holders of Covered Bonds should consult their own tax advisers on how these rules may apply to payments they receive under the Covered Bonds.

The application of FATCA to Covered Bonds issued after 18 March 2012 (or whenever issued, in the case of Covered Bonds treated as equity for U.S. federal tax purposes) may be addressed in the relevant Final Terms or a Supplement to the Offering Circular, as applicable.

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*)). If 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 of the Income Tax Act no. 90/2003 (**ITA**) (as amended by Act no. 70/2009, which imposes withholding tax on payments of Icelandic sourced interest to a foreign bondholders at a rate of 10%, unless exemptions are available to the relevant bondholders in their home countries or under a double taxation treaty with Iceland. It is expected that the law will be changed in the course of 2012, following which this withholding tax obligation will cease to exist. However, prospective investors of the Covered Bonds should consider the risk in the event that such changes in the law are not effected.

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 Act on 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 króna. For this purpose, the Central Bank issued new Rules on Foreign Exchange, no 1082, of 28 November 2008 (the **Foreign Exchange Rules**). These rules are subject to review every six months, and the Foreign Exchange Rules in force at the date of this Offering Circular were published in April 2010.

The Foreign Exchange Rules effectively prohibit the outflow of foreign currency from Iceland unless it is a payment for goods or services. Therefore all financial transactions leading to currency outflow are prohibited unless explicitly allowed for in the future. More specifically the Foreign Exchange Rules include provisions prohibiting certain transactions including lending and borrowing between resident and non-resident parties as well as currency-derivatives of any kind, the acquisition by domestic parties of financial instruments nominated in foreign currency etc. Furthermore the Rules make it compulsory for Icelanders and Icelandic companies to “repatriate” all their foreign currency back into the country.

The Foreign Exchange Rules have now been codified with the adoption of Act No 127/2011, amending the Foreign Exchange Act whereby the provision of the Foreign Exchange Rules were effectively adopted in the Act, as a new article 13, items a. to n. The codification included a number of minor amendments to wording. After the codification the restrictions will remain in place until 31 December 2013.

The currency restrictions 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. Thus the rules on currency restrictions may at any time be subject to the scrutiny of the EEA Institutions.

In light of this prospective investors must consider the risk of changes to the law and the impact on their investments.

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 "*Summary 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 "*Summary 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 has 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;
- 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 of Iceland

The parliamentary ombudsman has launched an investigation into whether the current rules of the Central Bank of Iceland 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 of Iceland, 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 of Iceland 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.

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

If 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:

Covered Bonds subject to optional redemption by the Issuer

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.

Index Linked Covered Bonds and Dual Currency Covered Bonds

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 should not be viewed as an indication of the future performance of such index during the term of any Index Linked Covered Bonds. Accordingly, each potential investor should consult its own financial and legal advisers about the risk entailed by an investment in any Index Linked Covered Bonds and the suitability of such Covered Bonds in light of its particular circumstances.

Partly-paid Covered Bonds

The Issuer may issue Covered Bonds where the issue price is payable in more than one instalment. Failure to pay any subsequent instalment could result in an investor losing all of his investment.

Variable rate Covered Bonds with a multiplier or other leverage factor

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

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.

Fixed/Floating Rate Covered Bonds

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 rates on its Covered Bonds.

Covered Bonds issued at a substantial discount or premium

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 the securities, the greater the price volatility as compared to 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 7.9. 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 brief description of certain 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.

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

The European Commission has proposed certain amendments to the Directive which may, if implemented, amend or broaden the scope of the requirements described above.

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Covered Bond as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive.

Change of law

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.

Covered Bonds where denominations involve integral multiples: definitive Covered Bonds

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 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 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 such that its holding amounts to a Specified Denomination.

If definitive Covered Bonds 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 depository (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 brief description of the principal market risks, including liquidity risk, exchange rate risk, interest rate risk and credit risk:

The secondary market generally

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.

Exchange rate risks and exchange controls

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.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. 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.

Interest rate risks

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 subsequent changes in market interest rates may 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 may not reflect all risks

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 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.

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 advisers 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 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 2009 and 31 December 2010 including the information set out at the following pages in particular:

	Annual Report for the financial year ended 31 December 2009	Annual Report for the financial year ended 31 December 2010
Consolidated Statement of Financial Position.....	Page 59	Page 67
Significant Accounting Policies.....	Pages 64 to 75	Pages 72 to 83
Table of Contents.....	Page 54	Page 62
Consolidated Statement of Cash Flows Statement.....	Page 61	Page 69
Consolidated Statement of Comprehensive Income.....	Page 58	Page 66
Consolidated Statement of Changes in Equity.....	Page 60	Page 68
Notes.....	Pages 62 to 127	Pages 70 to 141
Independent Auditor's Report.....	Page 57	Page 65

Any other information not listed above but contained in such document is incorporated by reference for information purposes only;

- (b) the interim unaudited consolidated financial statements of the Issuer for the six months ended 30 June 2011; including the information set out at the following pages in particular:

Interim Statement of Financial Position.....	Page 7
Interim Statement of Comprehensive Income.....	Page 6
Significant Accounting Policies.....	Pages 11 to 12
Interim Statement of Changes in Equity.....	Page 8
Condensed Interim Statement of Cash Flows.....	Page 9
Notes.....	Pages 10 to 47
Report on Review of Interim Financial Statements	Page 5

Any other information not listed above but contained in such document is incorporated by reference for information purposes only;

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.

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 either bearer form, with or without interest coupons attached, or (ii) 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 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 Note, each a **Bearer Global Note** 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**).

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 depository 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 which have an original maturity of more than 1 year and on all receipts and interest coupons relating to such Covered Bonds:

"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 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 depository 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 7.4 (*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 7.4 (*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, 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 at least 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.

APPLICABLE FINAL TERMS

Set out below is the form of Final Terms which will be completed for each Tranche of Covered Bonds issued under the Programme.

[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 9 February 2012 which constitutes a base prospectus for the purposes of the Prospectus Directive (Directive 2003/71/EC) (the **Prospectus Directive**) as amended (which includes the amendments made by Directive 2010/73/EU (the **2010 PD Amending Directive**) to the extent that such amendments have been implemented in a relevant Member State). 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 [address] 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 9 February 2012 which are incorporated by reference in the Offering Circular dated [current date] and are attached hereto. 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**) as amended (which includes the amendments made by Directive 2010/73/EU (the **2010 PD Amending Directive**) to the extent that such amendments have been implemented in a relevant Member State) and must be read in conjunction with the Offering Circular dated 9 February 2012 which constitutes a base prospectus for the purposes of the Prospectus Directive. 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 9 February 2012. 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.]

[Include whichever of the following apply or specify as "Not Applicable" (N/A). Covered Bond that the numbering should remain as set out below, even if "Not Applicable" is indicated for individual paragraphs or subparagraphs. Italics denote directions for completing the Final Terms.]

[When adding any other final terms or information consideration should be given as to whether such terms or information constitute "significant new factors" and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive.]

1. Issuer: Arion Bank hf.
2. (a) Series Number: []
- (b) Tranche Number: []
3. Specified Currency or Currencies: []
4. Aggregate Nominal Amount:
 - Tranche: []
 - Series: []
5. Issue Price: []% of the Aggregate Nominal Amount [plus accrued interest from [insert date] (in the case of fungible issues only, if applicable)]
6. (a) Specified Denominations: []

(If fungible with an existing Series, details of that Series, including the date on which the Covered Bonds become fungible)

(in the case of Registered Covered Bonds this means the minimum integral amount in which transfers can be made)

(N.B. Following the entry into force of the 2010 PD Amending Directive on 31 December 2010, Covered Bonds to be admitted to trading on a regulated market within the European Economic Area with a maturity date which will fall after the implementation date of the 2010 PD Amending Directive in the relevant European Economic Area Member State (which is due to be no later than 1 July 2012) must have a minimum denomination of EUR 100,000 (or equivalent) in order to benefit from Transparency Directive exemptions in respect of wholesale securities. Similarly, Covered Bonds issued after the implementation of the 2010 PD Amending Directive in a Member State must have a minimum denomination of EUR 100,000 (or equivalent) in order to benefit from the wholesale exemption set out in Article 3.2(d) of the Prospectus Directive in that Member State.)

(Note – where Bearer Covered Bonds with multiple denominations above €100,000 or equivalent are being used the following sample wording should be followed:

"€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.")

(N.B. If an issue of Covered Bonds is (i) NOT admitted to trading on an European Economic Area exchange; and (ii) only offered in the European Economic Area in circumstances where a prospectus is not required to be published under the Prospectus Directive, the €100,000 minimum denomination is not required.)

(b) Calculation Amount []

(If only one Specified Denomination, insert the Specified Denomination. If more than one Specified Denomination, insert the highest common factor. Covered Bond: There must be a common factor in the case of two or more Specified Denominations.)

7. (a) Issue Date: []

(b) Interest Rate: [Include a description of the interest rate]

(c) Interest Commencement Date: []

(N.B. An Interest Commencement Date will not be relevant for certain Covered Bonds, for example Zero Coupon Covered Bonds.)

8. Maturity Date: [Fixed rate – specify date/Floating rate – Interest Payment Date falling in or nearest to [specify month and year]]

9. Extended Final Maturity Date: [Fixed rate – specify date ● years after the latest maturing asset in the Cover Pool/Floating rate – Interest Payment Date falling in [specify month and year ● years after the latest maturing asset in the Cover Pool]]

[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]

10. Interest Basis: [[]% Fixed Rate]
[[LIBOR/EURIBOR] +/- []% Floating Rate]
[Zero Coupon]
[Index Linked Interest]

- [Dual Currency Interest]
 [Other (specify)]
 (further particulars specified below)
11. Redemption/Payment Basis: [Redemption at par]
 [Index Linked Redemption]
 [Dual Currency Redemption]
 [Partly Paid]
 [Instalment]
 [Other (specify)]
- (N.B. If the Final Redemption Amount is other than 100% of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.)*
12. Change of Interest Basis or Redemption/Payment Basis: [Specify details of any provision for change of Covered Bonds into another Interest Basis or Redemption/Payment Basis]
13. Put/Call Options: [Investor Put]
 [Issuer Call]
 [(further particulars specified below)]
 [(further particulars specified below)]
14. (a) Status of the Covered Bonds: [●]
- (b) [Date [Board] approval for issuance of Covered Bonds obtained:] [N.B. Only relevant where Board (or similar) authorisation is required for the particular Tranche of Covered Bonds.]
15. Method of distribution: [Syndicated/Non-syndicated]
16. Name and address of the Calculation Agent []

PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE

17. **Fixed Rate Covered Bond Provisions** [Applicable/Not Applicable]
- (If not applicable, delete the remaining subparagraphs of this paragraph)*
- (a) Rate(s) of Interest: []% per annum [payable [annually/semi-annually/quarterly] in arrear]
- (b) Interest Payment Date(s): [[] in each year up to and including the Maturity Date or the Extended Final Maturity Date, as applicable]/[specify other]
- (N.B. This will need to be amended in the case of long or short coupons)*

- (c) Fixed Coupon Amount[(s)]: [] per Calculation Amount
(Applicable to Covered Bonds in definitive form.)
- (d) Broken Amount(s): [] per Calculation Amount, payable on the Interest Payment Date falling [in/on] []
(Applicable to Covered Bonds in definitive form.)
- (e) Day Count Fraction: [30/360 or Actual/Actual (ICMA) or *[specify other]*]
- (f) Determination Date(s): [] in each year *[insert regular interest payment dates, ignoring issue date or maturity date in the case of a long or short first or last coupon.]*
- N.B. This will need to be amended in the case of regular interest payment dates which are not of equal duration*
- N.B. Only relevant where Day Count Fraction is Actual/Actual (ISMA)]*
- (g) Other terms relating to the method of calculating interest for Fixed Rate Covered Bonds: [None/give details]

18. **Floating Rate Covered Bond Provisions**

[Applicable/Not Applicable]

(If not applicable, delete the remaining subparagraphs of this paragraph)

- (a) Specified Period(s)/Specified Interest Payment Dates: []
[NB: Specify the Specified Period(s)/Specified Interest Payment Date(s) up to and including the Extended Final Maturity Date, if applicable]
- (b) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention /*specify other*]
- (c) Additional Business Centre(s): []
- (d) Manner in which the Rate of Interest and Interest Amount is to be determined: [Screen Rate Determination/ISDA Determination/*specify other*]
- (e) Party responsible for calculating the Rate of Interest and Interest Amount (if not the Fiscal Agent): []
- (f) Screen Rate Determination:

- Reference Rate: []
(Either LIBOR, EURIBOR or other, although additional information is required if other – including fallback provisions in the Agency Agreement (for Covered Bonds other than ISD Covered Bonds))

- Interest Determination Date(s): []
(Second London business day prior to the start of each Interest Period if LIBOR (other than Sterling or euro LIBOR), first day of each Interest Period if Sterling LIBOR and the second day on which the TARGET2 System is open prior to the start of each Interest Period if EURIBOR or euro LIBOR)

[NB: Specify the Interest Determination Date(s) up to and including the Extended Final Maturity Date, if applicable]

- Relevant Screen Page: []
(In the case of EURIBOR, if not Reuters EURIBOR 01 ensure it is a page which shows a composite rate or amend the fallback provisions appropriately)

- (g) ISDA Determination: []
 - 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)
Other]
(See Condition [Interest] for alternatives)

- (l) Fall back provisions, rounding provisions and any other terms []

relating to the method of calculating interest on Floating Rate Covered Bonds, if different from those set out in the Conditions:

19. **Zero Coupon Covered Bond Provisions**¹ [Applicable/Not Applicable]
- (If not applicable, delete the remaining subparagraphs of this paragraph)*
- (a) Accrual Yield: []% per annum
- (b) Reference Price: []
- (c) Any other formula/basis of determining amount payable: []
- (d) Day Count Fraction in relation to Early Redemption Amounts and late payment: [Conditions [●] apply/specify other]
- (Consider applicable day count fraction if not U.S. dollar denominated)*
20. **Index Linked Interest Covered Bond Provisions** [Applicable/Not Applicable]
- (If not applicable, delete the remaining subparagraphs of this paragraph)*
- (N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.)*
- (a) Index/Formula: [give or annex details]
- (b) Calculation Agent responsible for calculating the interest due: [give name (and, if the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies, address)]
- (c) Party responsible for calculating the Rate of Interest (if not the Calculation Agent) and Interest Amount (if not the Fiscal Agent): []
- (d) Provisions for determining Coupon where calculation by reference to Index and/or Formula is impossible or impracticable: [Include a description of market disruption or settlement disruption events and adjustment provisions]

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

- (e) Specified Period(s)/Specified Interest Payment Dates: []
- (f) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/specify other]
- (g) Additional Business Centre(s): []
- (h) Minimum Rate of Interest: []% per annum
- (i) Maximum Rate of Interest: []% per annum
- (j) Day Count Fraction: []

21. **Dual Currency Interest Covered Bond Provisions** [Applicable/Not Applicable]

(If not applicable, delete the remaining subparagraphs of this paragraph)

(N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.)

