



Interim Financial Statements

1 January - 31 March 2012

Unaudited

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

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Endorsement and Statement by the Board of Directors and the CEO

The Unaudited Interim Financial Statements of Arion Bank for the period ended 31 March 2012 include the Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, capital markets services, corporate financing and asset management and comprehensive wealth management for private banking clients.

Kaupskil ehf., a company owned by the creditors of Kaupthing hf. (formerly Kaupthing Bank hf.), holds 87% of the shares in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State Financial Investments on behalf of the Icelandic government.

The number of full-time equivalent positions at the Group was 1,179 at period-end compared with 1,222 on 31 March 2011, of which 887 positions were at Arion Bank, compared with 914 at the end of March 2011.

Operations during the period

Net earnings amounted to ISK 4,451 million for the period ended 31 March 2012. The Board of Directors proposes that profits will be added to equity and that no dividend will be paid. Total equity amounted to ISK 119,011 million at the end of the period, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 20.2%. When taking into account Net earnings for the first quarter of 2012 the ratio would be 20.8%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") requires it to be no less than 16%. The Group's liquidity position was strong with the liquidity ratio and cash ratio being 30% and 14% respectively at the end of the period. This compares favourably with the regulatory minimum of 20% and 6% respectively.

Arion Bank generally performed well during the period and core banking activities continued to yield strong results. The same applied to the vast majority of core subsidiaries.

The Bank experienced a liquidity stress test of sorts in the quarter when a large deposit, categorized by the Bank as capital control held deposit, was withdrawn on a very short notice. The Bank was able to deal with the deposit outflow without difficulties and as a result the quality of the Bank's deposit base has improved. The liquidity position of Arion bank continues to be strong but the Bank continually strives to diversify its funding base.

To that effect, the Bank, on 17 February, issued its first covered bonds under its EUR 1 billion Covered Bond Programme. The issue was ISK 2.5 billion index linked, with a final maturity in 2034, targeted towards Icelandic institutional investors. The issue was close to four times oversubscribed.

During the quarter additional steps were taken to sell the Bank's share in Hagar hf. with the sale of 13.3% share in the company. Remaining share at 31 March is below 10%.

The Bank continued to make good progress in the restructuring work on its loan book and other assets transferred from Kaupthing hf. The recovery work on loans to larger corporations is largely completed and work continues with SME's and individuals. The Supreme Court Ruling of 15 February 2012, regarding interest on FX linked loans was however a set-back in this respect. The ruling is not decisive enough and the restructuring work on SME's has therefore stalled somewhat. New rulings, that will provide further clarification, are expected in the near future. Uncertainties regarding the legality of foreign currency loans to corporations are further discussed in Note 50.

There are positive signs in the Icelandic economy which grew by 3.1% in 2011. Unemployment was at 7.1% in March, well below the EU average and the Republic has demonstrated twice the ability to tap the international financial markets. The recovery of the Icelandic economy, however, remains fragile and must be managed with care. Arion Bank is a financially strong institution which is in an ideal position to support the growth of the Icelandic economy over the coming years.

Endorsement and Statement by the Board of Directors and the CEO

Statement by the Board of Directors and the CEO

The Interim Financial Statements for the period ended 31 March 2012 have been prepared in accordance with International Financial Reporting Standard (IAS 34 *Interim Financial Reporting*) as adopted by the EU.

It is our opinion that the Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 31 March 2012, its financial position as at 31 March 2012 and its cash flows for the period ended 31 March 2012.

Further, in our opinion the Interim Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Interim Financial Statements of Arion Bank for the period 1 January to 31 March 2012 and confirm them by means of their signatures.

Reykjavík, 22 May 2012

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Gudrún Johnsen

Måns Höglund

Freyr Thórdarson

Jón G. Briem

Chief Executive Officer

Höskuldur H. Ólafsson

Interim Statement of Comprehensive Income for the Period from 1 January to 31 March 2012

	Notes	2012 1.1.-31.3.	2011 1.1.-31.3.
Interest income		15,298	11,117
Interest expense		(9,084)	(5,231)
Net interest income	9	6,214	5,886
Increase in book value of loans and receivables	10	119	2,057
Impairment of loans and receivables	11	(195)	440
Changes in compensation instrument	34	-	(2,910)
Net interest income less valuation changes on loans and receivables		6,138	5,473
Fee and commission income		3,806	4,124
Fee and commission expense		(1,470)	(1,632)
Net fee and commission income	12	2,336	2,492
Net financial income (expense)	13-16	346	729
Net foreign exchange gain (loss)	17	1,083	(312)
Share of profit or loss of associates	36	5	(17)
Other operating income	18	947	1,116
Operating income		10,855	9,481
Salaries and related expense	20	(3,045)	(2,658)
Administration expense		(2,105)	(1,909)
Depositors' and investors' guarantee fund	47	(238)	(180)
Depreciation and amortisation		(217)	(208)
Other operating expense	21	(197)	(166)
Earnings before tax		5,053	4,360
Income tax expense	22	(1,061)	(1,045)
Bank Levy	23	(268)	(67)
Net earnings from continuing operations		3,724	3,248
Net gain (loss) from discontinued operations, net of tax	24	727	(282)
Net earnings		4,451	2,966
Attributable to:			
Shareholders of Arion Bank		4,311	2,791
Non-controlling interest		140	175
Net earnings		4,451	2,966
Other comprehensive income			
Exchange difference on translating foreign subsidiaries	45	2	181
Total comprehensive income for the period		4,453	3,147
Earnings per share			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	25	2.16	1.40

The notes on pages 9 to 47 are an integral part of these Interim Financial Statements.

Interim Statement of Financial Position as at 31 March 2012

Assets	Notes	31.03.2012	31.12.2011	31.03.2011
Cash and balances with Central Bank	26	18,030	29,200	24,629
Loans and receivables to credit institutions	27-28	65,955	69,103	84,733
Loans and receivables to customers	29-30,52	584,154	561,550	432,505
Bonds and debt instruments	31-32	142,493	140,568	123,423
Shares and equity instruments with variable income	31	15,096	14,045	11,526
Derivatives	31,43	1,313	674	395
Securities used for hedging	31	2,102	2,372	2,145
Compensation instrument	34	-	-	22,507
Investment property	35	25,867	27,100	27,149
Investments in associates	36	2,992	2,987	2,968
Property and equipment		6,186	6,271	7,259
Intangible assets		4,863	4,765	4,357
Tax assets	37	629	724	306
Non-current assets and disposal groups held for sale	38	21,852	23,886	38,575
Other assets	39	7,840	8,876	20,210
Total Assets		<u>899,372</u>	<u>892,121</u>	<u>802,687</u>
Liabilities				
Due to credit institutions and Central Bank	31	37,032	16,160	68,322
Deposits	31	462,193	489,995	472,359
Financial liabilities at fair value	31	8,098	4,907	6,202
Tax liabilities	37	3,333	3,421	5,326
Non-current liabilities and disposal groups held for sale	38	4,444	4,950	10,181
Other liabilities	40	39,105	38,822	35,704
Borrowings	31,41	192,109	187,203	65,180
Subordinated liabilities	31,42	34,047	32,105	26,730
Total Liabilities		<u>780,361</u>	<u>777,563</u>	<u>690,004</u>
Equity				
Share capital	44	2,000	2,000	2,000
Share premium	44	73,861	73,861	73,861
Other reserves	45	1,639	1,637	1,706
Retained earnings		37,261	32,950	31,322
Total Shareholders' Equity		<u>114,761</u>	<u>110,448</u>	<u>108,889</u>
Non-controlling interest		4,250	4,110	3,794
Total Equity		<u>119,011</u>	<u>114,558</u>	<u>112,683</u>
Total Liabilities and Equity		<u>899,372</u>	<u>892,121</u>	<u>802,687</u>

The notes on pages 9 to 47 are an integral part of these Interim Financial Statements.

Interim Statement of Changes in Equity for the Period from 1 January to 31 March 2012

	Share capital and share premium	Other reserves	Retained earnings	Total Share- holders' equity	Non- controlling interest	Total equity
Changes in equity from 1 January to 31 March 2012:						
Equity 1 January 2012	75,861	1,637	32,950	110,448	4,110	114,558
Total comprehensive income for the period attributable to the shareholders of Arion Bank		2	4,311	4,313		4,313
Total comprehensive income for the period attributable to the non-controlling interest					140	140
Equity 31 March 2012	75,861	1,639	37,261	114,761	4,250	119,011
Changes in equity from 1 January to 31 March 2011:						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Total comprehensive income for the period attributable to the shareholders of Arion Bank		181	2,791	2,972		2,972
Total comprehensive income for the period attributable to the non-controlling interest					175	175
Equity 31 March 2011	75,861	1,706	31,322	108,889	3,794	112,683

The notes on pages 9 to 47 are an integral part of these Interim Financial Statements.

Condensed Interim Statement of Cash Flows for the Period from 1 January to 31 March 2012

	Notes	2012 1.1.-31.3.	2011 1.1.-31.3.
Cash flows (used in) from operating activities			
Earnings before income tax		5,053	4,360
Adjustments to reconcile earnings before income tax to net cash (used in) from operating activities:			
Non-cash items included in net earnings before income tax and other adjustments		(1,138)	(884)
Changes in operating assets and liabilities	51	(20,050)	(1,154)
Income taxes paid		(1,054)	(184)
Net cash (used in) from operating activities		(17,189)	2,138
Net cash (used in) from investing activities		3,753	(130)
Net (decrease) increase in cash and cash equivalents		(13,436)	2,008
Cash and cash equivalents at beginning of the period		82,815	72,797
Cash and cash equivalents acquired through business combinations		5	-
Effect of exchange rate changes on cash and cash equivalents		2,347	2,067
Cash and cash equivalents at the end of the period		71,731	76,872
Cash and cash equivalents comprises			
Cash in hand and demand deposits		18,030	24,629
Due from credit institutions		62,065	60,169
Mandatory reserve with Central Bank		(8,364)	(7,926)
Cash and cash equivalents at period-end		71,731	76,872

The notes on pages 9 to 47 are an integral part of these Interim Financial Statements.

