



Newsletter

Financial Institutions - Fourth edition - December 2010

Setting the *long-term* strategic direction

Arion Bank will be a relationship bank; a bank which provides universal banking services with a focus on larger corporations and individuals seeking a variety of financial solutions.

In the long term the Bank's explicit goal is to be a clear leader within the Icelandic financial sector in regards to return on equity, operational efficiency and the services it offers.

Arion Bank's capital ratio increased by 1.7 percentage points during the third quarter and was 18.1% on 30 September.

The year 2010 has been an eventful year. In early January the Resolution Committee of Kaupthing Bank announced that it was taking ownership of 87% of shares in Arion Bank on behalf of its creditors. Consequently, a new Board of Directors led by Chairwoman Monica Caneman was appointed, and one of the board's first tasks was to hire a new CEO, Höskuldur H. Ólafsson, who joined Arion Bank on 1 June.

Arion Bank - a relationship bank

Several changes have been made to the management team since Mr. Ólafsson took over the helm of Arion Bank. At a meeting with the employees in early October Mr. Ólafsson introduced the results of strategic planning that had been carried out in the previous months and outlined to the employees the Bank's new organisational structure as well as his vision and strategic direction for Arion Bank.

The key message Mr. Ólafsson communicated to the employees was that Arion Bank will be a relationship bank; a bank which provides universal banking services with a focus on larger corporations and individuals seeking a variety of financial solutions, with personal services and customised solutions. Arion Bank will focus its services on the greater Reykjavik area as well as the larger municipalities around the country.

Mr. Ólafsson underlined the importance of the Bank's financial strength, and stated that in the long term the Bank's explicit goal is to be a clear leader within the Icelandic financial sector in regards to return on equity, operational efficiency and the services it offers.

Arion Bank's strategic vision is the result of months of work with McKinsey & Company and builds on a detailed analysis of the Icelandic banking sector, the capabilities of the Bank's employees as well as its customer base.

Arion Bank's *financial results* for the first nine months of 2010

Arion Bank reported net earnings of ISK 8.9 billion during the first nine months of 2010. Net earnings in the third quarter totalled ISK 976 million. Foreign exchange loss and the depreciation of loans related to corporate and household debt restructuring had a negative impact on results during the third quarter. Return on equity was 10.4% on an annualised basis.

Arion Bank's capital ratio increased by 1.7 percentage points during the third quarter and was 18.1% on 30 September. This reflects the Bank's commitment to maintain a strong capital base.

The Bank's nine-month financial statement was not audited.

Net earnings of ISK 8.9 billion during the first nine months of 2010.

Income statement

Income statement - consolidated		
	2010	2009
Million ISK	9M	12M
Net interest income	16,034	12,146
Change in valuation on loans and receivables	1,119	-296
Net interest income less value on loans and receivables	17,153	11,850
Net commission income	4,437	5,862
Net financial income	-2,170	10,353
Other operating income	17,744	21,570
Operating income	37,164	49,635
Salaries and related cost	-8,986	-10,413
Other operating expenses	-16,501	-23,815
Net earnings before taxes	11,677	15,407
Income taxes	-2,764	-2,536
Net earnings	8,913	12,871

The interest-rate differential as a percentage of the average interest-bearing assets and liabilities was 3.0% during the first nine months of 2010 but was 1.9% in 2009.

There was no change to the valuation on loans and receivables during the third quarter of 2010 but the valuation is currently being conducted and will be a part of the Bank's financial statements for 2010.

The Bank's other operating income and expenses are unusually high due to subsidiaries taken over by the Bank and held for resale. The net result was around ISK 1 billion.

For further information on the unaudited accounts please visit our website for the full accounts.

Letter of intent represents key milestone in *resolving* household debt

Recently the Icelandic government, pension funds, the Housing Financing Fund and financial institutions signed a letter of intent outlining a broad range of coordinated measures to tackle household debt. This is of great significance as all lenders on the property market and the authorities have now made a joint effort to devise solutions and procedures to deal with problem debt.

The solutions introduced in the letter of intent will largely be similar to ones that Arion Bank has been offering its customers for some time now. Approximately 4,000 of the Bank's customers have already taken advantage of the Bank's solutions and as a result the Bank has to date written off ISK 12.8 billion in property loans to households.

Arion Bank recently set up a new advisory service designed to help individuals in financial difficulties. The goal is that within a few months everyone experiencing serious financial difficulties will have received assistance in sorting out their debt problems.

All lenders on the property market and the authorities have now made a joint effort to devise solutions and procedures to deal with problem debt.

A bill addressing FX loans to individuals

Our last issue of the Newsletter discussed the uncertainty surrounding FX loans to individuals. Since then the Parliament has passed a bill proposed by the minister of economic affairs which effectively will turn FX loans to individuals into ISK denominated loans bearing Icelandic interest rates as published by the Central Bank of Iceland. This is a measure taken by the minister to eliminate the uncertainty that has surrounded these loans following rulings by the Supreme Court.