- (a) Rate of Exchange/method of calculating Rate of Exchange: [give details]
- (b) Party, if any, responsible for calculating the principal and/or interest due (if not the Fiscal Agent): []
- (c) Provisions applicable where calculation by reference to Rate of Exchange impossible or impracticable: [Include a description of market disruption or settlement disruption events and adjustment provisions]
- (d) Person at whose option Specified Currency(ies) is/are payable: []

PROVISIONS RELATING TO REDEMPTION

22. **Issuer Call** [Applicable/Not Applicable]

(If not applicable, delete the remaining subparagraphs of this paragraph)

- (a) Optional Redemption Date(s): []
- (b) Optional Redemption Amount of [] per Covered Bond of [] Specified

each Covered Bond and method, if any, of calculation of such amount(s): Denomination

- (c) If redeemable in part:
 - (i) Minimum Redemption Amount: []
 - (ii) Maximum Redemption Amount: []
- (d) Notice period (if other than as set out in the Conditions): []

(N.B. If setting notice periods which are different to those provided in the Conditions, the Issuer is advised to consider the practicalities of distribution of information through intermediaries, for example, clearing systems and custodians, as well as any other notice requirements which may apply, for example, as between the Issuer and the Fiscal Agent)

23. Investor Put:

[Applicable/Not Applicable]

(If not applicable, delete the remaining subparagraphs of this paragraph)

- (a) Optional Redemption Date(s): [●]
- (b) Optional Redemption Amount and method, if any, of calculation of such amount(s): [●] per Calculation Amount
- (c) Notice period (if other than as set out in the Conditions):

[]

(N.B. If setting notice periods which are different to those provided in the Conditions, the Issuer is advised to consider the practicalities of distribution of information through intermediaries, for example, clearing systems and custodians, as well as any other notice requirements which may apply, for example, as between the Issuer and the Agent)

24. Final Redemption Amount of each Covered Bond

[[] per Covered Bond of [] Specified Denomination/other/see Appendix]

(N.B. If the Final Redemption Amount is other than 100% of the nominal value the Covered Bonds will

be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.)

25. Early Redemption Amount of each Covered Bond payable on redemption for taxation reasons and/or the method of calculating the same (if required or if different from that set out in Condition 8.5): []
26. [Relevant Percentage:] As at the Issue Date, [] per cent. [*Note: Relevant Percentage is the proportion the Series of Covered Bonds bears to the principal amount outstanding of all Covered Bonds issued by the Issuer from time to time.*]

GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS

27. 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].]
- [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.]*
- (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 Note (U.S.\$[] nominal amount) registered in the name of a common depository 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 [8] of Part B below.]

28. New Global Covered Bond:

[Yes] [No]

(If ISD Covered Bonds, insert "No")

29. Additional Financial Centre(s) or other special provisions relating to Payment Dates:

[Not Applicable/give details]

(Covered Bond that this item relates to the place of payment and not Interest Period end dates to which items 18(c) and 20(g) relate)

30. Talons for future Coupons or Receipts to be attached to definitive Covered Bonds in bearer form (and dates on which such Talons mature):

[Yes/No. *If yes, give details*]

31. Details relating to Partly Paid Covered Bonds: amount of each payment comprising the Issue Price and date on which each payment is to be made and consequences (if any) of failure to pay, including any right of the Issuer to forfeit the Covered Bonds and interest due on late payment:

[Not Applicable/give details]

(N.B. A new form of Temporary Global Covered Bond and/or Permanent Global Covered Bond may be required for Partly Paid issues)

32. Details relating to Instalment Covered Bonds; amount of each instalment, date on which each payment is to be made:

[Not Applicable/give details]

[For Instalment Covered Bonds:

Instalment Amount = [●]

Maximum Instalment Amount means, with respect to an Interest Period and a Series of Covered Bonds, the Relevant Percentage of the aggregate of principal receipts received by the Issuer in respect of

assets in the Cover Pool plus amounts in respect of notional principal received from any Swap Provider less amounts payable by the Issuer to any Swap Provider, in each case, converted where applicable into the Specified Currency at the applicable swap rate of exchange;]

(b) Instalment Date(s) = [●]

33. Redenomination: Redenomination [not] applicable (*if Redenomination is applicable, specify the applicable Day Count Fraction and any provisions necessary to deal with floating rate interest calculation (including alternative reference rates)*)

34. (a) Swap Provider [●]

(b) Nature of Swap [●]

35. Other final terms: [Not Applicable/give details]

(When adding any other final terms consideration should be given as to whether such terms constitute "significant new factors" and consequently trigger the need for a supplement to the Prospectus under Article 16 of the Prospectus Directive.)

DISTRIBUTION

36. (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: []

(The above is only relevant if the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies.)

(c) Stabilising Manager(s) (if any): [Not Applicable/give name]

37. If non-syndicated, name of Dealer: [Name]

38. U.S. Selling Restrictions: [Reg. S Category; TEFRA D/TEFRA C/TEFRA not applicable]

39. Additional selling restrictions: [Not Applicable/*give details*]

PURPOSE OF FINAL TERMS

These Final Terms comprise the final terms required for listing on the official list of the Luxembourg Stock Exchange, and admission to trading on the Regulated Market of the Luxembourg Stock Exchange of the Covered Bonds described herein pursuant to the €1,000,000,000 Covered Bond Programme of Arion Bank hf.

RESPONSIBILITY

The Issuer accepts responsibility for the information contained in these Final Terms. *[[Relevant third party information, for example in compliance with Annex XII to the Prospectus Directive Regulation in relation to an index or its components]* has been extracted from [specify source]. 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 [specify source], no facts have been omitted which would render the reproduced information inaccurate or misleading].

Signed on behalf of the Issuer:

By:

Duly authorised signatory

PART B – OTHER INFORMATION

1. LISTING AND 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)*] and, if relevant, listing on an official list (for example, the Official List 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)*] and, if relevant, listing on an official list (for example, the Official List of the Luxembourg Stock Exchange)] with effect from [].] [Not Applicable.]

(Where documenting a fungible issue need to indicate that original Covered Bonds are already admitted to trading.)

Estimate of total expenses related to admission to trading: [●]

2. RATINGS

Ratings:

The Covered Bonds to be issued have been rated:

[S & P: []]
[Moody's: []]
[Fitch: []]
[[Other]: []]

[Need to include a brief explanation of the meaning of the ratings if this has previously been published by the rating provider.]

(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.)

[The Covered Bonds to be issued [[have been]/[are expected to be]] rated [*insert details*] by [*insert credit rating agency name(s)*].]

[[*Insert the legal name of the relevant CRA entity*] is established in the European Union and is registered under Regulation (EC) No. 1060/2009 (as amended). [As such [*Insert the legal name of the relevant CRA*

entity] is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation.]]

[[*Insert the legal name of the relevant non-EU CRA entity*] is not established in the European Union and is not registered in accordance with Regulation (EC) No. 1060/2009(as amended). [[*Insert the legal name of the relevant non-EU CRA entity*] is therefore not included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation.]

[[*Insert the legal name of the relevant non-EU CRA entity*] is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009(as amended) (the **CRA Regulation**). However, the application for registration under Regulation (EC) No. 1060/2009 of [*insert the name of the relevant EU CRA affiliate that applied for registration*], which is established in the European Union and is registered under the CRA Regulation [(and, as such is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation)], disclosed the intention to endorse credit ratings of [*insert credit rating agency*]. While notification of the corresponding final endorsement decision has not yet been provided by the relevant competent authority, the European Securities Markets Authority has indicated that ratings issued in third countries may continue to be used in the EU by the relevant market participants for a transitional period ending on 30 April 2012.]

[[*Insert the legal name of the relevant non-EU CRA entity*] is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009(as amended) (the **CRA Regulation**). The ratings [[have been]/[are expected to be]] endorsed by [*insert the name of the relevant EU-registered credit rating agency*] in accordance with the CRA Regulation. [*Insert the name of the relevant EU-registered credit rating agency*] is established in the European Union and registered under the CRA Regulation. [As such [*insert the legal name of the relevant EU CRA entity*] is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation.]

[[*Insert the legal name of the relevant non-EU CRA entity*] is not established in the European Union and

has not applied for registration under Regulation (EC) No. 1060/2009(as amended) (the **CRA Regulation**), but it is certified in accordance with the CRA Regulation.] [[*EITHER:*] and it is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation] [*OR:*] although notification of the corresponding certification decision has not yet been provided by the relevant competent authority and [*insert the legal name of the relevant non-EU CRA entity*] is not included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation].]

[[*Insert the legal name of the relevant CRA entity*] is established in the European Union and has applied for registration under Regulation (EC) No. 1060/2009 (as amended), although notification of the corresponding registration decision has not yet been provided by the relevant competent authority[and [*insert the legal name of the relevant CRA entity*] is not included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation].]

[[*Insert the legal name of the relevant non-EU CRA entity*] is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009 (as amended) (the **CRA Regulation**). However, the application for registration under the CRA Regulation of [*insert the legal name of the relevant EU CRA entity that applied for registration*], which is established in the European Union, disclosed the intention to endorse credit ratings of [*insert the legal name of the relevant non-EU CRA entity*][, although notification of the corresponding registration decision has not yet been provided by the relevant competent authority and [*insert the legal name of the relevant EU CRA entity*] is not included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation].]

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

[Save for any fees payable to the [Managers/Dealer], so far as the Issuer is aware, no person involved in the issue of the Covered Bonds has an interest material to the offer. - *Amend as appropriate if there are other interests*]

[(*When adding any other description, consideration should be given as to whether such matters described constitute "significant new factors" and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive.*)]

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: []

The yield is calculated at the Issue Date on the basis of the Issue Price. It is not an indication of future yield.]

6. [PERFORMANCE OF INDEX/FORMULA, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING (INDEX-LINKED COVERED BONDS ONLY)]

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

[Where the underlying is an index need to include the name of the index and a description if composed by the Issuer and if the index is not composed by the Issuer need to include details of where the information about the index can be obtained.]

[Include other information concerning the underlying required by paragraph 4.2 of Annex XII of the Prospectus Directive Regulation.]

[(When completing the above paragraphs, consideration should be given as to whether such matters described constitute "significant new factors" and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive.)]

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. [PERFORMANCE OF RATE[S] OF EXCHANGE AND EXPLANATION OF EFFECT ON VALUE OF INVESTMENT (DUAL CURRENCY COVERED BONDS ONLY)]

[Need to include details of where past and future performance and volatility of the relevant rates can be obtained.]

[(When completing this paragraph, consideration should be given as to whether such matters described constitute "significant new factors" and consequently trigger the need for a supplement to the Offering Circular under Article 16 of the Prospectus Directive.)]

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.)

8. 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/*give name(s) and number(s)/ISD, Iceland. 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.*]
- (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) Intended to be held in a manner which would allow Eurosystem eligibility: [Yes][No]
- [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 satisfaction of the Eurosystem eligibility criteria.][*include this text if "yes" selected in which case the Bearer Covered Bonds must be issued in NGCB form*]

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 in relation to any Tranche of Covered Bonds may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Covered Bonds. 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 of Iceland, and any reference to currencies other than ISK, and to Index-Linked Covered Bonds and Dual Currency 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 (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, supplement these Conditions and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the Conditions, replace or modify 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.

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 are (a) expressed to be consolidated and form a single series and (b) identical in all respects (including as to listing and admission to trading) except for their respective Issue Dates, (unless this is a Zero Coupon Covered Bond) Interest Commencement Dates and/or Issue Prices.

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 10 February 2012 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 Index Linked Interest Covered Bond, a Dual Currency Interest Covered Bond or a combination of any of the foregoing, depending upon the Interest Basis shown in the applicable Final Terms.

This Covered Bond may be an Index Linked Redemption Covered Bond, an Instalment Covered Bond, a Dual Currency Redemption Covered Bond, a Partly Paid Covered Bond or a combination of any of the foregoing, 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.

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);

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 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, if they are Partly Paid Covered Bonds, the aggregate amount paid up); 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 and Index Linked Interest Covered Bonds

(a) Interest Payment Dates

Each Floating Rate Covered Bond and Index Linked Interest 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 and Index Linked Interest 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 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.

In the case of Floating Rate Covered Bonds other than ISD Covered Bonds, the Agency Agreement contains provisions for determining the Rate of Interest in the event that the Relevant Screen Page is not available or if, in the case of (A) above, no such offered quotation appears or, in the case of (B) above, fewer than three such offered quotations appear, in each case as at the time specified in the preceding paragraph.

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 Index Linked Interest Covered Bonds and 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. In the case of Index Linked Interest Covered Bonds other than ISD Covered Bonds, the Calculation Agent will notify the Fiscal Agent of the Rate of Interest and, in the case of Index Linked Interest Covered Bonds which are ISD Covered Bonds, the Calculation Agent will notify the ISD Agent of the Rate of Interest, in each case for the relevant Interest Period as soon as practicable after calculating the same.

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 or Index Linked Interest Covered Bonds for the relevant Interest Period by applying the Rate of Interest to:

- (i) in the case of Floating Rate Covered Bonds or Index Linked Interest 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, if they are Partly Paid Covered Bonds, the aggregate amount paid up); or
- (ii) in the case of Floating Rate Covered Bonds or Index Linked Interest 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 or Index Linked Interest 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:

Y₁ is the year, expressed as a number, in which the first day of the Interest Period falls;

Y₂ is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M₁ is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M₂ is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D₁ is the first calendar day, expressed as a number, of the Interest Period, unless such number is 31, in which case D₁ will be 30; and

D₂ 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 D₁ is greater than 29, in which case D₂ 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:

Y₁ is the year, expressed as a number, in which the first day of the Interest Period falls;

Y₂ is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M₁ is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M₂ is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D₁ is the first calendar day, expressed as a number, of the Interest Period, unless such number would be 31, in which case D₁ will be 30; and

D₂ 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 D₂ 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:

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

where:

Y₁ is the year, expressed as a number, in which the first day of the Interest Period falls;

Y₂ is the year, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

M₁ is the calendar month, expressed as a number, in which the first day of the Interest Period falls;

M₂ is the calendar month, expressed as a number, in which the day immediately following the last day of the Interest Period falls;

D₁ 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 D₁ will be 30; and

D₂ 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 D₂ 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 or Index Linked Interest 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 or Index Linked Interest 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 or Index Linked Interest 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 or Index Linked Interest 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 Dual Currency Interest Covered Bonds

The rate or amount of interest payable in respect of Dual Currency Interest Covered Bonds shall be determined in the manner specified in the applicable Final Terms.