Notes to the Interim Financial Statements

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Notes to the Interim Financial Statements

Accounting Policies

General information

1. Reporting entity

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Financial Statements for the period ended 31 March 2012 comprise the Parent Company and its subsidiaries (together referred to as "the Group"). The Group offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, retail banking, investment banking services and asset management.

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 22 May 2012.

2. Basis of preparation

a) *Statement of compliance*

The Interim Financial Statements are condensed and consolidated and have been prepared in accordance with International Financial Reporting Standard IAS 34, Interim Financial Reporting as endorsed by the European Union. The Interim Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Arion Banks' annual Financial Statements for the year 2011. The statements are available at Arion Banks' website www.arionbanki.is.

b) *Basis of measurement*

The Interim Financial Statements are prepared on the historical cost basis except for the following:

- Financial assets/liabilities held for trading are measured at fair value;
- Financial assets/liabilities designated at fair value through profit and loss are measured at fair value;
- Investment properties are measured at fair value; and

Non-current assets (or disposal groups) classified as held for sale are stated at the lower of their carrying amount and fair value less costs to sell. Immediately before the initial classification, or where the assets and liabilities are not within the scope of IFRS 5, the carrying amounts are measured in accordance with applicable IFRSs.

c) *Functional and presentation currency*

The Interim Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated.

d) *Use of estimates and judgements*

The preparation of the Interim Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, contingent liabilities as well as income and expenses in the Interim Financial Statements presented. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the differences may be material to the Interim Financial Statements.

Estimates and underlying assumptions are reviewed on an on going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Judgements made by management that have a significant effect on the Interim Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in Note 4 in these Interim Financial Statements and in the annual Financial Statements 2011.

Significant accounting policies

The accounting policies adopted in the preparation of these Interim Financial Statement are consistent with those followed in the preparation of the Group's annual Financial Statements for the year ended 31 December 2011.

3. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures.

Notes to the Interim Financial Statements

4. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

These disclosures supplement the risk management disclosures, provided elsewhere in these Interim Financial Statements.

Key sources of estimation uncertainty

i) Impairment losses on loans and receivables

The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Statement of Comprehensive Income, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

ii) Foreign currency linked loans

The Group is reviewing the impact of the Supreme Court judgment of 15 February 2012 on the currency-linked loan portfolio. The Group's preliminary evaluation is that currency linked loans can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland. However, if the borrower has paid according to the Bank's payment slips, then the Bank can not normally claim a larger amount of interest on the loan than the interest the borrower has actually paid.

As set out in Note 50 of these Interim Financial Statements, the Group recognised impairment of the currency linked loan portfolio at period-end for the estimated loss arising from the above judgment. The Group remains exposed to significant uncertainty regarding foreign currency linked loans arising from firstly, uncertainty over its interpretation of this judgment and secondly, uncertainty over the outcome of future legal decisions and new or amended government legislation.

Management judgment is required in the determination of the individual borrowers that require recalculation, and the estimated loss is based on assumptions that may be revised when it becomes clear how to interpret the Supreme Court's judgement. In addition, the outcome of future legal decisions and new or amended government legislation may require recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

iii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

iv) Assets classified as held for sale

The Group classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. For the sale to be highly probable management must be committed to sell the assets and be actively looking for a buyer, the assets must be actively marketed at a price that is reasonable in relation to their fair value and the sale is expected to be completed within one year. An extension of the period required to complete a sale does not preclude an asset or disposal group from being classified as held for sale if the delay is caused by events or circumstances beyond the Group's control and there is sufficient evidence that the Group remains committed to its plan to sell the assets or disposal groups.

When classifying assets as held for sale the Group has determined that the requirements of IFRS 5 have been met.

As set out in Note 21 in the annual Financial Statements for the year 2011, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair values less costs to sell. For the most part, fair values at the date of classification of these legal entities were calculated using valuation models based on discounted future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), would have a significant impact on the fair value of these disposal groups.

Notes to the Interim Financial Statements

4. cont.

v) Fair value of Investment Property

As the property market in Iceland is relatively inactive and assets are often quite dissimilar it is difficult to obtain reliable estimates of fair values of investment properties. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to use prices from recent market transactions in order to determine values of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

vi) Intangible assets

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

Changes within the Group

5. Acquisition of mortgage portfolio

At year-end 2011 Arion Bank and Kaupthing hf. reached agreement for Arion Bank to acquire a mortgage portfolio which has been managed in a special fund owned by Kaupthing hf. The agreement also specifies that the deals funded by the assumption of covered bonds by Arion Bank.

Under the agreement Arion Bank replaced Kaupthing hf. as issuer of the covered bonds. The covered bonds will be listed on Nasdaq OMX Iceland in 2012.

Through this acquisition total assets of the Group increased by ISK 94.4 billion and total liabilities increased by ISK 96.7 billion.

6. Disposal of subsidiaries

The subsidiary Ekort ehf. was merged into Arion Bank 1 January 2012. Prior to the merger part of the operation of Ekort ehf. was transferred to Einkalúbburinn ehf. which is a new subsidiary of Arion Bank. The subsidiaries AB-fjárfestingar ehf., ENK 1 ehf. and Vesturland ehf. were liquidated in the first quarter of 2012.

Notes to the Interim Financial Statements

Operating Segment Reporting

7. Segment information is presented in respect of the Group's operating segments based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

Inter segment pricing is determined on an arm's length basis. Business segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital and funding cost.

Segment capital expenditure is the total cost incurred during the period to acquire property and equipment and intangible assets.

Operating segments

The Group comprises six main operating segments:

Corporate Banking serves large enterprises and professional investors. The role of the division is to provide universal financial services as well as tailored services to meet the needs of each customer. *Corporate Banking* is divided into a *Corporate Banking* unit, *Factoring* services and a *Corporate Recovery* unit. *Corporate Banking* and *Factoring* together provide a wide range of credit solutions while the *Recovery* unit is responsible for the financial restructuring of companies which need to reorganise their capital structure.

Retail Banking, Arion Bank Mortgages Institutional Investor Fund (ABMIIF), AFL sparisjóður and Sparisjóður Ólafsfjardar provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 24 branches all around Iceland are over 100,000.

Asset Management and Stefmir hf. manage assets on behalf of its clients, who include institutional investors, corporations, high net wealth clients and retail investors. The entities offer clients variety of mutual funds, alternative vehicles, pension plan schemes and customized asset allocation strategies designed to meet the diverse needs of investors. The subsidiary Stefmir operates the fund management business.

Investment Banking is divided into Corporate Finance, Capital Markets and Research. *Corporate Finance* provides M&A advisory services and capital markets transaction services to corporate clients and investors. *Capital Markets* provides securities brokerage and FX sales for institutional investors and corporate clients. *Research* is split into Equity, Fixed Income and Macro Analysis with clients such as asset management companies, institutional investors, and other divisions of the Group.

Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency, liaison with other financial institutions, Proprietary trading and market making in domestic securities and currencies.

Other Divisions and Subsidiaries include Proprietary trading and the subsidiaries Eignabjarg ehf., Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Verdis hf., Valitor holding hf. and other smaller entities of the Group.

Headquarters: Overhead, Risk Management, Finance, Legal, Operations, Corporate Development and activities of other non-core entities.

Notes to the Interim Financial Statements

8. Summary of the Group's business segments:

1.1.-31.3.2012	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	2,713	2,453	487	68	977	(443)	(41)	6,214
Other income	57	1,136	552	338	1,018	1,490	50	4,641
Operating income	2,770	3,589	1,039	406	1,995	1,047	9	10,855
Operating expense	(197)	(1,395)	(326)	(143)	(44)	(1,296)	(2,401)	(5,802)
Allocated cost	(486)	(1,162)	(167)	(157)	(204)	-	2,176	-
Earnings before tax	2,087	1,032	546	106	1,747	(249)	(216)	5,053
Net seg. rev. from ext. cust.	4,666	2,828	(114)	365	(1,912)	4,916	106	10,855
Net seg. rev. from oth. seg.	(1,896)	761	1,153	41	3,907	(3,869)	(97)	-
Operating income	2,770	3,589	1,039	406	1,995	1,047	9	10,855
Depreciation and amortisation	-	39	-	-	-	57	121	217
Total assets	283,449	310,170	4,381	17,094	198,578	85,700	-	899,372
Allocated equity	45,351	23,689	417	(272)	35,297	14,529	-	119,011
1.1.-31.3.2011								
Net interest income	3,871	2,559	313	19	49	(935)	10	5,886
Other income	329	582	596	974	(1,069)	2,174	9	3,595
Operating income	4,200	3,141	909	993	(1,020)	1,239	19	9,481
Operating expense	(324)	(2,037)	(408)	(212)	(157)	(1,385)	(598)	(5,121)
Allocated cost	(190)	(202)	(25)	(20)	(79)	-	516	-
Earnings before tax	3,686	902	476	761	(1,256)	(146)	(63)	4,360
Net seg. rev. from ext. cust.	5,910	2,429	242	1,034	(937)	2,155	(1,352)	9,481
Net seg. rev. from oth. seg.	(1,710)	712	667	(41)	(83)	(916)	1,371	-
Operating income	4,200	3,141	909	993	(1,020)	1,239	19	9,481
Depreciation and amortisation	-	37	-	-	-	49	122	208
Total assets	271,207	299,207	3,621	16,477	207,099	94,510	-	892,121
Allocated equity	43,297	32,580	2,673	1,269	18,062	16,677	-	114,558

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

Notes to the Interim Financial Statements

Notes to the Interim Statement of Comprehensive Income

Net interest income

9. Interest income and expense is specified as follows:

	Interest income	Interest expense	Net interest income
1.1.-31.3.2012			
Cash and balances with Central Bank	171	-	171
Loans, receivables and deposits	12,884	4,935	7,949
Borrowings	-	3,646	(3,646)
Subordinated liabilities	-	430	(430)
Securities	2,147	-	2,147
Other	96	73	23
Interest income and expense	15,298	9,084	6,214
Interest income and expense from assets and liabilities at fair value	2,147	-	2,147
Interest income and expense from assets and liabilities not at fair value through profit or loss	13,151	9,084	4,067
Interest income and expense	15,298	9,084	6,214
1.1.-31.3.2011			
Cash and balances with Central Bank	104	-	104
Loans, receivables and deposits	8,896	4,291	4,605
Borrowings	-	602	(602)
Subordinated loans	-	329	(329)
Securities	1,919	-	1,919
Compensation instrument	173	-	173
Other	25	9	16
Interest income and expense	11,117	5,231	5,886
Interest income and expense from assets and liabilities at fair value	1,919	-	1,919
Interest income and expense from assets and liabilities not at fair value through profit or loss	9,198	5,231	3,967
Interest income and expense	11,117	5,231	5,886