Strong capital ratio

The solutions which are at the heart of the aforementioned letter of intent and the minister's bill on FX loans will not have a significant effect on Arion Bank's capital ratio. The Bank will continue to meet both the statutory requirements and the stringent 16% capital ratio requirement of the FME (Icelandic FSA). Arion Bank fully expects its customers to take full advantage of the solutions on offer, and in doing so the Bank's scope to address this important issue of household debt burden will be fully utilised.

The Bank will continue to meet both the statutory requirements and the stringent 16% capital ratio requirement of the FME (Icelandic FSA).

Making *good* progress in corporate recovery

From the outset Arion Bank has placed strong emphasis on the restructuring of the corporate loan book. The objective is not only to improve the quality of the loan book but also to create foundations for the financial recovery of Icelandic corporations through a healthy capital structure.

Arion Bank has made good progress with the restructuring of the larger companies in its portfolio and has already made decision on the restructuring of two thirds of the larger companies, or 300 companies out of 450. These are often very complicated cases involving many stakeholders and they demand time and numerous resources before being brought to completion.

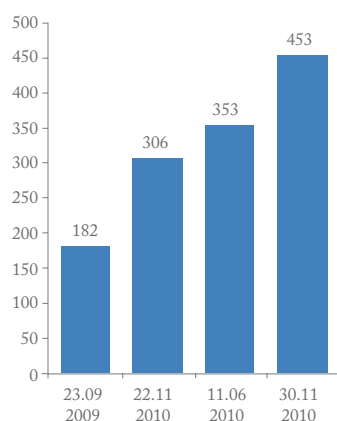
In light of the good progress with the larger companies Arion Bank has now shifted its focus to small and medium-sized companies. It is estimated that in the excess of 400 companies in that category need restructuring. The process is generally less complex for SMEs and therefore a more standardised and less time-consuming set of solutions have been adopted.

Arion Bank estimates that the debt restructuring of all corporations will be completed in 2011.

Book value represents expected recovery

It is important to note that the ongoing financial restructuring of corporations will not have a negative effect on the Bank's capital ratio. The Bank's loan portfolio is valued every six months and the book value fully represents what Arion Bank expects to recover of corporate loans. In fact the estimated value of the corporate loan book as represented in the Bank's financial statements has been increasing steadily during the last two years as the recovery work has progressed, and there is more certainty on the status of individual borrowers.

Companies that have entered the recovery process



The Bank's loan portfolio is valued every six months and the book value fully represents what Arion Bank expects to recover of corporate loans.



Frjálsi Pension Fund named the *best* pension fund in Iceland

Frjálsi Pension Fund has been named the best pension fund in Iceland for the second year in a row by the magazine Investment Pension Europe (IPE). Frjálsi Pension Fund, which is managed by Arion Bank, has assets of ISK 90 billion and more than 40,000 fund members.

The selection committee noted that Frjálsi had successfully risen to the challenge of managing funds in a time of severe crisis. The fund had reassured investors about its position through transparency and by improving communications with fund members.

Frjálsi has won IPE awards before. Last year Frjálsi was named the best pension fund in Iceland and in 2005 it won the best fund in Europe award in the category DB/DC Structuring/Strategies.

Frjálsi Pension Fund, which is managed by Arion Bank, has assets of ISK 90 billion and more than 40,000 fund members.

Contacts

Ída Brá Benediktsdóttir
Head of Communication, FI & IR
CEO Office
Tel: +354 444 7107
ida.benediktsdottir@arionbanki.is

Ólafur Frímánn Gunnarsson
Head of FX and Money Market
Treasury
Tel: + 354 444 7115
olafur.gunnarsson@arionbanki.is

Haraldur Guðni Eiddsson
Relationship Manager
CEO Office
Tel: +354 444 7108
haraldur.eiddsson@arionbanki.is

Delia Howser
Head of Trade Clearing
Back Office
Tel: +354 444 6620
delia.howser@arionbanki.is

Bjarki Rafn Eiríksson
Head of FX and
Fixed Income Sales
Capital Markets
Tel: + 354 444 7111
bjarki.eiriksson@arionbanki.is

Economic update

Each month the Research department at Arion Bank sends out an economic update with the latest economic developments in Iceland. To subscribe to mailing list or to read the latest economic updates please visit <http://www.arionbanki.is/?PageID=5394>

Disclaimer

This document has been prepared for information purposes only and should not be relied upon, or form the basis of any action or decision, by any person. Nothing in this document is, nor shall it be relied on, as a promise or representation as to the future. In supplying this document, Arion Bank does not undertake any obligation to provide the recipient with access to any additional information or to update this document or to correct any inaccuracies herein which may become apparent.

The information relating to Arion Bank, its subsidiaries and associates and their respective businesses and assets contained in, or used in preparing, this document has not been verified or audited. Further, this document does not purport to provide a complete description of the matters to which it relates. Some information may be based on assumptions or market conditions and may change without notice. Accordingly, no representation or warranty, express or implied, is made as to the fairness, accuracy, completeness or correctness of the information, forecasts, opinions and expectations contained in this document and no reliance should be placed on such information, forecasts, opinions and expectations. To the extent permitted by law, none of Arion Bank or any of their affiliates or advisers, any of their respective directors, officers or employees, or any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection with this document.

By accepting this document you agree to be bound by the foregoing instructions and limitations.