6.4 Interest on Partly Paid Covered Bonds

In the case of Partly Paid Covered Bonds (other than Partly Paid Covered Bonds which are Zero Coupon Covered Bonds), interest will accrue as aforesaid on the paid-up nominal amount of such Covered Bonds and otherwise as specified in the applicable Final Terms.

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 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 any fiscal or other laws and regulations applicable thereto in the place of payment, but without prejudice to the provisions of Condition 9.

7.2 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 in definitive bearer form (other than Dual Currency Covered Bonds, Index Linked Covered Bonds or 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 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, Dual Currency Covered Bond, Index Linked 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) 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.

7.3 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.

7.4 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.

7.5 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.

7.6 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.

7.7 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.

7.8 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 8.5); 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.

7.9 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 (including each Index Linked Redemption Covered Bond and Dual Currency Redemption 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 Index Linked Interest Covered Bond nor a Dual Currency Interest Covered Bond) or on any Interest Payment Date (if this Covered Bond is either a Floating Rate Covered Bond, an Index Linked Interest Covered Bond or a Dual Currency Interest 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 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, or determined in the manner 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.

8.4 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 depository 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.

8.5 Early Redemption Amounts

For the purpose of sub-clause 8.2 above (*Redemption for Tax Reasons*), each Covered Bond will be redeemed at the Early Redemption Amount. The Early Redemption Amount is calculated as follows:

- (a) in the case of a Covered Bond with a Final Redemption Amount equal to the Issue Price, at the Final Redemption Amount thereof;
- (b) in the case of a Covered Bond (other than a Zero Coupon Covered Bond but including an Instalment Covered Bond and a Partly Paid Covered Bond) with a Final Redemption Amount which is or may be less or greater than the Issue Price or which is payable in a Specified Currency other than that in which the Covered Bond is denominated, at the amount specified in, or determined in the manner specified in, the applicable Final Terms or, if no such amount or manner is so specified in the applicable Final Terms, at its nominal amount; or
- (c) in the case of a Zero Coupon Covered Bond, 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.

8.6 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.

8.7 Partly Paid Covered Bonds

Partly Paid Covered Bonds will be redeemed, whether at maturity, early redemption or otherwise, in accordance with the provisions of this Condition and the applicable Final Terms.

8.8 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.

8.9 Cancellation

All Covered Bonds which are redeemed or surrendered for cancellation pursuant to paragraph 8.8 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.

8.10 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 8.4 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 8.5(c) 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 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 (i) by or on behalf of any Tax Jurisdiction or (ii) 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 and any regulations or agreements thereunder or official interpretations thereof, unless such withholding or deduction is required by law (including pursuant to an agreement described in Section 1471(b) of the Code or otherwise imposed pursuant to Sections 1471 through

1474 of the Code and any regulations or agreements thereunder or official interpretations thereof). 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 7.7); or
- (d) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (e) presented for payment by or on behalf of a holder who would have been able to avoid such withholding or deduction by presenting the relevant Covered Bond, Receipt or Coupon to another Paying Agent in a Member State of the European Union; or
- (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.
- (g) where such withholding or deduction is required by reason of the failure by any person other than the Issuer or an Agent to claim or perfect an exemption from any withholding or deduction (including, for the avoidance of doubt, as a result of any payment being made through an intermediary other than an Agent that is subject to withholding or deductions pursuant to Sections 1471 through 1474 of the Code and any regulations or agreements thereunder or official interpretations thereof).

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 7.2) or any Talon which would be void pursuant to Condition 7.2.

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, a Registrar and an ISD Agent; and
- (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) 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); and
- (c) there will at all times be a Paying Agent in a Member State of the European Union that will not be obliged to withhold or deduct tax pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; 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.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in Condition 7.5. 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, a Participating FFI, 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 Luxemburger 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 notes 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 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 and each Interest Rate 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.

SUMMARY 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 state or other member state, municipality in Iceland or in another member state, or guaranteed by such member state within the European Economic Area 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 heildarffjárhæð 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 heildarffjárhæð 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 and registered address at Borgartún 19, Reykjavík. 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. Looking ahead, a new strategic plan was finalised 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.

In the year ended 31 December 2010, the Bank's net interest income was ISK 19.8 billion (compared to ISK 12.2 billion in 2009), its operating income was ISK 35.6 billion (compared to ISK 31.9 billion in 2009) and its net earnings were ISK 12.6 billion (compared to ISK 12.9 billion in 2009). In the six months ended 30 June 2011, the Bank's net interest income was ISK 11.2 billion, its operating income was ISK 24.5 billion and its net earnings were ISK 10.2 billion. As at 30 June 2011, the Bank's total assets were ISK 805.3 billion.

The Bank's 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 Althing. 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 Bogarnes, increasing its customer base by a further 2,000 clients.

In December 2009, the Kaupthing Resolution Committee acting through Kaupskil ehf. (**Kaupskil**), a wholly-owned subsidiary of Kaupthing, 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.

Current Winding up Proceedings for Kaupthing

In October 2008, Kaupthing was taken into a special resolution regime (see "*Risk Factors - The Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and remains vulnerable to external shocks and a range of internal risks*"), and the Kaupthing Resolution Committee was appointed by the FME. The relevant provisions which set out the details of this regime are found in the Act on Financial Undertakings no. 161/2002 (the FUA), and subsequent amendments and the Act on Bankruptcy etc. no.21/1991 (the **Bankruptcy Act**). The FUA in some respects deviates from the Bankruptcy Act, but in other respects applies its general provisions.

Under this regime, Kaupthing does not go bankrupt like other corporate entities or individuals under the Bankruptcy Act. 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.

Pursuant to the FUA, the Kaupthing Resolution Committee is given power by law to represent Kaupthing in all matters and safeguard its interest. The Kaupthing Resolution Committee has a legal obligation to maximise the value of Kaupthing's assets and preserve the interest of the creditors as a whole. In addition the Kaupthing Resolution Committee is responsible for managing 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. The Winding-up Committee works alongside the Kaupthing Resolution Committee. In short the Kaupthing Resolution Committee is primarily responsible for managing daily operations, including representing Kaupthing, safeguarding its interests and maximising creditors' asset value, whereas the Winding-up Committee administers the formal process of filing and handling all claims against Kaupthing.

Under winding-up proceedings, agreements and obligations of the financial undertaking continue to exist and Kaupthing is protected against petitions for insolvent liquidation. Its assets cannot become subject to an attachment, execution or forced sale. No law suit can be filed against Kaupthing in Iceland while it is 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 Winding-up Committee is in full control of Kaupthing during the winding-up proceedings and has full authority to manage its business, in accordance with the FUA.

In June 2011, the Icelandic parliament passed an amendment to the FUA. Changes put in place through this amendment include that the Kaupthing Resolution Committee was dissolved on 1 January 2012.

Consequently, the Winding-up Committee has assumed all responsibility for managing the Kaupthing estate as of 1 January 2012.

The current winding-up process is in essence a temporary period for Kaupthing. According to the FUA a company can only be in winding-up proceedings as long as the intention is to achieve a composition with creditors.

Since the claims against Kaupthing exceed its assets, the Winding-up Committee is currently seeking composition with Kaupthing's creditors and working to prepare a draft proposal to that effect. In the event that such efforts prove unsuccessful and a proposal is not approved by the creditors or there is no basis for seeking a composition, the Winding-up Committee is likely to request that the District Court which appointed it, to place Kaupthing in bankruptcy proceedings. If Kaupthing is declared bankrupt, the general rules on bankruptcy proceedings would apply, which may result in the forced sale of assets and other similar processes. However, all actions taken during the winding-up proceedings concerning claims against Kaupthing including the notice to creditors and the processing of claims submitted shall remain valid.

More information about Kaupthing, its current status and potential closing of the winding-up proceedings can be found on www.kaupthing.com.

Kaupskil as 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 Resolution 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/?PageID=14&NewsID=504>).

STRATEGY

Following his appointment in June 2010, the new CEO sought to establish a new strategic plan for the Bank which was finalised 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, efficiency and profitability in its operations. In particular, the Bank has reduced its branch network from 39 branches at the end of 2008 to 24 branches at 30 June 2011 and has also sought to reduce back office costs and streamline its organisational structure.

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

For management reporting purposes, the Bank's business has, since 1 January 2011, operated in the following four principal reporting segments:

- **Corporate Banking and Capital Markets:** which comprises the Bank's corporate banking and capital markets divisions;
- **Retail Banking:** which comprises the Bank's retail banking division;
- **Asset Management :** which principally comprises the Bank's asset management and private banking divisions; and
- **Corporate Finance:** which principally comprises the Bank's corporate finance division.

Prior to 1 January 2011, the Bank had three principal reporting segments as follows:

- **Corporate Banking and Capital Markets:** which comprises the Bank's corporate banking and capital markets divisions;
- **Retail Banking:** which comprises the Bank's retail banking division; and
- **Other:** which principally comprises the Bank's asset management and corporate finance divisions but also includes the support divisions and certain non-core activities.

The tables below show operating income and earnings before tax for each segment for each of the six month periods ended 30 June 2011 and 30 June 2010 and for each of the two years ended 31 December 2010 and the total assets of each segment at 30 June 2011, 31 December 2010 and 31 December 2009.

Six months ended/as at 30 June 2011						
	Corporate Banking and Capital Markets	Retail Banking	Asset Management and Private Banking	Corporate Finance	Other and eliminations	Total
	<i>(ISK million)</i>					
Operating income	15,230	8,086	2,408	398	(1,630)	24,492
Earnings before tax.....	13,905	1,350	1,499	269	(3,300)	13,723
Total assets	259,002	226,041	3,505	17,360	299,392	805,300
Six months ended 30 June 2010						
	Corporate Banking and Capital Markets	Retail Banking	Asset Management and Private Banking	Corporate Finance	Other and eliminations	Total

(ISK million)

Operating income	10,582	5,041	1,673	75	(239)	17,132
Earnings before tax.....	9,614	612	906	(266)	(2,135)	8,731

Year ended/as at 31 December 2010

	Corporate Banking and Capital Markets	Retail Banking	Other (including eliminations)	Total
	<i>(ISK million)</i>			
Operating income	24,189	15,107	(3,673)	35,623
Earnings before tax.....	21,856	5,231	(9,756)	17,331
Total assets.....	273,502	233,288	305,825	812,615

Year ended/as at 31 December 2009

	Corporate Banking and Capital Markets	Retail Banking	Other (including eliminations)	Total
	<i>(ISK million)</i>			
Operating income	6,941	11,047	13,876	31,865
Earnings before tax.....	5,286	2,747	8,486	16,519
Total assets.....	540,459	137,364	79,521	757,344

The chart below illustrates the Bank's principal operating and support functions as at December 2011.



Corporate Banking and Capital Markets Divisions

The Bank's Corporate Banking and Capital Markets divisions provide universal financial services to meet the needs of large corporations, asset management companies, institutional investors and domestic financial institutions. These divisions employed 41 employees at 30 June 2011.

Corporate Banking Division

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 food and beverages 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 and internet banking.

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 kronur. 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.

Capital Markets Division

The Capital Markets division provides securities brokerage and foreign exchange (FX) sales for institutional investors and corporate clients. It is divided into FX and Fixed Income Sales, Equity Sales and Research units.

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.

The Research unit provides equity, fixed income and macro analysis for its clients. The principal clients of the Research unit are asset management companies, institutional investors and other divisions of the Bank. The Research unit seeks to enhance the services provided to clients of the Bank by providing superior equity, fixed income, real estate and sector analysis. In addition, the Research unit issues regular economic forecasts and updates on key economic developments in Iceland.

In line with the Bank's strategy, the Corporate Banking and Capital Markets divisions aim to strengthen long-term relationships with current clients as well as attracting new customers to the Bank by continuing to provide outstanding customer service and products. In particular, these divisions financial focus on servicing larger corporations in complex working environments through the provision of tailored solutions.

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 June 2011, 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 385 employees at 30 June 2011.

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 by 15 branches 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 seven clusters, 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. Four 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.

Retail Banking is currently focused on delivering solutions for customers experiencing financial distress and, by 30 June 2011, had assisted around 14,000 such customers. At the end of 2010, the Bank launched a debt advisory service through which specialists working in debt recovery can work with households in default with a view to helping them resolve their financial problems as soon as possible. Through this programme, which finished at the end of June 2011, the Bank reduced the debt level of 4,976 families by an average of 24.4 per cent. At the beginning of 2011, an agreement was reached between various business sector interest groups, financial companies, the Ministry of Economic Affairs, and the Ministry of Finance on the financial restructuring of SMEs. This agreement outlined joint rules on the financial restructuring of companies, whereby SMEs that qualify under the agreement enjoy a standardised approach to debt restructuring under which their outstanding debt is re-classified into senior debt on which performance in full is expected and subordinated debt which is initially non-performing and on which the Bank takes significant provisions. In certain cases, the Bank may also acquire equity in a restructured SME. As at 30 June 2011, the restructuring of 470 SMEs had been finalised under this programme

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**), operates the fund management business and the Asset Management division is the main fund distributor within the Bank. As at 30 June 2011, the Bank had consolidated assets under management of ISK 642 billion. Asset Management had 35 employees at 30 June 2011.

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. Significant products offered by the division include an asset allocation scheme, Eignaval, offered to private banking customers, the SÍA I Private Equity Fund launched by Stefnir, which is one of only a few post-crisis Icelandic private equity funds, and the Frjalsi Pension Fund, which was voted "The Best Pension Fund in Iceland" by Investment Pension Europe (IPE) Magazine for the second consecutive year in December 2010.

Corporate Finance Division

The Corporate Finance division is divided into two units, Corporate Advisory and Corporate Recovery.

Corporate Advisory

Corporate Advisory provides advisory services to corporate clients and investors in relation to merger and acquisition (**M&A**) and capital markets transactions. Corporate Advisory also advises the Bank's restructuring teams and manages the sales of certain assets acquired by the Bank through corporate insolvencies and restructurings. Corporate Advisory had 10 employees at 30 June 2011.

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 Advisory 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 Advisory has also provided valuation reports, managed bond offerings and advised clients on investment opportunities.

During 2009, Corporate Advisory advised the Bank in relation to the valuation of its opening balance sheet and negotiations between the Kaupthing Resolution Committee and the Icelandic Ministry of Finance.

Corporate Recovery

The Corporate Recovery unit is responsible for the Bank's debt recovery and is particularly involved in restructuring companies which are experiencing payment difficulties. Corporate Recovery's 15 employees at 30 June 2011 are divided into three teams:

- SME restructurings;
- large corporate restructurings; and
- a support team.

Corporate clients who are unable to meet their obligations to the Bank are encouraged to enter into a four phase process of restructuring: obtaining information, restructuring, implementation and completion. The Bank estimates that up to 1,000 corporate clients will need to go through the restructuring process. As at 30 June 2011, 944 clients had entered the process and the restructuring process had been completed in 884

cases. The restructuring projects have been prioritised, with an initial focus on companies with debts to the Bank in excess of ISK 100 million.