Increase in book value of loans and receivables

10. The increase in book value of loans and receivables is determined in accordance with the accounting policy presented in the annual Financial Statements 2011. Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment of loans and receivables

11. Impairment of loans and receivables is specified as follows:

	2012 1.1.-31.3.	2011 1.1.-31.3.
Impairment of loans and receivables to credit institutions	29	321
Impairment of loans and receivables to customers	166	(761)
Impairment of loans and receivables	195	(440)

Notes to the Interim Financial Statements

Net fee and commission income

12. Fee and commission income and expense is specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Fee and commission income		
Asset management	523	603
Cards	2,245	2,548
Collection and payment services	296	281
Derivatives	53	42
Interbank clearing	175	164
Lending and guarantees	188	112
Security trading	52	48
Other fee and commission income	274	326
Fee and commission income	<u>3,806</u>	<u>4,124</u>
Fee and commission expense		
Asset management	19	28
Cards	1,064	1,335
Collection and payment services	5	3
Interbank clearing	180	172
Security trading	61	49
Other fee and commission expense	141	45
Fee and commission expense	<u>1,470</u>	<u>1,632</u>
Net fee and commission income	<u>2,336</u>	<u>2,492</u>

Asset management fees are earned by the Group on trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

Net financial income

13. Net financial income is specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Dividend income	2	3
Net gain (loss) on financial assets and liabilities classified as held for trading	(53)	(188)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	397	914
Net financial income	<u>346</u>	<u>729</u>
14. Dividend income is specified as follows:		
Dividend income on trading assets	2	1
Dividend income on financial assets designated at fair value through profit or loss	-	2
Dividend income	<u>2</u>	<u>3</u>
15. Net gain (loss) on trading assets and liabilities is specified as follows:		
Net gain (loss) on equity instruments and related derivatives	98	6
Net gain (loss) on interest rate instruments and related derivatives	(277)	(157)
Net gain (loss) on other derivatives	126	(37)
Net gain (loss) on trading portfolio	<u>(53)</u>	<u>(188)</u>

Notes to the Interim Financial Statements

16. Net gain (loss) on assets/liabilities designated at fair value through profit or loss is specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Net gain (loss) on interest rate instruments designated at fair value	403	90
Net gain (loss) on equity instruments designated at fair value	(6)	824
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	397	914

Net foreign exchange gain (loss)

17. Net foreign exchange gain (loss) is specified as follows:

FX gain (loss) of loans and receivables	5,456	2,388
FX gain (loss) on bank accounts	2,347	2,067
FX gain (loss) from deposits and borrowings	(5,708)	(3,728)
FX gain (loss) from subordinated liabilities	(1,941)	(1,337)
FX gain (loss) on bonds, equity and derivatives	789	37
FX gain (loss) from compensation instrument	-	106
FX gain (loss) on other assets and liabilities	140	155
Net foreign exchange gain (loss)	1,083	(312)

Other operating income

18. Other operating income is specified as follows:

Rental income from investment properties	488	542
Fair value changes on investment property	33	-
Realised gain on investment property	17	-
Earned premiums, net of reinsurance	214	202
Net gain (loss) on disposals of assets other than held for sale	18	4
Other income	177	368
Other operating income	947	1,116

Personnel and salaries

19. The Group's total number of employees is as follows:

Average number of full time equivalent positions during the period	1,157	1,220
Full time equivalent positions at the end of the period	1,179	1,222

The Parent company's total number of employees is as follow:

Average number of full time equivalent positions during the period	874	913
Full time equivalent positions at the end of the period	887	914

Notes to the Interim Financial Statements

20. Salaries and related expense are specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Salaries	2,349	2,143
Defined contribution pension plans	323	289
Salary related expense	373	226
Salaries and related expense	3,045	2,658

Salaries and related expense for the Parent company are specified as follows:

Salaries	1,740	1,563
Defined contribution pension plans	238	211
Salary related expense	301	168
Salaries and related expense	2,279	1,942

Other operating expense

21. Other operating expense:

Direct operating expense (including repairs and maintenance) arising on rental-earning investment properties	115	95
Claims incurred, net of reinsurance	82	71
Other operating expense	197	166

Tax expense

22. Income tax recognised in the Statement of Comprehensive Income is specified as follows:

<i>Current tax expense</i>		
Current period	832	1,030
<i>Deferred tax expense</i>		
Changes in temporary differences	229	15
Total income tax expense	1,061	1,045

Reconciliation of effective tax rate:	1.1.-31.3.2012	1.1.-31.3.2011
Earnings before income tax	5,053	4,360
Income tax using the Icelandic corporation tax rate	20.0% 1,010	20.0% 872
Additional 6% tax on financial institutions	4.5% 228	0.0% -
Non-deductible expense	1.9% 96	7.0% 303
Tax exempt revenues	(6.6%) (333)	(3.0%) (130)
Non-deductible taxes	1.2% 60	0.0% -
Effective tax rate	21.0% 1,061	24.0% 1,045

23. Bank Levy

Bank levy is calculated according to law. The levy is 0.1285% on total debt excluding tax liabilities at end of period. Non-financial subsidiaries are exempt from this tax.

Notes to the Interim Financial Statements

Net gain (loss) from discontinued operations net of tax

24. Net gain (loss) from discontinued operations net of tax is specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Net gain (loss) from legal entities	803	125
Impairment loss on remeasurement to fair value of legal entities	-	(1,222)
Net gain (loss) on revaluation and disposal of real estate	(43)	(13)
Other assets	(33)	(122)
Effect of compensation instrument	-	950
Net gain (loss) from discontinued operations net of tax	727	(282)

Net gain (loss) from legal entities comprises the Group's share of net profit after tax from operations of legal entities that were classified as held for sale during the period.

Earnings per share

25. Earnings per share are specified as follows:	2012	2011
	1.1.-31.3.	1.1.-31.3.
Net earnings attributable to the shareholders of Arion Bank	4,311	2,791
Weighted average share capital:		
Weighted average number of outstanding shares for the period, million	2,000	2,000
Basic earnings per share	2.16	1.40
Diluted earnings per share	2.16	1.40
Number of outstanding shares at the end of the period, million	2,000	2,000
Number of total shares at the end of the period, million, diluted	2,000	2,000

There were no instruments at period-end that could potentially dilute basic earnings per share.

Notes to the Interim Financial Statements

Notes to the Interim Statement of Financial Position

Cash and balances with Central Bank

26. Cash and balances with Central Bank are specified as follows:	31.03.2012	31.12.2011
Cash on hand	3,717	2,954
Cash with Central Bank	5,949	17,686
Mandatory reserve deposit with Central Bank	8,364	8,560
Cash and balances with Central Bank	18,030	29,200

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

Loans and receivables to credit institutions

27. Loans and receivables to credit institutions specified by types of loans:		
Bank accounts	62,065	62,175
Money market loans	853	4,720
Overdrafts	1	19
Other loans	3,839	2,963
Provision on loans and receivables	(803)	(774)
Loans and receivables to credit institutions	65,955	69,103

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

Balance at the beginning of the period	774	1,359
Provision for losses during the period	29	199
Write-offs during the period	-	(784)
Balance at the end of the period	803	774

Loans and receivables to customers

29. Loans and receivables to customers specified by types of loans:		
Overdrafts	44,881	43,178
Subordinated loans	583	550
Other loans and receivables	591,426	574,111
Provision on loans and receivables	(52,736)	(56,289)
Loans and receivables to customers	584,154	561,550

The total book value of pledged loans at 31 March 2012 was ISK 168 billion (31.12.2011: ISK 171 billion). Pledged loans at period-end comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

Notes to the Interim Financial Statements

30. Changes in the provision for losses on loans and receivables to customers are specified as follows:	31.03.2012	31.12.2011
Balance at the beginning of the period	56,289	41,843
Provision for losses during the period	166	27,225
Write-offs during the period	(3,789)	(13,230)
Payment of loans previously written off	70	451
Balance at the end of the period	52,736	56,289
Specific	45,571	46,776
Collective	7,165	9,513
	52,736	56,289

Information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in Note 53 c).

Notes to the Interim Financial Statements

Financial assets and liabilities

31. Financial assets and liabilities are specified as follows:

31.03.2012	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank	18,030	-	-	-	18,030
Loans and receivables to credit institutions	65,955	-	-	-	65,955
Loans and receivables to customers	584,154	-	-	-	584,154
Loans and receivables	668,139	-	-	-	668,139
<i>Bonds and debt instruments</i>					
Listed	-	1,160	53,592	-	54,752
Unlisted	-	61	87,680	-	87,741
Bonds and debt instruments	-	1,221	141,272	-	142,493
<i>Shares and equity instruments with variable income</i>					
Listed	-	220	1,415	-	1,635
Unlisted	-	722	8,434	-	9,156
Bond funds with variable income	-	2,314	1,991	-	4,305
Shares and equity instruments	-	3,256	11,840	-	15,096
<i>Derivatives</i>					
OTC derivatives	-	1,313	-	-	1,313
Derivatives	-	1,313	-	-	1,313
<i>Securities used for hedging</i>					
Bonds and debt instruments	-	1,204	-	-	1,204
Shares and equity instruments	-	898	-	-	898
Securities used for hedging	-	2,102	-	-	2,102
Other financial assets	-	-	-	6,933	6,933
Financial assets	668,139	7,892	153,112	6,933	836,076
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	-	-	-	37,032	37,032
Deposits	-	-	-	462,193	462,193
Borrowings	-	-	-	192,109	192,109
Subordinated liabilities	-	-	-	34,047	34,047
Liabilities at amortised cost	-	-	-	725,381	725,381
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading	-	7,682	-	-	7,682
Derivatives held for trading	-	416	-	-	416
Financial liabilities at fair value	-	8,098	-	-	8,098
Other financial liabilities	-	-	-	33,358	33,358
Financial liabilities	-	8,098	-	758,739	766,837

Notes to the Interim Financial Statements

31. cont.

