KMIIF

Financial Statements 2010

KMIIF
Borgartun 19
105 Reykjavik

Contents

Endorsement and Signatures of the Board of Directors and the Managing Director

The annual Financial Statements of KMIIF are included in part B of the annual financial statements of Stefnir hf. which contains the annual financial statements of mutual funds, investment funds and institutional investor funds of the management company. They have been prepared according to the same accounting methods as last year. This presentation of the financial statements is in accordance with regulations on the financial statements of management companies of mutual funds set by the Financial Supervisory Authority – Iceland.

The fund reported an annual loss of ISK 978 million according to the income statement and the loss is stated as a decrease in units in the fund's accounts. The net assets of the fund at the end of 2010 totalled ISK 16,325 million according to the balance sheet.

In response to the conditions created by the collapse of the financial sector in Iceland in the autumn of 2008, banks and financial companies have resorted to a range of measures to tackle clients' debt. In late 2009, Arion Bank gave its customers the option of adjusting the principal on the loans to 110% of the market value of the property. It was assessed how many loans of the fund had a loan-to-value ratio of more than 110% and a precautionary provision for losses was made for these loans. In the interim financial statement on 30 June 2010 the depreciation account was recalculated to ISK 3,921 million. In 2010 an agreement on measures to assist households in debt was reached under which the loan principal was reduced to 110% of the market value of the property. Applications to enter this process can be made until 1 July 2011. As it is unclear how many customers will take advantage of this measure, it was decided not to change the depreciation account during the period but instead to reassess the situation in the 2011 interim financial statement when it is known how many applications were made. The decrease in loan principal relating to the debt measures and defaults longer than 90 days totalled ISK 3,921 million on 31 December 2010, which will be recognised as impairment in the income statement. Of this total, ISK 1,797 million is being charged in 2010.

The Board of Directors and CEO of Stefnir hf. hereby confirm the fund's Financial Statements for 2010 with their signatures.

Reykjavik, March 16, 2011.

Board of Directors:

Hrund Rudolfsdóttir, Chairman

Eggert Teitsson

Snjólfur Ólafsson

Svava Bjarnadóttir

Ásgerður Sveinsdóttir

CEO:

Flóki Halldórsson

Independent Auditor's Report

To the unit holder of KMIIF.

We have audited the accompanying financial statements of KMIIF, which comprise the balance sheet as at December 31, 2010 and the income statement, statement of changes in net assets and investment statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Icelandic Financial Statements Act, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the fund as at December 31, 2010, and the results of its financial performance and its changes in net assets and investment statement for the year then ended in accordance with the Icelandic Financial Statements Act.

Report on the Board of Directors report

Pursuant to the legal requirement under Article 106, Paragraph 1, Item 5 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavik, March 16, 2011.

KPMG ehf.

Reynir Stefán Gylfason

Income Statement for the Year 2010

	Notes	2010	2009
Financial income and (expenses)	2-4		
Interests, indexation, dividends and currency exchange rate difference		8,836	16,346
Interest expense		(7,844)	(14,325)
Impairment on loans		(1,797)	(2,123)
Net financial income		(805)	(102)
Operating expenses			
Administration fee	5	141	136
Other operating expenses		32	3
		173	139
Loss for the year moved to units		(978)	(241)

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Balance Sheet at 31 December 2010

	Notes	2010	2009
Assets			
Securities with fixed income		120,046	122,273
Appropriated assets		347	1
Total securities	6	120,393	122,274
Cash		20,100	18,022
Total other assets		20,100	18,022
Total assets		140,493	140,296
Liabilities			
Units		16,325	17,303
Liabilities with management- og custody companies		10	12
Issued bonds		124,158	122,981
Total other liabilities		124,168	122,993
Total liabilities		140,493	140,296
Net assets		16,325	17,303
Number of units		9,637	9,637
Exchange rate of units at the end of the year		1.69	1.80

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Statement of Changes in Net Assets for the year 2010

	Notes	2010	2009
Operating activities			
Loss for the year moved to units		(978)	(241)
Financing activities			
Units sold		0	0
		0	0
Changes in net assets		(978)	(241)
Net assets at the beginning of the year		17,303	17,544
Net assets at the end of the period		16,325	17,303

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Investment Statement 31 December 2010