Since the third quarter of 2010, the Bank has increasingly focussed on its SME customers whose debts need to be restructured, see "*Retail Banking Division*".

The goal of the restructuring process is to create companies with a sustainable capital structure, no covenant breaches, satisfactory operating results and motivated management teams and owners. In certain cases, however, where the underlying cash flow of the company concerned is too weak to support ongoing operations, the company is put into liquidation or restructured. During the restructuring process the Bank may acquire assets previously owned by the restructured companies. These assets are transferred into separate holding companies under the control of the Bank, see "*Group Structure—Asset Holding Companies*".

Support Divisions

The Bank has five support divisions:

- **Corporate Development & Marketing:** This division assists the Bank in implementing organisational changes, entering new markets, introducing new products, acquiring or divesting assets or divisions and establishing strategic partnerships. The division also develops the Bank's marketing strategy and is responsible for brand management, coordinating marketing initiatives, marketing and tactical plans for products and services and market research, such as statistical analysis, focus groups, interviews and surveys. Finally, the division is responsible for developing the Bank's internet banking solutions, websites, online communication and electronic distribution channels. This division had 22 employees at 30 June 2011.
- **Finance:** The Finance division includes accounting, analysis, funding and treasury units. 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 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 46 employees at 30 June 2011.
- **Risk Management:** For a description of the activities of the Risk Management division, see "*Risk Management*". The Risk Management division had 27 employees at 30 June 2011.
- **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. As at 30 June 2011, the legal division was working on 5,900 collection cases, compared with 4,600 at 31 December 2009. The legal division had 34 employees at 30 June 2011.
- **Operations:** The Operations division comprises information technology (IT), human resources, back office and property management units. The Operations division had 233 employees at 30 June 2011.

GROUP STRUCTURE

The Bank is the parent company of a number of wholly-owned and majority-owned subsidiaries (together, the **Arion Group**), of which the most significant are:

Operating Subsidiaries

Stefnir

Stefnir hf. is Iceland's largest fund management company with assets of around ISK 300 billion under active management. 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 16 employees at 30 June 2011.

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 ráðgjöf, which also sells pension products on behalf of the Bank. Okkar is wholly-owned by the Bank and had 14 employees at 30 June 2011.

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. The Bank acquired 52.9 per cent. ownership of Valitor in October 2010.

Asset Holding Companies

The Bank has established a number of holding companies to manage the assets acquired by the Bank through customer debt restructurings. The aim is to preserve or increase the value of these assets before they are sold. The three principal asset holding companies are:

Eignabjarg ehf. (Eignabjarg)

Eignabjarg is a wholly-owned subsidiary of the Bank and is responsible for managing and selling shareholdings in companies which the Bank has acquired through debt restructurings or other enforcement procedures. Its function is 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. Eignabjarg aims to limit its holding period to as short a time as possible, without compromising its goal of maximising recovery through the divestment of assets.

Eignabjarg's principal holdings as at 30 June 2011 were:

- *Hagar hf.* – A retail company with extensive operations in Iceland. 35.5 per cent. of the shares in this company were sold in 2011. Following this, the shares in Hagar hf. were also listed on the NASDAQ OMX in Iceland (see <http://www.arionbanki.is/?pageid=3785&newsid=9436>).
- *Penninn á Íslandi ehf.* – This company owns and operates Eymundsson, Penninn, Griffill and Islandia stores in Iceland.
- *B.M. Vallá ehf.* – This company specialises in the production of cement, prefabricated housing units, walls and pumice. This company is in the process of being sold.
- *Reitir fasteignafélag ehf.* – This company is the largest service company in the field of commercial property letting in Iceland. Eignabjarg owns 42.7 per cent. of the shares of this company.

Landey ehf. (Landey)

Landey is a wholly-owned property development company which manages properties that currently do not generate revenue, such as building lots and unfinished housing developments. Landey's main objective is to maintain and maximise the value of its assets.

Landfestar ehf. (Landfestar)

Landfestar is a wholly-owned subsidiary and specialises in leasing business premises acquired through the debt restructuring process on a long-term basis. The majority of the property owned by Landfestar is commercial property in the Greater Reykjavík area. As at 30 June 2011, around 107,000 square metres was leased to approximately 100 tenants. The tenants include the Icelandic State Treasury and a number of Iceland's largest companies.

LOAN PORTFOLIO

The table below sets out details of the Bank's gross and net loans and receivables to customers as at 30 June 2011 and as at 31 December 2010 and 2009 classified by type of loan.

	As at 30 June	As at 31 December	
	2011	2010	2009
		<i>(ISK million)</i>	
Overdrafts	35,470	37,390	31,673
Subordinated loans	548	499	17
Other loans and receivables	452,388	455,173	354,780
Total gross customer loans and receivables	488,406	493,062	386,470
Provision on customer loans and receivables.....	(40,691)	(41,843)	(28,736)
Total net customer loans and receivables	447,715	451,219	357,734

The table below sets out details of the Bank's net loans and receivables to customers as at 30 June 2011 and as at 31 December 2010 and 2009 classified by customer sector.

	As at 30 June	As at 31 December	
	2011	2010	2009
		<i>(per cent.)</i>	
Individuals.....	24.2	24.7	15.5
Financial and insurance activities.....	17.2	14.1	14.8
Manufacturing, mining and other industries	9.7	13.3	16.1
Real estate activities	11.8	13.0	17.4
Agriculture, forestry and fishing	13.2	11.1	11.8
Wholesale and retail trade, transport, accommodation and food service activities	11.6	9.9	4.3
Business services.....	7.1	8.3	12.2
Construction.....	2.2	2.4	5.3
Public administration, defence, education, human health and social work activities	1.6	1.8	1.3
Other services.....	1.4	1.4	1.3
Total	100.0	100.0	100.0

As at 30 June 2011, the aggregate amount of the Bank's 10 largest customer loans and receivables equalled 29 per cent. of its total gross customer loans and receivables at that date.

In addition to its customer loans and receivables, the Bank has a portfolio of loans and receivables to credit institutions. The table below sets out details of the Bank's loans and receivables to credit institutions as at 30 June 2011 and as at 31 December 2010 and 2009 classified by type of loan.

	<u>As at 30 June</u>	<u>As at 31 December</u>	
	<u>2011</u>	<u>2010</u>	<u>2009</u>
		<i>(ISK million)</i>	
Bank accounts	55,419	57,707	24,037
Money market loans	10,646	1,294	4,733
Overdrafts	47	29	4,074
Other loans and receivables	6,502	10,175	6,353
Total gross loans and receivables to credit institutions	72,614	69,205	39,197
Provision on loans and receivables to credit institutions	(551)	(1,359)	(727)
Total net loans and receivables to credit institutions	72,063	67,846	38,470

The table below shows the credit quality of the Bank's total net loans and receivables as at 30 June 2011.

	<u>As at 30 June 2011</u>			
	<u>Neither past due nor impaired</u>	<u>Past due but not impaired</u>	<u>Individually impaired</u>	<u>Total</u>
		<i>(ISK million)</i>		
Loans and receivables to credit institutions	71,450	0	613	72,063
Loans and receivables to customers				
Loans to corporate	177,219	24,525	137,624	339,368
Loans to individuals	65,652	15,662	27,033	108,347
Total	314,321	40,187	165,270	519,778

The table below sets out details of the Bank's impaired loans and receivables to customers as at 30 June 2011 and as at 31 December 2010 and 2009 classified by customer sector.

	<u>As at 30 June</u>		<u>As at 31 December</u>			
	<u>2011</u>		<u>2010</u>		<u>2009</u>	
	<u>Impaired amount</u>	<u>Impaired loans</u>	<u>Impaired amount</u>	<u>Impaired loans</u>	<u>Impaired amount</u>	<u>Impaired loans</u>
	<i>(ISK million)</i>					
Individuals	6,594	33,627	5,472	35,118	1,201	8,058
Financial and insurance activities	5,294	22,068	4,673	24,228	6,934	20,990
Manufacturing, mining and other industry	2,678	20,972	2,136	19,095	2,466	18,207
Real estate activities	6,392	44,158	7,568	48,686	6,303	47,333
Agriculture, forestry and fishing	2,081	14,490	2,606	22,184	1,941	14,333
Wholesale and retail trade, transport, accommodation and food service activities	2,386	16,320	3,294	28,604	1,814	7,571
Business services	6,045	34,339	10,562	45,022	4,197	32,296
Construction	2,944	9,487	2,349	9,501	840	6,198
Public administration, defence, education, human health and social work activities	83	2,610	77	2,558	868	4,845
Other services	405	1,488	346	2,538	2,172	16,687
Total specifically impaired customer loans and receivables	34,902	199,559	39,083	237,534	28,736	176,518
Collective provision	5,789		2,760			
Total impaired customer loans and receivables	40,691	199,599	41,843	237,534	28,736	176,518

As at 30 June 2011, 32 per cent. of the book value of all non-performing loans was attributable to 5 customers. Of these 5 customers, one had performing senior loans and only restructured subordinated debt that was classified as non-performing. An additional 20 per cent. of non-performing loans as at 30 June 2011 was attributable to a further 11 customers.

FUNDING AND LIQUIDITY

Funding

The Bank is predominantly funded with domestic deposits. Its total deposit base was ISK 449 billion as at 30 June 2011 or 65.2% of its total Liabilities. The Bank's other funding as at 30 June 2011 was in the form of long-term debt provided by the Icelandic State and the Central Bank (ISK 100 billion as at 30 June 2011) and equity (ISK 110 billion as at 30 June 2011). As at 30 June 2011, 72.69 per cent. of the Bank's deposits were classified as on demand or withdrawable immediately, 7.57 per cent. had a maturity of up to three months, 7.79 per cent. had a maturity of between three and 12 months. 10.42 per cent. had a maturity of between one and five years and 1.54 per cent. had a maturity of more than five years.

The Bank's deposit base has been classified according to its stickiness. The stickiness of the deposit base is determined by the stability of the deposits in the past and their expected stability in the future. Deposits that are determined to have the highest stickiness are the ones that have proven to be the most stable funding source for the Bank in the past and are expected to remain so. The least sticky deposits are the deposits that are expected to be withdrawn under particular circumstances, such as the lifting of capital controls. The Bank's deposits are classified into seven categories, the first category being the least sticky and the seventh being the most sticky.

In the first category, which represented eight per cent. of the Bank's deposits as at 30 June 2011, are deposits from customers that are believed to be waiting to withdraw their deposits when the capital controls are lifted. This category includes foreign financial institutions. The second category, which represented nine per cent. of the Bank's deposits as at 30 June 2011, includes deposits from entities that are in the resolution process, these are in many cases entities that are insolvent and their deposits held as security against other liabilities. An example of such a depositor is Kaupthing Bank hf. The third category, which represented 29 per cent. of the Bank's deposits as at 30 June 2011, includes investors who may reduce their deposits when other investment opportunities become available or if a competitor bank raises its interest rates on deposits. This category includes Icelandic pension funds. The fourth category, which represented eight per cent. of the Bank's deposits as at 30 June 2011, includes legal entities where the deposit is the primary business with the Bank. The fifth category, which represented 12 per cent. of the Bank's deposits as at 30 June 2011, includes individuals that have little other business than depositing with the Bank, including people near to retirement age that have low debt and high savings. The sixth category, which represented 16 per cent. of the Bank's deposits as at 30 June 2011, includes legal entities which have a broader banking relationship with the Bank. The seventh category, which represented 18 per cent. of the Bank's deposits as at 30 June 2011, contains individuals who may have a mortgage or a bank account where their salaries are deposited.

The table below shows the split between different levels of the Bank's deposit stickiness as at 30 June 2011 and as at 31 December 2010 and 2009 according to the Bank's classification.

	As at 30 June		As at 31 December			
	2011		2010		2009	
	(per cent.)	(ISK million)	(per cent.)	(ISK million)	(per cent.)	(ISK million)
1 (least sticky)	8	41,924	7	39,932	6	36,547
2	9	47,688	9	48,718	12	73,093
3	29	149,877	29	160,437	25	152,278
4	8	43,496	9	49,817	9	54,820
5	12	61,837	12	66,423	13	79,185
6	16	85,944	17	94,100	15	91,367
7 (most sticky)	18	93,280	17	94,100	20	121,822
Total	100	524,046	100	553,527	100	609,112

As at 30 June 2011, the aggregate amount of the Bank's 10 largest deposits equalled 29 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 a 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 diversify its funding profile by issuing bonds in the domestic bond market when conditions permit.

Liquidity

The Bank is liquid and meets the FME's guidelines on a minimum secured liquidity ratio of 20 per cent. At 30 June 2011, secured liquid assets represented 35 per cent. of deposits which would enable the Bank to withstand an instantaneous deposit outflow in excess of the FME's requirements. The Bank's secured liquidity primarily comprises of cash deposits and Icelandic government bonds. The Bank's cash ratio at 30 June 2011 was 16 per cent., significantly higher than the five per cent. minimum stipulated by the FME. The ratio requires that the Bank should have more than five per cent. of its on demand deposits available in cash at any given time. See further "*Risk Management—Liquidity Risk*".

RISK MANAGEMENT

Overview

The Bank seeks to manage its risks through a process of ongoing 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 Arion Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Arion Group'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 its 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.
- Credit Committees. The Bank operates a number of credit committees. The committee with the highest authority is the Board Credit Committee which decides on all major credit risk exposures. The next highest credit granting authority is the Bank Credit Committee which operates within limits specified as a fraction of the Bank's capital. The Bank Credit Committee is chaired by the CEO. The third highest credit granting authority is the Corporate Credit Committee, which is a joint credit committee for the Corporate Banking, Capital Markets and Retail Banking divisions. There are also seven Retail Credit Committees, one for each branch cluster which have tighter limits than the Corporate Credit Committee.

The Bank also has two temporary recovery committees that are focused on recovery cases, one for corporate customers and the other for retail customers. The recovery committees have authority to approve credit and write-offs, within their limits, in connection with recovery proposals. The Bank expects that the recovery committees will be combined with the existing Corporate and Retail credit committees, respectively, once the corporate and retail restructuring processes have been substantially completed.

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 divided into five units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Credit Analysis, which supports and monitors the credit granting process; Portfolio Risk, which monitors liquidity risk and risks in the Bank's assets and liabilities at the portfolio level; Economic Capital, which is responsible for the Bank's ICAAP and for monitoring portfolio credit risk; and Operational Risk, which monitors risks associated with the daily operations of the Bank.

The Bank is exposed to four major areas of risk: credit risk, market risk, liquidity risk, foreign exchange risk and operational risk.