31.12.2011	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank	29,200	-	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	-	69,103
Loans and receivables to customers	561,550	-	-	-	561,550
Loans and receivables	659,853	-	-	-	659,853
<i>Bonds and debt instruments</i>					
Listed	-	2,919	52,688	-	55,607
Unlisted	-	44	84,917	-	84,961
Bonds and debt instruments	-	2,963	137,605	-	140,568
<i>Shares and equity instruments with variable income</i>					
Listed	-	153	1,163	-	1,316
Unlisted	-	657	8,382	-	9,039
Bond funds with variable income	-	1,774	1,916	-	3,690
Shares and equity instruments	-	2,584	11,461	-	14,045
<i>Derivatives</i>					
OTC derivatives	-	674	-	-	674
Derivatives	-	674	-	-	674
<i>Securities used for hedging</i>					
Bonds and debt instruments	-	1,922	-	-	1,922
Shares and equity instruments	-	450	-	-	450
Securities used for hedging	-	2,372	-	-	2,372
Other financial assets	-	-	-	8,004	8,004
Financial assets	659,853	8,593	149,066	8,004	825,516
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	-	-	-	16,160	16,160
Deposits	-	-	-	489,995	489,995
Borrowings	-	-	-	187,203	187,203
Subordinated liabilities	-	-	-	32,105	32,105
Liabilities at amortised cost	-	-	-	725,463	725,463
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading	-	3,711	-	-	3,711
Derivatives held for trading	-	1,196	-	-	1,196
Financial liabilities at fair value	-	4,907	-	-	4,907
Other financial liabilities	-	-	-	33,764	33,764
Financial liabilities	-	4,907	-	759,227	764,134

Included in unlisted Bonds and debt instruments designated at fair value is Drómi bond, which the Group received when acquiring deposits from SPRON in March 2009.

Notes to the Interim Financial Statements

32. Bonds and debt instruments designated at fair value specified by issuer:	31.03.2012	31.12.2011
Financial institutions	69,065	70,640
Public	64,273	59,368
Corporates	7,934	7,597
Bonds and debt instruments designated at fair value	141,272	137,605

The total amount of pledged bonds at 31 March 2012 was ISK 22 billion (31.12.2011: Nil).

33. Fair value hierarchy

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

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

Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and

Level 3: valuation techniques which include significant inputs that are not based on observable market data.

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

	Level 1	Level 2	Level 3	Total
31.03.2012				
Financial assets designated at FV through PL	6,674	144,357	2,081	153,112
Financial assets held for trading	3,252	4,618	22	7,892
	<u>9,926</u>	<u>148,975</u>	<u>2,103</u>	<u>161,004</u>
Financial liabilities held for trading	7,682	416	-	8,098
31.12.2011				
Financial assets designated at FV through PL	6,222	140,844	2,000	149,066
Financial assets held for trading	5,391	3,181	21	8,593
	<u>11,613</u>	<u>144,025</u>	<u>2,021</u>	<u>157,659</u>
Financial liabilities held for trading	3,711	1,196	-	4,907

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2012 is consistent with the classification used in 2011.

The following table shows transfers between Level 1 and Level 2 on the fair value hierarchy for financial assets and financial liabilities which are recorded at fair value:

	Transfers from Level 1 to Level 2	
	31.03.2012	31.12.2011
Financial assets		
Financial assets designated at FV through PL	916	886

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the period and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 during the period (2011: no transfers).

Notes to the Interim Financial Statements

33. cont.

Movements in Level 3 financial instruments measured at fair value

The level of the fair value hierarchy of financial instruments is determined at the beginning of each reporting period. The following table shows a reconciliation of the opening and closing amounts of Level 3 financial assets and liabilities which are recorded at fair value.

The following table shows the movements of Level 3 financial assets and liabilities (excluding the Compensation Instrument):

	31.03.2012	31.12.2011
Balance at the beginning of the period.....	2,021	1,688
Gain (loss) recognised in Statement of Comprehensive Income.....	73	771
Acquisition.....	-	160
Disposal.....	-	(599)
Transfer into Level 3.....	9	1
Balance at the end of the period.....	2,103	2,021

The following table shows the line items in the Statement of Comprehensive Income where gains (losses) related to fair value measurements in Level 3 are recognised:

	31.03.2012	31.12.2011
Net interest income.....	44	176
Net financial income (expense).....	1	520
Net foreign exchange gain (loss).....	28	75
Gain (loss) recognised in the Statement of Comprehensive Income.....	73	771

Compensation instrument

34. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing hf. to Arion Bank in 2008. On 30 June 2011 a Settlement and release of claims agreement was signed by Arion Bank and Kaupthing hf. to finalize a settlement of the Compensation Instrument and various other claims lodged against Kaupthing hf. by Arion Bank. By signing the agreement the Compensation Instrument was terminated and neither party has any payment obligations towards the other under the Instrument. For further information regarding the Compensation instrument see Arion Banks' annual Financial Statements for the year 2011.

	31.12.2011
Compensation instrument is specified as follows:	
Balance at the beginning of the period	24,188
Changes due to the Escrow and Contingent Value Rights Agreement	
Continuing operations	(19,593)
Discontinued operations	1,578
Accrued interest	322
Foreign exchange rate differences	325
Assets and liabilities upon settlement	(6,820)
Balance at the end of the period	-

Notes to the Interim Financial Statements

Investment property

35. Investment property is specified as follows:	Investment		Total 31.03.2012	Total 31.12.2011
	Investment property	property in progress		
Balance at the beginning of the period	21,948	5,151	27,099	27,642
Additions during the period	71	115	186	3,527
Disposals during the period	-	(1,451)	(1,451)	(5,760)
Transferred from property and equipment	-	-	-	775
Fair value adjustments	33	-	33	916
Investment property	22,052	3,815	25,867	27,100

Investments in associates

36. The Group's interest in its principal associates are as follows:	31.03.2012	31.12.2011
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43.5%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland	30.0%	30.0%
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	-	20.6%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	44.9%	44.9%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	25.0%	25.0%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	23.3%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmiðjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	23.6%
SMI ehf., Smáratorg 3, 210 Kópavogur, Iceland	39.1%	39.1%
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	20.0%	20.0%

Investments in associates are specified as follows:

Carrying amount at the beginning of the period	2,987	2,713
Additions during the period	-	2,854
Transferred to held for sale assets	-	(2,525)
Transferred from associates due to step acquisition	-	(9)
Impairment	-	(54)
Share of profit (loss)	5	8
Carrying amount at the end of the period	2,992	2,987

Tax assets and tax liabilities

37. Tax assets and liabilities are specified as follows:	31.03.2012		31.12.2011	
	Assets	Liabilities	Assets	Liabilities
Current tax	11	2,067	6	2,284
Deferred tax	618	1,266	718	1,137
Tax assets and liabilities	629	3,333	724	3,421

Notes to the Interim Financial Statements

Non-current assets and disposal groups held for sale

38. Non-current assets and disposal groups held for sale are specified as follows:	31.03.2012	31.12.2011
Legal entities	8,342	8,458
Associates	8,773	12,073
Real estates	2,669	2,875
Other assets	2,068	480
Non-current assets and disposal groups held for sale	21,852	23,886

The legal entities are subsidiaries that were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5. At period-end the largest entities were BM Vallá ehf., Fram Foods ehf. and Penninn á Íslandi ehf. All were held by the Group's holding company Eignabjarg ehf.

On 28 September 2011 an agreement to sell the Groups 38.9% shareholding in its associate N1 hf. was signed. A condition precedent for the sale is approval by the Icelandic Competition authority, which was pending at period-end.

On 4 October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf. A condition precedent for the sale is approval by the Icelandic Competition Authority, which was pending at period-end. Approval was obtained in April 2012.

The associates classified as disposal groups held for sale in accordance with IFRS 5 are HB Grandi hf. and N1 hf. It is expected that the associate HB Grandi hf. will be sold in 2012.

At end of 2011 the Group held 20.9% effective share in Hagar hf. During the period the Group sold 13.3% share in Hagar hf. and consequently the remaining investment was transferred from associates to other assets. As it is expected the Group's shareholding in Hagar hf. will be sold in 2012, this investment was classified as non-current assets and disposal groups held for sale at 31 March 2012. The gain resulting from this transaction was ISK 821 million and is recognized in the Statement of Comprehensive Income.

Real estates and other assets classified as non-current assets are generally the result of foreclosures on companies and individuals.

Liabilities associated with the legal entities held for sale are as follows:	31.03.2012	31.12.2011
Legal entities, total liabilities	4,444	4,950

Other assets

39. Other assets are specified as follows:	31.03.2012	31.12.2011
Unsettled securities trading	2,737	708
Accounts receivable	2,771	6,511
Accrued income	659	455
Prepaid expenses	675	678
Sundry assets	998	524
Other assets	7,840	8,876

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

Notes to the Interim Financial Statements

Other liabilities

40. Other liabilities are specified as follows:	31.03.2012	31.12.2011
Accounts payable	17,875	18,944
Kaupthing hf. due to investment in ABMIIF	-	3,048
Withholding tax	546	2,186
Depositors' and investors' guarantee fund	2,932	3,018
Insurance claim	2,139	2,023
Unsettled securities trading	2,941	132
Sundry liabilities	12,672	9,471
Other liabilities	39,105	38,822

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

Borrowings

41. Borrowings are specified as follows:		
Bonds issued	128,759	124,524
Other loans	63,350	62,679
Borrowings	192,109	187,203

The Group did not repurchase any own debts during the first three months of 2012 (31.12.2011: 442 million).

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006 to 2008. The bonds in question are covered bonds amounting to ISK 119.1 billion, net outstanding, with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund. It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Current repayment of principal is currently approximately 2.3 billion a year, currently total payment including repayment of principal, indexation and interest is 7.2 billion a year.