KMIIF	**Market value**	**% of assets**
Icelandic bonds		
Kaupthing hf., property loans	120,046	99.7%
Appropriated assets	347	0.3%
Total assets	120,393	100.0%
Issued bonds	(124,158)	(103.4%)
Other assets	20,100	16.7%
Other liabilities	(10)	(0.0%)
Total net assets	16,325	

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Notes to the Financial Statements

Accounting methods

1. Basis of preparation

The Financial Statement of Kaupthing Mortages Institutional Investor Fund has been prepared in accordance with the Financial Statements Act and regulations on financial statements of management companies of mutual funds. They are prepared on the historical cost basis with the exception that securities are generally stated at market value. The Financial Statements are prepared according to the same accounting methods as last year. The Financial Statements have been prepared in Icelandic krónur (ISK) and figures are in ISK millions. The fund is a part of Stefnir hf., which is a subsidiary of Arion Bank hf., and information on the group's results and financial position is contained in Stefnir's financial statements. Due to the nature of its operation, the Financial Statements of the fund does not form part of the financial statement of the bank.

2. Foreign currencies

Assets and liabilities in foreign currencies are translated into ISK at the exchange rate at the end of the year 2010. Operating income and operating expenses in foreign currencies are translated at the exchange rate on the date of transaction.

3. Interest income and expenses

Interest income and expense are recognised in the income statement as they are incurred and are based on the effective interest rate.

4. Dividends

Dividends are recognised as an expense when there is demand for redemption, i.e. on the date dividends are paid out. Capital gains tax on dividends from international equities is deducted from dividend income in the income statement in cases where a double taxation agreement stating that such income should be taxed in this country does not exist between Iceland and the country in question.

5. Administration fee

The fund pays Stefnir hf. an asset management fee which includes the following operating costs for the fund: salaries of employees of management company, marketing costs and administration; the fund also pays custody fees to Arion Custody Services. Administration fees are calculated as a percentage of the fund's total assets, as follows:

	Asset management fee	Security custody fée
KMIIF	0.07%	0.03%

6. Securities with fixed income

a. Property loans are recognised with accrued interest and indexation at the end of the year. At the end of 2010, 48% of the fund's property loans were calculated according to the index for mortgage payment adjustment.

b. In response to the conditions created by the collapse of the financial sector in Iceland in the autumn of 2008, banks and financial companies have resorted to a range of measures to tackle clients' debt. In late 2009, Arion Bank gave its customers the option of adjusting the principal on the loans to 110% of the market value of the property. It has been calculated how many loans in the fund have a loan-to-value ratio of more than 110%. The reduction in principal on loans exceeding this amount totalled ISK 3,921 million on 31 December 2010 which is recognised as impairment in the income statement. The impairment loss is deducted from fixed income securities in the balance sheet.

7. Taxation

Institutional investor funds do not pay income tax; instead profit or loss from operations are taxed with the unit holders. Individuals pay capital gains tax on profits on their securities when redeemed. Profit and loss on unit shares owned by companies are treated as taxable income and expenses, regardless of redemption.

The funds are exempt from capital gains tax in Iceland but not in those countries where capital gains tax is imposed on income of foreign residents and when no double taxation agreement stating that such income should be taxed in Iceland exists between Iceland and the relevant country.

8. Units

a. Real return of the mutual fund of Stefnir hf. as of 31 December 2010.

	Last 3 months	Last 6 months	Last 12 months
KMIIF	(2.92%)	(10.08%)	(18.17%)

b. Statement of book value and exchange rate of units.

	Book value			Exchange rate		
	2010	2009	2008	2010	2009	2008
KMIIF	16,325	17,303	17,544	1.69	1.80	1.82

9. Securities with fixed income are specified as follows:

	2010 Total	2009 Total
Property loans before impairment	123,967	124,396
Impairment loss	(3,921)	(2,123)
Property loans after impairment	120,046	122,273
Account for impairment losses as a ratio of total loans	(3.16%)	(1.71%)

10. Statement of proportional division of assets and investment policy.

	Assets 2010 %	Assets 2009 %	Change %	Investment policy Minimum %	Investment policy Maximum %
Other financial instruments	100	100	0	0	100

11. Segmentation of investments and proportional division:

	State, municipality or intern. inst.		Shares		Other		Total	
	ISK	%	ISK	%	ISK	%	ISK	%
Other financial instruments					120,046	100	120,046	100
	0	0	0	0	120,046	100	120,046	100

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