Credit Risk

The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and groups of connected clients, by monitoring exposures in relation to those limits and by taking collateral where appropriate. The Bank is principally exposed to credit risk through loans granted, through commitments to extend credit to the extent that they can't be cancelled, through guarantees given by the Bank and through derivatives which have positive fair values where the Bank is exposed to the ability of the counterparty to make any payments due. Note 53(a) to the Bank's consolidated interim financial statements as at and for the six months ended 30 June 2011 (the **Interim Financial Statements**) shows the Bank's maximum exposure to credit risk by type of instrument and industry classification of customer. As at 30 June 2011 and 31 December 2010, the Bank's total on and off balance sheet credit risk exposure totalled ISK 765.5 billion and ISK 781.5 billion respectively, of which the major industry exposures at 31 December 2010 were (i) financial and insurance activities (37 per cent. of the total exposure), (ii) individuals (17 per cent. of the total exposure) and (iii) services such as business services, public administration, defence, education, health and social work (15 per cent. of the total exposure).

The Bank is currently focused on recovering value from the portfolio of impaired assets which was acquired from Kaupthing. Accordingly, the Bank has expanded its Corporate Recovery unit, established procedures which outline how value will be maximised without compromising transparency and refined its internal classification system to provide early identification of possible changes in the creditworthiness of counterparties.

Credit Approval Process

As discussed above, the Bank has a tiered structure of credit approval committees. The table below summarises the authority of each relevant committee.

Credit Committee	Number		New loan	Total Limits	Write-offs	Debt forgiveness	Granting of waivers
	Members	Quorum					
Board	At least 3	2	>5% of CB ⁽¹⁾	>15% of CB	>ISK 500m	>ISK 150m	As applicable
Bank	4	2	<5% of CB	<15% of CB	<ISK 500m	<ISK 150m	All waivers
Corporate	5	3	<ISK 250m	<10% of CB *	<ISK 250m	0**	Limited waivers
Corporate Recovery ⁽²⁾	4	3	<ISK 250m	<10% of CB*	<ISK 250m	0**	None
Retail	3	2	<ISK 100m	<ISK 100m*	<ISK 100m	0**	None
Retail Recovery ⁽²⁾	4	3	<ISK 100m	<ISK 200 m*	<ISK 100m	0**	None

Notes:

- (1) CB means the Bank's capital base
- (2) The Bank expects that these recovery committees will be combined with the existing Corporate and Retail credit committees, respectively, once the corporate and retail restructuring processes have been substantially completed
- (3) * means that there are some exceptions
- (4) ** means that the Bank Credit Committee is authorised to extend the authority specified

The Bank's credit approval process begins when a loan application is made, through an account manager (in the case of a corporate client), using the Bank's standard application forms together with appropriate supporting material such as financial statements and budgets (for corporate customers) and proof of identity and income (for retail clients). In addition, information relating to any collateral to be provided must also be supplied.

A credit analyst will screen the application and confirm the customer rating. The application is then submitted to the appropriate credit committee for consideration and is either approved, rejected or further information is required. Once a loan has been approved at credit committee, appropriate legal documentation is prepared and the loan is disbursed once all documentation is signed and conditions precedent to lending have been satisfied.

The amount and type of collateral required by the Bank in relation to a new loan depends on the Bank's assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained by the Bank are:

- For retail lending, mortgages over residential properties;
- For corporate lending, charges over real estate, fixed and current assets, inventory and trade receivables; and
- For derivative exposures, cash or treasury bills.

The loan to value ratios (LTV) permitted by the Bank differ depending on the type of asset to be used as collateral. In the case of fixed assets such as commercial or residential properties and fishing vessels with an allocated fishing quota, the accepted LTV is 75 per cent. For commercial and residential properties, the Bank bases its valuation on (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. For fishing vessels and quotas, the Bank bases the valuation on the market prices of the quotas

concerned. When valuing fishing vessels, the Bank relies on the valuation from the borrower's insurance company or a ship brokerage company valuation.

The value of any collateral given is monitored by the credit control unit in the Risk Management department 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.

At 30 June 2011, the value of collateral that the Bank holds relating to loans individually determined to be impaired amounted to ISK 78,518 million, or 47.51 per cent., of the aggregate amount of such loans.

Credit Monitoring

The valuation of assets that were transferred to the Bank from Kaupthing attempted to account for all realised and foreseen losses. Whilst this has significantly reduced the credit risk that would otherwise have been present in the Bank's loan portfolio. The Bank is still exposed to credit-type risks through the loan portfolio relating to the accuracy of the transfer valuation, the performance of the loans and the success of the Bank in restructuring non-performing loans. The Bank also has credit concentrations to a few significant customers and to certain business sectors, such as the financial and insurance sector, the agriculture, forestry and fishing sector and the real estate sector.

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 the quality of their management and strategy and their current market position) and quantitative factors (such as their equity and liquidity ratios). The rating model for SMEs and individuals are purely quantitative models. The internal rating classifications used are:

- *Performing.* In order to be classified as performing, payments must be being made under the loan on a timely basis or, where there are payment delays, these must be of less than 30 days' duration. Performing loans must also have either a debt to EBITDA ratio of less than 4:5 or an LTV ratio of less than 75-90 per cent. (varying within these ranges for different industry sectors), as appropriate, and, where required under the terms of the relevant loan, an equity ratio of greater than 15-30 per cent. In all cases, the exact ratio to be satisfied depends on the sector concerned and the collateral underlying the loan. Performing loans must also have a credit rating (assigned by the economic capital unit in the Risk Management department) of greater than or equal to B and there must be no covenant breaches.
- *Watch.* These are loans for which there are payment delays of between 30 and 90 days' duration. In order to be classified as watch, loans must have a debt to EBITDA ratio of between 4-6 or an LTV ratio of less than 75-90 per cent. (varying within these ranges for different industry sectors), as appropriate, and, where required under the terms of the relevant loan, an equity ratio of between 10-30 per cent. In all cases, the exact ratio to be satisfied depends on the sector concerned and the collateral underlying the loan. Watch loans must also have a credit rating (assigned by the economic capital unit) of at least CCC+ and only minor covenant breaches.
- *Sub-performing.* Loans which have payment delays of more than 90 days' duration, a debt to EBITDA ratio of greater than 5-6 or an LTV ratio of between 90-100 per cent., as appropriate, an equity ratio of less than 10-20 per cent. (where required under the terms of the relevant loan), a credit rating (assigned by the economic capital unit) of less than CCC+ and/or serious covenant breaches will be classified as sub-performing. In all cases, the exact ratio to be satisfied depends on the sector concerned and the collateral underlying the loan. Only customers with sufficient collateral to cover the existing loan can be classified as sub-performing if the loan is more than 90 days in default.
- *Non-performing.* Sub-performing loans for which specific provisions have been made are classified as non-performing.

Customers with less than ISK 100 million of loans are classified based on provisioning, days in default, LTV ratio and credit rating.

In all cases, the determination is made with respect to customers rather than individual loans. As a result, if a customer has both performing and non-performing loans, all the loans will be classified at the same level. This will often be the case for customers whose loans have been restructured as the Bank's restructuring process includes solutions whereby a customer has both a senior loan which is expected to be fully performing and a subordinated loan which is classified as non performing and is significantly provisioned by the Bank, see "*Credit Recovery Process*".

In addition, the above classification is predominately based on contractual loan terms. For instance, the debt to EBITDA and equity ratios do not take into account the fact that the Bank is holding a borrower's debt at a discount. Also, a borrower who is making irregular payments may be in default relative to the contractual terms but may still be fulfilling the obligations anticipated for the loan when it was transferred to the Bank and on which its value to the Bank was calculated.

The following table shows a breakdown of the Bank's loan portfolio as at 30 June 2011 by classification:

	As at 30 June 2011
	(per cent.)
Performing	42
Watch	11
Sub-performing	17
Non-performing.....	30
Total	100

Credit Recovery Process

The Bank has developed a number of solutions to assist customers that are experiencing payment difficulties.

The recovery strategy is based on identifying clusters of similar customers and implementing standardised solutions for those customers based, where applicable, on the provisions of Icelandic law implementing an agreement between the Icelandic Government and financial institutions on the restructuring of loans to individuals and SMEs. In the case of larger companies, the solutions are tailored to the circumstances of each company.

Solutions for Individuals

These solutions are:

- Temporary payment relief, such as payment holidays, payment of a fixed amount of ISK 5,000 per ISK 1 million borrowed and amending loans which are linked to a consumer price index or currency exchange rate so that they are linked to a national salary index instead.
- Writing down mortgage loans to 110 per cent. of the market value of the underlying property, up to a limit of ISK 4 million per individual. If interest and instalment payments exceed 20 per cent. of the customer's total income, the write-off amount can be up to ISK 15 million per individual.
- Special debt adjustments for those with serious financial difficulties and a negative equity position. Payments are adjusted to the customer's ability to pay. The loan can be written down to 70 per cent. of the market value of the customer's assets/the underlying security for the loan and the difference between

70 per cent. and 100 per cent. of the value of the assets/security is restructured into a three year loan with no interest. Debt exceeding 100 per cent. of the customer's assets/security is written off.

Solutions for Companies

The corporate recovery portfolio is separated into two main clusters, corporate recovery for large companies and retail recovery for smaller companies. The solutions for each cluster are:

- **Corporate Recovery:** An independent business review of each company is undertaken with a range of possible outcomes including debt restructuring, full or partial debt for equity swap, acquiring control of the company and/or its assets and liquidation of the company. All seized assets are transferred to one of the Bank's specialised subsidiaries with the aim of divesting them as soon as is practical and economically viable.
- **Retail Recovery:** A standardised solution is applied. Indexed investment loans and business loans are offered up to the amount which maximises the operational capacity of the company concerned to service its debt. These loans are at standard market terms with a standard payment schedule. A subordinated loan is taken in an amount equal to the difference between the amount of investment and business loans and 100 per cent. of the asset value of the company. The subordinated loan bears below market interest and the payment schedule varies depending on the company's business sector and the availability of collateral. No equity position is taken in the company and any debts to the Bank exceeding the asset value of the company are written off.

Loan Provisioning

The Bank's loan portfolio consists of loans which were acquired from Kaupthing at a fair value, that is taking into account the likelihood of the loan being repaid. However, the Bank continues to maintain its loan portfolio on a face value basis. Accordingly, an allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due according to the original contractual terms.

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

Individually Assessed Allowances

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

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

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

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

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of improved collection of principal and interest.

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

Collectively Assessed Allowances

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

Special Provisioning for Currency Exchange Rate Impairment

The loan book transferred from Kaupthing contained certain loans which required special consideration. These are loans in ISK made to Icelandic companies and individuals whose income is primarily in ISK but where the principal amount repayable varies depending on the exchange rate between the ISK and a specified foreign currency (typically euro). When the ISK depreciates against the foreign currency, the ISK value of the loan increases. However, since the borrower's ability to pay does not increase, the increase in loan value is considered unrecoverable. Provisions are made for this unrecoverable value increase. Conversely, when the ISK appreciates (as occurred in 2010, for example) and the ISK value of the loan decreases, there is a reversal of loan impairment due to the borrower's increased ability to repay.

Derivatives

The Bank offers financial derivatives instruments to professional investors, including interest rate swaps and options and forwards on Icelandic treasury notes and housing financing bonds. The fair value of these derivative instruments varies in response to changes in interest rates and security prices. Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values (being those under which the Bank is owed money). The Bank applies limits to its total exposure and on the positive fair value net of collateral to control the Bank's risk in relation to these instruments. These limits are generally client specific and may refer specifically to different categories of derivative contract. Generally, collateral is required to cover potential losses on a derivative contract. The Bank accepts either cash or treasury bills as collateral for margin accounts. Should the net-negative position of a contract fall below a certain level, the Bank's policy is to seek additional collateral. If extra collateral is not supplied within the specified deadline, the contract is typically closed. The Bank also seeks to reduce its exposure to credit losses by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. These agreements reduce the Bank's credit risk since, in the case of default, all amounts owing between the Bank and the counterparty are terminated and settled on a net basis.

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 net of eligible collateral. The legal maximum for individual large exposures is 25 per cent. of a bank's risk capital and the sum of all large exposures cannot exceed 800 per cent. of a bank's risk capital. The Bank had no large exposures in excess of the legal limit of 25 per cent. at 30 June 2011. The sum of all of the Bank's large exposures was 98 per cent. on 30 June 2011 before taking account of collateral and 94 per cent. after taking account of collateral. The legal limit for aggregate large exposures is 800 per cent. and the Bank's internal limit, after taking account of collateral, is 150 per cent.

The loans which were transferred from Kaupthing to the Bank include loans which have led to high counterparty concentration for the Bank. The table below shows all gross exposures exceeding 10 per cent. of the Bank's risk capital as at 30 June 2011, and the equivalent exposures of those loans as at 31 December 2010 and 31 December 2009, together with the net amount of each of those exposures after taking account of collateral.

	As at 30 June		As at 31 December			
	2011		2010		2009	
	Gross	Net	Gross	Net	Gross	Net
	<i>(per cent.)</i>					
1 Dromi ⁽¹⁾	51%	1%	57%	1%	114%	1%
2	24%	24%	28%	19%	41%	29%
3	17%	17%	13%	13%	17%	17%
4	17%	16%	9%	9%	12%	11%
5	15%	15%	16%	16%	21%	20%
6	14%	11%	12%	8%	14%	14%
7	11%	11%	11%	11%	0%	0%
Total gross exposures exceeding 10% of the Bank's risk capital	149%	95%	146%	77%	219%	92%

Note:

- (1) This exposure comprises a bond claim on Drómi ehf. (**Drómi**), see "*Litigation*". The Icelandic Ministry of Finance has confirmed that the Bank will be held harmless in respect of this claim. The FME has agreed that the Bank can use this confirmation as a credit enhancement in relation to the claim.

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's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances in the Bank's balance sheet (referred to as its **banking book**) 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 principally in relation to currencies, maturities and interest rates.

Trading Book Market Risk

In the case of proprietary trading, the CEO determines limits for market risk exposure by asset class and for the total trading book, in each case expressed as maximum overnight exposure. The principal exposures are listed Icelandic treasury notes and Icelandic housing fund bonds and, to a very limited extent, listed equities.

Although the Bank uses derivatives, principally interest rate swaps and options and forwards on Icelandic treasury notes and Icelandic housing fund bonds, in its proprietary trading activities, the Bank did not have a material exposure to derivative instruments as at 30 June 2011.

Banking Book Market Risk

The principal banking book market risks faced by the Bank are interest rate risk, inflation risk, currency risk, equity risk and prepayment risk.

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 its interest bearing assets and its interest bearing liabilities. The principal mismatch is the large maturity gap resulting from the fact that the Bank has significant on demand liabilities. Note 55(a) to the Interim Financial Statements provides further information on the Bank's maturity asset and liability gap. 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 Bank's strategy for managing the interest rate risk in its banking book is to seek to achieve an interest rate balance between its assets and liabilities by offering deposit incentives and through targeted lending.