In February 2012 Arion Bank issued covered bonds from its EUR 1.0 billion covered bond programme. The bond issue is nominated in Icelandic króna, the amount issued was ISK 2.5 billion. The covered bond issue matures in February 2034 and is inflation indexed with a fixed 3.60% interest.

Interest of other loans is 3 month Euribor/Libor +300 bps until the loans expires in 2016. The loan can be extended up to 2022 with same terms.

Subordinated liabilities

42. Subordinated liabilities are specified as follows:	31.03.2012	31.12.2011
Tier II capital	34,047	32,105
Subordinated liabilities	34,047	32,105

The interest on the loan is 3 month Euribor/Libor +400 bps to the year 2015 and thereafter 3 month Euribor/Libor +500 bps.

Notes to the Interim Financial Statements

Derivatives

43. Derivatives at fair value are specified as follows:

31.03.2012	Fair value	
	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	888	77
Interest rate and exchange rate agreements	389	246
	<u>1,277</u>	<u>323</u>
Bond derivatives:		
Bond swaps, agreements unlisted	36	89
Options - sold agreements	-	4
Derivatives	<u>1,313</u>	<u>416</u>
 31.12.2011		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	193	671
Interest rate and exchange rate agreements	463	415
	<u>656</u>	<u>1,086</u>
Bond derivatives:		
Bond swaps, agreements unlisted	18	110
Derivatives	<u>674</u>	<u>1,196</u>

Equity

Share capital and share premium

44. According to the Parent Company's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at Shareholders' meetings of the Group.

	Number		Number	
	(million)	31.03.2012	(million)	31.12.2011
Issued share capital	2,000	75,861	2,000	75,861
	<u>2,000</u>	<u>75,861</u>	<u>2,000</u>	<u>75,861</u>

Share premium represents excess of payment above nominal value that Shareholders have paid for shares sold by the Group.

Other reserves

45. Other reserves are specified as follows:	31.03.2012	31.12.2011
Statutory reserve	1,637	1,637
Foreign currency translation reserve	2	-
Other reserves	<u>1,639</u>	<u>1,637</u>

Notes to the Interim Financial Statements

Off Balance Sheet information

Obligations

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

	31.03.2012	31.12.2011
Guarantees	8,402	8,662
Unused overdrafts	33,613	34,258
Loan commitments	27,878	17,687

47. Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund which, if passed, would entail a substantial increase in the size of the fund and related payments.

The Group expensed ISK 238 million in the first quarter of 2012 for the amounts estimated to meet future requirements.

Due to uncertainty of the shape of final legislation on the Depositors' and Investors' Guarantee Fund the liability brought forward from previous year is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,187 million.

Assets under management and under custody

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

	31.03.2012	31.12.2011
Assets under management	737,835	659,024
Assets under custody	1,783,303	1,716,230

Notes to the Interim Financial Statements

Contingent liabilities

49. Litigation is common in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland the prospect of possible litigation against the Group has become more likely. The Group has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Group makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year-end, the Group had several unresolved legal claims.

One significant court case is a case between Drómi and the Group. Following a decision issued by the Icelandic Financial Supervisory Authority (FME) on 21 March 2009, the Group acquired the deposits of SPRON. According to the decision the resolution committee of SPRON is supposed to establish a specific limited liability company owned by SPRON, later Drómi, designed 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 Group relating to the acquisition of SPRON's deposit obligations and was supposed to issue a bond to the Group as compensation for the deposit obligations. This obligation to the Group was documented with an agreement on repaying the debt. The agreement states that the interest rate on the debt principal shall be determined by the FME at any given time. The FME decided that the debt should bear a given annual interest rate plus an interest premium from that time until the debt has been paid 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 insisted that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear an annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Group has brought 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 legal action against the FME and the Group. Drómi principally demands the annulment of all decisions by the FME on interest rates, and secondly demands a different interest rate from the outset. On 23 April 2012 the District Court of Reykjavík dismissed both of these cases. On 4 May 2012 the Group and Drómi appealed these decisions to the Supreme Court.

The Group has made agreements with clients of Private Banking to buy their approved claims against the estate of Kaupthing hf. The claims relate to claims for damages by clients made against the estate of Kaupthing hf. These claims were initially rejected but Kaupthing hf. has since offered these parties a settlement. The claims involved are general claims against the Kaupthing hf. estate and as a compromise to the clients, the Group has acquired the claims at 30% of the claim value and paid them immediately instead of making the clients wait until the estate has been wound up. ISK 90 million of claims have already been acquired and it is likely that a similar amount will be paid for claims which will probably be agreed to by Kaupthing hf. There is still uncertainty over the recovery of these claims from Kaupthing hf. when the company is wound up or makes composition with creditors.

There are also a number of court cases, to which the Group is a party, whereby the legality of the Group's FX loans are called into question. In some of the cases, the interest rate which is used in the recalculation of said loans is called into question, and also if the Group is obligated to reimburse borrowers because of foreign currency linked loans which the borrower had repaid in full before the Group was founded in October 2008. If the courts side with the borrowers in the said cases, and for example, state that the Group is obligated to reimburse borrowers which had repaid before the Group was founded, the impact on the Bank's loan portfolio would be significant.

On 21 March 2012 Hagar hf. announced that it had decided to take legal action against the Group regarding Hagar hf.'s foreign currency linked loans, which it had reimbursed in full to the Group in 2009. Hagar hf.'s foreign currency linked loans were recalculated by the Group in accordance with the Group's notification of 15 June 2011. The outcome from the recalculation showed that the Group owed Hagar hf. approximately ISK 515 million, which the Group subsequently paid to Hagar hf. After the Supreme Court had passed its judgment of 15 February 2012, Hagar hf. expressed its view to the Group that, in light of the above judgment, Hagar hf. believed it had a further claim, amounting to ISK 824 million, against the Group regarding said foreign currency linked loans. The Group rejected Hagar hf.'s claim. In an announcement to the Stock Exchange on 21 March 2012, Hagar hf. announced that the company had decided to initiate legal proceedings against the Group for the payment of ISK 824 million.

The Group is party to a court case, whereby the claimant, a guarantor to a loan issued to the Group, claimed that the Group did not adhere to the rules of an agreement from 2001 on the use of guarantees for individual debts. According to the claimant, the Bank did not provide the claimant with a credit valuation of the debtor to be signed by the guarantor. With a judgment on 23 February 2012, the district court of Reykjavík sided with the Bank in the court case. The disputed amount in this case is not material for the Group but could affect the validity of guarantees held by the Group for a number of other loans to individuals.

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

The first investigation, commenced in September 2010, relates to whether or not the purchases by each of the new banks, i.e. the Group, Íslandsbanki hf. and Landsbankinn hf., 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 (EEA Agreement). The Group, which was state-owned at the time, acquired assets worth ISK 7.7 billion from the funds of Rekstrarfélag Kaupthings banka hf. (now Stefir 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 Group has objected to this opinion of the ESA, stating that the acquisition of the assets in question from the funds of Rekstrarfélag Kaupthings banka hf. was made for commercial reasons and does not constitute state aid under the EEA Agreement. It is difficult to predict the outcome of this case. 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.

Notes to the Interim Financial Statements

49. cont.

The second investigation was launched in December 2010 and relates to the state aid granted in the restoration of certain operation of Kaupthing hf. and the establishment and capitalisation of the Group. Similar investigations have been launched in relation to the restoration and capitalisation of Íslandsbanki hf. and Landsbankinn hf. The ESA will consider the appropriateness of the capitalisation measures taken by the 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 Group by the ESA. A restructuring plan for the Group 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 the recovery of the illegal state aid. If the ESA concludes that there was illegal state aid, the recipient of such illegal state aid may be required to reimburse the state funding.

The Icelandic Competition Authority (ICA) has opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Group, following a complaint by Kortathjónustan hf., a credit card payment acquirer, made in 2009. The ICA has also opened a formal investigation into the alleged abuse of their alleged collective dominant position by the three largest retail banks, including the Group. The investigation was initiated by separate complaints from BYR Bank hf. and MP Bank hf. made in 2010. The ICA received a similar complaint from Tryggingamidstöðin hf. in 2010. The complaints from BYR Bank hf. and MP Bank hf. 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 complaint from Tryggingamidstöðin hf. concerns the banks' alleged tying of banking services and insurances. The Group 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 Group.

In 2011 Stefmir hf. received two demands for the rescission of contract from the winding-up committee of Landsbanki Íslands hf. Firstly, the rescission of the sale of bonds, issued by Eimskipafélag Íslands hf. and owned by Peningamarkadssjóður, to Landsbanki Íslands hf. less than a month before the collapse of the bank in 2008. The total amount involved is ISK 1,600 million plus interest. Secondly, the demand to rescind Landsbanki Íslands hf.'s payment of money market deposits which matured early in October 2008 to five funds managed by Stefmir hf. The amount involved is ISK 1,451 million plus interest and the winding-up committee has filed cases in court for two of these payments. The amount of those two cases is ISK 450 million plus interest. Stefmir hf. has protested against the claims and believes that they are unfounded.

The uncertainty regarding the book value of Foreign currency lending

50. In two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic króna indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents. By a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic króna indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic króna interest rate posted by the Central Bank of Iceland.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic króna indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic króna posted by the Central Bank. Furthermore, the law requires that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed. In accordance with the act, the Group has now finished recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals were affected and as of March 2011 the book value of the loans reflected the result of the calculations.

In two similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans to small SMEs were in fact loans in Icelandic króna and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. The Court passed another two similar judgments on 8 March 2011 dealing with foreign currency loans. In a ruling on 9 June 2011, the Supreme Court, by a 4-3 vote, stated that a foreign currency loan to a corporate entity was in fact a loan in Icelandic króna and indexed to a foreign currency exchange rate.

Even though no foreign currency indexed ISK loans made by the Group have been deemed illegal by the Supreme Court, the Group announced on 15 June 2011 that recent rulings made by the Supreme Court provide a precedent for the Group to follow, and that the loans that fall under the conditions set forth by the Supreme Court in its rulings would be recalculated. The Group has thus recalculated around 2,000 loans, to both individuals and businesses.