Inflation Risk

The Bank is exposed to inflation risk when there is a mismatch between its inflation-linked assets and liabilities. As at 30 June 2011, the total amount of the Bank's inflation-linked assets was ISK 113.7 billion and the total amount of its inflation-linked liabilities was ISK 96.5 billion. The Bank also has significant maturity mismatches in its inflation-linked assets and liabilities. See note 55(b) to the Interim Financial Statements.

Currency Risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between its assets and liabilities. The Bank's liabilities are predominantly denominated in ISK whereas its assets principally comprise foreign currency denominated loans to customers. The Bank's foreign currency imbalances exceeded applicable regulatory limits until the second quarter of 2011 although the Bank was granted a dispensation from complying by the Central Bank.

The Bank's strategy for reducing its currency imbalance is first to seek to convert into ISK foreign currency denominated loans to customers who have ISK income and second to hedge its other currency imbalances, principally through agreements with the Central Bank and other counterparties. Until the end of 2010, the Bank was limited in its ability to pursue the first part of its strategy as a result of legal uncertainty relating to the status of foreign currency loans. However, following a series of cases in the Icelandic courts, on 18 December 2010, a new Icelandic law was passed relating to the calculation of interest on certain loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal amount of those loans is required to be recalculated from the loan commencement date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. In addition, the law required that banks should recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. In all cases, either the loan principal is adjusted or, if the borrower has overpaid, the amount overpaid must be reimbursed.

Currently, the legitimacy of loans to corporates and individuals not addressed by the December law remains unclear. By two similar judgments on 14 February 2011, the Icelandic Supreme Court held that two foreign currency loans to SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. As a result, these loans were held to be in breach of applicable Icelandic legislation relating to interest

and price indexation. The Icelandic Supreme Court passed another two similar judgements on 8 March 2011 dealing with foreign currency loans. In addition, on 9 June 2011, the Supreme Court, by a 4 to 3 majority vote, held that a foreign currency loan to a corporate was a loan in Icelandic krona and indexed to a foreign currency exchange rate.

Even though no foreign currency indexed ISK loans made by the Bank have been considered by the Icelandic Supreme Court, the Bank has decided and announced that these rulings provide a precedent for the Bank to follow, and that all of the Bank's loans which fall within the conditions established by the Supreme Court in its rulings will be recalculated into ISK denominated loans. The Bank estimates that around 2,000 retail and corporate loans will have to be recalculated.

The recently announced recalculation follows the recalculation of foreign currency indexed ISK mortgage loans which was implemented earlier in 2011. As a result, almost all of the Bank's foreign currency indexed ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of corporate loans, the Bank was advised in mid 2010 that certain of its foreign currency corporate loans were fully compliant with applicable regulations whilst others were more vulnerable, as the recent rulings of the Supreme Court have confirmed. The Bank remains party to a number of court cases relating to such loans, see "*Litigation*".

The recalculation of foreign currency loans will adversely affect the Bank's results of operations and financial position in 2011. However, the Bank's capital ratio is expected to remain well above the 16 per cent. requirement set by the FME.

The Bank's net exposures on a per currency basis are monitored centrally within the Bank. The table below indicates the currencies to which the Bank had significant exposure at 31 December 2010. 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.

The table assumes that all other variables remain constant.

	Year ended 31 December 2010	
	-10 per cent.	+10 per cent.
	<i>(ISK million)</i>	
EUR	882	(882)
USD	(1,125)	1,125
CHF	(1,800)	1,800
GBP	(411)	411
JPY	(1,597)	1,597
Other	(805)	805

The Bank's currency risk is partially mitigated by the specific nature of foreign currency loans to customers with ISK income, see "*Credit Risk—Loan Provisioning—Special Provisioning for Currency Exchange Rate Impairment*" and note 55(c) to the Interim Financial Statements which discusses this natural hedge.

Equity Price Risk

Equity price risk is the risk that the fair value of equity securities decreases as the result of changes in the level of equity indices and individual stocks. The Bank faces both trading book equity price risk which is managed through the proprietary desk within the Treasury department and banking book equity price risk as a result of the fact that, through the loan restructuring process, it has acquired significant shareholdings in troubled companies. Note 40 to the Interim Financial Statements provides information on assets seized by the Bank and held for sale.

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 June 2011.

Liquidity Risk

Liquidity risk is the risk that the Bank will encounter difficulty in repaying its funding or will only be able to secure funding 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, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of its loans exceeds the maturity of its deposits, the majority of which are on demand deposits.

The Bank's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Bank's liquidity reserve. 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 71.6 per cent. as at 31 December 2010 and 72.7 per cent. as at 30 June 2011.

Secured Liquidity and Cash Ratios

The FME has established minimum secured liquidity ratio and minimum cash ratio guidelines. These guidelines stipulate that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20 per cent. (the secured liquidity ratio guideline) and that its cash and cash equivalents should amount to at least five per cent. of its on demand deposits (the cash ratio guideline). The Bank calculates its secured liquidity ratio as the sum of (i) cash on hand and cash balances with the Central Bank, (ii) Icelandic treasury notes and housing fund bonds which are held specifically as liquidity reserves and (iii) other eligible assets for repurchase transactions with the Central Bank divided by the Bank's total interest-bearing liabilities. The high liquidity reserve required by the FME reflects uncertainty relating to the stickiness of the deposits made with Icelandic banks and the fact that a large part of these deposits are primarily short term or on demand while the contractual maturity of the assets held by Icelandic banks is much higher.

The Bank's secured liquidity and cash ratios during the six months ended 30 June 2011 and the year ended 31 December 2010 were as follows:

	Six months ended 30 June 2011	
	Secured liquidity ratio	Cash ratio
	<i>(per cent.)</i>	
As at 30 June 2011	35	16
Maximum during the period	37	18
Minimum during the period	29	12
Average during the period	34	15

	Year ended 31 December 2010	
	Secured liquidity ratio	Cash ratio
	<i>(per cent.)</i>	
As at 31 December 2010.....	25	11
Maximum during the year.....	35	16
Minimum during the year.....	24	6
Average during the year.....	28	11

The Bank's stress tests are primarily focused on what the effect of lifting capital controls in Iceland would be on the Bank's deposit base and its liquidity buffer.

Operational Risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error or from external events that affect the Bank's operations and can result in direct losses.

Operational risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner.

The Bank closely monitors its operational risks. Identification and measurement of these risks is undertaken through control and risk self assessment, the registration of loss events, near misses and quality deficiencies and by monitoring potential risk indicators and other early warning signals. The Bank seeks to reduce operational risk through effective staff training, process redesign where appropriate and enhancement of its control environment.

The Bank uses the Basel II basic indicator approach to the calculation of risk capital requirements for operational risk but manages its operational risk in accordance with the standardised approach. The Bank's risk capital 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, although as the Bank does not yet have three full years of operation, the measurement is made over the available periods.

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. In the six months ended 30 June 2011 and the year ended 31 December 2010, losses of ISK 32 million and ISK 391 million, respectively, were registered in the loss database. The majority of the loss events were due to mistakes in processing in the Retail Banking Division. The largest single loss of ISK 10 million in the six months ended 30 June 2011 and ISK 291 million in the year ended 31 December 2010 accounted for 30 per cent. and 78 per cent., respectively, of the total loss amount. In each case, this event occurred in the Asset Management division and, in 2010, was due to a duplicate settlement of an asset management transaction during the collapse of the banking system. It has not been resolved whether the total loss amount will be realised in full by the Bank or by a third party.

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. Long term capital planning for the Bank is currently based on a benchmark minimum core tier 1 capital ratio of 12 per cent. and a capital adequacy ratio of 16 per cent (which is in line with the current guidelines set by the FME for a capital adequacy ratio of 16 per cent.). Subject as provided below, the Bank's policy is to refrain from paying dividends and conducting share buy-backs for three years after its initial capitalisation on 21 October 2008.

In January 2010, Kaupskil, which is owned by the creditors of Kaupthing, acquired an 87 per cent. shareholding in the Bank from the Icelandic State. At the same time, the Icelandic State provided the Bank with tier 2 capital in the form of a subordinated loan, according to Article 84 of the Act No. 161/2002 on Financial Undertakings. As part of the agreement, the Bank was required to pay to the Icelandic State a special dividend amounting to ISK 6.5 billion out of retained earnings if, following the publication of the 2010 Financial Statements, the Bank's core tier 1 ratio was at least 12 per cent. after excluding ISK 6.5 billion of retained earnings. This dividend was paid in ISK in June 2011 and, at the same time, the Bank received a subordinated foreign currency loan from the Icelandic State which qualifies as Tier II capital.

Capital requirements according to Pillar 1 are based on the sum of risk weighted assets (**RWA**) for credit risk, market risk and operational risk, computed using formulas from the EU's Capital Requirements Directive (the **CRD**). 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.

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's ICAAP is an ongoing process intended to ensure 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.

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, foreign exchange risk, liquidity risk, interest rate risk in the banking book, reputational risk, legal and compliance risk, business risk and strategic risk.

In relation to its Pillar 2 calculations, the Bank has currently implemented methods to calculate concentration risk for single name concentration and sector concentration and includes valuation risk, interest rate risk in the banking book, legal risk and business risk. The Bank expects to develop methods for evaluating other Pillar 2 risks in due course.

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 Bank's capital base at 30 June 2011 amounted to ISK 145,587 million. The Bank's capital adequacy ratio, calculated in accordance with Icelandic requirements, was 21.4 per cent., exceeding the minimum legal requirement of eight per cent. and exceeding the FME's enhanced capital adequacy requirement of 16 per cent.

The table shows the Bank's RWA calculations as at 30 June 2011 and as at 31 December 2010 and 2009.

	As at 30 June	As at 31 December	
	2011	2010	2009
	<i>(ISK million, except percentages)</i>		
Total equity	117,248	109,536	90,034
Deduction from tier 1 capital	4,905	(4,647)	(2,843)
Total tier 1 capital	112,343	104,889	87,191
Tier 2 capital	33,244	26,257	-
Total capital base	145,587	131,146	87,191
Risk weighted assets			
Credit risk ⁽¹⁾	525,527	513,328	480,374
Market risk foreign exchange ⁽²⁾	66,827	97,657	89,233
Market risk other	29,400	20,397	14,849
Operational risk	57,267	57,267	51,055
Total risk weighted assets	679,021	688,649	635,511
Tier 1 ratio	16.5%	15.2%	13.7%
Capital adequacy ratio	21.4%	19.0%	13.7%

Notes:

- (1) The Bank is exposed to relatively high concentration in its loan portfolio. According to the Bank's ICAAP, single name concentration and sector concentration lead to an add-on of 1.8 per cent. and 1.9 per cent., respectively, to the capital requirement for credit risk. The add-on due to interest rate risk in the banking book is 2.0 per cent. Other add-ons applied reflect political and legal risk and sensitivity in valuation techniques.
- (2) The effect of the natural hedge that exists in relation to foreign currency denominated loans to borrowers with ISK income is reflected in the RWA for market risk where a 48 per cent. effective contribution of the corresponding portion of the imbalance has been accounted for as at 30 June 2011 (40 per cent. as at 31 December 2010), see "*Risk Management—Market Risk—Banking Book Market Risk—Currency Risk*".

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 six employees at 30 June 2011.

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 table below shows the classification of the Bank's investment portfolio at 30 June 2011.

	As at 30 June 2011	
	Trading	Designated at fair value
	<i>(ISK million)</i>	
Listed bonds and debt instruments	4,230	47,562
Unlisted bonds and debt instruments	20	89,515
Total bonds and debt instruments	4,250	137,077
Listed shares and equity instruments	6	1,721
Unlisted shares and equity instruments	671	8,808
Bond funds with variable income	2,352	1,462
Total shares and equity instruments	3,029	11,991

COMPETITION

The Bank currently faces competition from the two other large commercial banks in Iceland, although this competition is currently limited as all three banks are focused on restructuring their loan portfolios and improving their asset and liability matching. 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 109 employees at 30 June 2011. 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 is 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.

One significant court case is a case between Drómi and the Bank. By means of a decision issued by the FME on 21 March 2009, the Bank acquired the deposits of SPRON. According to the decision the resolution committee of SPRON was required to establish a specific limited liability company owned by SPRON (and later Drómi), to receive all the assets of the savings banks and all security interests, including all liens, guarantees and other comparable interests linked to SPRON's claims. The subsidiary was then supposed to take over all SPRON's obligations to the Bank relating to the acquisition of SPRON's deposit obligations and issue a bond to the Bank as compensation for the deposit obligations. The relevant documentation provided that the interest rate on the debt principal would be determined by the FME at any given time. The FME decided that the debt should bear an annual interest rate plus an interest premium until repayment of the debt originally in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months.

In a letter dated 2 December 2009, Drómi requested that the FME review its former interest rate decision. On 4 February 2011, the FME confirmed that the debt should bear the originally specified annual interest rate and premium from the takeover date until 30 June 2010, but that thereafter the premium should not be payable. The Bank has brought a legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011, Drómi brought a legal action against the FME and the Bank. Drómi's action seeks the annulment of all decisions by the FME on interest rates and the determination of a revised interest rate from the outset.

A number of clients have alleged that assets under management were improperly managed resulting in the clients suffering financial loss. Five of these claims have been taken to court. On 13 May 2011, all of these claims were dismissed by the district court. On 15 June 2011 the Supreme Court of Iceland upheld the previous decision of the district court although this decision does not mean that the issue is fully resolved.

There are also a number of court cases, to which the Bank is a party, in which the legality of certain of the Bank's FX loans has been called into question. Although none of these cases has yet been heard by the courts, a number of similar cases involving other banks have been determined during 2011 as a result of which the Bank has announced the recalculation of a significant number of its FX loans into ISK-denominated loans, in line with the decisions made in the relevant cases. See generally, "*Description of the Issuer - Risk management -Market Risk-Currency Risk*".

Since 30 June 2011, the Bank's subsidiary, Stefnir, has received two demands for the rescission of contracts from the winding up committee of Landsbanki Íslands hf. The aggregate amounts involved are approximately ISK 3 billion plus interest. Stefnir intends to defend the claims and believes they are unfounded.

The Bank is also subject to two formal investigations launched by ESA in 2010, see "*Risk Factors—The EFTA Surveillance Authority has opened the formal investigation procedures in relation to the Bank on certain matters which, if determined adversely to the Bank, could result in losses*".

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 individuals referred to above. Transactions with related parties are conducted on an arm's length basis.

Prior to 30 June 2011, the principal related party transaction was the compensation instrument issued by Kaupthing in an amount of ISK 38.3 billion, reflecting the difference between the fair value of the assets, liabilities and contingent liabilities transferred from Kaupthing to the Bank in accordance with the FME decision in 2008. The compensation instrument was denominated 50 per cent. in ISK and 50 per cent. in euro and was subject to floating rates of interest. The maturity of the compensation instrument was 30 June 2012 and it was a priority claim against Kaupthing.