The recalculation came in addition to the recalculation of foreign currency linked mortgage loans which was done last year. Therefore, the lion's share of the Group's foreign currency linked ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of businesses it is important to point out that in the summer of 2010 the legality of the Group's FX loans to businesses was assessed by a team of experts at the Group based on FME guidelines. They concluded that the legality of some FX loans to companies was beyond doubt, while others were more vulnerable, as the recent rulings of the Supreme Court have confirmed.

Notes to the Interim Financial Statements

50. cont.

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingarbankinn. As the judgment dealt with a dispute which rose from special circumstances, its precedent is not entirely clear. At this time the Bank is reviewing the judgment and evaluating its impact on the Bank. On first instance, it is likely the judgment does stipulate that loans, which are deemed to be currency-linked, can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland, however the Bank cannot claim from the borrower a higher payment of interest of the loan than the interest the borrower actually paid, if the borrower has paid according to the Bank's payment slips. Therefore, it is likely that the recalculation of certain foreign currency linked loans will have to be modified in accordance with the judgment. This also means that certain foreign currency linked loans, which have already been recalculated, will have to be recalculated again. It is worth noting that the Bank's review of the judgment is not over, so the above view of the judgment could change. The Group has now entered into a partnership, according to a decision by the Icelandic Competition Authority on 9 March 2012, with the member companies of the Icelandic Financial Services Association to coordinate actions in regards to the Judgment of the Supreme Court of 15 February 2012.

The Group currently estimates that the loss to the Group's foreign loan portfolio arising from the judgment of 15 February 2012 is ISK 13.8 billion. In calculating this estimate, the Group elected to follow the methodology prescribed in an impact analysis conducted by the FME. From the four scenarios prescribed in the FME's analysis, the Group has selected the one considered to be the most plausible interpretation of the judgment.

Despite the recognition of impairment for the above estimated loss, the Group remains exposed to significant uncertainty regarding foreign currency linked loans in two respects:

Firstly, the estimation uncertainty associated with the Group's interpretation of the impact of the Supreme Court judgment of 15 February 2012. Uncertainty exists with regard to firstly, the Group's preliminary determination of the specific loans that require recalculation and secondly, uncertainty with regard to assumptions used in the method of recalculation of loans to customers that were determined to fall within the scope of the judgment. As noted above, this uncertainty is somewhat mitigated by the use of FME prescribed methodology. In the event the Group's interpretation of the judgment of 15 February 2012 were to change, the loss could be significantly greater or less than the current estimate of ISK 13.8 billion.

Secondly, the legal uncertainty over the outcome of future legal decisions and new or amended government legislation that may require the recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

Significant uncertainty exists over the impact of the above matters on the carrying value of the Bank's portfolio of foreign currency linked loans at year-end.

Notes to the Condensed Interim Statement of Cash Flow

51. Changes in operating assets and liabilities specified as follows:	31.03.2012	31.03.2011
Mandatory reserve with Central Bank, net change	196	(157)
Loans and receivables to credit institutions	3,280	(6,977)
Loans and receivables to customers	(17,463)	23,920
Bonds and debt instruments	(705)	(3,378)
Shares and equity instruments	(1,254)	(343)
Derivatives and financial liabilities at fair value	3,008	7,002
Other assets	1,220	(1,573)
Due to credit institutions and Central Bank	20,872	(27,324)
Deposits	(30,599)	10,750
Borrowings	1,958	-
Other liabilities	(563)	(3,074)
	<u>(20,050)</u>	<u>(1,154)</u>

Notes to the Interim Financial Statements

Risk Management Disclosures

Further information regarding risk management is available in the annual Financial Statements 2011.

Credit risk

52. Credit risk

a) Maximum exposure to credit risk and credit concentration by industry sectors

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements. The Bank uses ISAT 08 standard classification for its industry classification. ISAT 08 is based on the NACE Rev. 2 classification standard.

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

	31.03.2012	31.12.2011
Cash and balances with Central Bank	18,030	29,200
Loans and receivables to credit institutions	65,955	69,103
Loans and receivables to customers	584,154	561,550
Overdrafts.....	44,881	38,885
Subordinated loans.....	583	550
Other loans.....	538,690	522,115
Bonds and debt instruments	142,493	140,568
Listed.....	54,752	55,614
Unlisted.....	87,741	84,954
Derivatives	1,313	674
Bonds and debt instruments, hedging	1,204	1,922
Listed.....	1,204	1,922
Other assets with credit risk	6,933	8,004
Total on balance sheet maximum exposure to credit risk	820,082	811,021

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

Guarantees	8,402	8,662
Unused overdrafts	33,613	34,258
Loan Commitments	27,878	17,687
Total off balance sheet maximum exposure to credit risk	69,893	60,607
Maximum exposure to credit risk	889,975	871,628

Notes to the Interim Financial Statements

52. cont.

b) Credit quality by class of financial assets

	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired	Total
31.03.2012				
Cash and balances with Central Bank	18,030	-	-	18,030
Loans and receivables to credit institutions	65,955	-	-	65,955
Loans and receivables to customers				
Loans to corporates	279,020	26,299	51,016	356,335
Loans to individuals	179,302	27,229	21,288	227,819
Bonds and debt instruments	142,493	-	-	142,493
Derivatives	1,313	-	-	1,313
Securities used for hedging	1,204	-	-	1,204
Other assets	6,933	-	-	6,933
Total	694,250	53,528	72,304	820,082

31.12.2011

Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers				
Loans to corporates	274,604	17,758	46,252	338,614
Loans to individuals	182,089	23,117	17,730	222,936
Bonds and debt instruments	140,568	-	-	140,568
Derivatives	674	-	-	674
Securities used for hedging	1,922	-	-	1,922
Other assets	8,004	-	-	8,004
Total	706,164	40,875	63,982	811,021

c) Past due but not impaired loans by class of loans and receivables:

	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
31.03.2012					
Loans to corporates	14,168	1,976	258	9,897	26,299
Loans to individuals	4,405	8,316	293	14,215	27,229
Total	18,573	10,292	551	24,112	53,528

31.12.2011

Loans to corporates	5,649	824	834	10,451	17,758
Loans to individuals	2,950	3,422	2,512	14,233	23,117
Total	8,599	4,246	3,346	24,684	40,875

d) Collateral repossessed

During the period, the Group took possession of real estates with the carrying value of ISK 546 million, all which the Bank is in the process of selling, see Note 38.

Notes to the Interim Financial Statements

52. cont.

e) Loans and receivables to customers specified by sectors:	31.03.2012	31.12.2011
Individuals	39.0%	39.7%
Wholesale and retail trades, transport, accommodation and food service activities	12.8%	11.7%
Financial and insurance activities	11.3%	10.8%
Agriculture, forestry and fishing	10.5%	11.1%
Real estate activities	9.0%	9.8%
Manufacturing, mining and other industry	8.6%	7.7%
Business services	5.1%	5.3%
Construction	1.3%	1.5%
Public administration, defence, education, human health and social work activities	1.2%	1.2%
Other services	1.2%	1.2%
Loans and receivables to customers	100.0%	100.0%

f) Impaired loans and receivables to customers by sector:	31.03.2012		31.12.2011	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals	12,280	33,568	12,662	30,392
Financial and insurance activities	6,579	11,913	6,098	11,498
Manufacturing, mining and other industry	1,892	11,691	1,911	11,112
Real estate activities	3,955	10,851	5,441	11,058
Agriculture, forestry and fishing	3,753	12,741	4,531	10,507
Wholesale and retail trades, transport, accommodation and food service activities	5,542	18,265	5,295	19,335
Business services	8,322	9,943	8,278	9,090
Construction	1,850	5,999	1,348	4,766
Public administration, defence, education, human health and social work activities	769	1,644	754	1,706
Other services	629	1,260	458	1,294
Impairment on loans and receivables to customers	45,571	117,875	46,776	110,758

g) Large Exposure Disclosures

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base net of eligible collateral according to FME rules No 216/2007.

The legal maximum for individual large exposures is 25% of capital base and the sum of all large exposures cannot exceed 400% of capital base.

The maximum exposure to a group of connected clients at period-end was ISK 33 billion (31.12.2011: ISK 33 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has five large exposures at period-end (31.12.2011: five exposures) net of eligible collateral.

No large exposure exceeds the legal limit of 25% of the group's capital base at period-end. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi. The FME has ruled that the Group can use the hold harmless statement as a credit enhancement towards the claim on Drómi ehf. Consequently, the Group finds that the net exposure on Drómi is zero, or 0.2% when taking into consideration financial related parties.

The sum of all large exposures is 133% before collateral mitigation or 85% net of eligible collateral, which is well below the 400% legal maximum and the Group's internal 150% limit net of collateral.

Notes to the Interim Financial Statements

Market risk

53. Market risk

a) Interest rate risk

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rate by currency and maturity in millions of ISK in the Group. Risk is quantified by assuming a 200 bps simultaneous upward shift in all yield curves in the relevant duration band. The sensitivity does not relate to variation of annual net interest income.

31.03.2012		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	54	(1,435)	(126)	(4,480)	(3,198)
Non Indexed linked	ISK	(547)	(659)	(178)	(91)	64
	EUR	30	(3)	-	-	-
	Other	257	(451)	(110)	-	-
31.12.2011						
CPI Indexed linked	ISK	40	(1,509)	(1,016)	(14,001)	7,684
Non Indexed linked	ISK	(418)	(1,390)	(701)	(265)	(388)
	EUR	15	(5)	-	-	-
	Other	(27)	(785)	(109)	-	-

Notes to the Interim Financial Statements

53. cont.

The table below analyses the Group's assets and liabilities at carrying amount by residual maturity.

31.03.2012	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	18,030	9,666	-	8,364	-	-	-
Due from banks	65,955	62,170	3,533	-	252	-	-
Loans and receivables to customers	584,154	20,244	54,262	81,677	210,261	217,710	-
Bonds and debt instruments	142,493	2,867	38	19,507	79,159	40,922	-
Shares and equity instruments	15,096	-	-	-	-	-	15,096
Derivatives	1,313	-	868	37	408	-	-
Assets leg	19,736	-	15,081	528	4,127	-	-
Liabilities leg	(18,423)	-	(14,213)	(491)	(3,719)	-	-
Securities used for hedging	2,102	1,205	-	-	-	-	897
Investment property	25,867	-	-	-	-	-	25,867
Investments in associates	2,992	-	-	-	-	-	2,992
Property and equipment	6,186	-	-	-	-	-	6,186
Intangible assets	4,863	-	-	-	-	-	4,863
Tax assets	629	-	-	-	-	-	629
Non-current assets held for sale	21,852	-	-	-	-	-	21,852
Other assets	7,840	347	4,552	1,517	419	97	908
Total assets 31.03.2012	899,372	96,499	63,253	111,102	290,499	258,729	79,290
Liabilities							
Due to credit inst. and Central Bank	37,032	11,222	23,168	2,642	-	-	-
Deposits	462,193	306,252	83,176	39,903	29,811	3,051	-
Financial liabilities at fair value	8,098	-	7,852	-	246	-	-
Assets leg	(11,035)	-	(10,840)	-	(195)	-	-
Liabilities leg	11,451	-	11,010	-	441	-	-
Short position bonds & derivatives	7,682	-	7,682	-	-	-	-
Tax liabilities	3,333	-	-	3,333	-	-	-
Non-current liabilities held for sale	4,444	-	-	-	-	-	4,444
Other liabilities	39,105	4,365	5,564	23,648	(446)	228	5,746
Borrowings	192,109	-	3,419	3,263	16,602	168,825	-
Subordinated liabilities	34,047	-	-	-	-	34,047	-
Total liabilities 31.03.2012	780,361	321,839	123,179	72,789	46,213	206,151	10,190
Off balance sheet items							
Guarantees	8,402	1,439	893	1,431	3,152	1,487	-
Unused overdraft	33,613	969	9,429	8,837	14,350	28	-
Loan commitments	27,878	377	4,864	9,381	12,444	812	-
Total off balance sheet items	69,893	2,785	15,186	19,649	29,946	2,327	-
Net interest sensitivity gap	49,118	(228,125)	(75,112)	18,664	214,340	50,251	69,100

Notes to the Interim Financial Statements

53. cont.

31.12.2011	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	29,200	20,640	-	8,560	-	-	-
Due from banks	69,103	62,155	6,703	-	245	-	-
Loans and receivables to customers	561,550	13,694	49,872	71,108	230,773	196,103	-
Bonds and debt instruments	140,568	3,994	515	15,256	80,125	40,678	-
Shares and equity instruments	14,045	-	-	-	-	-	14,045
Derivatives	674	-	188	3	483	-	-
Assets leg	9,589	-	5,603	299	3,687	-	-
Liabilities leg	(8,915)	-	(5,415)	(296)	(3,204)	-	-
Securities used for hedging	2,372	1,922	-	-	-	-	450
Investment property	27,100	-	-	-	-	-	27,100
Investments in associates	2,987	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	23,886
Other assets	8,876	598	5,446	492	843	68	1,429
Total assets 31.12.2011	892,121	103,003	62,724	95,419	312,469	236,849	81,657
Liabilities							
Due to credit inst. and Central Bank	16,160	10,341	231	5,588	-	-	-
Deposits	489,995	377,063	58,708	24,371	27,117	2,736	-
Financial liabilities at fair value	4,907	-	4,492	-	415	-	-
Assets leg	(35,374)	-	(34,697)	-	(677)	-	-
Liabilities leg	36,571	-	35,479	-	1,092	-	-
Short position bonds & derivatives	3,710	-	3,710	-	-	-	-
Tax liabilities	3,421	-	-	2,284	-	-	1,137
Non-current liabilities held for sale	4,950	-	-	-	-	-	4,950
Other liabilities	38,822	2,020	8,235	20,157	2,686	219	5,505
Borrowings	187,203	-	3,885	2,595	13,297	167,426	-
Subordinated liabilities	32,105	-	-	-	-	32,105	-
Total liabilities 31.12.2011	777,563	389,424	75,551	54,995	43,515	202,486	11,592
Off balance sheet items							
Guarantees	8,662	343	420	1,273	5,108	1,518	-
Unused overdraft	34,258	808	7,685	12,465	13,272	28	-
Loan commitments	17,687	1	2,892	8,385	4,409	2,000	-
Total off balance sheet items	60,607	1,152	10,997	22,123	22,789	3,546	-
Net interest sensitivity gap	53,951	(287,573)	(23,824)	18,301	246,165	30,817	70,065

Notes to the Interim Financial Statements

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b) Inflation risk

The Group is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 246.9 billion (31.12.2011: ISK 230.7 billion) and the total amount of indexed liabilities amount to ISK 224.5 billion (31.12.2011: ISK 218.5 billion).

31.03.2012	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets - CPI indexed linked				
Loans and receivables to customers	77	55,810	185,703	241,590
Bonds and debt instruments	38	9	1,790	1,837
Off balance sheet position	-	3,473	-	3,473
Total	115	59,292	187,493	246,900
Liabilities - CPI indexed linked				
Deposits	68,553	29,686	1,584	99,823
Borrowings	2,644	12,392	109,617	124,653
Total	71,197	42,078	111,201	224,476
Net on balance sheet position	(71,082)	13,741	76,292	18,951
Net off balance sheet position	-	3,473	-	3,473
Total CPI Balance	(71,082)	17,214	76,292	22,424
Total CPI Balance 31.12.2011	(58,423)	(1,448)	72,027	12,156

c) Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Bank are predominantly ISK denominated deposits whereas the Bank's assets consist largely of foreign currency denominated loans to customers.

Currency risk strategy

The Bank's strategy for reducing its currency imbalance is twofold: The systematic ISK redenomination of foreign currency loans to customers which have ISK income (the naturally hedged currency imbalance), and hedging of its real currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers. The task of redenominating loans to customers with ISK income was hampered by the uncertain legal status of foreign currency loans. The December 2010 legislation regarding the treatment of foreign currency loans to individuals and subsequent court decisions on certain loans to SMEs has accelerated the redenomination of the corresponding loans to ISK. Net exposures per currency are monitored centrally in the Bank.

Notes to the Interim Financial Statements

53. cont.

The following table shows the breakdown of assets and liabilities by currency at period-end:

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	14,453	752	1,001	1,080	252	21	471	18,030
Loans to credit institutions	24,178	14,192	12,151	1,965	5,505	788	7,176	65,955
Loans and receivables to customers	411,104	54,676	23,817	31,582	10,908	23,169	28,898	584,154
Bonds and debt instruments	130,146	376	11,971	-	-	-	-	142,493
Shares and equity instruments	8,145	5,274	929	-	294	-	454	15,096
Derivatives	1,099	120	-	6	87	1	-	1,313
Securities used for hedging	2,102	-	-	-	-	-	-	2,102
Investment property	25,867	-	-	-	-	-	-	25,867
Investments in associates	2,992	-	-	-	-	-	-	2,992
Property and equipment	6,186	-	-	-	-	-	-	6,186
Intangible assets	4,863	-	-	-	-	-	-	4,863
Tax assets	629	-	-	-	-	-	-	629
Non-current assets held for sale	16,968	4,884	-	-	-	-	-	21,852
Other assets	7,592	107	53	-	34	-	54	7,840
Total assets 31.03.2012	656,324	80,381	49,922	34,633	17,080	23,979	37,053	899,372
Liabilities and Equity								
Due to credit inst. and Central Bank	34,516	1,436	185	-	272	11	612	37,032
Deposits	380,045	27,366	12,478	5,539	5,806	1,484	29,475	462,193
Financial liabilities at fair value	7,767	6	246	7	1	30	41	8,098
Tax liabilities	3,333	-	-	-	-	-	-	3,333
Non-current liabilities held for sale	1,185	3,259	-	-	-	-	-	4,444
Other liabilities	34,405	2,159	1,665	6	511	-	359	39,105
Borrowings	128,799	3,307	20,523	21,741	7,143	10,596	-	192,109
Subordinated loans	-	27,489	2,530	-	4,028	-	-	34,047
Equity	119,011	-	-	-	-	-	-	119,011
Total liabilities and Equity 31.03.2012 .	709,061	65,022	37,627	27,293	17,761	12,121	30,487	899,372
Net on balance sheet position	(52,737)	15,359	12,295	7,340	(681)	11,858	6,566	
Net off balance sheet position	2,351	1,883	(2,909)	-	4,564	(6,902)	1,013	
Net position 31.03.2012	(50,386)	17,242	9,386	7,340	3,883	4,956	7,579	
Net position 31.12.2011	(42,631)	8,610	9,500	9,189	2,884	5,785	6,663	
Loans to customers with ISK income	12,933	(2,302)	(991)	(5,920)	(91)	(3,426)	(203)	
Net real position 31.03.2012	(37,453)	14,940	8,395	1,420	3,792	1,530	7,376	
Net real position 31.12.2011	(24,191)	5,788	8,276	1,025	2,793	(122)	6,431	

Notes to the Interim Financial Statements

53. cont.

A natural hedge for currency risk

The currency risk is mitigated by the specific nature of foreign currency loans to customers with ISK income. The Bank refers to this as a natural hedge because the loans do not generate profit and loss for small to moderate fluctuations in the exchange rate. These loans were purchased from Kaupthing hf. at a fair value which is based on the customer's ability to repay the loan, which is largely unaffected by changes in the exchange rate. IFRS accounting rules stipulate that the depreciation of the ISK against the loan currency be classified as an impairment event rather than a gain in the loan value if the borrower's ability to repay the loan remains unchanged. Conversely, an appreciation of the ISK is an impairment reversal and that this reversal may be made in certain situations up to the gross value of the loan, which may be significantly higher than the fair value at which the loan was transferred to Arion Bank. The Bank has modelled the effect of this mitigating effect and has presented the relevant authorities with its measure of the effective currency risk which is attributed to this portfolio of loans. The 31 March 2012 values of the foreign currency imbalance are shown in the following table with year-end 2011 values by comparison. The book value refers to the value of the imbalance without accounting for the natural hedge whereas the effective value takes into consideration the mitigating effect of the natural hedge, as modelled by the Bank. This strength of the natural hedge is different at different times.