Related to the compensation instrument was the ECVRA under which Kaupthing was entitled to receive 80 per cent. of the appreciation of certain loans transferred to the Bank (the **ring-fenced assets**). Any increase in value of the ring-fenced assets operated to decrease the value of the compensation instrument. If the compensation instrument is finally settled due to an increase in the aggregate value of the ring-fenced assets (such increase being 125 per cent. of the original value of the compensation instrument) then 50 per cent. of any future increase in the value of the ring-fenced assets must be passed on to Kaupthing up to a maximum amount of ISK 5 billion.

As at 31 December 2010, the outstanding value of the compensation instrument was ISK 24.2 billion. The Bank held a guarantee in specific assets of Kaupthing against the total balance of the compensation instrument. This guarantee was a priority claim against Kaupthing.

On 30 June 2011, a settlement and release of claims agreement was signed by the Bank and Kaupthing to finalise a settlement of the ECVRA, the compensation instrument and various other claims lodged against Kaupthing by the Bank. By signing the agreement, the ECVRA and the compensation instrument were terminated and the parties were released from all payment obligations under the compensation instrument and the ECVRA.

See notes 36 and 58 to the Interim Financial Statements and notes 56, 74 and 118 to the 2010 Financial Statements for further information in relation to the Bank's related party transactions.

RECENT DEVELOPMENTS

Acquisition of the mortgage portfolio related to Kaupthing's covered bond programme

In December 2011, the Bank and the Kaupthing Resolution Committee reached an agreement whereby, subject to the passing of an extraordinary resolution by holders of Kaupthing Covered Bonds (as defined below) to waive various existing events of default, the Bank would acquire the mortgage portfolio managed in a special fund (the **Fund**) owned by the bankruptcy 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**).

Kaupthing, like several other Icelandic banks, was significantly affected by the global financial and economic crisis during the last quarter of 2008 (See "*Risk Factors - The Bank's business is materially affected by Iceland's economy which was in recession throughout 2009 and 2010 and remains vulnerable to external shocks and a range of internal risks*" and "*Description of the Issuer - Current Winding up Proceedings for Kaupthing*"). On 24 November 2008, winding-up proceedings were brought against Kaupthing which triggered various events of defaults under the Kaupthing Covered Bonds as well as events of default under certain of the transaction documents relating to the Kaupthing Covered Bond Programme.

On 20 January 2012, the holders of the Kaupthing Covered Bonds (as creditors of Kaupthing and the Fund) passed an extraordinary resolution directing the representative appointed under the Kaupthing Covered Bond Programme to act for the benefit of the holders of the Kaupthing Covered Bonds to waive the various events of default under the Kaupthing Covered Bonds on their behalf.

Following this, the Bank:

- acquired all of the units in the Fund from Kaupthing, pursuant to a unit transfer agreement between Kaupthing and the Bank; and
- was substituted for, and 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.

In addition, 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 is valued at ISK 122.6 billion. See also "*Risk Factors - The Bank has acquired the mortgage portfolio related to Kaupthing's covered bond programme, and could be adversely affected if these assets do not generate sufficient revenue*".

MANAGEMENT AND EMPLOYEES

MANAGEMENT

Board of Directors

The Bank's Board comprises the following five members. Four of the members are nominated by Kaupskil and the fifth member is nominated by the Icelandic State.

Monica Caneman, Chairman

Monica graduated as an economist from the Stockholm School of Economics in 1976. She worked at Skandinaviska Enskilda Banken AB (publ) (**SEB**) from 1977 to 2001. Monica held various positions at SEB in retail banking. She became a member of the Group Executive Committee and Group Management in 1995 and became deputy CEO and a deputy member of the board of directors in 1997. Monica left SEB in 2001. Since then she has built a career around board assignments. Currently she sits on the board of several companies and non-profit organisations, some of which she chairs. Monica was appointed as a director at the Bank's Annual General Meeting on 20 May 2010.

Gudrún Johnsen, Vice-Chairman

Gudrún completed a BA in economics at the University of Iceland in 1999. In 2002, she graduated with an MA in applied economics at the University of Michigan, Ann Arbor in the United States and with an MA in statistics from the same university the following year. Gudrún worked as a securities broker at the Icelandic Investment Bank (**FBA**) between 1999 and 2001, as a teaching and research assistant at the University of Michigan, Ann Arbor in 2002-2003 and as a specialist at the RAND Corporation in the United States in 2004. Between 2004 and 2006 she worked as a specialist in the Monetary and Financial Systems Department of the International Monetary Fund in Washington, DC. Gudrún has been an assistant professor at Reykjavík University School of Business since 2006. She has served on the board of a fund management company of MP Bank, is the current chairman of a research and analysis company formed by a group of academics and sits on the advisory council of the Consumer Spokesman. Gudrún was appointed as a director at the Bank's Annual General Meeting on 20 May 2010.

Agnar Kofoed-Hansen, Director (State-appointed Board Member)

Agnar received a B.Sc. in mechanical and industrial engineering from the University of Iceland in 1981. He completed a master's degree in management engineering from the Technical University of Denmark in 1983. He attended a master's programme at MIT Sloan School of Business in the USA, including financial analysis. Agnar became an authorised securities dealer in 1991 and has completed numerous training courses in the field of management, operations and coaching. From 1983 to 1987, he worked for Thróun hf. as manager of sales and marketing. He worked for the Industrial Bank of Iceland hf. as head of the credit department from 1987 to 1989. Between 1989 and 2000, he served as manager of capital markets at Kaupthing hf., managing director of credit information Iceland ehf. and later as board member, owner and director of Credit Reporting Department at Creditinfo Lánstraust hf. He worked as managing director at SPRON Factoring hf. from 2000 to 2007. Agnar currently works as chief financial officer of HRV Engineering ehf.

Jón G. Briem, Director

Jón gained a degree in law from the University of Iceland in 1974. He qualified as a district court attorney in 1977 and as a supreme court attorney in 1990. In 1976 to 1990 he was a partner at the law firm Lögfræðistofa Sudurnesja sf. From 1991 to 1999 he was head of the legal division of Íslandsbanki hf. and from 2000 to 2001 he was branch manager at the same bank. He completed a certificate in business and

administration from the University of Iceland's Continuing Education Institute in 1999. In 2002, he opened a law firm in Reykjavík, where he still works. Jón has been a member of the boards of numerous companies and associations. Jón was appointed as an alternate director at the Bank's Annual General Meeting on 20 May 2010 and was elected as a director, in place of a previously appointed director, at a Board meeting on 12 October 2010.

Måns Höglund, Director

Måns is Swedish and lives in Sweden. He graduated from Stockholm School of Economics in 1975 where he taught classes and worked as a researcher after his studies. Måns held various posts at Hambros Bank in London from 1977 to 1984, including as regional director for Denmark and Iceland for two years. In 1984, he started working for Götabanken in London and transferred to Stockholm in 1989 where he was head of the international finance division of the same bank until 1991. From 1991 to 1999, he worked for Swedbank, including as director and head of the bank's large corporate business. In 1999 to 2002, he worked for both Unibank (as head of Sweden) and Nordea (as Head of Private Banking, Sweden). Since 2002, Måns has been working for Swedish Export Credit Corporation (SEK) as executive director and head of corporate and structured finance and is a member of SEK's Executive Committee. Måns was appointed as a director at the Bank's Annual General Meeting on 24 March 2011.

There are no conflicts of interest between the duties of the members of the Board listed above to the Bank and their private interests or other duties. The address of each Board member is Borgartún 19, 105 Reykjavík.

Senior Management

The Bank's senior management team comprises the following members:

Höskuldur H. Ólafsson, CEO

Höskuldur graduated with a degree in business administration from the University of Iceland in 1987. He joined the Bank in June 2010 from Valitor hf - VISA Iceland, where he was CEO from 2006. Prior to that he worked at the Icelandic transportation company, Eimskip, for almost 20 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organisations in Iceland and abroad.

Björk Thórarinsdóttir, Managing Director of Corporate Banking & Capital Markets

Björk graduated with a degree in business administration from the University of Iceland in 1990. She joined the corporate banking division of Búnadarbanki Íslands (later Kaupthing) in 2001. In 2009, she was appointed managing director of Corporate Banking at the Bank. In 2010, she also became managing director of Capital Markets. Björk was previously a specialist and financial director at Baxter International in the United States and later in Germany from 1991 to 1996. In 1997 and 1998, she was financial director of Philips Consumer Communications in France, before moving to Silfurtún in Iceland and Silverton in Norway in the 1998 to 2000 period as financial director. She was elected as chairman of the board of directors of Valitor hf. in January 2010.

Halldór Bjarkar Lúdvígsson, Managing Director of Investment Banking

Halldór graduated with a degree in mechanical engineering from the University of Iceland in 1991 and a B.Sc. in computer studies in 1992 from the same university. Between 1992 and 2005, Halldór held a number of management positions, including the position of CEO at Maritech A/S, an international company which sells technical solutions for the fishing industry. In 2005, Halldór joined the Corporate Banking division of Kaupthing where he supervised lending activities in Scandinavia. Halldór worked for the Kaupthing Resolution Committee in 2008 in his capacity as managing director of the Bank's Nordic asset portfolio and

in December 2009 he was appointed managing director of Corporate Finance at the Bank. Halldór has served on the boards of a number of companies, particularly start up companies.

Helgi Bjarnason, Managing Director of Retail Banking

Helgi graduated from the faculty of mathematics of the University of Iceland in 1992 and completed a degree in actuarial mathematics from the University of Copenhagen in 1997. From 1997 to 2006, Helgi worked as an actuary at Okkar Life Insurance. In 2006, Helgi started work at Sjóvá Almennar Insurance and served as managing director of the life insurance company in addition to being vice-president of the non life company. In October 2010, Helgi joined the Bank as managing director of Operations. Helgi has served on various boards of directors, such as the Association of Icelandic Actuaries, the Confederation of Employers and the Icelandic Financial Services Association. He is currently on the board of Okkar Life Insurance. He was appointed managing director of Retail Banking in October 2011.

Gísli S. Óttarsson, Chief Risk Officer and Managing Director

Gísli received a Ph.D. in mechanical engineering from the University of Michigan in 1994. Gísli worked as a software designer and adviser for various engineering software companies in the United States before he joined Kaupthing's risk management division as head of research and development in January 2006. In April 2009, Gísli became the chief risk officer of the Bank.

Jónína S. Lárusdóttir, Managing Director of Legal Division

Jónína graduated from the faculty of law at the University of Iceland in 1996 and qualified as a district court attorney the following year. In 2000, Jónína completed a master's degree from the London School of Economics and Political Science, including European competition law. In 1996, Jónína started working for the A&P law firm, but moved to the Ministry of Commerce in 2000 where she was a specialist in the financial markets department. She 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 Commerce, now the Ministry of Economic Affairs, where she worked until late 2010 when she took over the post of managing director of the Bank's Legal Division. Jónína has served on and chaired numerous committees and has worked as a lecturer in several institutions, including the faculty of law of the University of Iceland. She was chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004.

Margrét Sveinsdóttir, Managing Director of Asset Management

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

Rakel Óttarsdóttir, Managing Director of Corporate Development & Marketing

Rakel joined the IT division of Kaupthing Bank in 2005 where she was an account manager. In 2010 she became head of project management in the Corporate Development & Marketing division of the Bank. In December 2011 she was appointed managing director of Corporate Development & Marketing. Before

joining the Bank, Rakel was head of development at TM Software. Rakel is a computer science graduate from the University of Iceland and has an MBA from Duke University in the United States.

Stefán Pétursson, Chief Financial Officer and Managing Director

Stefán graduated with an MBA from Babson College in Massachusetts in 1991 and a degree from the faculty of business of the University of Iceland in 1986. Stefán was appointed CFO at the Bank in August 2010. In 1986 to 1989, Stefán worked as head of administration at the Icelandic Fisheries Laboratories Institute. After completing his studies in the United States, Stefán joined Landsvirkjun. He began as head of funding but later took over as treasurer and finally CFO, a position he held from 2002. Stefán was on leave from Landsvirkjun in 2008 while serving as the CEO of the investment company HydroKraft Invest hf. Stefán has held a number of directorship positions and other positions of responsibility in recent years. He is currently a member of the board of Landfestar hf.

Sigurjón Pálsson, Managing Director of Operations

Sigurjón joined the Investment Banking division of Kaupthing in 2005 and later became a departmental head in Corporate Recovery at the Bank. Sigurjón was appointed managing director of Operations in October 2011. Sigurjón previously held a management position at the contracting firm Ístak, where he was in charge of IT and other key projects. Sigurjón is educated as an engineer and has a master's degree from KTH in Stockholm and MIT.

Ólöf Embla Einarsdóttir, Compliance Officer

Ólöf Embla graduated from the faculty of law at the University of Iceland in 2000. From 2000 to 2004, she worked as a lawyer for the Consumers' Association of Iceland. From 2005 to 2007, she worked at the Ministry of Commerce on matters relating to banking and securities, including the introduction of the EU's Anti-Money Laundering Directive and the EU's Transparency Directive into Icelandic legislation. In 2007, Ólöf Embla was hired by Kaupthing as Compliance Officer. Ólöf Embla qualified as a district court attorney in 2002 and as a certified stockbroker in 2008. Ólöf Embla is currently on a leave of absence.

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 Arion Bank's Compliance Division in 2011.

Lilja Steinhórsdóttir, 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.

Brynhildur Georgsdóttir, Customers' Ombudsman

Brynhildur has a degree in law from the University of Iceland in 1994 and gained an MBA from the same university in 2008. Between 1994 and 1997, she worked as representative for the County Commissioner of Vestmannaeyjar. She then worked as chief of vehicle registration at The Road Traffic Directorate from 1997 until 2006, where her job involved being part of the organisation's management team, preparing laws and directives, communicating with the authorities and liaising with international organisations. Before she joined the Bank in 2009, she worked for the town of Mosfellsbær as chief of administration, town clerk and deputy to the mayor. She has been chairman of the unemployment complaints committee at the Ministry of Social Affairs since May 2008. She joined the Bank as Customers' Ombudsman in early 2009.

There are no conflicts of interest between the duties of the members of senior management listed above to the Bank and their private interests or other duties. The address of each member of senior management is Borgartún 19, 105 Reykjavík.

Corporate Governance

The Bank's corporate governance framework is centred on the guidelines issued in 2009 by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers. The framework ensures disclosure and transparency and increases accountability.

The framework is also provided by the Internal Control and Procedure Handbook (**ICPH**) which describes the relationship between all stakeholders and defines the responsibilities of the Board and the members of senior management. The ICPH is reviewed and approved on an annual basis.

Shareholders' meetings

The supreme authority in the affairs of the Bank is the shareholders at a shareholders' meeting, 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.