	31.03.2012		31.12.2011	
	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income	37,453	37,453	24,191	24,191
FX imbalance due to customers with ISK income	12,933	4,138	18,440	6,823

The effective FX imbalance due to customers with ISK income during the period was 32% (31.12.2011: 37%), whereas the effective FX imbalance due to customers with FX income is always 100%.

The relevant authorities have granted temporary dispensation from rules regarding the currency imbalance.

Liquidity risk

54. Liquidity risk

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

Secured liquidity

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

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The high liquidity reserve required by the FME reflects the uncertainty of the deposit's stickiness of the Icelandic banks and the fact that a large part of the Bank's liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is much higher. The Bank actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base. The ratios during the period were as follows:

	Liquidity ratio	Cash ratio
Period-end	30%	14%
Maximum	37%	23%
Minimum	30%	11%
Average	34%	15%

Notes to the Interim Financial Statements

54. cont.

Deposit stickiness

The Group's deposit base has been split into seven different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described as being sticky if it has shown to be a stable funding for the Group in the past and is expected to remain stable in the future. Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Group and the maturity of the deposit. These criteria's are based both on qualitative and quantitative methods.

- Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls;
- Resolution process: Deposits from customers in a resolution process;
- Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate;
- Deposits - legal entities: Deposits from legal entities with no other business relationship with the Group and not quantified as an active investor;
- Deposits - retail individual: Deposits from retail individual with no other business relationship with the Group and not quantified as an active investor;
- Deposits - legal entities with business relationship: Deposits from legal entities with business relationship with the Group; and
- Deposits - retail individual with business relationship: Deposits from retail individual with business relationship with the Group.

The table below shows the split between different levels of the Bank's deposit stickiness at period-end, according to the Bank's classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky.

% of deposit base:

Stickiness rating	31.03.2012		31.12.2011	
1 Capital controls	2%	11,653	9%	43,977
2 Resolution process	14%	70,767	11%	58,315
3 Investors	24%	117,656	25%	124,596
4 Deposits - legal entities	14%	71,055	16%	80,494
5 Deposits - retail individuals	12%	59,237	11%	57,559
6 Deposits - legal entities with business relationship	17%	82,364	11%	57,664
7 Deposits - retail individuals with business relationship	17%	86,493	17%	83,550
Total	100%	499,225	100%	506,155

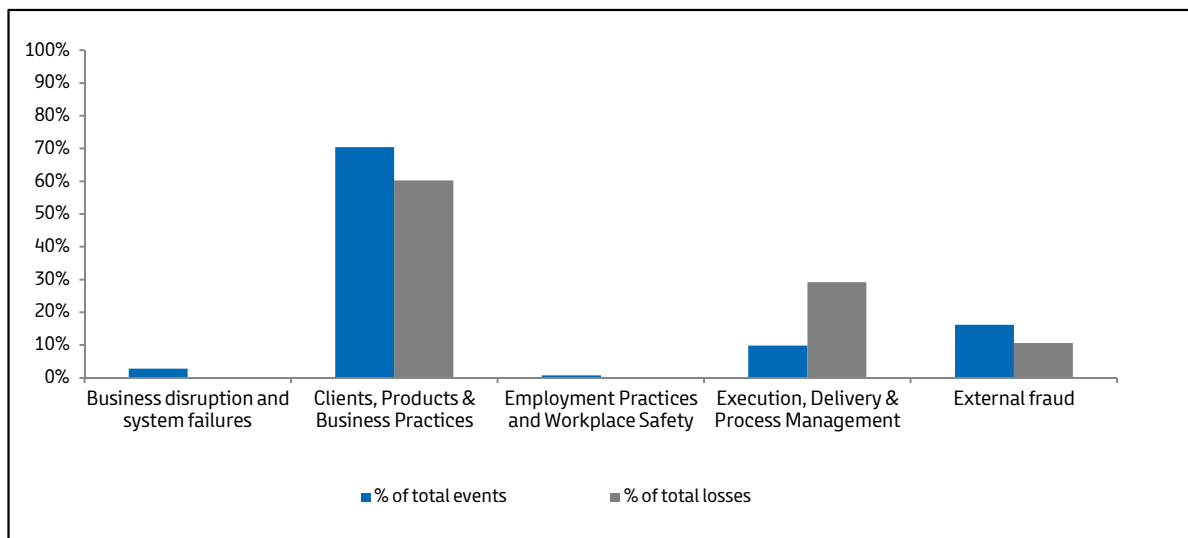
Notes to the Interim Financial Statements

Operational risk

55. Operational risk

Losses of ISK 12.9 million were registered in the loss database for the first three months. Failure in clients, products & business practices accounted for 60.2% of the total loss amount and 70.4% of total events.

Figure show the breakdown of loss events and amount by Basel categories in 2012:



Notes to the Interim Financial Statements

Capital Adequacy and ICAAP Strategy

56. Capital Adequacy Disclosures

Capital base at 31 March 2012 amounts to ISK 147,567 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 20.2%, exceeding the minimum legal requirement of 8%.

The Group, parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (31.12.2011: the same).

A remark about capital requirements for currency imbalance is in order. As indicated in the discussion about currency risk, there exists a risk mitigation in the form of a natural hedge when the imbalance is due to an FX loan to a borrower with ISK income. The effect of this natural hedge is reflected in the RWA for market risk where on average a 32% effective contribution of the corresponding portion of the FX imbalance has been accounted for at period-end (31.12.2011: 37%).

The table shows the Group's RWA calculations:

	31.03.2012	31.12.2011
Capital Base		
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve*	1,639	1,637
Retained earnings*	37,261	32,950
Non-controlling interests	4,250	4,110
Total Equity	119,011	114,558
Deduction from Tier 1 capital	5,491	5,489
Total Tier 1 capital	113,520	109,069
Tier 2 capital	34,047	32,105
Total Capital base	147,567	141,174
Risk weighted assets		
Credit risk	576,596	543,233
Market risk FX	41,577	31,990
Market Risk Other	31,103	30,757
Operational risk	58,976	58,976
Total Risk weighted assets	708,252	664,956
Tier 1 ratio	16.0%	16.4%
Capital adequacy ratio	20.8%	21.2%
Official Tier 1 ratio	15.4%	16.4%
Official Capital adequacy ratio	20.2%	21.2%

*Retained earnings based on unaudited figures.

Notes to the Interim Financial Statements

Other information

Related parties

57. The Group has a related party relationship with Kaupskil ehf., Kaupthing hf., the Group's associates, the Board of Directors of Arion Bank, the key management personnel of the Group and close family members of individuals referred to above.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) holds a 13% stake in the Group and the Ministry of Finance is the holder of all subordinated notes that represent Tier 2 capital of the Group. Accordingly the Ministry of Finance, ISFI and government entities related to them are related parties and balances and transactions with these entities are included in the tables below under "shareholders with significant influence over the Group".

No unusual transactions took place with related parties during the period. Transactions with related parties have been conducted on an arm's length basis.

Balances with related parties:

	Assets	Liabilities	Net balance
31.03.2012			
Shareholders with significant influence over the Group	-	1,735	(1,735)
Shareholders with control over the Group	483	57,263	(56,780)
Board of Directors and key Management personnel	172	303	(131)
Associates and other related parties	59,170	27,625	31,545
	<u>59,825</u>	<u>86,926</u>	<u>(27,101)</u>
31.12.2011			
Shareholders with significant influence over the Group	-	1,730	(1,730)
Shareholders with control over the Group	493	41,376	(40,883)
Board of Directors and key Management personnel	104	367	(263)
Associates and other related parties	74,135	29,088	45,047
	<u>74,732</u>	<u>72,561</u>	<u>2,171</u>

Events after Balance Sheet date

58. Events after Balance Sheet date

a) B.M. Vallá ehf.

In October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf., which was approved by the Icelandic Competition Authority in April 2012. The effects from the sale of this entity will have minor effects on the Statement of Comprehensive income in the second quarter of 2012.

b) Valitor Holding hf.

In April 2012 the Group acquired 7.2% share in Valitor Holding hf. After the acquisition the Group holds 60.8% share in Valitor Holding hf.

c) Verdis hf.

In March 2011 Arion Bank and Landsbanki Íslands hf. signed a letter of intent whereby Landsbanki Íslands hf. would purchase new equity issued by Verdis hf., a wholly owned subsidiary of Arion Bank. At year end 2011 an approval by the Icelandic Competition Authority was pending. In 2012 Landsbanki Íslands hf. withdrew from the agreement and following Arion Bank decided to merge Verdis hf. into the bank. Approval from FME is pending.

d) Bond offering

On 11 May 2012 Arion Bank completed its first non-indexed fixed rate covered bond offering, issuing ISK 1.2 billion worth of bonds in the series Arion CB 15. The series is expected to be admitted for trading on NASDAQ OMX Iceland in May. The bonds bear 6.50% interest and mature in 2015.

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Subsidiaries

59. Shares in subsidiaries in which Arion Bank held a direct interest at period-end were as follows:

Company:	Country	Currency	Equity interest accum. %
AFL - sparisjóður, Adalgata 34, 580 Siglufjörður	Iceland	ISK	94.5
EAB 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Eignabjarg ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
Einkaklúbburinn ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Gen hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town	Cayman Isl.	ISK	100.0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	100.0
Tekjuvernd ehf., Hlíðasmári 17, 201 Kópavogur (former KB Ráðgjöf ehf.)	Iceland	ISK	100.0
Landey ehf., Hátún 2b, 105 Reykjavík	Iceland	ISK	100.0
Landfestar ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
NS1 ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík	Iceland	ISK	100.0
Sparisjóður Ólafsfjardar, Adalgata 14, 625 Ólafsfjörður	Iceland	ISK	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Valitor Holding hf., Laugavegur 77, 101 Reykjavík	Iceland	ISK	53.6
Verdis hf., Ármúli 13, 108 Reykjavík	Iceland	ISK	100.0