The Board of Directors

The Board is the supreme authority in the affairs of the Bank between shareholders' meetings. It is elected at a shareholders' meeting for a term of one year.

The Board is responsible for formulating a risk appetite, setting business objectives, the Bank's strategy and its business plan. It is also responsible for ensuring transparency and clarity in the decision-making process and ensures that senior management responsibilities and authorisations are delegated clearly in order to prevent conflicts of interest. The Board has established working procedures, presented in the ICPH, which further describe its duties and areas of responsibility.

The Board is required to have a thorough knowledge of the relevant rules and to regularly evaluate its own activities. The Board follows strict rules on the eligibility of directors and is governed by statutory law. All the Board's directors and alternate directors have passed the FME's qualification assessment.

There are two mandatory sub-committees of the Board: the Board Audit and Risk Committee and the Board Remuneration Committee, which both serve as advisory committees to the Board. In addition there is a sub-committee of the Board, the Board Credit Committee, which is the highest ranking credit committee at the Bank. The Board has set working procedures for each of the sub-committees which are specified in the ICPH.

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 her 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 ten employees at 30 June 2011.

Employees

During 2010, the average number of full time equivalent employees at the Bank was 1,201 (compared to 1,177 during 2009). At 30 June 2011, the number of full time equivalent employees at the Bank was 1,251.

FINANCIAL MARKETS IN ICELAND

General

Towards the end of 2008, Iceland suffered a currency and banking crisis. The government of Iceland was forced to step in and take control of the three major Icelandic banks Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf., which had been very active in the international financial market, to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly function of the payment system. Following this, certain assets and liabilities were transferred from the banks into three new entities, including the Issuer, which have operated as commercial banks from that time.

The establishment of the new banks

After the government took control of Kaupthing Bank hf., Glitnir Bank hf. and Landsbanki Íslands hf. in October 2008, certain assets and liabilities were transferred from the banks into new entities, which have now become the Issuer, Íslandsbanki hf. and Landsbankinn hf. 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% of the Issuer's equity, and subsequent capital injection took place on 8 January 2010. Kaupthing Bank, through its subsidiary Kaupskilehf., now holds an 87% stake in the Issuer and the Ministry of Finance holds the remaining 13%. A similar agreement was reached between the government and Íslandsbanki hf., and the Kaupthing Resolution Committee, through ISB Holding, now holds 95% of the shares in Íslandsbanki and the Ministry of Finance holds the remaining 5%. Landsbankinn hf. remains fully state-owned.

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 agreement on the European Economic Area (EEA), 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 Bank hf., Glitnir Bank hf. and Landsbanki Íslands hf.), 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 2007.²

Other relevant institutions

A new Housing Financing Fund (www.ils.is) was established at the beginning of 1999. The new fund is based on legislation approved by the Parliament in June 1998, which is aimed at rationalising the existing state housing fund system. The Regional Development Institute will remain a state-owned institution. 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 prior to 2008 its market share shrunk significantly. However, after the collapse of the banking system, the importance of the Housing Financing Fund has greatly grown.

² <http://sedlabanki.is/lisalib/getfile.aspx?itemid=848>

Furthermore, 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. It is also worth noting that 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.

The Financial Supervisory Authority, the Central Bank of Iceland and the Icelandic Stock Exchange

At the beginning of 1999, the Bank Inspectorate of the Central Bank of Iceland 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 the commercial banks and savings banks. The purpose of this limitation is to ensure that credit institutions have sufficient margin on the reserve requirement account to meet fluctuations in their liquidity positions. Foreign exchange transactions have been subject to capital controls since the banking system collapsed in 2008. The Central Bank oversees surveillance of the Rules on foreign exchange.

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.

SUMMARY 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 "*Summary 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 "*Summary 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 "*Summary 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 "*Summary 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, potential investors in Covered Bonds who wish to hold their Covered Bonds through Euroclear and Clearstream, Luxembourg are advised to contact those clearing systems to determine the nature of the tax certifications required by each clearing system as a condition to making payments on the Covered Bonds.

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, potential investors in Covered Bonds who wish to hold their Covered Bonds through Euroclear and Clearstream, Luxembourg are advised to contact those clearing systems to determine the nature of the tax certifications required by each clearing system as a condition to making payments on the Covered Bonds.

(a) Non-Icelandic Tax Residents

There are taxes payable under the laws of Iceland or any authority of, or in, Iceland in respect of the amounts payable on the Covered Bonds paid to a holder who is not a tax resident of Iceland. Article 3 (8) of the ITA specifically states that any interest received from Iceland (outbound payments), such as e.g. the interests payable according to the bonds, received by any person or entity residing outside of Iceland is taxable income in Iceland unless a double taxation treaty states otherwise. According to Article 70(b) of the ITA, numerical 8, the tax shall be (a) 10% for individuals, of all income exceeding the annual amount of ISK 100,000.00; and (b) 10% for legal entities.

The Issuer will be making the relevant withholding at source in accordance with the provisions of Regulation No 1082/2009, on the taxation and withholding of interest to parties 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). The Issuer confirms that appropriate applications for the exemption/lowered tax rate, have been or will be filed in connection with issues of Covered Bonds under the Programme, upon receipt of necessary documentation from the relevant bondholders, in order to implement and make full practical use of the provisions of Regulation No 1082/2009.

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.

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.

Subject to certain exemptions (which apply, *inter alia*, to most banks and pension funds), the Issuer is required to withhold a 20% tax on the interest paid to the holders of Covered Bonds who are Icelandic residents. Such withholding is considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder.

EU Savings Directive

Under EC Council Directive 2003/48/EC (the **Directive**) on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

The European Commission has proposed certain amendments to the Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

Luxembourg Taxation

The following summary is of a general nature and is included herein solely for information purposes. It 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. 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.

Withholding Tax

(i) *Non-resident holders of Covered Bonds*

Under Luxembourg general tax laws currently in force and subject to the laws of 21 June 2005 (the **Laws**) mentioned below, there is no withholding tax on payments of principal, premium or interest made to non-residents 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.

Under the Laws, implementing the EC Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments and ratifying the treaties entered into by Luxembourg and certain dependent and associated territories of EU Member States (the **Territories**), payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the immediate benefit of an individual beneficial owner or a residual entity, as defined by the Laws, which are resident of, or established in, an EU Member State (other than Luxembourg) or one of the Territories will be subject to a withholding tax unless the relevant recipient has adequately instructed the relevant paying agent to provide details of the relevant payments of interest or similar income to the fiscal authorities of his/her/its country of residence or establishment, or, in the case of an individual beneficial owner, has provided a tax certificate issued by the fiscal authorities of his/her country of residence in the required format to the relevant paying agent. 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 Laws would at present be subject to withholding tax of 35 per cent..

(ii) *Resident holders of Covered Bonds*

Under Luxembourg general tax laws currently in force and subject to the law of 23 December 2005 (the **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 Law payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the benefit of an individual beneficial owner who is a resident of Luxembourg 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 would be subject to withholding tax of 10 per cent.

SUBSCRIPTION AND SALE AND SELLING RESTRICTIONS

The Dealers have, in a programme agreement dated 10 February 2012 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 Stabilising Manager(s) named in the applicable Final Terms (or persons acting on behalf of any Stabilising 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.

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 European Economic Area 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 100 or, if the relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 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 (and amendments thereto, including the 2010 PD Amending Directive to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in the Relevant Member State and the expression **2010 PD Amending Directive** means Directive 2010/73/EU.

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 any 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 Control 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 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 (Cap. 571) of Hong Kong 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 and 11 October 2011.

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 audited financial statements of the Issuer in respect of the financial years ended 31 December 2009 and 31 December 2010 (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) a copy of this Offering Circular;
- (f) 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 European Economic Area nor offered in the European Economic Area 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
- (g) 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.

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 and 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 or material change

There has been no significant change in the financial or trading position of the Issuer since 30 June 2011 and there has been no material adverse change in the financial position or prospects of the Issuer since 30 June 2011.

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 auditors of the Issuer are Ernst & Young hf., members of The Institute of State Authorised Public Accountants in Iceland, who have audited the Issuer's accounts, without qualification, in accordance with International Standards on Auditing for each of the two financial years ended on 31 December 2010. The auditors of the Issuer have no material interest in the Issuer.

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

\$	5	Currency Swap Provider	8, 101
£	5	Custodian	159
€	5	customer loan portfolio	20
2010 PD Amending Directive	3, 165	Day Count Fraction	78, 83
2010 PD Amending Directive	52	Dealer	1
2010 PD Amending Directive	52	Dealers	1
30/60	78	Deed of Covenant	71
Accrual Period	78	Designated Account	88
Actual/Actual (ICMA)	78	Designated Maturity	80
Agency Agreement	70	Determination Period	78
Agents	71	Deutsche Bank	7
ALCO	124	Directive	162
Amending Act	31	Distribution Compliance Period	74
AML	138	Drómi	131
Amortised Face Amount	93	EEA Agreement	26
applicable Final Terms	71	EFTA	18
Arion	7	Eligible Swaps	8, 158
Arion Group	118	Emergency Act	32
Asset Management	112	ESA	26
ATMs	115	ESMA	45
AY	93	Established Rate	77
Bank	1	EUR	5
banking book	131	EURIBOR	80
Bankruptcy Act	107	euro	5, 77
BARC	124	Euroclear	1, 48, 72
Barclays	7	Exchange Date	48
Bearer Covered Bonds	1, 70, 72	Exchange Event	49, 50
Board	110	Exchange Notice	76
Bunadarbanki	109	Extended Final Maturity Date	40
Business Day	79	FATCA	30
Calculation Agent	80	FBA	143
Central Bank	16	FFI	30
CEO	110	FIEA	166
Clearing Systems	159	Final Terms	1
Clearstream	1	Fiscal Agent	70
Clearstream, Luxembourg	48, 72	Fitch	13
Common Depository	48	Fixed Interest Period	77
Common Safekeeper	48	Floating Rate	80
Conditions	15, 30, 52	Floating Rate Option	80
Corporate Banking and Capital Markets	112	FME	7, 19, 104, 150
Corporate Finance	112	Foreign Exchange Act	31
Couponholders	71	Foreign Exchange Rules	31
Coupons	71	Framework	29
Cover Pool	9, 101	FSMA	166
Cover Pool Revenue	32	FUA	110
Cover Pool Swap	8, 101, 151	Glitnir	16
Cover Pool Swap Agreement	101, 151	Global Covered Bond	70
Cover Pool Swap Provider	101	holder of Covered Bonds	51, 73
Covered Bondholder	73	holders	71
Covered Bondholders	9, 51, 71, 72	holders of Covered Bonds	72
Covered Bonds	1, 70	ICA	27
CRA Regulation	2, 45, 66	ICAAP	124
CRD	29, 136	<i>Iceland</i>	31, 91
CSSF	1	Icelandic Covered Bond Act	7, 28, 70, 104
Currency Swap	8, 101, 154	ICPH	147
Currency Swap Agreement	101, 154	IMF	16

Indexed Currency Swap	8, 102, 156	Prospectus Directive	3, 52, 165
Indexed Currency Swap Agreement	101, 156	Put Notice	92
Indexed Currency Swap Provider	8, 102	Receiptholders	71
Interest Amount	82	Receipts	71
Interest Payment Date	79	records	102
Interest Rate Swap	8, 102, 153	Redeemed Covered Bonds	92
Interest Rate Swap Agreement	102, 153	Redenomination Date	77
Interest Rate Swap Provider	8, 102	Register	102, 105
Interim Financial Statements	125	Registered Covered Bond Register	87
Investor's Currency	44	Registered Covered Bonds	70, 72
IRS	30	Registrar	70
ISD	1, 70	Regulation S	48, 74
ISD Covered Bonds	1, 70	Regulation S Covered Bonds	164
ISDA Definitions	80	Regulation S Global Covered Bond	74
ISDA Rate	80	Relevant Covered Bonds	77
ISK	5	Relevant Date	95
Issuer	1, 70	Relevant Factor	38
IT 117		Relevant Implementation Date	165
ITA	31, 95	Relevant Member State	4, 165
Joint Economic Programme	16	Relevant Percentage	102
Kaupskil	110	Relevant Series of Covered Bonds	40
Kaupthing	16, 109	Reset Date	80
Kaupthing Covered Bond Programme	141	Responsible Person	3
Kaupthing Covered Bonds	141	Retail Banking	112
Kaupthing Resolution Committee	109	ring-fenced assets	141
KPMG	7	RP	93
krona	5	Rules	29, 70, 105
kronur	5	RWA	136
Landsbanki	16	S&P	13
Law	163	SEB	143
Laws	162	Securities Act	1, 74
LIBOR	80	Selection Date	92
London Business Day	85	Series	71
Long Maturity Covered Bond	87	SMEs	21
LTV	36, 105, 126	Specified Currency	70
Luxembourg	1	Specified Denomination	70
M&A	116	SPRON	19
Market Value	106	Stefnir	116
<i>Maximum Instalment Amount</i>	62	Sterling	5
Member State	3	Substitute Collateral	104
MiFID	146	sub-unit	78
Moody's	13	Swap Providers	8, 102
Mortgage Bonds	8	Swaps	8
New Banks	17	Talons	71
NGCB	48	TARGET2 System	80
Other	112	Tax Jurisdiction	95
Participating FFI	30	Temporary Global Covered Bond	48
Paying Agent	70	Territories	162
Payment Day	89	Tranche	71
Payments	86	Transfer Agent	70
Permanent Global Covered Bond	48	Treaty	77
Proceedings	100	U.S. dollars	5
Programme	1	U.S.\$	5
Programme Agreement	164		

THE ISSUER AND ISD AGENT

Arion Bank hf.
Borgartúni 19
105 Reykjavík
Iceland

DEALERS

Barclays Bank PLC
5 The North Colonnade
Canary Wharf
London E14 4BB

UBS Limited
1 Finsbury Avenue
London EC2M 2PP

Deutsche Bank Aktiengesellschaft
Grosse Gallusstrasse 10-14
60311 Frankfurt am Main
Germany

FISCAL AGENT, PAYING AGENT AND TRANSFER AGENT

The Bank of New York Mellon, London Branch

One Canada Square
London E14 5AL
United Kingdom

LEGAL ADVISERS

To the Issuer as to English law

Allen & Overy LLP
One Bishops Square
London E1 6AD

To the Issuer as to Icelandic law

ADVEL
Attorneys at Law
Sudurlandsbraut 18
108 Reykjavík
Iceland

To the Dealers as to Icelandic law

LOGOS legal services
Efstaleiti 5
IS-103 Reykjavík
Iceland

AUDITORS

Ernst & Young hf.
Borgartúni 30
Reykjavík105
Iceland

LISTING AGENT AND REGISTRAR

The Bank of New York Mellon Luxembourg S.A.

Vertigo Building – Polaris
2-4 rue Eugène Ruppert
L-2453 Luxembourg